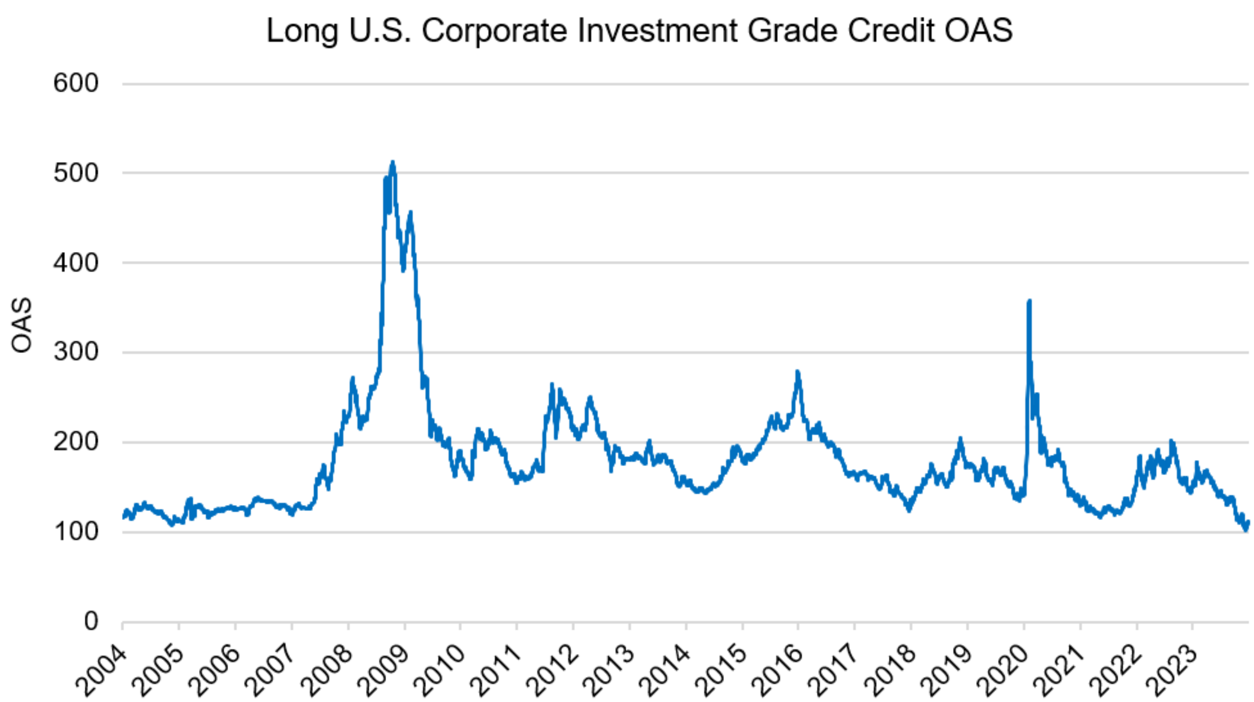
SMITH
CAPITAL INVESTORS

Crosscurrents: Yields and Spreads

You have by now likely heard someone say “credit spreads” are tight. This may seem totally reasonable to you, depending on whether you have been bracing for impact from one of the most historic rate hiking cycles in our lifetimes or not. We wouldn’t disagree by comparative measures over the last two decades that spreads are tight. Currently, Investment Grade (IG) Credit spreads are at 95 (OAS), which sits inside the 20th percentile to the relative tights and wides over the past twenty years.

