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Corporate Bond Market Insight | March 2023

Dangerous Curves Ahead?

Key takeaways

- » February continued to show economic momentum. Consumer spending was unexpectedly strong, the services economy improved significantly, and companies continued to add employees at a rapid pace.
- » Markets expect at least three more increases of 25 basis points (bps) and no rate cuts during 2023.
- » We still believe the Fed will pause hikes before midyear to assess the lagged effect of what by then will be nearly 500 bps of tightening.
- » With rapid tightening of loan standards, sharp declines in leading economic indicators, and the deep inversion of the Treasury yield curve, we believe 2023 could see a recession.

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Recap

February was notable for the rapid shift in the narrative around Federal Reserve policy, the economy, and inflation. In January and early February, the belief that inflation had peaked and that a recession was imminent created the narrative that the Fed would be forced to pivot. In anticipation, Treasury rates fell sharply, equities moved higher, and credit spreads tightened. But much stronger-than-expected economic data and poor progress on inflation abruptly changed the narrative.

Economic momentum was evident. Consumer spending showed unexpected strength, the services economy improved significantly, and companies continued to add employees at a rapid pace. Upside surprises in the monthly inflation data suggest price pressures are more persistent than markets had hoped.

In early February, markets priced several Fed rate cuts for this year. They now expect at least three more 25-bps increases and no rate cuts during 2023. Terminal rate expectations also shifted sharply higher, with current fed funds rate projections approaching 5.5%. As a result, equities weakened and Treasury rates rose sharply. Interestingly, market expectations have exceeded those of the Fed, projecting more increases than the Fed's dot plot. Two-year Treasury rates hit a new cycle high to end the month and are now the highest in the past 16 years.

Against this backdrop, the 10-year Treasury yields rose 41 bps and intermediate investment-grade (IG) credit spreads widened three bps for the month. The combination of higher rates and narrower spreads resulted in the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returning -1.86% for the month. The negative returns were driven almost entirely by higher Treasury rates, with wider spreads contributing slightly. Year-to-date corporate returns remain positive. Performance differences among the IG rating cohorts and various sectors were muted.

A shockingly strong employment situation report suggested that, despite the Fed's efforts to weaken it, the employment economy remains strong. It could be that employers are more reluctant to lay off employees after the difficulty in hiring them postpandemic. But the lowest unemployment rate since 1969, the highest job openings in six months, and the extremely low level of unemployment claims all continue to suggest levels of employment inconsistent with a recession. Other metrics like the Job Openings and Labor Turnover Survey (JOLTS) and the low level of initial claims also suggest that the labor economy remains strong. Importantly, employment lags the business cycle but so far shows few signs of distress.

There were many expansionary economic readings this month. After printing a contractionary result in December, the ISM Purchasing Manager's Services Index's January result unexpectedly rose back into expansion territory. The forward-looking New Orders Index also rose sharply. Retail sales rebounded strongly from December's weakness, rising 3% and thoroughly offsetting December's -1.1% decline. This was the strongest monthly growth in almost two years, proving that consumption, which accounts for roughly 70% of GDP, remains strong.

Optimism surrounding inflation also diminished as February reports uniformly surprised to the upside. Core Personal Consumption Expenditures (PCE)—the Fed's favored inflation metric—came in at 0.6% month over month, and the year-over-year (YOY) rate rose to 4.7%, still far above the Fed's 2% target. The core Consumer Price Index (CPI) accelerated, and median CPI, which removes the strength or weakness of the outlier sectors, is still 7.1% YOY.

The combination of stronger inflation and stronger economic output make it clear the Fed still has work to do. At the February meeting, it increased the federal funds target range at a slower increment compared with its previous meeting, just 25 bps. This brought the total rate increase for this cycle to 425 bps and a federal funds range of 4.5% to 4.75%. The Fed also continue to shrink its balance sheet through quantitative tightening. We still believe the Fed will pause hikes before midyear to assess the lagged effect of what by then will be nearly 500 bps of tightening.

Looking ahead

We continue to expect that 2023 could bring a recession. The rapid tightening of loan standards, sharp declines in leading economic indicators, and the deep inversion of the Treasury yield curve are all consistent with a building recession. In addition, the lagged effects of last year's rate increases are only beginning to work their way into the real economy.

If a recession does develop, we continue to see solid value for IG ladder investors. Starting yields are high and offer a significant buffer against additional rate increases. It's also likely that rates will fall should the economy stall. As we've seen the last year, with corporate balance sheets in good condition, rates are the prime mover of returns. Falling rates would aid ladder returns, while a shallow recession shouldn't have a large impact on credit fundamentals. From a credit perspective, IG corporate balance sheets are solid, refinancing needs are modest, and earnings remain stable.

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27494 | 3.15.2023