PICTET WEALTH MANAGEMENT

Investment-grade corporate bonds

Spread widening in credit could raise the appeal of cash

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FLASH NOTE

SUMMARY

- Corporate bonds have outperformed government bonds this year, mainly due to spread tightening and corporate bonds' more elevated yields. Credit spreads now look particularly tight compared to their historical ranges, especially for US investment-grade (IG) corporate bonds. And corporate bonds' historically attractive yields are mostly due to the significant rise in central banks' policy rates.
- Given that euro IG spreads remain close to their historical median, euro IG should continue to outperform cash this year as we expect the European Central Bank (ECB) to cut short-term rates by 100 bps by year's end. By contrast, the prospect of delayed US Federal Reserve (Fed) rate cuts means that cash in US dollars will likely continue to offer juicy returns while we expect US IG spreads to widen given their high valuations.
- We remain overweight euro IG credits but have moved from overweight to neutral on US IG and from neutral to overweight on cash.

ROBUST DEMAND FOR CREDIT

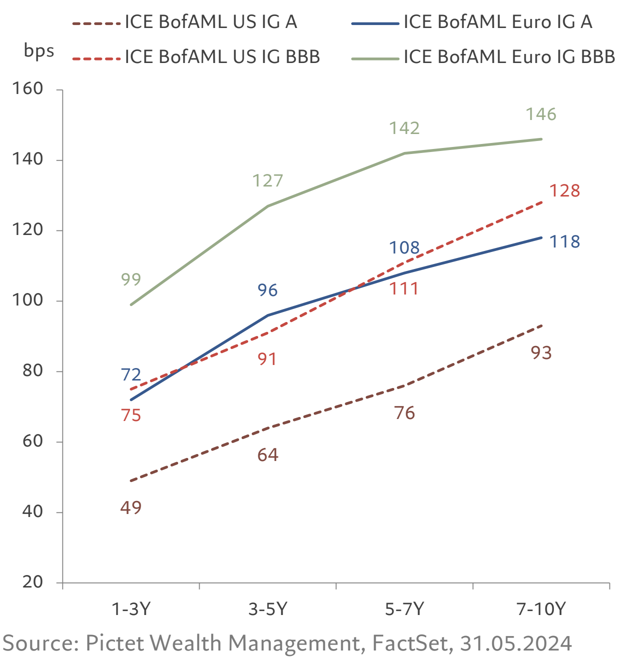
Corporate bonds have outperformed government bonds this year, mainly due to spread tightening and corporate bonds' more attractive yields. Whereas year-to-date 10-year US and German government bonds had posted negative total returns of -3.1% and -4.5%, respectively by end May, US and euro IG corporate bonds performance was only mildly negative at -0.6% and -0.2%, respectively (according to ICE indices). In other words, investors have been gaining excess returns from credit over government bonds of similar duration.

The reasons behind the relentless tightening of credit spreads in the last few months are manifold. First, US and European economic growth has been more resilient than expected, as fears of a sharp economic slowdown in the wake of central banks' aggressive rate-hiking campaigns have faded. For example, earnings growth for US IG companies has accelerated in Q1 this year and has stayed in positive territory since late 2020. However, as indebtedness has risen even faster, the median net leverage ratio (net debt over 12-month profits) for US IG companies outside the financial and utilities sectors continues to increase, standing at 2.1x in Q1, well above the pre-pandemic average. And although the median interest coverage ratio (interest expenses over 12-month profits) has declined to a median of 9.8x as companies have had to refinance at higher rates, it is likely to remain manageable for most non-financial US IG companies as long as positive nominal GDP growth ensures increases in profits. In 2024, we expect nominal GDP growth to be a solid 5.8% in the US, but lower (3.2%) in the euro area.

Additionally, demand for quality corporate bonds has been strong as investors seek to lock in elevated yields from quality issuers as central banks pivoted from rate hikes to talk of rate cuts last December. Moreover, while sovereign yield curves are inverted, corporate bond yield curves are flat thanks to steep credit spread curves, ensuring that investors are compensated for the duration risk they take. For example, US IG yields hover around 5.5% across maturities and euro IG ones around 4%, with credit spreads below 100 bps for short-dated maturities both in US and euro IG, but above 100 bps for mid-to-longer dated issues (according to ICE indices, *chart 1*).

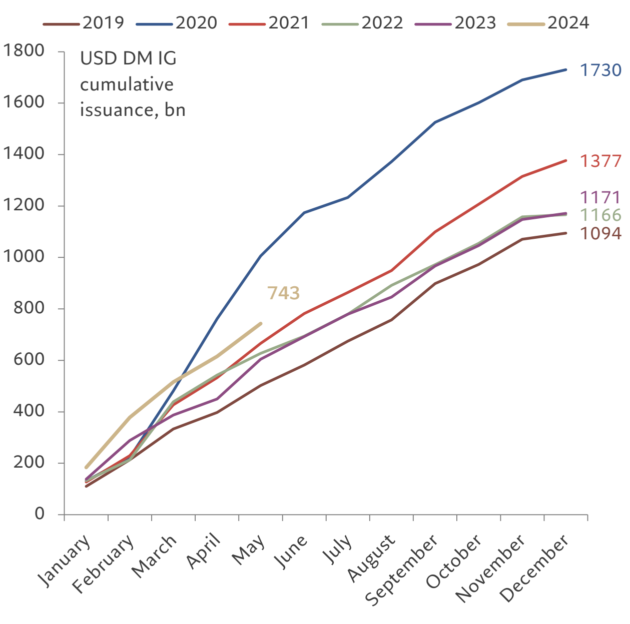
IG companies have taken advantage of investors' appetite for quality debt, and the ensuing spread tightening, to issue. Gross developed market (DM) IG issuance came to USD743 bn in the first five months of 2024, the highest level ever for a comparable time period (except in 2020, *chart 2*). Although the strength of new issuance has contributed to the afore-mentioned fall in the interest coverage ratios of IG companies, it has also helped push back the 'maturity wall' that IG companies were facing into 2025 and beyond.

