November 14, 2024

Global Credit Weekly:

New cycle tights

BlackRock

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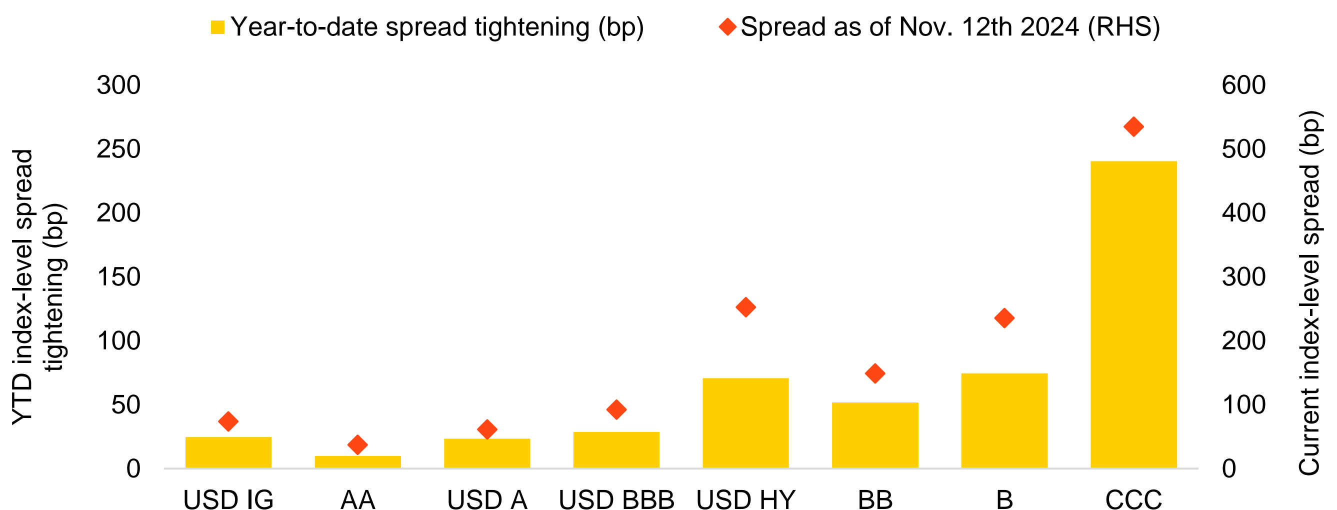
Key takeaways

- USD IG and HY corporate credit spreads have continued their march tighter, reaching new post-global financial crisis (GFC) era lows in recent days. In mid-October, we characterized the spread levels in the USD HY market as "warranted resilience", owing to a range of positive fundamental factors and technical tailwinds. As we discuss within, relative to its USD HY peer, the recent tightening in the USD IG market is perhaps even more notable.
- So long as the U.S. growth backdrop remains supportive, we expect USD IG and HY corporate credit spreads to remain resilient, at the tight end of the historical range. We see a particularly compelling opportunity in Financials. One key risk we are monitoring is the potential for a "disorderly" move higher in U.S. Treasury yields (i.e., not a gradual rise, driven by better growth), which may deter yield-based buyers from deploying capital in corporate credit. Granular credit and sector selection will also be key, in our view, given the potential for significant policy shifts.
- As for monetary policy following the November FOMC, we see scope for another 25bp Federal Reserve (Fed) rate cut in December – reflective of a continued normalization of monetary policy. That said, uncertainty around the longer-term path is elevated. In early 2025, additional clarity on the FOMC's view of the neutral rate will be increasingly important to differentiate between "normalizing" and "easing" monetary policy (we expect normalization).
- Because we are not expecting a significant rate cutting cycle, we place more emphasis on the income and carry (yield) components of USD corporate credit total returns, and less emphasis on the potential total return from duration exposure (which would benefit fixed rate bond total returns, mechanically, if/when rates decline). Floating rate exposures can offer an important element of portfolio diversification, in this regard.

Exhibit 1: Corporate credit spreads have tightened across the quality spectrum

Year-to-date spread tightening (in bp) and current index-level option-adjusted spread metrics (RHS) for the USD IG and HY Corporate indices, as well as their respective rating-specific subindices.



Source: Bloomberg, BlackRock, As of November 12, 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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November FOMC: Still moving toward neutral

The November 6th-7th Federal Open Market Committee (FOMC) meeting delivered a widely anticipated 25bp rate cut, bringing the Fed Funds rate to 4.5-4.75% (vs. 5.25-5.5%, just before the September FOMC).

During the Q&A, Chair Powell was asked "how proactive or reactive" the Fed would be to "changes in economic policies with the next administration." He noted that "in the near term, the election will have no effects on our policy decisions," owing to uncertainty related to the "timing and substance of any policy changes" and their effects on the economy. Chair Powell added: "We don't guess, we don't speculate, and we don't assume." That said, he did acknowledge that there could be "economic effects over time" that would matter for the Fed's dual mandate, which would be included in modeling of the economy and "taken into account through that channel."

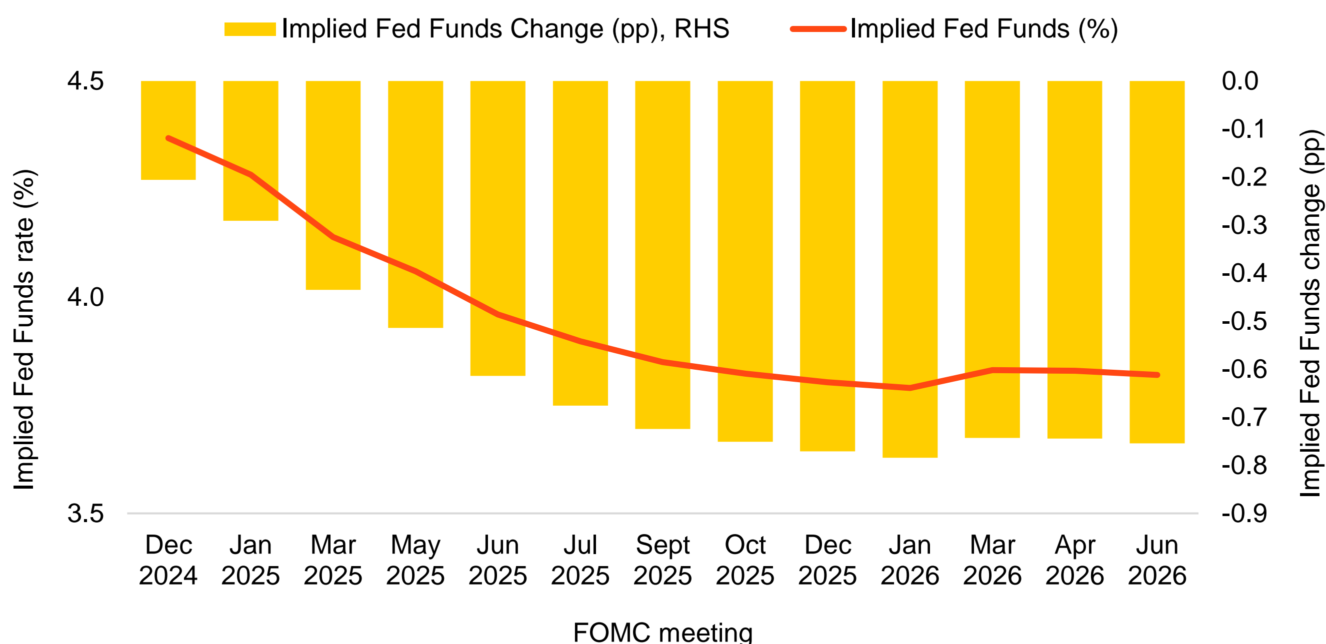
As we outlined last week, we see scope for another 25bp rate cut in December – reflective of a continued normalization of monetary policy. That said, once rates approach the 3.75%-4% level in early 2025, we believe additional clarity on the FOMC's view of the neutral rate will be increasingly important to differentiate between "normalizing" and "easing" monetary policy. Absent a sharp downturn in growth, we expect monetary policy normalization from the Fed – not monetary policy easing.

