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Corporate Bond Market Insight | January 2023

Coming Out of Turbulent Times

Key takeaways

» The combination of rising rates and tightening spreads resulted in the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returning 0.09% for the month, 2.70% for the quarter, and -9.63% for the year.

» The Fed again raised rates but slowed the pace of tightening from 75 to 50 basis points (bps), and Chairman Powell reiterated that inflation is a much greater threat than economic contraction.

» Now that there's considerable carry value in the yield curve, we expect periods of yield weakness to be met with demand, particularly as growth and inflation slow. We also expect that bonds will regain their traditional role as a hedge to risk.

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Recap

2022 will long be remembered as the year when global central banks, faced with a 40-year high in inflation, undertook historic monetary tightening campaigns. The rapidity and magnitude of interest rate hikes shocked markets that had become complacent during the long period of low inflation. As a result, bonds suffered their worst annual return in more than a century and equities their worst since the 2008 financial crisis. Uncharacteristically, bonds failed to provide their accustomed offset to losses in equity and other risk assets.

In February the Russian invasion of Ukraine had the dual effect of slowing global growth and further increasing goods inflation. As much higher energy costs took a toll, domestic growth slowed markedly. Despite beginning the year with two consecutive quarters of negative GDP, the US economy—particularly the labor market—remained resilient and avoided recession. Consumers faced a rare decline in housing prices, but wage and employment data suggest they can continue spending at current levels for a while longer.

The Fed was firmly committed to bringing inflation back to its 2% target and raised rates seven times over the course of the year to do so. This brought the Fed funds upper target rate from 0.25% to 4.5%, the highest level since just before the 2008 financial crisis. As the year progressed, Treasury yield curves inverted. In July the two-year/10-year curve inverted, and in November the three-month/10-year curve—a measure preferred by the Fed—did as well. These inversions strongly suggest a 2023 recession is likely.

Against this backdrop, the 10-year Treasury yield rose 237 bps for the year, five bps for the quarter, and 27 bps for December. Intermediate IG credit spreads tightened five bps for the month and 22 bps for the quarter and widened 56 bps for the year. The combination of rates and spreads resulted in the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returning 0.09% for the month, 2.70% for the quarter, and -9.63% for the year. IG corporate bonds produced the worst annual return since the inception of the index. The record negative annual return was driven mostly by increases in Treasury rates.

Despite clear signs of softening, the economy continued to avoid recession. Another large upside surprise in the payroll data and steady initial unemployment claims suggest the labor economy remains healthy. It's notable that growth in non-farm payrolls continues to slow incrementally from a solid level. The Institute for Supply Management (ISM) Services Purchasing Managers Survey—a measure of business activity in the services economy—at 56.5 is still very strong, but the manufacturing survey at 49.0 and the forward-looking new orders survey at 47.2 suggest that the manufacturing economy is contracting.

Inflation continued to inflect lower as commodities weakened from their mid-year highs. The year-over-year consumer price index growth rate slowed to its lowest point since December 2021 but is still far above the Fed's target rate of 2%. Goods inflation has come under control, but services inflation remains quite high.

Over the course of 2022, the Fed consistently surprised markets with both the pace of its increases and the hawkishness of its rate projections. The December meeting was no exception. The Fed again raised rates but slowed the pace of tightening from 75 to 50 bps. Importantly, the dot plot (FOMC's projections for the Fed's target overnight rate) was sharply more hawkish than it was at its last meeting and remains significantly more hawkish than the market is pricing. Chairman Powell continues to make two points: Rates are likely to be held higher for longer, and the danger of stopping too soon outweighs the danger of continuing. He has been consistent in communicating that inflation is a much greater threat than economic contraction. No matter what happens with policy rates, the Fed will continue to normalize its balance sheet by reducing its holdings of Treasuries and mortgage-backed securities at a pace of about $1.1 trillion per year through quantitative tightening.

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Looking ahead

We expect the elevated volatility to continue. The inversion of the Treasury curves and the sharp deceleration in the leading economic indicator strongly suggest 2023 will contain a mild to moderate recession. The Fed will likely increase rates 25 to 50 bps a couple times to start the year, then pause to assess the lagged effects of the tightening campaign to date.

It's rare for bonds to have consecutive negative years—never mind three in a row—and it's common for rates to fall during a recession. Now that there's considerable carry value in the yield curve, we expect periods of yield weakness to be met with demand, particularly as growth and inflation slow. We also expect that bonds will regain their traditional role as a hedge to risk.

IG corporates remain well positioned for both economic contraction and higher rates. Balance sheets are in good condition, earnings have remained solid, and interest coverage remains near a record high. Intermediate corporate yields doubled last year, and the front end of the corporate curve now offers compelling value. This is particularly true in shorter-maturity (one- to five-year) corporate bond ladders, where there's little duration risk and the starting all-in yield offers significant protection against additional rate increases.

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