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4 April 2024

AEGON Asset Management

AEGON **INSIGHTS**

Fixed Income Opportunities: Evaluating Spreads vs. Yields

Rising rates have led to attractive yields across the fixed income market. However, corporate credit spreads are tight. This leaves many investors grappling with the valuations conundrum, as they debate yields versus spreads to determine their fixed income allocations. Will slowing economic conditions result in spread widening? Do higher yields provide a sufficient cushion against downside risk? And is now the time to add fixed income exposure?

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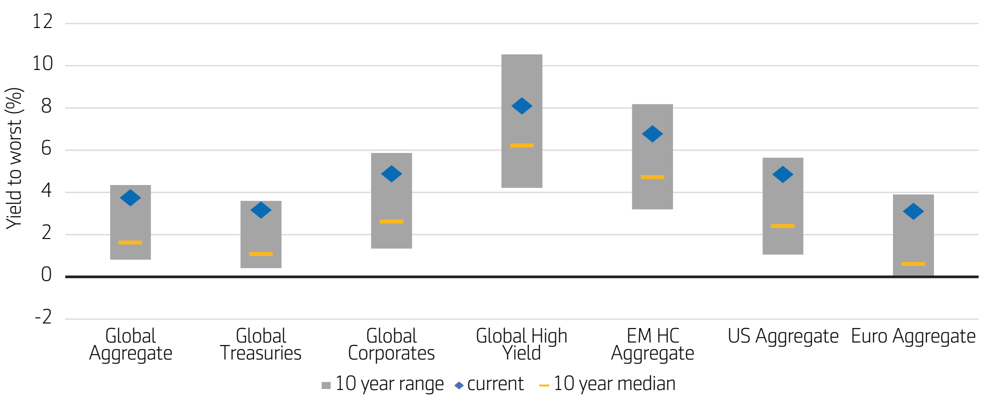
In our view, it's not too late for fixed income investors to take advantage of elevated yields.

Spreads have narrowed, but yields remain attractive

Corporate bond spreads have narrowed to lows not seen since 2022. As the cycle extends and economy slows, it is no wonder investors are starting to worry about potential spread widening given the upside for capital returns is now more limited.

However, the attractiveness of asset classes can be evaluated using various metrics including yields, spreads, expected returns, etc. Many fixed income assets have the potential to offer higher yields than has been normal in the last decade. Fixed income also offers the potential for enhanced income as coupon rates have reset higher. While spread levels look less compelling, all-in yields and higher coupons remain attractive.

Exhibit 1: Current yields are still well above 10 year medians



Source: Bloomberg as at March 29, 2024. Based on monthly yield-to-worst data from the Bloomberg Global Aggregate Total Return hedged to USD Index, Bloomberg Global Treasuries Total Return hedged to USD Index, Bloomberg Global Aggregate Corporate Total Return hedged to USD Index, Bloomberg Global High Yield Total Return hedged to USD Index, Bloomberg EM Hard Currency Aggregate Total Return hedged to USD Index, Bloomberg US Aggregate Total Return unhedged USD Index, Bloomberg Euro Aggregate Total Return hedged to USD Index. Past performance is not indicative of future results. For illustrative purposes only. Based on index data from March 31, 2014, to March 29, 2024. Indices do not reflect the performance of an actual investment. It is not possible to invest directly in an index, which also does not take into account trading commissions and costs. Statements concerning financial market trends are based on current market conditions which will fluctuate. All investments contain risk and may lose value.

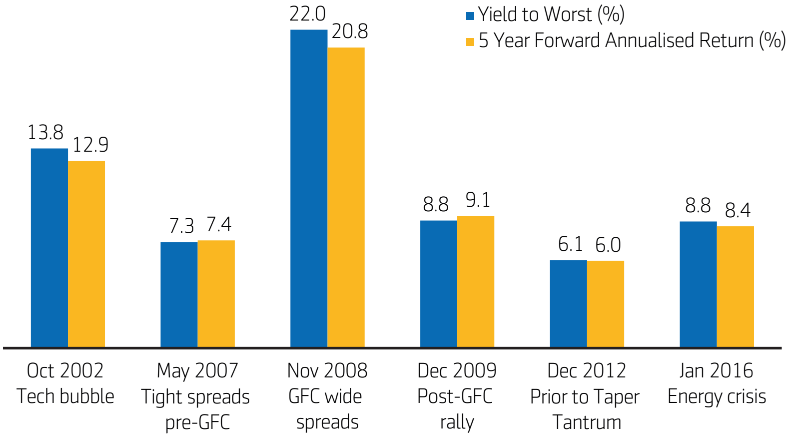
Past performance doesn't predict future returns, but can yields?