This is consistent with market pricing, as shown in Exhibit 2. Using Fed Funds Futures, market pricing implies roughly 75bp of additional cuts through mid-2026 (to the 3.8% area). And 5y5y Overnight Index Swaps (OIS, a proxy for market pricing of the neutral rate) paint a similar picture, trading at 3.9% as of November 13, 2024.

That said, uncertainty around the path for monetary policy in 2025 is elevated. While not our current base case, a reacceleration of inflationary pressures – materializing from potential fiscal and/or trade related policies, following the U.S. election – could cause the Fed's terminal rate to land towards the higher end of this range (implying fewer rate cuts).

Because we are not expecting a significant rate cutting cycle, we place more emphasis on the income and carry (yield) components of USD corporate credit total returns, and less emphasis on the potential total return from duration exposure (which would benefit fixed rate bond total returns, mechanically, if/when rates decline).

Exhibit 2: Market pricing reflects fewer rate cuts relative to earlier points this year
Implied Federal Funds rate (%) and implied change (in percentage points, RHS), based on Fed Funds Futures, through mid-2026



Source: Bloomberg, BlackRock. As of November 13, 2024. **There is no guarantee any forecasts may come to pass.**

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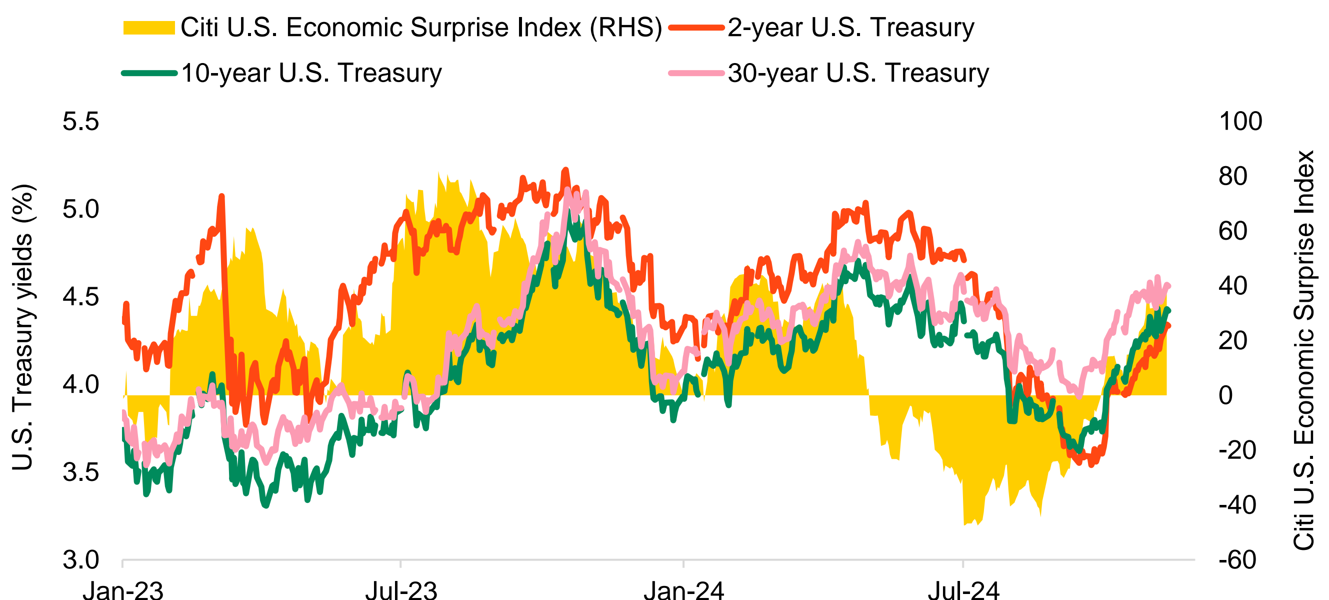
Key takeaways from the November FOMC press conference include:

- **Policy is viewed as restrictive.** The current policy level "is still restrictive," although it's "not possible to say precisely how restrictive." Chair Powell added that the 25bp cut in November represented a "further recalibration" of monetary policy to help maintain the strength of the economy and labor market while enabling further progress on inflation "as we move toward a more neutral stance over time."
- **Neutral is still unclear.** While Chair Powell noted the Committee was "on a path to a more neutral stance," it remains to be seen *exactly where* neutral is. He reiterated a statement he has made previously, regarding the neutral rate: "We don't know exactly where that is; we only know it by its works. We're pretty sure it's below where we are now."
- **The bias is still towards cutting.** Chair Powell noted, "if the economy remains strong and inflation is not sustainably moving toward 2%, we can dial back policy restraint more slowly." Meanwhile, if the "labor market were to weaken unexpectedly or inflation were to fall more quickly than anticipated, we can move more quickly." When asked if he could rule out an interest rate hike in 2025, Chair Powell replied: "I wouldn't rule anything out that far away. But that's certainly not our plan. I mean, our baseline expectation is that we'll continue to move gradually down towards neutral…"
- **The pace may slow.** As for the pace of cuts, Chair Powell said, "as we move ahead, we are prepared to adjust our assessments of the appropriate pace and destination as the outlook evolves." He added: "as we approach levels that are plausibly neutral or close to neutral, it may turn out to be appropriate to slow the place at which we're dialing back restriction."
- **Further cooling in the labor market is still unwelcome.** Chair Powell noted that the three-month average of payroll job gains slowed to a pace of +104k/month but also clarified that this figure would have been "somewhat higher," excluding the impact of a labor strike and hurricanes in October. The labor market is not a source of inflationary pressures, per Chair Powell: "We don't want the labor market to soften much from here. We don't think we need that to happen to get inflation back to 2%." He added that the labor market is "continuing to very gradually cool, but it seems to be in a good place."
- **Watch for the December projections.** Lastly, when asked if the September Summary of Economic Projections (SEP) was still relevant, Chair Powell said, "I wouldn't want to comment one way or the other." Updated projections are expected in conjunction with the Fed's December 17th-18th meeting.

Exhibit 3: U.S. Treasury yields have moved higher, in tandem with positive growth surprises

On-the-run 2-year, 10-year, and 30-year U.S. Treasury yields vs. the Citi U.S. Economic Surprise Index (CESI, RHS). A positive reading on the CESI means that data releases have been stronger than expected, and a negative reading means that data releases have been worse than expected.



