Three reasons to allocate to short duration high yield in 2025

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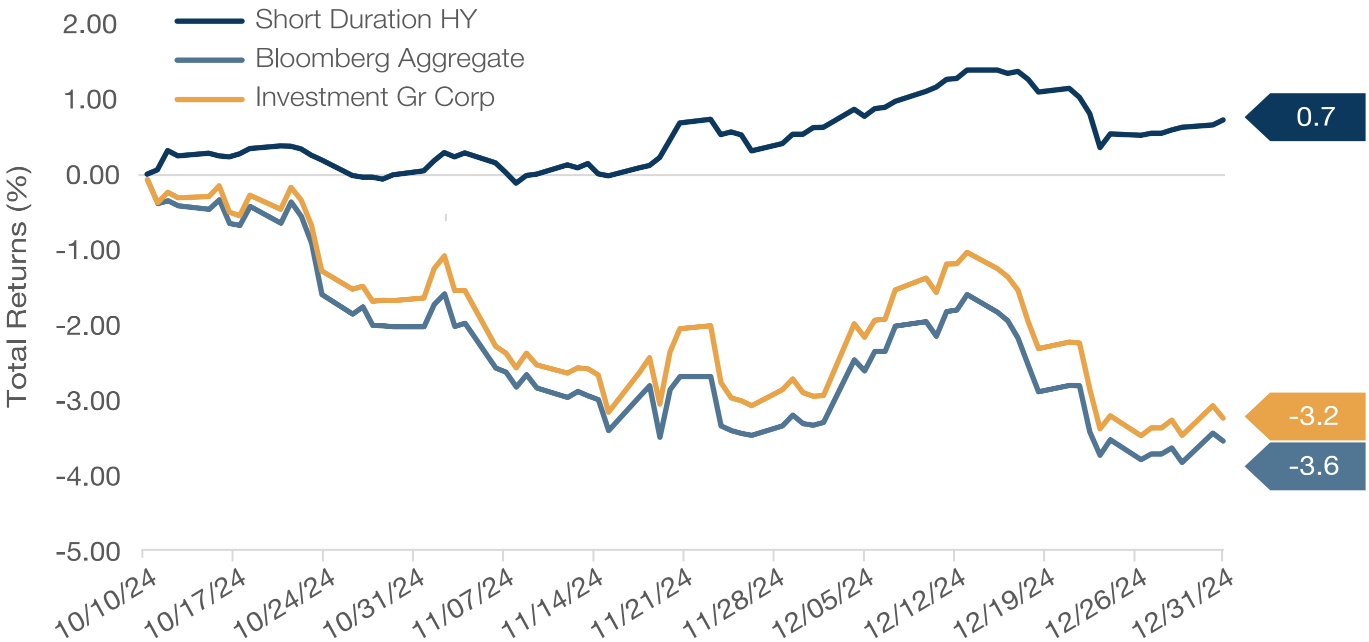
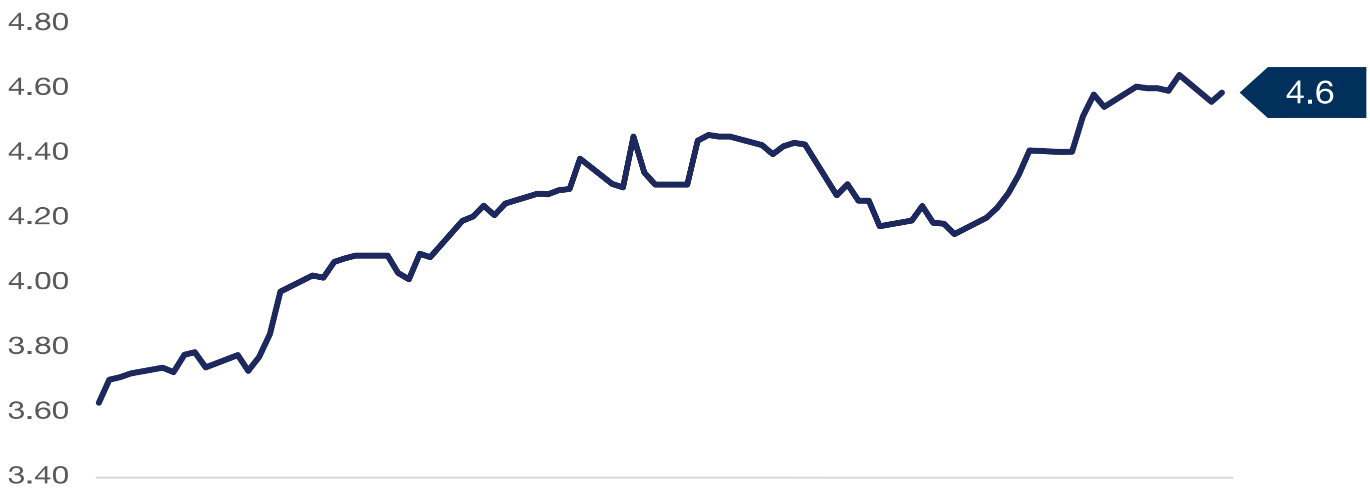
#1 Rate Uncertainty – Short Duration High Yield Is Less Sensitive to Interest Rates

