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Corporate Bond Market Insight | December 2021

Market outlook looks strong despite a few bumps

Key takeaways

» Consumer price pressures appear to be broadening, even as supply logistics problems may be resolving. However, the resulting inflationary trend appears likely to be with us for some time.

» The Fed has capitulated on this view, having turned decidedly more hawkish. It clearly signaled its intent to shorten the wind-down of its quantitative easing (QE) program to clear the way for rate increases earlier in 2022.

» Despite the obvious concerns, our constructive outlook remains intact. The economic recovery, record earnings, and cash-rich balance sheets suggest investment-grade credit will remain strong through 2022.

» Keep an eye on the Omicron variant of COVID-19. So far, it doesn't appear likely to be highly disruptive to the recovery, but only time and further analysis will confirm that early assessment.

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General market update

Volatility returned in November. President Biden renominated Federal Reserve Chairman Jerome Powell for a second term. Not surprisingly, the news reassured markets of the future consistency of monetary policy. Despite the highly publicized supply-chain issues, economic data remained strong overall, most notably the year-over-year CPI headline inflation rate, which reached a 30-year high. It's increasingly clear the Fed is now intent on ending its current quantitative easing (QE) program sooner than originally planned to clear the way for rate increases earlier in 2022. Late in the month, news of COVID-19 mutation Omicron was first reported. While the epidemiological implications are uncertain, health authorities imposed new travel restrictions and, in some countries, reinstituted lockdowns. That news, coupled with a decidedly more hawkish Fed, interrupted the equity market rally that had produced record highs earlier in the month.

Against this backdrop, 10-year Treasury rates fell modestly, commodities posted small declines, and large-cap equity indexes gave ground. Investment-grade (IG) credit spreads widened 15 basis points (bps), the most since the onset of the pandemic 19 months ago, while 10-year Treasury rates fell 12 bps. As a result, IG corporate bonds, as measured by the ICE BofA/Merrill Lynch 1–10 Year US Corporate Index, returned -0.15%. Spreads across all sectors widened more or less consistently. The best performing sector was insurance, which widened 10 bps, followed closely by banking, automotive, and capital goods, which all widened 11 bps. The worst performer was transportation, which widened 17 bps. As for credit quality, investment grade significantly outperformed high-yield, with AA outperforming A, which in turn, outperformed BBB.

COVID-19 and supply chains

Amidst the combination of a resurgent COVID-19 virus mutation and ongoing supply chain logistics issues, the economy remained resilient. Employment rose sharply again as non-farm payrolls increased by 531,000 in October, bringing the 2021 monthly average to 582,000. The unemployment rate declined to 4.6%. Despite possible reporting issues, new claims for unemployment are not only below pre-pandemic levels, but just set a 52-year low. Both the Institute of Supply Management Manufacturing and the Services Purchasing Manager indexes remain solidly in expansion territory. The manufacturing index just posted its 18th consecutive month of growth, and the services component set a new record high. In addition, new orders remain strong, suggesting further momentum to come. Finally, inflation continues to appear more persistent. Price pressures appear to be broadening, and, while logistics problems may actually be cresting, the resulting inflation created appears likely to be with us for some time.

Several COVID-19 related developments also got our attention. Rising U.S. infections suggest we may be entering a third wave. However, due to rising vaccination rates, well-adapted social-distancing behavior, new drug therapies, and an aversion to lockdowns, we believe that a new wave will prove far less disruptive than its predecessors. The Omicron variant may change that calculus, but further epidemiological analysis will be required before we know that with any certainty.

Inflation

The Fed is clearly pivoting from its focus on economic growth to fighting inflation. Late in the month, Powell, in his first congressional testimony since being renominated, suggested it was time to abandon the word "transitory" to describe inflation and to discuss wrapping up QE purchases a few months early. The market agrees and has moved forward the possibility of rate hikes prior to June 30, 2022. Granted, there is some hesitancy given the uncertainty introduced with Omicron; but assuming no major disruption, it seems certain the Fed will accelerate the end of the purchase program at its December meeting. The reappointment of Powell assured the continuity of policy, but, of the seven seats on the board, three will be vacant by year's end, while a fourth opens in early 2023. No doubt, the character of the Fed will change significantly over the coming year.

Looking ahead

In prior comments, our list of risks included a resurgent pandemic and higher-than-expected inflation spurring a steeper trajectory of rising rates. While we remain constructive, November saw both risks increase significantly. Granted, we continue to expect that each new COVID-19 wave will be sequentially less disruptive, but Omicron represents an unknown. In terms of rates, it's clear the Fed is prioritizing reducing inflation over growing the economy. Unless Omicron dramatically disrupts the economy, we expect the Fed will be compelled to raise rates next spring. If Omicron does slow the economy dramatically, we have to wonder exactly how the Fed will manage in the face stagflation. As we have mentioned, this is a regrettable combination of economic circumstances that's always proven challenging to policy-makers.

Bottom line

Despite these concerns, our constructive outlook on investment-grade credit remains intact. The economic recovery, record earnings, and cash-rich balance sheets suggest corporations are in solid shape. Our conservative principal-protection investment philosophy and systematic approach to portfolio construction are likely to offer significant protection and opportunity in the advent of rising rates and widening spreads.

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