

Corporate Bond Market Insight | March 2024

Going for Corporate Growth but Readying for Recession

Key takeaways

- » No single sector exhibited significant widening, but the technology sector went slightly higher, and the leisure and transportation sectors performed the best.
- » Roughly one-third of the first quarter's data is in place, and the Atlanta Federal Reserve's latest GDPNow estimates project growth of 3.2%. We don't believe this data is consistent with a recession.
- » After January's inflation, markets are questioning how aggressive the Fed can be in cutting rates this year. As a result, markets repriced their expectations for rate cuts lower.
- » A moderate recession might be in store for late this year or early next. We think rates will decline and enhance returns if the economy does enter a shallow recession.

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Recap

A combination of higher-than-expected inflation and solid economic growth in February forced markets to reconsider their expectation for rapid Fed rate cuts. Treasury rates rose moderately, while markets priced out several projected cuts. Even with the rise in rates, several tech-heavy large-cap equity indexes reached new all-time highs. Despite extremely heavy new issuance, strong fundamentals fueled robust demand for investment-grade (IG) corporate credit, which kept credit spreads near their post-global financial crisis tight. We also saw apparent progress toward avoiding a government shutdown in early March.

Against this backdrop, the 10-year Treasury yield rose 34 basis points (bps) and credit spreads narrowed four bps for the month. As a result, the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned -0.83% for the month. Lower quality generally outperformed higher quality, and sector credit spreads tightened, with only the technology sector slightly wider on the month. The leisure and transportation sectors performed the best, and no single sector exhibited significant widening.

Economic data remains very strong. With roughly one-third of the first quarter's data in place, the Atlanta Federal Reserve's latest GDPNow estimate projects growth of 3.2%. While this would represent a moderately slower pace of growth than the prior quarter's 4.9% rate, it's not at all consistent with a recession. February was another strong month for labor markets, and the Institute of Supply Management (ISM) Purchasing Managers' manufacturing and non-manufacturing indexes had significant upside surprises. Forward-looking new orders readings suggest growth in both the manufacturing and services sectors may be accelerating. Somewhat offsetting this positive news, consumer credit card balances are rising, along with debt servicing costs and delinquency rates. Weaker retail sales and lower consumer confidence may be beginning to reflect the stress that inflation has placed on consumer finances. That said, personal incomes rose at their fastest level in more than a year.

Higher-than-expected inflation interrupted the consistent progress that's been made toward the Fed's 2% inflation target. Consumer and producer prices both surprised significantly to the upside. Rising shelter costs generated much of the upside surprise in the Consumer Price Index (CPI), contributing to more than two-thirds of the overall increase. Core CPI prices rose the most in eight months, while supercore inflation—from core services excluding housing and energy—climbed 0.8% from December. Core Personal Consumption Expenditures (PCE),

the Fed's favored inflation gauge, rose 0.4% and brought the year-over-year rate to 2.8%. January inflation data tends to be volatile, but this year's numbers caused markets to question how aggressive the Fed can be in cutting rates this year. It will be interesting to see if the January data was a fluke or represented something more lasting. It's clear that we've likely made easy gains in the fight to bring inflation lower.

Responding to the rise in inflation and the economic strength, markets repriced the number of rate cuts expected in 2024. Futures markets had priced in a full 150 bps of cuts entering the year, doubling the 75 bps that the Fed had projected in its mid-December dot plot estimate. Now market-based expectations have fallen and are roughly in accordance with the current Fed estimates. However, the FOMC will release a new dot plot with updated projections at its March 20 meeting.

Chair Jerome Powell and other Fed speakers have been quite clear in their intention to move slowly. Powell said in a CBS interview that the "danger of moving too soon is that the job's not quite done, and that the really good readings we've had for the last six months somehow turn out not to be a true indicator of where inflation's heading... but the prudent thing to do is to just give it some time and see that the data continues to confirm that inflation is moving down to 2% in a sustainable way." The minutes from the January meeting reinforced this view, and multiple Fed speakers reiterated the message throughout the month.

Economic strength and rising inflation were evident in the ISM Purchasing Managers' index (PMI) reports. Manufacturing PMI rose to 49.1, the best print since October 2022, suggesting the manufacturing economy is in expansion. The forward-looking new orders segment rose sharply from 47 to 52.5, but the prices paid component soared disturbingly from 45.2 to 52.9. Non-manufacturing (services) PMI also moved sharply higher to 53.4 versus December at 50.5, and new orders moved higher again from 52.8 to 55. The Services Prices Paid index also moved sharply higher to 64 from 57.4, the largest one-month surge in 11 years.

Labor markets remain strong. Nonfarm payrolls added 353,000 new jobs in January, and the December release was revised sharply higher to 333,000. Private payrolls added a solid 317,000 new jobs. Average hourly earnings moved higher by 0.6%, doubling the consensus estimate. This was the largest earnings gain since March 2022.

Looking forward

While IG corporate returns have been moderately negative over the first two months of the year, we view the negative return as a natural correction to last year's strong 7.34% performance, most of which occurred late in the year. Returns pulled forward and are now correcting somewhat.

We continue to believe it's likely that a moderate recession will begin either late this year or early next. But IG balance sheets remain solid, earnings are good, and companies continue to hold record amounts of liquidity. Should the economy enter a shallow

recession, we think it's likely that rates will decline and enhance returns. When investors deploy bonds in a ladder structure, which allows for structured reinvestment no matter the economic outcome, they become largely agnostic to moderate changes in rates and spreads.

We expect that a data-dependent Fed will continue to move cautiously. Unless circumstances or untenable data force its hand, we believe the Fed be slow to cut rates, particularly with national elections drawing near.

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