Allspring's Schueller Says This 'Muddle-Through Economy' Is Good For Junk Bonds

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Chuck Jaffe, in this episode of The NAVigator podcast interviews Mike Schueller, Co-Manager of the Allspring Income Opportunities fund. Mike says that high-yield bonds are poised to be steady performers through the current wave of headline risks and market uncertainty because the economy is solid enough that there's no reason to expect a spike in defaults. With the potential for recession "having receded into the background," he's expecting a "muddle-through economy," with defaults remaining at current low levels, allowing high-yield to keep delivering "high, consistent income" and total returns at or above historic norms for the high-yield asset class.

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Mike Schueller, co-manager of the Allspring Income Opportunities fund is here, we're talking high-yield investing now on The NAVigator. This is The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization representing the full spectrum of the closed-end fund business from investors and users to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today we're looking into the potential for generating high levels of current income safely, and we're doing it with Mike Schueller, co-manager of the Allspring Income Opportunities fund, which trades under the ticker symbol EAD, and you can learn more about it, Mike, and all of the other funds that he works on by going to AllspringGlobal.com. And if you're hunting for information in general about closed-end funds, interval funds, and also business-development companies, include AICAlliance.org into your search, it's the website for the Active Investment Company Alliance. Mike Schueller, welcome to The NAVigator.

MIKE SCHUELLER: Thank you for having me, Chuck.

CHUCK JAFFE: One thing I know that's a little bit different about your management style with EAD, with Allspring Income Opportunities, is that you focus on a six-month investment horizon to try to figure out where the market's going next. And this is a tough time for a six-month look, because well, you got sticky inflation and you've got a Fed that's looking to limit its actions and you've got a ton of headline risk covering everything from tariffs and economic policies to wars. So how about we start with your outlook for the rest of the year in the high yield market?

MIKE SCHUELLER: Yeah, there is a lot going on within the six-month outlook that we typically employ as we think about how we're going to position our funds, typically we do that because we think it tends to minimize the number of variables. Obviously this is a really unique period in time, as there are many uncertainties that you outlined, but I think as we step back for a moment, the key driver for high-yield returns is really the default rate, and one of the key inputs there is the strength of the economy, recessions tend to lead to default spikes that cause spreads to widen out and yields to move dramatically higher. As we think about the next six months though, we really think that left-tail or worst case scenario of a recession has receded into the background, obviously you see that priced into risk markets across the board, and we really think the most likely scenario now is a muddle-through economy, and a muddle-through economy is going to be supportive for high yield were defaults are very low right now at 1.1%. We would expect in that kind of an environment, high yields should continue to do well and the default rate will be manageable.

CHUCK JAFFE: Is there a reason why the default rate has stayed as low as it has at a time when rates go up? Because it's normally pretty much linear, you raise rates, default rates go up, and we really haven't seen that. Although I will point out, on the BDC front and a little bit from what I was reading into the high-yield market, we saw maybe a little blip up at the first quarter of this year. So did you see that blip, and is there a reason why we haven't had the normal tie between higher rates, higher default?

MIKE SCHUELLER: We did see a blip, particularly when rates moved up starting in 2022, because they did move up so sharply. One of the advantages of the high-yield bond market though is the issuers tend to lock in their rates for a longer period of time, and that enabled them to sort of ride out the worst of the volatility, but I think the key here really is the rise in rates was accompanied by a really strong economy, and I think the strong underlying economy translated into really good financial performance for most high-yield issuers. And I think the other thing that's worth noting is we just did go through a default cycle in 2020, during Covid a number of the weaker companies did default at that point, leaving us with a slightly stronger cohort to be able to manage through this period of higher interest rates.

CHUCK JAFFE: You divide the high-yield world in a lot of different ways, sometimes it's based on quality, sometimes it's based on expected return, et cetera, but given the risks that you see out there, and the fact that we're not worried too much about defaults and the rest, what is the sweet spot for you right now? I mean, in high yield, is there an area where you're particularly focused?

MIKE SCHUELLER: Yeah, right at the moment we're really focused on bonds that yield between seven and 10%, and just for reference, the high-yield index yields in the low 7% area, and I would contrast that with the distressed portion of the market that yields over 20%. We're largely avoiding that portion of the market. As I mentioned earlier, the default rate is just 1.1%, so any company that is yielding 20% has significant problems of its own, and generally speaking we're avoiding that. However, we do like that seven to 10% yielding portion of the market, again, that pairs well with our outlook of at least a muddle-through economy at worst, and possibly stronger than expected growth, so we think that gives us starting yields that put us in a good position to outperform the broader index.

CHUCK JAFFE: A muddle-through economy is certainly in the middle, it's not bad, it's not worst case, but what's your best case scenario and how likely is it that we get something better than muddle-through?

