Parametric

Corporate Bond Market Insight | June 2025

Underlying Issues Have Us Cautious as Widening Resolves

Key takeaways

» The bulk of the post-inauguration credit spread widening of the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index has been reversed, but we're cautious since the issues that caused it initially have yet to be resolved.

» Moody's downgraded the United States sovereign debt rating from Aaa to Aa1, mostly due to Congress passing the budget that will make many of the tax cuts in the 2017 Tax Cuts and Jobs Act permanent.

» A temporary trade truce with China will allow them and the United States time and space to negotiate a longer-lasting trade agreement.

» The Fed is maintaining a "wait and see" position while it continues to watch how inflation and the economy respond to tariff policy.

Recap

The White House delayed the implementation of several previously announced tariff policies in May and announced a temporary trade truce with China. The actions relieved some economic uncertainty, helped stabilize markets and dramatically improved the mood of US consumers. Moody's downgraded the rating of US sovereign debt in mid-May in response to the continued deterioration of its fiscal position. Despite fears of a tariff-induced slowdown, the economy continued to perform well, and inflation continued to moderate. Against this backdrop, the Fed chose to leave rates unchanged. Ten-year rates rose somewhat but remain well within the bounds of the year-to-date range.

As tariff news became less dire and the economic backdrop stabilized, investment-grade (IG) credit spreads continued to narrow from their mid-April highs. They have now reversed the bulk of the post-inauguration widening. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index rests only 11 basis points (bps) wider than at the inauguration and only 16 bps wider than the 10-year low of 65 bps. Tariff-exposed, economically-sensitive cyclical sectors like autos and energy have led the recovery. More defensive sectors like utilities and pharmaceuticals have lagged somewhat. We continue to think that, short of a recession, the narrower spreads are justified. IG corporate balance sheets remain strong, and market liquidity is solid. However, we're still cautious, since the tariff and economic concerns that caused the initial widening have yet to be resolved.

Moody's ratings downgraded the United States sovereign debt rating from Aaa to Aa1 on May 16. The downgrade follows the S&P Global Ratings downgrade in 2011 and the Fitch Ratings downgrade in 2023. The core issue remains the continued fiscal deterioration in national finances, but the immediate catalyst was the House of Representatives budget draft. The proposal makes permanent the tax cuts contained in the 2017 Tax Cuts and Jobs Act and further lowers personal and corporate tax rates. Depending on who does the scoring, the House proposal is projected to increase the deficit by $3 to $4 trillion over the next decade. The bill has moved to the Senate, where significant changes are likely. Unless the combination of lower tax rates and a reduced regulatory burden creates significant increases in revenues, the deficit is bound to grow.

The distinction between Aaa and Aa1 is small. Due to prior downgrades by S&P and Fitch, the US was already a split-rated entity. Since the 2011 downgrade, most investment and collateral guidelines have been modified in such a way that changes no longer trigger large amounts of mandatory selling. We can see this in the muted reaction to the downgrade: Ten-year rates are now lower than the day of the announcement. While the fiscal path is concerning in our view, the downgrade doesn't change default risk, and US credit quality remains high.

Changes in tariff policy continued to drive market sentiment. Consensus grew over the month that the US hoped to deescalate the rapidly expanding trade war. The US and China announced a mutual but temporary reduction of previously announced tariffs in mid-May. The decrease reduced US tariffs to a baseline of 30% and Chinese tariffs to a baseline of 10%. The 90-day pause allows the two countries time and space to negotiate a longer-lasting trade agreement. The US and United Kingdom also announced a trade agreement.

The Fed met in May to maintain the federal funds rate in the same 4.25% to 4.50% range that's been in place since December 2024. Chair Jerome Powell continued to stress that the Fed is in a "good position to wait and see" how inflation and the economy respond to tariff policy. He continued to emphasize that the cost of waiting for more clarity is low. Currently both sides of the dual mandate are reasonably balanced. Employment data has only deteriorated modestly, and inflation continues to move toward target. Year-over-year Core PCE, the Fed's favored inflation gauge, fell to the lowest level since April 2021 at 2.5%, only 0.50% above the Fed's stated target. We believe the bar for near-term change in rates is high.

Against this backdrop, the 10-year Treasury yield rose 24 bps on the month, and credit spreads narrowed 18 bps on the month. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned 0.2% for the month and 7.13% for the trailing one-year yield as a result. Credit spreads in all sectors narrowed over the month. Leisure, transportation and energy performed best, while healthcare, telecommunications and consumer goods lagged somewhat. Lower quality outperformed higher quality, and more cyclical sectors and lower quality overperformed in general.

Despite the -0.2% Q1-2025 GDP print, May's economic data was again reasonably strong. Imports saw large increases as consumers and companies rushed to buy before the tariffs dropped heavily, influencing the negative GDP print. The negative contribution of imports to the GDP calculation outweighed positive consumer and business spending. The Atlanta Fed's GDPNow real-time estimate for Q2 2025 is running a strong 3.8%, modified to account for the outsized influence of gold imports on Q1 estimates.

Employment growth was again solid. Employers added 177,000 new nonfarm jobs in April, 167,000 of which were private-sector jobs. While the recent rise in claims and deterioration in the JOLTS survey are beginning to generate concern, strong labor markets and rising wages continue to suggest a reasonable level of consumer comfort. However, weakness in retail sales and housing may be signs that consumers are beginning to pull back somewhat. The housing weakness is particularly concerning, since housing is an important driver of the domestic economy. Recent equity recovery, the anticipation of additional tax cuts, and optimism that the damage from tariffs will be limited have reversed much of the recent decline in consumer sentiment.

Looking forward

The issues that have created volatility over the last four months have yet to be resolved. The impact of the tariffs are now beginning to filter into the real economy. We also think there's clearly still potential for further surprises. There's also the question of businesses and consumers front running goods prior to the implementation of the tariffs creating distortion.

We continue to view IG fundamentals as supportive of valuation and the potentially high starting yield of ladder products as providing an attractive total-return cushion. Professionally managed ladder structures continue to provide an important hedge against uncertainty.

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