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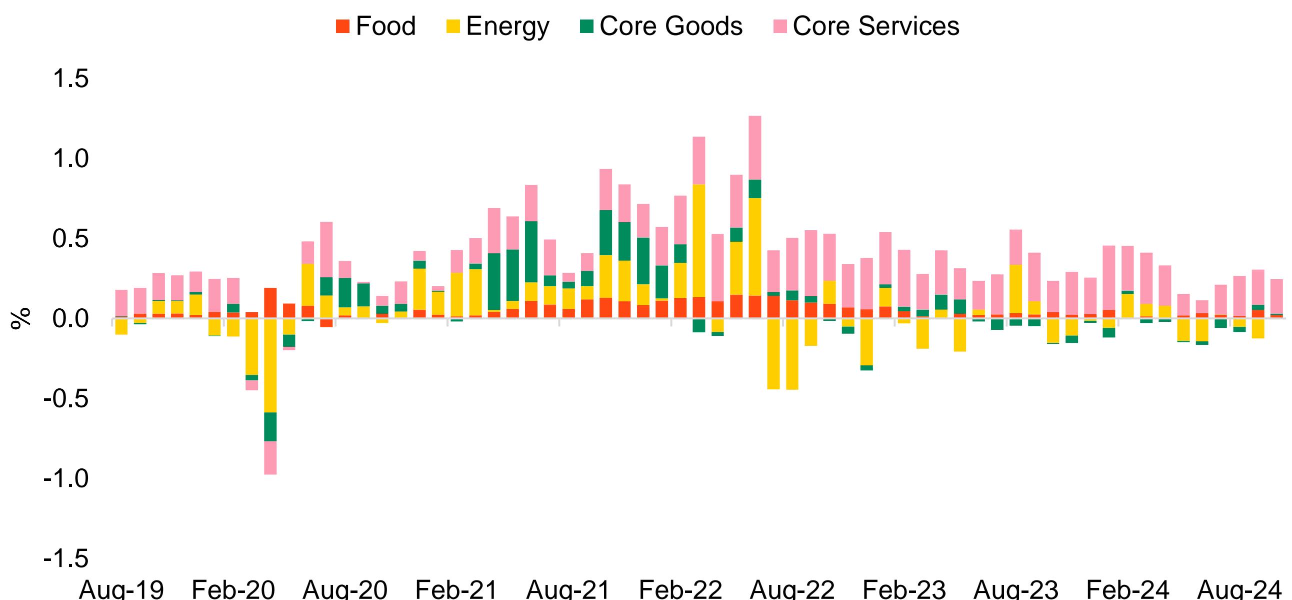
- **The focus is on *sustained* changes to financial conditions.** Chair Powell acknowledged the sharp increase in U.S. Treasury yields since the September FOMC (Exhibit 3) but offered that stronger growth has played a role in the moves. He said the FOMC takes changes in financial conditions (Exhibit 4) into account in its policy "if they're persistent and if they're material," adding, "we're not at that stage right now."
- **Shelter costs remain sticky.** Powell also acknowledged that the delayed "catch-up" in shelter costs is keeping housing services inflation elevated. October CPI inflation data echoed this, with shelter costs (a component of core services) accounting for more than half of the month-over-month inflation increase (Exhibit 5). Shelter inflation has been persistently elevated over the last year (due in part to lagged effects), increasing by 4.9% year-over-year. Other notable categories contributing to higher month-over-month inflation included used cars and trucks, airfares, medical care and recreation.

Exhibit 4: Financial conditions, in aggregate, have eased since late 2023
Goldman Sachs U.S. Financial Conditions Index

Source: Bloomberg, Goldman Sachs Global Investment Research, BlackRock. As of November 11, 2024.

Exhibit 5: 'Core Services' has been the largest driver of month-over-month price inflation
Contributions to month-over-month headline U.S. CPI (seasonally adjusted)



Source: Bloomberg, Bureau of Labor Statistics, BlackRock. Captures data through October 31, 2024 (most recent).

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The case for floating rate exposures

As mentioned earlier, we are not expecting a significant rate cutting cycle from the Federal Reserve (beyond what has already been delivered), nor are we expecting to revisit the ultra-low interest rates that defined much of the post-financial crisis period. As a result, we place more emphasis on the income and carry (yield) components of USD corporate credit total returns and less on the potential total return from duration exposure (which would benefit fixed rate bond total returns, mechanically, if/when rates decline).

This has a few important implications for asset allocation and credit selection, in our view.

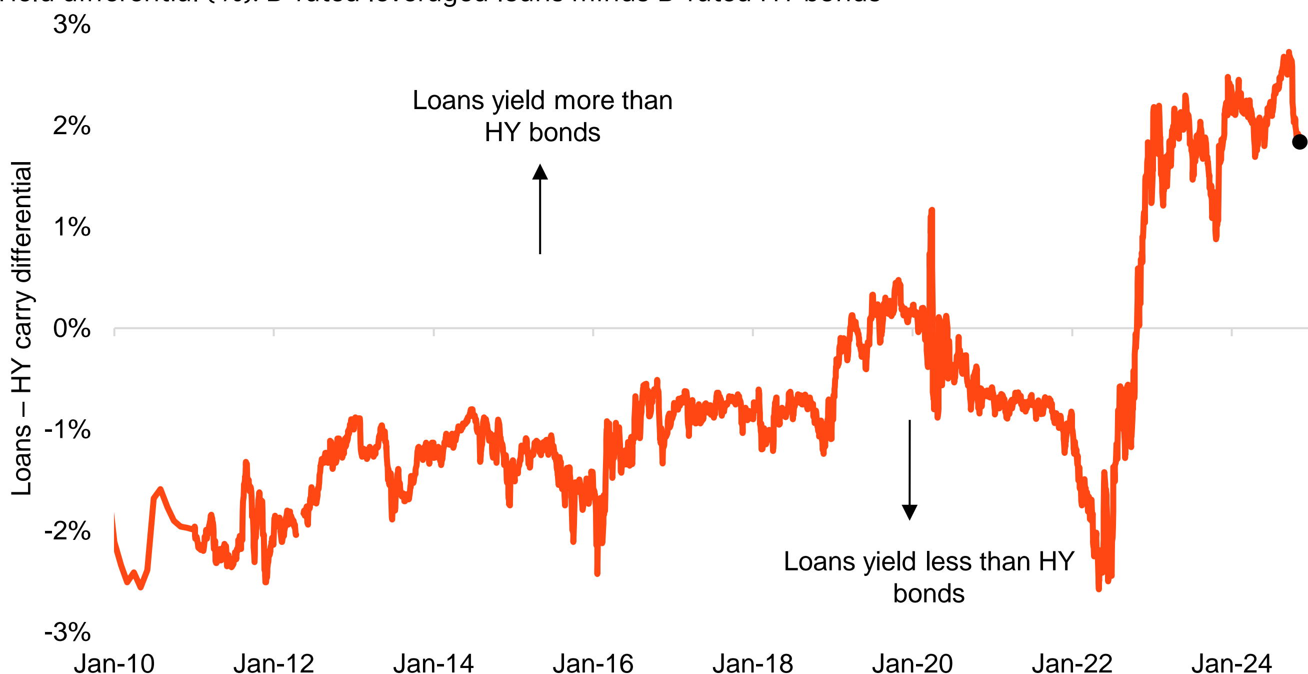
First, within the fixed rate universe, investors may gravitate towards shorter-duration credit over longer-duration credit. At the index level, the USD IG universe has more duration exposure vs. its HY peer (Exhibit 16). But there is a significant degree of variation *within* the IG and HY markets (across maturities, rating cohorts, etc.). This makes active credit selection important. More broadly, we still see a strong case for IG and HY spreads to continue to trade in their recent tight ranges, due to the fundamental and technical tailwinds we have discussed previously, as well as the supportive U.S. growth backdrop.

Second, this rate backdrop supports the case for allocating to leveraged loans, in our view. There are some important fundamental differences between the HY bond and leveraged loan markets (for example, sector exposures). That said, at the index level and when isolating for ratings, leveraged loans offer a meaningful yield "pick-up" vs. HY bonds which is attractive from a historical perspective (Exhibit 6). Furthermore, floating rate exposure also provides an important element of portfolio diversification, in our view.

