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How AI Spending Is Reshaping Corporate Bonds

Key takeaways

- The market responded to the Fed's July "hawkish hold" reinforced its commitment to price stability, with chair Kevin Warsh signaling a firm focus on returning inflation to the 2% target.with long term rates rising more than short term rates.
- Treasury yields rose and the curve steepened as markets reacted to inflation concerns and the Fed's reduced use of forward guidance.
- Growing investor caution around AI hyperscalers and their record amount of issuance drove investment-grade credit spreads to widen modestly.and their rising share of index duration risk drove investment-grade credit spreads to widen modestly.
- A disappointing second quarter GDP reading can be explained by an increase in imports needed to fund the AI buildout.
- Despite short-term pressure from higher Treasury yields and modestly wider spreads, solid balance sheets, resilient earnings and yields that remain comfortably above inflation continue to support the bond market.

Recap

July saw renewed hostilities in the Middle East that created significant volatility in energy markets while the Federal Reserve (Fed) kept rates unchanged. Inflation appeared to ease somewhat, and employment growth was disappointing. Despite good corporate earnings, concerns around the growth prospects of the artificial intelligence (AI) hyperscalers kept technology stocks under pressure and contributed to wider investment-grade (IG) credit spreads. The combination of rising Treasury yields and modestly wider corporate spreads pressured investment-grade returns.

At its July meeting, the Federal Open Market Committee (FOMC) maintained the federal funds target range at 3.5%—3.75%. This marked the fifth consecutive meeting at which it left rates unchanged. There was significant dissent among the committee, with three of the 12 voting members favoring a 25 basis points (bps) increase due to their inflation concerns. As a result, the press mostly characterized the meeting as a hawkish hold.

Following the meeting, long and intermediate Treasury rates rose more than short-term rates, reflecting concerns about rising inflation and questions about the likelihood that the Fed would hike rates. This move caused the Treasury yield curve to steepen by 14 bps. The bear steepening trend reflects a continuation of the trend that began following the June FOMC meeting.

We think chair Warsh's commitment to price stability is clear. His history as an inflation hawk supports that assessment. In the July FOMC statement, the subsequent press conference and an early July speech at the European Central Bank's annual forum, he was explicit in terms of the Fed's commitment to restoring price stability. For instance, in the press conference he said: "There is no soft inflation target, there is no soft implicit target, not on this Committee's watch. There is only one target, and it is two percent. Not one of my FOMC colleagues is under any illusion. We have begun a new chapter, and we understand that the five-plus years of inflation above target cannot be cured in nine weeks—or by a single month of modest price decreases."

In keeping with the new chair's desire to eliminate forward guidance, neither the FOMC statement nor the press conference that followed included any clue about future policy. We suspect that this lack of guidance is the new normal. He has long argued that guidance can trap the Fed into a defined narrative that discourages change and limits flexibility as economic data and conditions change. He also believes that guidance encourages speculation rather than restraint on the part of investors.

He also highlighted the strength in business investment. He described the surge of high-tech capital expenditures as "extraordinary," mentioning the trailing four-quarter growth rate of nearly 20%.

Against this backdrop, the 10-year Treasury yield rose 27 bps for the month and 1–10-year IG credit spreads widened three bps for the month. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned -0.58% for the month, and 3.42% over the trailing one year. For the month, changes in credit spread across sectors outside of technology and media were narrowly mixed. The best-performing sectors were automotive, insurance, transportation and energy, while retail and telecommunications underperformed somewhat. Media and technology underperformed significantly.

Despite another robust month of issuance, IG spreads were well behaved. New issuance totaled $133 billion, roughly 35% higher than last year's July issuance. This brings the year-to-date issuance to nearly $1.3 trillion.[1] The pace of issuance was particularly notable in the context of summer trading, when staffing levels and liquidity are lower than normal. The surge of AI hyperscalers new issuance is beginning to meet investor resistance while concerns grow around the scale of capital expenditures needed to support AI infrastructure.

IG credit spreads widened modestly. However, the widening was almost entirely confined to the hyperscalers. The growing weight of hyperscalers in the IG indexes leaves the broader market increasingly exposed to developments in the sector. Because the new issuance generally has longer maturities than that of the existing index, changes in Treasury yields or credit spreads in the sector have a greater impact on index returns. For instance, at month's end, hyperscalers represented 4.3% of the IG index, up from 3.5% at the end of 2025, yet they now represent 8.1% of the duration risk.

[1] Source: JP Morgan

Balance sheets across the remainder of the IG universe remain solid, and robust earnings continue to support the sector. The current all-in yield of 5.09% also provides significant investor value. This is still comfortably above the current inflation rate, providing investors with positive real income and an added cushion against market volatility.

June economic data was mixed. Employment appears to be slowing, but the labor outlook is complicated. The labor force continues to shrink as baby boomers retire, and net immigration has shifted from a positive to a negative contributor to labor force growth. Because the labor force is shrinking, fewer jobs are needed to keep the economy at full employment. For instance, June's nonfarm payrolls increased by only 57,000. The Bureau of Labor Statistics revised April and May payroll estimates downward by a combined 74,000.

Despite the slow growth, the unemployment rate fell from 4.3% to 4.2%. This decline was largely the result of the labor force participation rate falling to 61.5%. Excluding the pandemic years of 2020 and 2021, this was the lowest participation rate since 1976.

The Bureau of Economic Analysis reported a disappointing initial estimate of 1.5% annualized GDP growth for the second quarter. However, much of the weakness was attributable to net exports as companies brought new capital equipment into the country in anticipation of expected tariffs. This subtracted 1.00% from the overall growth. It's important to note that this type of weakness doesn't reflect weakness in underlying domestic demand. For instance, real final sales to private domestic purchasers, which include both domestic consumer and business investment while excluding trade and inventory effects, rose at a strong 3.9% annualized rate.

June inflation surprised on the downside, with CPI, PPI and PCE all weaker than expected. However, much of the softness reflected the sharp decline in energy prices. Core PCE, the Fed's preferred inflation measure, only rose 0.1%, bringing the year-over-year rate to 3.3%.

Looking forward

Solid fundamentals, strong balance sheets and growing corporate earnings combined with yields well above the inflation rate continue to support IG corporate investment. We believe that the FOMC is acutely aware of the growing inflation threat and that chair Kevin Warsh is committed to containing it. Economic growth, particularly capital investment and earnings, is still solid.

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