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Corporate Bond Market Insight | September 2022

Bonds May Offer Safety as the Fed Fights Inflation

Key takeaways

» With the 10-year Treasury rate up 61 basis points (bps) and credit spreads narrower by six bps, the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned -1.76% this month.

» As the month closed, Federal Reserve chair Jerome Powell reaffirmed his commitment to defeating inflation, even if it results in much slower growth or a recession.

» With 10-year Treasury rates back above 3%, we believe bonds will likely begin filling their traditional safe-haven role, rallying when economic and market conditions worsen.

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Recap

After suffering one of their worst yearly starts, risk markets enjoyed one of their best summers ever. Much of the strength followed July's Federal Reserve press conference, after which markets interpreted chair Jerome Powell's comments as far less hawkish than they'd priced in. A sharp decline in gasoline prices, a modest deceleration in consumer inflation, and a decent earnings season all contributed to the improving mood.

Despite the market's optimism, there were growing signs of stress in both domestic and global economies. Weakness in housing, rising geopolitical risk, declining GDP, and the cost of energy are all weighing on sentiment. As the month closed, in a Paul Volcker–like speech at the annual Jackson Hole symposium, Powell reaffirmed his commitment to defeating inflation, even if it results in much slower growth or a recession.

Against this backdrop, the 10-year Treasury rate rose 61 basis points (bps). Investment-grade (IG) credit spreads narrowed six bps for the month—not enough to offset the significant rise in Treasury rates. The combination saw the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index return -1.76% this month. Spreads in all sectors narrowed as risk tolerance increased. As for credit quality, high yield (HY) modestly outperformed IG. Inside IG, BBB outperformed A- and higher-rated securities.

It took only six business days for new IG issuance to surpass expectations of $60 billion for the month, and August concluded with a total of $109 billion. Favorable market conditions were a main reason for the increase in supply, and the market absorbed the influx well. At the same time, demand as measured by retail fund flows to IG mutual funds and exchange-traded funds (ETFs) were positive every week, a big change from the 21 consecutive weeks of outflows we saw prior to this.

The US economy continued to produce weakening data but with a few bright spots. Payrolls posted another impressive upside surprise, with nonfarm employment up by 528,000—including an impressive 471,000 private-sector jobs—and the unemployment rate falling to 3.5%. The Institute for Supply Management's monthly Manufacturing Purchasing Managers (PMI) Survey at 52.8 and Services PMI at 62.7 also suggest that the economy is continuing to avoid a technical recession. However, the growing weakness in US housing is concerning. New home sales declined 12.6% in July, which suggests slowing demand for durable goods. Also, the manufacturing survey's forward-looking new orders series came in at 48, below the 50 threshold for expansion. Finally, the Standard and Poor's Flash Global Composite PMI is at 45, a very weak reading that strongly suggests the global economy may be entering a synchronized recession. This will further complicate the domestic outlook and the Fed's job.

Inflation moderated somewhat. The month-over-month change in July consumer prices was reported to be unchanged. This improvement was driven by a sharp decline in energy, particularly gasoline. However, the large decline in energy masked the continued rise in food prices, up 13.1% year over year, and continued inflation in housing, which feeds through to CPI with a long delay. Despite the slowing in the monthly release, YOY headline inflation at 8.5% and core inflation at 5.9% remain far above the Fed's target range.

Following the July Federal Open Market Committee (FOMC) press conference, the market decided Powell's remarks suggested a potential pivot early next year. In our view, Powell and several important voting members have made it abundantly clear that they'll continue tightening until they're certain inflation is contained. Powell underscored our view with his remarks at the annual Jackson Hole gathering, where he said restoring inflation to the 2% target is the central bank's "overarching focus." He also stated that "the historical record cautions strongly against prematurely loosening policy." The Fed is committed to bringing inflation back under control and is willing to put up with significant slowing to do so. Quantitative tightening (QT) kicks into high gear in September, and balance sheets should begin to reflect significant declines.

Looking ahead

Autumn appears to hold greater-than-normal potential for increased volatility. As QT begins in earnest in the US, we expect to see stronger resolve from central banks to prioritize inflation over growth. Corporate earnings have held up well, but we suspect margins will decline as it becomes increasingly difficult to pass price increases through to consumers. With 10-year Treasury rates back above 3% and the Fed focusing on inflation, we believe bonds will likely begin filling their traditional safe-haven role, rallying when economic and market conditions worsen.

We continue to view credit fundamentals as solid. IG companies used the ultra-low rate environment to improve balance sheets and insulate themselves from having to issue new debt into a higher-yield environment. The credit cycle also remains positive, with upgrades exceeding downgrades. The 2020 recession already removed over $200 billion of fallen angels from the IG index, significantly reducing the number of potential downgrades. While we believe spreads may widen and yields may rise, positions are averaged in for IG ladder investors, no matter the environment. All-in yield levels for 1–10 year BBB ladders exceed 4%, providing extensive protection against rising rates and widening spreads. These conditions offer the most attractive all-in yields of the last decade, particularly in conjunction with the cost-averaging power of a fixed income ladder.

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