A compelling case for diversification beyond treasuries: Echoes of the mid-1990s

From MacKay Shields Global Fixed Income Team

One benefit of higher interest rates has been that many investors have become comfortable holding U.S. Treasuries, and with good reason—they've served as a low-volatility, liquid core holding. This is particularly true of investors who prefer taking risk in equity markets. However, the current economic and market conditions provide a powerful case for diversifying into a broader set of fixed-income opportunities. By selectively investing in sectors such as agency mortgages (MBS), asset-backed securities (ABS), commercial mortgage-backed securities (CMBS), and corporate debt, we see opportunity to enhance your portfolio's income without taking on outsized risk.

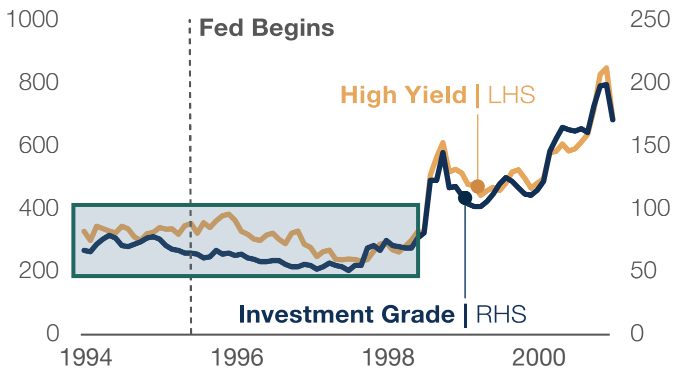
Below, we'll outline how the current environment parallels the mid-1990s—a period marked by an extended economic expansion and range-bound credit spreads (see Figure 1)—and why we believe this backdrop is favorable for taking on a moderate amount of additional credit exposure. We'll also highlight how today's environment differs from the mid-1990s and discuss associated risks you should keep in mind.

A favorable economic backdrop: Parallels to the mid-1990s

THEN

In the mid-1990s, the Federal Reserve was cautiously adjusting monetary policy in a growing economy. Although inflation ran slightly above target at times, strong economic conditions ensured that modest rate increases did not stifle growth. This helped risk appetite remain robust and kept credit spreads tight for an extended period of at least two years.

Figure 1: Mid-1990s: An extended period of tight credit spreads (BPS)



Source: Bloomberg

Indices: Investment Grade = Bloomberg U.S. Corporate Bond Index; High Yield = Bloomberg U.S. High Yield Bond Index. See additional disclosures below.

NOW

- **Steady Growth, Solid Fundamentals:** Much like that earlier era, the economy is on solid footing. Corporate profits are robust, and balance sheets are generally healthy. Ratings upgrades outpace downgrades (except in the lowest-quality categories), and default rates remain contained.
- **Productivity Gains:** Businesses have adapted to challenges from the pandemic era—heightened labor costs, supply chain constraints—by becoming more efficient. Coupled with emerging AI technologies, the potential for meaningful productivity gains provides an additional tailwind for corporate profitability (see Figure 2).
- **Resilient Households:** Low interest rates during the pandemic allowed many households to lock in mortgage rates at historically low levels. This also reduces systemic fragility in the consumer sector (see Figure 3).

KEY TAKEAWAY

Economic conditions strongly support corporate and securitized credit. Spreads may remain range-bound, but that still translates into attractive yield relative to Treasuries.

Figure 2. Business productivity

Average productivity growth by period	
1995-99	2.46%
2010-19	1.27%
2020-24	1.83%

Source: Bureau of Economic Analysis, MacKay Shields.

Figure 3. Household debt service ratio

Data as of December 31, 2024.
Source: Bureau of Economic Analysis.

Attractive valuations in credit markets

When we talk about "range-bound" credit spreads, we mean that even though they are historically tight, they can stay at these levels for an extended period—much like in the mid-1990s. For a portfolio that's primarily in Treasuries:

- **Incremental Yield**—Moving into agency MBS, ABS, CMBS, or corporate bonds provides an opportunity to earn noticeably higher yields than Treasuries. Even if spreads don't compress much further, the additional carry (i.e., extra income) can enhance your portfolio returns over time.
- **Low Historical Default Rates**—In high-grade corporate debt and agency-backed securities, in our view the probability of default is minimal, yet the yield pickup versus Treasuries can be significant. In an environment characterized by steady (if unspectacular) growth, well-managed companies and structured products backed by solid collateral can thrive.

KEY TAKEAWAY

Investors in the mid-1990s who took moderate credit risk were rewarded with higher coupon income while spreads stayed relatively tight. We see a similar opportunity today.

