



## The Great Debate

One of the core foundations of our business is bottom-up fundamental credit research. But we also believe in active management and sector rotation. As such, it is important to us to understand the risk / reward function offered by different areas of fixed income and how these sectors fit into our macroeconomic outlook.

We recently conducted a Bull vs. Bear exercise for credit to help inform our positioning and battle any psychological biases that we might have with regard to the current portfolios. We split the research team into a Bull team and a Bear team, each given the objective to win the debate over how attractive or unattractive the current opportunity set is within credit. Both sides were tasked with bringing in-depth and detailed research to argue their position.

Below we lay out a few of the key arguments from both sides. While we believe effectively navigating the current environment is particularly challenging given what seems to be several divergent variables, we found additional clarity after performing this exercise and we hope that by sharing the insights it does the same for you.



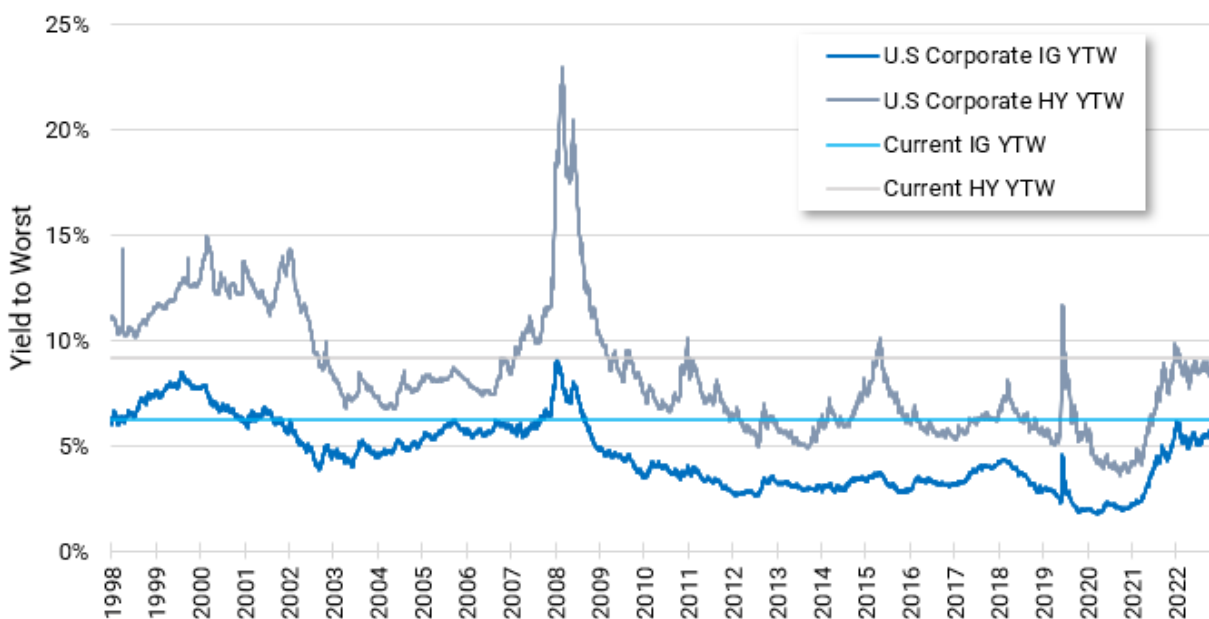
## Bull Case

We often talk about “the math behind the market,” referring to a focus on the likely drivers of forward fixed income returns. This focus leads us to ask questions such as: Will returns likely come from spread tightening or from coupon income? How sensitive are returns to interest rates? What does the upside vs. downside relationship look like in credit? While we don’t pretend to have perfect competency in predicting the future, we do feel that the math behind the current credit market is attractive in a historical context.

