Alternative Income Solutions, LLC

Is it Time to Buy Bonds?

May 2023

AIS
ALTERNATIVE INCOME SOLUTIONS

Our opinion is no.

With short rates rising above 5% and Ten-Year yields rising to 3.70% (as of May 30, 2023), there is discussion among financial commentators and fixed-income asset managers that now may be the time to buy bonds. There is a certain reflexive logic to this statement as after a period of historically low interest rates and yields have risen substantially. However, there are numerous factors that affect bond prices, including default risk, inflation expectations and availability of credit. Fed Policy is a very important factor, but it is not the only one. If investors purchase bonds for stability, lack of correlation and yield – we are of the opinion that there are significantly better options.

A quick primer. Bond prices have an inverse relationship to yield. Attractive credits can be priced at very narrow spreads to treasury yields (or what were until this month considered risk free) whereas riskier businesses must offer higher yields (wider spreads) to attract interest. During periods of economic expansion or monetary easing, business conditions are favorable, and it is relatively easy to access capital. In an environment where borrowers have an array of options lenders must compete for business and tend to compete on price or the terms/covenants of the offering.

However, as economies enter periods of economic slowdown or contraction, lending standards tighten, availability of credit shrinks and default risk increases. See Warren Buffet's adage re. tides and lack of clothing. This is all Econ 101 – however, in 2023 we have additional risks to consider when evaluating fixed income investments.

- **Inflation** – despite the Fed's suggestion that they may be done with or very near the end of the tightening cycle, inflation remains persistent and troublesome. In the chart that follows you can see that despite the rise in rates, inflation has been exacerbated by the expansion of the Fed's balance sheet and its Quantitative Easing program. The expansion from January 2020 through the peak in March of 2022 was nothing short of breathtaking. The balance sheet more than doubled to nearly $9 Trillion. While the Fed has raised the Fed Funds rate by a full 5%, the 10-year yield is still only 3.70% (as of May 30, 2023) and the balance sheet is still significantly inflated. Milton Friedman once said, "Inflation is always and everywhere a monetary phenomenon." The graph below agrees with him as does this writer. The Fed has barely started their *Quantitative Tightening* campaign. Normalizing the balance sheet will require the market to absorb trillions of dollars in refinanced debt, likely placing additional upward pressure on yields (downward pressure on price) over time.

