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Corporate Bond Market Insight | September 2023

Will a Debt Ceiling Downgrade Leave Corporate Balance Sheets in a Bind?

Key takeaways

- Fitch downgraded the US sovereign debt rating from AAA to AA+ due to concerns about the country's fiscal outlook.
- Ten-year Treasury yields are the highest they've been since 2007 due to the improving economy and the growing issuance calendar.
- Monthly retail sales came in very strong, wages rose at a greater rate than inflation, and the direct input to GDP rose a strong 1% on the month.
- The Fed reiterated its commitment to bringing inflation back to the 2% target, and it acknowledged that the reacceleration in the economic data is a significant upside threat to inflation.

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Recap

Normally placid August arrived with Fitch unexpectedly downgrading the US sovereign debt rating. The month also saw a sharp acceleration in economic data and an upward surge in rates. Even with inflation weakening somewhat, the annual Jackson Hole symposium underscored the Fed's commitment to bringing inflation back to the 2% target.

Fitch downgraded the US sovereign debt rating from AAA to AA+, citing concerns about the country's fiscal outlook. The downgrade brought the Fitch rating in line with Standard and Poor's Global Ratings and leaves Moody's as the only one of the big three Nationally Recognized Statistical Rating Organizations (NRSROs) to hold US sovereign debt ratings at AAA. Fitch justified its downgrade by citing the likelihood of fiscal deterioration, the size of the debt burden, and the expectation that governance will continue to erode. While the general deterioration of the US fiscal position is undeniable, its debt remains one of the highest-quality credits on the planet.

The sharp improvement in the economy, coupled with the ratings change, accelerated the recent rise in Treasury yields. Ten-year yields rose as high as 4.34% before reversing sharply toward the end of the month, slightly exceeding last October's peak. That's the highest yield for 10-year Treasuries since 2007. The rise in real yields has pushed much of the increase. The 10-year real yield touched 2% for the first time since September 2008. We believe the surprising economic strength and rising worries around the growing issuance calendar drove the rise in yields rather than the downgrade or a resurgence in inflationary expectations.

Against this backdrop, the 10-year Treasury yield rose 15 basis points (bps) for the month, and intermediate investment-grade (IG) credit spreads tightened by six bps. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned -0.11% for the month as a result. Sector spreads widened modestly in most sectors, apart from insurance and real estate, which remained unchanged. No sector stood out other than the small leisure sector, which widened 22 bps.

Consumers continue to spend despite growing headwinds. Monthly retail sales came in strong, nearly doubling both the prior month's increase and the consensus estimate. The direct input to GDP is the control group and rose a strong 1% on the month. Wages are rising at a rate greater than inflation, and the strong labor economy continues to buttress consumer balance sheets. Workers benefited from favorable outcomes due to several major labor contracts being renegotiated. Teamsters/UPS, United Auto Workers/General Motors, and Allied Pilots/American Airlines contracts all featured labor-friendly wage and benefit increases.

The economy added 187,000 new nonfarm payroll jobs, and the unemployment rate dropped 0.1% to 3.5%. Average hourly wage growth was also strong, but signs of slowing are emerging. Nonfarm payroll growth over the last two months averaged 186,000, far below the 12-month average of 312,000. The average work week fell to 34.3 hours, matching the lowest reading since the onset of the pandemic. The fall in the work week is notable because employers tend to cut hours before reducing staff when demand weakens. Late in the month, the Job Openings and Labor Turnover Survey (JOLTS) report showed a dramatic fall in job openings and the rate of quits.

The Atlanta Federal Reserve GDPNow offers a real-time estimate of the current quarter's GDP based on the quarter's economic releases to date. The GDPNow reading illustrated the strength of this month's data, which suggests that if the third quarter ended now, the GDP would have achieved a nearly 6% growth rate. While the data for Q3 is only roughly one-third in place, it would take a virtual collapse in the August and September data to produce a negative quarter.

Inflation continued to moderate. However, the Fed noted in the minutes from its July meeting that the recent slowing in inflation is likely temporary, and the risks to the outlook for inflation remain tilted to the upside. Core CPI posted the smallest back-to-back monthly gains in more than two years, and CPI ex-shelter came in flat in July. The Fed's preferred measure of inflation, the core Personal Consumption Expenditures (PCE) index, is at 4.2% YOY and still far above the 2% target.

Chair Jerome Powell reiterated at the annual Jackson Hole symposium the Fed's commitment to bringing inflation back to its target. He acknowledged that the Fed was data-dependent and the reacceleration in the economic data was a significant upside threat to inflation. Despite growing pressure to raise the 2% target, Powell reiterated the Fed's commitment to maintaining it. It's likely that the Fed will skip raising rates at its September meeting with the moderation in CPI inflation and cooling job growth.

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Looking ahead

We expect the economy will cool as excess savings are depleted, student loan abeyance ends, and the lagged response to rate increases continues to go through the markets. A cooling economy should produce lower Treasury rates. IG corporate balance sheets remain solid in the meantime, financing needs are modest, and earnings remain strong. No year between now and 2030 has greater than an 8% finance need of the S&P 500® companies, for instance, and 48% of all debt comes due after 2030. Modest financing needs leave IG companies insulated from many of the rate increases.

IG corporate ladders continue to hedge against both rising rates and recession in the meantime. If the economy begins to cool, rates are likely to fall. High-quality longer-duration ladders should produce good returns if so. High current yields provide a return cushion against higher rates that will likely remain significant if inflation persists.

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