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Bond Market Not Signaling Recession

Spreads are Tight and Credit is Available

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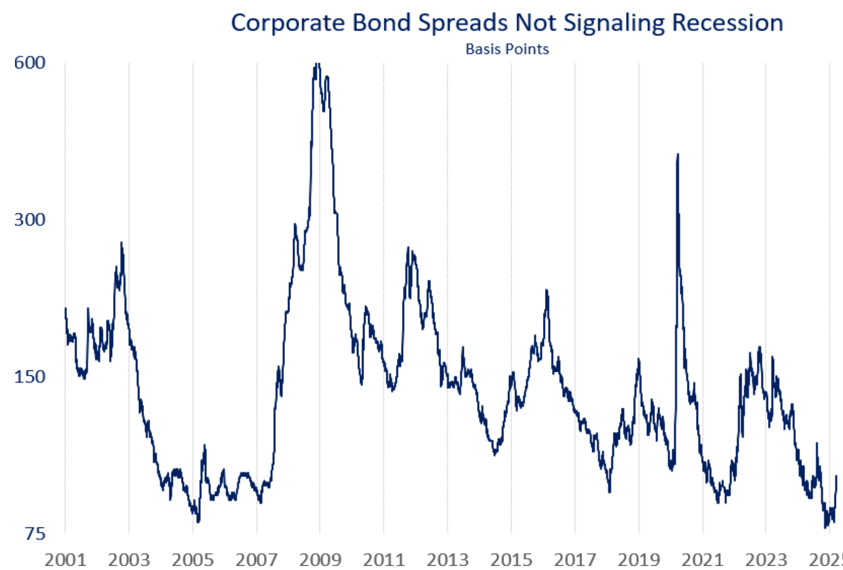
SUMMARY

- The stock market sell-off appears to be signaling a recession.
- However, we believe the bond market disagrees, as spreads are tight, and credit is available.
- The Fed is more aligned with the bond market, based on its pause of rate cuts, in our opinion.

The first quarter of 2025 has been tough for US equity investors, as the S&P 500 has underperformed both international stocks and the bond market. The sell-off caused the S&P 500 to retrace more than 23% of its rally that started in October 2023. During the broad market pullback, the S&P fell into correction territory, falling more than 10% from the February 19th high of 6147 to the March 13th low of 5504. This stock market action seemed to signal that a recession was on the horizon. At one point earlier in March, Fed fund futures were even predicting the Fed would cut interest rates three times this year. In the world of bulls and bears, the stock market has sent investors into hibernation... at a time when the bond market is telling a different story.

Currently, we believe the bond market is signaling that the US economy is stable, despite some signs of growth slowing. The Treasury bond market serves as the benchmark for bond investors when it comes to determining the level of risk being taken. The Treasury market serves as the 'risk free rate' because the full faith and credit of the US government backs the principal and interest payments. The level of risk taken by an investor is determined by the premium "spread" paid above Treasuries with a similar maturity. During robust periods of economic growth, investors are willing to accept a lower spread over Treasuries as the perceived risk is lower. However, during periods of slow growth investors demand a higher premium to compensate for the higher probability of a recession. Using this measuring stick, we will now look at the investment grade corporate bonds and high yield sectors to see how they are perceiving the current market risk.