When the Fed cut rates in September, many expected Treasury rates to fall based on flows into Intermediate Core and Intermediate Core Plus funds. In fact, they had been trending downward during the months leading up to the rate cut. However, after that first 50-basis-point rate cut, the 10-year Treasury yield actually increased 100 bps, ending the year close to 4.60%. During that time, the Bloomberg Aggregate Index declined 3.6%, and investment grade corporate bonds lost 3.2%. During the same time period, short duration high yield returned 0.7%, demonstrating lower sensitivity to interest rates. For the 2024 calendar year, short duration high yield returned 7.1%, significantly outperforming core and investment grade corporate bonds which returned 1.3%, and 2.8%, respectively.

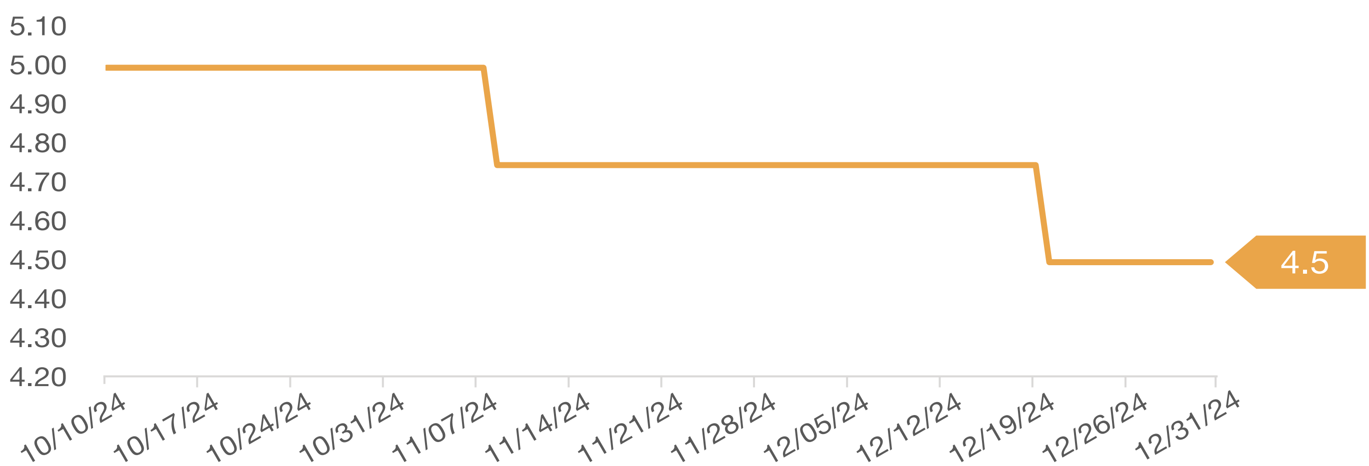
Chart 1: Short duration high yield outperformed investment grade since the first Fed rate cut



10 Year Treasury



Fed Fund Target Rate



Source: FactSet as of 12/31/2024. Past performance is no guarantee of future results, which will vary. It is not possible to invest directly in an index. Short Duration High Yield represented by ICE BofA Cash Pay High Yield (1-5 Y)(BB-B) Index. Investment Grade Corporates represented by ICE BofA US Corporate Index. Treasury Securities are backed by the full faith and credit of the United States government as to payment of principal and interest if held to maturity. Interest income on these securities is exempt from state and local taxes.

