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RMI – Be Ready for the “Credit-Quake”

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There is still plenty of opportunity in the credit markets, but there are warning signs, as well. It is a great time to invest in these markets with a proven risk management system. Since its inception nearly thirteen years ago, the Risk Managed Income (RMI) strategy has skillfully navigated bond markets in many different regimes – bull markets and bear markets, declining rates and rising rates, inflationary and deflationary backdrops. Currently RMI is the top multisector bond separate account strategy in the Morningstar™ database, ranked by risk adjusted returns (5-year Sharpe ratio) for strategies with over \$100 million in assets.

Since the post-pandemic recovery, the RMI strategy has been allocated heavily to credit markets, with a healthy overweight to floating-rate notes. The notable exception was during the extreme volatility events within the bond markets in 2022 and early 2023 when the portfolio was in risk-off mode and invested in money markets. This allocation was not the result of prediction or guessing at the future like most active managers attempt to do. Instead, we measure and react to what the market is telling us at any point in time. If trend and volatility metrics are stable, then we seek yield. That process has led us to a heavy bank loan and high-yield allocation which has rewarded RMI investors.

Over the past four years, credit has been the place to be, as you can see from the chart below (courtesy of Bank of America). We have just witnessed the biggest period of outperformance of corporate debt over Treasury debt ever (and by a large margin). Not only that, but the returns have come with less volatility, as the Bloomberg High Yield Index has

had a lower standard deviation than the Bloomberg Aggregate Index over the past three years.



Chart 1

But what happens next? Every time you hear about the biggest move in the past 100 years, the safe bet is for a reaction in the other direction at some point, but when? Also, credit is expensive. We measure this by looking at credit spreads, the excess yield earned on lower quality high yield bonds over U.S. Treasury bonds. As you can see from the chart below, spreads are at about the thinnest levels that they can be. That said, spreads can stay tight for a long time.



Chart 2

So, what is an investor to do? If it is going to be a soft landing for the economy, then credit should continue to do well, and the tight spreads are justified for now. Some are worried that Trump's policies of tariffs, reduced taxes and more spending could push bond yields higher, maybe from inflation worries or concerns about the debt and deficit, resulting in recession. Recession would be terrible for corporate bonds. However, these same policies could lead to robust economic growth and support domestic companies, which could be great for credit.

The bottom line is that nobody knows. For the past several years, most bond managers have been lousy at predicting the markets. "Getting it wrong" could severely impair portfolio returns. Our process is never "right" or "wrong" because we do not predict. Instead, we measure and react. If the credit markets show signs of deterioration, then we will look for the best yield possible at that time in other areas of the bond market. Otherwise, we will seek shelter in money markets. Bottom line, we have a plan to navigate the unwinding of this trade that we have benefited so greatly on. While the timing of when that will be is unknown, the process is in place and ready to act when needed.

IMPORTANT DISCLOSURES:

Sources include eSignal.com, Bureau of Economic Analysis, Bureau of Labor Statistics and FactSet.

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