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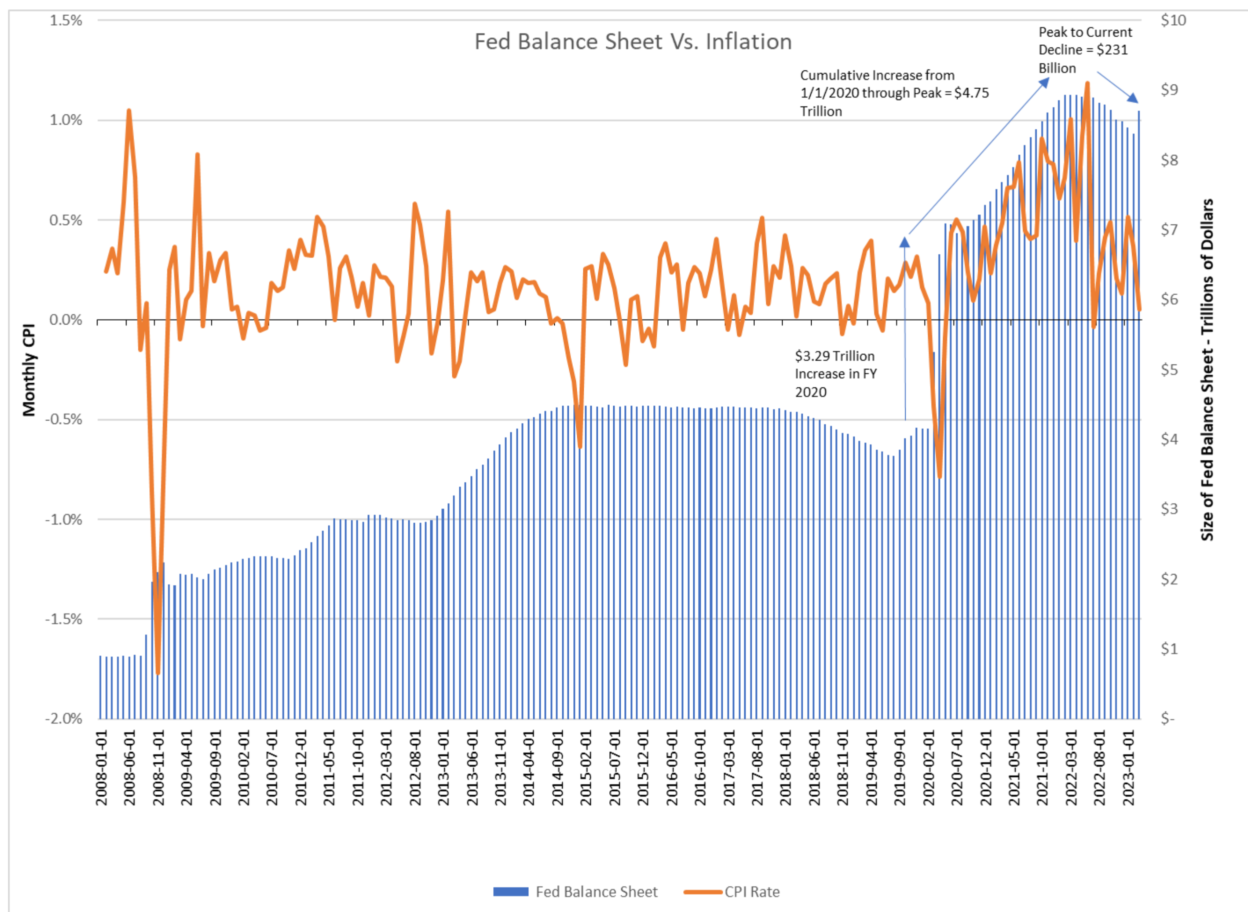

U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average [CPIAUCSL],
Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL]
Retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPIAUCSL, May 15, 2023.

