PICTET 1805

PICTET WEALTH MANAGEMENT

Corporate bonds - update

Resilience in a high-rate environment

AUTHOR
LAURÉLINE RENAUD-CHATELAIN
lchatelain@pictet.com

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FLASH NOTE

SUMMARY

- We have moved from neutral to overweight on US investment-grade (IG) corporate bonds and from overweight to neutral on euro IG. We have lowered our year-end forecasts for US and euro IG spreads to 180 and 190 bps, respectively, given we now expect only a mild US recession.
- Total return prospects look better for US IG than for their euro IG counterparts, both because US IG yields are more elevated and because we see more downside potential for US Treasury yields than for euro sovereign bond yields in H2.
- Historically tight spreads at the top end of the HY universe mean we prefer to remain underweight HY overall. Potential spread widening as a consequence of economic downturn means we expect US and euro HY total returns to be lower than for their IG counterparts in the second half of this year.

LOCK IN ELEVATED COUPONS

Thanks to tighter credit spreads, **US and euro corporate bond yields have remained broadly stable in recent weeks compared to the surge in sovereign bond yields**. On 6 July, US and euro investment-grade (IG) corporate bond yields stood at 5.75% and 4.50%, respectively (according to ICE Bank of America indices, *see chart 1*). Yields of this level represent an attractive alternative to short-term money-market funds (for example, the three-month US Treasury bill yield was 5.35% on the same date) for investors who want to lock in high coupons for longer.

Although yields on short-term IG corporate bond yields remain higher than on longer-dated ones, **a steep and positive credit spread curve means that investors are still being compensated for taking additional duration risk** (*see chart 2*). This is no longer the case for either US and German sovereign bonds. A deeply inverted yield curve meant that on 6 July, two-year US Treasuries were offering 97 bps more than 10-year ones, and two-year German bonds 68 bps more than the Bund.

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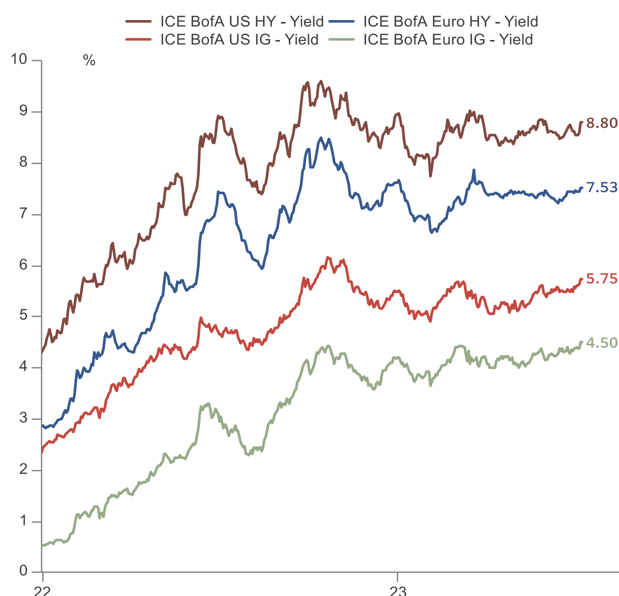
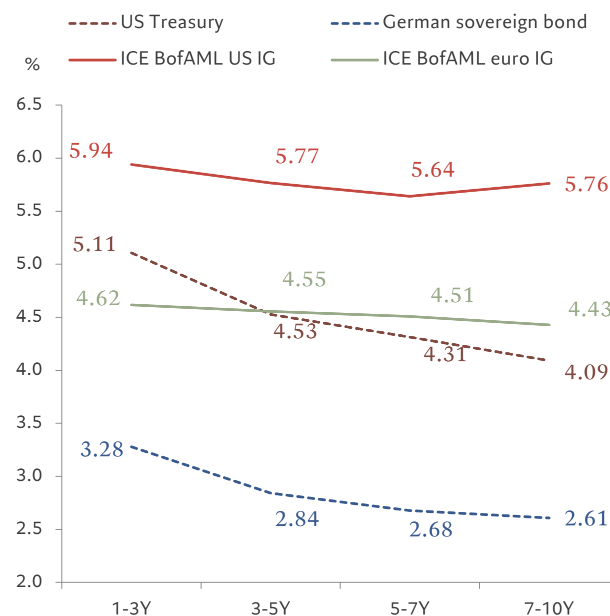
Chart 1: US and euro IG and HY corporate bond yields



Source: Pictet Wealth Management, FactSet, as of 06.07.2023

Chart 2: US and euro sovereign and IG corporate bond yield curves



Source: Pictet Wealth Management, FactSet, as of 06.07.2023

For many months, in a context where fast-increasing policy rates have been threatening growth prospects and pushing sovereign bond yields up, our favourite investment theme in fixed income has been short-term (one-to-three years maturity) IG corporate bonds. Now, **the attractive absolute levels of US IG yields and the recent surge in US Treasury yields mean we are ready to lengthen the duration of our US IG holdings to at least five years.**

We expect one last 25 bp rate hike from the US Federal Reserve (Fed) this month, after which we believe it will pause until the end of this year. Historically, medium-term IG corporate bonds tend to perform better than short-term ones in times when Fed policy is on pause, because of the usual positive impact on US Treasury prices. **Although hawkish Fed rhetoric and a resilient US labour market could maintain upward pressure on US Treasury yields over the summer, we still expect a shallow US recession.** Even if it is likely to be milder than we previously expected, it could last longer (up to Q1 2024, see Two-speed economies in the US and Europe). **This could start to bring Treasury yields down** (and prices up).

