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Corporate Bond Market Insight | May 2024

Unexpected Growth Might Frazzle a Fed Focused on Inflation

Key takeaways

» The Fed confirmed its wait-and-see stance, and futures are suggesting that the chance of rate cuts this year has dwindled to one, late-year, 25 basis point (bps) cut.

» First quarter GDP was much weaker than expected, with growth slowing to a near two-year low. This suggests that the strong economic momentum evident in 2023 may have slowed.

» Inflation has consistently surprised to the upside over the last several months, and the rapid progress toward the Fed's 2% inflation goal has stalled. The stall is mostly attributable to the stickiness of service-sector inflation.

» Wages continue to grow faster than inflation, with average hourly earnings growing at a 4.1% year-over-year (YOY) rate. Though month-over-month retail sales slowed modestly, the YOY rate has increased from 2.1% to 4%.

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Recap

The opening month of the second quarter proved difficult. Strong economic growth and persistently high inflation tempered the outlook for Fed rate cuts and pushed Treasury rates sharply higher. The sharp rise in geopolitical risk temporarily roiled markets mid-month, but markets regained their composure in a short time. Investment-grade (IG) corporate monthly returns were negative despite reduced issuance compared to the first quarter. Rising rates drove negative returns but were somewhat offset by tightening credit spreads.

The third consecutive month of stronger-than-expected inflation and growth has likely placed the Fed onto an extended hold. Futures now suggest the chances of rate cuts this year have dwindled to a single, late-year, 25-basis-point (bps) cut after entering the year pricing as many as six rate cuts. Chair Jerome Powell and a succession of other Fed speakers have confirmed the tilt toward a more hawkish "wait and see" policy stance. We expect the Fed to keep rates steady at its May and June meetings as a result, unless there's evidence of a sudden economic slowdown. The Fed is likely to announce a tapering of its quantitative tightening program to relieve some of the upward pressure on Treasury rates.

The advanced estimate of first-quarter GDP was much weaker than expected, with growth slowing to nearly a two-year low. The shift suggested that the strong economic momentum evident in 2023 may have slowed. The inflation-adjusted final sales to private domestic purchasers, an important gauge of domestic demand, rose at an acceptable 3.1% rate after adjusting for government spending and accounting for inventories and trade imbalances. A solid string of monthly economic reports continues to suggest that much of late last year's momentum is persisting.

The rapid progress toward the Fed's 2% inflation goal has stalled. Inflation has consistently surprised to the upside over the last several months, but the stall is mostly attributable to the sticky inflation in the service sector. For instance, the 5.1% jump in service-sector inflation drove the first-quarter increase in the advance estimate of Personal Consumption Expenditures (PCE), nearly double the prior quarter's pace. Inflation remains uncomfortably above the Fed's 2% core PCE target in the final analysis. Commodities moved higher in reaction to rising geopolitical risk and stronger global growth, putting yet more pressure on the outlook.

Against this backdrop, the 10-year Treasury yield rose 37 bps, and credit spreads narrowed four bps for the month. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned -1.25% for the month with a trailing one-year return of 3% as a result. Lower-quality credit generally outperformed higher quality over the month. Credit spreads in all sectors tightened moderately. The transportation and leisure sectors lagged somewhat.

The economy continued to generate growth. After contracting for 16 months, the Institute of Supply Management's (ISM) Purchasing Managers' Manufacturing Index finally moved into expansion with just over 50% of purchasing managers reporting growth. The March reading marks the first time that manufacturing activity has expanded since October 2022 and likely marks the end of the third-longest manufacturing downturn in ISM history. The forward-looking new orders at 51% encouragingly suggest that manufacturing should continue to expand over the coming months. A rise in the prices paid component somewhat offset the good news.

Consumers remain in good shape. The employment economy remains strong, and wages continue to grow faster than inflation. The March employment report saw the economy add 303,000 new nonfarm payroll jobs. This was the largest monthly gain since May 2023 and marked 39 straight months of job gains. Average hourly earnings grew at a 4.1% year-over-year (YOY) rate. Rising wages can also be seen in the Fed's preferred wage gauge, the Employment Cost Index (ECI), where wages and benefits expanded at a 4.2% annualized rate in the first quarter. The unexpectedly strong growth in ECI might concern a Fed focused on reducing inflation.

Consumers continued to spend, buoyed by gains in stock portfolios, wages and higher interest income. Month-over-month retail sales slowed modestly, but the YOY rate has increased from 2.1% to 4%. Redbook retail sales, a private report that directly compares same-store sales from period to period, rose at a strong 5.5% YOY rate last month. Consumers seem to be willing to shop, particularly those in the higher-income cohorts. Lower-income cohorts face more headwinds: Savings and stimulus associated with the pandemic have been drawn down, inflation has taken a toll and credit card debt and delinquencies are rising. But if the employment economy remains strong and wages continue to grow faster than inflation, even lower-income consumers should be generally fine.

Following a series of higher-than-expected inflation and economic data releases, Powell suggested policymakers need to wait longer than previously thought before cutting interest rates. He was particularly concerned with the lack of progress made on inflation, noting it will likely take more time for officials to gain confidence that price growth is headed toward the Fed's 2% goal before it lowers borrowing costs. Markets are now pricing only one rate cut this year, with futures beginning to suggest at least an outside chance of a rate increase.

Looking ahead

Navigating the postpandemic economy has been a challenge. Traditional indicators, such as the inversion of the Treasury yield curve, and the prolonged weakness in leading economic indicators that have reliably projected past recessions haven't resulted in a recession. Fund manager surveys have now

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turned extremely positive. Around 90% of managers surveyed expect either a soft or no landing over the next 12 months. The excess liquidity from pandemic programs, consumers and corporations locking in low rates that isolated themselves from the rate increases and the wealth effect generated from higher interest income and gains in equities has supported economic growth and inflation. We expect a modest recession beginning late this year or early next as these factors dissipate.

IG corporate fundamentals remain supportive of credit, even at current spread levels and in a modest recession. Earnings are somewhat mixed but continue to support credit fundamentals. High-starting yields still provide a solid forward return cushion for ladder investors, who are mostly agnostic in terms of rates. And while higher yields are painful in the short term, they offer solid reinvestment levels for maturing IG corporate and Treasury ladder rungs.

Rate volatility has increased, and directionality has become mixed. But as the economic numbers become more mixed in coming quarters, we expect that rates will again turn lower. In the case of a recession or a renewal of Middle East hostilities, rates may turn sharply lower.

We think the Fed is beginning to edge toward lowering the policy rate, but any cuts may be delayed. The economic numbers remain solid, and the path to the Fed's inflation target appears to be somewhat less sure. The balance sheets of IG companies remain well positioned to weather a moderate slowdown. An economic recession is likely to be accompanied by falling rates, boosting corporate bond returns.

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