Market Commentary 9/25/25

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Fed Rate Cut and Historic Tightness in Credit Spreads

Last week's Federal Reserve rate cut was widely anticipated, but the market reaction underscored just how unusual today's credit environment has become.

Corporate credit spreads, already compressed by historical standards, tightened further, underscoring investor appetite for corporate bonds even as Treasury yields remain elevated.

Credit Spreads at Multi-Decade Lows

Corporate borrowers are paying risk premiums not seen in decades. Investment-grade spreads have fallen to 0.77%, a level last observed in 1998 and far below the long-run average of roughly 1.30%.

Additionally, high-yield spreads, at 2.79%, are similarly depressed, marking their tightest level since 2007 and sitting well below the median of 4.59% since 1996.

This divergence highlights the unusual dynamic of today's market: investors are willing to accept historically low compensation for corporate risk even as concerns about U.S. fiscal sustainability keep Treasury yields elevated. In effect, corporations are viewed as safer bets than the sovereign balance sheet they borrow against.

Why Spreads Are So Tight

Several forces are supporting these extreme valuations:

1. Attractive Absolute Yields
Even with tight spreads, investment-grade and high-yield bonds yield, on average, 4.80% and 7.03%, respectively. Compared to the ultra-low yields of the past decade, today's levels are appealing for investors seeking income.

2. Healthy Corporate Fundamentals

Strong earnings growth, moderate leverage, and high interest coverage ratios have reassured investors that companies can withstand a slower growth environment.

3. Fed Policy Outlook

The Fed's shift toward easing into 2026 has boosted confidence that today's yields may not last. Investors are eager to lock in income before further rate cuts drive yields lower.

What Could Change the Narrative

While tight spreads can persist for long stretches, reversion often requires a catalyst. Two key risks stand out:

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- **Economic Weakness** – A slowdown in growth or shrinking profit margins could cause investors to demand higher compensation for credit risk, widening spreads.
- **Supply Pressures** – If corporations take advantage of low spreads to issue debt for buybacks, mergers, or expansion, an oversupply of bonds without matching demand could weaken valuations.

Both scenarios would challenge today's complacency, particularly as spreads offer little buffer against adverse surprises.

Implications for Investors

For income-focused investors, today's yields remain compelling. But with spreads at multi-decade lows, the margin of safety is thin.

For income-focused investors, today's yields remain compelling. But with spreads at multi-decade lows, the margin of safety is thin. This environment calls for discipline in fixed-income portfolio allocation:

- **Emphasize Quality** – Focus on higher-quality issuers where fundamentals are strongest.
- **Diversify Broadly** – Maintain exposure across Treasuries, corporates, and municipals to balance risks.

- **Keep a Long-Term View** – Extreme valuations often correct unpredictably, making patience and risk management essential.

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The market is not signaling imminent danger, but neither is it offering generous protection. In a landscape defined by compressed spreads and shifting monetary policy, we believe prudent positioning is the best defense. We get nervous when investors are complacent and question whether both the equity and corporate debt markets are priced to perfection.

Please reach out at your convenience if you'd like to discuss.

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