Portfolio Management Outlook

Avoiding the Fate of ‘98

Anne B. Walsh, JD, CFA
Chief Investment Officer,
Fixed Income

Steve Brown, CFA
Portfolio Manager

Adam Bloch
Portfolio Manager

We do not think the rally in risk assets is sustainable.

There are key historical lessons that investors must bear in mind with regards to an overheating economy. The first is that these are periods when bubbles form. Our Global CIO draws parallels to the experience in 1998, when the Fed cut interest rates by 75 basis points and prolonged the expansion. The period that followed saw technology stocks inflate and disconnect from fundamentals. It ultimately ended in a dramatic decline in tech stocks that spilled over into the broader equity and credit markets.

The second lesson about overheating economies is from John Maynard Keynes, who reminded us that the market can remain irrational longer than you can stay solvent. Fed easing this year could bring about the same fate to risk assets as in the late 1990s. When the Fed eased in 1998, investment-grade corporate bonds tightened by 40 basis points over a brief six-month rally, though spreads never revisited the 1997 tights of 51 basis points. To this day, the 1997 tights remain the tightest level for the index on record. Today, the Bloomberg Barclays Corporate Bond index sits at a spread of 108 basis points, tighter than when the Fed eased in 1998, despite being of lower average credit quality. The Fed’s pivot could bring about new record tights for corporates. But this rally would be doomed to end painfully, similar to 1998, when spreads entered a multi-year widening trend six months after the Fed eased. Further, history shows that spreads tend to widen when the Fed is easing, not tighten.

The rally in credit is not being supported by fundamentals, and we cannot ignore the overwhelming technical variable which results in negative-yielding sovereign debt overseas. As our investment-grade sector team highlights on page 8, there is now over $1 trillion in negative-yielding corporate debt globally, which is attracting non-U.S. investors to positive-yielding U.S. corporates. Just as credit spreads widened in Europe before the last round of quantitative easing (QE), so, too, credit spreads in the U.S. will likely widen before the Fed moves to restart QE, which ultimately may prove to be the impetus that pushes U.S. rates below zero.

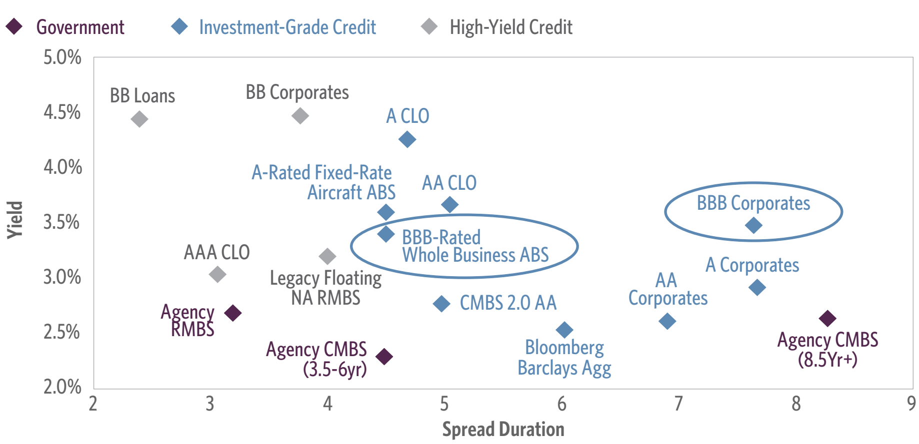
The likelihood is that we are only seeing the beginning of negative-yielding global corporate debt. In the Bloomberg Barclays Euro Aggregate Corporate Index, AAA and AA bonds are yielding -0.09 percent and -0.21 percent, respectively, but are trading at average spreads of 66 and 65 basis points, which is only in the middle of their historical trading range. As sovereign yields plummet further into negative territory, the added room for spread compression combined with a possible renewal of the European Central Bank’s corporate bond purchase program means that corporates could also sink deeper into negative yields. If Treasury rates ultimately fall below zero in the next recession, the probability is high that spreads on U.S. corporate debt will submerge to new historic lows while yields on select issues may well probe negative territory.

As a result, our portfolios continue to prioritize capital preservation with a preference for asset categories that we believe are credit-loss remote. In Core-Plus, this includes government guaranteed securities, senior CLOs and non-Agency RMBS. The fundamentals in non-Agency RMBS are underpinned by a more prudent, de-levered mortgage borrower and attractive LTVs, both of which support long term credit performance. We continue to have a low weighting in investment-grade corporate bonds versus the benchmark, particularly further out the curve, which is consistent with our capital preservation strategy.

Our decision outlined in the last Fixed-Income Outlook to move some duration from the long end to the front end has been beneficial as the curve has steepened. Treasury securities may be overbought in the near term, however, as the July FOMC meeting showed that the Fed is not planning to cut rates as much as the market is pricing in. Thus there may be more opportune times to lengthen duration.

Regardless of the near-term direction of interest rates, we expect the curve to steepen. The two-year/10-year Treasury swap curve, currently at about 3 basis points, is flat on a historical basis. If the Fed eases significantly more than the market is pricing in, the 2s/10s curve would steepen as the front-end rallies more than the long-end. If economic data are strong and the Fed doesn't deliver the expected rate cuts, the curve would steepen as long-end rates rise more than short-end rates. Both the Core-Plus and Multi-Credit strategies are positioned to potentially benefit from a steepening of the yield curve.

Structured Credit Has Offered Better Relative Value by Ratings Category



Source: Guggenheim Investments, Credit Suisse, Bloomberg, Citi. Data as of 7.25.2019. Representative indexes: BB loans: Credit Suisse Leveraged Loan Index (BB subset); BB Corps: Bloomberg Barclays High-Yield Corporate Bond Index (BB subset); AA, A and BBB Corporate Bonds: Bloomberg Barclays Corporate Bond index (AA, A, and BBB subsets); Agency RMBS and Agency CMBS: Bloomberg Barclays U.S. Aggregate Index (RMBS and CMBS subsets); CLOs: JPM CLOIE Index (AAA, AA, and A subsets); CMBS 2.0 AA: Bloomberg Barclays CMBS 2.0 Index (AA subset), legacy floating non-Agency RMBS, BBB-rated Whole Business and A-rated Fixed-Rate Aircraft ABS: Based on the Guggenheim's sector desk indicative levels.

Yield and spread duration are two metrics that help assess relative value. Spread duration is the percent change in prices for a 100 basis-point move in spreads. If BBB corporate bond spreads widen by 100 basis points, for example, BBB corporates lose between 7–8 percent in market price, while BBB-rated whole business ABS offers comparable yield and lower spread durations. Thus for the same spread widening, you lose less in price.