Corporate Bond Market Insight | August 2021

Pandemic and Inflation Concerns May Slow Economic Growth

Key takeaways

» A rise in COVID-19 cases linked to the Delta variant, on top of other pandemic-related economic uncertainties, raised doubts around the economic recovery.

» The National Bureau of Economic Research confirmed that the economy troughed in April. The COVID-19 shutdown in 2020 spurred the shortest recession in US history.

» While corporate bond spreads are tight, we remain confident that economic growth, strong credit fundamentals, and highly supportive fiscal and monetary policies will support them.

» We see three risks to our view: (1) potential policy mistakes with regard to fiscal and monetary stimulus programs, (2) the sunsetting of key moratoriums, and (3) an unanticipated slowing of the economy due to the Delta variant's spread.

Parametric
800 Fifth Avenue
Suite 2800
Seattle, WA 98104
T 206 694 5575
F 206 694 5581
www.parametricportfolio.com

A rise in COVID-19 cases in July linked to the Delta variant sowed the seeds of doubt around what until now has been an impressive economic recovery. Adding to these worries, inflation rose faster than anticipated. As a result, the Federal Reserve continued to prepare markets for the tapering of its bond and mortgage purchases. Despite rising inflation and a Fed seemingly on the verge of tapering, Treasury rates fell for a fourth straight month. In particular, 10-year Treasury Inflation-Protected Securities (TIPS) real rates, which mostly reflect growth prospects, fell to new all-time lows.

The National Bureau of Economic Research officially confirmed that the economy troughed in April 2020. The two-month recession was the shortest recession in US history and, with the initial estimate of second-quarter GDP growth of 6.5%, the economy has already exceeded its pre-pandemic size. Clearly the ongoing monetary and fiscal responses were central to the historic brevity of the contraction. Even in the face of a growing list of concerns, large-cap equity indexes set all-time highs. Credit spreads remained historically narrow.

Against this backdrop, markets improved as investment-grade (IG) credit spreads widened four basis points (bps) but were more than offset by the 25-bps drop in 10-year Treasury rates. As a result, IG corporate bonds, as measured by the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index, returned 0.71% in July. In a reversal from last month, credit spreads widened modestly across all sectors, with leisure leading the way, followed closely by retail, media, and services. The insurance, utility, and real estate sectors were among top performers. As for credit quality, IG outperformed high-yield bonds, with only small differences among the IG cohorts.

GDP growth moderated somewhat from its strong showing earlier in the year, suggesting the second quarter's 6.5% estimate may represent the peak of economic activity for this phase of the recovery. The Institute of Supply Management reported that both its manufacturing and services Purchasing Manager Indexes weakened slightly while still reflecting strong growth. While the new-orders survey component also retreated slightly, the prices-paid portion—a leading indicator of inflation—suggests that purchasers are paying much higher prices for raw materials.

Inflation continued to rise at an above-trend pace. The headline Consumer Price Index (CPI) for June rose 0.9%, bringing the year-over-year rate to 5.4% and the year-over-year core rate to 4.5%. The last three monthly CPI prints represent the strongest three-month sequence in the last 40 years. Despite this, we see significant reasons for optimism. Last month we discussed the base effects created by last year's massive declines. Those base effects are quickly dissipating as the year-over-year comparisons normalize. On top of that, some outliers are driving consumer prices in aggregate. For instance, used-car prices rose 10.5% in June, representing roughly one-third of that month's change and the largest monthly increase since the index's inception in 1953. Price action like this seems likely to moderate as economic bottlenecks dissipate and supply chains mend.

Finally, over the course of the pandemic, productivity growth has soared. Think of productivity as the economy's productive efficiency or the economic output per hour worked. The ratio between output and the number of employees has risen sharply as employers have found new ways to increase efficiency. This bodes well, since wages have a very strong influence on the core inflation rate.

June marked an inflection point for the Fed. Officials began discussing the eventual tapering of open-market purchases and signaled via the dot plot that it expects to begin raising rates in late 2023. Recent public statements by Federal Open Market Committee members and the official statement after the July meeting represented little change, with the exception of growing concerns surrounding the recent rise in COVID infections.

Looking ahead

We remain optimistic in both economic and investment terms, even as we face rising Delta variant cases. It should be no surprise, given the complex nature of such an infectious pathogen, that the path to recovery isn't a straight line. However, we expect the economy and inflation to revert to near long-term trend growth rates as the volatility associated with the pandemic abates.

To be sure, we see three main risks to our view. First, fiscal and monetary stimulus of this magnitude significantly raises the risk of a policy mistake and a subsequent sharp adjustment of Treasury rates. However, we continue to believe the dissipation of base effects, resolution of logistics problems, and productivity improvements will serve to mitigate this risk.

The second threat is the sunsetting of the moratoriums on evictions and student loans and the end of mortgage forbearance scheduled by September, although talk of extensions is ongoing. But jobs are plentiful for those who wish to work. We think the disruption, while meaningful and painful for those affected, will be temporary.

Finally, the Delta variant may slow the economy more than we anticipate. While corporate bond spreads are tight, we continue to see them supported by a powerful combination of economic growth, strong credit fundamentals, and highly supportive fiscal and monetary policy. Should those factors change, our view of the corporate market may change as well.

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Parametric is headquartered at 800 Fifth Avenue, Suite 2800, Seattle, WA 98104. For more information regarding Parametric and its investment strategies, or to request a copy of Parametric's Form ADV or a list of composites, contact us at 206 694 5500 or visit www.parametricportfolio.com.

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