Private Markets

March 14, 2024

Global Credit Weekly:

Resetting rate expectations

BlackRock

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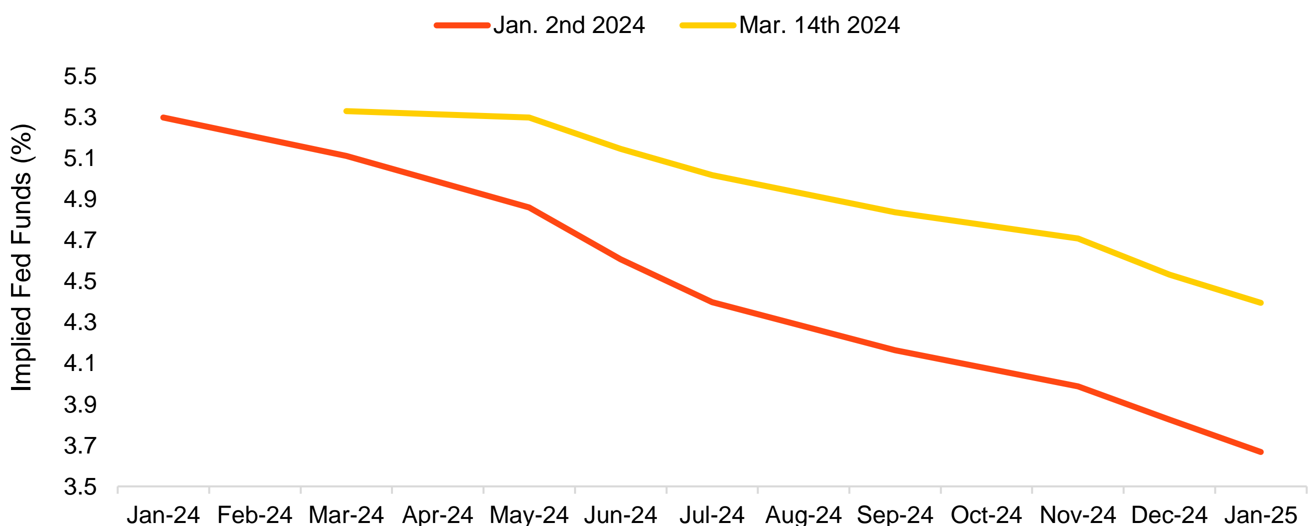
Key takeaways

- Market pricing continues to reflect a later start to the Federal Reserve's rate cutting cycle, relative to just a few months ago (Exhibit 1). But this has not derailed market sentiment. Average index-level spreads for the Bloomberg USD investment grade (IG) and high yield (HY) corporate indices have marched toward multi-year tights of 92bp and 303bp, respectively (Exhibits 4 and 5). And in the USD HY market, 55% of the index trades at a spread less than 225bp.
- To us, this supportive risk sentiment reflects continued optimism regarding a so-called "soft landing" as well as the significant yield support provided by the risk-free rate, which has encouraged yield-based investors to deploy capital into the USD credit market at historically attractive all-in yields. The tightening in index level spreads is even more notable considering the heavy pace of new issue activity in both the USD IG and HY primary markets so far this quarter (Exhibits 6 and 7). With many public firms approaching their earnings-related, quarter-end blackout periods, issuance is likely to slow from the brisk pace of the past few months. This should lend some additional technical support to spreads (at least temporarily), in our view, likely pushing them closer to the mid-2021 local tights.
- Our base case remains for the first Fed rate cut to begin in 2H2024, with the risks skewed earlier within that timeframe. That said, and as we have noted previously, the *timing* of the start of rate cuts is not the primary consideration for corporate credit investors. Rather, the following are the factors most critical for investor risk appetite to remain supportive, in our view: 1) a high likelihood that the current Fed Funds rate represents the peak for this cycle (i.e., no more rate *hikes* are expected), 2) the expectation that rate *cuts will begin eventually* in 2024, and 3) the reason for the eventual rate cuts will be sustained improvement in inflation, as opposed to a sharp growth downturn. This also has implications for asset allocation, as we detail within.

Exhibit 1: Market pricing continues to reflect a smaller number of cuts vs. the start of 2024

The U.S. policy rate implied by Fed Funds Futures, through early 2025



Source: BlackRock, Bloomberg. As of March 14, 2024.