Current volatility as an opportunity, not a threat

We recognize there's uncertainty in the market. A new administration raises questions about fiscal stimulus, trade policy, and regulatory changes. The possibility of shifts in monetary policy adds another layer of complexity. However, for active managers in the fixed-income space, uncertainty can be a source of opportunity rather than merely a risk.

- **Mispriced Credits**—Policy shifts can lead to periods of volatility, during which certain bonds—corporate or securitized—may temporarily trade at wider spreads than fundamentals warrant. This can create an attractive entry point for patient investors.
- **Risk Management**—Because agency MBS, CMBS, ABS, and higher-quality corporate bonds have relatively lower default risk, you can earn incremental yield while still controlling for downside risk. By actively managing sector exposures, duration, and individual security selection, we aim to capitalize on dislocations rather than suffer from them.

KEY TAKEAWAY

In the mid-1990s, Fed policy moves stirred volatility, yet credit spreads still stayed in a favorable range. Today's environment may well yield similar opportunities for active managers to source value as the market digests new policies.

Why move beyond treasuries now?

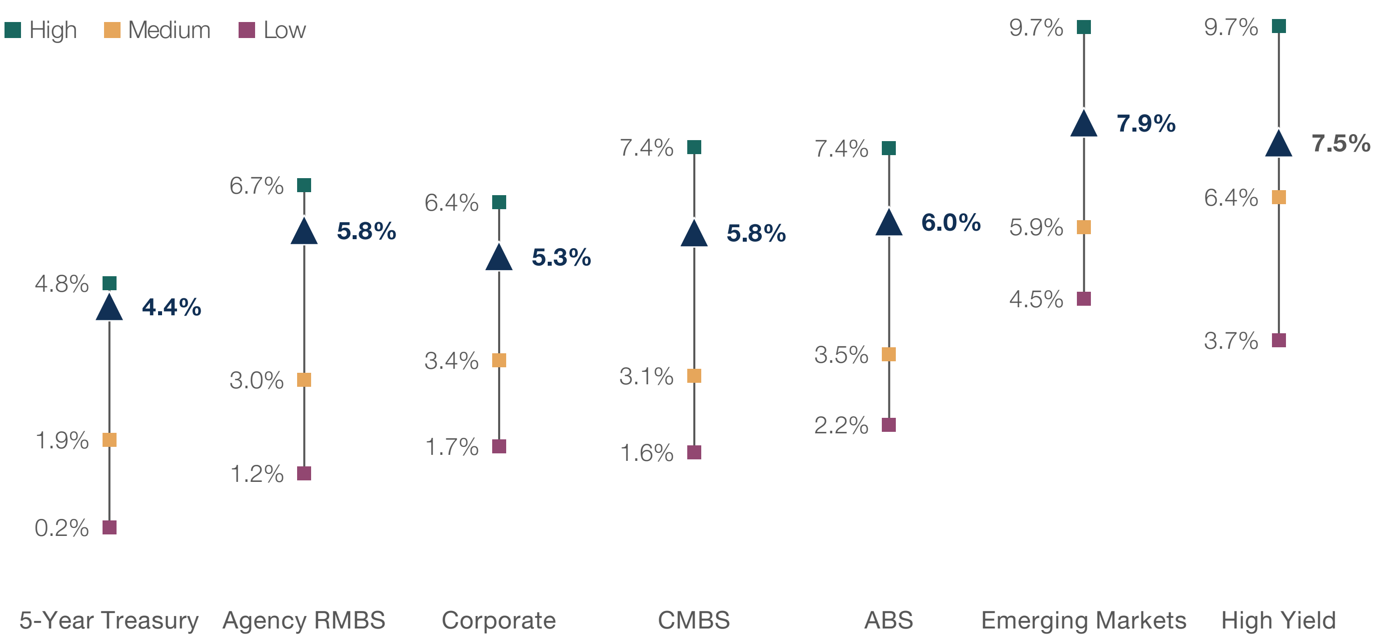
Yield enhancement

Treasuries, while safe, offer limited income in a low-rate environment. Even marginal increases in credit exposure can significantly enhance yield, which can be critical for meeting long-term objectives. (see Figure 4)

Stronger corporate balance sheets

Our research indicates that corporations largely used the low-rate environment to refinance debt on favorable terms. They have higher levels of cash, improved interest coverage ratios, and generally healthier metrics than in past cycles.

