



A Franklin Templeton Company

AOR Update: Resilient Economy Gets More Credit

3 June 2024

Key Takeaways

- ▶ Narrowing risk premiums caused Credit Spreads to become the first indicator to turn green this month while Profit Margins improved to yellow, moving the ClearBridge Recession Risk Dashboard closer to an overall green signal.
- ▶ Credit Spreads were one of the first indicators to flash a warning signal as the Federal Reserve ramped up its tightening campaign in 2022 but ultimately proved a false positive due to high-yield issuers locking in low interest rates and exhibiting higher quality than in the past.
- ▶ Improving credit spreads are consistent with diminished risks and rising equity valuations, an encouraging development for long-term investors.

Incorporating an Array of Signals Leads To a Better Informed Outlook

The bond market has often gotten credit for being “smarter” than the stock market. In recent years, however, this maxim has been called into question. In late 2023, Fed Fund futures — a part of the market focused on expectations for short-term interest rates — had fully priced six interest rate cuts in 2024, an outcome that now appears unlikely with less than two rate cuts currently priced. While it’s impossible for any market to consistently predict the future, incorporating signals from an array of asset classes can help investors construct a richer mosaic on the unfolding backdrop than focusing solely on any single area. This is in part why the ClearBridge Recession Risk Dashboard evaluates information from the commodity and fixed income markets, in addition to economic data, to help make an informed decision on the path forward.

One of the fixed income signals the dashboard evaluates is Credit Spreads, which measures the additional compensation investors demand to lend their money to the riskiest corporations (high yield). Bonds of these issuers carry higher risk of default compared with Treasury or even investment grade corporate bonds. While considered the riskiest type of bonds, the high-yield market has funded several blue-chip companies over the years such as Ford, Tesla, Netflix and Uber, in addition to launching entire industries such as shale oil exploration, gaming and cable.

Credit spreads widen when perceived default and downgrade risks are greater and investors require additional compensation, and narrow when perceived risks diminish. In recent months spreads have narrowed considerably, resulting in the Credit Spreads indicator becoming the first green signal on a recovering dashboard. Profit Margins have also improved this month and are now yellow. While the overall reading remains in yellow territory, it has moved closer to green beneath the surface.

Exhibit 1: ClearBridge Recession Risk Dashboard

	May 31, 2024	March 31, 2024	December 31, 2023
Consumer	Housing Permits	●	✘
	Job Sentiment	✘	✘
	Jobless Claims	●	●
	Retail Sales	●	●
	Wage Growth	●	✘
Business Activity	Commodities	●	●
	ISM New Orders	●	✘
	Profit Margins	●	✘
	Truck Shipments	●	●
Financial	Credit Spreads	↑	●
	Money Supply	✘	✘
	Yield Curve	✘	✘
Overall Signal	●	●	✘

↑ Expansion
 ● Caution
 ✘ Recession

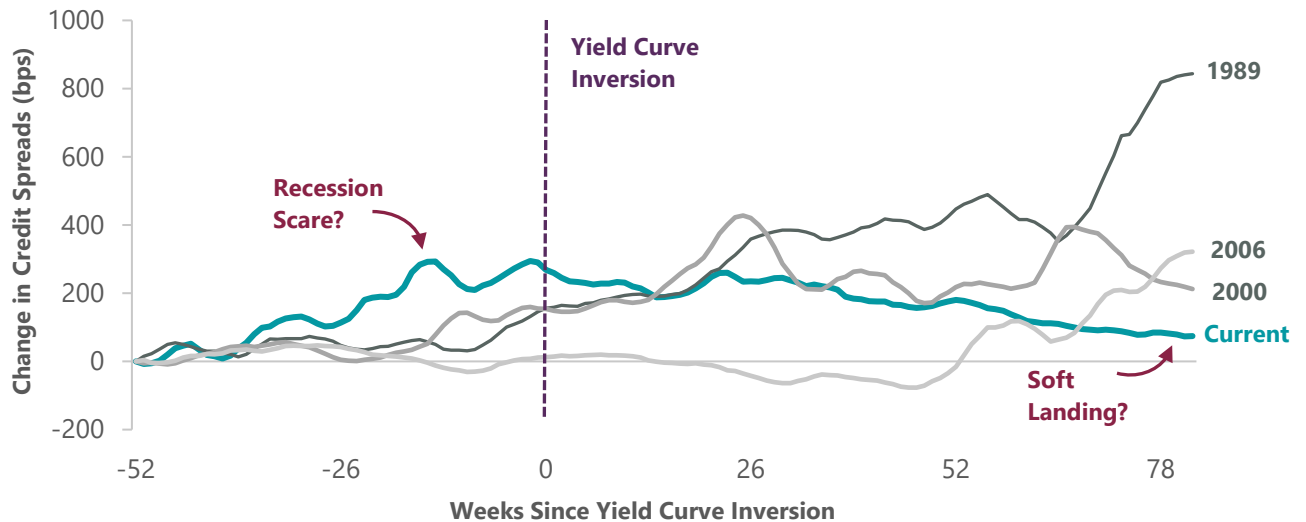
Source: ClearBridge Investments.

Credit Spreads have not been immune from the challenges facing many traditional recessionary indicators in recent years due to the [unique nature](#) of the current cycle. They spiked in early 2020 when the COVID-19 pandemic began to unfold and the likelihood of corporations being able to repay their debts fell. However, the Federal Reserve stepped in to maintain the orderly functioning of capital markets, introducing a novel program to buy corporate bonds.