MIKE SCHUELLER: Yeah, I think the best case scenario would be to return to something like two to maybe 3% growth, it's still a little unclear how we get there, because while the president has negotiated some trade deals and it appears that we're not going to see the worst of the tariff rates that we initially feared, tariffs still in our view are taxes, we view that as a little bit of a headwind. I would note that growth in that two to 2.5% area is really good for high yield. If you get growth that's much faster for a sustained period of time, it does seem to lead to excessive risk taking in the C-suite, you'll see more M&A, you may see more LBOs, and that sort of thing, so 2-2.5% tends to be kind of the sweet spot for high yield.

CHUCK JAFFE: Given where things are, how much will the picture change when we start to see rate cuts? Will rate cuts be a better opportunity for you? How will rate cuts change what you see happening now?

MIKE SCHUELLER: Rate cuts will help in a couple of ways. The first is that I think it would represent a continuation of the path the Fed was on before the tariffs were announced, the so-called "golden path", where we see the Fed able to reduce rates without having to concern ourselves with the potential for a recession, it's sort of threading the needle in a way that we don't typically see. And the other area in which I think it helps is as rates come down, particularly on the front to intermediate portion of the curve, that's a tailwind for our investments. As rates come down, our dollar prices can go up, and that's a nice tailwind for total returns in the high yield market.

CHUCK JAFFE: If we wind up seeing that rate cut or we see any of the potential surprises out there, if we go beyond muddle-through, is the real problem for investors going to be more about volatility or is it going to be that the performance will be disappointing? In other words, volatility equates to loss or danger, and high yield can be volatile, but you're supposed to take on high yield with the idea that I don't mind a little volatility. Yet in practice that doesn't always work that way, so what's going to happen to the volatility picture and how much will it change the trajectory?

MIKE SCHUELLER: We would actually welcome a little bit of volatility, we're positioned in what we view as sort of a neutral fashion, so we have dry powder to add risk should that happen. Vut I think it's important for investors to step back for a moment and just note that in high yield over long periods of time, investors have been paid about 3% more in income than they've lost in defaults of issuers. In other words, you have been very well paid, in fact overpaid, for the default risk that you take over long periods of time. That includes periods that are very volatile, and certainly there are times when we see drawdowns within the high yield market, it can certainly happen, but again I think you're always getting paid that underlying coupon that compounds over time, and I think does mute some of that drawdown. And again, I think that high, consistent income is the path to attractive total returns.

CHUCK JAFFE: Considering the market that we are in and the times that we are in, can investors who are looking for yield safely take on a little bit more of high yield? Because historically, if I'm looking at general financial planners and their advice, they're like, "Yes, we want to put a little sleeve of high yield in," but it's always been very narrow. We've gone years without real default crises in high yield, and I understand I'm asking a guy who's a high-yield manager, and you're talking from your book so I will expect you to say yes, but I guess the question becomes, given your comfort with where we are, in a muddle-through place where people are looking for yield, how much of a portfolio are you telling your relatives that you can put into high yield?

MIKE SCHUELLER: You're right, I've been in the high-yield market for 25 years, and while there is volatility, I've seen how that extra yield leads to outperformance of higher quality fixed-income alternatives. I do think that it always merits a strategic allocation, there's certainly people who become concerned about the volatility and do focus a little bit more on timing and are perhaps a bit more tactical, but I think one thing that's worth noting, in the last 10 to 15 years, we've seen real growth in the broadly syndicated loan market and also private credit, I'm sure your listeners are familiar with both of those. One of the byproducts of that is for a variety of reasons, a lot of the riskier lending that used to happen in high yield has moved to those parts of the leveraged finance market, so that's left us with a higher quality cohort than we've ever had. In other words, BBs, which is the highest quality rating within high yield, are about as large as they've ever been, so we do think that there has been a structural change within the high-yield market. Perhaps that will change if we get an extended period of really high growth and we see some more froth generally speaking, but that's not in our outlook in the near or even intermediate time frame.

CHUCK JAFFE: Mike, really interesting, appreciate you taking the time to join us. Hope we get a chance to follow up down the line.

MIKE SCHUELLER: Very good. Thanks for having me, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe, and I am Chuck Jaffe, I'd love it if you'd check out my show on your favorite podcast app or by going to MoneyLifeShow.com. Now if you want to learn more about closed-end funds, interval funds, and business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. Thanks to my guest Mike Schueller, co-manager of the Allspring Income Opportunities fund, which trades under ticker symbol EAD and which you can learn more about by going to AllspringGlobal.com. The NAVigator podcast is new every Friday, although next week we will be out on Thursday, July 3rd because of the July 4th holiday. You can make sure you never miss an episode by subscribing or following along on your favorite podcast app. We will be back and see you next week, but until then, happy investing, everybody.

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