Equity Trustees

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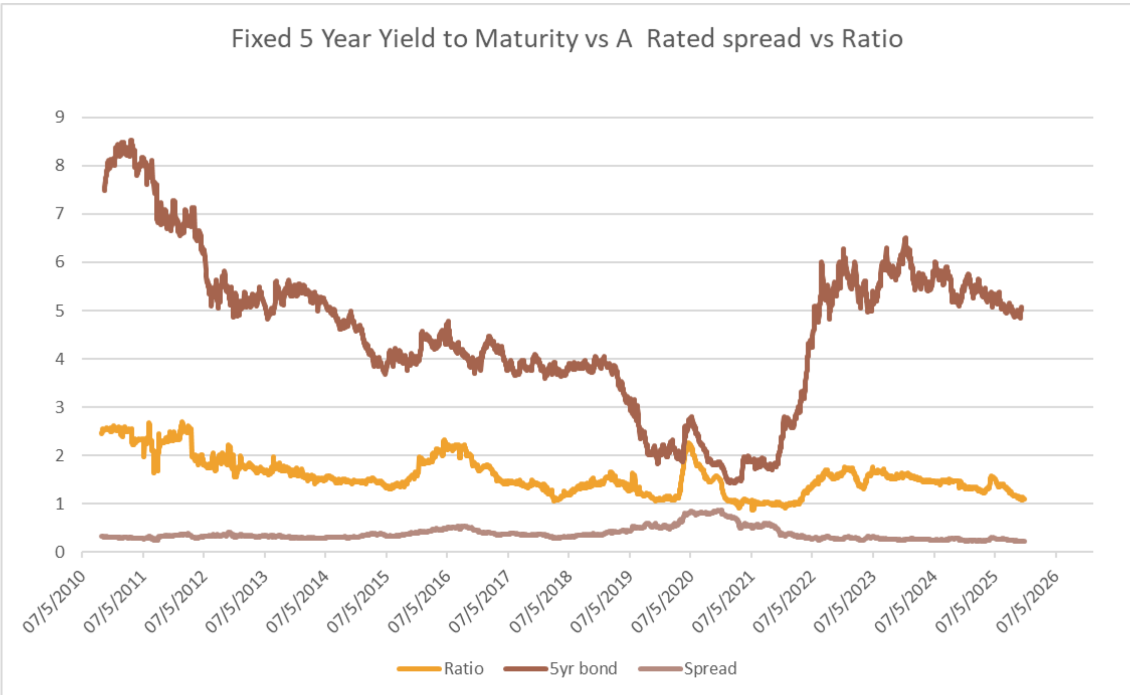
ARE CREDIT SPREADS TOO TIGHT?

Many market pundits are talking about credit spreads being too tight, but are they really? If one looks at the various credit indices it's hard not to say that spreads are too tight. Optically the indices suggest spreads are tight but are they really?

When comparing indices, it's important to understand how the indices are composed and change over time and how the financial environment has changed over time. For example, the Ausbond All Maturities Index has seen its credit quality change from where credit was approximately 15% prior to the GFC to one now with a credit exposure of approximately 30%. The Government remains the major issuer, however the next cohort of larger issuers the semi-governments have seen their ratings slip. Duration has also moved from pre-GFC levels of 4.5 years to 7 years. That shift has been influenced by longer dated Government issuance. For example, 10 years ago, the Government did not issue 30-year bonds.

One often hears discussions about U.S. High Yield being tight especially now, but is it? The U.S. High Yield Index has changed significantly in structure, but those changes have often been overlooked. The composition of CCC's in the index has fallen, the percentage of senior secured bonds has increased to 30%, the duration is shorter, and the composition of BB entities have increased, so of course the index looks tight compared to 5, 10 or 20 years ago.

What is happening? It's easy to draw comparisons, however if we delve into the respective rating cohorts we see something different. For example, the ratio of spread to yield in a generic five-year security is within 1 standard deviation of the mean. So, are spreads really that tight?



