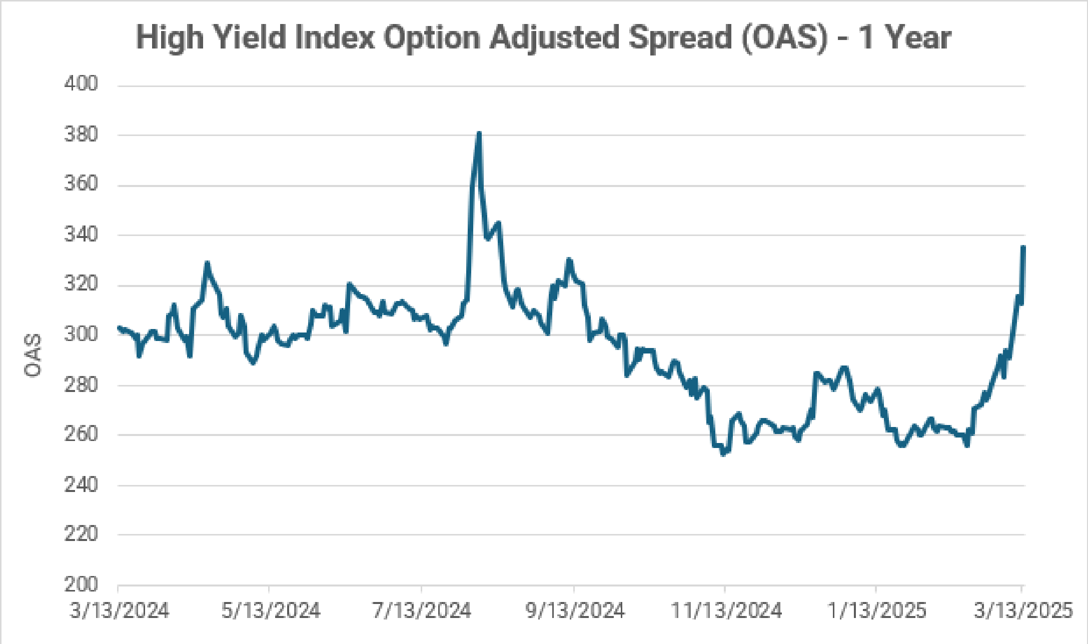
Credit Volatility Has Arrived…

On March 7th, we wrote that we expected uncertainty and volatility to remain high and that we believed additional compensation for increased volatility in credit was warranted (see piece HERE). This week, credit volatility arrived, alongside the VIX spiking close to 30. Investment grade option-adjusted spreads (OAS) widened by 9bps and high yield OAS widened by 44bps.



Source: Smith Capital Investors, Bloomberg (3/14/2025)

Throughout the year, we have spoken about our defensive portfolio positioning, and we entered this week with our internal high yield risk rating at a 3 out of 10. This reflects recent trends, including historically tight spreads, a record percentage of the high yield universe trading inside 250bps, and a surplus of supply from fallen angels and gross new issuance.

Broadly, if the risk of recession increases materially due to a trade war or consumer retrenchment amidst uncertainty, high yield credit is likely to underperform. Despite the recent move, spreads are still below average on a long-term basis (in the 18th percentile on a 15-year basis) and well below levels seen during prior periods when recessionary risks were rising. Therefore, we continue to advocate a cautious approach to high yield overall. However, there are a few areas within leveraged credit where we see potential opportunities on a bottom-up basis:

- **Short duration high yield:** While macroeconomic uncertainty may limit visibility of future corporate and bond-specific cash flows, securities with a short final maturity in issuers with ample flexibility to pay down or refinance the maturity (such as cash on the balance sheet, free cash flow generation, revolving credit capacity, incremental secured debt capacity) should exhibit low fundamental risk and could offer favorable risk-adjusted returns. The yield per unit of duration is attractive in this environment, especially with front rates highly correlated to the Fed's monetary policy direction.

- **Crossover credit:** Although the spread pickup between BB-rated vs. BBB-rated credits is relatively low in a historical context, current levels of +94bps are near one-year wides. Fundamentally improving credits are a primary focus at Smith Capital Investors, and recent spread widening may offer opportunities to gain exposure to issuers where credit improvement is not reliant on benign macroeconomic factors. In addition to potential spread tightening from fundamental improvement, technical factors can enhance the risk-adjusted return profile of crossover credit as a new buyer base is often compelled to purchase the security once it is included in the investment grade credit indices.

- **Select high quality leveraged loans:** We have been negative on the leveraged loan asset class (2 out of 10 internal risk rating) given weak underlying fundamental and credit rating trends. However, we have identified opportunities in select high quality issuers with ample fundamentals and balance sheet resiliency. Following a record repricing wave and recent volatility, the percentage of leveraged loans trading above par is at a 13-month low (11%), which could represent an opportunity to garner some price upside in a traditionally negatively convex asset class.

While we continue to emphasize defensive positioning, exposure to fundamentally improving credits, and high liquidity within portfolios, we believe that elevated volatility can create opportunities for fundamentally focused investors with an emphasis on security selection and sector rotation.

Our dedication to our core principles—investment excellence, relationships and people, and an intentional culture—remains steadfast. We are deeply grateful for our clients' ongoing trust and partnership. As we anticipate an impactful year ahead, we remain diligent and disciplined in our approach, focusing relentlessly on what matters most: serving our clients with integrity and dedication.

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