WELLS FARGO
Investment Institute

Market Commentary

Weekly perspective on current market sentiment **April 12, 2023**

Scott Wren
Senior Global Market Strategist

Last week's S&P 500 Index: -0.1%

High yield for a reason

Key takeaways

- In most cycles, the spread between U.S. Treasury yields and high-yield bond yields has historically moved in a familiar pattern.
- As the economy moves toward the anticipated recession, we see high-yield spreads widening in the months ahead and continue to carry an unfavorable rating on that asset class.

The spread between the yield on the 10-year U.S. Treasury note and riskier high-yield bonds of comparable maturity has held well below the average going back to 2000 of 530 basis points (100 basis points equals 1%) so far this year. The spread currently stands at 465 basis points. Note that when we are talking about comparative risk, we are discussing the probability of default and not about the risk of a price decline as interest rates rise. Remember, as interest rates rise, bond prices fall and vice versa. The credit quality of the issuer typically influences only the magnitude of the underlying security's price move.

Many investors who bought bonds when interest rates were low, and are still holding those bonds, are now looking at lower market prices for their securities as interest rates have moved meaningfully higher. As a reference point, the 10-year Treasury yield has moved from approximately 1.5% in late December of 2021 to the current level of 3.4% (at the time of this writing). That means the price of that fixed-income security has moved in the opposite direction, down, as rates have risen.

In most cycles, the spread between U.S. Treasury yields (aka the perceived "risk free rate") and high-yield bond yields has moved in a familiar pattern. When the economy is anticipated to be on good footing and growing moderately without much inflation, investors tend to be more willing to buy relatively riskier higher-yielding bonds. This is because the issuers of those bonds are more likely to be able to meet their principal and interest payments as their underlying businesses are benefitting from the favorable economic environment. The spread between the Treasury yield and the yield on high-yield bonds has tended to narrow (fall) during this part of an economic cycle.

On the other hand, when economic conditions are deteriorating or perceived to be deteriorating in the future, investors become more concerned that some companies will be unable to meet their principal- and interest-payment obligations as their revenues potentially stumble. Under these conditions, the spread between the Treasury and these higher-yielding bonds has tended to widen as investors demand a higher yield to compensate for increased risk.

Our base case calls for the economy to slow and slip into a moderate recession that will begin later this year. Along with that outlook, we see corporate earnings contracting on a year-over-year basis in 2023 versus last year. Under these conditions, we see high-yield spreads widening in the months ahead and continue to carry an unfavorable rating on that asset class. At some point during the anticipated recession, we would expect wider high-yield spreads to potentially offer investors an attractive opportunity as we eventually look ahead to an improving economy. But for now, we continue to recommend that investors move up in credit quality.

Risk considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability or best interest analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon. The material contained herein has been prepared from sources and data we believe to be reliable but we make no guarantee to its accuracy or completeness.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. CAR-0423-01457