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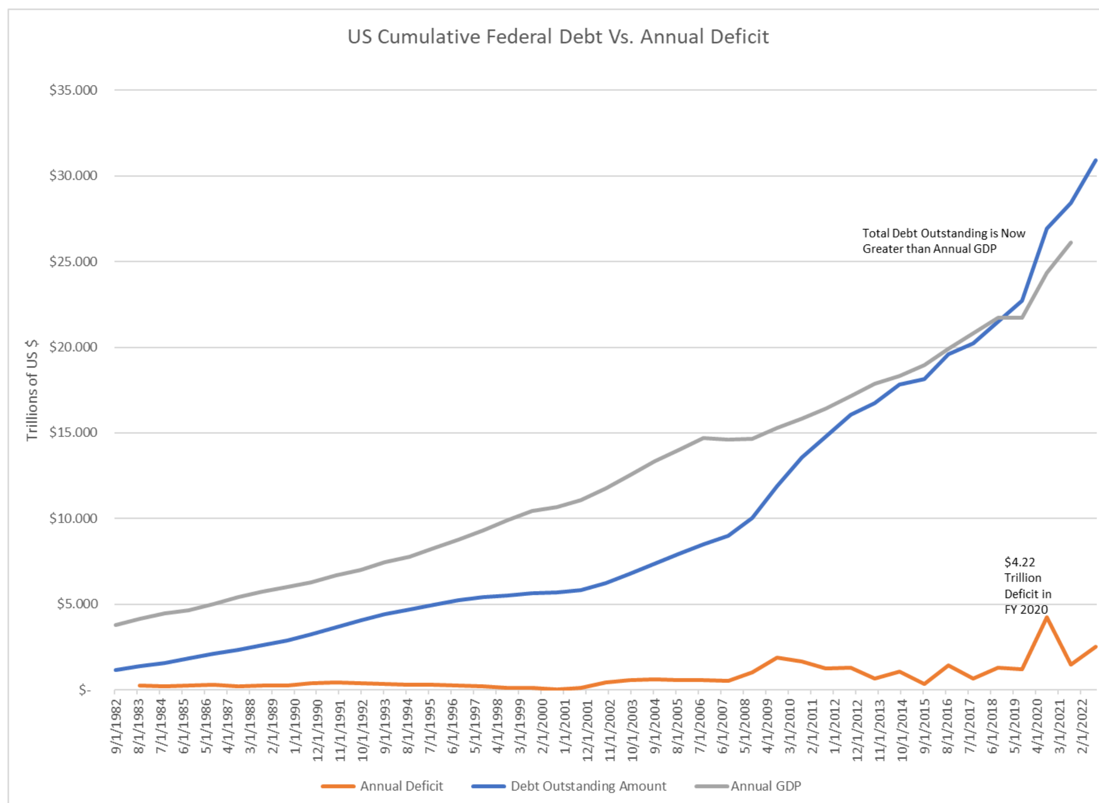
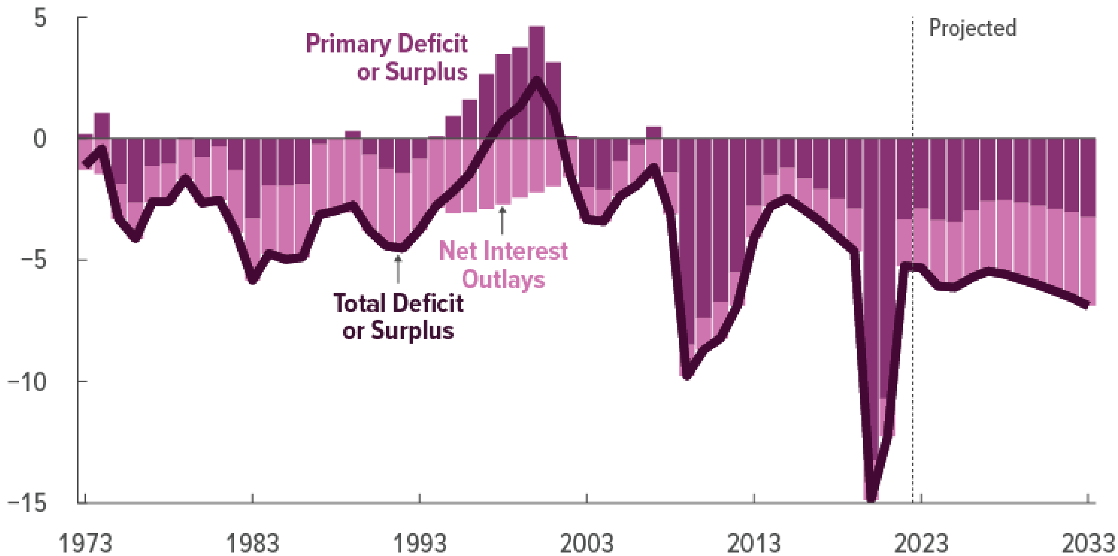
- **The National Debt** – At the same time that the Fed has signaled its intentions to shrink the balance sheet, Congress and the White House are negotiating over the debt limit. Whether you believe that spending needs to be cut or that tax rates need to go up, one thing is for sure: we are at or near dangerous levels of debt. It has been conventional wisdom that once a country reaches debt levels in excess of 100% of GDP, there will be consequences. The main one being higher interest rates. We crossed that line in 2018. This isn't a political argument, as both parties have had control of both the White House and Congress since 2001 and in that period each Congress and each Administration, regardless of party, have done their part to exacerbate the problem and get us to this point. We have record debt, and a significant amount of that debt was purchased by the Fed with newly created money (in both 2008-09 and in 2020-21). We will now have to fund the additional debt that will be created over the next decade (likely) without the help of the Fed. The cuts that are being discussed by both parties are not cuts to the existing debt, but rather cuts to the projected increase in debt over the next decade. At the same time, existing debt held by the public and the Fed will mature and will need to be refinanced at higher rates and absorbed by the public. The higher rates will further exacerbate the deficit in the coming years necessitating more borrowing and putting even more upward pressure on rates.



