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Market Ethos

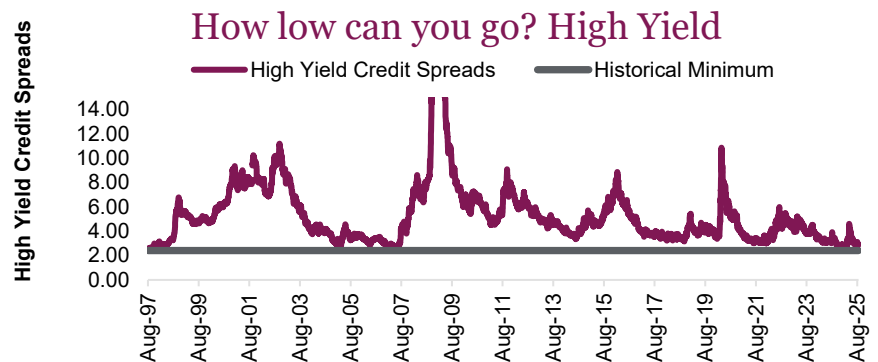
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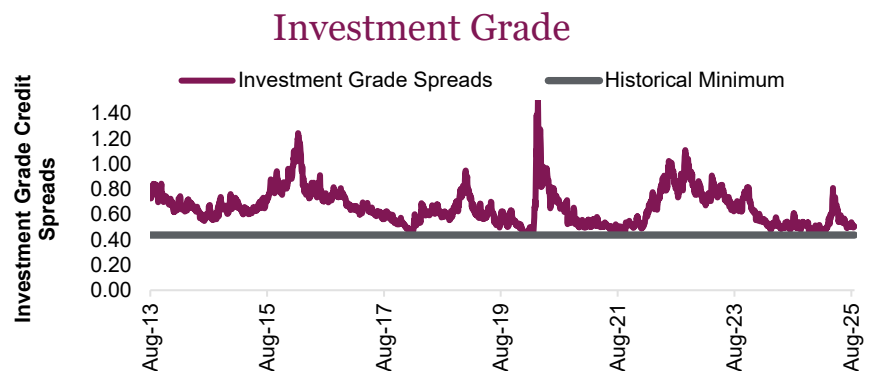
Craig Basinger

Hidden risk in risk-free

The risk-free rate, aptly named, is the nominal return you can earn without assuming any risk. Generally, government bonds or bills are used as a proxy for the risk-free rate to quantify it across different time periods. What got us thinking about the risk-free rate was credit spreads — the added yield above the risk-free rate provided by corporate bonds to compensate for such things as defaults. And these credit spreads are very low right now.



Source: Fred, ICE BofA US High Yield Option adjusted spread, Purpose Investments



Source: Bloomberg, Purpose Investments

There are a few supporting factors that support such low credit spreads. Corporate debt, while high relative to assets, does enjoy coverage ratios (debt to EBITDA) that are very healthy. Perhaps the quality of issuers has improved over time. Or, with such healthy credit markets, companies just don't go bankrupt like they used to. Just like equity investors tend to buy the dip on any sign of weakness, so do credit managers when spreads tick higher. There is clearly no shortage of buyers. That being said, do you think the world is so perfect to justify such euphorically low spreads?

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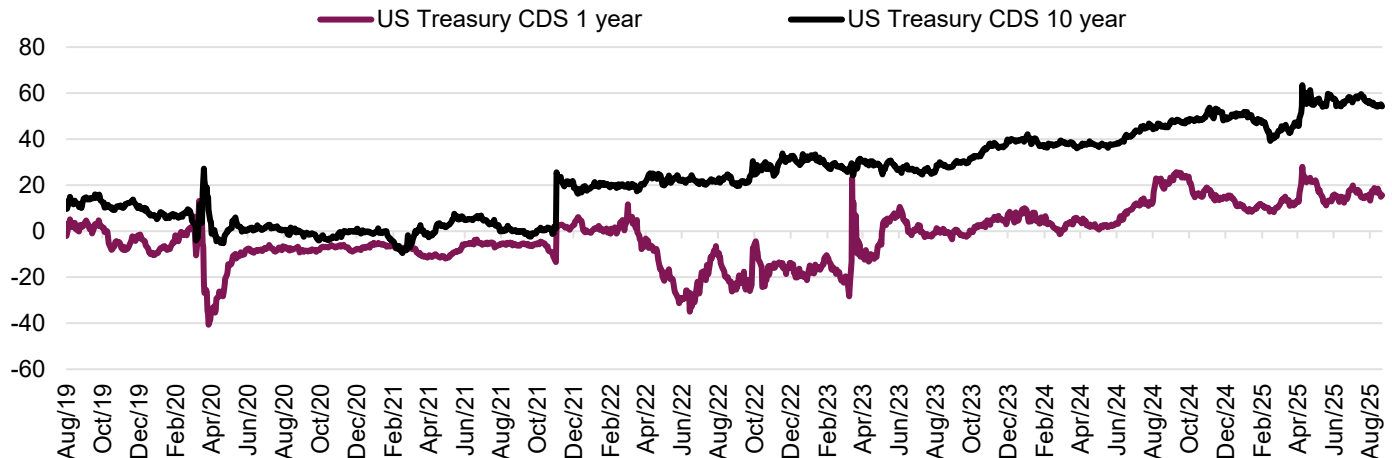
Then again, corporate spreads may be wider than they appear. As we highlighted, corporate spreads are measured off this 'risk-free rate' which is government bond yields. What if government bond yields aren't risk-free anymore and now contain a bit of a risk premium? If so, that would suppress the stated corporate spread.

