Perspectives

Credit markets and the rate spike

from **MacKay Shields Global Fixed Income Team**

March 2021

Steven Friedman

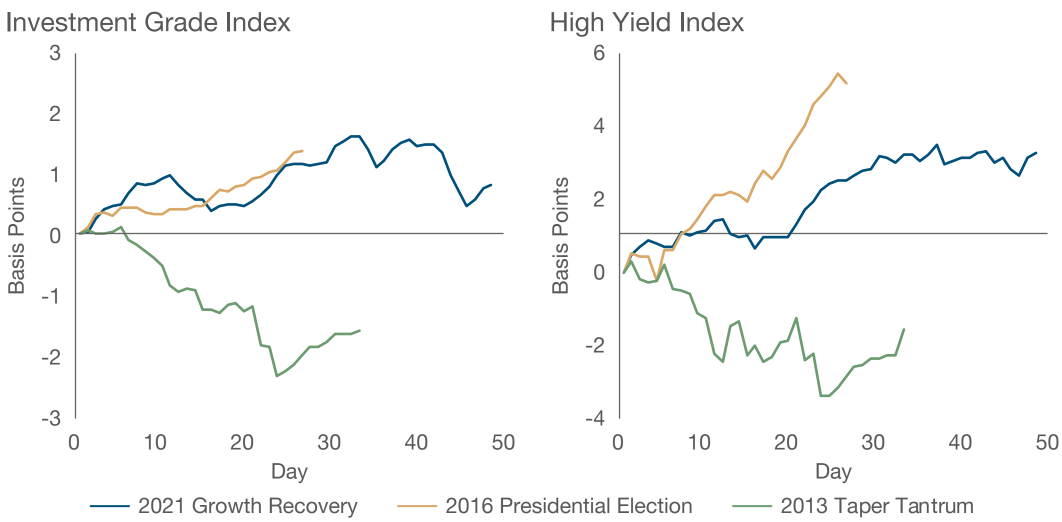
Senior Macro Economist,
Global Fixed Income team
MacKay Shields LLC

Not all periods of sharply rising interest rates are the same – the reasons for a rate rise matter as much as its magnitude and speed. In contrast to the monetary policy-driven Taper Tantrum in 2013, shifting expectations for fiscal policy and growth have driven up risk-free yields this year. This positive fundamental backdrop underscores our constructive view on credit markets in the year ahead.

The recent spike in Treasury yields has drawn comparisons to the 2013 Taper Tantrum, when uncertainty over how the Federal Reserve would adjust monetary policy pushed up yields on ten-year Treasuries by almost 150 basis points over just four months. Superficially, the two episodes share similarities. In both, an unfolding recovery prompted renewed focus on prospects for policy tightening. But we see meaningful differences between them, with important implications for credit markets.

The 2013 Taper Tantrum was primarily a monetary policy shock; investor concerns that the Federal Reserve was making a policy error drove up rates and initially widened credit spreads. This year, by contrast, investors expect sustained fiscal support and the ongoing vaccine rollout to boost the economy. Those expectations have driven up Treasury yields but narrowed credit spreads; both investment grade and high yield debt have outperformed Treasuries **(Figure 1)**.

Figure 1: Cumulative excess returns per basis point rise in 10-year treasury yield[1]



Source: ICE Data, MacKay Shields. As of 3/12/21. High Yield is represented by ICE BofAML U.S. High Yield Constrained Index; Investment Grade is represented by Bloomberg Barclays U.S. Aggregate Bonds. Past performance is no guarantee of future results, which will vary. It is not possible to invest directly in an index. See additional source information below.

A different period of rising rates is more comparable to this year: late 2016, when Donald Trump's election victory sparked hopes that tax cuts and deregulation would boost the economy. In that period, too, investment grade and high yield debt outperformed, as **Figure 1** also shows.

