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Corporate Bond Market Insight | November 2021

Amid Inflationary Pressure and Labor Shortages, the Fed Takes Action

Key takeaways

» The Fed has announced a tapering of its bond-buying programs in an effort to begin to normalize monetary policy.

» COVID continues to weigh down the labor market, reducing the workforce and causing workers to reevaluate priorities, yet the economy continues to recover.

» Investment-grade corporate bond spreads remained stable in October, widening by just one basis point. Corporate balance sheets remain robust and continue to benefit from strong earnings momentum.

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Recap

Logistics and labor-supply issues negatively impacted economic activity while pushing inflation higher in October. At the same time, rising energy costs, higher rents, and the sunsetting of enhanced pandemic benefits combined to undermine consumer confidence. As a result, the 2.0% third-quarter advance estimate of gross domestic product (GDP) was not only disappointing but also the slowest since the economic trough in the second quarter of 2020.

Price pressures have finally caught the attention of the Federal Reserve. On November 3 the Fed announced its intent to begin reducing open-market bond purchases. Still, against this backdrop, the US earnings season has started strongly, particularly when viewed in the context of rising fuel costs and labor shortages. To this point US corporations have navigated the challenging environment surprisingly well. What's more, new COVID infections continued to fall sharply from their summer peak as vaccination rates continued to rise.

As a result, Treasury rates rose modestly, commodities rallied, and large-cap equities indexes strengthened to new all-time highs. Investment-grade (IG) credit spreads were stable, widening by just 1 basis point (bp) while 10-year Treasury rates rose 7 bps. As a result, IG corporate bonds, as measured by the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index, returned -0.46% in October. With spreads little changed, we saw only marginal differences in performance across sectors. The best performers included transportation, which narrowed 5 bps, and capital goods, which narrowed 2 bps. The laggards were telecommunications and basic industry, which widened by 4 and 2 bps, respectively. As for credit quality, IG outperformed high yield, with the highest-quality issuers slightly outperforming A and BBB issuers.

Despite disappointing GDP growth, data from the Institute for Supply Management's Purchasing Managers' Indexes (PMI) suggests that the economy continues to grow. For example, the manufacturing PMI rose to 61.1 from 51.9, marking the 16th consecutive month of expansion. Importantly, new orders rose again. Firms are now making the decision to carry more inventory and make labor-saving investments in durable goods as a hedge against further disruption.

Despite employer efforts to manage their workforce needs, labor shortages may be difficult to resolve. Aside from changing attitudes toward work, COVID appears to have had a significant impact on the labor force. According to a study published in September in the *Annals of Internal Medicine,* estimates of excess mortality by age group in the US suggest that the under-65-year-old age bracket lost 4.5 million years of cumulative productive life. Combined with long-COVID disability, early retirements, and the normal demographic cycle, a falling labor participation rate and rising labor costs are likely to be factors for some time.

Inflation continues to surprise on the upside, with the Consumer Price Index hovering over 5% on a year-over-year basis. We expected to see the base effects created by the sharp price declines associated with pandemic lockdowns to normalize by year-end. Given that the disruptions are more widespread and persistent than we anticipated, we see little evidence just yet that our outlook will become reality over the next two months.

Minutes from the Fed's September meeting made it clear that it's increasingly uncomfortable with the current inflation outlook. Not only are disruptions proving persistent, but consumer expectations for future inflation are rising. As consumers anticipate higher inflation, they move purchases forward in time and demand higher wages. The combination creates even higher inflation and a self-reinforcing feedback loop.

The Fed views keeping expectations anchored as central to the price-stability portion of its mandate. As a result, the Fed reiterated its desire to begin reducing bond purchases before the end of the year, and the market's expectation for the first rate increase has now moved forward by about six months, into the second quarter of 2022. It seems the Fed's view that inflation is transitory has changed as well.

Outlook

Our outlook remains constructive as we continue to recover from the pandemic and adjust to the changes it set in motion. This experience has affected production, with many reimagining former notions of work and career. Clearly consumer behavior has changed as well—remember, consumption makes up roughly 70% of GDP. The supply-chain and labor-market disruptions are impacting inflation and thereby consumer spending. This is reflected in weaker consumer sentiment and rising consumer inflation expectations. While we think inflation will slow over time as the recovery continues and the economy adjusts, it's important for the Fed to begin to address the issue in a credible way, just as the market expects.

While tapering asset purchases and Fed rate hikes will almost certainly affect markets, we can expect volatility to increase. At the same time, corporate bonds and issuer credit profiles continue to be supported by the ongoing economic recovery, strong earnings momentum, and robust, cash-rich balance sheets. As we've noted, credit spreads remain narrow given the backdrop, but regardless of the path of interest rates or credit spread volatility, we always stick to our conservative principal-protection philosophy and our systematic portfolio construction discipline.

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