Be Careful When Reaching for Yield

FREEDOM INVESTMENT MANAGEMENT

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We believe the narrower yield premiums afford investors little compensation for the heightened risk embedded in these asset classes and recommend that investors review their allocation to corporate credit and high yield, especially for those who have built up a sizeable overweight.

Although the U.S. high yield default rate is expected to drop to 3.5-4.0% from 5.0-5.5%[1], corporate credit spreads have compressed to their richest levels since the aftermath of the 2008 Great Financial Crisis. On an option-adjusted basis (i.e., the option for the borrower to refinance at lower rates), high-yield investors are currently earning a meager 2.50% premium above comparable U.S. Treasuries (as of 11/11/2024).

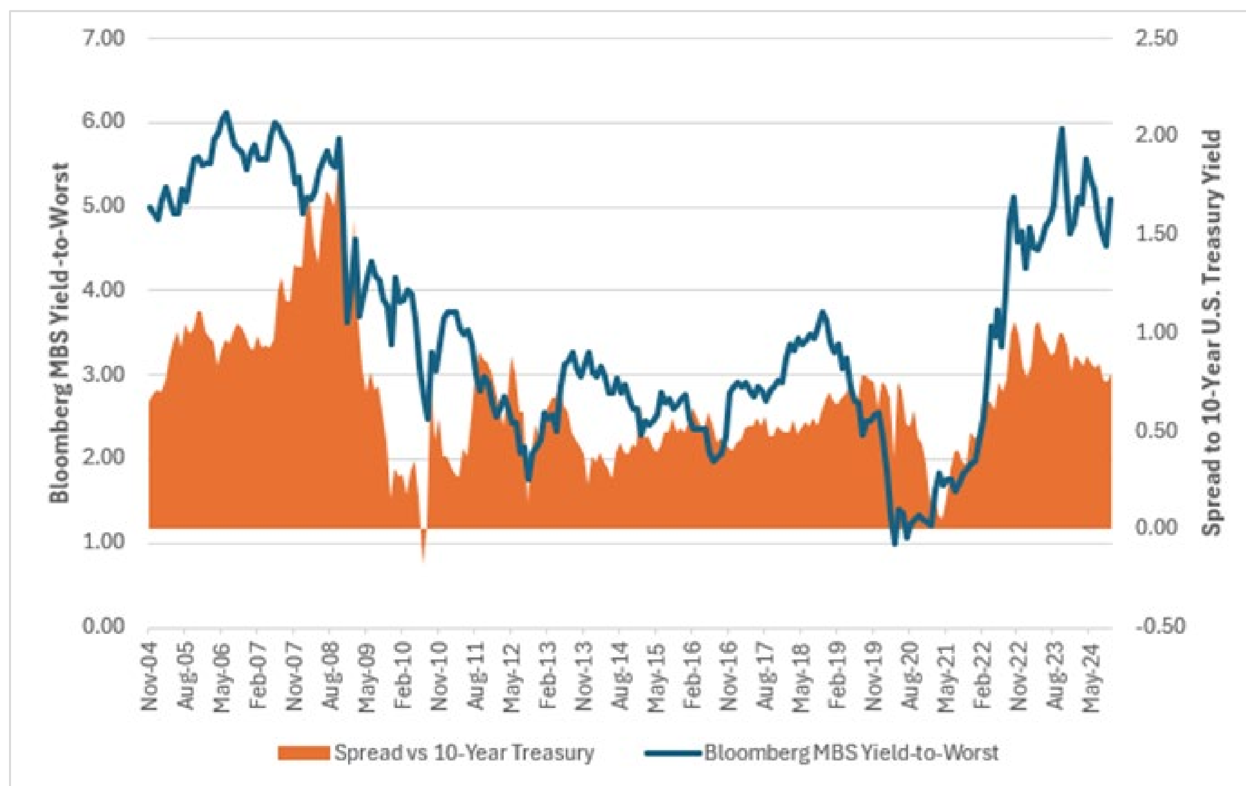
Corporate credit, especially below investment grade, can be priced at a premium relative to historical averages and remain elevated over an extended period, as occurred in the mid-1990s. In today's market, a combination of high investor demand, lower supply due to refinancing, and post-COVID fiscal support has created a strong market for high-yield debt. The Fed's recent initiation of a rate cut cycle in September 2024 has also attracted investors seeking to lock in high absolute yields.

[1] S&P Global Ratings 8/19/2024 Report, Moody's Credit Strategy Report 5/20/2024, Fitch Wire 4/3/2024

While the economic and corporate backdrop remains strong for U.S. corporate credit risk, a potential slowdown driven by weakening demand and reduced fiscal support, along with a decelerating pace of Federal Reserve rate cuts in response to heightened inflation risks post-election, could produce headwinds that tighten financial conditions for leveraged borrowers. Corporate borrowers may hesitate to take on high-yield debt if they anticipate future earnings or cash flows could be constrained. Meanwhile, banks and investors may impose stricter lending standards, making it harder for lower-rated issuers to access the market, thereby decreasing overall supply and liquidity.

In contrast to corporate credit, mortgage-backed securities (MBS) look relatively cheap, as their spread to U.S. Treasury yields is near the upper range of historical valuations. The MBS market has underperformed relative to the U.S. credit sector since the Fed began hiking rates in 2022. Even with the Fed now embarking on a rate-cutting cycle, investors still demand a high premium to compensate for a range of risks, primarily prepayment risk, which may arise if rates drop enough to encourage mortgage borrowers to refinance.

Mortgage-Backed Securities Have Both Attractive Yields (When Adjusted for Prepayment Risk) and Valuation Spreads Above U.S. Treasury Yields (Through 10/31/2024)



Source: Bloomberg

Freedom Investment Management recommends that investors who are over-allocated to high-yield risk consider paring back that exposure and reallocating to higher-quality sectors offering attractive yields relative to U.S. Treasuries, such as mortgage-backed securities. While we believe the market and economic environment remain favorable for corporate profitability and revenue growth, corporate credit risk is increasingly asymmetric if conditions deteriorate, given today's compressed spread levels.

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