The forward path of interest rates is also relevant for *borrowers* in the corporate credit market, as it directly impacts their debt service costs – especially for floating rate borrowers, who have been navigating the higher cost of capital since the Fed began its rate hiking cycle in March 2022. (Floating rate debt service costs have moved higher in tandem with the Fed Funds rate, while the transmission of monetary policy is more delayed for fixed rate debt borrowers).

In our view, slower – or fewer – Fed rate cuts (relative to market pricing) because of strong economic activity can likely be easily digested by corporate credit borrowers, without significant damage to credit fundamentals. By contrast, slower – or fewer – Fed rate cuts because of reaccelerating inflation would be a much less favorable backdrop for credit, in our view, especially if coupled with weaker economic activity.

Exhibit 6: Loans offer a historically attractive yield "pick-up" relative to HY bonds
Yield differential (%): B-rated leveraged loans minus B-rated HY bonds



Source: Pitchbook LCD, BlackRock, Morningstar/LSTA, ICE-BAML. As of November 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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Spreads take another leg tighter, but yields are still supportive

USD IG and HY corporate credit spreads have continued their march tighter, reaching new post-financial crisis era tights in recent days (Exhibit 7). In mid-October, we characterized these tight spread levels in the USD HY market as "warranted resilience" owing to a range of fundamental and technical factors. These included an "up-in-quality" tilt visible in the rating distribution, credit metrics that were converging with the low-end of the USD IG universe (i.e., BBBs), and limited amounts of "new money" entering the index, owing to the strong skew towards refinancing activity.

The elevated risk-free rate has also contributed to the resilience of spreads, as historically attractive all-in yields (Exhibit 8) have encouraged yield-based investors to deploy capital into corporate credit. Indeed, this spread vs. yield "tug-of-war" has been a tailwind for corporate credit for the last few quarters. That said, a key risk to corporate credit, in our view, is a "disorderly" sell-off in U.S. Treasury yields. A sharp, outsized move higher in U.S. Treasury yields (i.e., one that is not gradually driven by better growth data) may discourage such yield-based investors from deploying capital into corporate credit (in anticipation of further volatility). For this reason, developments related to U.S. Treasury auctions and deficit funding will be important to monitor in 2025, in our view.

Exhibit 7: Index-level spreads for USD IG and USD HY are tight...

Index-level option-adjusted spreads (OAS) for the Bloomberg USD IG and HY Corporate indices

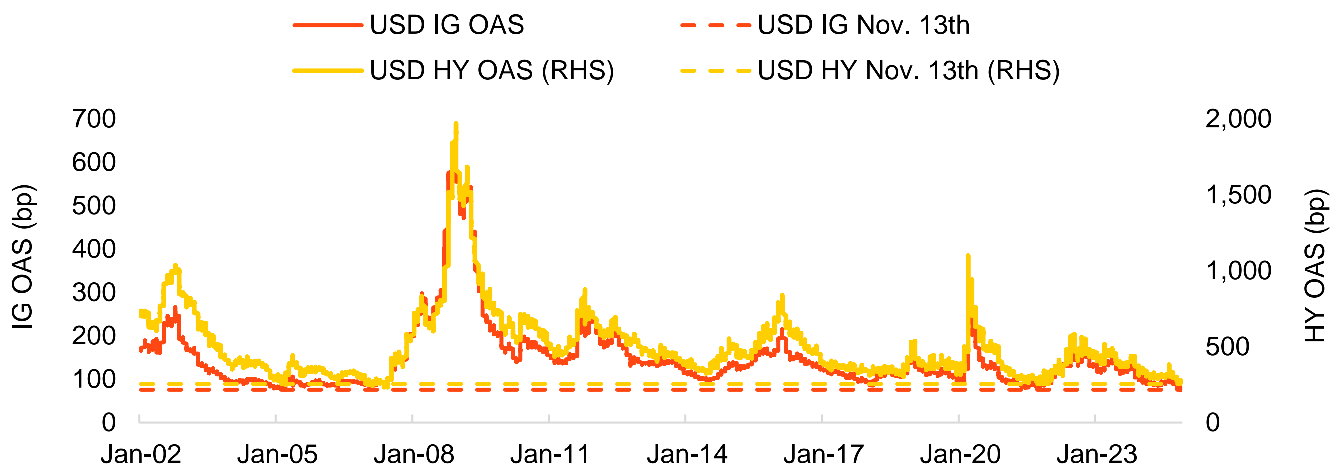

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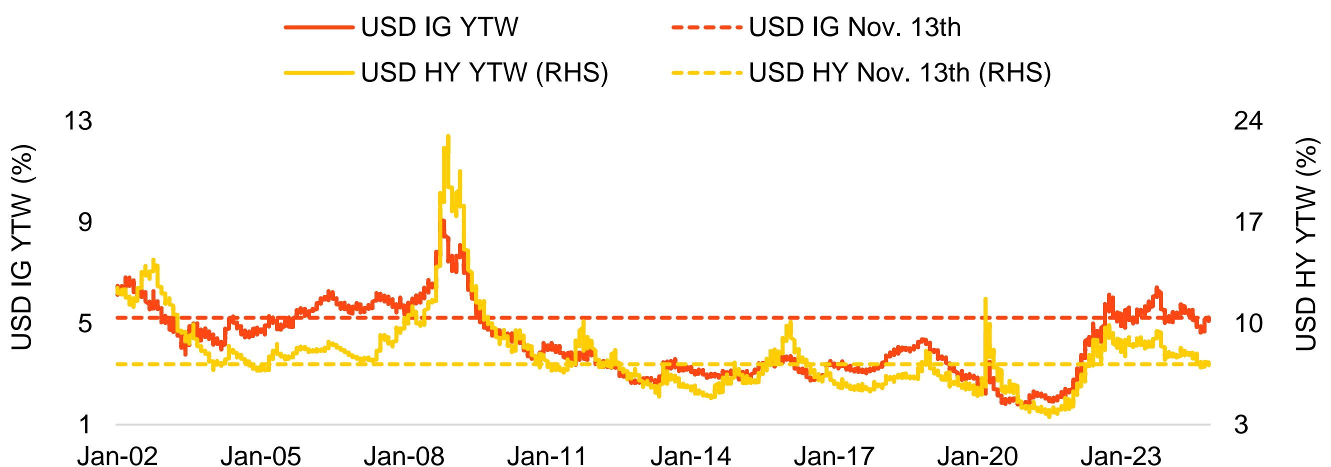
Exhibit 8: ...but all-in yields are still attractive on a historical basis

Index-level yield-to-worst (YTW) for the Bloomberg USD IG and HY Corporate indices



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Unpacking structural shifts in the USD IG market

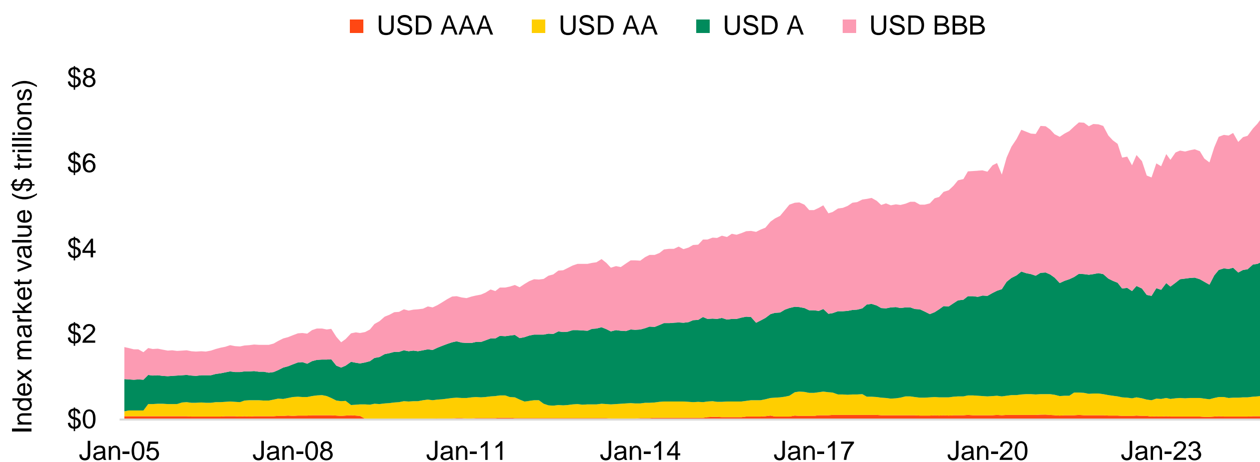
A few weeks ago, we outlined the positive fundamental drivers and technical tailwinds behind the resilience of USD HY spreads. But relative to its USD HY peer, the recent tightening in the USD IG Index is perhaps even more notable. This is because, for example, the rating distribution of the Bloomberg USD IG Corporate Index has moved *lower* as it has grown over the past several years (Exhibits 9 and 10).