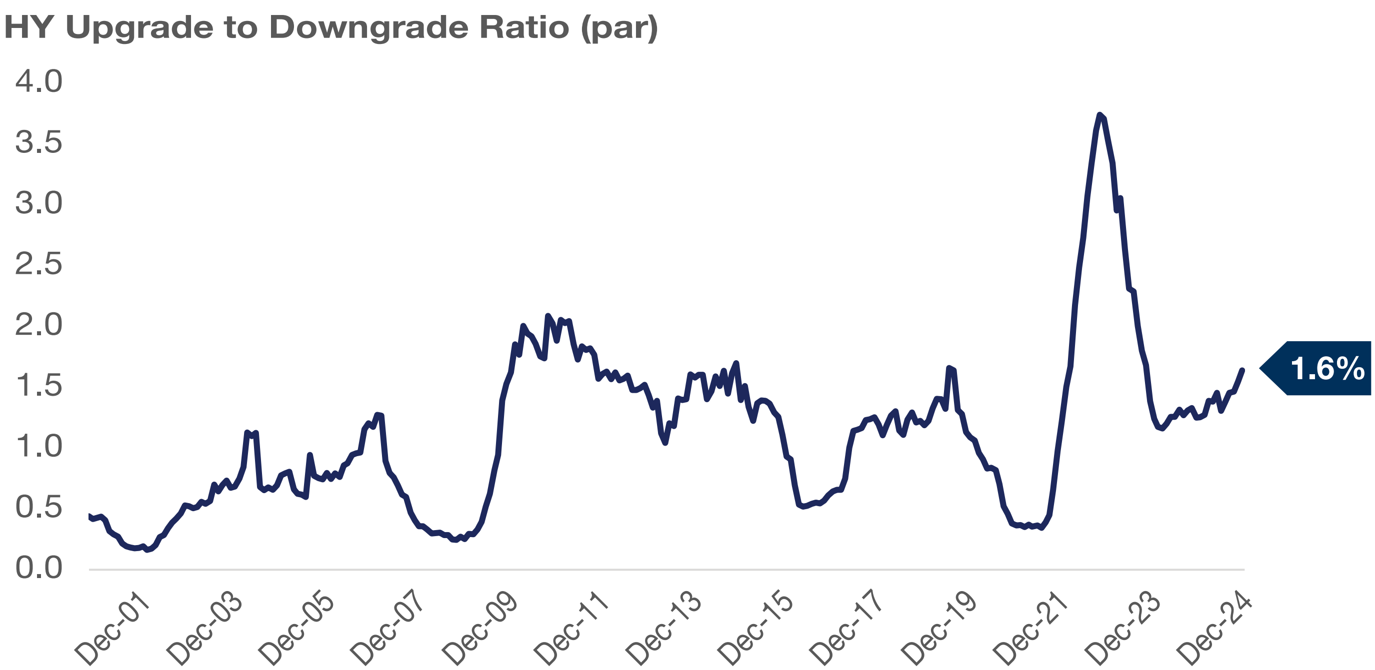
High yield bonds are more credit sensitive than rate sensitive bonds, and their performance is generally more correlated to the economy and health of corporate issuers than to Treasury rates. With a stronger growth outlook held by many strategists, it is possible that the 10-year does not drastically decline any time soon. In that case, we believe a "credit/duration" barbell is an effective way of seeking to generate income while helping to manage both rate and credit risk. Pairing higher-quality, longer-duration fixed income with shorter-duration credit may help investors achieve a favorable outcome without having to time markets.

#2 Healthy Fundamentals and Higher-Quality Issuers

Since high yield is more dependent on the health of issuers, corporate fundamentals are important. The default rate as per J.P. Morgan ended the year at 1.5%, less than half the long term average. According to their forecasts, the default rate will end 2025 at 1.25%, well below long-term averages. One reason high yield issuers have been so resilient is that many refinanced their debt during 2020 and 2021 at very low yields, reducing their interest-rate expense and improving interest coverage ratios. A more secular trend has been the higher-quality nature of the asset class. Approximately half of the market is rated BB, and mostly comprised of public companies, many of which are in the S&P 500.

Another positive indicator is the ratio of upgrades to downgrades within high yield. As the Fed hiked rates, tightening lending conditions, the upgrade to downgrade ratio remained above one and has been increasing. This means that credit agencies are upgrading the ratings of more credits than they are downgrading, signaling a healthy market. Notably, there is somewhat of a bifurcation as more of the upgrade activity is occurring in the higher-quality segment of the market, whereas CCCs and split-rated single-Bs are experiencing more downgrades.