Under section 13(3) of the Federal Reserve Act, the Fed is able to backstop individuals, partnerships and corporations “in unusual and exigent circumstances,” which the pandemic was deemed to be. Under this authority, the Fed created a host of facilities, including the Secondary Market Corporate Credit Facility, which purchased high-yield ETFs among other instruments. This action — along with the broader fiscal and monetary response — helped stabilize financial markets and credit spreads began to narrow in the second half of 2020. Ultimately, by mid-2021, spreads had declined to the narrowest levels since 1994.

They began to widen again in 2022, however, as the Fed began to rapidly raise interest rates to combat inflation. Investors believed this would lead to increased default risk for highly indebted companies due to rising interest burdens, which could ultimately contribute to a recession. Credit Spreads were one of the first indicators to flash a warning sign, turning yellow just over two years ago (April 2022) and red two months later (June 2022) even as the overall dashboard signal remained green.

Exhibit 2: Credit Spreads & Yield Curve Inversions

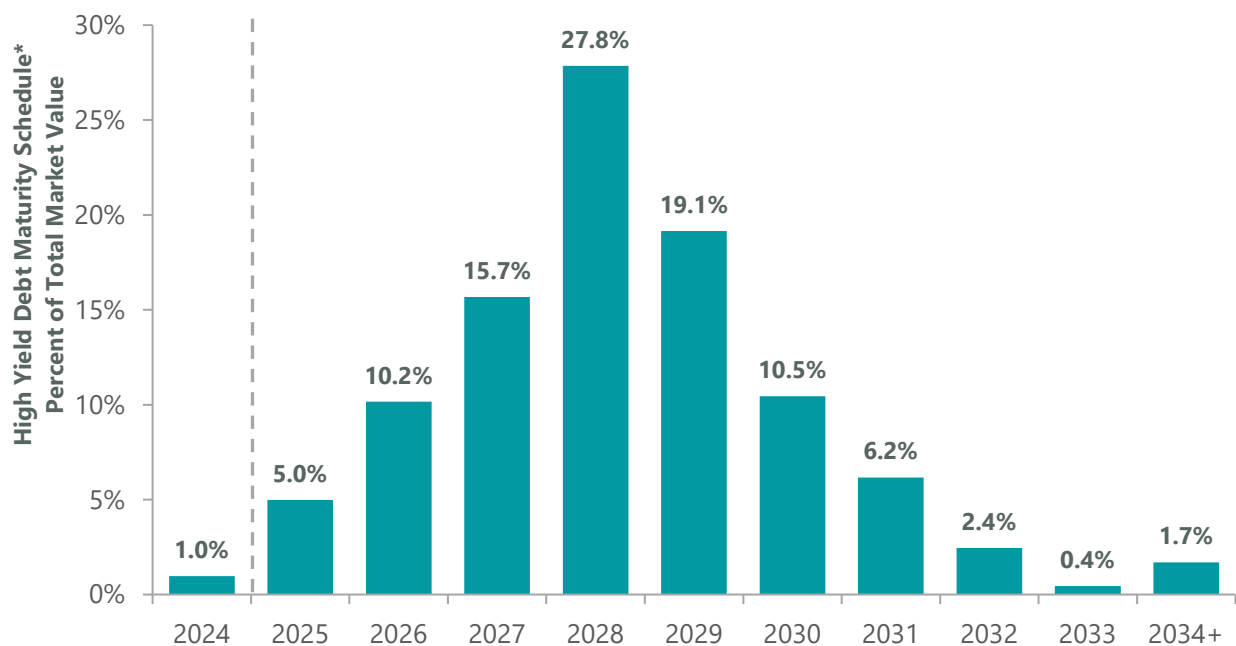


Note: 4-Week moving average. Data as of 29 May 2024. Source: Bloomberg.

Ultimately, this period happened to be the high-water mark for credit spreads, which retrenched moderately and remained largely stable even in the face of concerning developments such as the inversion of the yield curve later in 2022 and the regional bank crisis in early 2023. Credit spreads began to move meaningfully lower in the fourth quarter of 2023 as the prospects of a soft landing increased, a trend that has continued in 2024 and driven the improvement to a yellow signal at year-end and now to green.

We believe several factors contributed to Credit Spreads experiencing a false positive. First, corporations have not been fully exposed to the impact of higher rates given a surge of issuance in 2020 and 2021 that allowed them to lock in historically low rates. A look at the so-called “maturity wall” shows that the near-term rollover risk is low, with a relatively benign percentage of high-yield debt maturing over the next few years.

Exhibit 3: High Yield, Low Refinancing Risk



*The chart represents the amount of high yield debt maturing as a percent of total outstanding high yield debt by calendar year for the ICE BofA ML U.S. High Yield Index. Maturities shown are from 2024 through 2034+. As of April 30, 2024 latest available as of May 31, 2024. Sources: ICE, Bank of America Merrill Lynch Global Research. Due to rounding, figures may not total 100%.

Further, the high-yield market itself has changed in recent years. The pandemic witnessed a wave of “fallen angels” or companies that previously held investment grade ratings but were downgraded to high yield. Many of the factors that contributed to these downgrades were transitory due to temporary pandemic-induced changes and, so far, many companies have proven capable of navigating through tough conditions while continuing to pay their debts. Put differently, the high-yield market is of higher quality today than ratings alone may suggest.

This has driven a divergence within the market, as the riskiest high-yield bonds are still seeing considerable strain. CCC-rated bonds have seen an uptick in defaults, and with the Fed set to continue its “higher for longer” monetary policy stance, it would not be a surprise to see additional defaults in the coming quarters. However, over the past few years, debt holders have increasingly preferred restructuring to bankruptcy when defaults occur, working with companies to keep operations going while cleaning up the balance sheet. This has the effect of protecting jobs when companies run into trouble, boosting the likelihood of a continued economic expansion at the margin. Ultimately, improving credit spreads are consistent with diminished risks and rising equity valuations, and we believe this positive development is an encouraging one for long-term investors.

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