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Corporate Bond Market Insight | August 2022

Non-GDP Indicators Suggest a Recession Isn't Here Yet

Key takeaways

- The 10-year Treasury rate fell 36 bps, while IG credit spreads also narrowed 11 bps for the month. This led to the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returning 2.46% this month.
- The Fed continued to move aggressively against inflation. The July Federal Open Market Committee (FOMC) meeting resulted in an additional 75 bps increase in the federal funds target to a range of 2.25% to 2.50%.
- Economic activity continued to weaken as high and rising inflation exacted its toll on consumers and business finances.
- We feel IG credit fundamentals are strong. Corporations entered the downturn with solid balance sheets, and the refinancing wave of the last two years leaves them insulated from issuing into the higher rate environment.

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Recap

Investor attention shifted in July from inflation to the growing likelihood of a global economic slowdown. Treasury rates fell sharply as investors looked for safety, resulting in the best month of performance for investment-grade (IG) corporate bonds since April 2020. As the month progressed, despite the Consumer Price Index (CPI) setting new year-over-year and month-over-month cycle highs, significant declines in industrial materials—particularly energy—suggested that inflation was peaking. The Federal Reserve again increased the federal funds target rate by 75 basis points (bps), and the European Central Bank joined the rapidly growing number of monetary authorities that have tightened policy rates.

Against this backdrop, the 10-year Treasury rate fell 36 bps, while IG credit spreads also narrowed 11 bps for the month. This led to the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returning 2.46% this month. While the fall in the Treasury rates accounted for most of the return, narrowing IG credit spreads also contributed to the strongly positive total return for the month. Spreads in all sectors narrowed as risk tolerance increased. As for credit quality, high yield (HY) handily outperformed investment grade. Inside IG, A- and higher-rated securities performed in line with BBB securities.

Economic activity continued to weaken as high and rising inflation exacted its toll on consumers and business finances. While employment remained generally strong, the four-week initial jobless claims average continued to rise. Other forward-looking metrics also continue to weaken: The Conference Board Leading Economic Index, a composite reading of 10 leading economic indicators, declined for the fourth consecutive month. The sharp slowdown in the Institute of Supply Management (ISM) Report on Manufacturing, particularly the new orders component, also supports the weakening theme.

The -0.9% initial estimate of second-quarter gross domestic product (GDP) followed a -1.6% first-quarter decline. While two consecutive quarters of negative GDP growth provides a reliable recession marker for investors, the National Bureau of Economic Research (NBER) and its Business Cycle Dating Committee don't date recessions this way. They consider a wide array of economic data in addition to GDP, including employment, real consumer spending, real personal income, and the duration and depth of the contraction. Based on those additional factors, the economy may in fact be avoiding a recession. Many economists make the argument that a recession can't be happening while employment remains this strong. They fail to consider that both employment and inflation badly lag changes in the federal funds rate. In practical terms, this means it takes months before changes in the policy rate are reflected in economic indicators. This "long and variable lag" problem makes it very difficult for a central bank to fine-tune policy and significantly increases the odds of a policy error.

The Fed continued to move aggressively against inflation. The July Federal Open Market Committee (FOMC) meeting resulted in an additional 75 bps increase in the federal funds target to a range of 2.25% to 2.50%. This brings the total rate increases to 225 bps over the last four FOMC meetings. At the post-meeting press conference, Fed chair Jerome Powell said it's "likely appropriate to slow increases at some point" and that any further increases will be "data dependent." By returning to the meeting-by-meeting data-dependent status of past Feds, he underscored just how difficult the current environment is.

Looking ahead

Dwindling forward guidance will make markets more vulnerable to policy surprises. Interestingly, markets are now pricing a rate cut in early 2023. As the Fed is clearly prioritizing inflation over employment and the economy, we think a pivot is unlikely. With the next FOMC meeting not scheduled until September, the Fed will have the benefit of seeing two additional CPI reports before deciding on its next move.

While inflation may be peaking, there's still significant pricing pressure in the pipeline. Housing, which is about one-third of headline CPI, is only beginning to be reflected. We believe the prospect of inflation returning any time soon to the Fed's 2% average target is limited. Europe and Asia are also suffering inflation and business slowdowns. On a brighter note, both personal and corporate balance sheets remain solid, and overstock in retail inventories and declines in gasoline prices should provide some relief to consumers. We see few signs of systemic stress, aside from the difficulty that the strong dollar is creating in emerging markets, which we're monitoring closely.

In terms of portfolio positioning, we feel IG credit fundamentals are strong. Corporations entered the downturn with solid balance sheets, and the refinancing wave of the last two years leaves them insulated from issuing into the higher rate environment. In fact, interest coverage is at a record high of 12.8 times. Our analysts continue to see only modest deterioration in the balance sheets of the names we invest in, and the upgrade-to-downgrade ratio remains positive. From a maturity perspective, the corporate yield curve has flattened over the past few months, and the spread between 10-year and five-year corporate yields has narrowed. This means the short end of the yield curve now offers a significant percentage of the yield available in the intermediate part of the curve.

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