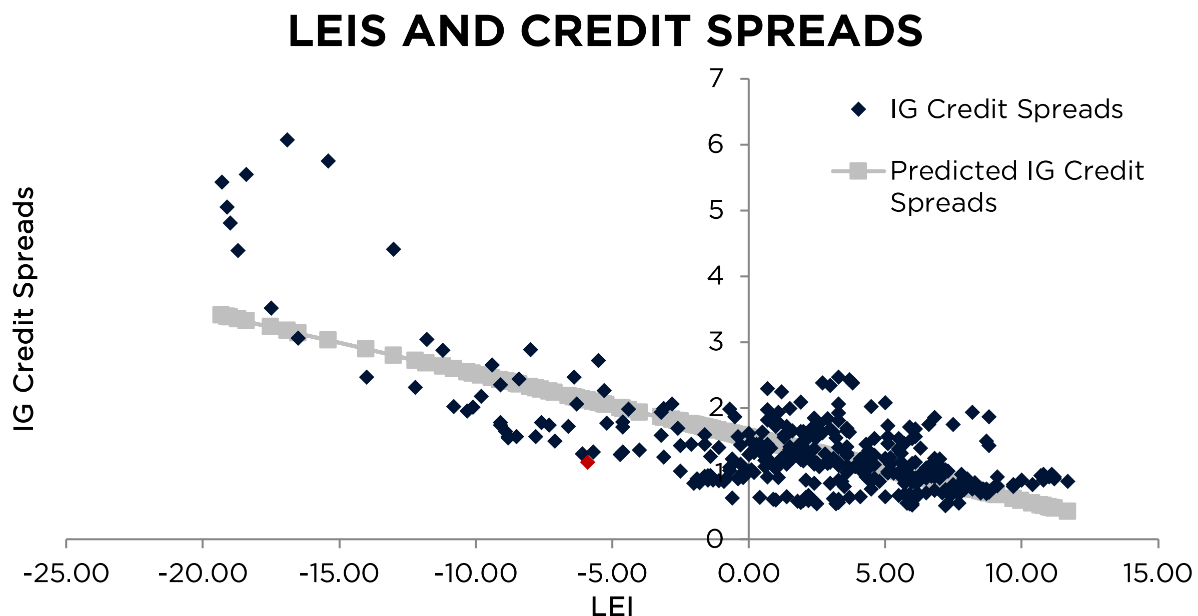
MARCH 2023

BOND iQ
Intra Quarter Update

Are Credit Spreads Out of Sync with the Economy?

After a volatile 2022, corporate bond spreads have steadily tightened so far this year. In fact, the Bloomberg Investment Grade Index OAS has compressed by over 40 basis points since last October, and now sits squarely on historically average levels. However, this improvement in credit markets has not coincided with a corresponding improvement in economic fundamentals. As a result, many investors have questioned the outlook for corporate bond spreads over the remainder of this year. In this month's "BondiQ", we explore the relationship between credit spreads and two important economic variables in an effort to assess the implied fair value of credit spreads.

When it comes to economic data, few variables are as reliable as the Conference Board's Leading Economic Indicators Index ("LEI"). In a sea of backward-looking and sometimes heavily revised economic data, the LEI's have been one of the most stable and accurate forward-looking gauges of the health of economy. In contrast to credit spreads, which have been steadily improving, LEI's remain under pressure. In fact, LEI's are now down -5.9% versus this time last year, a level that is consistent with prior recessionary periods. In a simple regression analysis, LEI's exhibit a statistically significant relationship with corporate bond spreads. As LEI's increase (a sign the economy is improving), credit spreads typically tighten. As LEI's decline (a sign of future economic deterioration), credit spreads have historically widened. In Exhibit 1, we plot the relationship between year-over-year changes in LEI's against Investment Grade Corporate Bond Spreads. As this chart shows, credit spreads have never been *this* tight while LEIs were *this* negative (current reading indicated by the red dot). In fact, this analysis suggests that an LEI level of -5.9% is more consistent with Investment Grade Spreads around 211 bps – almost 90 basis points wider than current levels.



