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From the Desk of the Global CIO

Risk and Reward of Successful 'Mid-Cycle' Rate Cuts

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In July, after the Federal Reserve (Fed) made its first rate cut in a decade, Fed Chair Jerome Powell referred to the first cut as a brief “mid-cycle” rate adjustment, as opposed to the beginning of a lengthy cutting cycle. This distinction was critical, because it spoke to the Fed’s mixed track record of using rate cuts to stave off recession. The central bank had successfully staved off recession using a similar adjustment in 1998, but it was not effective in several other late cycle scenarios.

In all likelihood, Powell’s hopes have been realized and the Fed has successfully staved off recession and extended the expansion. Weakness in manufacturing data has bottomed out, the consumer is in good shape, and the labor market remains extraordinarily resilient. The recovery in the U.S. is also helping to drive a pickup in global economic activity.

This is all good economic news, but the rhyming of history reminds us to consider how the 1998 scenario played out. The Fed’s accommodation helped sustain the expansion, but it also led to large amounts of malinvestment and excesses building up in the stock market. The Fed’s 1998 mid-cycle adjustment resulted in a liquidity-driven rally that caused the Nasdaq index to double within a year before the bubble finally burst. It also led to a significant widening of credit spreads.

Today, current spreads reflect just how little upside there is in credit even as the expansion continues. As I write this letter, investment grade bonds stand at a spread of 96 basis points, just 23 basis points from their historical tights, and 514 basis points from their historical wides. For every basis point of upside to the historic tight, there are about 22 basis points of downside to the historic wide. The story is similar for high-yield bonds: They currently stand at a spread of 322 basis points over the Treasury curve, which is 105 basis points from their historical tights and 1,626 basis points from their historical wides, or about 15 basis points of potential downside (widening) for every basis point of potential upside (tightening). It is clear there is far more downside risk than upside potential in credit.

In terms of total return, using high-yield as an example, the asymmetry of returns is stark. If a strong bull market brought spreads to their historical tights, the excess

return over Treasurys would be about 9 percent (factoring in coupon income of 6.3 percent and spread return). Contrast that with a bear market scenario that brought spreads to their historic wides. In this case, the excess return would be about -43.8 percent (again factoring in coupon income and spread return). Again, 9.0 percent is upside to historic tights, and -43.8 percent is downside to historic wides. Put another way, a widening in high-yield spreads of just 207 basis points would entirely offset coupon income. Investors are not being adequately compensated for the outsize risk they are taking on in the current market.

Throughout this report, our portfolio managers and sector teams underscore the reasons why we continue to upgrade credit quality and reduce spread duration risk in our portfolios. On page 2, our portfolio management team describes how we continue to increase credit quality and minimize spread volatility. On page 8, our investment-grade corporate bond team cites various reasons why credit spreads may tighten over the coming months—none of them fundamental. Meanwhile, our asset-backed securities team on page 14 discusses how investors are not getting compensated to assume the additional credit and spread duration risk of subordinated CLO tranches.

Taken together, conditions today are characteristic of those that precede a Minsky Moment, in which excessive speculation and taking on additional credit risk during stable markets leads to a tipping point that leads to a period of instability. How long can this phase last? As John Maynard Keynes famously noted, the market can remain irrational longer than you can remain solvent. Thus, while the Fed has prolonged the expansion, the reality is that it is also the start of silly season in risk assets. By heeding the lessons of the past we continue to position defensively so that we can preserve capital and be prepared to take advantage of opportunities when asset prices inevitably reset.

While we very well may miss the short-term returns offered by speculative madness, our goal is always to maximize long-term returns and preserve capital for when opportunity presents itself.

Important Notices and Disclosures

One basis point is equal to 0.01 percent.

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