Bond Blog

PGIM FIXED INCOME

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Tracking the Transition from Tighter Policy to Corporate Spreads

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One of the most impressive features of the current Fed tightening cycle has been the resilience of the U.S. economy and the associated outperformance of U.S. assets. While we cannot rule out a cyclical downturn in the months to come, we've found several factors in the current cycle that have reduced the U.S. economy's interest-rate sensitivity. This feature has potentially underpinned the resiliency of U.S. corporate profits in the face of higher interest rates and pressure on profit margins. Indeed, our corporate profits outlook is fairly benign in most of our macro scenarios, including our base case of slow growth and elevated, but falling, inflation.

In the concluding piece of our interest-rate sensitivity package, we explore the historical transmission from tighter monetary policy to corporate bond spreads and discuss the respective investment implications under our "weakflation" scenario.

Extrapolating Tighter Policy to Corporate Profits and Asset Prices

The economic and market outlook remains riddled by a highly idiosyncratic cyclical outlook, as well as secular forces that are reshaping some important long-term drivers of growth and inflation. Indeed, the Fed's latest policy tightening has been more aggressive both in size and speed than in previous cycles (Figure 1).

FIGURE 1: The Fed's historically aggressive tightening cycle (change since t0 in percentage points).

Source: Bloomberg and PGIM Fixed Income. *1-month tenor

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Ultimately, the key determinant for central banks is whether that tightening is restrictive enough to moderate the pace of inflation. While policy's effect on inflation can be difficult to quantify, the shape of the yield curve is not a bad way of gauging the level of monetary tightening that is needed to cool the economy and lower inflation. Figure 2 shows that in the U.S., about 16 months have passed since the 2/10s curve inverted. What does that length of inversion mean for valuations on fixed income assets, such as credit spreads on corporate bonds?

FIGURE 2: An inverted U.S. yield curve as a proxy for restrictive Fed policy (%).

Source: PGIM Fixed Income and Macrobond.

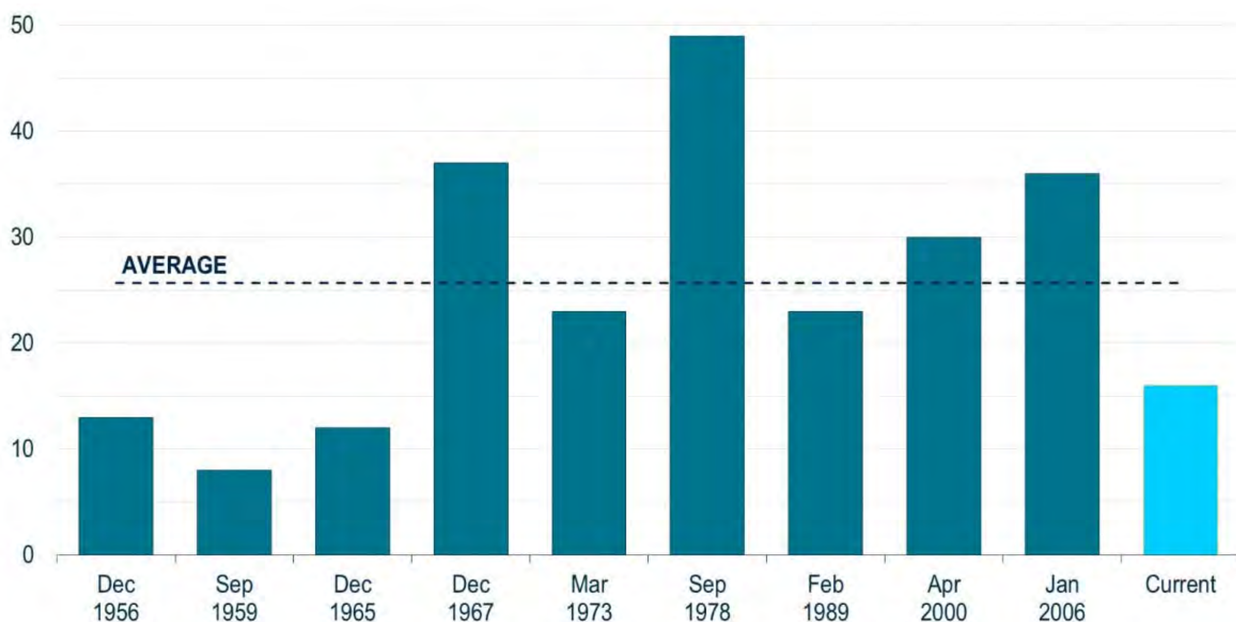
It is well understood that monetary policy progresses through the economy with long and variable lags. Further, during tightening cycles, prices on risk assets can quickly reflect anticipation for weaker macroeconomic fundamentals. Figure 3 demonstrates how this sequencing unfolded during previous Fed tightening cycles. As the Fed tightens policy, the yield curve inverts (yellow sections) and usually foreshadows corporate profit drawdowns (light blue columns). Corporate spreads typically widen as those profit drawdowns become deeper. It takes time for spreads to peak, but they usually do so when profit recessions (drawdowns) hit a trough.