***All-in-Yields are attractive and provide a significant structural tailwind for forward return profiles.***

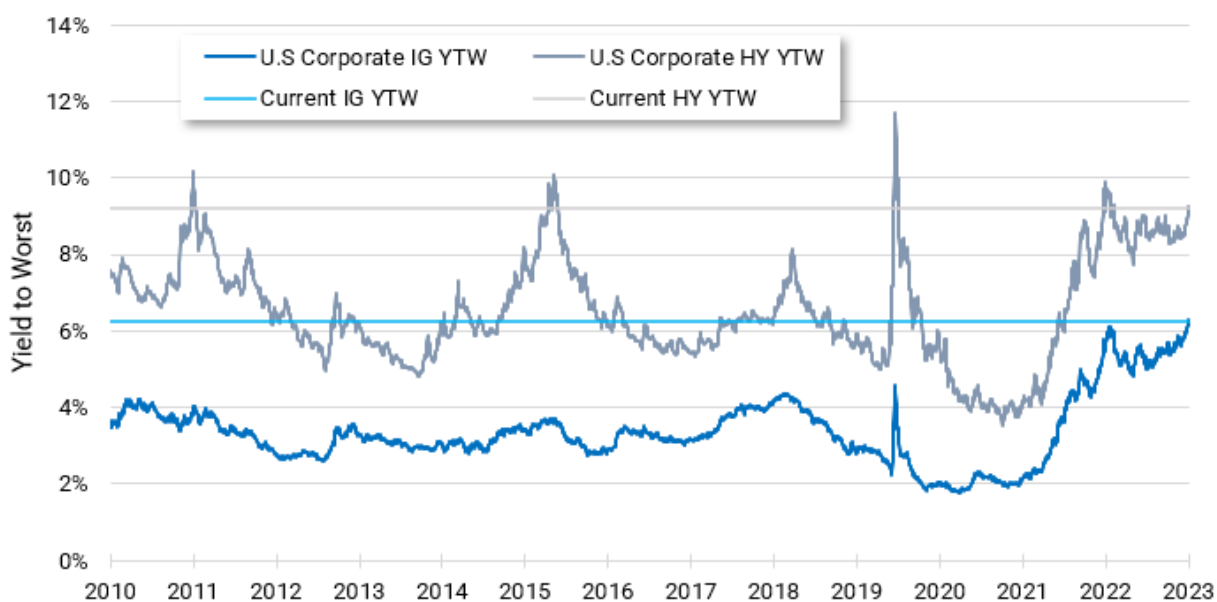
As of 10/6/2023 and looking back over the past two and a half decades, yields (yield to worst; YTW) on Investment Grade (IG) and High Yield (HY) credit sit at the 82<sup>nd</sup> and 71<sup>st</sup> percentile respectively, where the 0<sup>th</sup> percentile would be the lowest and the 100<sup>th</sup> percentile being the highest in terms of yield. If one were to shorten this timeline to exclude the Great Financial Crisis (GFC) and look back over the past 13 years, yields sit at the 100<sup>th</sup> and 97<sup>th</sup> percentiles respectively.

IG and HY YTW Last 25 Years



Smith Capital Investors, Barclays (10/6/23)

## IG and HY YTW Last 13 Years



Smith Capital Investors, Barclays (10/6/23)

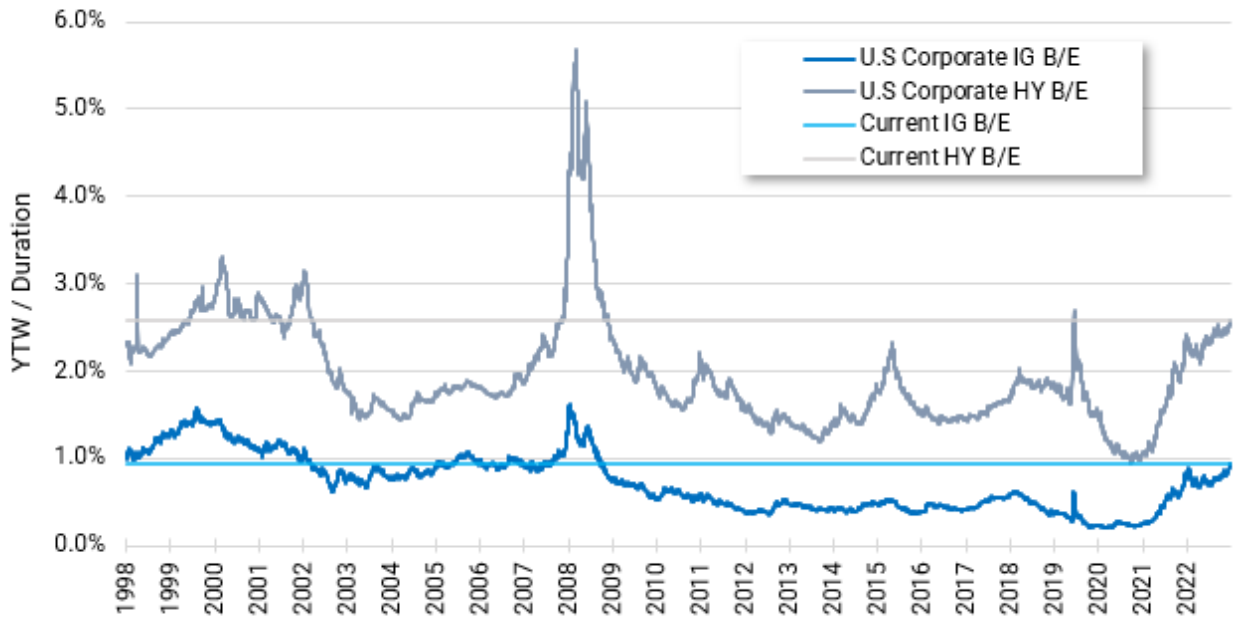
### ***The importance of yield per unit of duration.***

One might ask, how does this compare with respective duration profiles and how much cushion or resiliency does that really provide? Here we turn to breakevens\*, which have similarly gotten materially more attractive over the past two years.

A breakeven calculation in corporate credit very simply illustrates how much protective dampening a particular bond possesses before its forward return profile (typically expressed over a 1yr period) crosses from positive to negative. Said another way, how much change in yield can a bond withstand before its return is 0%?

