JAG Fixed Income Thematic Insights: Q1 2025

Total reading time = 2 minutes

Context on Credit Spreads: *Should Investors be Concerned?*

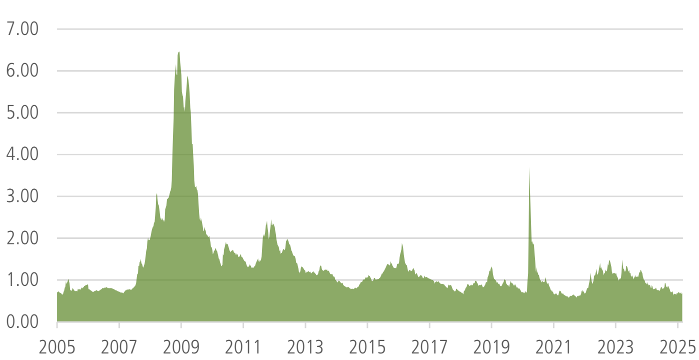
Our clients routinely ask us to comment on the overall levels and trends in corporate credit spreads. For the last year or so, these inquiries have taken on a greater sense of urgency as spreads have tightened significantly. While we agree that the backdrop for spreads warrants monitoring, we do not believe bond investors should be alarmed. Even in the event of a mean reversion scenario, we think the long-term merits of an allocation to credit remain in place.

In our last quarterly **Insight**, we illustrated how broad, top-down views of a sector can differ dramatically from the security-level opportunities within it. In this piece, we zoom-out to add greater context and show why credit spreads, at or near historic lows, are not as extreme a scenario as they may seem.

Our charts examine weekly data from the Bloomberg US Intermediate Corporate Bond Index.

Chart 1 shows the path of index spreads towards today's historic lows. While spreads are objectively narrow, current levels are not extreme outliers when compared to previous lows within the past 20 years. Still, this view does offer a clear and simple reason for caution: spreads are lower than usual, and rising spreads can lead to price declines.

Chart 1: Option-Adjusted Spread (%)

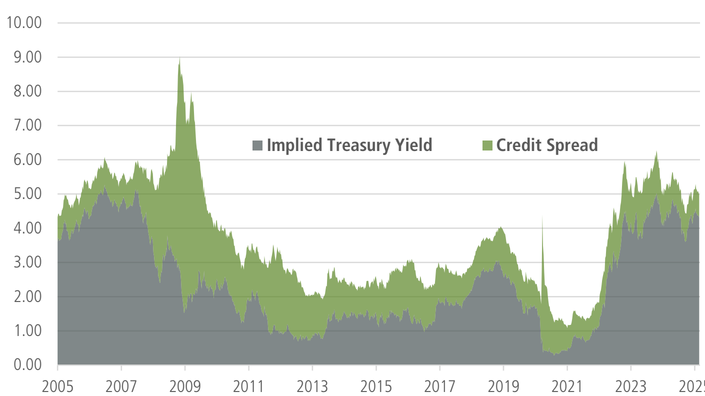


Source: Bloomberg Finance LP, JAG Capital Management

Like price action driven by fluctuating interest rates, changes in market value in response to broad trends in credit spreads are reversed as bonds approach maturity. What is more, market-wide occurrences are notoriously difficult to predict (how many of us predicted the Global Financial Crisis or COVID-19 pandemic?). These facts and others make attempts at market-timing a potentially costly endeavor indeed, and one that is overly reliant on luck. They contribute to JAG's emphasis on individual credit selection, limited duration, and a consistent, disciplined process.

When examining spread within the context of overall yield (Chart 2), one can easily see a pattern that offers some explanation for the market's willingness to accept this general tightening. Yields remain well above the levels investors were forced to grow accustomed to in the post-Global Financial Crisis era.

Chart 2: Yield-to-Worst (%)

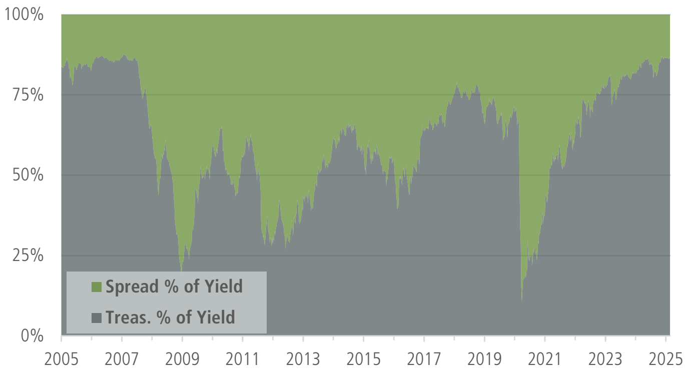


Source: Bloomberg Finance LP, JAG Capital Management

By deducting spread from index yield, we can derive the portion of total yield determined by the risk-free benchmark (i.e., US Treasurys). Incorporating Chart 3, we see that investors have been content to lend to quality corporate borrowers, even as US Treasury yields rose, and that this pattern is quite typical, historically.

