Parametric

Corporate Bond Market Insight | January 2025

Hedging Uncertainty with Disruptive Debt Ceilings and Dissipating Stimulus

Key takeaways

» Even though 2024 began on a sour note, with only 1.4% first-quarter growth, it defied expectations with solid earnings. The Conference Board now estimates 2025 growth at a strong 2.7%.

» Progress toward the Fed's 2% inflation target proved disappointing, with the year ending at a rebounded 2.8% rate.

» The implications of Republicans winning the presidency, House and Senate are still uncertain, since the full scope of new policy hasn't been announced. But we think it's likely that current tax policy will remain in place.

» Economic data from December tells us the economy might be defying expectations again, with solid consumption and 227,000 new nonfarm jobs added in November.

Recap

Last year ended quietly. The economy extended its recent trend of exceeding expectations in December. Progress toward the Fed's inflation target remained stalled, and rates—particularly long rates—rose. The Fed cut rates 25 basis points (bps) at the December meeting, emphasizing that it's become less concerned with the economic outlook but more with the lack of progress toward its inflation target. The federal debt limit was extended when the month ended, but Congress will need to renegotiate the current continuing resolution in March 2025. A bruising fight seems likely.

2024 defied expectations and produced solid growth and earnings, but the year began on a sour note. First-quarter growth of only 1.4% seemed to set the stage for a sharp slowdown. Markets expected in January that the Fed would begin rate cuts in March and had priced in as many as six cuts for the year. But the economy grew handily despite the early concerns. Upbeat consumers spent, buoyed by wealth effects and rising wages, and corporate earnings proved solid. The Conference Board now estimates 2025 growth at a strong 2.7%.

Progress toward the Fed's 2% inflation target proved disappointing in contrast. Over the course of 2023, the Fed's favored inflation gauge, Core Personal Consumption Expenditure (PCE), declined sharply. The year-over-year rate had dropped to 3.10% by January 2024 and improved to 2.6% by midyear. However, this proved to be the low point, and the rate had rebounded to 2.8% at year end. Core PCE ended the year at a 3.3% year-over-year rate.

In response to weakening labor markets in September, the Fed finally lowered the federal funds rate 50 bps. The Fed cut twice more throughout the year for a total reduction of 100 bps. Market rates rose, particularly at the long end of the curve. The economic slowdown also proved fleeting, and inflation was stubborn despite the Fed cutting the federal funds rate 25 bps to a range of 4.25% to 4.50% at its December meeting.

A contentious election saw Republicans win the presidency and sweep both the House and Senate. The implications of the victory are still uncertain, since the White House has yet to announce its full scope of new policy and the legislative margins are thin. But it's likely that current tax policy will remain in place, allowing consumers and corporations to continue to spend at current rates.

The Fed also raised the 2025 growth forecast to 2.1% and projected a minor increase in the unemployment rate to 4.3%. Over the last few months, several officials have expressed concern that the improvement in inflation may be stalling and they would prefer to slow the pace of cuts. Chair Jerome Powell's post-meeting comments remained consistent with this viewpoint. In the press conference after the meeting, he said, "With today's action, we have lowered our policy rate by a full percentage point from its peak and our policy stance is now significantly less restrictive… We can therefore be more cautious as we consider further adjustments to our policy rate." Coming changes in economic and immigration policy have further complicated the Fed's mission. It seems to us that pausing to assess is prudent.

Against this backdrop, the 10-year Treasury yield rose 39 bps for the month, 79 bps for the quarter and 71 bps for the year. Credit spreads narrowed one bps for the month, 11 bps for the quarter and 27 bps on the year. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned -0.67% for the month, -1.70% for the quarter and 4.17% for the year as a result. Credit spreads in all sectors narrowed over the year, and lower-quality investment-grade (IG) credit outperformed higher IG quality. Best performing sectors in 2024 included real estate, leisure, insurance, financial services and banking. Healthcare, retail and technology lagged somewhat.

December economic data suggests the economy is again defying expectations and strengthening. The Institute of Supply Management's Manufacturing Purchasing Managers Index (PMI) posted its best one-month gain since June. The new orders segment of the survey moved above the 50 level, suggesting strength to come. The Services PMI and new orders surveys (ISM), while weakening modestly, remain in expansion. More good news came in the National Federation of Independent Business Optimism survey, which has improved from 93.7 to 101.7. This is its highest reading since June 2021 and reflects the economic optimism of small businesses following the election. Small businesses represent 43% of GDP and are responsible for the bulk of new hiring. The retail sales report and the Redbook survey of same-store sales also remains consistent with solid consumption. There's also evidence that consumers and corporations are beginning to buy potentially tariff-affected durable goods and components.

Employment rebounded from the weather and strike-impacted levels of October. The economy added a solid 227,000 new nonfarm jobs in November, and we saw upward revisions to the two prior months. Including the revisions, the three-month average gain is now a respectable 172,000. Most of the growth has been in private industry rather than government. Hourly earnings were also strong.

Looking forward

The 2025 outlook is one of uncertainty. Changes in economic policy associated with the new administration have the potential to create significant volatility. Recent economic strengthening and threatened tariffs also have the potential to keep inflation sticky. While we believe the inflation outlook is benign, we could also make the case that the first half of the year may prove problematic. If comprehensive tariffs come in, the resulting one-time bump higher to inflation would certainly be concerning.

We also need to consider the historic relationships between the normalization of the yield curve and the recent triggering of the Sahm employment rule. Both have historically been reliable precursors to recessions. While we think it's likely that the economy will avoid outright recession, it's hard to deny the historical relationship.

The largest question moving forward will be the consumer. Gains in equity and real estate markets have generated wealth effects that have acted as powerful inducements to spend. But equities are coming off one of their strongest two-year performances in history and seem overdue for a significant correction. Just as the surge in immigration helped strengthen the economy and reduce inflation over the last several years, the reversal in immigration may well prove a headwind. Much of the fiscal and monetary stimulus that propelled the economy throughout 2023 and 2024 should begin to dissipate, to say nothing of the likelihood of a disruptive debt ceiling fight in March.

A rules-based ladder structure fortunately acts as an uncertainty hedge, and the outlook for IG credit is good. IG corporate balance sheets are sound, and demand for credit is robust. Despite 2024 IG net issuance being up 33% over 2023 levels, IG spreads are near their all-time tights. Upgrade-downgrade ratios also continue to improve. All-in starting yields for ladders offer good value. Both provide a solid uncertainly cushion for ladder investors.

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