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Market Conditions Support Corporate Bonds

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Credit spreads for corporate bonds — the yield difference between corporates and Treasuries of the same maturity — are close to the tightest they've been in the past two decades.

Ultra-tight spreads are a cautionary sign that credit may be overvalued, as investors receive relatively little compensation for the greater risk of owning corporate bonds compared to owning government debt. In early 2016, the investment-grade (IG) spread was 2.2% above Treasuries; now, it's inside 1.2%. High-yield (HY) spreads have narrowed from 8.6% to less than 4% over the same period.

While credit prices look to be on the lofty side, there are several key reasons why we think they may be resilient for at least the next few quarters, and maybe even longer.

The first reason is improving U.S. corporate fundamentals, which stand to reduce the risk that companies might default on their debt.

Revenue and earnings growth for the Standard & Poor's 500 came in much higher than expected in the first three months of 2017. In fact, it was the best quarter in more than five years, and the current outlook for the rest of the year is good. Companies are also spending more on building their businesses. This is not just a U.S. phenomenon; fundamentals are also improving in several global markets.

The U.S. default rate for both IG and HY credits has been below average for some time now, even with debt issuance up sharply due to historically low interest rates. The consensus forecast calls for the default rate to edge even lower, though some companies in some industries (such as retail and energy) may be vulnerable to moving in the other direction.

KEY TAKEAWAYS

- While corporate bond valuations look to be on the high side, there are several key reasons why we think prices may be resilient for at least the next few quarters, and maybe even longer.
- These reasons include improving U.S. corporate fundamentals that stand to reduce default risk, less pressure on the Federal Reserve given declining economic growth expectations, and strong market demand for yield.
- Our outlook presumes that inflation remains in check, and that the economy doesn't slide into recession and thus jeopardize the corporate earnings trend. If macro conditions change, we would reassess our views.

A second reason is ebbing expectations for U.S. economic growth as Trump agenda dreams — tax reform, regulatory cutbacks and a huge infrastructure program — run up against Congressional reality. This could result in less inflation pressure and thus less need for the Federal Reserve to be aggressive in raising short-term interest rates.

We agree with the consensus that a June hike is pretty much locked in. But, assuming inflation remains in check, the Fed may or may not opt to act again in 2017. And it's worth a reminder that Fed rate policy raises only the short end of the yield curve. Yields at the longer end of the curve are down year to date, reflecting a market view that GDP growth projections may be too optimistic.

Such meager fixed-income yields have created strong and persistent demand for securities generating higher income than Treasuries or other government debt. This is the third reason we believe IG and HY prices may hold up. The U.S. credit market is attracting inflows not only from domestic buyers, but also from yield-starved investors overseas whose local interest rates are even lower.

We build and manage our portfolios bond by bond, with our buying decisions being based on a rigorous analysis of each individual credit. These days we are finding selective opportunities in some beaten-up sectors; these include European banks, energy and mining. Of interest on the HY side are bonds issued by retailers with a compelling reason to maintain a brick-and-mortar presence.

Our general outlook presumes that market conditions more or less stick to their current course — no inflation spike that might animate the Fed and no recession that could undercut corporate earnings expectations, raise default risk and create other uncertainties. Should these macro conditions change, we would have to reassess our views.

As always, we encourage investors to speak with one of our financial advisors, who can help determine which investment vehicles are suited for you based upon your individual goals, objectives, risk tolerance and time horizon.

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