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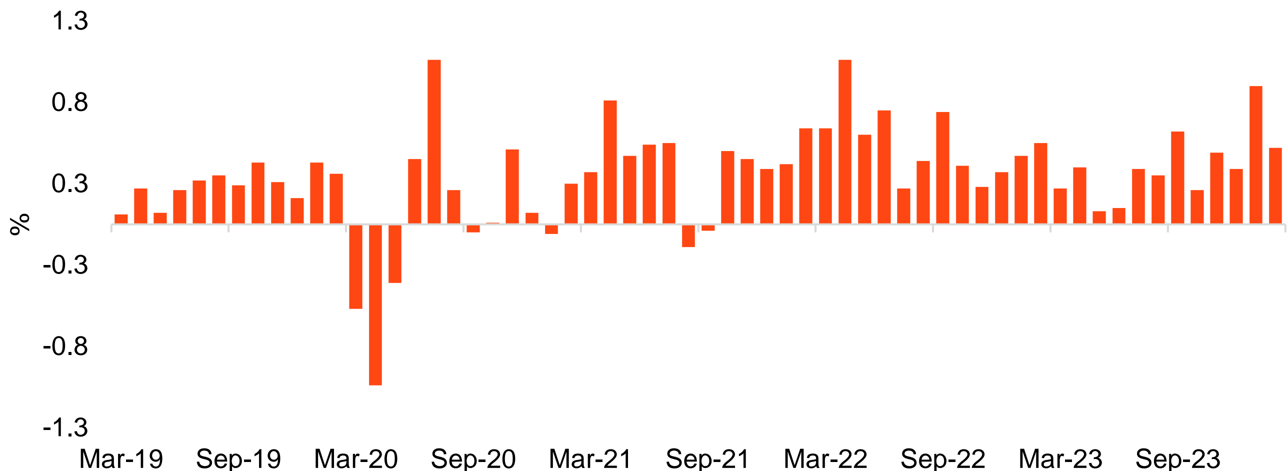
Inflation data will likely reinforce the Fed's patient stance

The U.S. Consumer Price Index (CPI) for February 2024 (released March 12th) was somewhat stronger than anticipated, on both a month-over-month and year-over-year basis. For example, core CPI inflation (which excludes Energy and Food) increased 0.4% in February – flat with January's figure but above Bloomberg consensus estimates for a 0.3% increase.

The upside surprise vs. expectations was driven by a mix of categories, including costs for shelter (which captures rent, owners' equivalent rent and hotels), airline fares, car insurance, apparel, used cars/trucks, and recreation. On the encouraging side, non-housing services inflation (often referred to as "Supercore") was +0.47% for February – a deceleration from January's elevated +0.85% level (Exhibit 2). But as illustrated in Exhibit 3, the "core goods" category reported *inflation* for the first time since May 2023 – breaking the trend of *disinflation* which had been in place for the previous several months.

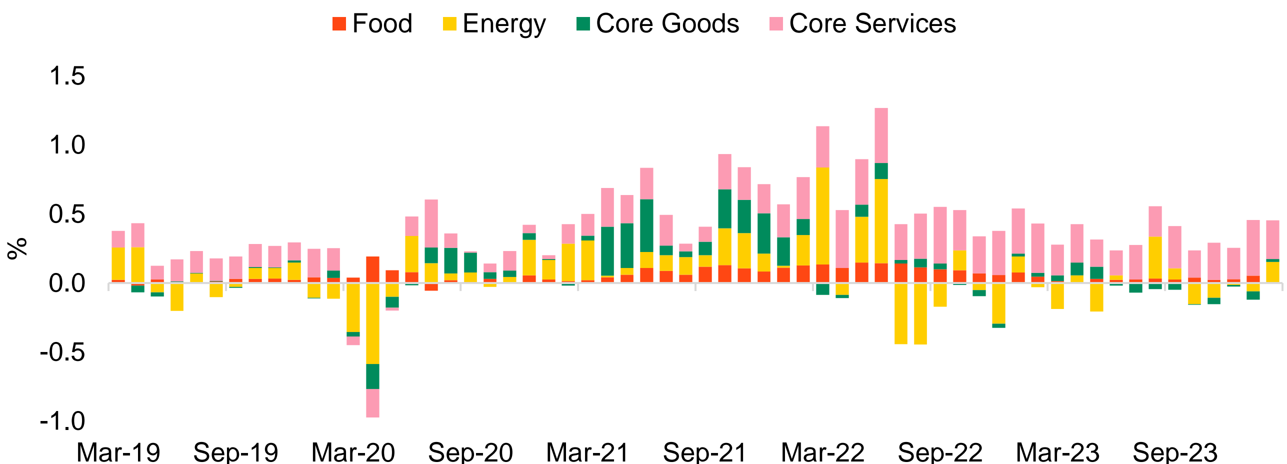
With the most recent CPI data showing pockets of strength, and the year-over-year rate at 3.8% on a core basis, we expect the Federal Reserve (Fed) to refrain from easing monetary policy in the very near term – consistent with the messaging from a range of Fed officials in recent weeks. Indeed, a still-solid U.S. growth backdrop leaves little urgency to cut in the next few months, in our view. According to the Atlanta Fed's "GDPNow" forecasting model, 1Q2024 real U.S. GDP was tracking at 2.5% (as of March 7th).

