Parametric

Corporate Bond Market Insight | November 2024

Choosing the Utility of Rules-Based Ladders During Uncertainty

Key takeaways

» Rates rose unusually sharply in October, while compelling economic data forced markets to reassess expectations.

» Markets project one to two 25 bps cuts this year and five 25-bps cuts next year. We think the Fed will continue to cut rates, but perhaps at a slower pace than the markets anticipated.

» Economic growth surprised to the upside, with robust third-quarter GDP estimates at 2.8% and strong real consumer spending at 3.7%. These relieved fears of an imminent recession.

» Despite the high inflation, consumer resilience remains high. Spending, saving rates and the annual benchmark revisions covering the prior five years of consumer income all revised massively higher.

Parametric
800 Fifth Avenue
Suite 2800
Seattle, WA 98104
T 206 694 5575
F 206 694 5581
www.parametricportfolio.com

Recap

October saw significant improvement in the economic outlook and moderately higher-than-expected inflation. Interest rates, particularly intermediate and long rates, rose sharply while the market adjusted to the idea that the Fed may not lower rates as aggressively as expected at the end of September. There was a surge in geopolitical uncertainty as fighting in the Middle East intensified and a hotly contested presidential election came to a head. Large-cap equity indexes continued to march higher, and investment-grade (IG) corporate spreads tightened. Earnings remained consistent with growth, particularly in the banking sector.

October's sharp rise in rates is unusual for the early stage of a Fed cutting cycle. Rates typically fall when the Fed reacts to spreading economic weakness or, in extreme cases, financial contagion. But rates had already fallen sharply since April, discounting a significant amount of economic weakness. October's compelling economic data—including the strongest employment report in six months, strong retail sales and nearly 3% GDP growth—forced markets to reassess expectations. It seems to us that rates are mostly rising for the right reasons. The economy has continued to produce reasonable growth, and while the trend to lower inflation has moderated, it continues to move toward the Fed's target. The combination continues to support tight IG corporate credit spreads, and the rise in yields has moved all-in intermediate IG corporate yields close to 5% again.

We discussed the Fed's dual mandate and their reasons for shifting focus from inflation to the labor market in September's commentary. The rise in the unemployment rate had just triggered a Sahm rule recession indicator, and the yield curve had finally normalized after having been inverted for 22 months. Both phenomena have strong track records of occurring immediately prior to recessions. Despite the most recent slight dip in the unemployment rate, we think the Fed is still concerned. The current federal funds target rate is in the 4.75 to 5.00% range, and the estimated neutral rate—the rate at which federal funds is neither stimulative nor restrictive—is at 2.9%. There remains plenty of room to lower rates without reigniting inflation.

Federal funds futures can be used to evaluate how expectations have changed. At the end of September, futures projected three 25 basis point (bps) cuts through the end of the year and seven additional cuts for next. After the recent adjustment, markets project one to two 25 bps cuts this year and five 25-bps cuts next year. We expect the Fed to continue to cut rates, but perhaps at a slower pace than the markets anticipated, as it works its way toward the estimated neutral rate.

Against this backdrop, the 10-year Treasury yield rose 50 bps and credit spreads narrowed six bps for the month. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned -1.45% for the month and 10.24% for the trailing 12 months as a result. Lower quality IG credit generally outperformed higher quality, and credit spreads in all sectors narrowed over the month. Best performing sectors included leisure and transportation, while healthcare and retail lagged somewhat.

After a disappointing September, economic growth surprised to the upside. Nonfarm payrolls posted its largest monthly increase in six months, and the unemployment rate fell one-tenth of a percent. Solid wage growth and a robust retail sales report suggest consumers are willing and able to continue spending. Rising investment interest income, wage gains and the persistent rally in equities continue to buoy them. A very robust first estimate of third-quarter GDP at 2.8%, including strong real consumer spending at 3.7%, relieved fears of an imminent recession. Falling job openings and a falling quits rate offset this somewhat, continuing to imply developing weakness in the labor market.

One of the mysteries surrounding the resilience of growth over the last two years has been consumer resilience in spite of high inflation. Late September's annual benchmark revisions—which covered the prior five years of consumer income, savings rates and spending—were all revised massively higher. The revisions for the last two years were particularly strong, suggesting that consumers spent far less relative to income than first thought and the savings rate has been much higher. Given the upward revisions, there's little wonder that the cycle has extended itself.

Looking ahead

The outcome of the election, including tightly contested House and Senate majorities, should begin to clarify economic policies. We believe the results will produce a steeper yield curve since president-elect Trump's policies are inflationary. But promises made on the campaign trail seldom result in actual policy change. Words are far different than actions.

In more immediate terms, the impact of the twin hurricanes Milton and Oscar and resultant flooding in Florida and Belize will muddy the economic waters for the next few months. We might not get a clear look at inflation and employment dynamics again until early next year.

The unexpected rate increases of the last month again demonstrated the utility of rules-based ladders as an uncertainty hedge. While painful in the short run, rising yields offer solid reinvestment opportunities. The agnostic nature of the structure provides the opportunity to reinvest at higher levels of yield, since ladders systematically reinvest maturities. In a rising rate environment, the agnostic reinvestment process could increase the yield of the portfolio over time, thereby reducing both rate and credit risk.

IG fundamentals remain supportive. Higher all-in yields should support flows, and starting yields around 5% provide a solid forward return cushion for agnostic ladder investors. IG corporates have now enjoyed 13 consecutive quarters in which upgrades outpaced downgrades. IG balance sheets remain fundamentally solid.

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Parametric is headquartered at 800 Fifth Avenue, Suite 2800, Seattle, WA 98104. For more information regarding Parametric and its investment strategies, or to request a copy of Parametric's Form ADV or a list of composites, contact us at 206 694 5500 or visit www.parametricportfolio.com.

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