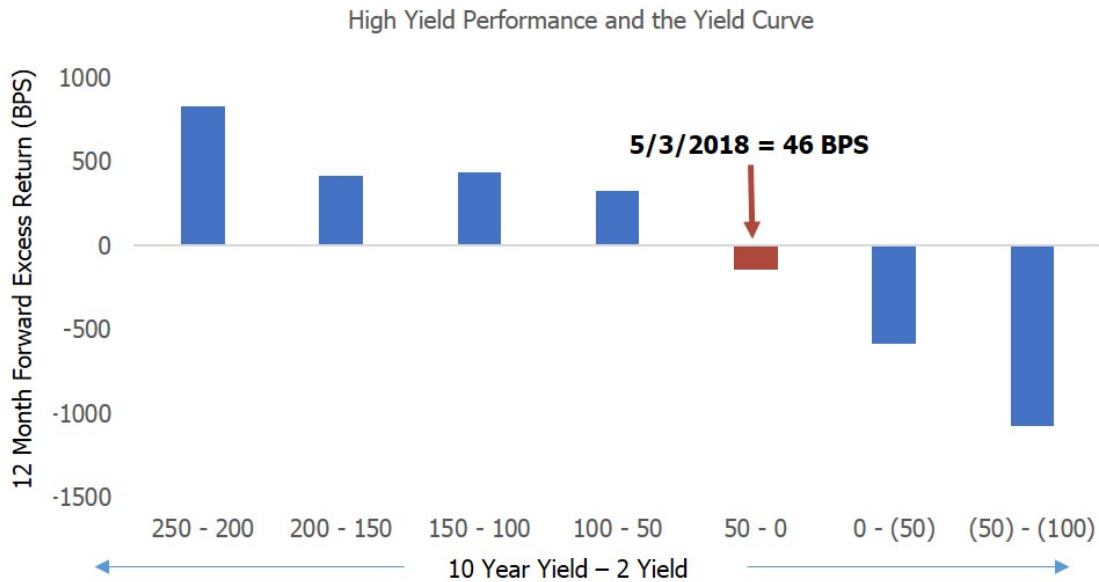


Message from the Yield Curve: Time to Trim High Yield

The yield curve has long been considered one of the most reliable predictors of economic turning points, but its value as a credit risk allocation tool is less well known. Because credit risk cycles tend to align closely with longer term economic cycles, the yield curve has been a helpful barometer for investors who are looking to optimize their exposure to lower quality fixed income sectors. Continued Fed tightening has pushed the spread between two-year and ten-year treasury bonds below 50 basis points – a level that has historically not been supportive of subsequent High Yield returns. As the chart below illustrates, as the yield curve flattens beyond 50 basis points, High Yield has underperformed duration matched Treasuries over the subsequent 12 months on average. For fixed income investors who have supplemented traditional bond portfolios with allocations to “Plus” sectors, now may be a good time to consider trimming exposure to low quality sectors.



In addition to the yield curve’s warning signal for low quality credit, the valuation advantage of owning high yield that persisted throughout the era of zero interest rates has diminished. Fed rate hikes have pushed the yield offered by traditional bond portfolios to their highest level in almost eight years, while fiscal stimulus and a stable economy have tightened High Yield spreads to their tightest level in over a decade. This has narrowed the yield advantage of the Bloomberg Barclays High Yield Index versus the Bloomberg Barclays Aggregate Index to just 297 basis points, well below the ten year average of 519 basis points. Despite our view that the economic recovery is likely to persist well into the coming year, the combination of a flattening yield curve and lack of compelling value offers bond investors who are looking to limit future volatility and dial back risk with a unique and early opportunity to get back to basics.

Brandon Zureick, CFA
Portfolio Manager & Strategist

Dale Coates, CFA
Vice President & Portfolio Manager