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Back to School (Part One)

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Getting our heads back into markets, we reflect this week on the shape of public equities and fixed income. The S&P 500 has gained about 10% year-to-date, less than half of the 20% return for the comparable period in 2024. Similar figures for the DJIA are 7% and 10.5%, respectively.

Ten-year Treasurys bottomed out a year ago at 3.6%, heading higher since then, and now at 4.2%. Rates since April have been in a range, thanks to tariff concerns. The S&P US Aggregate Bond Index stands at 4.5% year-to-date, while the comparable Bloomberg Agg is 3.75%. On the leveraged front, loans have gained 4.5% (per the Morningstar LSTA 100) and high-yield bonds returned between 5.6% and 6.25%, per the ICE BofA and Morningstar indices, respectively.

KBRA's Van Hesser spoke last month to asset returns in his podcast, *Three Things in Credit*. He refers to a Goldman research piece expecting annual equity returns of 3% over the next decade. In a world where S&P values stocks in the index today at 3.3 times sales, "an all-time high."

He also referred to Bloomberg's recent study showing "credit spreads are the tightest in 27 years. Credit risk is priced to perfection in an imperfect world."

Yet as Hesser notes, there's a difference between spreads and yields. While public credit spreads are tight (and getting tighter), the benchmark remains above where it was at the end of the GFC. The S&P Leveraged Loan Index yield-to-maturity was at 10.6% in 4Q 2022 (after four consecutive rate hikes of 75 bps). Today it stands at 8.1%, above the 7.5% twenty-year average.

On the private side, direct lending (unleveraged) yields are in the 9-10% range. Per KBRA DLD, upper middle market yields were at 9.8% in April, only modestly down to 9.65% in July. In contrast, DLD saw single-B yields drop 160 bps over the same period from 9.2% to 7.6%.

All this amid signs of an economic slowdown. While tariff pressures seem to have leveled off, predictions for growth next year remain soberly below 2025's GDP expectations. As our *Chart of the Week* highlights, at least one economic forecast suggests 2026 GDP will mildly outperform 2025 – both below 2%.

Hesser reported the core US GDP for the first half of 2025 – final sales to private domestic purchasers – was 1.2%. This was the lowest number since 2H 2022 when Covid-induced inflation was rising fast. Consumer spending still shows signs of strength, with July's 0.5% a tad higher than the 0.4% in June. The full effect of higher prices from tariffs still awaits.

Sluggish growth and stubborn inflation are constructive for credit. Bloomberg's high-yield data show net debt-to-Ebitda of 3.8x in the fourth quarter of 2019. Today that number is 3.7x. Interest coverage six years ago (when Fed funds was 1.5%) was 2.6x. With the benchmark 3% higher now, interest coverage is *up* to 2.7x.

All these dynamics signal the persistence of credit benefits in today's macro cross currents.