RGB Perspectives

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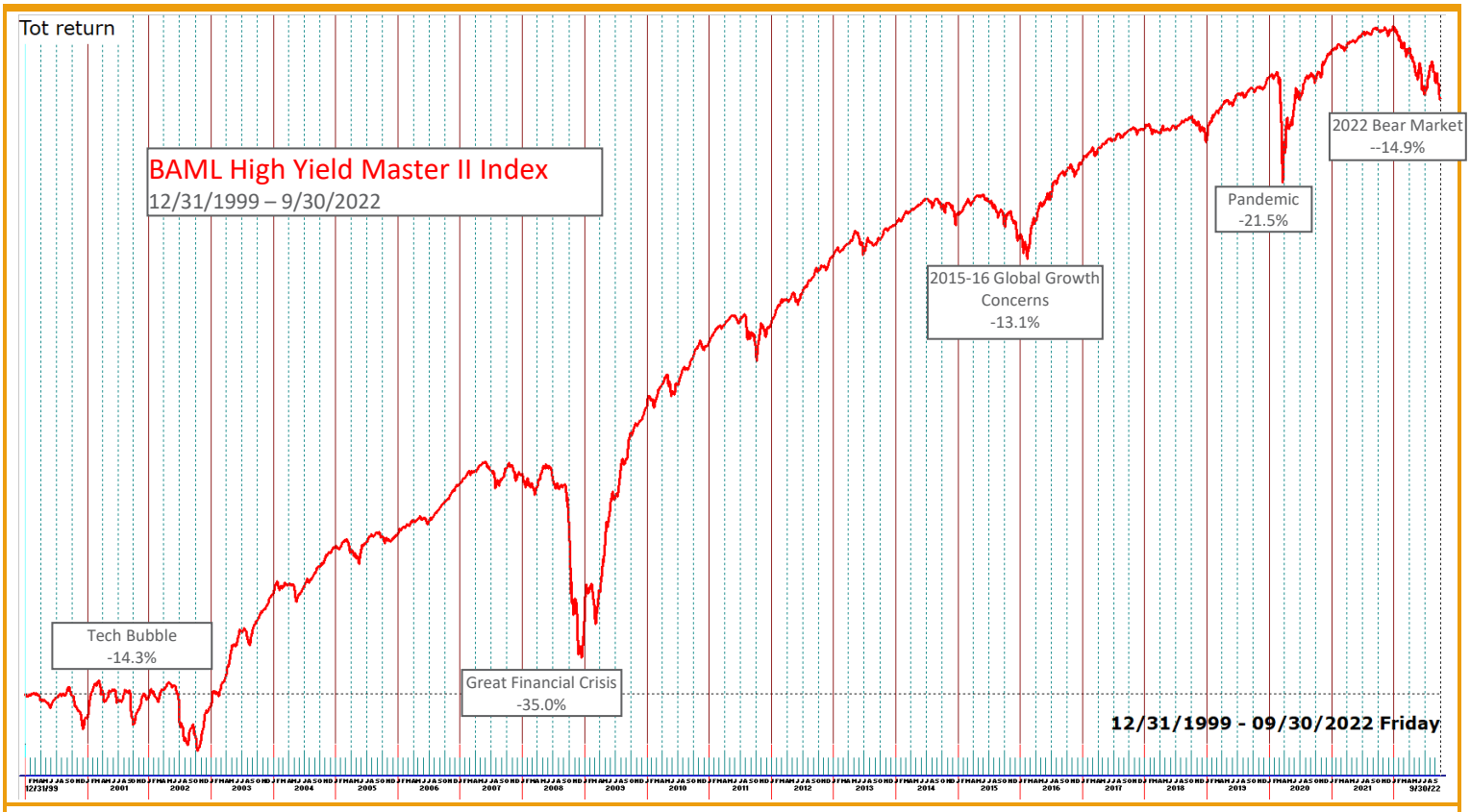

As many of you know, I follow the BAML High-Yield Master II Index (junk bond index) as an indicator of overall market risk. When junk bonds decline, it is generally an indication that market risk is high. In this type of environment, junk bond investors demand higher yields to compensate them for that additional risk. As bond yields and prices are inversely correlated, the higher yields cause junk bond prices to fall. We can see this repeating pattern over the last 20+ years in the chart above. Each time the market faced a significant crisis, junk bond prices fell along with other risk assets (i.e. stocks). Eventually the market forces driving the market decline will dissipate creating an environment of declining yields and higher junk bond prices in the future. As the chart above shows, each period of elevated risk was followed by a period of steady returns.

Not only are junk bonds a great barometer of the health of the financial markets, junk bond mutual funds make good investments given their lower volatility characteristics and trend persistence when compared to other risk assets such as stocks. These characteristics make it easier to make rational decisions to enter and exit junk bond positions providing an opportunity to protect our capital during weak market environments and benefiting from the outsized gains that typically follow periods of market weakness. The RGB Core and Balanced strategies use junk bond mutual funds, as well as other low volatility asset classes, to take advantage of these unique characteristics. Currently, we don't hold any junk bond positions and are waiting for a better, lower risk opportunity to reenter the market in the future.

While the drivers behind the 2022 bear market decline may be different than those that we have seen during other periods of market stress over the last 20 years, the impact on the junk bond market is no different. The current decline in the BAML High-Yield Master II Index is the third largest decline in the junk bond market which is setting up a great opportunity for low volatility returns in the future. While I don't know when the current decline will end, the bear market will eventually pass setting up for a period of declining yields and higher junk bond prices.

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