NEW YORK LIFE INVESTMENTS

Navigating complex bond markets

From MacKay Shields

Bonds, volatility, and the value of active insight

In a time of persistent volatility and shifting macroeconomic signals, fixed income markets are revealing overlooked opportunities across sectors. We provide timely insights into how active managers can position portfolios for both resilience and return potential.

We explore three distinct segments—municipal bonds, high yield bonds, and multi- sector fixed income—and show how each offers different opportunities for today's fixed income investor:

- Elevated muni-to-treasury ratios and steepened yield curves offer compelling entry points, particularly in high-grade and short-duration instruments.
- High yield bonds have demonstrated resilience, buoyed by stronger fundamentals, higher average quality, and reduced leverage. Strategic exposure to short-duration BBs and selective bank loans helps manage volatility without compromising on income.
- Multi-sector fixed income goes beyond the limitations of the Bloomberg Aggregate Index by tapping into securitized credit, emerging markets, and high-quality high yield—areas where skilled managers can uncover relative value and inefficiencies.

We continue to emphasize the importance of sector rotation, credit selection, and curve positioning over duration for navigating today's market environment.

Municipal bonds: Volatility opens up value across the curve

April presented a perfect storm for municipal bonds, with seasonal headwinds from tax-driven redemptions and a surge in issuance colliding with growing investor anxiety about potential federal policy changes targeting tax exemption. These dynamics triggered weakness in what has otherwise been a resilient market, setting up more attractive valuations.

One indicator of opportunity is the municipal-to-treasury ratio, which recently reached 100% on the long end. That level implies tax-exempt municipals are being priced on an equal basis with taxable bonds—a rarity that historically signals strong relative value. While uncertainty around tax policy emerges cyclically, the underlying fundamentals for municipals remain intact.

Technical factors have also exaggerated market pressure. Retail investors, reacting to stock market weakness and tax liabilities, added to outflows, creating price dislocations. These technicals are temporary in nature, and active managers see them as a chance to lean in selectively.

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The yield curve adds to the case for selective exposure. The municipal curve has steepened meaningfully this year and remains structurally steeper than the treasury curve. The 15-to 25-year maturity range currently offers a sweet spot in terms of carry and roll-down.

Credit quality remains robust, but sector discipline is key

Fundamentally, municipal credit remains strong. Many issuers continue to benefit from solid revenue streams and conservative budgeting, enabling portfolios to move up in quality. That said, not all sectors offer equal footing.

Higher education is an area of caution. Demographic headwinds and declining enrollment, particularly at smaller and more expensive private universities are starting to impact creditworthiness. High-profile headlines have further politicized the sector, adding headline risk that can impact spreads.

Healthcare may also come under pressure. If the federal government looks to rein in spending, more cost responsibility could shift to states and nonprofit providers. Active managers are beginning to anticipate some spread widening as this dynamic plays out.

Despite these pockets of concern, municipal portfolios remain well-positioned, with a tilt toward high-grade issuers and selective exposure to credits that can benefit from technical rebounds or credit spread normalization.

Short-term municipals delivering on expectations

Earlier this year, the expectation was that short- duration municipals could outperform cash on a tax- adjusted basis—and that thesis is proving out. Year- to- date, municipals with maturities of seven years or less have delivered positive returns, while longer- duration segments have struggled.

Tax-exempt yields on the short end now range from 3.5% to 4%,[1] offering an appealing alternative to taxable Treasury bills, especially for investors seeking income without adding significant duration or volatility.

Given the shape of the curve and the tax advantages, short-duration municipals are likely to remain a strong consideration for advisors allocating cash or repositioning out of ultrashort taxable strategies.

High yield credit: Fundamentals, spreads and technical strength

High yield has delivered strong returns since the lows of 2022, underpinned by solid credit fundamentals and a favorable market structure. Today's high yield market includes more public issuers and fewer leveraged buyouts, contributing to transparency and lower overall leverage. Default rates remain historically low and are still trending lower.

Recent volatility—including political noise, tariff announcements, and a sharp rise in Treasury yields—led to the largest outflows from the asset class since the Global Financial Crisis. Even so, price declines were shallow (down less than 2%) and short- lived. Investors quickly returned, highlighting the segment's structural resilience and the strength of demand for income-producing assets.[2]

Spreads have widened off their lows, now hovering around 390 basis points (bps), compared to a long- term, post-crisis range of 300-500bps. With average bond prices below par (~$95), high yield offers not just income, but also price appreciation potential in the event of calls or change- of-control events.[2]

Positioning for upside risk in high yield

Tactically, the sweet spot remains in shorter-duration, BB rated bonds. This segment of the market provides high coupon income with lower sensitivity to both rate volatility and default cycles. These higher-quality credits are also more likely to benefit from investor demand as volatility moderates.

