A Rangebound Study in Long U.S. Corporates

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One of the themes from our first-quarter outlook focused on the rangebound environment across global fixed income. When navigating the range for long U.S. corporates, the key factor isn't market timing. Rather, it's recognizing the contours of the channel and the factors contributing to the range. With this context, we believe long-duration U.S. corporates may be attractive for institutional investors, such as pension plan sponsors and insurance accounts, due to several factors including:

- the likely peak in the Fed funds rate;
- the sector's historically elevated yields;
- pension plans' improved funding status;
- limited long-duration supply;
- and attractive valuations relative to equities.

At this point in the market cycle, the long U.S. corporate sector is a fitting example of an asset class in a range defined by a combination of factors. As investors anticipated that the Fed was approaching the peak in its policy rates - with the presumption that rate cuts would eventually follow - they logically piled into long-duration, high-quality assets in 2023. As a result, long corporates easily outperformed the broader corporate index last year.[1]

Long corporates' outperformance was accompanied by tighter spreads and a flatter spread curve, which may raise valuation questions for some participants. However, those conditions require a notable degree of context when looking ahead.

At the forefront, spread curve flattening tends to occur during periods of elevated yields (Figure 1). The increase in yields has contributed to a brisk tailwind for long corporates given the consistent demand from yield-based buyers and limited, long-dated issuance.

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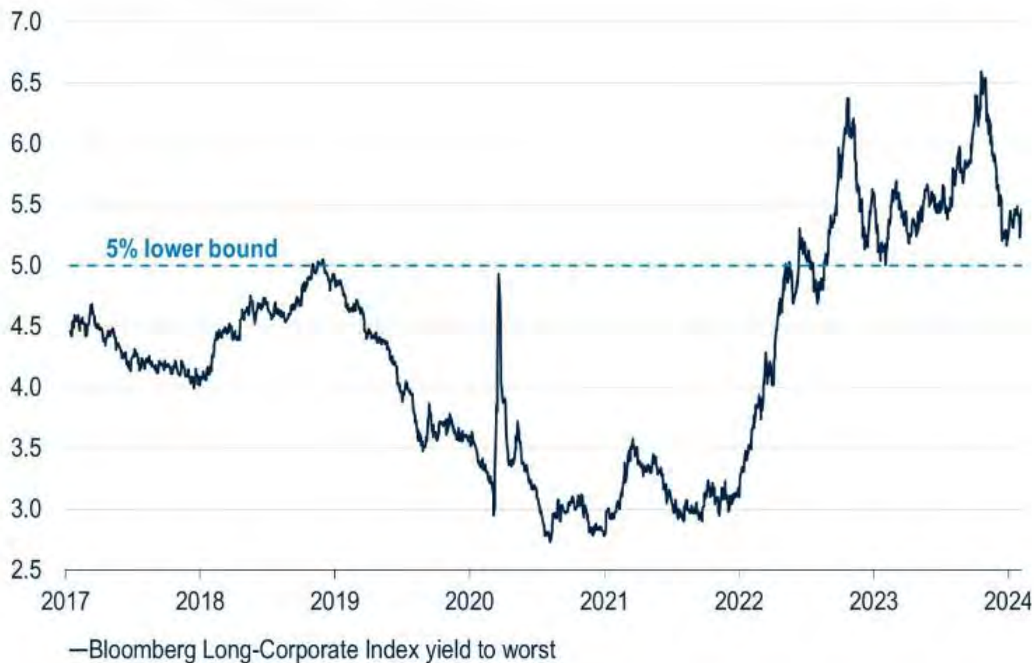
FIGURE 1: Flatter 10s/30s corporate spread curves tend to accompany elevated U.S. IG yields (lhs: bps; rhs: %)

Source: J.P. Morgan

We expect continued demand from accounts seeking duration to match their liabilities or from those seeking a certain yield level to persist as yields on the long-corporate benchmark have stabilized in an apparent channel with a 5% lower bound (Figure 2).

FIGURE 2: Although long corporate yields are off their cycle peaks, they remain near decade highs in a potential range with a 5% lower bound (%)



Source: Bloomberg

This demand may include pension plan sponsors as they engage in various transactions related to managing their defined benefit liabilities or exiting the pension business altogether.[2] The funded ratio of the 100 largest U.S. plans now exceeds 100% following the recent gains in their growth assets, likely led by equities, and the multi-year increase in long-term interest rates, which reduced their liability valuations.

While there are multiple ways to track pension activity, such as open contracts on long-term futures, another proxy is through U.S. Treasury stripping activity as accounts seek various forms of long-duration assets. Figure 3 shows a steady relationship between Milliman funding ratios and the level of stripping activity. Although STRIPS pertain to the U.S. Treasury complex, we regard the demand for these zero-coupon assets in a similar context to the pension-related demand for high-quality, long-duration corporates.

For reference, Milliman's base case sees the funded status improving to nearly 104% in 2024 and more than 105% in 2025.[3] If that estimate comes to fruition, pension plan sponsors may continue to shift away from equities or other risk assets and choose to hedge more, or all, of their remaining liabilities through additional allocations to long-duration fixed income.

FIGURE 3: U.S. Treasury stripping activity continues to rise as pension plan funding ratios exceed 100% (ratio; lhs: %; rhs: US$ billion)

Source: PGIM Fixed Income, Milliman, Bloomberg

This steady demand comes amid a supportive supply picture. Figure 4 shows that issuance of 13+ years is consistently the lowest of the segments shown with 2023 coming in at the low end of the range. Meanwhile, the trend of declining net issuance of U.S. corporates over the last couple of years should continue given the expectations for approximately zero net new issuance in 2024.