Chart 2: Positive credit trends as rating agencies are upgrading more bonds than downgrading



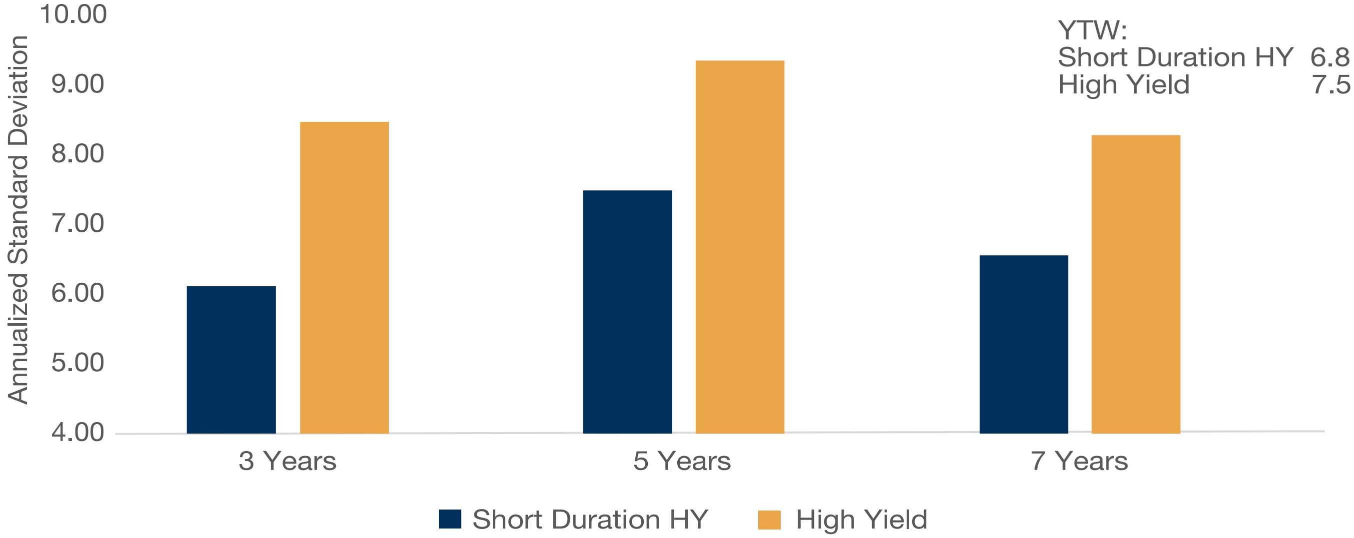
Source: JP Morgan, 12/31/2024. Past performance is no guarantee of future results, which will vary.

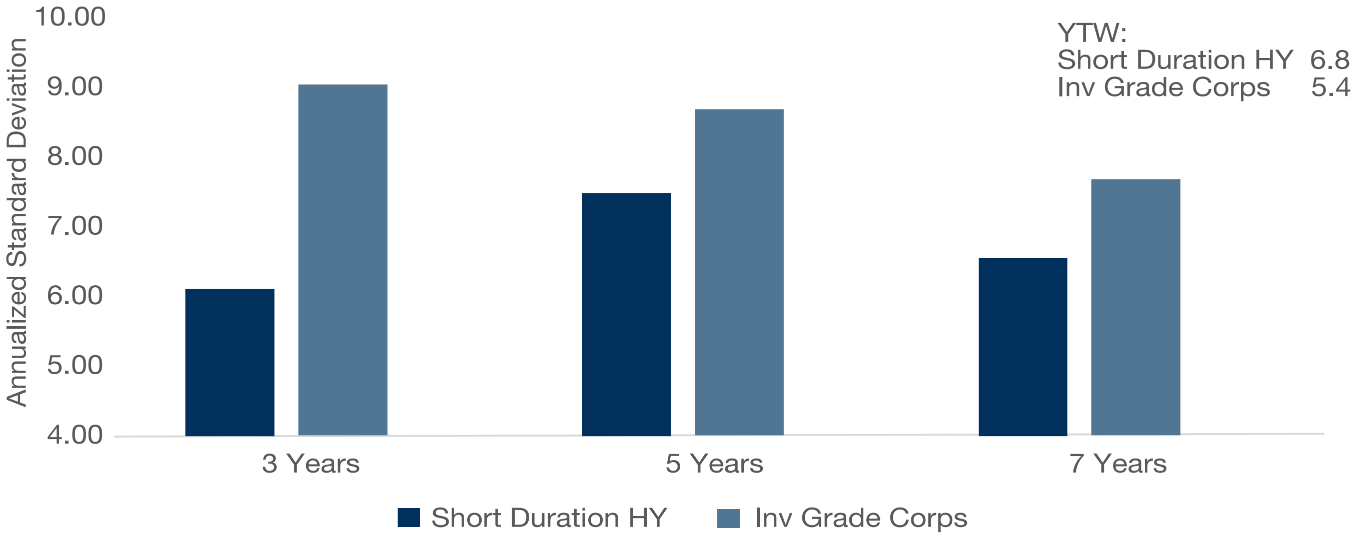
#3 Attractive Yield with Limited Volatility

