Parametric

Corporate Bond Market Insight | December 2024

The Culmination of the Election's Effects on Corporate Bonds

Key takeaways

» President-elect Trump's proposed changes in trade and tax policy should have a significant impact on domestic growth and corporate profitability, which would raise inflation levels if enacted.

» It appears the lower personal and business taxes enacted with the 2017 Tax Cuts and Jobs Act will remain intact.

» The Fed cut the federal funds rate another 25 bps in November, bringing the funds rate to the 4.50% to 4.75% range.

» Chair Jerome Powell characterized the level of fed funds as restrictive before the election, but he appeared to pivot afterwards. We think it's likely that the Fed will move slowly while assessing the actions of the new administration.

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

Recap

The culmination of a contentious presidential election cycle in November left Republicans with the presidency and narrow majorities in both houses of Congress. Markets responded positively as equities powered to new all-time highs and credit spreads tightened appreciably. The economy continued to perform well, but progress toward the Federal Reserve's 2% inflation target showed evidence of stalling. As the month ended, chair Jerome Powell pushed back against market expectations of rapid rate cuts and pivoted toward a more restrained rate-cutting regime. While the outcome of the election has offered insight into future policy, major questions around implementation and timing remain unanswered.

Proposed changes in trade policy, deregulation and tax policy should have significant impact on domestic growth and, by extension, corporate profitability. Deregulation and favorable changes in tax policy would be economically stimulative in general. On the other hand, if the White House fully implements its tariff policy, it would serve to reduce economic growth. Both policies would raise the level of inflation.

The election ensures the lower personal and business taxes enacted with the 2017 Tax Cuts and Jobs Act will remain intact. Individuals and businesses won't need to change spending and saving habits to account for higher tax rates. President-elect Trump has also proposed reducing the corporate income tax rate from 21% to 15% for companies who produce goods domestically. Exempting Social Security benefits, tip income and overtime pay from taxation have also been proposed by the president-elect. However, the elevated level of Fed debt, combined with thin Republican majorities in both House and Senate, make the passage of significant new tax reductions unlikely.

What's less clear are the impacts of trade policy. It's almost certain that Trump will enact tariffs. But how quickly they're erected, in what quantity and against whom carry vastly different economic implications. Tariffs not offset via tax policy will create an immediate increase to the inflation rate and have the potential to slow the domestic economy. In the short run, tariffs may be stimulative as companies begin to stockpile inventory and consumers rush to buy electronics, automobiles and other goods before they become more expensive.

At its November meeting, the Fed cut the federal funds rate another 25 basis points (bps). This brings the funds rate to the 4.50% to 4.75% range and the cumulative total of cuts to 100 bps. The markets currently expect another 25 bps cut in December and three more 25 bps cuts next year. Before the election, Powell characterized the current level of fed funds as restrictive. He appeared to pivot after the election, pushing back against expectations of steep rate cuts in a speech in Dallas, saying that "The economy is not sending any signals that we need to be in a hurry." It's likely the Fed will move slowly while assessing the actions of the new administration.

Against this backdrop, the 10-year Treasury yield fell 12 bps and credit spreads narrowed five bps over the month. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned 0.79% for the month and 8.09% for the trailing 12 months as a result. Lower-quality investment-grade (IG) credit slightly outperformed higher-quality, and credit spreads in all but two sectors narrowed. The best-performing sector was media, while transportation and leisure lagged modestly.

November began with a shockingly weak employment report in which only 12,000 new payrolls were added. The report was far weaker than economists' expectations, but the effects of disruptive weather and major strikes had a significant impact. The poor result wasn't reflected in initial jobless claims or the unemployment rate, which remained steady at 4.1%. Jobs openings fell to their lowest level since January 2021, and the quits rate fell to 1.9%, the lowest since June 2020. Workers' reluctance to leave their current employment is also reflected in the wage premium, which those who switch jobs receive over those who stay in their current jobs. That premium has declined to 0.4%, matching the lowest since September 2015, down sharply from January 2022's 2.2% premium. But while there are some worrisome developments, labor market dynamics generally remain good.

The economy continues to avoid recession and may be accelerating again. The Institute of Supply Management's monthly Purchasing Managers' Index (PMI) jumped to 56, its highest level in 27 months and well into expansion territory. There was also a strong 57.4% increase in the forward-looking new orders segment. The Q4 2024 GDPNow estimate is tracking a respectable 2.7%, with about one-third of the data in place.

Looking forward

2025 is going to be complicated. The economy appears to be reaccelerating, and progress toward the Fed's inflation target has stalled. Add policy uncertainty and the level of Fed debt, and the range of economic outcomes is quite wide. We do expect one more rate cut this year before the Fed pauses to assess the impact of new policy.

Even though IG credit spreads are at the tight end of their historic range, our view of valuation remains upbeat. We believe the tight spreads reflect the underlying fundamental strength in IG corporate balance sheets. That strength can be seen in the upgrade-downgrade ratio: There have been 2.7 upgrades for every downgrade in 2024. History shows significant precedence for IG spreads remaining narrow for extended periods. Spreads remained below 100 bps from 2004 to 2007 and for over four years in the mid-1990s.

Even at current spread levels, we believe IG corporates continue to offer significant downside risk mitigation from credit losses. Moody's estimates the average IG default and recovery rates for buy-and-hold investors at 0.2% and 43%, respectively, resulting in annual index-level default losses of only 12 bps.

In the meantime, the total carry (Treasury yield plus credit spread) remains attractive. The all-in starting yield on a one- to five-year BBB corporate ladder is only modestly below 5%. A rules-based corporate ladder structure can continue to insulate against wider spreads, higher rates and policy uncertainly.