PARAMETRIC

Corporate Bond Market Insight | November 2022

Despite Cracks, the Economy Remains Resilient

Key takeaways

» The initial October estimate of third-quarter GDP at 2.6% was the first positive GDP print of the year and, when combined with the strength in employment, suggests the economy continues to avoid recession.

» The combination of higher rates and wider spreads resulted in the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index (C5A0) returning -0.52% for the month and brought the year-to-date decline to -12.3%.

» The 6.6% year-over-year consumer price index (CPI) core reading was the highest since 1982, and the headline rate was the highest in three months.

» We continue to believe the sharp increase in Treasury rates has created compelling value in shorter-maturity (one- to five-year) corporate bond ladders.

Parametric
800 Fifth Avenue
Suite 2800
Seattle, WA 98104
T 206 694 5575
F 206 694 5581
www.parametricportfolio.com

Recap

October brought continued mixed economic data but also a growing conviction that the Federal Reserve may slow the pace of its rate increases. The initial estimate of third-quarter GDP at 2.6% was the first positive GDP print of the year and, when combined with the strength in employment, suggests the economy continues to avoid recession. Despite the weakness in commodities, inflation again exceeded consensus expectations, reaching multi-decade highs. Encouragingly, crude oil, a major contributor to goods inflation, is now roughly unchanged on a year-over-year basis. The sharp move higher in Treasury rates has translated to the highest mortgage rates since 2001 and downward pressure on home prices. Finally, the global economy weakened as central banks and governments continue to deal with a variety of problems created by inflation, debt, the war in Ukraine, and trade tensions.

Against this backdrop, the 10-year Treasury rate rose 22 bps, while investment-grade (IG) credit spreads widened five bps for the month. The combination of higher rates and wider spreads resulted in the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index (C5A0) returning -0.52% for the month and brought the year-to-date decline to -12.3%. Because of the rise in interest rates, IG corporate bonds remain on course to suffer their worst yearly return since the inception of the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index. As has been the case over the balance of the year, negative returns are mostly attributable to the rise in Treasury rates rather than a deterioration in credit spreads or fundamentals.

While weak, the US economy continues to avoid recession. The initial estimate of Q3 GDP of +2.6% is encouraging, but the details are troubling. Much of the strength resulted from the increase in government spending and a large increase in petroleum exports as US producers shipped liquid natural gas to energy-starved Europe. The good news was somewhat offset by the -26.4% contraction in residential investment, a primary gauge of housing market activity. We also see this weakness in the sharp contraction in existing home sales and month-over-month declines in home prices. While housing price declines have the immediate impact of reducing economic activity through consumption, housing contributes roughly one-third of the CPI. The weakness will ultimately pressure CPI lower and help the Fed return inflation to its target.

The CPI again surprised on the upside. The 6.6% year-over-year core reading was the highest since 1982, and the headline rate was the highest in three months. Shelter, food, and medical care indexes were the largest contributors, while prices for gasoline and used cars declined. Services inflation, particularly rents, continue to rise strongly, but the growing weakness in housing, which represents about a third of the overall index, will eventually feed through and provide relief. Goods inflation is now mitigating the overall CPI rise, but the more persistent services inflation continues to rise.

There was no Fed meeting in October, but it's widely expected that it will again raise the benchmark rate by 75 bps at the early November meeting. That will be the fourth consecutive 75-bps increase and bring the funds rate into the 3.75% to 4% range. While the Fed remains resolute in its commitment to combating inflation, recent comments by officials and actions of other central banks suggest the Fed is becoming concerned with developments around global financial stress. Interestingly, domestic measures of financial stress, including credit spreads, continue to be very well behaved, while global stress appears to be rising rapidly.

