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Corporate Bond Market Insight | May 2022

Interest Rates Remain the Primary Return Driver for Corporate Bonds

Key takeaways

» Volatility remained the theme across markets in April, driven by a hawkish Fed, geopolitical risks, and inflation—the likes of which we haven't seen in a generation.

» Higher rates have been the primary driver of a record-setting four straight months of negative bond returns, but corporate bond technicals have weighed on corporate bond spreads as well.

» Despite the first quarter's negative GDP reading, accelerating inflation seems poised to force the Fed toward a steeper path of future interest rate increases.

» As long as rates keep driving bond returns, investors can benefit from reinvesting at today's higher rates and recognizing potentially valuable tax losses that may offset gains elsewhere in the portfolio.

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Recap

Volatility showed few signs of abating in April as investors are still waiting for clarity on the factors driving it: the pace of Fed rate increases, geopolitical risks, and inflation. Investors' primary concern, inflation, continues to climb at rates unseen in four decades, all but ensuring the Fed hikes rates by 50 bps at its May meeting. In addition, US GDP shrank by 1.4% in Q1 2022, but risk assets improved as markets looked past the headline number and saw optimism in consumer and business spending figures, which remain in growth territory. At the same time, unemployment set another postpandemic low of 3.6%, within 0.1% of the 50-year low last reached just before the pandemic. This confluence of factors contributed to US Treasury rates rising and the curve steepening over the month.

Against this backdrop, 10-year Treasury yields moved 60 bps higher, and investment-grade (IG) credit spreads widened 21 bps. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned -2.72% for the month, with both widening credit spreads and rising Treasury rates contributing to the negative return. The index has now produced a negative return in the first four months of the year for the first time ever and tied last year's record for the most consecutive months of negative returns. Performance from a sector perspective was fairly uniform, with all sectors posting negative returns. Media performed the worst, with 25 bps of spread widening, while automotives and transportation performed the best, with 12 bps of spread widening each. As for credit quality, high yield once again outperformed investment grade, while A-rated bonds performed the best among the IG cohorts—more evidence that rates are the primary driver of returns.

Technical factors in the corporate market continue to be headwinds. After four straight weeks of outflows in March, another four straight weeks of outflows followed for a total of $13.5 billion in outflows for April. On the other side of the equation, supply remains elevated. April saw $107.2 billion in new issuance price, well above expectations, which puts supply 9% higher than at this point last year. However, there are reasons to be optimistic. IG outflows have been persistent, but the pace of outflows hasn't accelerated despite continuing negative performance. Also, while year-to-date supply has been high, we haven't seen expectations for total issuance for the year increase as many issuers pull forward funding plans to avoid higher rates in the future.

Inflation continued to strengthen as year-over-year (YOY) headline consumer prices rose 8.5%, another four-decade high. Core prices—inflation less food and energy—rose at an accelerated rate of 6.5%. The Institute for Supply Management (ISM) Services Prices Paid and Manufacturing Prices Paid indexes are both growing at faster rates, suggesting future inflation could continue to accelerate. With inflation still accelerating, there are few possible events that could slow the Fed's march toward higher interest rates.

One surprising data point this month was first-quarter GDP, which shrank by 1.4%. The drop in GDP was attributed to both a growing trade deficit—imports far in excess of exports—and a slower pace of inventory build by business. We've discussed growing inventories in the past as a reflection of businesses trying to insulate themselves from supply-chain disruptions. It seems logical that those same companies may have built up their inventories to comfortable levels and no longer need to build at the same pace. We'll have to wait and see if this GDP figure ends up being a sign of slow growth ahead.

Looking ahead

Economic data seems to be pointing in multiple directions, but we still believe the economy is on solid footing. Markets showed little reaction to the disappointing GDP number and actually rallied in the immediate aftermath. Most observers looked past the headline number to see consumer and business spending—the main drivers of GDP—remaining strong and even growing, which suggests GDP could bounce back in forthcoming quarters. In addition, jobless claims remain close to historically low levels, and initial earnings reports show most companies beating expectations.

Our outlook for laddered bond investors hasn't changed. We think credit spreads have room to drift wider on the technical backdrop we're experiencing. However, there's little cause for concern given solid balance sheets, earnings, and cash flow. In the event our credit outlook does change, investors can take comfort from our high-quality bias and consistent credit monitoring.

That leaves interest rates as the main driver of future returns. Investors should prepare for interest rates to continue to rise. The Fed appears to be staying on course for six more hikes of varying magnitude this year, as well as beginning its balance sheet runoff. This will further depress bond prices and weigh on performance. However, that in turn will present excellent opportunities to systematically reinvest at higher rates and take advantage of harvesting tax losses that can be used to offset gains elsewhere in the portfolio.

Rising interest rates also offer a more attractive entry point than we've seen in quite some time. While higher rates have yet to attract buyers to the corporate market, we expect flows to lag performance once the tide does turn. Our systematic reinvestment of interest payments and maturing bonds allows clients to dollar-cost average into today's higher rates, creating opportunities to increase the yield earned on many accounts.

The ICE BofAML 1–10 Year Corporate Bond Index measures the performance of corporate bonds with a time to maturity between one and 10 years. The index data referenced herein is the property of ICE Data Indices, LLC (ICE), its affiliates, and its third-party suppliers. ICE, its affiliates, and its third-party suppliers accept no liability in connection with its use.

27494 | 5.5.2022