This risk premium in government debt isn't about inflation or where yields are going next, it is more about default risk. This concern isn't anything new. In the early 1990s, Ross Perot warned the U.S. government was on an unsustainable fiscal path when the total debt was a mere \$4 trillion; three decades later and debt is over \$37 trillion. Clearly his warnings were premature in the 1990s, but today there are increased rumblings on the sustainability, or path forward.

Without going down the rabbit hole of how government debt works, we will jump to the current state for the U.S. Their debt is very large, interest costs are rising and demographics are a challenge. So too is the current deficit level and expected increases based on current programs and policies. The global reserve currency is a huge plus though, as is the depth of the U.S. financial system — there are many levers to pull. Today, there is no shortage of buyers of U.S. debt, despite some of the headlines. So, this isn't a today problem.

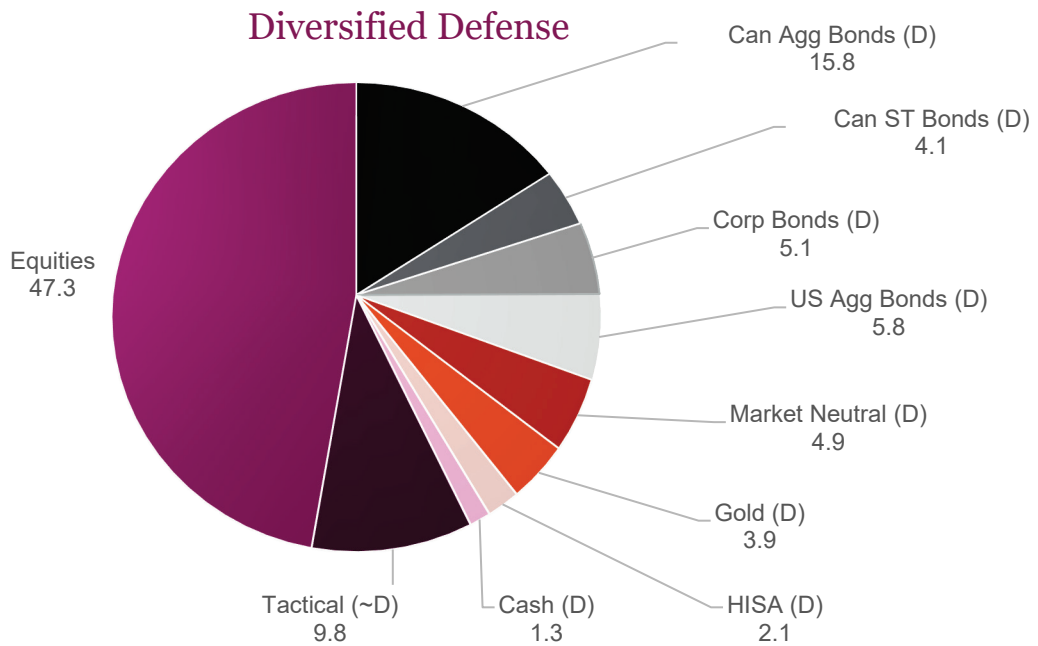
But it is a rising future risk without question. As a proxy for this risk, we will listen to the markets. Credit default swaps (CDS) are available on U.S. Treasuries, providing further evidence government yields are not risk-free, because if they were you wouldn't need insurance, now would ya? CDS pricing is influenced by a number of factors that can push pricing around. There are two key takeaways: 1) Treasury yields are now incorporating some degree of risk and 2) that degree of risk rises the farther out you look.

CDSs are telling us Treasury yields are not risk-free anymore



Source: Bloomberg, Purpose Investments

We are not alarmists on government debt or sustainability at this time, but we do believe this subject is on the rise. There are vast implications on how and/or when policy evolves in an attempt to address this rising risk, with potential knock-on effects. Today we are not losing any sleep, but we do believe portfolios should increasingly diversify their defensive positioning to include bonds, credit, hard assets, options strategies, momentum and alternatives. As an example, below are our defensive bucket allocations.



Source: Morningstar. Richardson Wealth MP Allocation. As at July 31, 2025.

Final thoughts

The crux is that a Microsoft 10-year bond trading with a credit spread of 10 bps to the 10-year Treasury yield is actually closer to 70 bps above the true risk-free rate. Maybe credit spreads are not as tight as they appear given the benchmark they are measured against has moved. For those with exposure to credit, including ourselves, this may provide some solace that the posted historically low credit spreads to Treasury yields is not a reason to be overly nervous.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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*This report is authored by Craig Basinger, Chief Market Strategist at Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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