Chart 1: US and euro credit spread curves



Source: Pictet Wealth Management, FactSet, 31.05.2024

Chart 2: IG corporate bonds, gross issuance



Source: Pictet Wealth Management, ICE indices, 31.05.2024

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HIGH VALUATIONS FOR US IG SPREADS

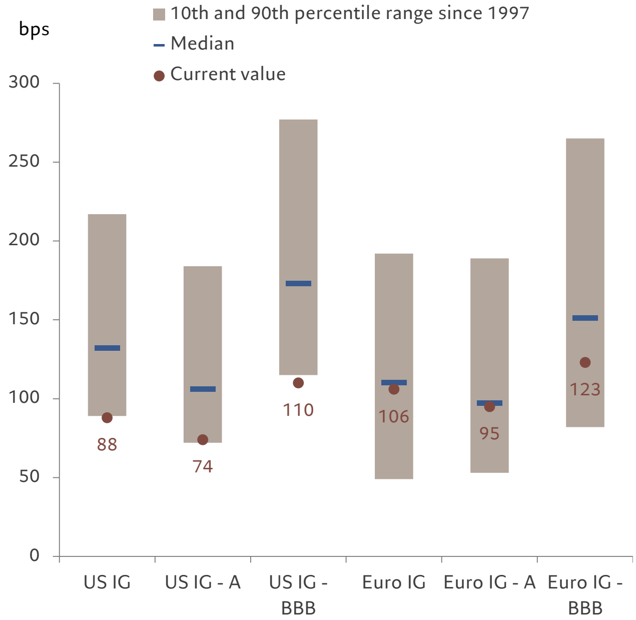
After months of tightening, credit spreads look tight compared to their historical ranges, especially for US IG corporate bonds (*chart 3*). At 88 bps the US IG spread was below its 10th percentile on 3 June (based on the ICE Bank of America US IG index), with the BBB-rated segment looking particularly expensive relative to history. In a context of high-for-longer rates in the US and decelerating nominal GDP growth, we expect US IG companies' fundamentals to continue to deteriorate gradually. As we no longer expect a recession in the US this year, our base scenario now is for only two Fed rate cuts in H2, so we now see a limited spread widening in US IG. We have thus lowered our year-end forecast from 130 bps to 110 bps—still below its long-term median of 132 bps, but 22 bps wider than at present.

Euro IG does not look as highly valued, with spreads remaining close to their historical median. Moreover, after a shallow recession in H2 23, non-financial companies' fundamentals could be supported by the ongoing economic recovery in the euro area and the ECB's rate-cutting cycle. Starting in June, we foresee the ECB cutting its deposit rate by 100 bps by year's end. We therefore believe that spread widening will be more limited for euro IG than for its US equivalent. We see euro IG widening from 106 bps on 3 June to 120 bps at year's end (less wide than our previous forecast of 140 bps).

While we remain somewhat concerned about tight IG spreads, we have to admit that US and euro IG corporate bond yields are still at historically attractive levels (*chart 4*). However, after the relentless spread tightening of recent months, these elevated yields are mostly due to the significant rise in policy rates. In this context, we continue to believe in our investment theme *From cash to duration*, which aims to lock in the elevated yields offered by quality corporate issuers in anticipation of central banks' rate-cutting cycle.

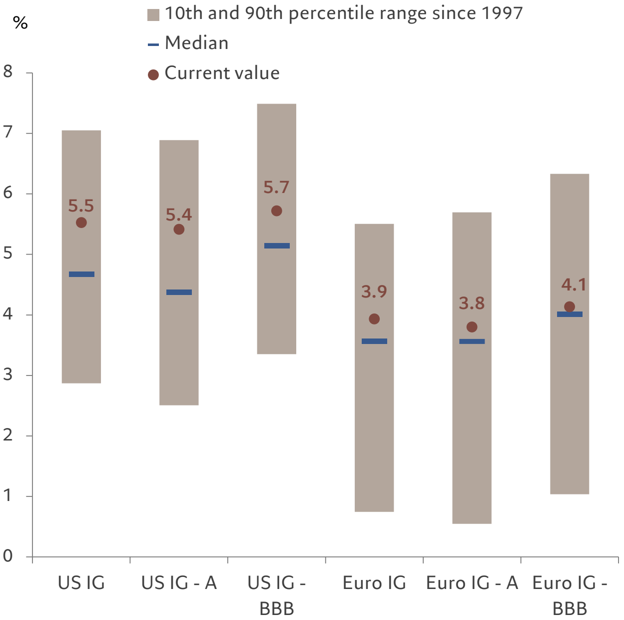
Euro IG should continue to outperform cash this year given our expectations for 100 bps of cuts in the ECB's deposit rate. By contrast, the delay in Fed rate cuts means that cash in US dollars will likely continue to offer juicy returns, while we expect US IG spreads to widen given their high valuations. As such, we remain overweight euro IG credits, but we have moved from overweight to neutral on US IG and from neutral to overweight on cash.

Chart 3: US and euro credit spreads valuation



Source: Pictet Wealth Management, FactSet, 03.06.2024

Chart 4: US and euro credit yields valuation



Source: Pictet Wealth Management, FactSet, 03.06.2024

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