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Attractive yields but narrow spreads: The credit dilemma

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Even after the late-year "Santa" rally, all-in yields in many credit sectors are near multi-decade highs, making it tempting to portfolio managers to have overweight credit allocations to maximize the yield opportunity. But credit spreads[1] are relatively narrow and the distinct risk of an economic or financial market recession looms eventually, so managers might opt to underweight credit sectors.

What's the solution to this portfolio construction dilemma? I think the answer is to lean even more heavily on the work of our global team of credit analysts to selectively find positions that offer attractive spreads and yields relative to their fundamental credit quality.

Lulled into complacency by near-zero defaults

Some fixed income investors may have been lulled into credit risk complacency by the near-zero default rates that have dominated the markets since the global financial crisis (GFC) of 2008–2009. Even following the worldwide economic shutdown at the onset of the pandemic in 2020, default rates did not spike as various government fiscal support programs bridged the gap to financial health for most corporations. I still think that a global recession in 2024 is more likely than not, which would push the number of defaults meaningfully higher.

Many corporate debt issuers were able to take advantage of rock-bottom interest rates in 2020 to refinance their higher-rate debt. But almost four years later, some corporations may face a "wall" of maturing bonds that will require them to tap the markets for funding. In the event of a financial markets recession—which I view as even more likely than an economic recession—credit spreads would widen, driving the cost of new issuance up and potentially increasing the debt burden for corporations.

> "...high yield bonds and bank loans could be areas to take risk...."

Prefer high yield bonds, bank loans

Taking a broad view of the corporate credit sectors, high yield bonds and bank loans (which also typically have non-investment-grade credit ratings) could

[1] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

be areas to take risk.The credit quality of high yield issuers has steadily improved since before the GFC. As of November 2023, 53% of the global high yield bond market[2] was BB rated[3], up from only 38% at the beginning of 2004. While high yield bond credit spreads are not notably wide on a historical basis, their combination of improved credit quality and attractive yield can provide a good source of credit exposure, although comprehensive credit analysis is still essential as global growth slows.

But we have also been finding some opportunities in short-maturity investment-grade corporates. Yields in this short-dated segment are actually approaching those on long-term corporate bonds, providing attractive carry[4] paired with less credit and interest rate risk as a result of their shorter maturity. The long-dated end of the investment-grade corporate market, especially in the U.S., appears distinctly unappealing for those who are not forced to buy in this area

Fundamental credit analysis drives individual positions

When it comes to positioning within these credit sectors—whether corporate or sovereign credit, investment-grade or high yield—we rely on our global team of credit and environmental, social, and governance (ESG) analysts (ESG considerations form part of our overall investment decision making process alongside other factors to identify investment opportunities and manage investment risk. At T. Rowe Price this is known as ESG integration. As part of our wide range of investment products we also offer products with specific ESG objectives and/or characteristics). Their issuer-by-issuer fundamental work drives our individual credit positions. Our fixed income portfolio managers collaborate closely with sector credit analysts to identify names that may provide value relative to others in the same subsector or industry as well as those to avoid because of lack of relative value.

> “Blue bonds provide funding for ocean health and water resource management projects....”

A new credit segment: Blue bonds

I would like to highlight one specific area of credit investing that we have recently started analyzing. Blue bonds provide funding for ocean health and water resource management projects, which are sorely needed to help address the degradation of ocean and inland water ecosystems. Sovereigns, development banks, quasi-sovereigns, and corporations can all issue blue bonds to raise capital dedicated to closing the funding gap for projects seeking water-related environmental benefits.

While blue bonds currently account for only a tiny slice of the global fixed income market, the sheer size of the “blue economy” (sectors connected to oceans) and the problems facing it indicate that the blue bond market could grow substantially. Estimates from the United Nations Environment Programme Finance Initiative show that ocean-linked sectors contribute $2.5 trillion to the global economy, supporting over 30 million jobs. Increasing water demand and supply problems worldwide have led to water accessibility challenges for about 2 billion people. Faced with that data, it’s hard to argue against considering this essential new segment of the credit market.

[2] J.P. Morgan High Yield Bond Index Global.
[3] The credit ratings are based on S&P, Moody’s, and Fitch ratings. A rating of “BB” represents the highest-rated high yield rating.
[4] Carry is the excess income earned from holding a higher-yielding security relative to another.

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Fixed-income securities are subject to credit risk, liquidity risk, call risk, and interest-rate risk. As interest rates rise, bond prices generally fall. Investments in **high-yield bonds** involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. Investments in **bank loans** may at times become difficult to value and highly illiquid; they are subject to credit risk such as nonpayment of principal or interest, and risks of bankruptcy and insolvency.

International investments can be riskier than U.S. investments due to the adverse effects of currency exchange rates, differences in market structure and liquidity, as well as specific country, regional, and economic developments. These risks are generally greater for investments in emerging markets.

Blue bonds involve credit risk, interest rate risk and emerging markets risk.

There is no assurance that any positive environmental or social outcome will be achieved.

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Call 1-800-225-5132 to request a prospectus or summary prospectus; each includes investment objectives, risks, fees, expenses, and other information you should read and consider carefully before investing.

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