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Corporate Bond Market Insight | January 2022

What Can We Expect in 2022?

Key takeaways

- IG credit spreads strengthened modestly as interest rates rose, resulting in a monthly return of 0.04% for the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index.
- While inflation continues to be an overriding concern, economic data remains robust and there are tentative signs logistics problems may be lessening.
- Our IG credit outlook remains positive, since cash-rich balance sheets offer IG companies a great deal of flexibility and protection should rates rise.
- A principal-protection investment philosophy and systematic approach to portfolio construction are likely to offer significant protection and opportunities with the advent of either rising rates or widening spreads.

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Recap

Economic growth in 2021 was very strong despite supply chain disruptions and inflation. Pent-up demand, cash-rich consumers, and the ongoing inventory rebuild have all provided a significant lift to the economy. By midyear, the economy had exceeded its pre–COVID-19 size, and company earnings set record highs. In addition, the combination of robust fiscal and monetary stimulus generated much higher than expected inflation. The degree and persistence of inflation led the Federal Reserve to begin tapering its quantitative easing (QE) program and preparing markets for possible rate hikes as early as the first half of 2022. As a whole, markets performed very well. For the year, the S&P 500® returned nearly 30%. While rising rates resulted in a negative total return for investment-grade corporates, they outperformed a duration-matched Treasury.

Against this backdrop, IG credit spreads strengthened modestly, narrowing six basis points (bps), and 10-year US Treasury rates rose seven bps in December. IG corporate bonds, as measured by the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index, returned +0.04% for the month. The annual return was -0.85%, driven entirely by rising rates.

Credit spreads across all sectors narrowed for both December and the year. For the month, the best-performing sector was media, which narrowed 11 bps, followed by healthcare and basics, both of which narrowed 10 bps. The laggards were insurance, which narrowed two bps, and capital goods and leisure, which narrowed three bps each. On the year, the best-performing sector was transportation, which narrowed 39 bps, followed by energy, which narrowed by 24 bps. The worst-performing sectors were telecommunications, consumer goods, and utilities, all of which narrowed three bps. As for credit quality, high-yield outperformed IG in both monthly and yearly perspectives, while the lower-quality rungs of IG—particularly BBB—outperformed higher-quality rungs over both periods.

Economic data remained robust. Both the Institute for Supply Management (ISM) Manufacturing and Services Purchasing Managers Indexes increased from their already strong levels, and forward-looking New Orders surveys continued to suggest strong future growth. Non-farm employment disappointed somewhat, but year-to-date gains averaged 550,000 new jobs per month, and the unemployment rate fell from 6.7% at the height of the pandemic to 4.2% in November. Importantly, there are tentative signs that logistics problems may be lessening. For instance, commodities prices are beginning to soften, particularly on a rate-of-change basis. Also, the Baltic Freight Rate Index, which tracks ocean shipping prices, has fallen sharply. Despite the logistics disruption, the New York Fed Weekly Economic Index is projecting a nearly 8% increase in gross domestic product (GDP) for the year.

Inflation continues to be the overriding concern for markets and the Fed. The 6.8% year-over-year (YOY) headline inflation in November represented the largest YOY increase since 1982, and core inflation at 4.9% YOY was the highest since 1991. The Fed's preferred inflation metric—the Core Personal Consumption Expenditures Price Index—is rising at a nearly 5% annual rate. While we think inflation will peak soon, we expect subsequent inflation will be in excess of the Fed's 2% average target.

The degree and persistence of current inflation has garnered the Fed's full attention. Importantly, the Fed successfully pivoted from dovish to hawkish without damaging markets. At its December meeting, it voted to double the pace of the taper to conclude all purchases by the end of the first quarter. The end of QE removes the Fed's only remaining impediment to raising interest rates. The median estimate of Fed forecasts—the "dot plot"—now suggests there could be as many as three increases in 2022 followed by three more in 2023. It's likely a rate increase could be announced as early as the March meeting. By that meeting, the normal yearly rotation among the voting members will result in a more hawkish-leaning voting group. However, there are currently three open seats, the nominees for which appear to be somewhat more dovish or centrist than current voters. This may slow the pace of tightening.

Looking ahead

Our 2022 IG credit outlook remains positive. The economic recovery has created record earnings, while extremely low interest rates have allowed corporations to issue debt at very attractive levels. In many cases the debt was used to retire older, higher-cost debt. The cash-rich balance sheets offer IG companies a great deal of flexibility and protection should rates rise. Returns in 2022 are more likely to be driven by changes in rates than by changes in credit spreads. In the meantime, a principal-protection investment philosophy and a systematic approach to portfolio construction are likely to offer significant protection and opportunities with the advent of either rising rates or widening spreads.

We've made the point that there are two main risks to this view. The first is that Omicron or another COVID-19 variant creates additional economic disruption. More concerning is the chance inflation will continue to rise and, in response, interest rates will rise significantly. However, we think as the supply chain returns to normal, prices will soften, and the base effects created by the higher index values of the last few months will come into play, raising the bar for future inflation. Ultimately it appears the Fed is finally on the case.

As for the direction of interest rates, we don't have a strong conviction, but we believe the path of least resistance is higher. From our perspective, the laddered structure, strong credit fundamentals, and the ability to harvest tax losses will continue to help laddered bond investors produce consistent and predictable income from their portfolios, regardless of the direction of interest rates.

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