Exhibit 2: "Supercore" inflation for February 2024 showed a moderation vs. January's level
Month-over-month change in CPI Services ex-Housing ("Supercore" CPI)



Source: BlackRock, Bloomberg, Bureau of Labor Statistics, Bloomberg. As of February 29, 2024.

Exhibit 3: The trend of core goods disinflation was interrupted in February 2024
Contributions to month-over-month U.S. CPI (seasonally adjusted)



Source: BlackRock, Bloomberg, Bureau of Labor Statistics. As of February 29, 2024.

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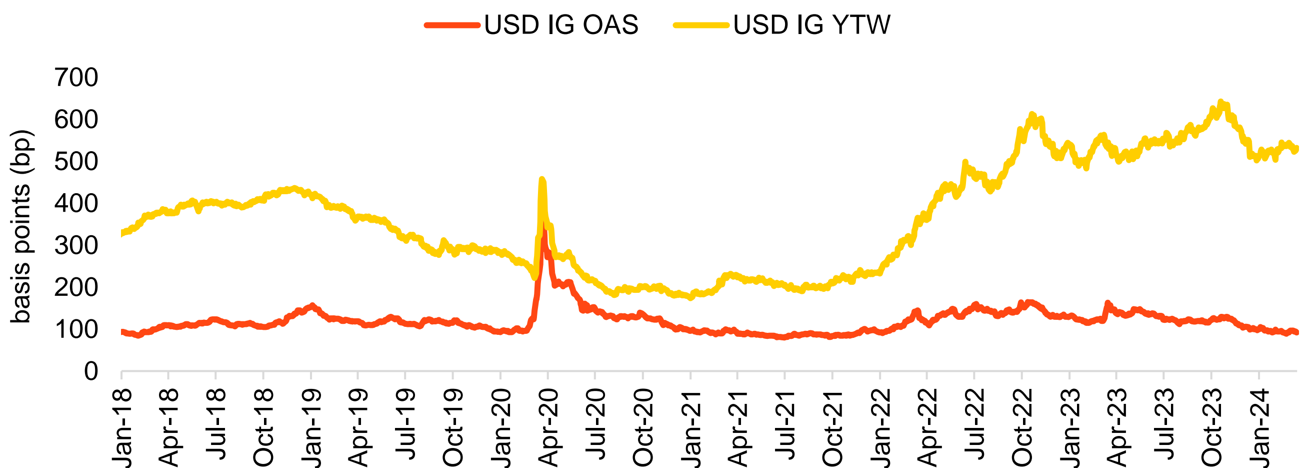
“Delayed” rate cuts have not hindered broad risk sentiment

Our base case remains for the first Fed rate cut to begin in 2H2024, with the risks skewed earlier within that timeframe. That said, and as we have noted previously, the *timing* of the start of rate cuts is not the primary consideration for corporate credit investors. Indeed, even as rate cut expectations for 2024 have continued to reset (Exhibit 1) to reflect a later start, average index-level spreads for the Bloomberg USD investment grade (IG) and high yield (HY) corporate indices have marched toward multi-year tights (Exhibits 4 and 5). To us, this reflects continued optimism regarding a so-called “soft landing” as well as the significant yield support provided by the risk-free rate, which has encouraged yield-based investors to deploy capital into the USD credit market at historically attractive all-in yields (again, Exhibits 4 and 5).

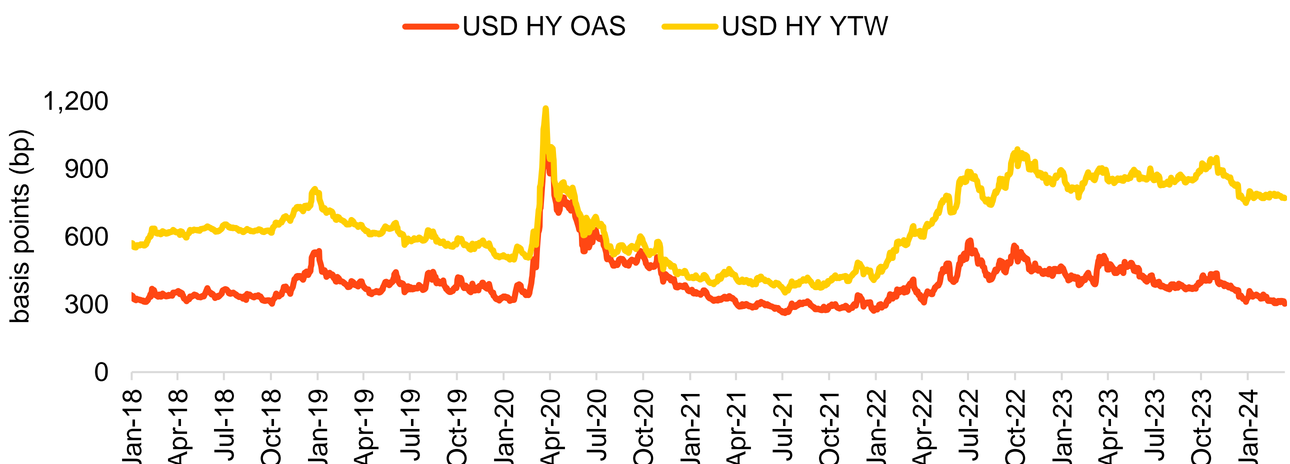
The tightening in index level spreads is even more notable considering the heavy pace of new issue activity in both the USD IG and HY markets so far this quarter (Exhibits 6 and 7). Quarter-to-date USD HY gross supply of $68 billion (as of March 13th) is already the most active since 4Q2021 (Exhibit 6). And USD IG primary market activity so far in 1Q2024 is the heaviest since 1Q2022 (Exhibit 7).