FIGURE 3: Overtightening affects corporate profits and spreads with a significant lag (%).

Source: PGIM Fixed Income and Bloomberg.

Figure 4 explores the timing from the first point of curve inversion to the peak in corporate credit spreads. We find that these lags average 26 months, but they vary materially from cycle to cycle. In fact, they can be as long as several years and tend to be longer in high inflation episodes (like the 1970-80s). We are about 16 months into curve inversion in the U.S., thus we are closer to the zone historically associated with wider spreads. However, we are careful about being too precise considering the large variability around this mean.

FIGURE 4: After the curve inverts, spreads peak an average of about two years later (months).



Source: PGIM Fixed Income and NBER.

In fact, there might be other reasons behind the cyclical resilience of the U.S. economy beyond the usual long and variable lags of monetary policy. As discussed in our accompanying white paper a staggered adjustment process in various interest-sensitive sectors may be acting as a cushion that lowers the economy's sensitivity to interest rates going forward and otherwise blunts the total impact of tighter monetary policy.

Investment Implications - Grasping Yield Opportunities

The prospect of higher-for-longer core bond yields restored the attractiveness of fixed income as an asset class, but with a caveat. Despite periods of sizable rallies and selloffs - resulting in wide trading ranges and enhanced tactical opportunities - we don't think its strategic attractiveness is due to possible capital appreciation. Rather, the new, elevated level of yields and the respective carry potential present a compelling opportunity set. Furthermore, this return profile dovetails with our preference for high-quality spread products and to capitalize on wide dispersions within the respective sectors.

In the government bonds space, 10-year U.S. and German government bond yields have reset to higher levels. In comparison to the prior regime of historically low inflation and interest rates, the current paradigm may last into the foreseeable future (Figure 5). Pockets of stubborn inflation, higher neutral interest rates, and rising Treasury issuance amid the Fed's quantitative tightening remain upside risks to yields. Disinflation and recessions are the main downside risks.