A diversifying quality is also observable across Charts 2 and 3: higher spreads correspond with lower US Treasury yields, and vice versa. This stems, in part, from the expectation of monetary policy easing when corporate fundamentals (or other leading macroeconomic indicators) begin to deteriorate. Further, these charts suggest that investors tend to be more concerned with the overall yield of their portfolios than with the individual components of that yield.

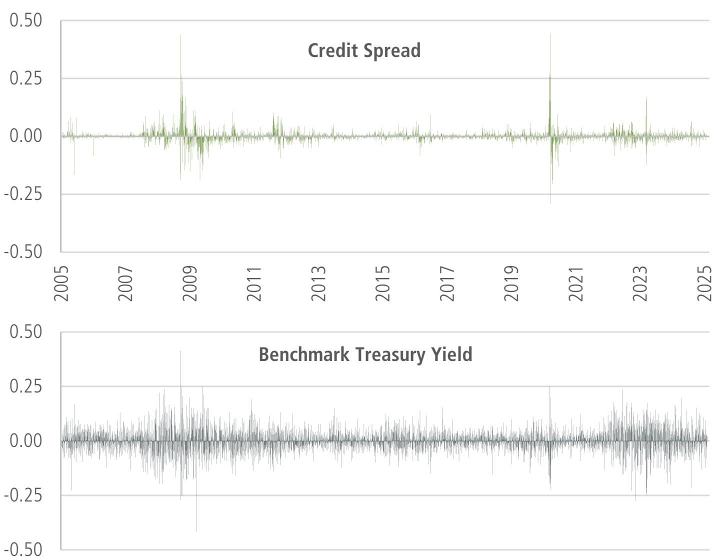
Chart 3: Yield Components: Spread vs Treasury



Source: Bloomberg Finance LP, JAG Capital Management

As illustrated in Chart 4, except for "black swan" events like the Global Financial Crisis and the COVID-19 pandemic, the benchmark interest rate component of corporate bond yields is far more volatile than the spread component, which remains relatively stable.

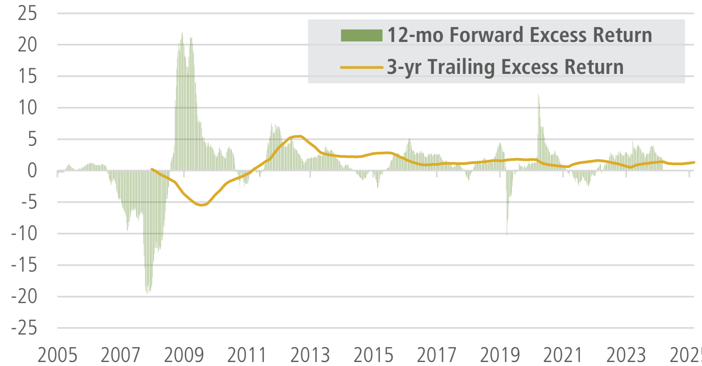
Chart 4: Daily Change in Yield Component (bps):



Source: Bloomberg Finance LP, JAG Capital Management

Finally, in Chart 5, we translate these yield and spread observations into streams of excess return. We offer two measures, one forward-looking and one backward-looking. Excess return measures the total return of corporate bonds versus US Treasurys in each respective period. We note that, in the last 20 years, outsized spread-related losses associated with historical credit downturns have been swiftly recouped. More important for long-term investors, the yield premium offered by corporates has translated to positive excess returns, on a rolling 3-year basis, since 2011 – including through the COVID-19 pandemic.

Chart 5: Excess Return (%)



Source: Bloomberg Finance LP, JAG Capital Management

Of course, many factors can influence credit spreads, and not all of them are addressed here. Corporate fundamentals, prevailing default rates, and changes in index composition are just a few. While these specific factors have trended positively in recent years, further supporting the tightening trend, our goal is not to justify current spread levels or to marginalize the risks associated with widening. In fact, our team has adjusted our portfolios specifically to address this risk. Rather, our goal is to provide assurance to long-term investors that it is prudent to "stay the course." Today's spreads, despite being at or near record lows, are not entirely unprecedented when viewed in a fuller context.

JAG continues to position our strategies to weather a broad range of economic outcomes. We aim to maintain a yield premium versus the benchmark, while carefully managing duration risk, via our bottom-up credit selection. We see no shortage of compelling opportunities in the current environment, index-level conditions notwithstanding, and we remain excited about bonds' renewed role in our clients' portfolios.

– JAG's Fixed Income Research Team

Disclosures

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Ownership: Fifty-one percent ownership by a Veteran or Veterans. The applicant must share in all risk and profits commensurate with their ownership interest.

Control and Management: Proof of active management of the business. Veteran must possess the power to direct or cause to direct the management and policies of the business.

Contribution of Expertise and Capital: Contribution of capital and/or expertise by Veteran owner(s) to acquire their ownership interest shall be real and substantial and be in proportion of the interest acquired.

Independence: The Veteran owner(s) shall have the ability to perform in their area of specialty/expertise without substantial reliance on non-Veteran-owned businesses.

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