Exhibit 4: The USD IG index is trading at an average OAS of 92bp – a multi-year tight
Historical average option adjusted spread (OAS) and yield-to-worst (YTW) for the Bloomberg USD IG Corporate Index



Source: BlackRock, Bloomberg. As of March 13, 2024.

Exhibit 5: The average OAS for the USD HY index is 303bp – still above the mid-2021 tights
Historical average option adjusted spread (OAS) and yield-to-worst (YTW) for the Bloomberg USD HY Corporate Index



Source: BlackRock, Bloomberg. As of March 13, 2024.
For both charts: The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

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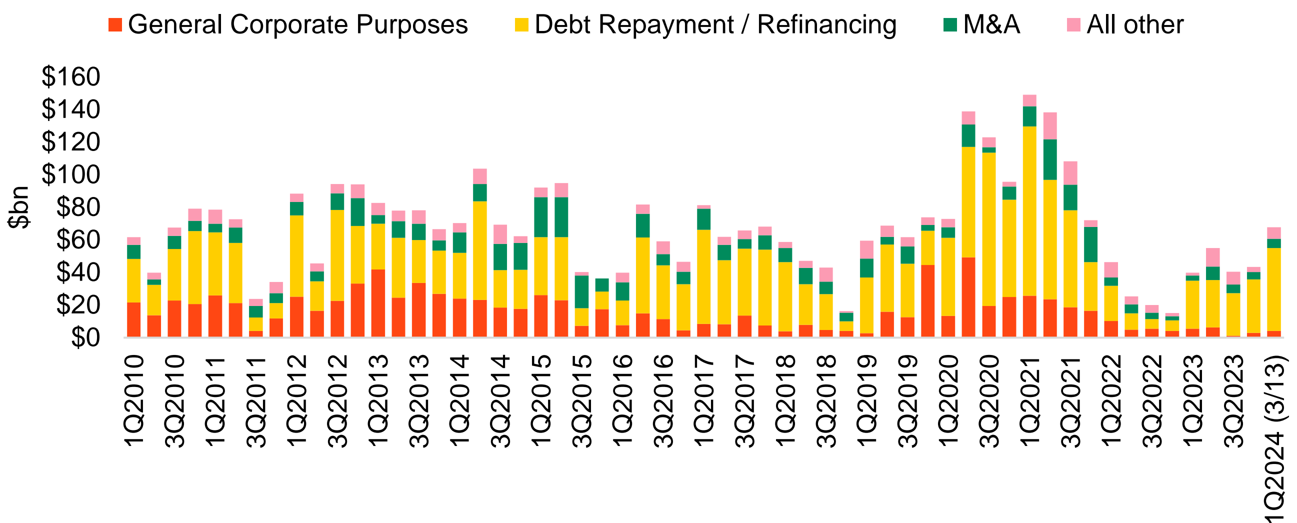
Beyond these large absolute issuance figures, the data shows that this elevated level of supply has been well absorbed. According to deal-level data complied by Bloomberg, the average new issue concession (NIC) for USD IG deals in 1Q2024 (as of March 11th) was just 3.8bp. This compares to an average NIC of 8.5bp for all of 2023. Books for the USD IG deals so far this year have been, on average, 3.7x covered according to Bloomberg (vs. 3.5x covered on average in 2023).

With many public firms approaching their earnings-related, quarter-end blackout periods, issuance is likely to slow (at least temporarily) from the brisk pace of the past few months. This should lend some additional technical support to spreads, in our view, likely pushing them closer to the mid-2021 local tights (again, Exhibits 4 and 5). Notably, when looking under the surface, the *distribution* of spreads skews even tighter than the average index level suggests (Exhibit 8).

