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Investment Grade Bonds: The Reliable Option for Yield

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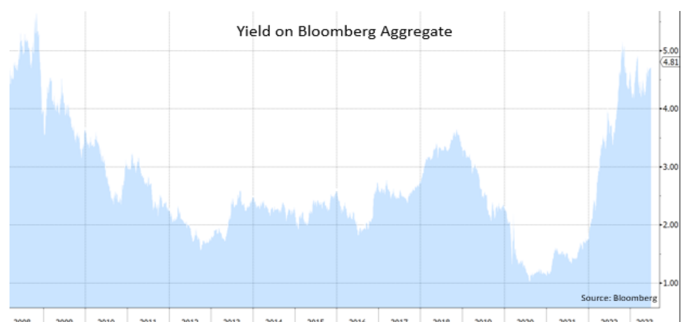
- Due to higher interest rates, the opportunity in fixed income is the most appealing it has been in over a decade.
- The prior scarcity of yields led investors to look at higher yielding instruments for their fixed income allocation, such as high-yield and private credit, which come with inherent risks.
- A new interest rate environment brings potential for economic stress and financial difficulties for companies with weaker credit profiles.
- Given the risks in the economy and concerns for the financial wellbeing of risker companies, we believe that an emphasis on high quality fixed income is important.

Whether it was in reaction to the Financial Crisis in 2008 or the Covid pandemic in 2020, the Fed has continually intervened with bouts of quantitative easing over the last decade plus to stimulate the economy. These stretches of QE resulted in low interest rates and a lack of yield across the fixed income space. However, interest rates viciously rose beginning in 2022 as Central Banks around the globe took steps to stem the ever-increasing threat of inflation.

These higher interest rates led to fixed income being viewed once again as an attractive asset class as yields rose to levels not seen in over a decade.



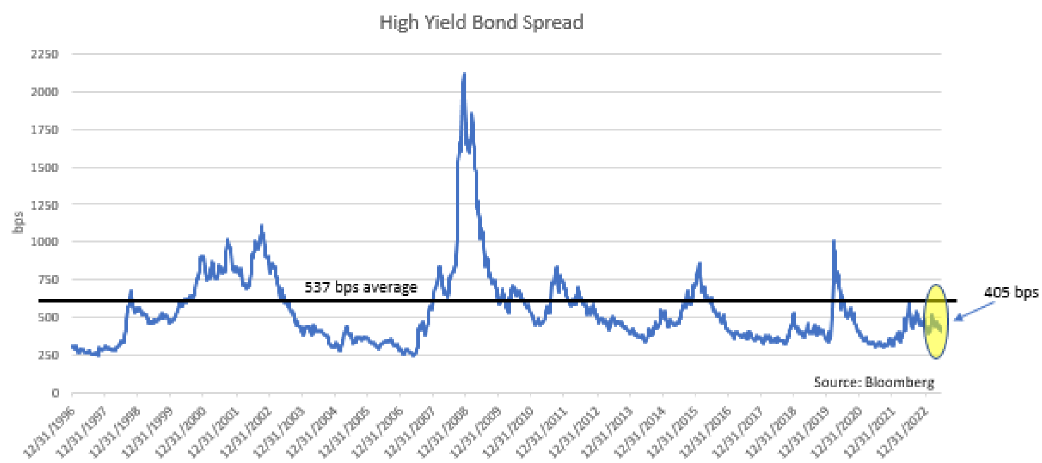
Opportunities exist now that can allow fixed income to thrive, both as a stand-alone asset class and as a diversifier in a portfolio of riskier asset classes. We believe that investors should focus on high-quality investment grade bonds as the most efficient avenue to take advantage of higher yields while minimizing the perils that potentially exist in the market.

Risks Still Remain in Marketplace

Inflation, while still high, has been moderating since late 2022 and it does appear as if the Fed may be nearing the end of its hiking cycle. However, as we head into the 2nd half of 2023, there are many more risks that remain. The drastic steps taken by central banks were intended to slow the economy and it remains to be seen whether a smooth landing can be accomplished, or if we are headed for a prolonged recession. Inflationary pressures have increased the cost of labor and higher interest rates will raise interest expense, negatively impacting company's bottom lines. **We expect that the market's attention will transition from inflation to concerns over the economy, company earnings and potential defaults.**

Potential Pitfalls of Alternative Fixed Income Investments

The ICE U.S. High Yield bond index was yielding 8.6% as of 6/30. But context is important, especially given the current higher rate environment. Looking closer at the spread of HY over U.S Treasuries, the story may not be as appealing. The spread of HY over U.S. Treasuries is 405bps. Dating back to 1996, the historical average of the spread of HY over Treasuries is 537bps. While HY can play a role in an overall portfolio, on a relative basis, **it does not appear to be compensating investors for the elevated amount of risk in the market.**



Nobody knows for certain whether are not we are facing an upcoming recession. Vulnerable companies who took on more debt than they can handle are at risk of financial stress and may fail to deliver their promised bond yields. The high yield market has a substantial amount of maturities due over the next few years. **At higher rates and potentially damaged from a weak economy, the ability of these companies to access financing so easily will be tested.**

Viewing high-yield as a traditional fixed-income investment can prove to be a fallacy in stressful environments. **HY tends to be much more correlated to equities than to traditional investment grade fixed income.** As has been the case in past times of stress, this relationship only increases and the correlation of HY to equities can become even more pronounced.

High yield is not the only asset class that investors fled to with the recent scarcity of yield in fixed income. Economic concerns and higher interest rates have caused lenders to adopt to higher standards for loans. As such, companies have been forced to look for alternative means of financing and have turned to private lending. These borrowers tend to have weaker credit profiles and, therefore, must accept higher rates and weaker covenants. Typically, they are only willing to accept these terms because they were denied financing elsewhere.

While yields on these investments may be attractive, especially when the economy is humming along, the risks become much more prevalent in times of stress. A larger percentage of these private loans come with a floating rate component. Rising interest rates can serve as a double whammy for these companies. **A weaker economy impacts their bottom line and the floating rate component make it harder to meet their interest expense and roll over their debt.**

In summary, we believe that an emphasis on high quality assets in the fixed income space will be of utmost performance as the market begins to feel the impact of rising interest rates. The prospect of a higher rate environment can present exciting opportunities, but these should be balanced with an emphasis on credit risk controls, given the potential for economic stress in the near-term.