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Investment Institute

Market Commentary

Weekly perspective on current market sentiment September 27, 2023

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Last week's S&P 500 Index: -2.9%

High yield thoughts

Key takeaways

- The high-yield bond sector as whole tends to outperform early in a cycle when the economy is perceived to be coming out of a slowdown or recession.
- While we want to retain some exposure to high yield, we do not anticipate a whole-hearted endorsement of the sector in the near term.

At this point in the cycle, we do not want to overweight, or for that matter evenweight, high-yield bonds in portfolios. Our recommendation has been unfavorable for quite some time. When strategists believe the Federal Reserve (Fed) is going to continue to hike interest rates and the economy is likely to dip into recession at some point over the coming 12 months, high yield (HY) is typically not the place for overexposure. Yield spreads relative to Treasury securities would likely widen. High-yield debt carries higher interest rates for a reason: The companies issuing it are perceived to be more risky than the better-quality companies issuing investment-grade debt. When the economy slows or potentially contracts, these higher-risk companies are perceived to have a greater chance of default. As a result, investors require a higher yield to compensate for higher perceived risk.

But all is currently not equal in the HY sector. We are not recommending that investors zero-out their HY fixed-income holdings. Remember, in a well-diversified portfolio, there may be reasons to retain some exposure to a variety of sectors and asset classes, ideally whose prices do not all move up and down together. Typically, as one sector or asset class underperforms, others outperform, and an investor's portfolio will not be fully exposed to the underperformer. As we know, putting all of your eggs in very few baskets is usually not wise portfolio management.

The HY sector (and related indexes that track that sector) has seen a growing concentration of double-B-rated (BB) companies. This segment has historically had lower default rates than the rest of its HY brethren. These BB-rated issuers have generally featured stable business models that employ somewhat higher debt leverage than BBB-rated issuers or are within a cyclical industry that is more sensitive to the ebb-and-flow of the economy. The domestic economy has been resilient over the last 12 months, which has contributed to stable HY spreads that have remained below 4% since early June, even with the 10-year Treasury note climbing to just over 4.5% and the Fed still taking a hawkish tone.

Given our outlook for the economy in coming quarters, we believe investors will need to be selective when choosing HY portfolio exposure and stay with the highest-quality (BB) issuers. The HY sector as whole tends to outperform when the economy is perceived to be coming out of a slowdown or recession. In other words, while we want to retain some exposure to HY, we do not anticipate a whole-hearted endorsement of the sector in the near term.

For now, in terms of favored fixed-income guidance, we are most favorable on investment-grade U.S. short- and long-term taxable securities from an asset-class perspective. We also favor investment-grade essential service municipal bonds.

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Investments in fixed-income securities, including **municipa**l securities, are subject to market, interest rate, credit, liquidity, inflation, prepayment, extension and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. **High yield fixed income** securities are considered speculative, involve greater risk of default, and tend to be more volatile than investment grade fixed income securities. Municipal securities may also be subject to the alternative minimum tax and legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

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