Selective exposure to bank loans (typically 15–17%) provides floating-rate yield and complements the lower-duration structure of the strategy. The emphasis remains on carry, resilience, and managing downside risk rather than reaching for incremental yield through lower-rated or more volatile names.[3]

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[1] Source: Bloomberg, as of 05/8/25. Short term municipals represented by Bloomberg 3-Year Municipal Index. The Bloomberg 3-Year Municipal Index tracks the performance of U.S. investment-grade municipal bonds with 2 to 4 years remaining to maturity, typically offering tax-exempt income. Past performance does not guarantee future results. An investment cannot be made directly into an index.

[2] Source: ICE BofA and JP Morgan, as of 05/8/25. High yield represented by ICE BofA U.S. High Yield Index. 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 US domestic market. Past performance does not guarantee future results. An investment cannot be made directly into an index.

[3] The short duration, low volatility strategy seeks to generate consistent income through floating-rate bank loans ("carry"), while maintaining resilience by focusing on higher-quality issuers, managing interest rate risk with lower-duration assets, and limiting exposure to more volatile or lower-rated securities.

Private credit's growth and its implications for public markets

The rapid rise of private credit introduces a different return and risk profile. While the asset class has attracted significant institutional capital, concerns remain about underwriting standards, illiquidity, and limited transparency.

Compared to public high yield, private credit markets lack real-time price discovery and typically involve smaller, highly levered companies. While both segments can coexist, public high yield currently offers superior liquidity, transparency, and diversification—critical benefits in uncertain markets.

Multi-sector credit: A broader playbook in a fragmented market

In a landscape where many fixed income portfolios are benchmarked to the Bloomberg U.S. Aggregate Index, flexibility has become a source of alpha. The Agg remains heavily weighted to treasuries and agency mortgage-backed securities (MBS)—instruments that are liquid but commoditized and offer limited spread income.

Multi-sector strategies benefit from the ability to shift among asset classes, seeking inefficiencies in securitized credit, high yield, and select global opportunities. This broader playbook allows for more nuanced curve and credit positioning, especially valuable in a market where dispersion and relative value are elevated.

Securitized markets: An underrated source of diversification and yield

Asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) continue to be a source of compelling risk-adjusted return. The ABS market, though often overlooked, is large and diverse—including subsectors like autos, credit cards, data centers, and franchise loans. These structures often feature amortization, reducing reinvestment risk and duration sensitivity.

CMBS markets are frequently misunderstood, particularly as concerns about office exposure dominate headlines. However, office represents only about 20% of the market. Other segments, such as multifamily and industrial, provide more stable fundamentals and pricing opportunities.

Duration and curve positioning: Navigating with precision

Instead of relying on bold duration calls, sophisticated strategies focus on the shape of the curve. One example: the 10s–30s treasury curve compressed to 18 bps in 2024, despite a long- term average closer to 60 bps.[4] Re-steepening trades offer asymmetrical risk/reward in environments where macro catalysts or fiscal expansion drive long-end pressure.

This curve-based approach allows for rate sensitivity management while retaining exposure to spread sectors with attractive carry. In a rate regime still marked by uncertainty, flexibility and precision matter more than ever.

[4] Source. Bloomberg as of December 2024. The yield difference between 10- and 30-year U.S. Treasuries narrowed to just 18 basis points—well below the historical average of 60 basis points—indicating an unusually flat long-end of the yield curve

Active fixed income for an evolving landscape

Advisors have an opportunity to guide clients toward fixed income allocations that are not just defensive, but opportunistic. Today's dislocations offer avenues to enhance after-tax yield, reduce duration risk, and uncover inefficiencies often missed by passive strategies. In a world of constant macro flux, flexibility, credit selectivity, and structural diversification remain essential.

Leverage active management to identify and respond to opportunities in fixed income. For more details, visit:

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ABOUT RISK:

Investing involves risk, including possible loss of principal.

Active management typically involves higher fees than passive investment strategies. There is no guarantee that any investment strategy will achieve its objectives, produce positive returns, or outperform passive strategies or market benchmarks.

Municipal bonds are subject to interest rate risk, credit risk, and liquidity risk. In some cases, income from municipal bonds may be subject to state and local taxes or the federal alternative minimum tax. High-yield securities, also known as “junk bonds,” carry a higher risk of default and greater price volatility than investment-grade bonds. Short-duration bonds, while generally less sensitive to interest rate changes, may offer lower yields and still carry credit and reinvestment risks. Bonds subject to interest rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk which is the possibility that the bond issuer may fail to pay interest and principal in a timely manner. 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.

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.

The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark tracking the U.S. dollar-denominated, investment-grade, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, various mortgage-backed securities, asset-backed securities, and commercial mortgage-backed securities.

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