# Higher For Longer - The Impact on High Yield Spreads

In the last year or so, US Treasury markets have exhibited enormous volatility, with the number of anticipated interest rate cuts by the US Federal Reserve ranging from a high of ten cuts estimated in September 2024 to a low of one cut in January 2025. The act of removing these cuts from expectations means that markets are warming to a “Higher for Longer” scenario, under which interest rates would remain at, or rise from, their current levels over the foreseeable future.

For today, we want explore what a Higher for Longer scenario might mean for high yield spreads, the yield premium garnered by owning high yield bonds as opposed to Treasuries, which are currently at historically tight levels. Unfortunately, the answer is not that simple. The impact on spreads will largely depend on the way markets arrive at a “Higher” level of interest rates.

Generally, there are two ways we would likey find ourselves in a Higher for Longer environment. The first would look like this: the economy is doing well from a GDP perspective, and inflation is also well contained. This would mean that interest rates would remain Higher for Longer because the Fed would have no need to lower interest rates. **In this favorable “Goldilocks” case, high yield spreads would remain near today’s levels in the near term**, because no credit weakness would be the offing: defaults would remain benign, as they have been for years now, and investors would pocket the excess yield premium in high yield. However a prolonged high interest rate environment may put pressure on the lower rated cohort, which would cause spreads to widen back to their historical averages over time.

The second possible path is one where GDP is fine, but inflation proves stubborn and remains above the Fed’s 2% target. In this case, the Fed would need to *raise* rates in order to slow the economy and bring down inflation. The sequencing is that rate hikes would cause the economy to weaken, and defaults would pick up to some degree. Because of this, **high yield spreads would properly rise, the degree of which would intensify as you went down the credit ratings scale** (i.e. CCC rated spreads would rise the most).

Adding it all up, we think high quality, short duration high yield bonds offer the most favorable risk-adjusted means of steering between either of the Higher for Longer scenarios. **Short duration high yield minimizes both interest rate risk and any risk of rising spreads,** while allowing investors to capture the yield premium provided by the high yield market in the event that markets take a different path**.**

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