Investment Grade Corporates: Spreads Remain Tame So Far

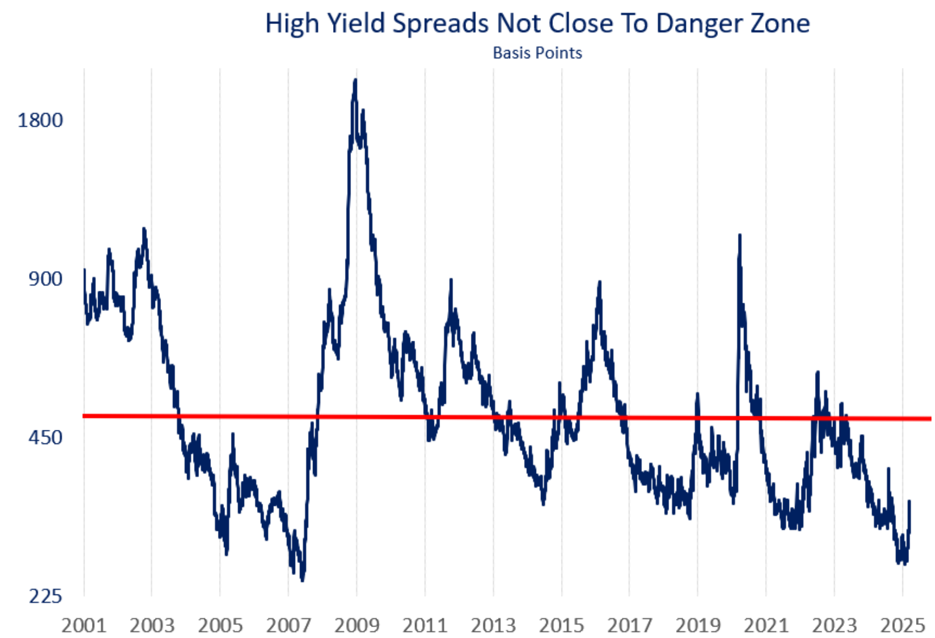


Source: RiverFront, Factset. Data daily as of March 18, 2025. Chart shown for illustrative purposes. Not indicative of RiverFront portfolio performance. Index definitions are available in the disclosures.

Investment grade corporate bonds are currently priced 91 basis points (91/100th of 1% percent) more than comparable maturing Treasuries.

This level has risen from 77 basis points late last year but remains considerably lower than the 20-year average of 155 basis points over comparable Treasuries. During the Global Financial Crisis (GFC) and the pandemic, corporate bonds spreads reached levels of 622 and 401 basis points, respectively. Hence, the investment grade corporate bond market is not signaling a recession… just a moderate slowdown, in our opinion.

High Yield: Spreads Not Close to 'Danger Zone'



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It is comforting to know that the biggest and best rated companies in the US are not experiencing financial stress, but what about their lower rated peers? Similar to investment grade corporate bonds, high yield bonds have experienced an increase in spreads over Treasuries since the start of the year but remain low relative to history. High yield spreads began the year at 259 basis points but have since increased as the economic outlook has dimmed a bit. Currently, high yield bonds are priced 319 basis points higher than comparable Treasuries, which is well below the 20-year average of 510 basis points. Like their investment grade peers, high yield companies saw dramatic spread widening during the GFC and the pandemic. During the GFC, spreads widened to a high of 2147 basis points, and to 1087 basis points during the pandemic as the risk of defaults dramatically increased. Thus, viewing the high yield bond market through this historical lens highlights the overreaction regarding the S&P's pullback from all-time highs over the last two months, in our view. In the chart above, the red line highlights the level where we would become concerned regarding high yield spreads. Currently, we are a long way away from that level of 500 basis points. Hence, we reiterate our stance that the bond market is not signaling the economy is going into recession, as access to credit is readily available for below-investment grade companies based on current high yield spreads.

Federal Reserve: On Hold for Now

Going beyond simply looking at credit spreads, we now turn to the Fed. The Fed reiterated its position at its recent meeting by holding interest rates steady, stating that it is well positioned to wait for greater clarity. The clarity that the Fed seeks is around its price stability mandate, as the ultimate outcome will depend on whether tariffs are a negotiation tool or policy that will significantly impact inflation, in our opinion. We do not believe that the other half of the Fed's dual mandate of full employment is a concern despite unemployment rising slightly to 4.1%. Projected unemployment rates including federal layoffs are still consistent with full employment. Hence, we would say that the Fed is aligned more with the bond market than the stock market, as we think if the Fed were concerned that recession was on the horizon, it would be quick to lower interest rates. Now, that we have established that both the bond market and the Fed are not signaling as recession, let's explore how we believe bonds could help portfolios going forward.