Exhibit 6: 1Q2024 (to date) USD HY new issue activity is the strongest since late 2021

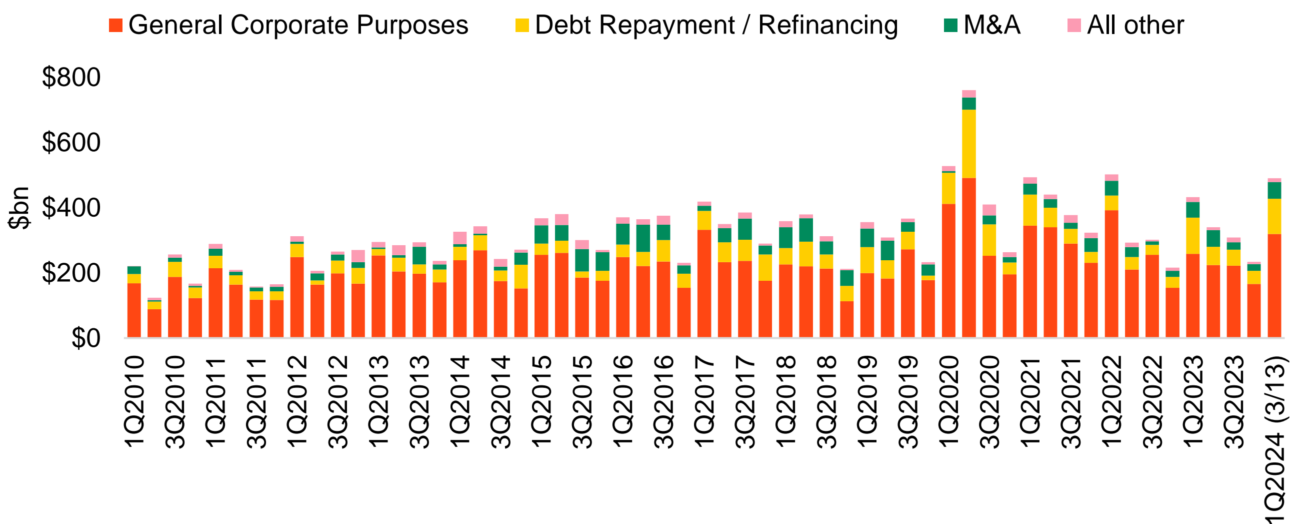
USD HY gross issuance by quarter and primary use of proceeds (as captured by Dealogic)



Source: BlackRock, Dealogic (ION Analytics). 1Q2024 is as of March 13, 2024. "All other" includes: LBO/MBO, Dividend Recapitalization, Spin-Off, Restructuring, Capital Expenditures, Working Capital, Investments, Recapitalization, Exit Financing, Project Financing, Aircraft, DIP Financing, Property, Dividend Payment, Public Finance, Securitization, Equity Infusion, Expansion, and Shipping

Exhibit 7: 1Q2024 USD IG supply is on track to surpass 1Q2022's level

USD IG gross issuance by quarter and primary use of proceeds (as captured by Dealogic)



Source: BlackRock, Dealogic (ION Analytics). 1Q2024 is as of March 13, 2024. "All other" includes: Recapitalization, Restructuring, Project Financing, Spin-Off, Working Capital, Capital Expenditures, Aircraft, Investments, Dividend Recapitalization, Exit Financing, Securitisation, Expansion, Public Finance, Property, LBO/MBO, Shipping, ECA Financing, Private Placement, and Dividend Payment.

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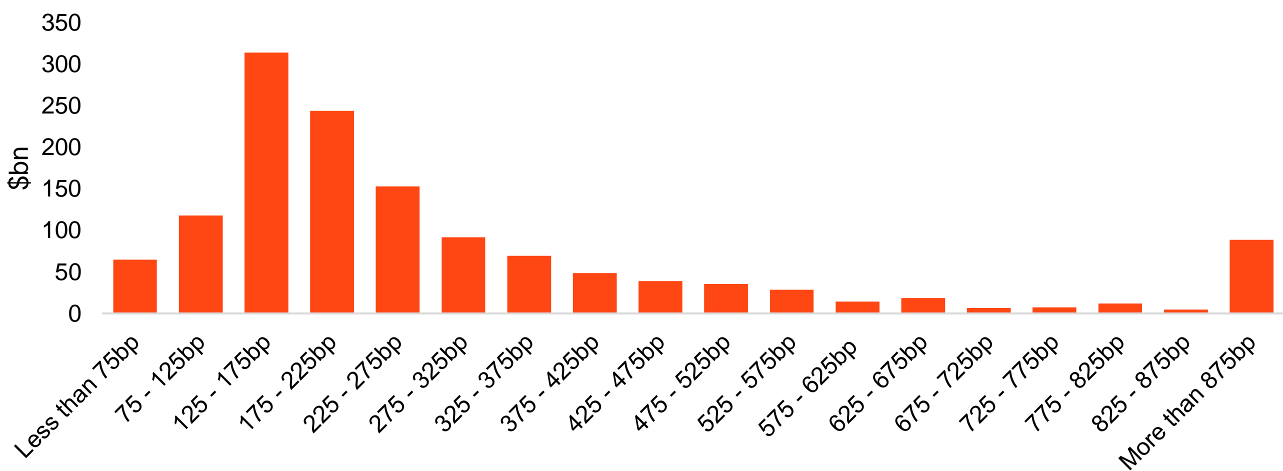
The case for a tactical allocation to floating rate assets