For example, at the start of the post-financial crisis era in January 2010, the Bloomberg USD IG Corporate Index was $2.6 trillion in market value. At that time, the rating distribution was: 1% AAA, 16% AA, 46% A, and 37% BBB. As of November 2024, the USD IG index market value totaled $6.9 trillion, with a rating distribution of: 1% AAA, 7% AA, 44% A, and 48% BBB.

We believe the downward migration in index-level ratings reflects corporate CFOs and Treasurers' views on where the cost of debt capital may be best optimized. As such, we believe many corporate decision-makers came to realize that their cost of debt capital was not materially lower (or, alternatively, optimal for their capital structure) as a *very highly rated* IG debt issuer. Rather, some may have concluded that if the firm could stay comfortably *within IG ratings territory* – as a BBB+ or BBB issuer, for example – that was sufficient from an overall cost of debt capital perspective and may allow for a prudent reallocation of resources (i.e., share buybacks, M&A, capital investment, etc.).

Exhibit 9: The USD IG Index has grown from $2.6 trillion in January 2010 to $6.9 trillion as of November 2024

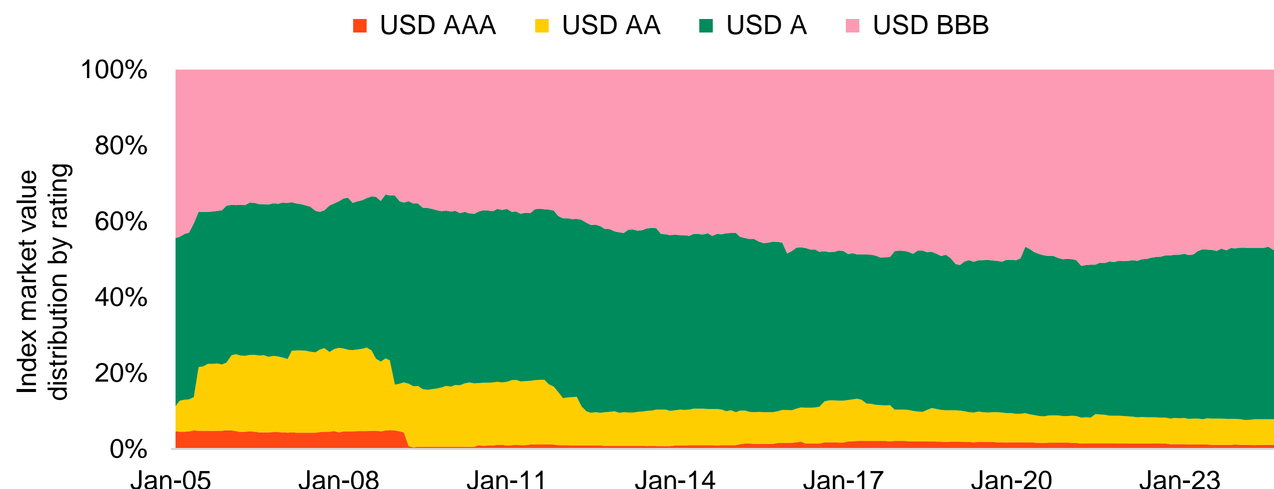
Index market value ($ in trillions) for rating-specific indices within the Bloomberg USD IG Corporate Index



Source: BlackRock, Bloomberg. As of November 8, 2024. Excludes debt that is not index eligible.

Exhibit 10: The USD IG Index is 48% BBB, as of November 2024, vs. 37% as of January 2010

Index market value distribution for rating-specific indices within the Bloomberg USD IG Corporate Index



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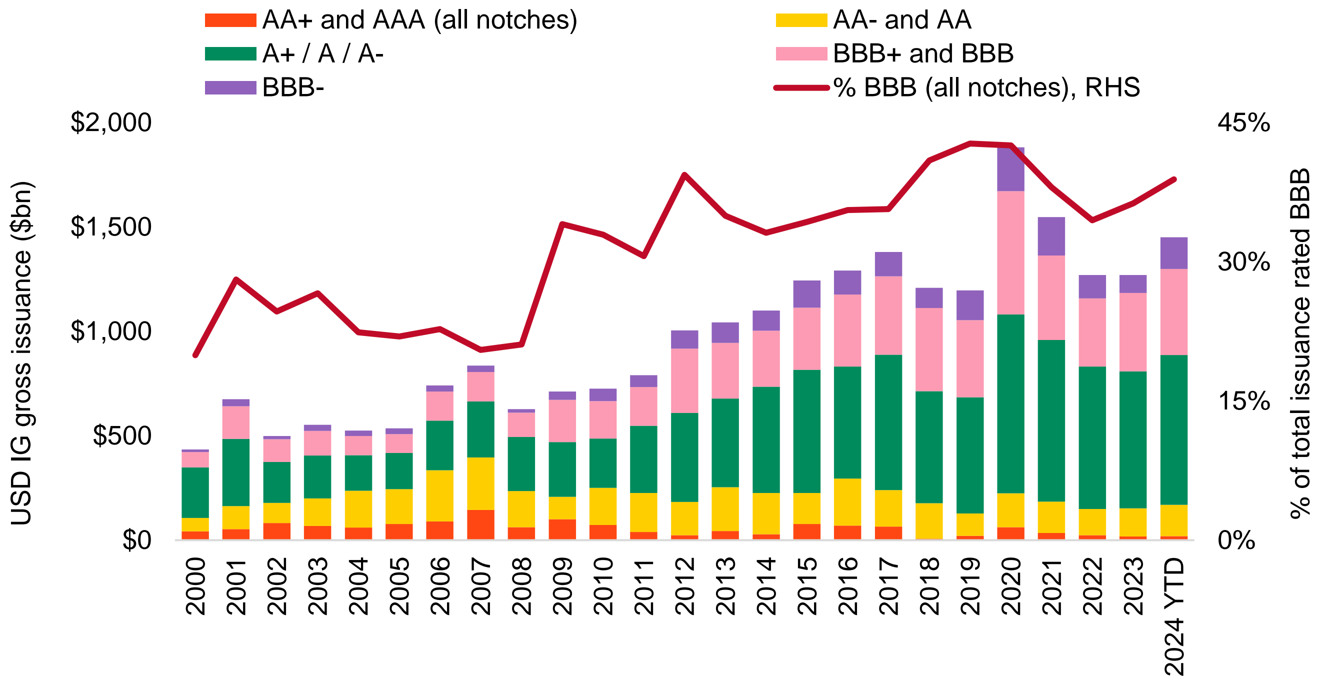
The downward shift in the USD IG ratings distribution is also evident in issuance trends