Fixed Income Outlook: Despite Investor 'PTSD', Bonds Are Attractive Again

Bond investing has experienced a resurgence after more than a decade, when investors ignored the asset class due to historically low interest rates. Despite Treasuries that mature two years or later yielding 4 percent or higher, many investors continue to have 'post traumatic syndrome disorder' (PTSD) from the sell-off in the bond market in 2022 that led us to the current environment. It is understandable that investors would worry that their portfolio allocation to bonds will not act as a portfolio diversifier in case of a stock market sell-off. After all, in 2022 when the S&P 500 was down -18%, the Bloomberg Aggregate Bond Index was down -13%. However, this line of thinking has not been successful this year as the Aggregate has returned over +2%, while the S&P 500 is down over -3% on a total return basis. It is important to remember that the starting yield matters when investing in bonds…and yields today are much more attractive than they were in '22. At current levels, bonds can withstand a larger move up in yields before the price depreciation caused by higher yields outweighs the income generation that an investor receives from semi-annual interest payments.

Now that we have reviewed the past, let's turn to the future of bond investing and how investors can use their fixed income allocation to help attain the portfolio diversification that was missing in 2022. Most of the wealth in the US is held by individuals who are either retired or nearing retirement, yet ever since the Great Financial Crisis (GFC) portfolios have become more stock centric due to bonds yielding virtually nothing. Now, with Treasuries yielding 4% or more the stock portion of portfolios no longer must do all the work. For instance, if an investor requires an 8% return annually in a balanced portfolio, stocks only have to produce 4%. This diversification should lower the volatility of the overall portfolio and provide a smoother ride for the investor, in our opinion. Additionally, it can help to better align the risk tolerances of investors with their investment objectives.

Conclusion

The bond market serves as both a recession indicator and portfolio diversifier. With credit spreads sitting close to historical lows, we believe the bond market is not signaling a recession. Given that volatility may persist for an extended period, we believe exposure to the asset class could help manage portfolio drawdowns.

Risk Discussion: All investments in securities, including the strategies discussed above, include a risk of loss of principal (invested amount) and any profits that have not been realized. Markets fluctuate substantially over time, and have experienced increased volatility in recent years due to global and domestic economic events. Performance of any investment is not guaranteed. In a rising interest rate environment, the value of fixed-income securities generally declines. Diversification does not guarantee a profit or protect against a loss. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Please see the end of this publication for more disclosures.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

The Bloomberg Aggregate Bond Index or "the Agg" is a broad-based fixed-income index used by bond traders and the managers of mutual funds and exchange-traded funds as a benchmark to measure their relative performance.

Definitions:

Fed funds futures are financial futures contracts based on the federal funds rate and traded on the Chicago Mercantile Exchange (CME) operated by CME Group Inc. (CME). The federal funds rate is the rate banks charge each other for overnight loans of reserves on deposit with the Federal Reserve.

Diversification does not ensure a profit or protect against a loss.

High yield bonds are debt securities often referred to as "high-yield" or "junk" bonds issued by corporations. High-yield bonds tend to pay higher interest rates because they have lower credit ratings than investment-grade bonds. High-yield securities (including junk bonds) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.

Treasuries are government debt securities issued by the US Government. Treasury securities typically pay less interest than other securities in exchange for lower default or credit risk. With relatively low yields, income produced by Treasuries may be lower than the rate of inflation.

Treasury Bonds is represented by the Bloomberg US Treasury Index which measures the performance of the US Treasury bond market.

US Equities include stocks listed in the United States. Stocks represent partial ownership of a corporation. If the corporation does well, its value can increase, and investors can share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Small/mid-cap equities, MLPs, REITS and alternatives equities are types of US Equities and assume further risks described below.

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A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security. (bps = 1/100th of 1%)

A recession is a significant, widespread, and prolonged downturn in economic activity. A common rule of thumb is that two consecutive quarters of negative gross domestic product (GDP) growth indicate a recession. However, more complex formulas are also used to determine recessions.

Inflation is a gradual loss of purchasing power, reflected in a broad rise in prices for goods and services over time.

The global financial crisis (GFC) refers to a period of extreme stress in global financial markets and banking systems between 2007 and 2009, which changed the financial system culminating in the Dodd-Frank Wall Street Reform and Consumer Protection Act.

When referring to being "overweight" or "underweight" relative to a market or asset class, RiverFront is referring to our current portfolios' weightings compared to the composite benchmarks for each portfolio. Asset class weighting discussion refers to our Advantage portfolios.

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