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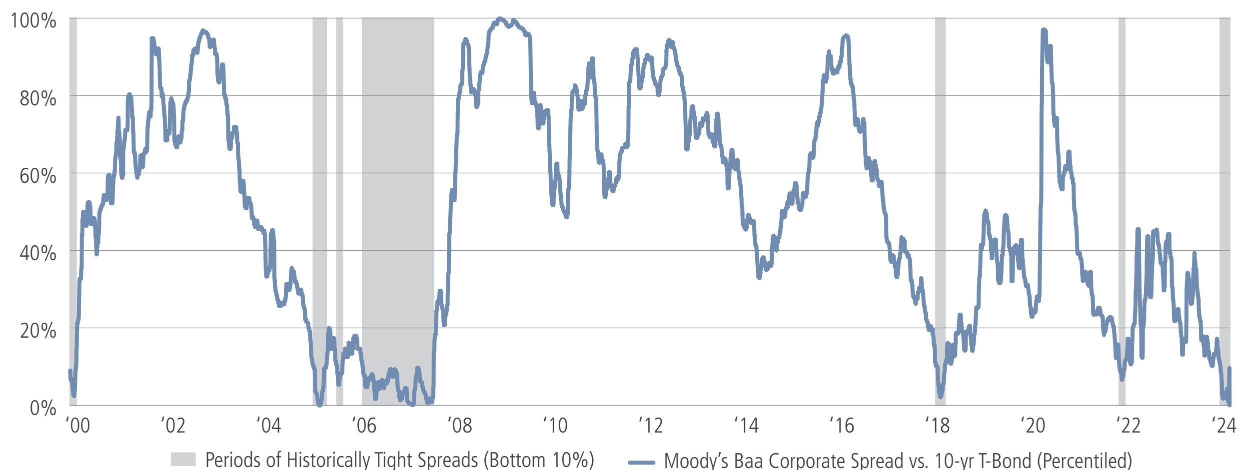
The Importance of Monitoring Credit Spreads In Positioning Equity Portfolios

On February 5, 2024, the yield spread between the Baa corporate bond and the 10-year Treasury bond sat at 157 bps—just 9 bps wider than the narrowest level seen since 2000, a period that included the height of the global savings glut. As shown in figure 1, spreads were tighter during only 0.7% of that stretch.

In this note, we explore the usefulness of credit spreads as a business cycle indicator, and highlight the historical performance of equity indices and sectors as spreads widen from extremely tight troughs.

FIGURE 1: CREDIT SPREADS ARE TOUCHING HISTORIC LOWS SINCE 2000



Source: Neuberger Berman Research and FactSet. Data as of January 31, 2024. **Past performance is not indicative of future results.**

Why Credit Spreads Matter

The track record of credit spreads at heralding rising and fading economic stresses is among the most enviable of all economic indicators. Spreads not only have an optimal -40% to -60% correlation[1] with classic economic indicators (such as the ISM and other leading indicators), they also have the benefit of being *market-based*, thereby offering an arguably timelier gauge of changes in economic activity than more popular indicators published at a monthly cadence.

Over the last 104 years, flaring credit spreads have presaged 16 of the past 18 recessions with an average lead time of four months.[2] In light of the Fed's aggressive tightening campaign, we fear that persistent widening of credit spreads could indicate that the lagged effect of monetary policy has finally gotten the upper hand, and that the implications—for both the economy and asset prices—could be worse than the current consensus expects.

A series of good economic data and accommodative policy can lead to extremely tight spreads, as is the case right now. In our view, this suggests an extremely—and unsustainably—favorable macroeconomic environment and investor complacency; such conditions, we observe, are often followed by extended periods of market and economic volatility during which investors tend to bid up low-risk and defensive assets.

Similarly, we believe widening spreads indicate rising economic stress and slowing growth. When spreads widen to the extreme 10% of all episodes, we find that investors tend to be excessively—and unsustainably—risk averse. Such periods, we observe, are often followed by a rapidly improving growth outlook and investor sentiment, which tend to favor higher-beta, more-cyclical stocks and sectors.

And yet, among equity investors, credit spreads don't often get the credit they deserve when compared with other sentiment-shaping economic and market data, including the ISM, retail sales, employment rates and GDP growth.

Indeed, *we believe monitoring credit spreads is essential when managing equity portfolios and allocating risk among sectors*, especially as spreads revert to the mean from extremes.

[1] Source: Neuberger Berman Research and FactSet, data as of January 31, 2024. Note: We believe this level of negative correlation is significant in that greater (absolute) correlation would imply that spreads were duplicating the information captured by other indicators, while a lower figure would indicate that not enough of the signal corresponds to movements in the economic cycle.