LEIs are not the only indicator consistent with a more sanguine outlook for credit. The Federal Reserve recently released their updated Senior Loan Officer Opinion Survey on Bank Lending Practices. This release showed that banks have considerably tightened lending standards.

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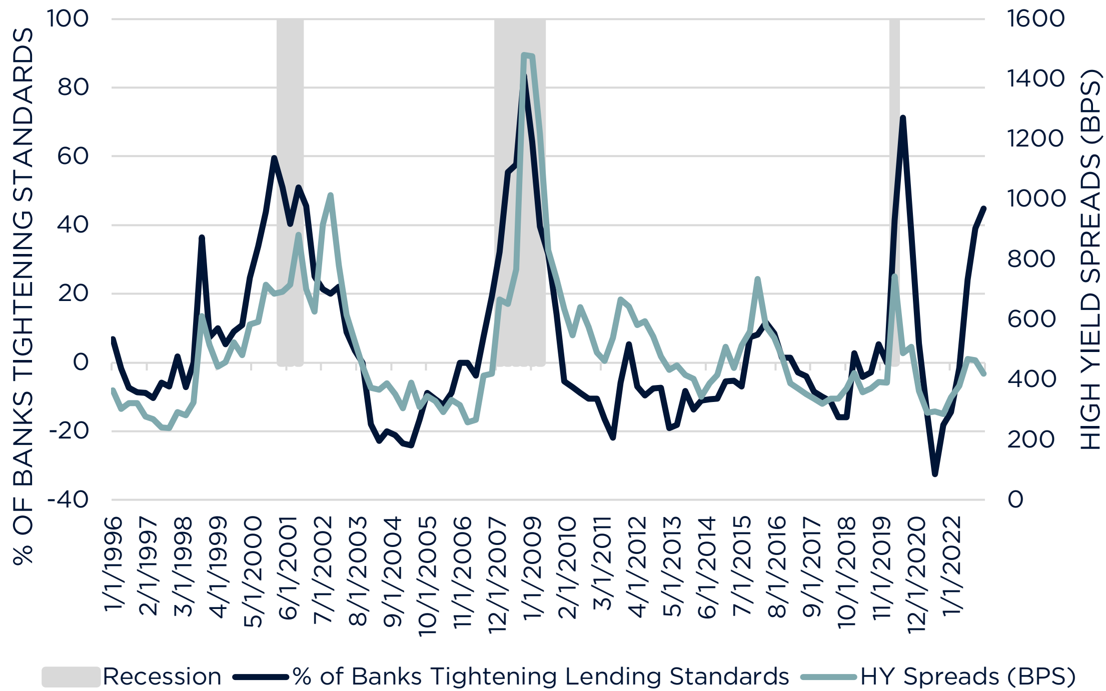
Similar to LEI's, the Loan Officer Survey also exhibits a strong correlation with credit spreads. Intuitively, this makes sense – as banks are tightening lending standards, capital market standards (as measured by credit spreads) grow more restrictive as well. As Exhibit 2 shows, this relationship has recently broken down. In this case, the improvement in high yield credit spreads is inconsistent with an environment where banks are tightening lending standards. In fact, the gap between these two metrics is the widest on record – suggesting that perhaps high yield spreads are also tighter than justified by economic fundamentals.



Ultimately, it's fair to conclude that without meaningful economic improvement, corporate credit spreads may be at risk of widening. Given the Fed remains committed to aggressively tightening policy, we believe that a near-term reacceleration in the economy remains unlikely. As a result, we have been advocates of reducing exposure to low-quality sectors of the fixed income universe, in favor of high-quality Core Fixed Income allocations. Within portfolios, we continue to incorporate a defensive position, trimming tightly trading corporate names in favor of government securities. With yields at multi-decade highs, we believe high-quality Core Fixed Income will once again serve as a hedge against additional equity market volatility, while also offering investors historically attractive income. As we look toward the remainder of the year, the best offense may prove to be a good defense.

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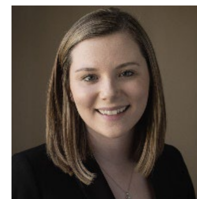

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