Beyond the technical tailwinds mentioned earlier, the following are the factors most critical for investor risk appetite to remain supportive, in our view: 1) a high likelihood that the current Fed Funds rate represents the peak for this cycle (i.e., no additional rate *hikes* are expected), 2) the expectation that rate *cuts will begin eventually* in 2024, and 3) the reason for the eventual rate cuts will be sustained improvement in inflation, as opposed to a sharp growth downturn.

With rate cuts "delayed", for asset allocators in corporate credit, a tactical increase in exposure to floating rate assets (for example, to leveraged loans vs. HY bonds) can be attractive in the near-term. Indeed, the carry differential between the two asset classes remains at the high end of the historical range (Exhibit 9). While a "high-for-longer" cost of capital environment poses fundamental pressure for some floating rate borrowers with limited financial flexibility (who may have been relying on prospects for near-term rate relief), this is somewhat mitigated, in our view, by the solid economic backdrop in the U.S. and receptive capital markets.

Exhibit 8: 55% of the USD HY Corporate Index has a spread tighter than 225bp

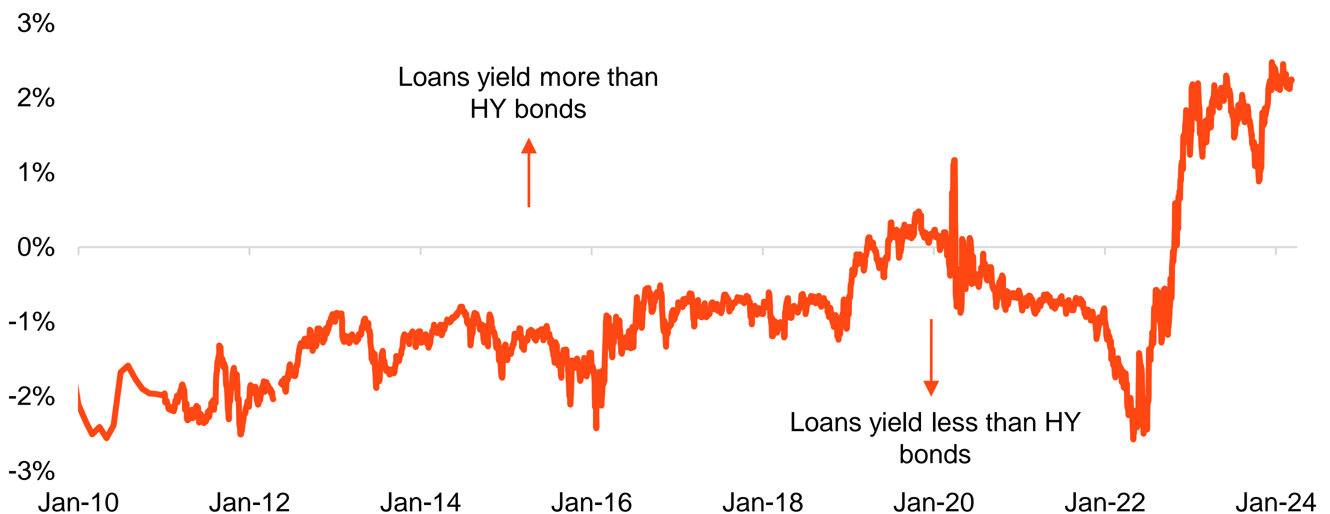
USD HY par value by spread bucket, using the Bloomberg USD HY Corporate Index



Source: BlackRock, Bloomberg. As of March 13, 2024. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Exhibit 9: The carry differential between USD leveraged loans and HY bonds remains at the high-end of the range

Carry differential: B-rated USD syndicated leveraged loans minus B-rated USD HY bonds



Source: BlackRock, ICE-BAML, Morningstar/LSTA, Pitchbook LCD. As of March 8, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