Courtesy LSEG EQT Asset Management

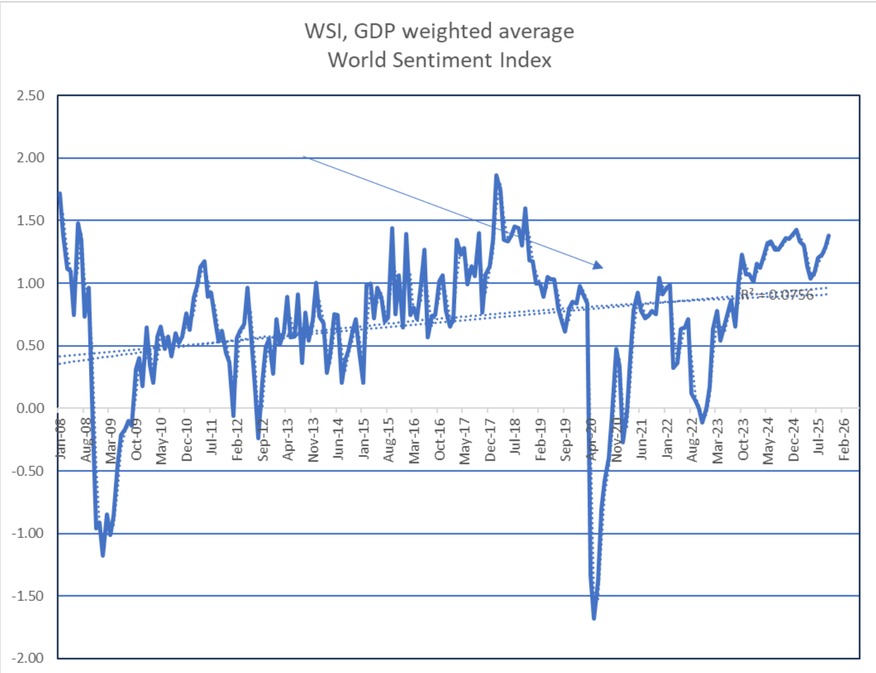
The driver of credit, and importantly spreads, is a low-interest rate environment, solid growth, sound credit metrics and a supportive equity market. The Australian market has over time become more liquid, traders can feel comfortable holding inventory and the market has attracted quality offshore interest and quality offshore investors.

Importantly tight spreads reflect upon the quality of the issuer and the "all-in yield". The Australian corporate bond market foundation is built on strong metrics, attractive all-in yields and good liquidity. The other feature that is sometimes forgotten is that investment grade credits are rated, and with these ratings comes a covenant with the ratings agencies. Corporates do not willingly or unnecessarily put their ratings at risk.

Credit is evolving to become more of a defensive asset that provides income but also some consistency as the credit rating effectively acts as a gatekeeper. Government debt has become somewhat clouded as governments struggle with elevated debt levels and interest payments. For example, France at 115% debt to GDP has seen the country's debt rating fall markedly. The United States at 100% debt to GDP and 3% interest payments to GDP has seen traditional investors become agitated. It is not surprising to see some well rated corporates trade through or close to the comparable government bond. For example, Microsoft trades close to the U.S. treasury whilst in France, LVMH trades through the equivalent government bond. Default rates remain low and in the current environment all-in yields look attractive. So, are spreads too tight? Spreads may appear tight historically but in the current environment and with equity markets performing then spreads may not be as tight as one believes.

The other driver of credit spreads is the easing cycle that Central banks are performing globally. As expected, the easing cycle has slowed, and the neutral rate may have been reached. While the easing's have slowed this is a normalisation of rates rather than a desperate act to kick start an ailing economy. In such situations equity markets have provided a period of outperformance and only really slow when interest rates start to rise.

Yes, we may see credit spreads widen a little but with this widening comes opportunity. The current environment suggests we may have more to run. Volatility may continue and that is the main danger, but sentiment remains supportive.



Courtesy 'Measuring Economic Policy Uncertainty' by Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com. EQT Asset Management.

For those considering an investment in Australian listed credit, the Spectrum Strategic Income Fund is an actively managed credit fund that invests in a range of debt and hybrid securities with the objective of maximising income whilst preserving capital. The portfolio holds a diversified number of securities with risk limits imposed and actively monitored across security type, credit risk, industry, and issuers. Issuers include government bodies, banks, and corporates.

The Fund seeks to deliver higher returns to investors than traditional cash management and fixed income investments. The Funds lower duration profile seeks to limit volatility of returns. It is suited to investors with a low tolerance for volatility of returns and focuses on capital preservation and growth as well as income production. The portfolio is mostly floating rate, so returns increase as interest rates rise. Income is distributed quarterly.

For more information please click here or contact:

Lindsay Skardoon,

Portfolio Manager – EQT Spectrum Strategic Income Fund

Grant Mundell
Investment Specialist
GMundell@eqt.com.au

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Spectrum Strategic Income Fund's Target Market Determination is available https://swift.zeidlerlegalservices.com/tmds/ETL0072AU A Target Market Determination is a document which is required to be made available from 5 October 2021. It describes who this financial product is likely to be appropriate for (i.e. the target market), and any conditions around how the product can be distributed to investors. It also describes the events or circumstances where the Target Market Determination for this financial product may need to be reviewed.