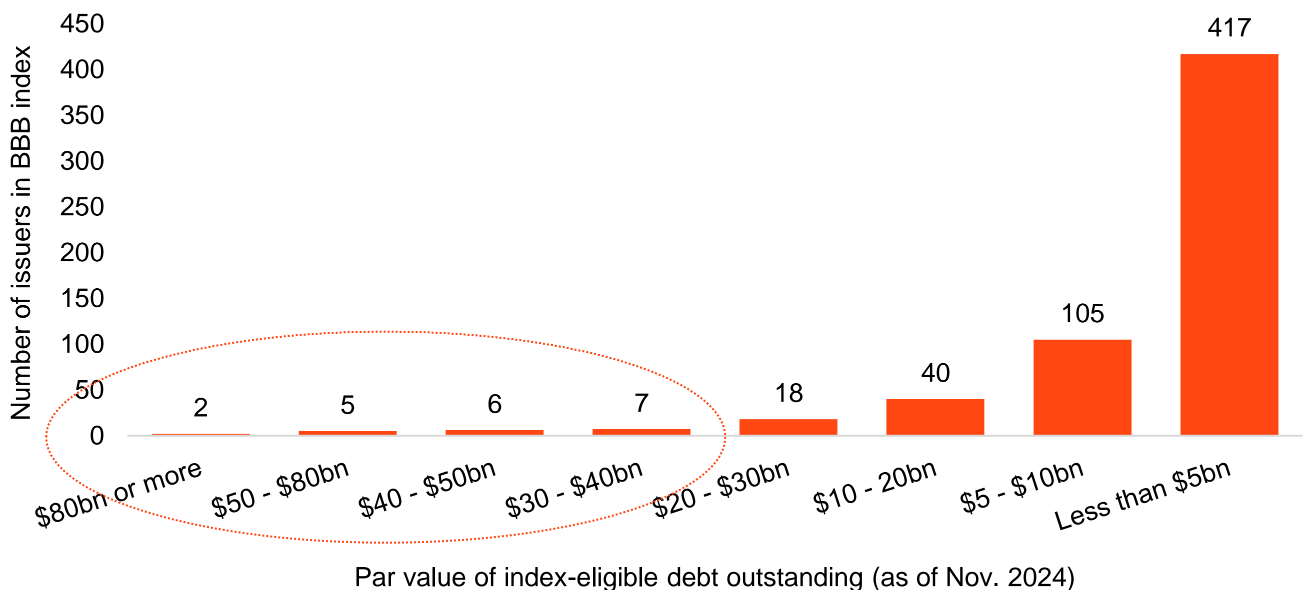
Unsurprisingly, this same "down in ratings" trend is visible in the pattern of new issue activity, which feeds directly into the index-eligible market value we referenced earlier. Exhibit 11 illustrates this using gross USD IG corporate new issue activity, per Dealogic. As shown below, 39% of the year-to-date USD IG gross new issue activity has been rated BBB+, BBB, or BBB-. This compares to 33% for the full-year 2010. And as Exhibit 11 also illustrates, it is structurally higher than the 2000-2008 period. Further, some of the BBB capital structures outstanding in the USD IG market are quite large, as shown in Exhibit 12.

Exhibit 11: 39% of USD IG gross issuance so far this year has been rated BBB+, BBB, or BBB-
USD IG gross issuance by Dealogic "Effective Rating at Launch," and the share of total USD IG gross issuance rated BBB (across all three notches), RHS



Source: Dealogic (ION Analytics), BlackRock. As of November 11, 2024.

Exhibit 12: Some of the BBB capital structures in the USD IG market are quite large
Number of issuers in the Bloomberg USD BBB Corporate Index by index-eligible debt outstanding



Source: Bloomberg, BlackRock. Excludes debt and issuers that are not index-eligible. As of November 6, 2024.

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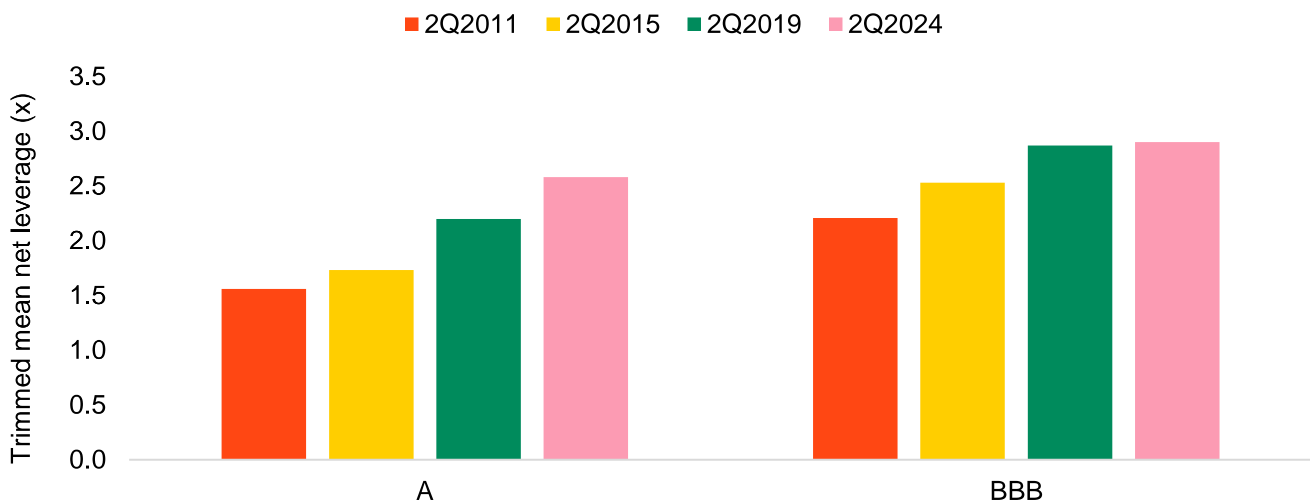
Leverage *within* rating categories is also moving higher

Beyond moving "down in rating" over the past several years, the leverage *within* a given rating category has also increased. Exhibit 13 illustrates this using trimmed mean net leverage for the issuers in the two largest rating-specific subindices of the Bloomberg USD IG Corporate Index. This, in our view, is likely a function of corporates' capital management approach to optimizing their balance sheets (as discussed earlier). And when taken at face value, it also suggests, in our view, that rating agencies may now be permitting somewhat higher leverage within each rating-specific band (if a company's cash flow generation, profitability, and overall business model can support it).