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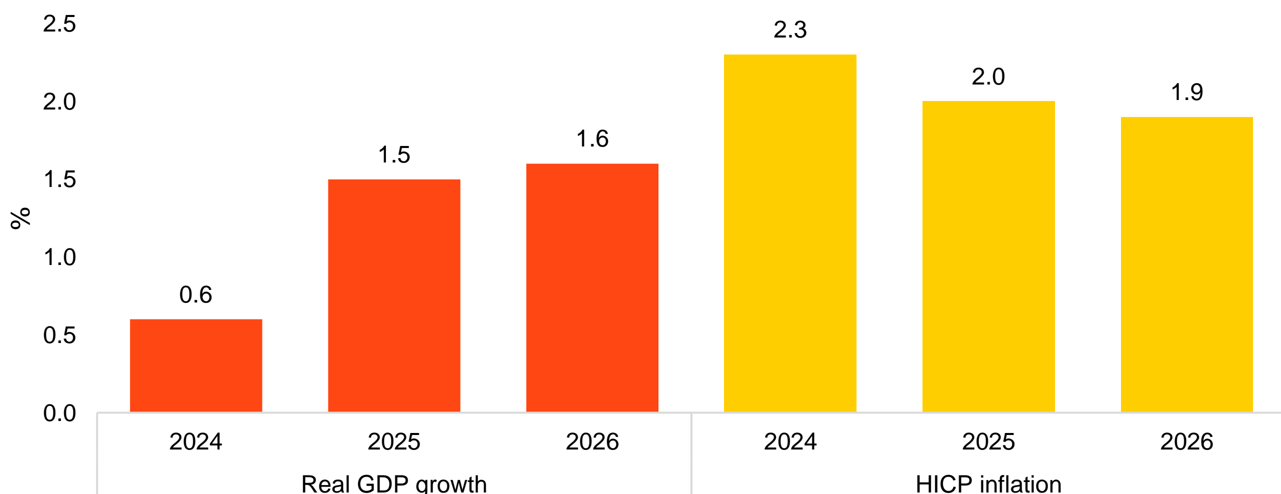
ECB: more inflation data is key, especially related to wages

The European Central Bank's (ECB) March 7th press conference underscored a patient approach, even as "the risks to economic growth remain tilted to the downside." ECB President Lagarde noted that most measures of underlying inflation (as well as energy prices) have continued to ease as the impact of past supply shocks fades and tight monetary policy weighed on demand. That said, she highlighted that services inflation remained sticky, noting "domestic price pressures remain high, in part owing to strong growth in wages." We drew the following key takeaways from the ECB's March press conference:

- **Near-term growth will be muted.** As illustrated in Exhibit 10, ECB staff decreased their 2024 growth projection to 0.6% (from 0.8%), as they expect near-term economic activity to remain subdued (but gradually recover over the course of 2024, and in 2025-2026). In her prepared remarks, President Lagarde noted that "consumers continued to hold back on their spending, investment moderated and companies exported less, reflecting a slowdown in external demand and some losses in competitiveness."
- **More "confidence" is required on inflation.** Similar to commentary from Fed officials, President Lagarde expressed a desire for more confidence that inflation is moving sustainably to the ECB's 2% target. She noted "there is a definite decline which is under way, and we are making good progress towards our inflation target. And we are more confident as a result. But we are not sufficiently confident, and we clearly need more evidence, more data. We know that this data will come in the next few months. We will know a little more in April, but we will know a lot more in June… And what we are seeing in the data at the moment is indicating certain movements that are directionally good, but it is not strong enough and durable enough, for the moment, to give us sufficient confidence."
- **Inflation does not need to reach 2% before cutting rates.** President Lagarde stated: "I am not saying here that we will wait until we are at 2% and that we see 2% to take a decision. This is not what I'm saying here…Once the data confirms that we are sufficiently confident to reach our 2% target in the medium term and make sure that it will be sustainable, we will act…we did not discuss cuts for this meeting, but we are just beginning to discuss the dialing back of our restrictive stance, provided that we have enough and certainly more information to be sufficiently confident."
- **Little guidance on the *pace* of any rate cuts.** President Lagarde said she "would not commit to any kind of pace, rhythm, magnitude, because we will continue to be data dependent. We will continue to observe how the economy evolves, how the labour market moves, how wages moderate, and the impact of tightening on the financing of the economy. All these factors will be taken into account to determine future moves."

Exhibit 10: ECB staff project muted near-term growth, with a recovery in 2025-2026
European Central Bank staff projections (released March 2024) for real GDP growth and Harmonized Index of Consumer Prices (HICP) inflation for the Euro Area



Source: BlackRock, European Central Bank. As of March 2024.