In Europe, the European Central Bank (ECB) is not yet seeing the fall in core inflation and the moderation in wage growth it is looking for to consider pausing its rate hiking cycle. As such, we expect the ECB to hike the deposit rate in both August and September, bringing it up to 4%, if not more. **Given potential upside risks on euro sovereign bond yields, we are sticking to short-term IG corporate bonds in euro and have downgraded our stance from overweight to neutral**. Between lower carry (with an average yield at 4.5% for the ICE Bank of America (BofA) euro IG index, on 6 July) and less downside potential on euro sovereign bond yields, our total return expectations are lower for euro IG than their US IG counterparts in H2.

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RESILIENT, BUT FOR HOW LONG?

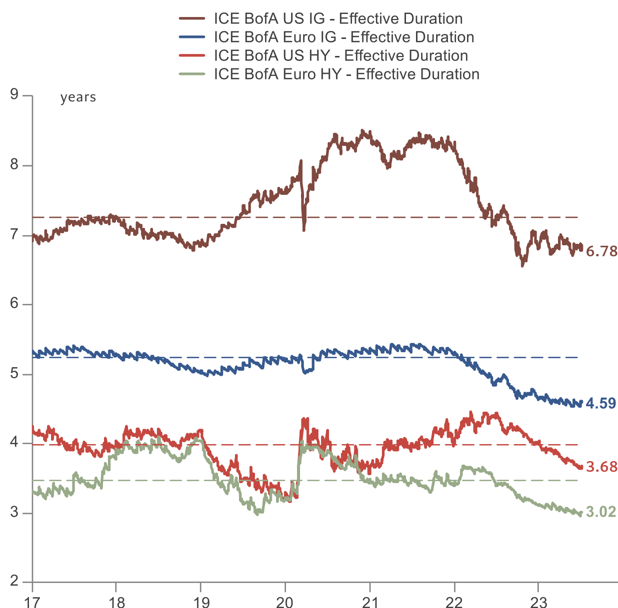
US and euro high-yield corporate bonds have been extremely resilient in the face of this year's rise in interest rates. Both thanks to lower effective duration and much higher coupons, HY's total returns have surpassed those of their IG counterparts year-to-date, at 4.6% for US HY and 4.3% for euro HY (on 6 July, according to ICE BofA indices).

However, cracks have been opening in the riskiest credit segments, such as the lowest-rated HY bonds and leveraged loans. **Default rates are rising fast in these areas due to prohibitive financing costs.** High financing costs have meant that net issuance in HY has been negative since the start of 2022, as companies postpone refinancing and use cash or other sources of funding instead. One can see the consequence of this in the steep decline in the weighted effective duration of corporate bond indices (*see chart 3*).

Yields on both ICE BofA US and euro HY remain much higher than for their IG counterparts (8.8% and 7.5%, respectively, on 6 July, *see chart 1*). As for spreads, they are still the most elevated in the riskiest ratings segments (CCC & lower), especially in euro HY (*see chart 4*) whereas in the 'quality' part of HY (BB-rated bonds), spreads are trading close to their long-term median in euro but well below it in US HY.

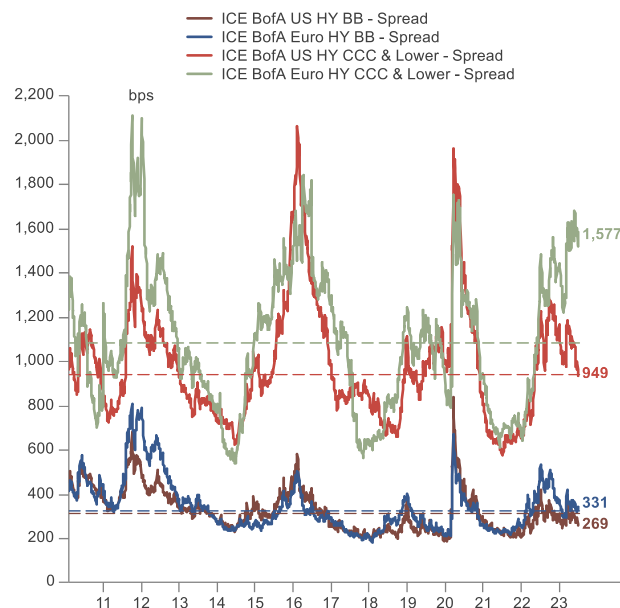
This means that HY investors continue to differentiate between bonds that are the most at risk of defaulting and the ones better suited to navigate a higher-for-longer rate environment and an economic slowdown. **But while better-quality HY names may look attractive, their already tight spreads mean we prefer to stick to IG bonds.** Our continued underweight position in HY is founded on the belief that IG will offer better total return prospects should spreads widen in H2.

Chart 3: US and euro IG and HY corporate bond indices, effective duration (dotted line = median)



Source: Pictet Wealth Management, FactSet, as of 06.07.2023

Chart 4: US and euro HY bond spreads by rating categories (dotted line = median)



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