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Corporate Bond Market Insight | April 2024

Inflation is Sticky, but Corporate Bonds Stay Strong

Key takeaways

- Market expectations around rate cuts continue to be less than optimistic, but the Fed seems intent on lowering rates later this year.
- The Swiss National Bank lowered policy rates by 25 bps, becoming the first developed-market central bank to lower policy rates following the COVID-19 pandemic. The Bank of Japan hiked rates, in a major change of policy with global implications.
- The Atlanta Fed GDPNow estimate of second-quarter GDP rests at an acceptable 2.3%. That number is quite strong despite being moderately slower than the Q4 2023 pace of 3.4%.
- The dot plot continued to project three cuts for the remainder of the year. The perception is that the Fed is likely to tolerate moderately higher inflation to ensure that the economy continues to grow.

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Recap

March saw the continuation of similar economic and market trends that dominated the first two months of the quarter. The economy weakened moderately in comparison to recent months but remained quite strong. Inflation surprised modestly to the upside for the second month in a row, but the broader trend toward the Fed's 2% target remains intact. Strong demand for investment-grade (IG) corporate debt continued to compress spreads closer to their near-record lows, despite record first-quarter issuance. Demand for other risk assets is also strong, including several large-cap equity indexes that set multiple new all-time highs.

Expectations around the pace and timing of Fed rate cuts continued to become less optimistic. Investors entered 2024 expecting as many as six cuts beginning in March. Markets are only pricing in three cuts at quarter end, commencing in June. This aligns market expectations with the current dot plot. The Fed seems intent on lowering rates later this year, despite the strong economy and uneven progress toward bringing inflation back to target.

The Swiss National Bank became the first developed-market central bank to lower policy rates following the COVID-19 pandemic, by 25 basis points (bps). In a major change of policy with global implications, the Bank of Japan hiked rates for the first time in 17 years, becoming the last major-market central bank to exit negative rates.

The 10-year Treasury yield fell five bps in March and rose 27 bps for the first quarter. Credit spreads narrowed six bps for the month and 10 bps for the quarter. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned 0.90% for the month and 0.44% for the first quarter, with a trailing one-year return of 5.19% as a result. Only minor performance differences appeared between lower and higher quality in the month. Media and leisure sectors outperformed, while capital goods underperformed.

March's economic growth moderated somewhat from January and February's strong pace. However, the Atlanta Fed GDPNow estimate of second-quarter GDP still rests at an acceptable 2.3%. While this is moderately slower than the Q4 2023 pace of 3.4%, it's still quite strong, particularly when we consider 500 bps of Fed tightening. March GDP component data will publish in April, but growth continues at a pace inconsistent with near-term recession.

The Institute of Supply Management Purchasing Managers Indexes for manufacturing and services weakened moderately from their strong January levels, with the forward-looking new order component declining somewhat. Services account for roughly 70% of the economy and remain well into expansion territory at 56.1. The strength in services new orders implies significant future economic momentum. The services sector saw both the prices paid and employment components moderating somewhat from February levels.

The employment economy slowed slightly but remains strong. Nonfarm payrolls added 275,000 new jobs in February, including 223,000 private sector jobs, with a 167,000 downward revision to the prior two months. Even with this revision, the three-month average of nonfarm payrolls is running a solid 265,000. It's somewhat troubling that the unemployment rate rose from 3.7% to 3.9% and now rests 0.5% above its February 2023 low, a two-year high. Wage growth remained solid but also slowed somewhat from the prior month, offset by employees working more hours. The Jobs Opening and Turnover survey (JOLTS) also showed that the quits rate and job openings are both falling rapidly as the labor economy continues to normalize.

Headline and core Consumer Price Index (CPI) inflation both rose more than expected in the past two months. While longer-term moving averages continue to moderate toward the Fed's target, the three-month moving average of headline CPI has turned higher. Shelter costs again largely drove the increase in the core rate. Core inflation ex-shelter is generally below 2% year-over-year (YOY). Private measures of leases and rentals have declined sharply over the last year and should eventually feed through and help lower CPI. The Producer Price Index also had significant gains in the last two months, growing at a 2.8% YOY rate. Core Personal Consumption Expenditures (PCE), the Fed's favored metric, moderated slightly but continues to rise at a 2.8% YOY, the slowest growth rate in the last three years. Inflation is proving stickier than the Fed would prefer, complicating its rate calculus.

The Fed continued to hold rates steady at its March meeting. The Summary of Economic Projections (dot plot) continued to project three cuts for the remainder of the year despite an increase in both the 2024 GDP and inflation forecasts. The perception is that the Fed is likely to tolerate moderately higher inflation to ensure that the economy continues to grow. Chair Jerome Powell indicated that the Fed would discuss a tapering of quantitative tightening in May. He added, "The committee doesn't expect that it will be appropriate to reduce the target range [for Fed funds] until it has gained greater confidence that inflation is moving sustainably toward 2%." The markets perceived the statement following the press conference as dovish. We think his statement indicates that the Fed is moving closer to cutting rates, even though the economy remains on sound footing and the decline in the inflation rate may be stalling above the Fed's target.

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Looking ahead

Leading economic indicators and the inverted yield curve are historically excellent indicators of a coming recession. This time may be different, but our baseline expectation remains for a modest recession to develop either late this year or early next. Growing consumer stress is evident, particularly in the lower quintiles of income. For instance, the consumer delinquency rates at large banks are back to 2012 levels and at all-time highs at smaller banks. Upper-income quintiles have benefited from the significant increase in their interest income and the intense rally in equities. We expect credit spreads to widen should a recession occur. This may cause a flight to quality that will drive interest rates down, providing an offset to widening spreads.

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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