Although spreads are tight, investors mustn't lose sight of the bigger picture. Historically, and over the long term, the starting yield has been a steady indicator of future long-term total returns.[1]

As shown below, the starting yield-to-worst for the high yield index has been close to the subsequent annualized five-year return. This relationship has generally held true in strong and weak economic environments, as well as periods with tight and wide spreads, With high yield corporate bonds offering a starting yield to worst around 7.6%[2], we continue to like the asset class on a yield basis.

Exhibit 2: Starting yields have been a reasonable estimate 5-year returns

ICE BofA Global High Yield Index monthly YTW and forward 5-year index returns



Source: Aegon AM, Bloomberg, ICE BofA. The chart is based on monthly ICE BofA Global High Yield (HW00) index data and includes the index YTW and forward five-year annualized return in local currency. Past performance is not indicative of future results. For illustrative purposes only. Indices do not reflect the performance of an actual investment. It is not possible to invest directly in an index, which also does not take into account trading commissions and costs. Statements concerning financial market trends are based on current market conditions which will fluctuate. All investments contain risk and may lose value.

Enhanced breakeven rates

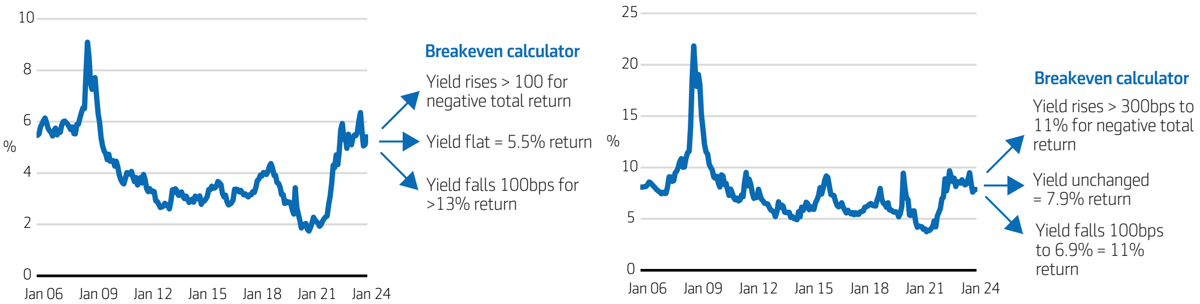
Even if spreads or yields widen from here, the breakeven rate for bonds is now considerably more attractive. The breakeven rate measures how high yields (or spreads) would need to rise before the total return of a bond becomes negative, typically over a one year time horizon. The total return of a bond has two components: price return and income return from coupon payments.

Prior to 2022, there was little income or yield available from newly issued bonds as markets had a prolonged period of low interest rates. However, as rates have shifted higher, yields across fixed income have risen and newly issued debt now offers higher coupon rates. Therefore, bond prices can now fall by a much greater degree before the total return becomes negative. For example, the yield on the Bloomberg US High Yield Bond Index can rise from the current level of 7.9% to over 10% over one year- through wider spreads and/or higher US Treasury bond yields - before total returns break even. For US investment grade, yields can widen by as much as 100 bps before certain investments lose money. This cushion is the biggest it has been for over a decade.

1 There is no guarantee any investment will work under all market conditions or is suitable for all investors. Each investor should evaluate their ability to invest over the long-term, especially during periods of increased market volatility.

2 Based on index yield-to-worst data as at 29 March, 2024, for the ICE BofA Global High Yield Index.

Exhibit 3: Enhanced breakeven profile for corporate bonds



Source: Aegon AM, Bloomberg as at February 29, 2024. Based on monthly yield to worst data for the Bloomberg US Corporate and Bloomberg US Corporate High Yield indices. Past performance is not indicative of future results. For illustrative purposes only. Based on index data from January 1, 2006, to February 29, 2024. Example breakeven figures are calculated using Bloomberg FIHZ function which calculates the total return on a selected bond for a selected horizon period, discount yield at the horizon date, and the reinvestment rate. Indices do not reflect the performance of an actual investment. It is not possible to invest directly in an index, which also does not take into account trading commissions and costs. Statements concerning financial market trends are based on current market conditions which will fluctuate. All investments contain risk and may lose value.

While there are attractive opportunities for fixed income investors to take advantage of current yields, we are cognisant that risks remain. While not our base case, reacceleration in inflation or a deeper-than-expected recession, could impact future returns. A sharp focus on selection can help investors capitalize on market inefficiencies.

Asset Management

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