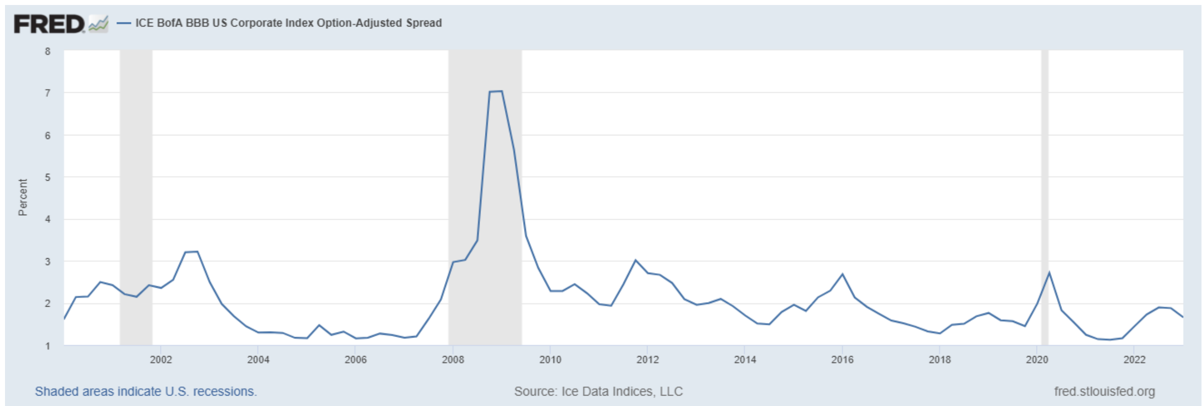
Source: U.S. Department of the Treasury. Fiscal Service
U.S. Department of the Treasury. Fiscal Service, Federal Debt: Total Public Debt [GFDEBTN],
U.S. Bureau of Economic Analysis, Gross Domestic Product [GDP]
U.S. Office of Management and Budget, Federal Surplus or Deficit [-] [FYFSD]
Retrieved from FRED, Federal Reserve Bank of St. Louis;
https://fred.stlouisfed.org/series/GFDEBTN, May 15, 2023.



[Congressional Budget Office](https://www.cbo.gov/publication/58946)
https://www.cbo.gov/publication/58946

In CBO's projections, net interest outlays increase by 1.2 percent of GDP from 2023 to 2033 and are a major contributor to the growth of total deficits. Primary deficits (that is, revenues minus noninterest outlays) increase by 0.4 percent of GDP over that period.

- **Default Rates** – In a recession, default rates tend to increase. We are not currently in a recession, but inflation has remained persistently high, and the Fed is working to bring it down. They have raised rates significantly and rapidly and say that they will proceed with Quantitative Tightening. At the same time, banks are having their own problems and are tightening credit. Each of these things will ultimately lead to a contraction of credit and, likely, a recession (or at a minimum, slower growth) and that will likely lead to higher default rates. As can be seen below, corporate bond spreads tend to widen in recessions to reflect the increased risk of default. If we do enter a recession, corporate bond spreads are likely to widen (perhaps significantly) resulting in higher yields when we do.



Ice Data Indices, LLC, ICE BofA BBB US Corporate Index Option-Adjusted Spread [BAMLC0A4CBBB], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BAMLC0A4CBBB, May 15, 2023.

Our preferred domain for yield is Specialty Finance. We are seeing more opportunity to obtain highly secured cash flows at higher rates as credit is tightening. These assets tend to be high yielding, highly secured and of short duration. While these assets do not offer the daily liquidity characteristics of public fixed-income, they offer predictable liquidity with monthly or quarterly cash flows. The risk tends to be low as these cash flows are secured by assets. The short duration of these investments also allows the portfolio yield to rise as interest rates rise.

While our view may be biased, we believe the data supports the belief that public fixed-income will continue to be challenged in the coming months and years. Those who are seeking stability and diversification should be wary of buying bonds at current levels and should consider other alternatives.

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