Like the period above, when looking back over the past 25 years the breakevens on IG and HY are at the 73<sup>rd</sup> and 86<sup>th</sup> percentiles respectively. In nominal terms those breakevens translate to 93bps and 258bps of cushion. Taking out the GFC and shortening the look back period to 13 years we find that breakevens for IG and HY are both at the 100<sup>th</sup> percentile!

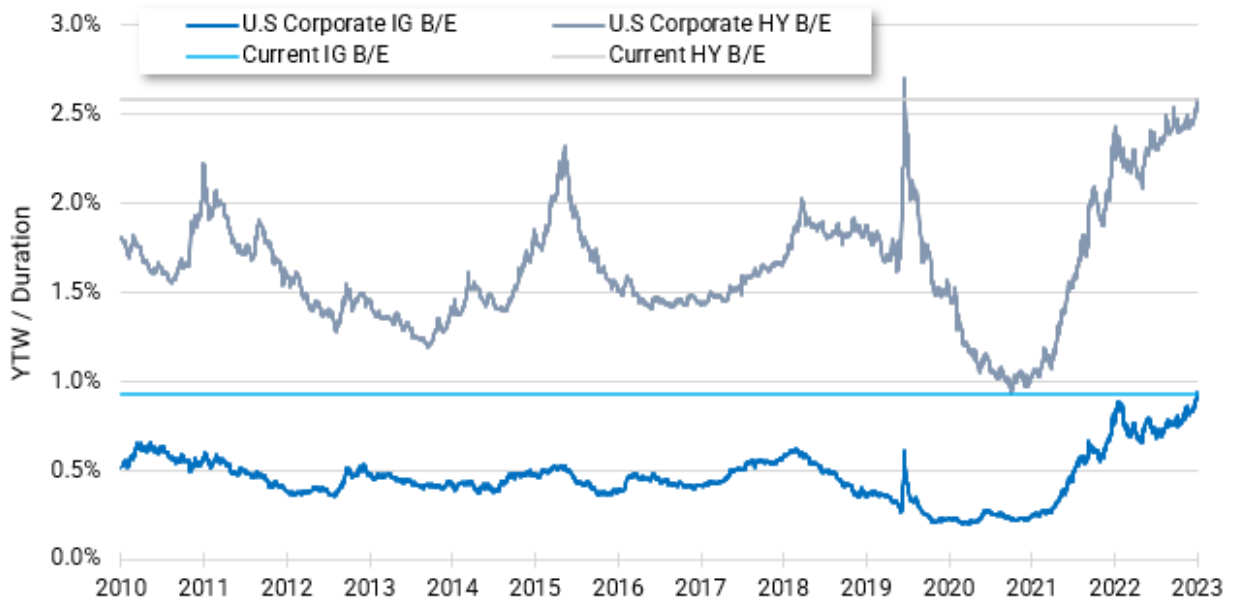
## IG and HY Breakevens Last 25 Years



Smith Capital Investors, Barclays (10/6/23)