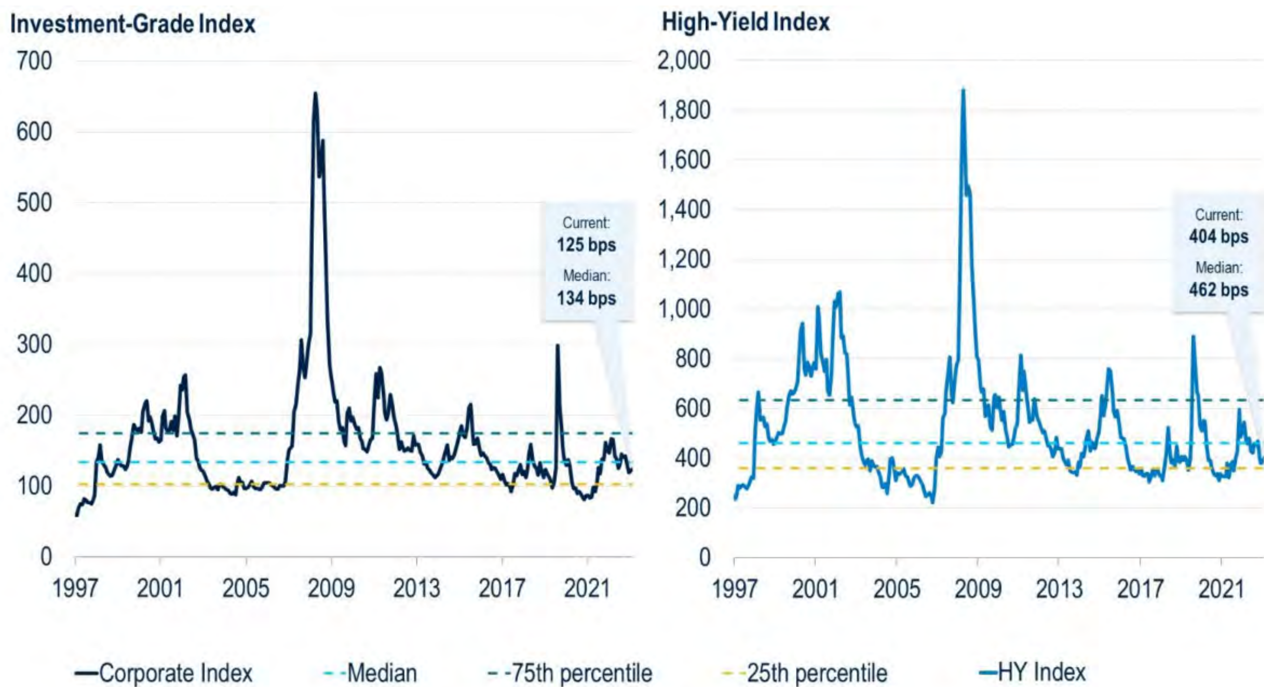
FIGURE 5: U.S. and German yields look set to remain elevated into the foreseeable future (%).

Source: Macrobond and Bloomberg.

An environment of weakening global growth and elevated, but falling, inflation (i.e., our macroeconomic base case of "weakflation") can be a constructive one for spread products. Indeed, U.S. IG and HY spreads can remain range bound around their historical averages in a "weakflation" environment (Figure 6) and, in doing so, maintain what has become an increasingly attractive carry opportunity. We have a preference for IG over HY as our base case involves "higher for longer" rates that could hurt levered capital structures.

We have more long-term confidence in U.S. assets given the better growth prospects versus those in other regions. European corporate bond spreads offer higher spreads, largely because they already discount weaker prospects for the economy and the corporate sector.

FIGURE 6: "Weakflation" supports U.S. spreads, but lingering risks warrant a preference for high-quality spread products (bps).



Source: ICE BofAML, PGIM Fixed Income and ICE Data Indices, LLC, used with permission. An investment cannot be made directly in an index.

Concluding Thoughts

While acknowledging that we've entered a new paradigm is a necessary investing step, meeting clients' various objectives also requires identifying the contours of the emerging regime. Indeed, our research series establishes a relationship between easing supply chain constraints and a staggered economic adjustment to rising interest rates. This sequential reaction is a key aspect that may mitigate the economy's sensitivity to interest rates going forward. That said, each cycle presents a different lag in the transmission between policy adjustments and the real economy, and our research shows that the full effects of the current cycle's tightening campaign have yet to be felt. As that transmission process continues, it points to a backdrop consistent with our "weakflation" base case.

Weakflation conditions would seemingly pose a tangible threat to corporate profit margins, as well as corporate credit spreads. However, our modeling of profit margins under our macro scenarios reveals that most of the compression has already occurred. Taking it a step further, under our base case, we consequently expect corporate profits to drift sideways from here. When we shift to a probability-weighted forecast based on our scenarios - including the recession scenario's outsized effect - profits continue to appear resilient amid our projection that they flatline into 2024.

Although the prolonged inversion of the U.S. Treasury curve is consistent with a recession scenario, the factors identified in our research likely mitigated the forces that would have otherwise pulled the economy into a recession by now. The relative buoyancy of the economy and corporate profits points to fixed income opportunities, but perhaps in a different manner than prior periods of positive returns. While there may be periods of capital appreciation as observed in November 2023, we believe that carry opportunities from higher yields will generate the bulk of fixed income returns in the future. In that context, we believe we can meet various investment objectives without taking undue credit risk in overly levered capital structures and with an emphasis on U.S. assets amidst the country's relative economic stability.

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