Figure 4: Bond yields near 10-year highs across credit markets



Corporates = Bloomberg U.S. Corporate Bond Index; High Yield = Bloomberg U.S. Corporate High Yield Bond Index; Agency RMBS = Bloomberg U.S. Mortgage Backed Securities (MBS) Index; CMBS = ICE U.S. Fixed Rate Non-Agency CMBS Index; Sub. ABS = ICE BofA AA-BBB U.S. Asset Backed Securities Index; Emerging Markets = JP Morgan EMBI Global Diversified Index.

Source: Bloomberg, ICE Data. Data as of 12/31/2024.

It is not possible to invest directly into an index. See additional disclosures below.

Support from housing & securitizations

Agency mortgages and securitized products enjoy substantial structural protections, and these markets have matured significantly in the past two decades. With consumer finances solid, securities backed by consumer loans (e.g., ABS, CMBS) can offer attractive risk-adjusted returns.

Lessons from history

The mid-1990s demonstrated that credit spreads can remain tight for several years during a period of consistent, modest growth. Investors who leaned into credit exposure early found themselves well-compensated for the risk they took on, while still maintaining a prudent level of portfolio resilience.

Key risk consideration: fiscal policy and deficits

While the parallels to the mid-1990s are noteworthy, there is one significant contrast that investors should keep in mind: the current fiscal environment.

Persistent deficits vs. Clinton-era surpluses
In the mid- to late 1990s, government finances improved substantially. The Clinton administration ran budget surpluses, which helped keep interest rates lower and inflation pressures contained. Today, deficits remain wide and are virtually unprecedented in a strong economy.

Potential for sticky inflation
Coupled with substantial fiscal spending, the risk is that inflation remains elevated or "sticky." If the new (or any subsequent) administration enacts additional stimulative measures—whether through tax changes, infrastructure spending, or other forms of fiscal expansion—it could prompt the Federal Reserve to keep monetary policy tighter for longer.

Risk of renewed recession concerns
If higher inflation forces more aggressive rate hikes, that could dampen economic growth and heighten recession risks over time. Elevated deficits also leave less room for fiscal maneuvering in a downturn, increasing potential market volatility.

Despite these risks, there is ample reason to remain constructive on credit markets—particularly as corporate and household balance sheets still look relatively healthy. The key is to monitor developments in fiscal policy and inflation expectations and to remain nimble in portfolio positioning.

Conclusion: A strategic transition in seeking enhanced returns

We appreciate the comfort there has been with U.S. Treasuries, and they will always have a place in a well-balanced portfolio. However, today's environment—echoing many aspects of the supportive conditions of the mid-1990s—offers what we see as a compelling opportunity to diversify into agency MBS, ABS, CMBS, and corporate bonds. The additional yield can enhance your income potential, and active risk management can cushion your portfolio against volatility.

By carefully adding credit exposure, you stand to potentially benefit from the sustained economic cycle, productivity gains, and manageable policy changes. While fiscal deficits and potential policy shifts differ from the mid-1990s, and could lead to stickier inflation and economic uncertainty, active management and thoughtful risk controls can help navigate these headwinds. In short, the rewards of moving beyond "safe haven" assets may outweigh the risks, provided you have the right strategy and manager in place.

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Index Definitions

Bloomberg U.S. Mortgage Backed Securities (MBS) Index—The Bloomberg U.S. Mortgage Backed Securities (MBS) Index tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage.

Bloomberg U.S. Corporate Bond Index—The Bloomberg U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

Bloomberg U.S. Corporate High Yield Bond Index—The Bloomberg U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded.

Bloomberg Non-Agency Investment Grade CMBS Index— The Bloomberg Non-Agency Investment Grade CMBS index tracks the market for non-agency commercial mortgage-backed securities in the United States. The index includes non-agency CMBS conduit and fusion deals with a minimum size of $300 million.

ICE BOfA AA-BBB U.S. Fixed Rate Asset Backed Index—The ICE BofA AA-BBB U.S. Fixed Rate Asset Backed Index tracks the performance of U.S. dollar denominated investment grade fixed rate asset backed securities publicly issued in the U.S. domestic market rated AA1 through BBB3, inclusive.

J.P. Morgan EMBI Global Diversified Index—The J.P. Morgan EMBI Global Diversified Index tracks USD-denominated bonds issued by sovereign and quasi-sovereign entities from emerging market countries. The index caps individual country weights at maximum exposure limits of 10% and redistributes the excess weight to smaller countries to avoid concentration risk.

ICE U.S. Fixed Rate Non-Agency CMBS Index—The ICE U.S. Fixed Rate Non-Agency CMBS Index tracks the performance of U.S. dollar denominated investment grade fixed rate non-Agency commercial mortgage backed securities publicly issued in the U.S. domestic market.

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