\*Calculated as YTW/Duration

## IG and HY Breakevens Last 13 Years

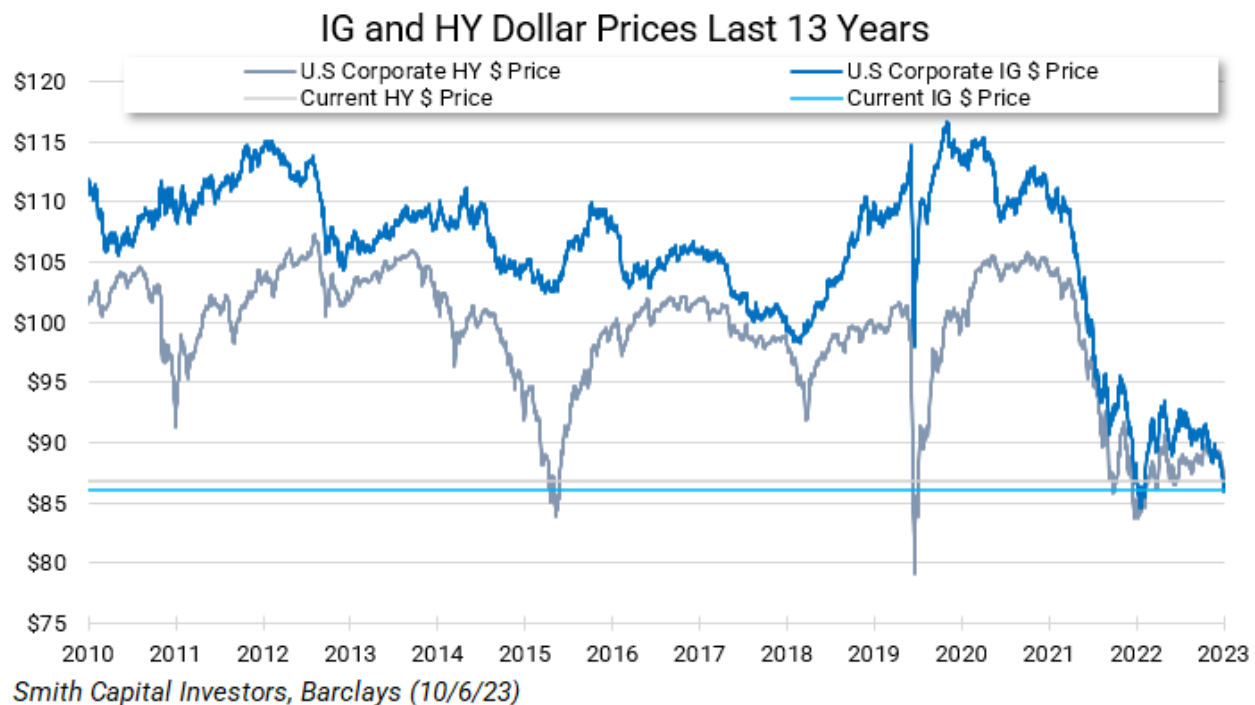


Smith Capital Investors, Barclays (10/6/23)

\*Calculated as YTW/Duration

**Average dollar prices on IG and HY are historically low—another structural tailwind.**

Another bullish data point for the math behind the market is the historically low average dollar price in credit currently. IG and HY Index average dollar prices are \$86.0 and \$86.9, respectively, which is in the 1<sup>st</sup> and 4<sup>th</sup> percentile over the past 10 years. When comparing to the past 25 years, current average index prices are in the 1<sup>st</sup> percentile and 22<sup>nd</sup> percentile.



**Low dollar prices and elevated yields have historically translated into favorable forward return outcomes.**

Looking back even further, over the past 30 years, NTM (next twelve months) credit returns have been outsized on average when buying the index at YTW levels at or above current levels. The average NTM return for IG credit when YTW is at or above current levels is 9.36% vs. an annualized 4.86% return over the past 30 years, representing 450bps of annual excess return. The data is similarly favorable for HY credit, with 10.47% average NTM return for HY credit when YTW is at or above current levels vs. an annualized 6.52% return over the period, representing 395bps of annual excess return.

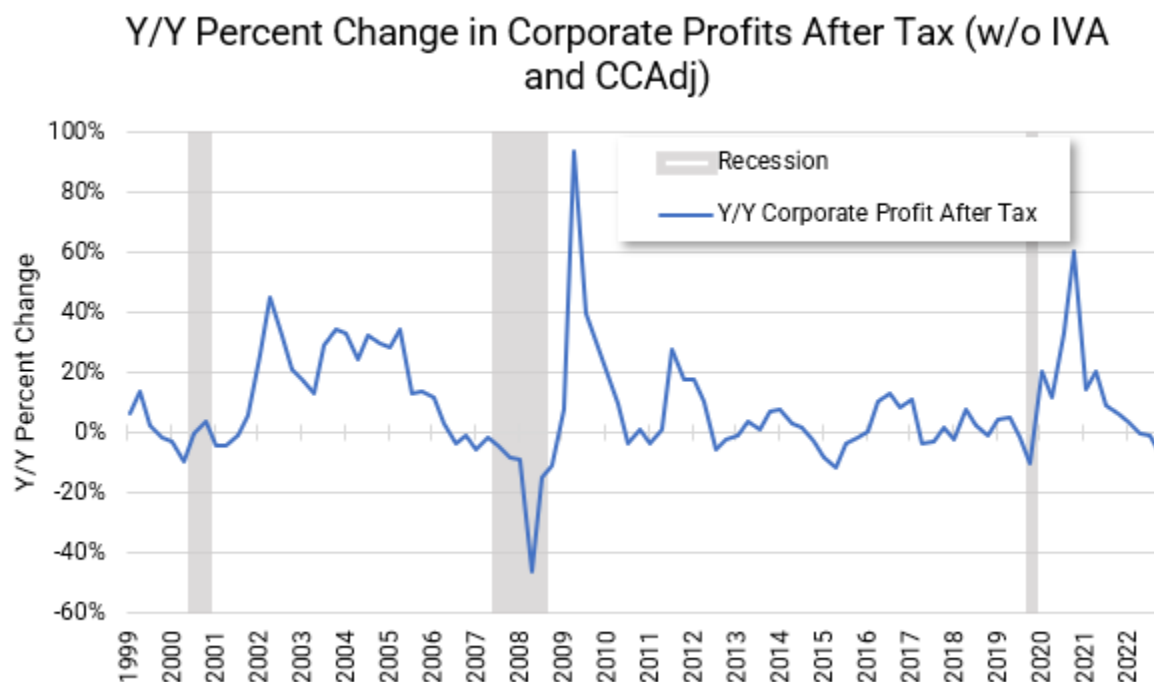
And with respect to dollar prices and realized outcomes, over the past 30 years, HY Index NTM returns have averaged 13.06% when average dollar price is at or below current levels vs. an annualized return of 6.52% over the period, representing 654bps of excess annual return. On the IG side, there are limited data points in the past 30 years where prices have been lower than they are today, however, it is intuitive that buying at lower average dollar prices would increase the likelihood of greater forward returns, which was clear in the HY data.