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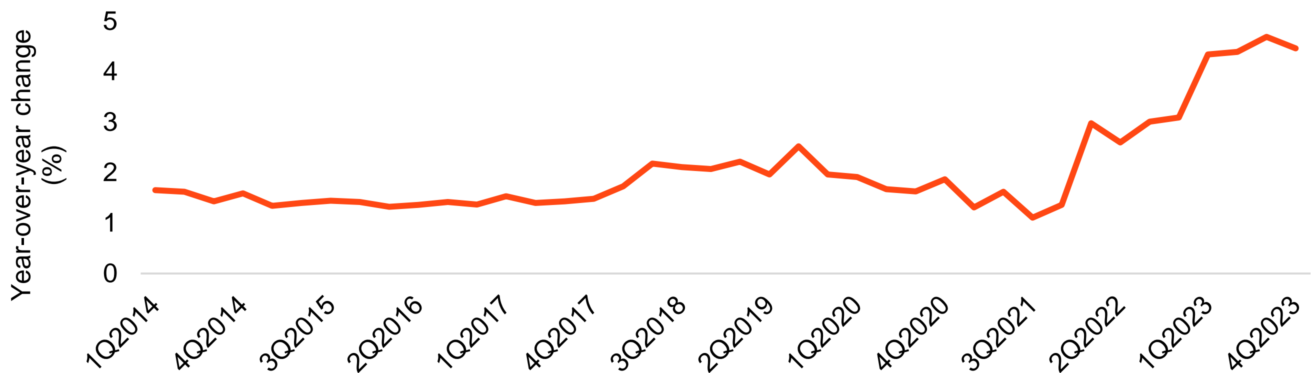
Euro Area wage costs are showing early signs of easing

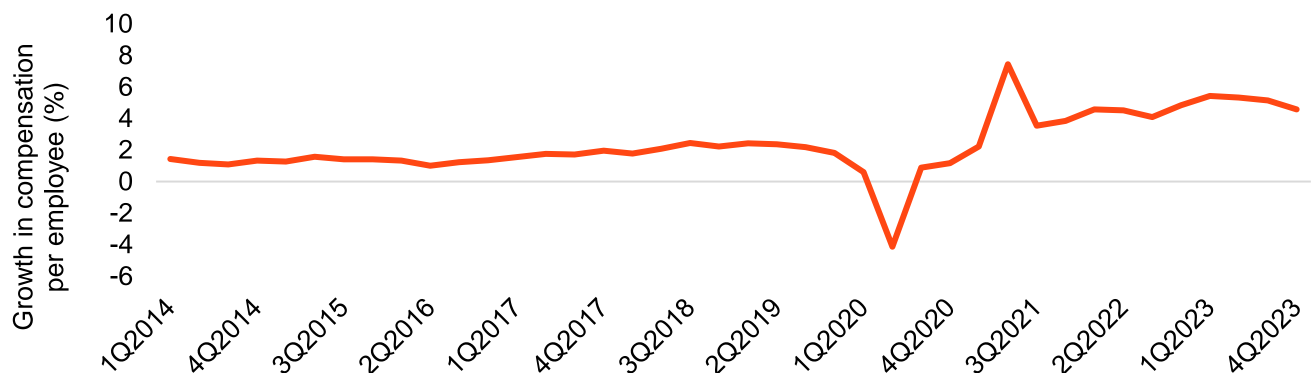
- **The ECB will act independently of the Fed.** President Lagarde emphasized: "the ECB is an independent central bank and will act independently. We will decide on the basis of the three criteria that I mentioned earlier. On the basis of the measurements that we have, the projections that we have, and the additional data that we need, we will determine what action we need to take, and that will be done independently from what my colleague at the Fed decides to do."
- **Wages are key to lowering inflation.** President Lagarde noted: "when we look at the underlying inflation and the measurement of underlying inflation, there is one obvious outlier in the measurements – and that is domestic inflation, and that is services. So you have to get under the skin of that and determine what it is behind it and what drives it up: clearly it is wages. But of course we need a lot more information coming in in the next few months to be sufficiently confident…when you look at what will be published and what data we will have, in terms of activity, wages and profits, we will have a little in April, and we will have a lot more of that for our June meeting. It matters, because we are data dependent."
- **The ECB is watching for the risk of a "wage-price spiral".** In highlighting the persistence of wage inflation (Exhibits 11 and 12), President Lagarde also stressed that it will be important to see profit margins *absorbing* those higher wages, to reduce the potential for so-called "second round effects" (i.e., a "wage-price spiral"). She said: "and because of this determination to avoid what I've called the tit-for-tat on previous occasions, we are also very attentive to profits…We want to see that movement confirmed by both moderation of wages, as we anticipate, but also by the squeezing of profit margins so that the unit profits absorb part of the unit labour costs."

Exhibit 11: Negotiated wages in 4Q2023 showed some tentative signs of cooling
ECB Indicator of Negotiated Wages for the Euro Area, non-seasonally adjusted year-over-year change (%)



Source: BlackRock, European Central Bank, Haver Analytics.

Exhibit 12: Compensation per employee in 4Q2023 slowed modestly vs. the 3Q2023 pace
Year-over-year growth (%) in compensation per employee, for the Euro Area, using seasonally and working day adjusted quarterly data



Source: BlackRock, European Central Bank, Haver Analytics. As of 4Q2023 (most recent).

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