FIGURE 4: The sector's favorable supply/demand technical backdrop may persist given expectations for very little net issuance in 2024 (lhs: %; rhs: US$ trillion)

Source: J.P. Morgan

However, as non-financial entities wrap up reporting their quarterly results, we anticipate a pending uptick in gross long-end issuance. Considering the expectations for long-dated supply, investors may be making room for the new paper, resulting in a minor, re-steepening of the spread curve. When combined with the range bound conditions in the long Treasury bond following the less-than-dovish FOMC meeting and the stronger-than-expected January payroll report, long yields may continue to trade within the recent established range referenced in Figure 2.

For investors with a total return perspective, yields that remain rangebound may mean that most of their returns come from income, rather than capital appreciation from declining yields. Given those prospects, there may be multiple reasons why investors seek additional exposure to long corporates, starting with valuations relative to equities. After all, fixed income spent much of the past two years repricing, while equities did not and continued to set new highs in 2024. As a result, the yield on the long U.S. IG sector recently climbed above the earnings yield on the S&P 500 for the first time in more than a decade (Figure 5).

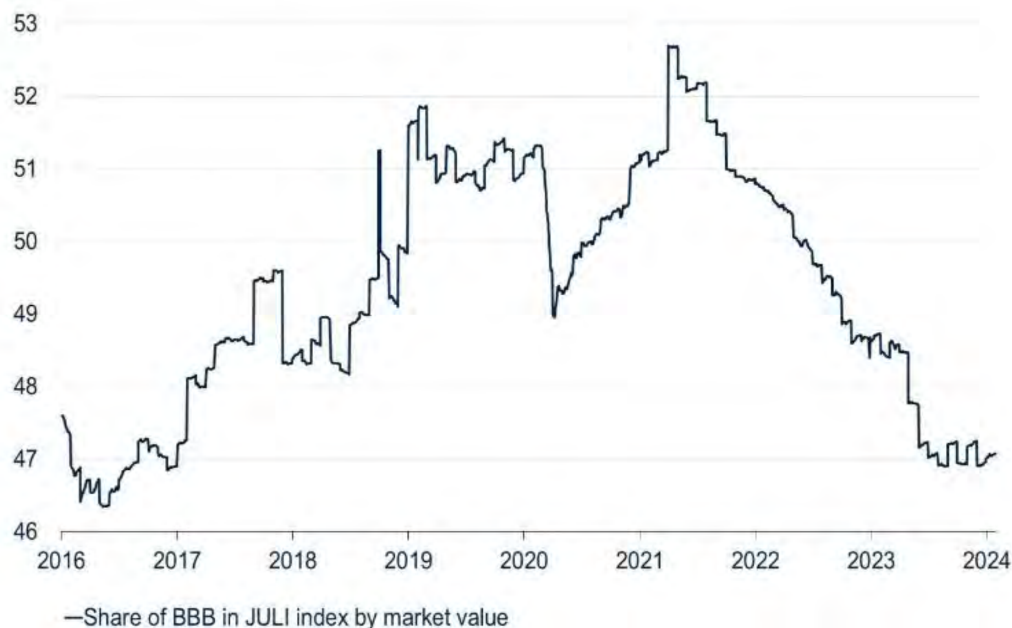
FIGURE 5: Fixed income's prior repricing in contrast to equities leaves IG yields notably above the S&P 500's earnings yield (%)

Source: PGIM Fixed Income, Bloomberg, Morgan Stanley

We'll reiterate the other potential reasons that also appeared in our first-quarter outlook. In terms of a long-term income hedge, if another unexpected shock forces central banks to cut rates dramatically, investors who hunkered down in money market funds and similar vehicles will face reinvestment risk after failing to lock in elevated yields for a prolonged period of time. Furthermore, in a risk off event - such as the Silicon Valley Bank and Credit Suisse crisis in the Spring of 2023 - high-quality, long-duration corporates may provide some ballast to a portfolio's total return potential.

A final point pertains to yield-based buyers and total return investors as each could be affected by negative credit migration in long-duration corporates. For example, Moody's found that more than a third of A-rated credits were downgraded over the course of 10 years.[4] More than 50% of the U.S. IG index was rated BBB as of March 2021, but management teams have maintained a cautious posture amid the Fed's historically rapid hiking cycle (not to mention other risks), and the share of BBBs in the index fell to 47% as of early 2024, which was the lowest level since late 2016 (Figure 6).[5] Furthermore, the credit migration in an individual portfolio may be mitigated by accurate, bottom up industry and issuer selection from a deep team of credit analysts throughout the course of a market cycle.

FIGURE 6: The quality composition of the U.S. IG Index has improved in recent years with the multi-year low in BBB representation (%)



Source: J.P. Morgan

Conclusion

We highlighted the long U.S. corporate space as it's a logical consideration given the Fed's presumptive rate cuts. In addition to our expectations for the Fed, consistent demand, limited supply, and valuation considerations relative to equities have also helped to define the sector's range. With this context, rather than timing potential exposure to a particular point in the range, we suggest investors continue familiarizing themselves with these factors and how long corporates might align with their respective investment objectives.

1. The referenced outperformance is on a total return basis.
2. Plan sponsors are increasingly using pension risk transfers (PRT) as an approach to exiting the pension business. PRT volume reached more than $71.3 billion in 2023, an increase of nearly 10% from 2019's volume of $65.4 billion, according to Pensions & Investments.
3. The Milliman projections are based on a 5.8% median asset return and a discount rate of 5.0%.
4. US Corp rating migration. 10-Years Long Average Rating Migration Rates: January 1, 1993-Dec 31, 2020. Moody's Default and Rating Analytics, Historical Rating Transitions, withdrawals excluded.
5. According to J.P. Morgan and based on the JULI Index by market value.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of February 9, 2024.
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