## Bear Case

From the Bear team's view, the primary bearish argument against credit is that corporate fundamentals face multiple headwinds and are likely to deteriorate from current healthy levels and there are additional other factors that must be considered.

### **Corporate fundamentals are broadly facing pressure.**

Going forward, we expect corporate margins to face pressure from increasing cost of labor and elevated cost of capital. Indeed, earnings have already started to decline based on several different measures, with the St. Louis Fed reporting corporate profits after tax declined 9.4% y/y for 2Q23. In 2Q23 the S&P 500 saw EPS decline 3.4% y/y and operating margin decline by 58bps, while the Russell 2000 saw EPS decline 25.0% y/y and operating margin decline by 78bps.



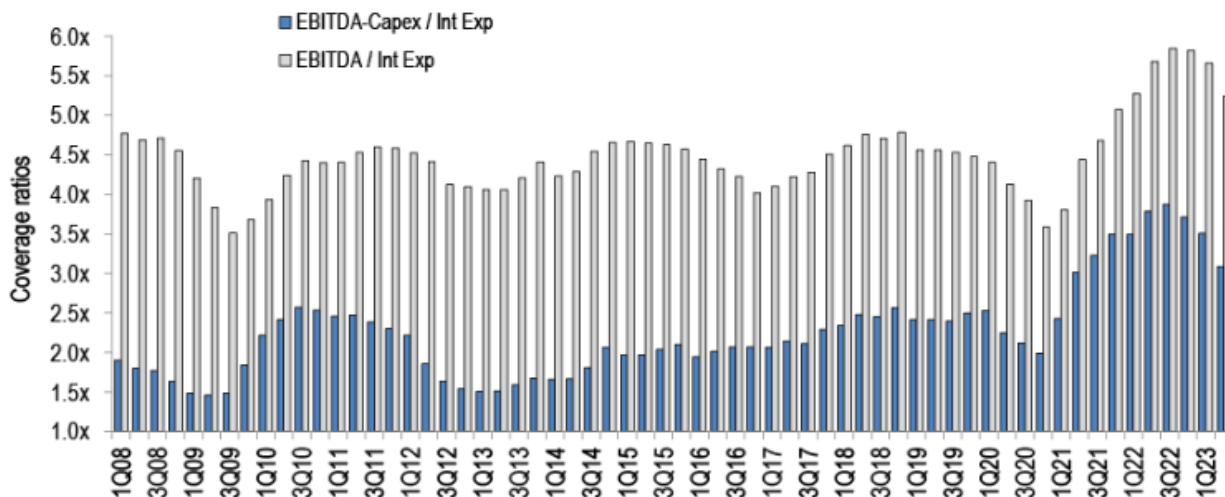
*Smith Capital Investors, U.S Bureau of Economic Analysis (10/6/23)*

While we are already seeing earnings decay, these pressures may become more acute going forward. On the labor front, the market remains tight and union successes at American Airlines and UPS have emboldened other unions to seek better wages and benefits, with strikes initiated or threatened by automotive, healthcare, hospitality, and entertainment unions across the country. These developments are likely to result in a step-change higher in union wages and come on the back of broad-based wage gains seen in August with average hourly earnings having increased 4.3% y/y. With profitability likely to decline, we would expect corporate leverage ratios to increase.

On the cost of capital side of the ledger we are also in the early stages in terms of flow-through to corporate margins. While the increase in interest rates has certainly impacted how management teams view incremental capital allocation decisions, the increase in interest expense has been limited to companies needing to refinance or those with floating rate debt outstanding that reprices on a more regular basis. According to Bank of America estimates, only

10% of bonds in HY and 14% in IG have reset to the higher market cost of debt. For the coupons that have reset, the increase has been significant (+2.8% in HY). That said, the increase in cost of capital will eventually find its way into interest burdens as companies will be forced to either pay down debt with cash or refinance at higher rates as maturities come due. With increased interest burdens, the ability to service debt will be reduced, a factor we have already seen with decreasing interest coverage ratios in HY.

