Investment-Grade Corporate Bonds

Spreads Are Likely to Tighten Further

Justin Takata
Managing Director

Technical indicators suggest that the rally we experienced in the fourth quarter has more room to run.

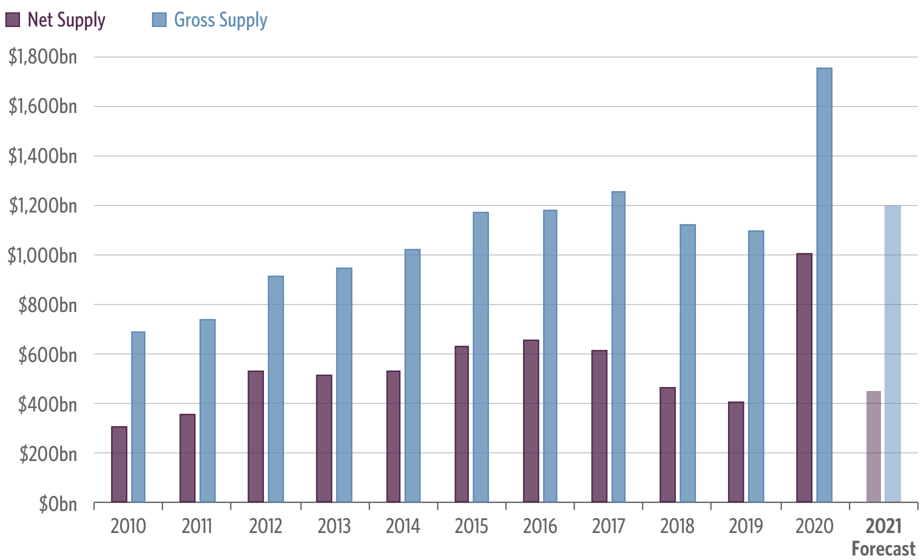
Investment-grade spreads have tightened to pre-COVID levels, driven largely by progress on the development of COVID vaccines, support from ongoing fiscal and monetary stimulus, and resolution of the political drama of the contentious presidential election. We witnessed an impressive rally in the fourth quarter as the Bloomberg Barclays U.S. Corporate Bond Index tightened to 96 basis points from 135 basis points on an option-adjusted spread (OAS) basis. Furthermore, technicals continue to lead the narrative for what we believe will result in further spread tightening in the first quarter of 2021.

Gross investment-grade primary issuance reached almost $1.8 trillion, and net issuance neared $1.0 trillion through the first three quarters of 2020 (see chart, top right). However, the fourth quarter saw virtually flat net issuance. We believe 2021 primary issuance will see a reversion to the mean closer to $1.2 trillion on a gross basis, providing further technical support to credit spreads. Foreign demand has continued to pick up at the margin as well, which contributed to nearly $55 billion of inflows to investment-grade corporate bond mutual funds in the fourth quarter.

As investment-grade corporate spreads currently sit near decade tights (see chart, bottom right), and with much good news priced in, we expect credit spreads to trade in a narrow range. Barring a monetary policy misstep or a dramatic increase in interest rate volatility, the near-term path for spreads appears tighter. We believe the negative headwinds for both equities and credit, in the form of election unrest and aggressive COVID-19 lockdown policies, have subsided. That said, we expect to see bouts of volatility around COVID-19 mutation fears and vaccine efficacy and distribution. We anticipate risk selloffs to be shallow and present buying opportunities, with compression among the lower-rated cyclical credits relative to higher-rated, larger capital structure credits.

Looking past the first quarter, the market will need confirmation the economic recovery is taking shape in order to support performance. Orderly rate back-ups due to additional stimulus will be welcomed by the market but a prolonged or aggressive jump in yields could cause some rotation out of corporate bonds.

Investment-Grade Supply Is Expected to Decrease in 2021



Source: Guggenheim Investments, J.P. Morgan. Data as of 1.31.2021.

Gross investment-grade primary issuance reached almost $1.8 trillion, and net issuance neared $1.0 trillion through the first three quarters of 2020. However, the fourth quarter saw virtually flat net issuance. We believe 2021 primary issuance will see a reversion to the mean closer to $1.2 trillion on a gross basis, providing further technical support to credit spreads.

Investment-Grade Corporate Bond Spreads Are Likely to Tighten Further

Source: Guggenheim Investments, Bloomberg. Data as of 1.26.2020. Shaded areas represent recession.

As investment-grade corporate spreads currently sit at near decade tights, and with much good news priced in, we expect credit spreads to trade in a narrow range. Barring a monetary policy misstep or a dramatic increase in interest rate volatility, the near-term path for spreads appears tighter.