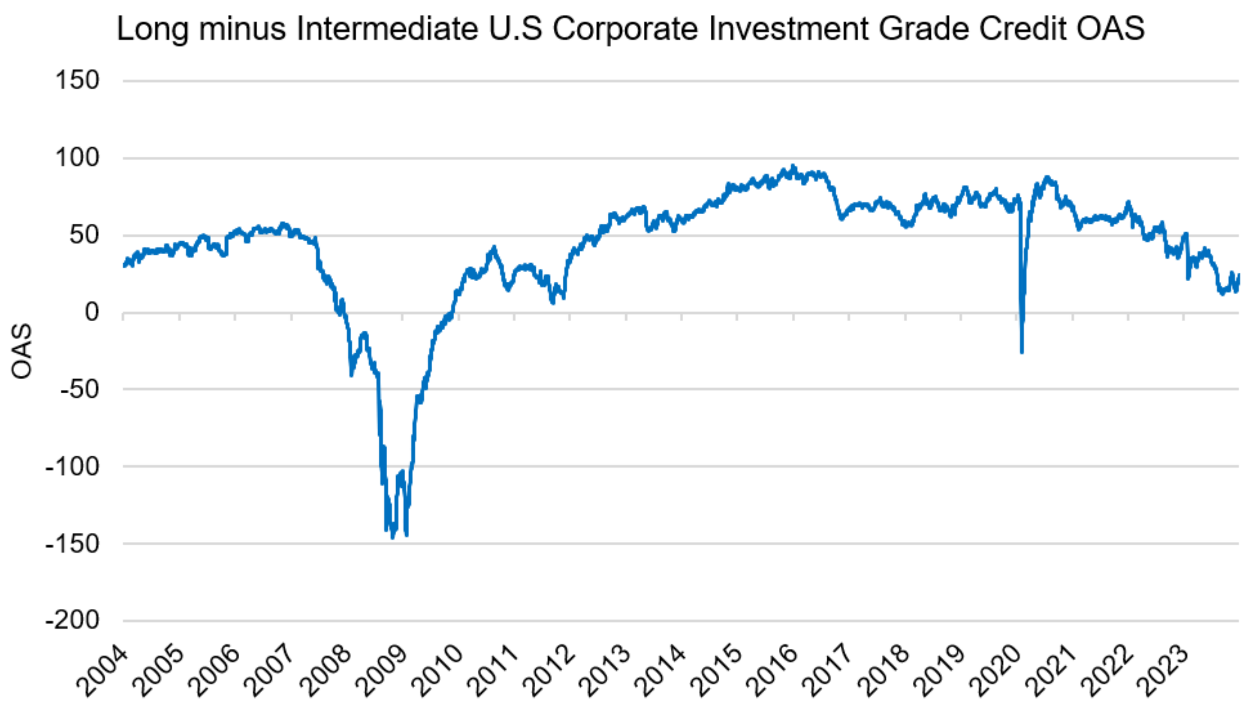
Source: Smith Capital Investors, Barclays (2/14/24)

Long IG Credit spreads are even tighter on a relative basis — inside of the 2nd percentile over the past twenty years.



Source: Smith Capital Investors, Barclays (2/14/24)

And how does Long IG Credit compare to Intermediate Duration IG Credit, or said another way, what does the spread curve look like? To move from Intermediate Duration IG Credit to Long Duration IG Credit, one currently gets paid, on average, an additional 19bps of spread. This is historically small when compared to the past twenty years, particularly when one recognizes curves have really only been flatter (or inverted) in major spread selloff environments of which we do not currently find ourselves.