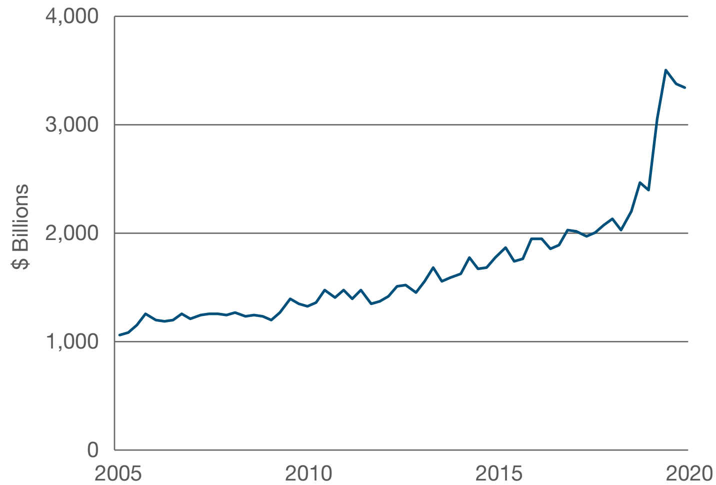
Current outlook for credit

We believe the current environment remains supportive of U.S. credit spreads, particularly the lower-quality portions of the investment grade and high yield markets. We expect stronger consumer spending on the back of the ongoing vaccine rollout and the tailwind from fiscal policy to translate into improved earnings for issuers. Second, we expect the Federal Reserve will continue clarifying its forward guidance on monetary policy, leading investors to reassess their current expectations for asset purchase tapering and liftoff, which in our view are overly aggressive given that it will take some time for the economy to reach maximum employment and for sustained inflation pressures to emerge. Finally, there is a limit to policy-makers tolerance for higher risk-free rates. If a further rise in rates leads to a meaningful tightening of financial conditions, we would expect the Federal Reserve to respond by lengthening the maturity of its asset purchases or even temporarily increasing the pace of purchases.

In terms of corporate credit fundamentals, beyond the positive impact of stronger growth on profits, we have also taken note of management teams finding significant cost savings as they adapted to the pandemic. In addition, management teams took advantage of highly accommodative monetary policy last year to build up precautionary liquidity **(Figure 2)**. This should provide flexibility to adapt to any move higher in interest rates. And looking specifically at the high yield market, the quality mix of the market is extremely high at present. Recent downgrades from investment grade have increased BB-rated credits' share of the index to over 50%; in prior economic recoveries, BB-rated credits typically made up around 45% of the index. At the other end of the credit spectrum, CCC-rated credits now account for less than 10% of the market, compared to over 20% after the Great Recession.

Our constructive view on credit does not necessarily mean smooth sailing in the near term. Most recently, credit spreads have shown greater sensitivity to interest rate volatility, and both the investment grade and high yield markets have given back a portion of their excess returns for the year. If interest rate volatility remains elevated, credit spreads are likely to widen in the near term.

Figure 2: Non-financial corporate cash on hand



Source: Federal Reserve, MacKay Shields. As of 12/31/20. Includes foreign deposits, repo and commercial paper investments.

The next risk event is this week's FOMC meeting. We expect Chairman Powell to push back against market expectations for an earlier withdrawal of policy accomodation. Most effectively, Powell can provide greater clarity on the thresholds for eventual interest rate increases, while continuing to stress that it is too early to begin discussing a tapering of asset purchases. Failing to do so risks more disorderly market conditions and a meaningful tightening in financial conditions. But given our expectations for strong growth and accommodative policy, we would likely view any spread widening as an opportunity to add risk to credit portfolios in those sectors benefitting from the economy's re-opening and improving balance sheets.

Footnotes and references

[1] Excess returns in the three rising rate episodes are based on January 5, 2021 – March 12, 2021 for this year's growth recovery; November 8 – December 15, 2016 for the presidential election episode, and May 21 – July 1, 2013 for the Taper Tantrum. Although rates began rising before May 21 in 2013, we use that date as the start as it was the day of Chairman Bernanke's Congressional Testimony. In the 2013 and 2016 episodes, excess returns are calculated for less than 50 days to correspond to a peak in the 10-year Treasury yield. Excess returns in each scenario are normalized by the yield change in the 10-year Treasury.

Important disclosures

The views expressed herein are from MacKay Shields' Global Fixed Income Team and do not necessarily reflect the views of New York Life Investment Management LLC or its affiliates. New York Life Investments engages the services of affiliated, federally registered investment advisors such as MacKay Shields LLC. The products and services of New York Life Investments' boutiques are not available to all clients and in all jurisdictions or regions.

This material is intended to be educational and informative in nature; is subject to change; and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any funds, financial products, or any particular issuer/security.

The information presented herein is current only as of the date of this report. Any forward-looking statements are based on a number of assumptions concerning future events and although we believe that the sources used are reliable, the information contained in these materials has not been independently verified and its accuracy is not guaranteed.

The information discussed is strictly for illustrative and educational purposes and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. There is no guarantee that any information discussed will be effective or that market expectation will be achieved.

This material contains general information only and does not take into account an individual's financial circumstances. This information should not be relied upon as a primary basis for an investment decision. Rather, an assessment should be made as to whether the information is appropriate in individual circumstances and consideration should be given to talking to a financial advisor before making an investment decision.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the Investment Grade, U.S. dollar-denominated,fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities.

The **ICE BofAML U.S. High Yield Constrained Index** is a market value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities. Issuers included in the index have maturities of one year or more and have a credit rating lower thanBBB-/Baa3, but are not in default. No single issuer may constitute greater than 2% of the Index.

NEW YORK LIFE INVESTMENTS

1892591 MS23c-03/21