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Corporate Bond Market Insight | July 2024

An Economic Inflection Point Has Us Going for Corporate Bonds

Key takeaways

» Credit spreads narrowed to near their all-time tights relative to Treasurys, and the quarter saw strong demand for investment-grade (IG) corporate debt, producing attractive all-in yield levels for IG corporates.

» Employment growth may be slowing, but nonfarm payrolls surprised sharply to the upside, from a 165,000 gain in April to 272,000 in May.

» The Fed left rates unchanged at their June meeting and revised its projections of future policy (dot plot) from three cuts in its March meeting to a single rate cut for 2024.

» A growing number of internal conflicts in the economic data, specifically in the employment economy and nonfarm payrolls, indicate an economic inflection point.

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Recap

Inflation moderated, and evidence of a slowdown in the employment and consumer economies grew in the month of June. Slowing inflation and a weakening economic outlook led to growing optimism that the Fed would begin to lower rates this year. Technology and the promise of artificial intelligence primarily drove several large-cap indexes to set new all-time highs while Treasury rates declined modestly throughout the month.

The second quarter saw growth estimates rebounding from the sharp slowdown of the first quarter. The Atlanta Fed's GDPNow estimates second-quarter growth of 3%, with approximately 70% of the quarter's data reported. Upward surprises in inflation in April and May created doubt that the Fed would be able to ease this year. However, sharply weaker inflation prints in June created optimism that the broader trend toward the Fed's 2% inflation target had resumed. The Fed left the federal funds rate unchanged over the quarter but reduced the dollar amount of securities allowed to mature off its balance sheet in May. The reduction in quantitative tightening (QT) represented the first tangible move toward easier monetary policy. The quarter also saw strong demand for investment-grade (IG) corporate debt. Credit spreads narrowed to near their all-time tights relative to Treasurys despite near record issuance. We believe the combination of narrower spreads and higher Treasury base rates continues to produce attractive all-in yield levels for IG corporates.

Progress toward the Fed's inflation target resumed in June. Headline month-over-month Consumer Price Index (CPI) was unchanged and the weakest since July 2022. The 3.4% year-over-year (YOY) core rate represented the lowest YOY level since April 2021. Personal Consumption Expenditures (PCE), the Fed's preferred gauge of inflation, also fell to 0.1% month over month. This brought both headline and core PCE YOY growth rates to 2.6%. We think this means clear progress, even though 2.6% is still above the Fed's 2.0% target. The CPI core goods category registered its largest fall in nearly 20 years. Services, particularly shelter costs, are driving what remains of the inflation problem which are sticky and lag real-world housing and rent data significantly.

Against this backdrop, the 10-year Treasury yield fell 10 basis points (bps) for the month and rose 20 bps for the quarter. Credit spreads widened eight bps for the month and three bps for the quarter. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned 0.66% for the month and 0.86% for the quarter, with a trailing one-year return of 6.15% as a result. Higher-quality IG credit generally outperformed lower quality over the month, but the differences were small. Credit spreads in all sectors widened modestly, but performance among sectors was tightly grouped. Leisure and banking performed the worst, and French banks led the widening in banking in response to the French election.

The labor economy remains strong, but signs say employment growth may be slowing. May nonfarm payrolls (NFP) surprised sharply to the upside with 272,000 new jobs, mostly in private industry. This represented a significant rebound from the 165,000 NFP gain in April. On the other hand, the unemployment rate rose from 3.9% to 4.0% and is now up a full 0.6% from its low. Other employment economy anecdotes are also weakening: Job openings fell to their lowest level in three years, and the four-week average of initial jobless claims is now at its highest level since September 2023.

Consumer spending is finally showing unsurprising evidence of weakening. Retail sales and purchases of consumer durables were weaker than expected, and credit delinquencies and credit card balances are rising. Wealth effects, rising interest income, higher wages and solid balance sheets have buoyed consumers. Ongoing inflation continues to exact its toll, and excess pandemic savings have been spent. We've seen a tangible weakening in consumer confidence surveys over the last few months.

The Fed left rates unchanged at its June meeting, maintaining the 5.25 to 5.50% range set in July 2023. The Fed revised its projections of future policy (dot plot) from three cuts in its March meeting to a single rate cut for 2024. It also increased its median forecast for year-end core inflation to 2.8%. We believe the Fed doesn't want to repeat the mistake of late last year by assuming inflation is beaten. The Fed need proof that the trend toward its inflation target has resumed. As Chair Jerome Powell noted in the press conference following the meeting, "It will take additional improvement in inflation, or an unexpected deterioration in the labor economy, to finally trigger a rate cut."

A growing number of internal conflicts have appeared in the economic data. The Institute for Supply Management's Purchasing Managers Manufacturing Survey saw the new orders component decline by the most in two years, even while new orders for services increased. The conflict can also be seen in the employment economy: NFPs were much stronger than even the most optimistic consensus estimates, with the unemployment rate increasing to the highest levels in two-and-a-half years. Conflicts of this nature tend to occur around economic inflection points.

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Looking ahead

We continue to expect either a slowdown or a mild recession either late this year or early next. Elevated interest rates, tighter credit, depleted excess savings and a weakening job market are weighing on consumers, and housing appears to be weakening. While housing directly represents only a small portion of GDP, weakness ripples throughout the economy.

We believe the Fed will cut rates at least once this year. Significant progress toward the Fed's inflation target will become more difficult when the base effect of several low-inflation prints from last year come into play. We expect the Fed will be careful around the election, but a spike higher in the unemployment rate would clear the way for an ease, no matter what's happening in the economy or government. Policy could shift profoundly or not much at all, with no clear leader in the presidential election and both the House and Senate close. This uncertainty has the potential to spill over to the bond market.

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

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