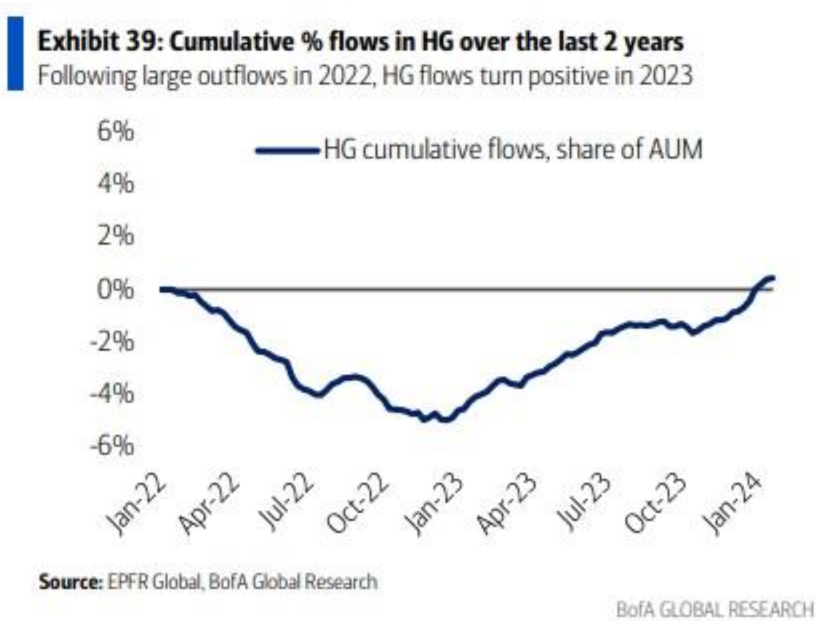


Source: Smith Capital Investors, Barclays (2/14/24)

What is driving these observed valuations? We think of two main things:

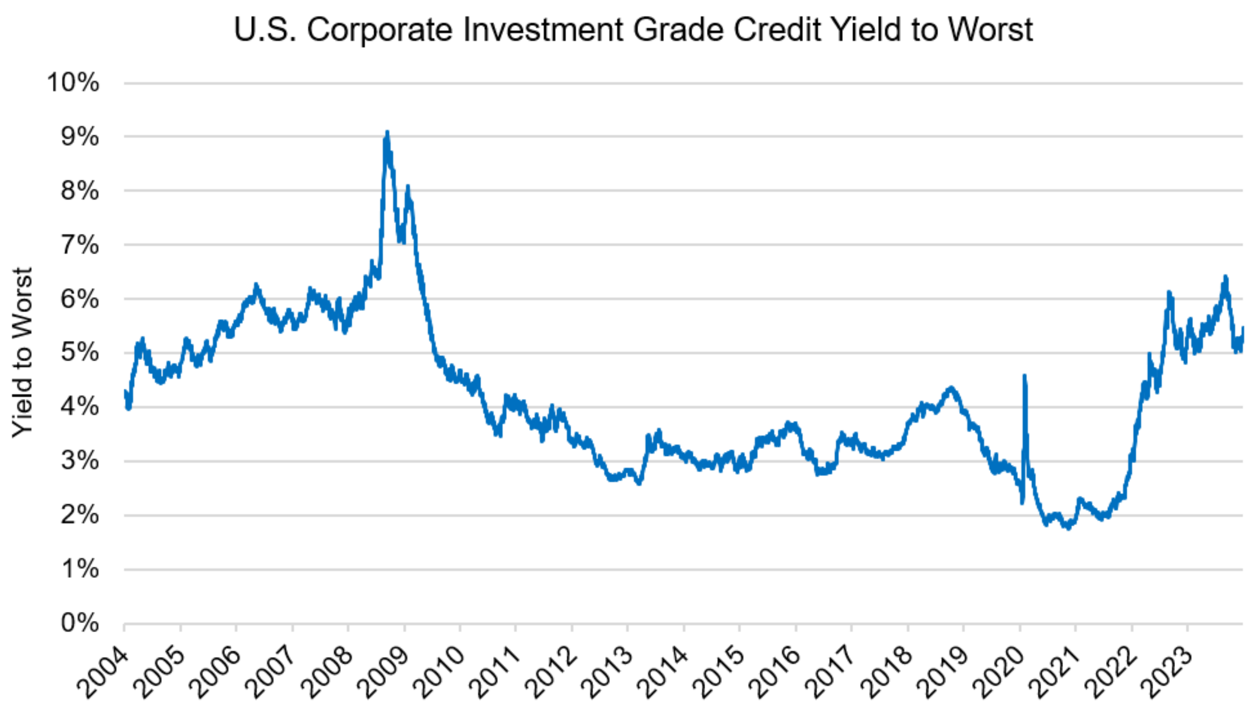
1. More resilient than expected consumer, economic, and corporate health.
2. Significant demand to lock in yields.

Since the tightening cycle has begun, the economy, the consumer, and corporations have proven to be much more resilient. This has aided spreads in their tightening along with another very powerful tailwind — demand. While we believe the Fed's balance sheet is a key element of this durable footing, we will save that for another discussion.