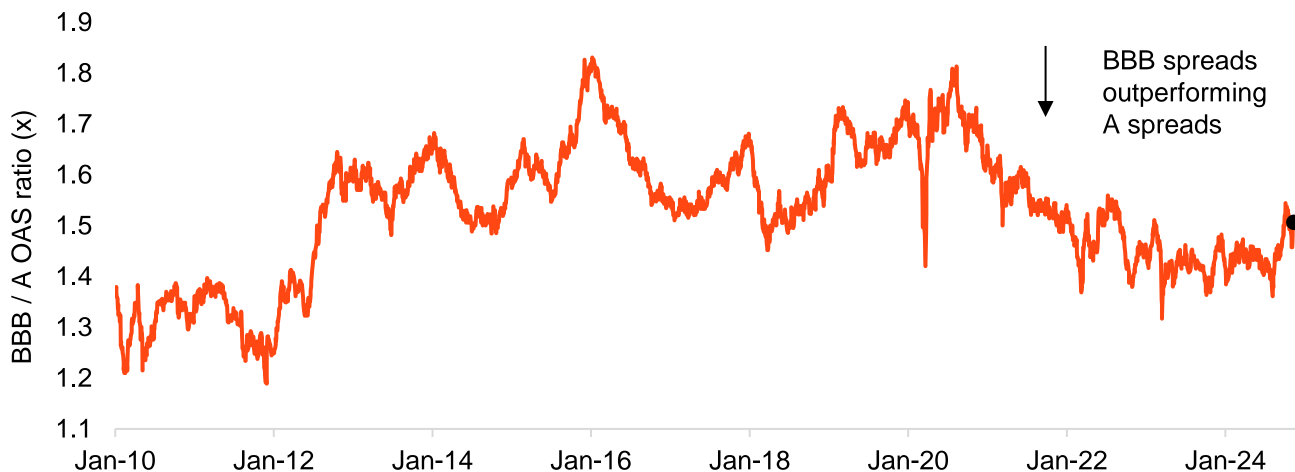
As of 2Q2024, the trimmed mean net leverage for the A-rated Index is 2.6x, compared to 2.9x for the BBB-rated Index (again, Exhibit 13). We view this as a modest increase in leverage for the additional index-level spread pick-up offered by BBBs, relative to their higher rated peers (i.e., 92bp for BBBs vs. 61bp for As). We are comfortable moving "down in quality" within the USD IG universe. We see scope for the BBB/A OAS ratio (shown in Exhibit 14) to compress, under a base case of above-trend growth in the U.S., which should allow corporate fundamentals to remain solid, in aggregate.

Exhibit 13: IG borrowers' net leverage, on average, has been increasing over the past decade
Trimmed mean (excludes the top 10% and bottom 10%) net debt to EBITDA for the universe of borrowers captured in the Bloomberg USD A and USD BBB Corporate indices



Source: Bloomberg, BlackRock. Captures trailing 12-month leverage through 2Q2024 (most recent available as of November 11, 2024). We exclude the AA cohort due to its much smaller size, relative to the A and BBB cohorts.

Exhibit 14: We see some room for BBB spreads to compress vs. their higher rated peers
Option adjusted spread (OAS) ratio (x): USD BBB Corporate Index / USD A Corporate Index



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Active credit selection is important

That said, this index-level observation is a highly simplistic approach. In practice, asset allocation decisions need to incorporate a significant level of granular credit *and* sector (Exhibit 19) selection – especially in the current environment where meaningful policy shifts are likely on the horizon (as our colleagues in the *BlackRock Investment Institute* recently highlighted).

There are some additional nuances which may make historical comparisons somewhat challenging. For example, the average dollar prices of the Bloomberg USD IG ($93.7) and USD HY ($96.3) Corporate indices are currently *below par* (Exhibit 15). These index-level prices were *above par* in mid-2021, for example, when credit spreads were last trading in such a tight range (the higher dollar price was a function of the much lower risk-free rate, at that time; again, Exhibit 8).

Generally, investors will demand at least *some* additional spread compensation for holding a bond that is trading well above par to compensate for the additional notional (i.e., principal) risk. This is because when a bond is held to maturity, an investor is simply repaid the par amount. And while defaults of IG-rated firms are historically very unusual, a bond trading above par nonetheless exposes an investor to increased notional at risk, in the event of one. This is another reason why bonds that trade well above par may often trade at a wider spread, all else equal. The duration (or price sensitivity to a change in yields) has also been declining for the USD IG and USD HY indices over the past several quarters (Exhibit 16).

Exhibit 15: The USD IG and HY indices have an average dollar price that is *below* par

Par weighted average index price for the Bloomberg USD IG and HY Corporate indices

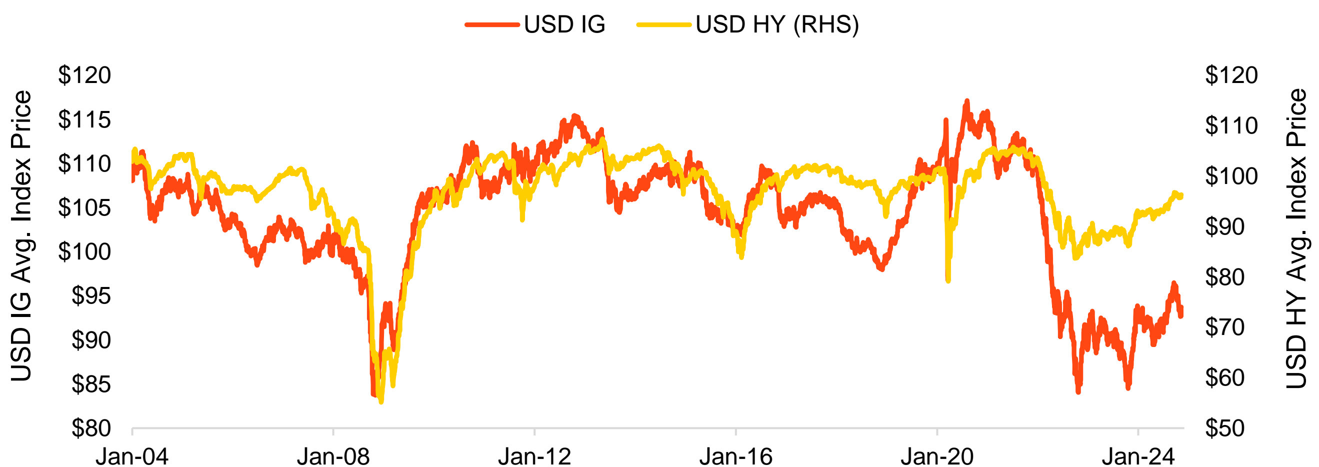

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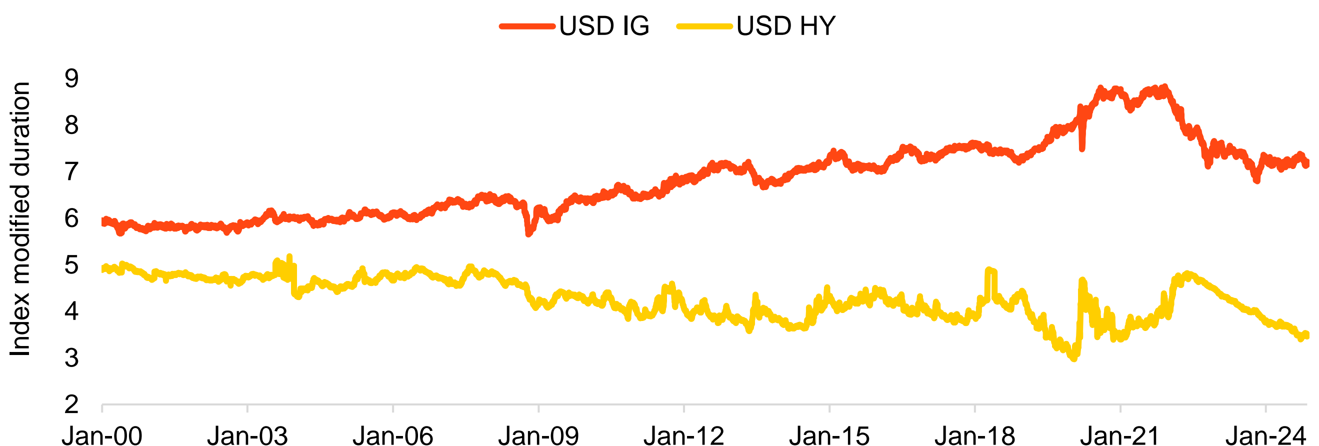
Exhibit 16: The duration of both indices has also declined over the past several quarters