Looking at the short duration segment of the market, this typically includes bonds that are closer to maturity and excludes CCC-rated bonds. Since most bonds that default are rated CCC a year before defaulting, strategies tied to a short duration high yield index have historically experienced lower default rates.[1] Additionally, because this part of the market has shorter maturities than the broad market, it is inherently less volatile due to bond math. Bond prices are less sensitive to changes in yield and spread. As shown below, not only has short duration high yield exhibited less volatility than the broad high yield index, but investment grade corporates as well. Still, short duration high yield is yielding over 90% of the broad high yield market and more than the investment grade corporate index.

[1] J.P. Morgan.

Chart 3: Short duration high yield has lower volatility than both high yield and investment grade corporates





Source: FactSet as of 12/31/2024. Past performance is no guarantee of future results, which will vary. It is not possible to invest directly in an index. Short Duration High Yield represented by ICE BofA Cash Pay High Yield (1-5 Y)(BB-B) Index. High Yield represented by ICE BofA US High Yield Index. Investment Grade Corporates represented by ICE BofA US Corporate Index. Yield to worst (YTW) is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. Standard Deviation measures how widely dispersed a fund's returns have been over a specified period of time.

As rates on the front end come down, so too are yields on cash instruments such as T-bills, money markets and CDs. The 3-month T-bill is yielding 4.3%, 100 bps less than it was just a few months ago. Short duration high yield is currently generating attractive levels of income without excessive rate or credit risk. On the other end of the curve, having a concentration in longer-duration fixed income may expose investors to excessive amounts of interest-rate risk. By diversifying exposure to both rate and credit risk, investors may best position themselves to help achieve favorable investment outcomes across a wide range of economic scenarios.

About Risk

Past performance is no guarantee of future results, which will vary. All investments are subject to market risk and will fluctuate in value.

Investing in below-investment-grade securities may carry a greater risk of nonpayment of interest or principal than higher-rated bonds. High yield securities (junk bonds) have speculative characteristics and present a greater risk of loss than higher-quality debt securities. These securities can also be subject to greater price volatility.

Bonds are subject to interest-rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner.

Bond ratings are expressed as letters ranging from AAA, which is the highest grade, to C ("junk bonds"), which is the lowest grade. Different rating services use the same letter grades but use various combinations of upper- and lower-case letters to differentiate themselves. To illustrate the bond ratings and their meaning, we'll use the Standard & Poor's format: AAA and AA = high credit-quality investment grade; AA and BBB = medium credit-quality investment grade; BB, B, CCC, CC, C = low credit-quality (non-investment grade), or "junk bonds"; D = bonds in default for non-payment of principal and/or interest.

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Definitions

The **ICE BofA 1-5 Y BB-B Cash Pay HY Index** tracks the performance of BB-B rated U.S. dollar-denominated, corporate bonds publicly issued in the U.S. domestic market with maturities of one to five years.

The **ICE BofA U.S. Corporate 1-5 Year U.S. Corporate Index** is a subset of ICE BofA U.S. Corporate Index including all securities with a remaining term to final maturity less than five years.

The ICE BofA U.S. High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities and commercial mortgage-backed securities.

The **Standard and Poor's 500, or simply the S&P 500**, is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the United States.

Duration measures how long it takes, in years, for an investor to be repaid the bond's price by the bond's total cash flows. Duration is a measure of sensitivity of a bond's or fixed-income portfolio's price to changes in interest rates.

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