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WHERE DO CREDIT SPREADS GO?

In March, we passed a full year since the pandemic interrupted our status quo. Who needs theme parks open when our days are filled with wild rides of reforecasting financial budgets, volatile markets, and twists and turns including an election and uncharted Fed policies? Don't tell Disney, but there may have been a few moments of screaming out loud on my rollercoaster ride this past year!

While we're not out of the woods quite yet, there are expectations of strong GDP growth resulting from vaccine rollout, government stimulus, and accommodative Fed policies. In this newsletter, we explore what this momentum means for long-term borrowing rates. Have we bottomed?

1. Treasury Rates on the Rise
2. Little Room for Spreads to Compress
3. Long-Term Borrowing Costs Have Bottomed Out

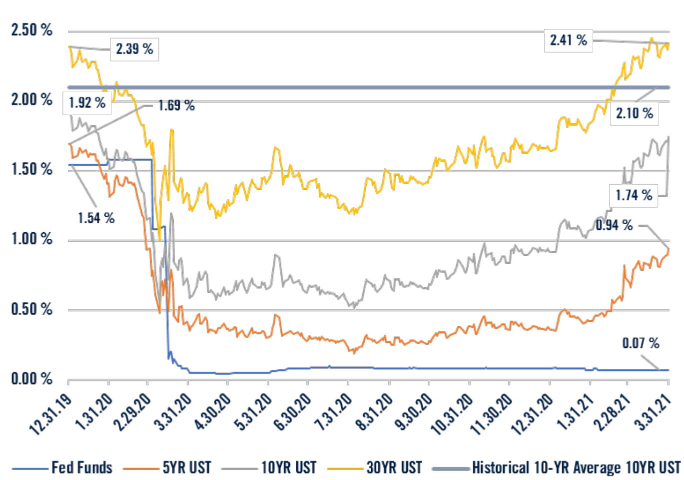
If you anticipate long-term borrowing needs in the next two years, it may be an opportune time to explore locking in rates today.

TREASURY RATES ON THE RISE

Prior to the market dislocation in March 2020, Treasury rates were at all-time lows, with the 10-year US Treasury trading well below the 2.10% 10-year average. Uncertainty arising from the onset of the pandemic drove investors to the safety of US Treasury bonds, causing the 10-year Treasury yield to drop approximately 117bps in 1Q20 to 0.73%.

Despite falling concurrently with the Federal Reserve quickly cutting rates and increasing liquidity in the economy, the drop in long-term Treasury rates was not caused by Fed action alone. While the short end of the curve is affected by Fed policy, longer-term rates are influenced by economic growth and inflation expectations. Throughout 2020, those expectations were heavily determined by the unknown timing of the vaccine rollout and economic re-opening pitted against strong fiscal and monetary support. All these uncertain influences resulted in volatile Treasury markets throughout the year.

Figure 1: LTM Fed Funds and 5, 10, 30 Year UST Rates



Source: Bloomberg

After reaching a new decade-low of 0.51% in August, the 10-Year US Treasury, and long-term rates in general, have been steadily increasing, signaling a coalescing of market expectations around a growth and expansion narrative.

The anticipation of continued economic improvement, supported by significant pent-up consumer demand, coupled with a 10-year UST rate below the decade average, leads us to believe that there is support for higher interest rates.

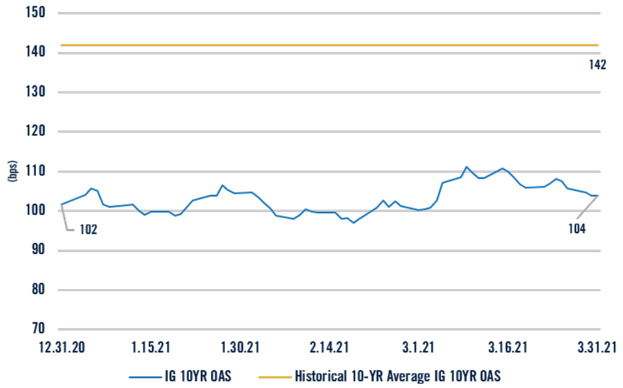
LITTLE ROOM FOR SPREADS TO COMPRESS

Market participants often observe an inverse relationship between interest rates and credit spreads—expectations of economic growth lead to higher treasury rates but lower perceived risk, manifesting into tighter spread levels.

This historical correlation is not as apparent in recent months. Despite the 10-year Treasury increasing 90% or 83 basis points since year-end, spreads have remained relatively flat.

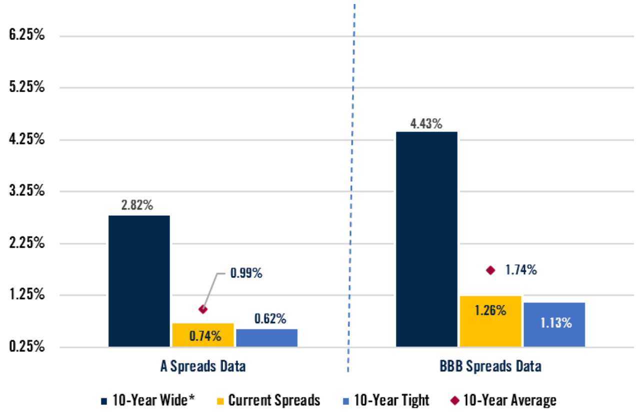
Like treasury rates, spreads are at historic lows with little room left to price in incremental positive economic news, such as the Fed's revised increased economic growth projections. As shown in Figure 3, since hitting a peak in March of 2020, spreads have aggressively tightened to levels that are close to the tightest seen in the past 10 years. This suggests that even with a positive outlook on the economy and robust corporate technicals, it is **unlikely that spreads can compress much further**.

Figure 2: YTD 10-Year U.S. IG Spreads



Source: Bloomberg Barclays US Credit Index. Includes all bonds with a rating of A+ to BBB-.

Figure 3: 10-Year Spreads Overview (%)



*10-Year Wide levels reflect the 2020 peak across both credit qualities
Source: Bloomberg Barclays US Credit Index

LONG-TERM BORROWING COSTS HAVE BOTTOMED OUT

Following the initial downturn in early 2020, the economy has proven resilient and has shown signs of recovery after unprecedented liquidity support provided by the Fed. This liquidity support has continued into 2021 with many market participants anticipating 2021 GDP growth expectations to surpass 6% while inflation expectations have breached 2% for the first time in two years.

Despite this positive economic outlook, spreads are stagnant near historic lows with little room to price in incremental positive news on the economy.

The limited room for spreads to tighten coupled with the forecast of additional increases in treasury rates strongly imply that overall long-term borrowing costs are likely to increase in 2021.