A Word About Bonds

THE LEAD | August 15, 2023

”The bond market is the most important market in the world. It is the backbone of all other markets.” – Ray Dalio, founder, Bridgewater.

A recent Financial Time piece on bonds [link] reminded us of their long, proud history as well as their critical importance to the proper functioning of today’s global markets. The article points out that while banks have faded in importance as holders of capital, bonds – led by US Treasurys – are major components of the world’s financial system.

Size-wise, the total bond market at $133 trillion (per BIS) is smaller than the $181 trillion global banks represent, according to the Financial Stability Board. But as part of the “shadow banking” system, it is having an impact on how policy makers view regulation.

Ironically, the failure of Silicon Valley Bank put a spotlight on the relationship between the bond market and the banking system. Fixed rate instruments, even mortgage debt, in themselves aren’t necessarily risky beyond their fundamentals. But in the context of a bank asset/liability mismatch amid rising rates where cash deposits are fleeting, they can be problematic.

While the Fed’s hike regime has had a dampening effect on some aspects of the capital markets, particularly broadly syndicated loans and high-yield bonds, the corporate high-grade market has seen strong activity. As our *Chart of the Week* highlights, IG bond issuance has had a better 2023 through July than the same period in 2022.

This dynamic is driven in part by the attractiveness for buyers of investment grade yields. The Fed’s High Quality Market (HQM) bond yield is 5.2%. That compares to 2% in early 2021.

Further down the rating spectrum, single-B bonds are trading at an average bid of 91 for a yield-to-worst of 8.5% (Pitchbook LCD). The discounted price reflects rate moves since March, 2022, an element factoring into the poor performance of fixed income generally last year.

Despite 2023 outflows of over $9 billion from retail funds, some measure of stability is returning to HY bond issuance. US volume year-to-date is $103 billion versus $72 billion for the comparable 2022 period. Compare that to the institutional leveraged loan market whose activity level has shrunk from $178 billion year-to-date last year to $133 so far this year.

For investors higher bond yields have been attractive, especially given how tight they were before the Fed’s rate boost. But as our friends at FundFire quoted one wealth management pro saying, as nice as that trade is now, fixed income “doesn’t displace the power of private credit.

“If anything,” he continued, “they complement each other really nicely. You can still earn structural yields in the private credit market that take advantage of the illiquidity premium and some other structural inefficiencies, and I think both coexist in a big way.”

? From the Editor: The Lead Left will be on its annual August break and will return the week of Sept 4.