#### Coverage ratio for HY companies decreased for a third consecutive quarter to a 6-quarter low



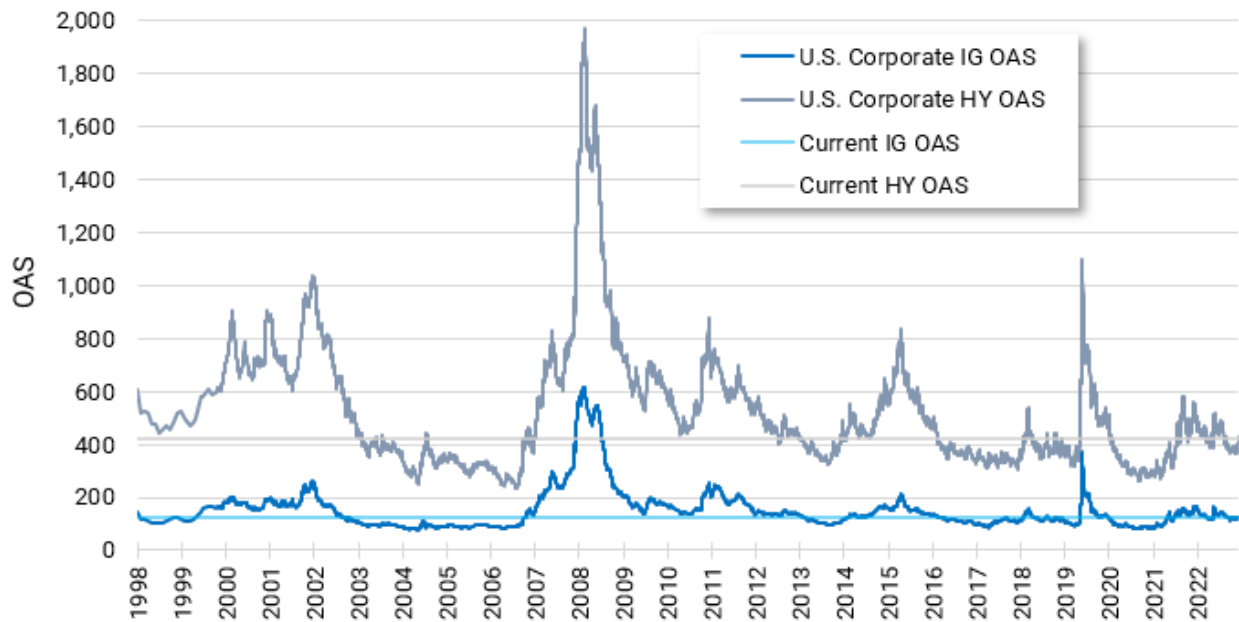
Source : J.P. Morgan; S&P Capital IQ

J.P. Morgan 2Q23 High Yield Credit Fundamentals (9/18/23)

#### Spread levels are lukewarm at best.

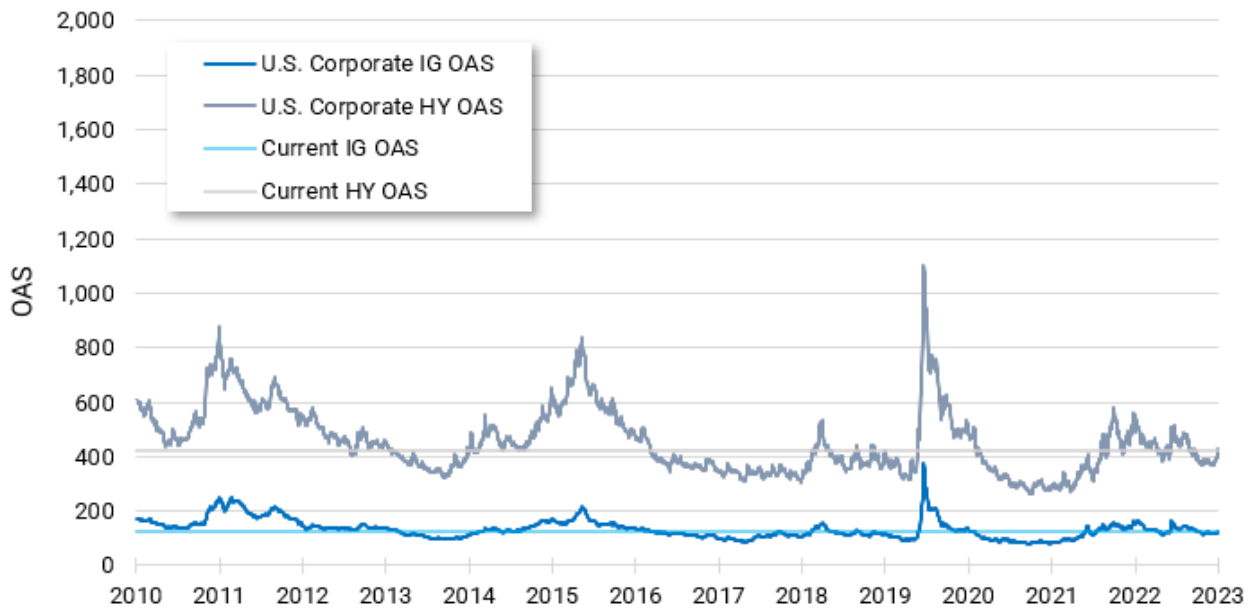
We have talked about yields, but what about spreads? As of 10/6/2023 spreads on IG and HY were 125 and 422 OAS respectively. Looking back over the past 25 years those levels land in the 43<sup>rd</sup> and 42<sup>nd</sup> percentiles. Taking out the GFC and shortening the look back period to 13 years reveals a similar story—IG spreads in the 45<sup>th</sup> percentile and HY spreads in the 46<sup>th</sup>. While not terribly tight, one could argue that current spread levels do not incorporate a high probability of a potential recession or at the least are not as compelling as all-in yields.