Beginning a year ago, flows into Investment Grade started to flip from negative to positive and in 2024 have begun taking AUM share. Why? Besides the aforementioned consumer, economy, and corporations, the answer is pretty straightforward: yield. The fixed income market is in a yield environment akin to seeing an endangered species slinking across a sunsetting savanna. People are grabbing their cameras and locking in duration at elevated yields.

Contrary to spreads, yields over the past twenty years are in the 79th percentile. And even more uniquely this comes at a time when spreads aren't the main contributor to all-in yield profiles.

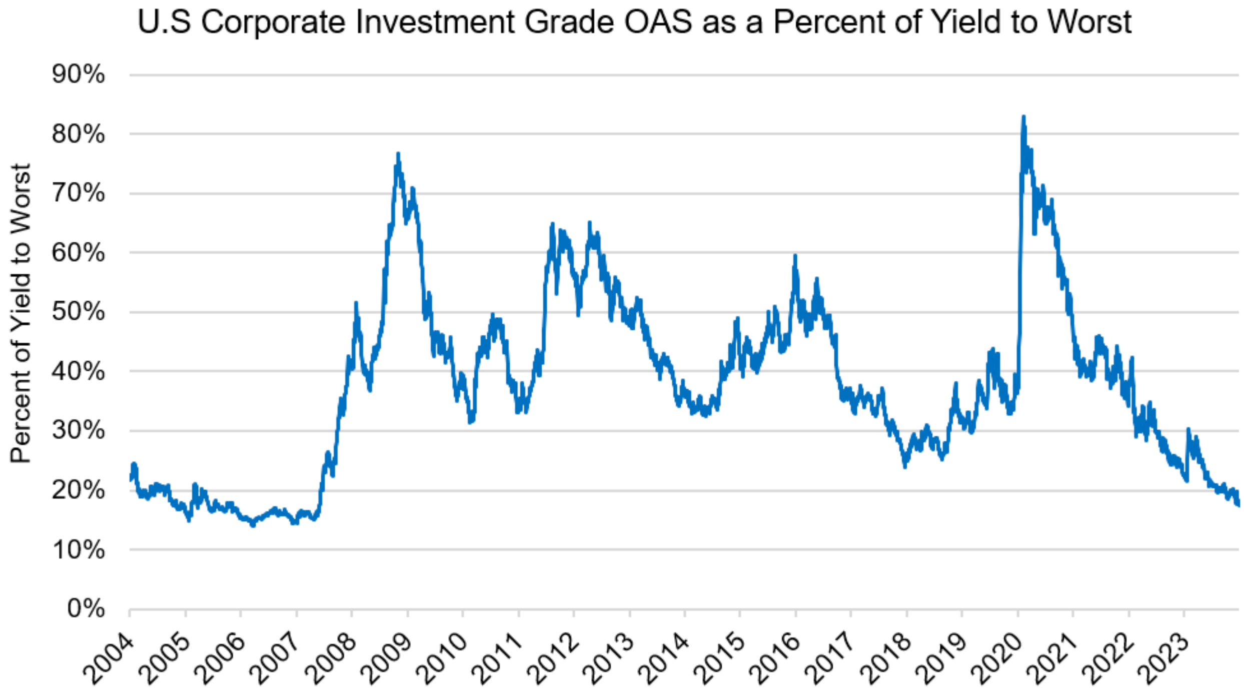


Source: Smith Capital Investors, Barclays (2/14/24)

There are a few ways to look at this:

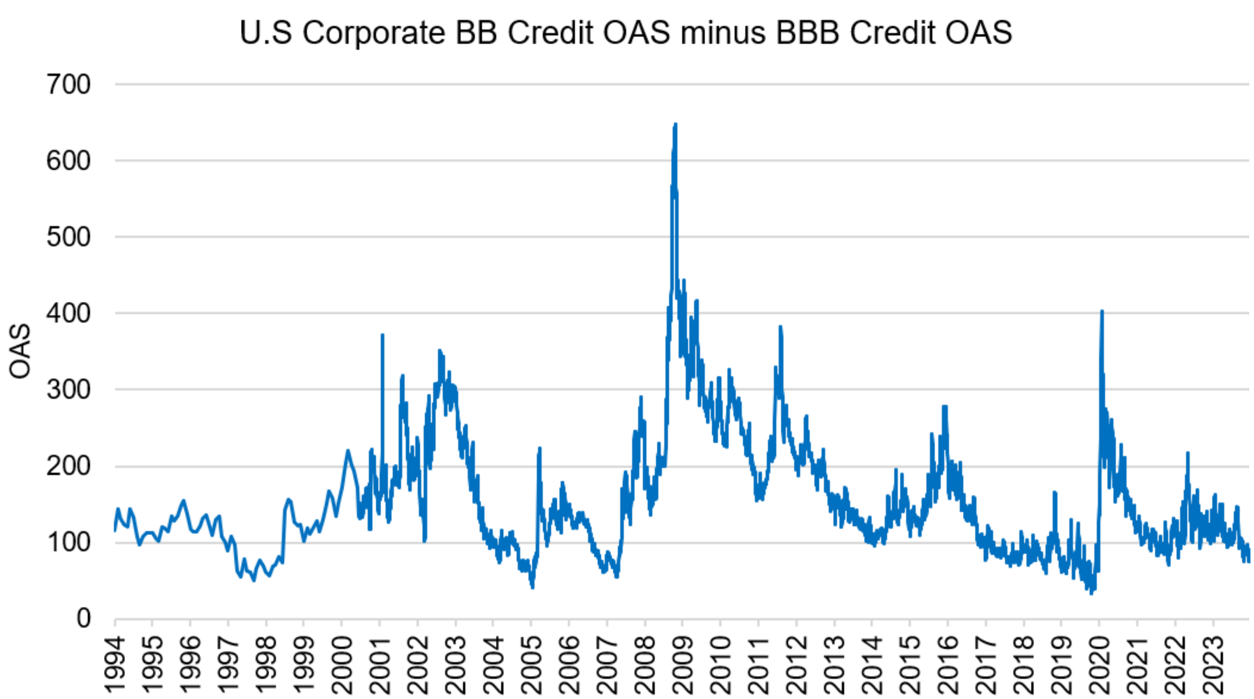
1. In IG Credit one is getting paid a lot of "relatively risk free" yield to own the asset class
2. One is not getting paid a lot of spread for owning the asset class, or
3. A combination of 1 and 2

As we have contemplated this, we cannot say anything other than both matter. We try to find the right balance for holding onto each where our scale is measured in units of risk-adjusted return.



Source: Smith Capital Investors, Barclays (2/14/24)

Drilling down from the asset class valuation discussion there are numerous cross currents and nuances that create an interesting opportunity set. Within corporate credit, valuations have compressed across rating buckets, leading to interesting opportunities to pick up quality without giving up much spread or yield. For instance, the spread pickup to move from BBB-rated credit to BB-rated credit stands at just 75bps, in the 7th percentile over the last 30 years.



Source: Smith Capital Investors, Barclays (2/14/24)

In this same vein, we are seeing historically wide yield pickups to move from fixed-rate unsecured high yield bonds into secured, floating-rate leveraged loans, often within the same structure. While the market expectation is for the floating-rate component of coupons to move lower in rate cut scenarios, the significant starting yield advantage often shifts the scenario analysis to more favorable outcomes, especially when considering the pickup in credit quality from moving up in the capital structure. These are just a couple examples of interesting crosscurrents, which are multiplied when drilling down even further to a sector and individual security level basis.

Despite being built on a more resilient than expected foundation, we do not expect a material portion of 2024 return profiles to come from tightening spreads (excess returns) as historically low starting spread levels leave little room for error. That said, we believe yield (carry) and downside protection will likely be two of the more important elements over the next 12 months when selecting credits and constructing portfolios, and we are taking advantage of opportunities within the market to increase quality and create incremental resiliency without giving up too much potential return.

Let’s keep talking!

Smith Capital Investors

Our mailing address is:
Smith Capital Investors
1430 Blake Street
Denver, CO 80202
303-597-5555
833-577-6484
info@smithcapitalinvestors.com

www.smithcapitalinvestors.com

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