Looking ahead

We expect the Fed to continue raising rates, perhaps pausing early next year as the federal funds rate reaches terminal level to assess the lagged effects of the rapid increases of the last year. The next challenge for markets will be Q4 earnings. Q3 results have been reasonably good, particularly for banks, as rising rates increase their net interest margins and most business lines remain solid. It's interesting that earnings seem to be differentiated, with old economy companies (staples and health care, for instance) doing better than new economy companies. As margins continue to deteriorate, however, the forward outlook is less sanguine.

We continue to view corporate balance sheets as solid, but the upgrade-downgrade cycle is turning in favor of downgrades. The downgrade of so many BBB issues to high yield during the pandemic leaves IG in much better position to weather a downgrade cycle than in the past.

We continue to believe the sharp increase in Treasury rates has created compelling value in shorter-maturity (one- to five-year) corporate bond ladders. This part of the curve is flat, allowing investors to pick a significant amount of the yield available on longer indexes with far less duration risk.

About

Parametric Portfolio Associates® LLC ("Parametric"), headquartered in Seattle, is registered as an investment advisor with the US Securities and Exchange Commission under the Investment Advisers Act of 1940. Parametric is a leading global asset management firm, providing investment strategies and customized exposure management directly to institutional investors and indirectly to individual investors through financial intermediaries. Parametric offers a variety of rules-based investment strategies, including alpha-seeking equity, fixed income, alternative, and options strategies. Parametric also offers implementation services, including customized equity, traditional overlay, and centralized portfolio management. Parametric is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley, and offers these capabilities through offices located in Seattle, Boston, Minneapolis, New York City, and Westport, Connecticut.

Disclosures

This material may not be reproduced, in whole or in part, without the written consent of Parametric. Parametric and its affiliates are not responsible for its use by other parties.

This information is intended solely to report on investment strategies and opportunities identified by Parametric. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. We believe the information provided here is reliable but do not warrant its accuracy or completeness.

This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Past performance is not indicative of future results. The views and strategies described may not be suitable for all investors. Investing entails risks, and there can be no assurance that Parametric will achieve profits or avoid incurring losses. Parametric and Morgan Stanley do not provide legal, tax, or accounting advice or services. Clients should consult with their own tax or legal advisor prior to entering into any transaction or strategy described herein.

Charts, graphs, and other visual presentations and text information were derived from internal, proprietary, or service vendor technology sources or may have been extracted from other firm databases. As a result, the tabulation of certain reports may not precisely match other published data. Data may have originated from various sources, including, but not limited to, Bloomberg, MSCI/Barra, FactSet, or other systems and programs. Parametric makes no representation or endorsement concerning the accuracy or propriety of information received from any third party.

The views expressed in this report are those of portfolio managers and are current only through the date stated at the top of this page. These views are subject to change at any time based on market or other conditions, and Parametric disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions are based on many factors, may not be relied on as an indication of trading intent on behalf of any Parametric strategy. This commentary may contain statements that are not historical facts, referred to as "forward-looking statements." The strategy's actual future results may differ significantly from those stated in any forward-looking statement, depending on factors such as changes in securities or financial markets or general economic conditions.

An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads, and a lack of price transparency in the market. As interest rates rise, the value of certain income investments is likely to decline. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. While certain US government–sponsored agencies may be chartered or sponsored by acts of Congress, their securities are neither issued nor guaranteed by the US Treasury. Mortgage- and asset-backed securities are subject to credit, interest rate, prepayment, and extension risk. Derivative instruments can be used to take both long and short positions, be highly volatile, result in economic leverage (which can magnify losses), and involve risks in addition to the risks of the underlying instrument on which the derivative is based, such as counterparty, correlation, and liquidity risk. Diversification does not guarantee profit or eliminate the risk of loss.

Parametric is headquartered at 800 Fifth Avenue, Suite 2800, Seattle, WA 98104. For more information regarding Parametric and its investment strategies, or to request a copy of Parametric's Form ADV or a list of composites, contact us at 206 694 5500 or visit www.parametricportfolio.com.

27494 | 11.10.2022