## IG and HY OAS Last 25 Years



Smith Capital Investors, Barclays (10/6/23)

## IG and HY OAS Last 13 Years

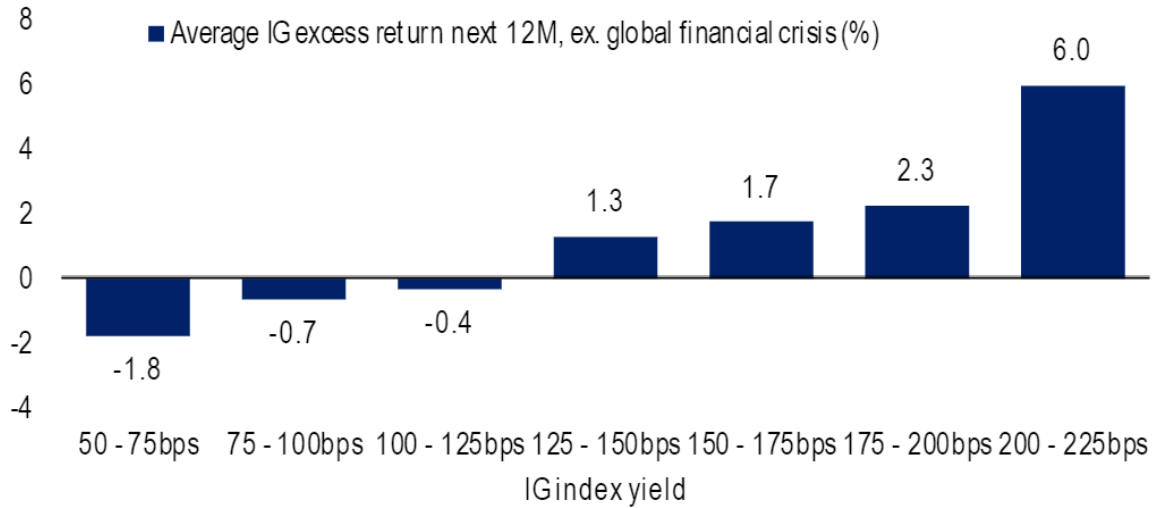


Smith Capital Investors, Barclays (10/6/23)

Furthermore, according to research conducted by Bank of America, when IG spreads are around 120-130 average excess returns over the ensuing 12 months are typically flat, aligning with our lukewarm assessment of current spread valuations.



Average excess return over the next 12M, by starting level of IG corporate spread.



Source: BofA Global Research, ICE Data Indices, LLC

BofA GLOBAL RESEARCH

*BoFA Credit Market Strategist: The 6.3% IG yield vs. Returns (10/6/23)*

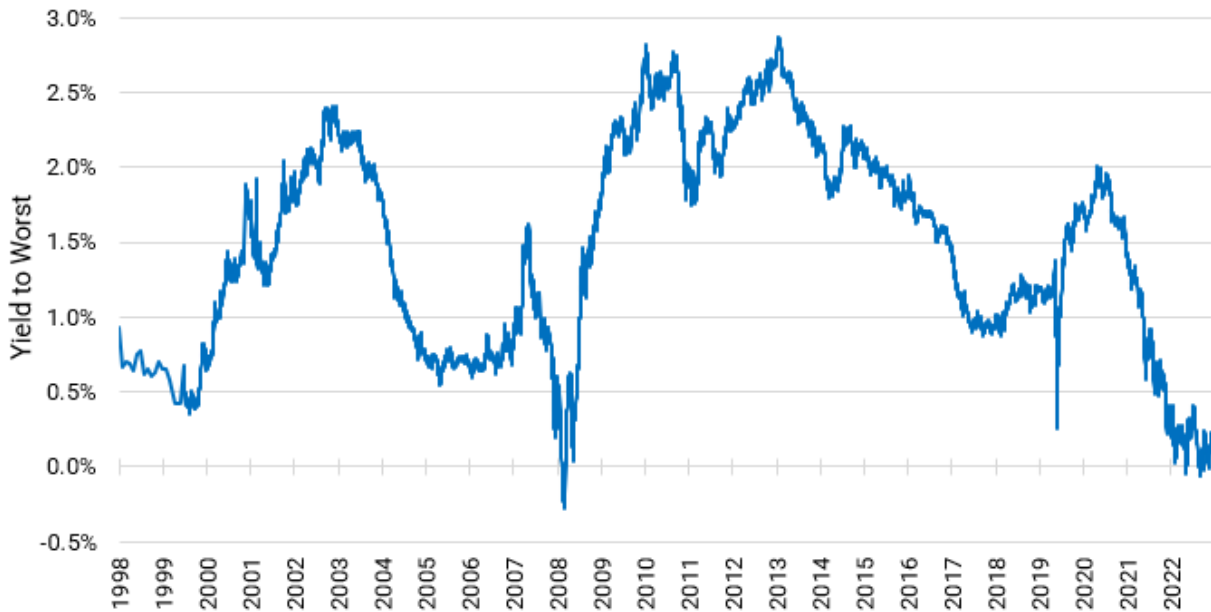
### **Bonus Consideration**

***The cost to shorten credit duration, and by nature become incrementally more defensive, is historically little in terms of yield and spread give.***

Over the course of this hiking cycle one of the things we have been paying particular attention to is the shape of term structures or curves and what signals the nature of those structures may or may not be telling us. Bringing that focus to IG credit spread and yield curves\*\*, we currently sit at the flatter end of the past 25 years on both.

