Stirling Bridge
Wealth Partners, LLC

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Synch or Swim.

When viewed on a television broadcast of the Olympics, the sport of synchronized swimming appears to be a graceful, aquatic ballet. The extraordinarily fit women who participate wear industrial grade, water-proof makeup, tight nose plugs, glinting bathing suits, and matching caps or hairstyles. What's not to like? In fact, our favorite version of the sport comes from the opening credit montage of an Austin Powers movie where Austin, hairy chest and all, charmingly dons a pink, poofy swim cap that closely resembles a shower cap that might have been worn by one of our grandmothers.

It turns out that what, from above seems so beautiful, may carry risks that lurk unseen beneath the surface. Amidst the swirling combat zone of flailing arms, legs, and heads underwater, the athletes are routinely kicked and punched. Some wind up with minor concussions. Through it all, the ladies emerge over the surface with brilliant smiles!

The investment grade corporate bond market may be shaping up to be something similar in the future. At and over the surface, it remains peaceful with high quality companies issuing responsible levels of debt, maintaining covenants, and paying the required interest and principal. Below the surface, however, the churning corporate bond market might be adding in risks that weren't there a decade ago during the Great Recession.

Time for a fast primer. Very generally, there are two classes of bonds. Investment Grade and Junk. Forget Junk. We save that topic for another day. Investment Grade Bonds are those that are rated by S&P at BBB and above (from best to worst: AAA, AA, A, BBB). Therefore, a mutual fund or ETF that focuses on investment grade corporate bonds will own various percentages of each rating.

Some commentators have fretted over the surge in outstanding corporate debt. But, though the dollar values are large, by all measures the total increase followed almost exactly in line with the growth of the overall economy. Therefore, the gross amount of debt is not the issue.

There is one possible area of slowly blooming risks, however. Ten years ago, the lowest rung of the quality ladder (BBB) made up 33% of the investment grade corporate bond market. Today, the market is clogged with a 49% share of the lowest rung.

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That means that the average corporate bond fund, though still safely and honestly called investment grade, actually carries a lower credit quality than ten years ago! The pond in which they fish is just providing these managers a little lower quality of fish.

As Austin might say at this point, *What's it all mean, baby?*

Probably nothing today. However, over time it means more. Especially, if the trend of mounting proportions of lower rung bonds continues.

An adverse scenario may unfold in the following manner. From some extraneous event, a minor recession hits a certain industry whose bonds <u>used to be</u> represented more evenly up and down the quality ladder. Now, however, a large chunk of the industry's debt might be concentrated on that last, bottom rung. As greater risks are perceived by investors, prices of their stocks fall a lot. Prices of their investment grade bonds fall a little. The danger of default for a small handful of companies in that industry increases. The rating agencies downgrade. The only rungs left are Junk status. High quality mutual funds are no longer allowed to own them. They sell. The price drops fairly significantly. As a result of the larger chunk of lower quality bonds in their total portfolio, the mutual funds themselves (still investment grade) suffer a bigger drop than they might have in the past.

The state of affairs we describe above is actually a fairly moderate outcome. Chicken Littles among us might conjure ideas that the next step in the process would be a spreading contagion among all bonds, lenders, and investors, to a total credit deep freeze a la 2008. As of today, that grave scenario still seems unlikely.

But we continue to monitor the situation and credit quality weightings. Many of our clients own a fair chunk of investment grade corporate debt outright or via funds. <u>We are not selling.</u> However, where we already own our maximum allocation, we are not adding more. Stay tuned.

Stirling Bridge Wealth Partners, LLC is fortunate to count many of you as clients. In the good times and bad, we remain committed to providing customized investment solutions and robust financial planning wrapped in a package of exceptional service. We thank each of you for your dedication to us and for your trust.

Sincerely

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