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High Yield Spreads: The Chicken or the Egg?

Where will high yield spreads be heading, as 2023 closes and 2024 unfolds? Bears point out that those so-called spreads – the yield difference between high yield bonds and theoretically risk-free U.S. Treasuries --- are far from their widest (i.e. highest) historical levels. Indeed, high yield spreads premiums have tended to peak at 10% over Treasuries in serious recessions, and today that level is perhaps only 5%. So isn't the right thing to do, they argue, is to wait until yields rise to those elevated levels and then buy the high yield market? That would be true, if only spreads are destined to get there in the first place.

Of course, the operative phrase above was "in serious recessions", and recession forecasts for the United States have been dialed back, if not in some cases eliminated by economists as 2023 has progressed. Seen in that light, it makes sense that spreads would now be at and then remain at the narrow end of their historical range.

The focus of this article, however, is to point out that **high yields spreads are not only the result of policy….but they can also be the target of policy.** That is because high yield spreads are an important component of broader financial conditions, and central bankers target accommodative or restrictive financial conditions as a tool in and of themselves in order to influence economic activity and the central bank's mandates toward managing inflation and unemployment.

So while it is true that high yield spreads take their cue from economic conditions such as recessions or expansions, central bankers also take their cue from high yield spreads. Indeed, memorably in December 2015 when oil prices were low and this important sector of the high yield market was suffering, former Treasury Secretary Larry Summers looked at the high yield market and argued that the Fed didn't need to raise interest rates because the increase in high yield spreads ranked commensurately with a ¼% rise in the policy rate.

Looked at from this angle, we at Northeast believe that policy makers in no way would target high yield spreads of 10% and, without an outside-influence economic shock creating a recession, there is no impetus from either direction to drive high yield spreads significantly wider. Put more directly: **we do not believe the Fed wants to target any sort of recession that would be associated with 10% high yield spreads.**

Accordingly, we think that the short-hand of relying on the highest historical levels of spreads as a guidepost for 2024 levels ignores the causalities that would be preconditions for visiting those high spread levels, and we do not believe those preconditions will be in place in 2024.

In short, we think high yield spreads will not rise significantly in 2024, and we recommend investors take advantage of today's relatively benign economic conditions and pocket the extra yield that the high yield market offers.

Bruce H. Monrad is chairman and portfolio manager of Northeast Investors Trust (NTHEX), a no-load, high-yield fixed income fund whose primary objective is the production of income. Bruce is among the longest-tenured bond fund managers in the industry, having run Northeast Investors Trust for more than 30 years.

CONTACT: 1-800-225-6704 (M-F 9:00am - 4:45pm EDT); Bmonrad@northeastinvestors.com

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