First, looking at the IG credit yield curve we see that one only gets compensated an additional 24bps in yield to go from intermediate to long duration IG credit. This is inside of the 5<sup>th</sup> percentile and has only been this flat only one other time in the past 25 years, which was in 2008.

## IG Yield Curve Last 25 Years

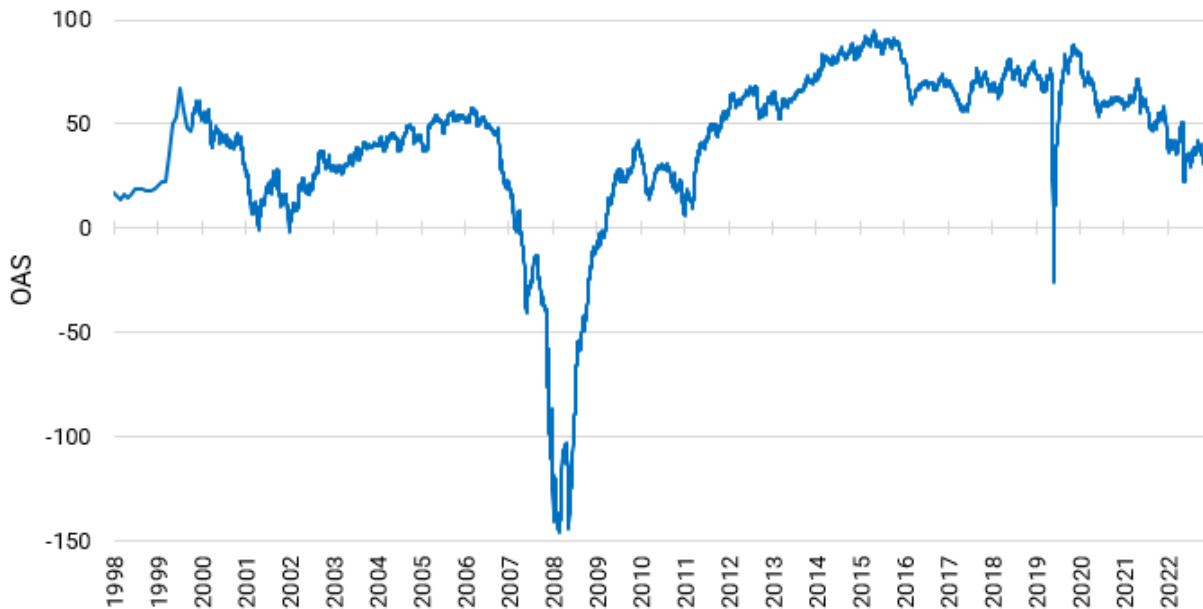


*Smith Capital Investors, Barclays (10/6/23)*

\*\*IG Long Duration Credit – Intermediate Duration Credit (YTW)

Turning to spread curves, the option adjusted spread (OAS) difference between intermediate and long duration IG credit is only 14bps. Over the past 25 years this too is at the tighter end of its historic range (13<sup>th</sup> percentile) and compares to a mean difference of over 41bps.

## IG Spread Curve Last 25 Years



*Smith Capital Investors, Barclays (10/6/23)*

\*\*IG Long Duration Credit – Intermediate Duration Credit (OAS)

In both instances one can look at the IG corporate credit curves in two directions:

- 1) the spread and yield compensation to move out the curve very little, or
- 2) the spread and yield cost to move in the curve is very little

We think framing corporate credit curve discussions in this way is helpful, particularly given that in a benign spread environment there have been few times in the past 25 years where the cost to move into typically more defensive, shorter-maturity securities has been this cheap. One of the key words in the last sentence is “benign”. We do not have certainty if the forward outlook for spreads will be benign or not, but we do know that the market is currently providing a very cheap option (in terms of spread and yield give) to own shorter dated securities.

Lastly, on credit curves we think it is important to point out the dissection of both spread and yield term structure supports security selection cases and then feeds into allocation decisions, not the other way around.

### **Conclusion**

While it may come across as a tenuous time, there are many reasons to be excited about the outlook for fixed income. As the bull points highlight, income “is back” in fixed income and provides both tailwinds and resiliency to forward return profiles. Said another way, yields act as both a sail and ballast for fixed income returns, giving the structural propensity for positive forward returns and acting as the protection or absorption mechanism by which to weather stormy seas. As the main bear points highlight, the erosion of corporate fundamentals is likely and spread valuations are not particularly attractive in a historical context. Uniquely, however, given the shape of both spread and yield curves in credit, one can get many elements of why credit looks attractive while limiting some of the downside brought up in the bearish argument.

These debates are a foundational element of our process. We welcome the opportunity to discuss these in greater detail.

Let’s keep the debate going!

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