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DEMAND FOR U.S. INVESTMENT GRADE BONDS REMAINS STRONG

A GOOD TIME TO EXTEND DURATION

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Borrowers aren't thrilled with higher rates, but investors are. Demand for investment grade corporate bonds has been strong this year. Spreads have tightened despite interest rate volatility. Late last year, many expected rate cuts, but with inflation heating up, rates rose again, and now it seems the Fed won't cut rates soon.

We predict the Fed will reduce the number of cuts penciled in for 2024. Our view is that we'll likely see just one cut in December. A cut in September seems less likely unless inflation drops significantly. The November meeting is just after the election, making December the more likely time for a cut.

We were too defensive last year but changed our stance early in 2024. Our theme this year is "Believe," inspired by Ted Lasso. Despite tight spreads and fewer Fed cuts than hoped, we see strength in the corporate market. We're getting more aggressive to generate alpha this year, as we don't expect spreads to widen significantly.

Investment grade companies refinance a small portion of their debt each year, so many locked in low rates during the pandemic. Their average borrowing cost has only risen slightly, so they're managing well. High yield issuers might face issues later, but not immediately. They still have some runway before refinancing at higher rates becomes problematic.

Why no dramatic increase in defaults?

The reason for that is, within the investment grade corporate universe, which is over $9 trillion alone, is that a lot of these companies don't just borrow all of their money at once, wait for it to mature in 30 years, and then borrow it again. So, these large corporations tend to issue debt, some of them once a year, some twice a year. The banks will come every quarter. They're really refinancing about six or 7% of their debt on an annual basis. They were able to take advantage of very, very cheap borrowing costs during the pandemic and post the pandemic. And they were able to refinance a lot of their longer maturity debt, say 10- and 30-year debt. Since that time, rates have obviously gone up, but their costs of borrowing used to be over 6% pre the great financial crisis in 2008.

Since that time, it's fallen dramatically, and it got as low as 3.6% about a year ago. Since that time, even with much higher rates, it's only gone up to an average coupon cost of around 4.2% today. So it's not like they're refinancing all their debt at the five

and a half or 6% now. When they average it all, it's only gone up about 50 or 60 basis points. So, it's not that material for them and they aren't slowing down their issuance. What they've been doing is just changing the maturity profiles. During the pandemic, they're issuing a lot of 20 and 30-year debt since treasury rates were so low. Now they switched to issuing more front end again, two-, three-, and five-year debt instead. So they'll have these higher borrowing costs locked in for a shorter period.

The inverted yield curve

We often look at the three-month vs. 10-year curve, which remains very inverted. Typically, an inverted curve signals a recession, but we've seen strong GDP growth. Companies prepared their balance sheets well, and inflation has been sticky. We believe the Fed is managing the situation well and expect a soft landing. Inflation should gradually decline, allowing for eventual rate cuts, which benefits the corporate bond market.

We see value in Euro and Sterling denominated corporates, which offer a spread pickup over U.S. corporates. European corporates have performed well this year despite recession fears. They recently got a rate cut, putting them ahead of the Fed. We see good global opportunities but believe the U.S. economy remains resilient.

It's a good time to extend duration, especially with 30-year corporates yielding around 5.7%. Holding these longer positions now will benefit from price appreciation when the Fed eventually cuts rates. The front end still offers high yields, but there's reinvestment risk with shorter maturities. A balanced approach with some long-duration holdings makes sense.

The Fed's 2% inflation rate target

Publicly, they [the Fed] won't back away from the 2% target. They need to see a consistent decline in inflation before cutting rates. While they might tolerate slightly higher inflation temporarily, they'll stick to the 2% target to manage market expectations. Even if it takes until 2025, the Fed will maintain this target to ensure stability.

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