[2] Source: Neuberger Berman Research, Fama French data, FactSet. Data as of December 31, 2023. Note: The two exceptions were the recessions starting in 1926 and 1945. Corporate bond spreads are calculated as Moody's Baa corporate bond yield minus the U.S. 10-year Treasury Yield. Before 1953, long-term government bond interest rates were used.

Potential Portfolio Ramifications of Widening Spreads

In mid-December, Baa spreads had fallen to their lowest-10% range since 2000, and they have been hovering within 0.20 percentage points of that low ever since.[3] We believe this expression of extreme optimism among investors is partially due to the trifecta of ample liquidity, recent economic data suggesting a Goldilocks economy, and potentially optimistic pricing of five-to-six rate cuts by the Fed in 2024.

So what could happen when highly favorable macroeconomic conditions inevitably recede and, as a result, spreads widen out?

For closer historical perspective, consider figure 2: Since 2000, spreads have tightened to the bottom 10% of their historical range on six occasions. Spreads eventually widened from their troughs—often rapidly—during periods of marked equity volatility and rising risk aversion.

FIGURE 2: SINCE 2000, WIDENING SPREADS HAVE FAVORED DEFENSIVE SECTORS

Spreads Trough	Spreads Peak	Days	Spread Widening (bps)	S&P 500	R1K Growth	R1K Value	Russell 2000	Comm Svcs.	Cons. Disc.	Cons. Stpl.	Energy	Financials	Health Care	Industrials	Materials	Technology	Utilities
1/27/2000	10/10/2002	987	235	-40%	-57%	-22%	-33%	-69%	-38%	11%	-10%	-11%	-6%	-29%	-21%	-76%	-41%
3/11/2005	5/18/2005	68	44	-1%	1%	-1%	-3%	-1%	-3%	2%	-9%	-1%	5%	-1%	-10%	0%	3%
8/9/2005	11/22/2005	105	25	3%	4%	3%	4%	0%	-2%	3%	4%	9%	-2%	5%	4%	3%	0%
2/12/2007	12/16/2008	673	468	-34%	-32%	-37%	-39%	-25%	-43%	-6%	-7%	-63%	-21%	-34%	-33%	-32%	-18%
1/31/2018	3/23/2020	782	275	-17%	-6%	-30%	-34%	-12%	-14%	-10%	-65%	-38%	-11%	-36%	-36%	7%	-5%
11/10/2021	3/10/2022	120	69	-8%	-14%	-3%	-15%	-18%	-16%	0%	37%	-8%	-2%	-7%	-7%	-11%	6%
Median		**397**	**152**	**-13%**	**-10%**	**-17%**	**-24%**	**-15%**	**-15%**	**1%**	**-8%**	**-9%**	**-4%**	**-18%**	**-15%**	**-5%**	**-3%**
Sector Rank (Average)				**2**	**3**	**1**	**4**	**10**	**9**	**1**	**3**	**8**	**2**	**5**	**6**	**7**	**4**
Average Beta to S&P 500				**1.00**	**1.05**	**0.97**	**1.12**	**0.88**	**1.04**	**0.56**	**1.00**	**1.29**	**0.73**	**1.01**	**1.03**	**1.21**	**0.64**
Beta Rank				**3**	**2**	**4**	**1**	**7**	**3**	**10**	**6**	**1**	**8**	**5**	**4**	**2**	**9**

Source: Neuberger Berman Research and FactSet. **Past performance is not indicative of future results.**

The median trough-to-peak widening during these episodes was 152 bps over 397 days. During these periods, the S&P 500 declined in all but one case, and the median decline was 13%; other major benchmarks, notably the Russell 1000 Growth, Russell 1000 Value and Russell 2000, shed a median 10%, 13% and 24%, respectively.

Sector performance during these widening episodes is equally instructive: In our historical sample, cyclical sectors performed the worst—including Industrials, Consumer Discretionary and Materials—whereas defensive sectors—such as Consumer Staples, Utilities and Healthcare—held up the best.

As noted above, equity volatility often accompanies the widening of credit spreads from historically low levels. With spreads as tight as they are now, we believe equity investors would be wise to keep aggregate portfolio risk, beta and cyclicality in line with, or lower than, the benchmark.

[3] Neuberger Berman Research and FactSet. Data as of January 31, 2024.

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A bond's value may fluctuate based on interest rates, market conditions, credit quality and other factors. You may have a gain or loss if you sell your bonds prior to maturity. Of course, bonds are subject to the credit risk of the issuer. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the investor's state of residence. High-yield bonds, also known as "junk bonds," are considered speculative and carry a greater risk of default than investment-grade bonds. Their market value tends to be more volatile than investment-grade bonds and may fluctuate based on interest rates, market conditions, credit quality, political events, currency devaluation and other factors. High yield bonds are not suitable for all investors and the risks of these bonds should be weighed against the potential rewards

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