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Corporate Bond Market Insight | June 2022

The Market Isn't the Economy: Why the Worst May Be Behind Us

Key takeaways

- » While volatility extended into May, investment-grade (IG) corporate bonds posted their first positive return of the year as a result of falling interest rates, breaking the recent string of negative monthly returns.
- » The Fed raised the benchmark rate by 50 basis points (bps), bringing the total rate increase this year to 75 bps. Interest rate increases and quantitative tightening are likely to pressure risk assets, particularly equities, over coming quarters.
- » While spreads are widening somewhat, corporate credit fundamentals remain solid. This combination of higher rates and wider spreads offers attractive all-in yields, particularly in conjunction with the cost-averaging power of the investment ladder.

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Recap

While volatility extended into May, IG corporate bonds posted their first positive return of the year as a result of falling interest rates. However, we're seeing the first signs of an economic slowdown appear at the same time inflation remains very high, sparking fears of *stagflation*. Core inflation, which excludes food and energy, rose above expectations at 6.2%. At the Federal Reserve's May meeting, it increased the federal funds rate by 50 bps and set expectations that further 50-bps hikes will be coming to meet the top priority: reducing inflation. The Fed's newfound commitment to tackling inflation resulted in the M2 money stock—an indicator of future inflation—showing a monthly decline for the first time since March 2010 and indicating a significant tightening of financial conditions.

Against this backdrop, Treasury rates rose early in the month before the weakness in equity and risk markets generated a flight to quality buying that lowered and steepened the yield curve. The nine-bps decline in the 10-year Treasury rate more than offset the moderate five-bps widening in IG credit spreads. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned 0.66% this month, breaking the recent string of negative monthly returns. In terms of sectors, most changed only moderately; leisure, which widened 39 bps because of an outlier in a small sector, was by far the worst, while telecommunications, which compressed six bps, performed best. As for credit quality, IG slightly outperformed high-yield (HY). Inside IG, A- and higher-rated securities outperformed BBB, but the differences were marginal.

In an economy that is roughly 70% consumption, consumer attitudes and expectations are extremely important. Over the last 12 months, the Michigan Consumer Current Economic Conditions Survey, a measure of consumer confidence, declined from 85 to a dismal 63. Negative portfolio wealth effects, sharply higher energy and food costs, higher interest rates for consumer loans (including mortgages), and an end to fiscal subsidies are all contributing factors to this reduction in confidence. On a brighter note, the misery index—the sum of inflation and the unemployment rate—remains around its historic average, and personal consumption expenditure spending data remains solid.

Worriedly, a recent string of disappointing earnings calls makes it clear that employers, after adding to head count to service stimulus-fueled spending, are beginning to rightsize the labor force. This pattern is likely to repeat across the economy as inflation reduces consumer spending power and Fed tightening raises borrowing costs, which in turn directly affects corporate profitability. The latest GDP revision suggests that profitability is declining at an 8% annual rate before accounting for the effects of inflation. We're watching the recent increase in jobless claims closely to see whether the recent move above 200,000 in initial claims lasts or is just seasonal noise.

In May, the Fed raised the benchmark rate by 50 bps, bringing the total rate increase this year to 75 bps. It also signaled plans to raise the benchmark rate by 50 bps in each of the next two meetings. In addition, it willl begin its quantitative tightening program of not reinvesting maturing securities from its portfolio beginning June 1. The runoff of holdings will rapidly ramp up to $95 billion a month by September, roughly twice the pace of its last round of quantitative tightening. Just as the injection of liquidity during periods of quantitative easing served to support risk assets, quantitative tightening is likely to pressure risk assets, particularly equities, over coming quarters.

The Fed has completed its pivot toward inflation. Its actions and statements suggest it will take extreme weakness in asset markets and the economy for it to pivot again. The good news is that the economic slowdown that appears to be unfolding will help bring inflation down. Indeed, slowing economic growth is a time-honored prescription for lowering inflation. However, it will take a delicate touch, one the Fed hasn't historically demonstrated, to keep the economy from slipping into a recession while bringing down inflation.

Looking ahead

While it's clear that the economy is slowing, markets aren't the economy. Recent sharp declines in intermediate and long-term rates are starting to steepen the yield curve, suggesting the tightening cycle is already producing results. In fact, recent forward federal funds pricing implies the market expects the Fed to pause after its September meeting to assess the impact of the tightening of financial conditions. Nevertheless, corporate balance sheets contain tremendous amounts of excess cash and, because of the refinancing wave of the past two years, are heavily insulated from having to roll debt over into the higher rate environment. In our opinion, while spreads are widening somewhat, corporate credit fundamentals remain solid. We will continue to monitor new claims, the steepening of the yield curve, and other leading indicators for real-time evidence of economic distress, but today we remain optimistic.

Ladder investors should be comforted by the strong credit fundamentals of issuers we invest in and the very attractive current reinvestment rates. Interest rates will continue to be the main driver of corporate ladder returns in the short term, and we have reason to believe the worst of interest rate volatility is behind us. In addition, the steepening yield curve ensures investors are compensated for the duration they take on. The combination of higher rates and wider spreads offers the most attractive all-in yields of the last decade, particularly in conjunction with the cost-averaging power of the investment ladder.

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