Index modified duration for the Bloomberg USD IG and HY Corporate indices



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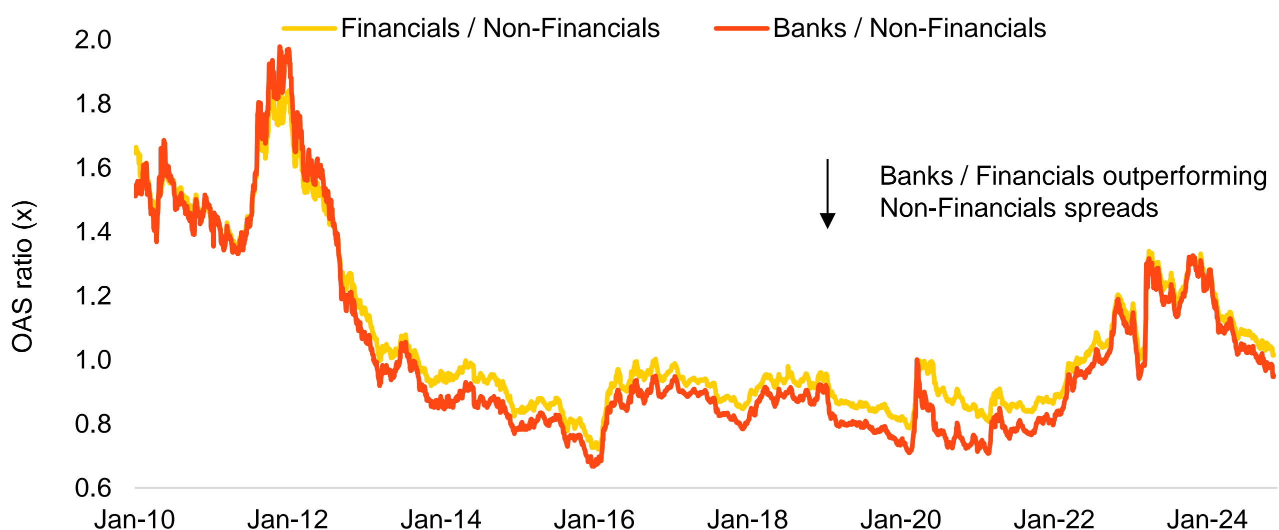
The case for continued outperformance in the Financials sector

Financials have been a strong performer in the USD IG market so far this year. For example, the Banks sector has contributed 105bp of the 272bp year-to-date total return generated by the Bloomberg USD IG Corporate Index, and the broader Financials sector (which also includes Insurance, REITs, Brokerage, Asset Managers, Exchanges and Finance Companies) contributed 137bp of the overall 272bp index total return. The pattern of outperformance is also illustrated in Exhibit 17, which shows the ratio of Banks and Financials index-level spreads relative to their Non-Financials peer set. And finally, on an excess return basis (which excludes the return impact from fluctuations in U.S. rates), Financials have generated a year-to-date excess return of 3.2%, compared to 2.3% for Non-Financials.

We see scope for additional outperformance. Indeed, for a large part of the post-financial crisis era, Banks and Financials spreads traded *inside* of Non-Financials – as highlighted by an OAS ratio of less than 1.0x (again, Exhibit 17). Continued outperformance in the Banks and broader Financials sectors would be an important tailwind for overall USD IG Corporate Index spread performance, in our view. As shown in Exhibit 19, the Banks sector represents 22.5% of the Bloomberg USD IG Index market value as of November 2024 – by far, the largest sector weight. And the broader Financials category represents 33% of the USD IG Index. Our expectation for additional outperformance is underpinned by a few factors:

- **A potential rebound in capital markets activity.** Clarity on the outcome of the U.S. election – coupled with some additional easing in monetary policy (discussed earlier) and our base case of supportive growth should support a rebound in M&A. Using data from Dealogic for deals valued at $100 million or more by North American and European acquirers, year-to-date announced strategic M&A of $1.34 trillion is tracking 6% below the run-rate of the past 10-years, while sponsor-related M&A of $717 billion is tracking 9% below (Exhibit 18).
- **Relative resilience vis-à-vis potential tariffs.** As a service-based industry (vs. goods-based), we view Financials as less exposed to potential disruptions in trade and/or higher input costs related to the implementation of possible tariffs. As we outlined previously, the degree of any impact will depend on the extent of any new tariffs (i.e., broad-based or country specific) and any product/country exclusions. This makes granular credit and sector selection increasingly important for 2025, in our view.
- **Potential for deregulation.** As our colleagues in the *BlackRock Investment Institute* recently highlighted, there is an expectation for some deregulation under the new Trump administration, including possibly rolling back some banking regulations.

Exhibit 17: We see scope for additional outperformance in Financials in USD IG
Sector-specific option adjusted spread (OAS) ratios for the Bloomberg USD IG Corporate Index



Source: Bloomberg, BlackRock. As of November 12, 2024. Non-Financials includes Consumer (Cyclical and Non-Cyclical), Technology, Communications, Energy, Capital Goods, Basic Industry, Transportation and Other Industrial. Financials includes Banking, Insurance, REITs, Brokerage, Asset Managers, Exchanges, Finance Companies, and Other Financial. **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.

Exhibit 18: We see some scope for a rebound in M&A activity in 2025

Year-to-date announced M&A volumes (strategic and sponsor-related, $ in trillions) by acquirers based in North America and Europe. Captures deals valued at $100 million or more, at announcement. Excludes cancelled or withdrawn deals.

Source: BlackRock, Dealogic (ION Analytics). As of November 13, 2024.

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Exhibit 19: There is a wide degree of variation in sector exposures across USD IG and USD HY
Index sector weights (based on market value) for the Bloomberg USD IG and HY Corporate indices

	USD IG	USD HY
Banking	22.5	0.9
Technology	9.3	7.3
Electric	8.3	2.8
Pharmaceuticals	5.3	1.6
Healthcare	4.2	5.5
Midstream	3.7	5.6
Food and Beverage	3.5	2.1
Retailers	3.2	4.9
Wirelines	2.6	3.2
Automotive	2.4	2.1
Aerospace/Defense	2.1	2.1
P&C	2.0	2.4
Wireless	2.0	1.5
Media Entertainment	1.9	3.6
Health Insurance	1.8	0.2
Cable Satellite	1.7	6.4
Diversified Manufacturing	1.6	1.9
Brokerage Asset managers Exchanges	1.6	1.0
Integrated	1.5	0.0
Independent	1.3	3.6
Finance Companies	1.3	3.7
Chemicals	1.3	2.5
Railroads	1.3	0.2
Tobacco	1.2	0.1
Life	1.1	0.3
Consumer Products	1.0	1.5
Metals and Mining	0.9	2.6
Construction Machinery	0.8	1.4
Retail REITs	0.8	0.1
Natural Gas	0.7	0.0
Other REITs	0.7	1.3
Transportation Services	0.6	1.0
Restaurants	0.5	1.3
Healthcare REITs	0.5	0.4
Apartment REITs	0.5	0.0
Other Industrial	0.5	1.2
Environmental	0.4	0.6
Refining	0.4	0.3
Paper	0.4	0.6
Building Materials	0.4	2.3
Consumer Cyc Services	0.3	3.4
Gaming	0.3	3.4
Supermarkets	0.3	0.6
Oil Field Services	0.3	1.8
Airlines	0.2	1.4
Office REITs	0.2	0.3
Lodging	0.2	0.9
Other Utility	0.2	0.0
Packaging	0.2	2.4
Home Construction	0.1	1.1
Other Financial	0.0	1.2
Leisure	0.0	3.3

Source: Bloomberg, BlackRock. As of November 8, 2024. Excludes debt that is not index eligible.

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