

# The Fed's big cut may favor high yield bonds



From the Field  
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## Key Insights

- Historically, high yield bonds performed well after the first rate cut in a Federal Reserve easing cycle if that move was not followed by a recession.
- The Fed's large September cut improved the odds of avoiding a U.S. recession. Strong credit fundamentals and attractive yields are also supportive.



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**A**fter a lengthy wait, the U.S. Federal Reserve began cutting interest rates in September. Many investors may be wondering how this could affect their fixed income allocations.

Initially, at least, markets viewed the Fed's first cut of 50 basis points (0.5 percentage point) as positive for the U.S. economic outlook. Longer-term yields, which are sensitive to changes in economic expectations, rose over the week following the Fed's move.

Historically, long-term investment-grade (IG) bonds have tended to be an excellent hedge against economic weakness but less attractive when the economy strengthens. High yield bonds, on the other hand, have tended to benefit from economic strength. This being the case, bond investors may want to consider the

mix between IG and high yield bonds in their portfolios.

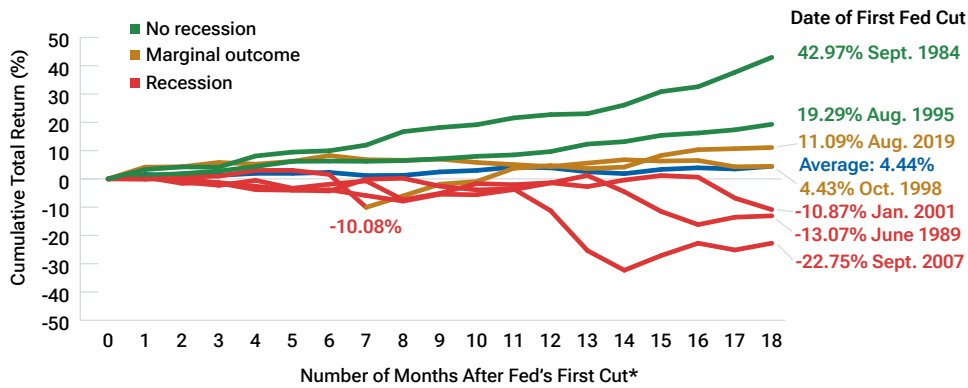
## High yield performance after Fed cuts

On average, the Bloomberg U.S. High Yield Index has returned 4.44% in the 18 months after the Fed has embarked on a rate-cutting cycle. But the range of outcomes has been very wide (Figure 1).

These results depended heavily on whether a recession occurred after the Fed's initial cut. In three out of the four cases where a recession did occur in the next 18 months, high yield bonds produced negative double-digit returns. In the fourth case, after the Fed cut rates in August 2019, high yield bonds fell sharply once the COVID pandemic hit the U.S. economy six

## High yield performance after the Fed's first cut

(Fig. 1) Performance of Bloomberg U.S. High Yield Index over following 18 months



### Past performance is not a reliable indicator of future performance.

\*First Fed cut is defined as the first month in which the federal funds effective rate fell 0.25% below the trailing 12-month peak.

Sources: Bloomberg Finance L.P. T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved.

months later, but bounced back when that recession proved to be deep but very short.

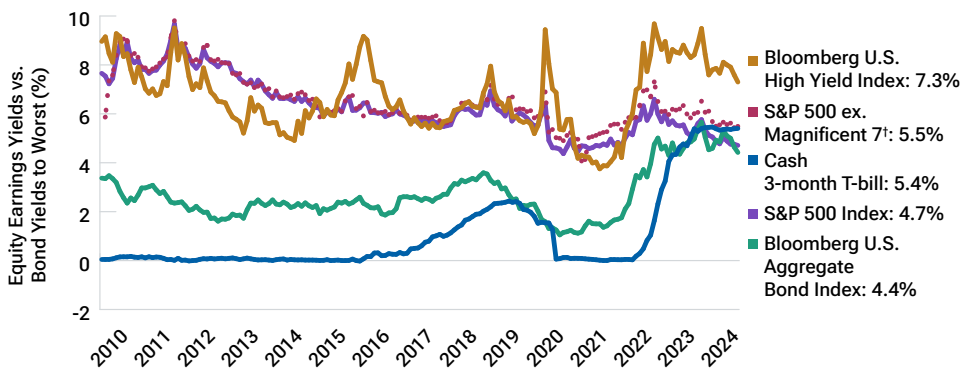
Results were much more encouraging when an initial Fed cut was not followed by a recession. In all three cases, high yield bonds provided positive returns. But those gains were relatively modest after the Fed starting cutting rates in 1998, and a U.S. recession eventually hit in 2001.

## High yield fundamentals appear quite strong

On the bright side, several key metrics used to gauge the health of the high yield market remain high by historical standards. This is typically not the case before the onset of a recession.

## Yields are attractive on a relative basis

(Fig. 2) Equity, fixed income, and cash yields\*



January 2010 to August 2024.

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\*Yields for the Bloomberg U.S. High Yield Index, the Bloomberg U.S. Aggregate Bond Index, and Cash are yield to worst. Yields for the S&P 500 Index and the S&P 500 ex. Magnificent 7) are earnings yields.

†The "Magnificent 7" are Apple, Alphabet, Amazon, Meta, Microsoft, NVIDIA, and Tesla. The specific securities identified and described are for informational purposes only and do not represent recommendations.

Sources: Bloomberg Finance L.P. and Standard & Poor's (see Additional Disclosure).

As of June, earnings before interest, taxes, depreciation, and amortization (EBITDA) were almost five times interest expense in the high yield universe—below the recent peak of 5.77 but above the highest level reached from 2008 through 2020.<sup>1</sup>

This was true even after we adjusted EBITDA for capital expenditures.

### Attractive yields versus equities

Lastly, high yield bonds now offer attractive yields—not only relative to other fixed income assets but to equities as well (Figure 2). At the end of August, the Bloomberg U.S. High Yield Bond Index had a yield to worst<sup>2</sup> of 7.3%, while the earnings yield for the S&P 500 Index was only 4.7%.

Even if we ignore the impact of the so-called Magnificent Seven technology stocks (which pull the S&P 500 earnings yield lower), high yield bonds still offer considerably more attractive levels of yield.

### Conclusion

We believe the Fed's recent dovish shift has increased the likelihood that a recession will be avoided over the near to medium term. If so, high yield bonds could prove more attractive than longer-term IG bonds over the next 18 months. As a result, our Asset Allocation Committee is maintaining an overweight position in high yield bonds.

<sup>1</sup> J.P. Morgan Chase North America Credit Research

<sup>2</sup> Yield to worst is the lowest possible yield on a bond if it is called before maturity.

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