Lots of Supply, Lots More Demand

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Key Takeaways

- Inflation continues to cool, but mixed economic data suggests the need for a tactical approach to interest rate exposure.
- The all-in yield backdrop in corporate fixed income remains unequivocally attractive, especially considering global central bankers are likely on our side going forward.
- Although index-level credit spreads may not be overly compelling, strong technical tailwinds are expected to persist this year and help support valuations, and active management can play a key role in limiting reliance on broad market moves.

Will they, or won't they?

Markets entered the year expecting central bankers to embark on an aggressive monetary easing cycle. At its peak in early January, U.S. markets were pricing in nearly seven rate cuts for 2024, with similar forecasts for the Bank of Canada and the European Central Bank. We viewed these projections as excessive, especially given policymakers' insistent concern over inflation sitting above target. Stronger-than-expected growth and inflation data, particularly in the U.S., has now led markets to significantly reduce rate expectations to roughly three to four cuts in 2024, which we believe is much more reasonable and better aligned with policymakers' projections.

We acknowledge that some prominent economists are now calling for no rate cuts in 2024, with some even assigning non-zero probabilities of the next Federal Reserve move being a hike. We do not subscribe to this notion as we believe the downward trend in inflation seems to remain intact. While we concede that stickier components of inflation (e.g., shelter) may keep back-end rates higher, we expect normalization at the front end of the yield curve, with goods deflation supporting this narrative.

More recently, economic data has been mixed as the U.S. economy continues to show resilience while the Canadian and European economic backdrops prove to be much more vulnerable. All else equal, "maintenance" cuts later this year seem reasonable, with lower inflation levels fueling higher real rates (nominal yields minus inflation) that are becoming increasingly restrictive on the economy.

High-quality bonds, higher yields

The all-in yields currently offered by developed market investment grade corporate debt are unequivocally attractive on an absolute and relative basis. High-quality corporate bond yields currently sit at or above their 90th percentiles since 2010 and surpass the earnings and dividend yields offered by equities.[1] Additionally, these yield levels provide a substantial margin of safety as bond investors can collect handsome coupon payments even if the path of inflation and risk-free yields is choppy.

[1]Source: Bloomberg. Data as of March 6th, 2024. Data is based on the dividend and earnings yield of the S&P 500 and the daily yield to maturity of the Bloomberg Global Corporate, Bloomberg Canada Corporate, and Bloomberg US Corporate bond indices since 2010.

Accordingly, we are constructive on interest rate exposure (duration), but we believe the juxtaposition in economic data calls for a data-dependent and tactical approach. Simply put, we plan to continue managing duration with a common sense mindset, reducing interest rate exposure when risk-free yields rally sharply with the intent to add back upon any weakness.

Strong supply, stronger demand

Credit spreads have proven quite resilient this year and have generally exhibited a negative correlation to rising risk-free yields. While there is no denying that index-level spread valuations screen between average to rich, it is essential to take stock of the strong and persistent technical tailwinds at play.

Investment grade companies have tapped the primary market for a record amount (~$400bn) of new issuance year-to-date.[2] This rampant supply is due to the reignition of M&A related supply combined with a notable pull-forward of issuance to take advantage of a period of low volatility prior to the U.S. presidential election. Traditionally bound by the classic economic dynamic of supply/demand, such an influx of issuance typically leads to weaker credit spreads; however, spreads have grinded tighter (rallied) year-to-date.

The impressive digestion of record new issuance indicates a healthy market and is a testament to the insatiable demand for fixed income. We expect large yield-based buyers (i.e., pensions, etc.) and the potential redeployment out of money market funds to continue fueling demand. Contrarily, forward net supply (i.e., new issuance minus redemptions and coupons) is projected to fall off a cliff into negative territory for the entire year. This dynamic of demand outweighing supply would be a supportive technical tailwind for credit spreads.

Again, we acknowledge that index-level credit spreads may not be overly compelling, and there could be marginal bouts of weakness. Consequently, we have modestly reduced credit risk across our portfolios at this juncture, maintaining dry powder to redeploy upon any material weakness. As active global managers, however, we are not constrained to broad market exposures, and we emphasize that there are plenty of outright and relative value opportunities as dispersion increases. For instance, we have been taking advantage of the capital gains opportunity in short-dated U.S. and European investment grade bonds trading at attractive discounts across our mandates. Please feel free to reach out if you are interested in learning more about specific themes or trades in our portfolios.

No shortage of opportunities in corporate credit

We firmly believe in our ability to limit the reliance on broad market moves and identify idiosyncratic opportunities beneath the surface. We are well-positioned to capitalize on any material weakness, and we will likely see opportunities in the ensuing new issue calendar to redeploy capital and optimize the portfolios.

We believe global central bankers are now on our side, barring a significant reversal in the inflation trend, and we expect strong technical tailwinds to persist, underscored by tapering net supply and robust demand for attractive all-in yields. Bottom line, we reaffirm our belief that corporate credit in developed markets will be among the best risk-return opportunities in the coming quarters.

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[2]Source: Bloomberg, ICE BofA Global Research. Data as of February 29th, 2024. ~$400bn of new issuance is based on year-to-date gross supply of US investment grade corporate issuers.

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