Investment-Grade Corporate Bonds

Reversal of Fortune

Jeffrey Carefoot, CFA
Senior Managing Director

Justin Takata
Managing Director

A dovish Fed, strong fundamentals, and growing demand support investment-grade corporate bond sector performance.

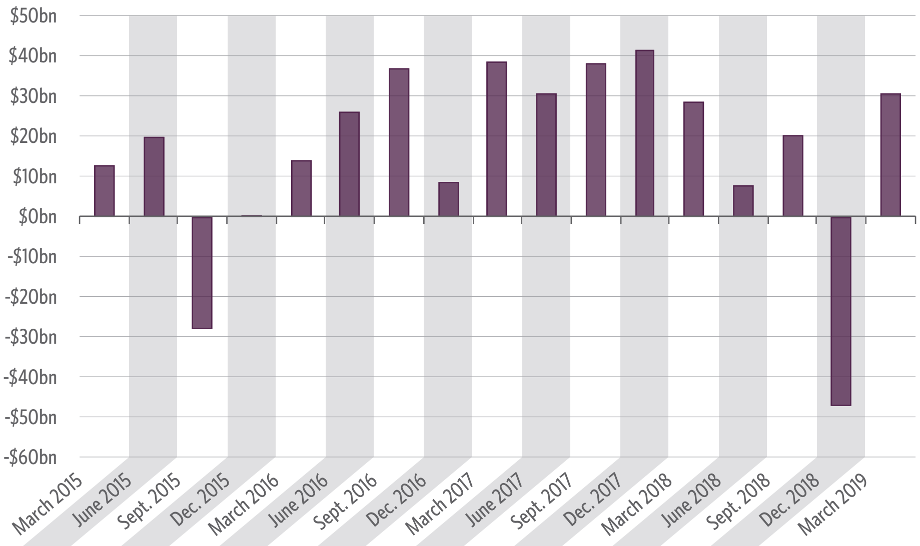
Investment-grade corporate bond spreads rallied in the first quarter of 2019, largely due to the swing in macroeconomic and central bank policy perceptions. Investor sentiment shifted abruptly alongside the Fed policy pivot, highlighted by a surge of investment-grade fund inflows. The resurgence of demand from overseas investors across the credit curve was also integral in the Bloomberg Barclays U.S. Corporate Bond index spread rally of 44 basis points, a retracement from wides of 163 basis points in December.

The market experienced strong inflows into investment-grade funds during the first quarter of 2019, a sharp reversal from the fourth quarter (see chart, top right). These inflows, combined with an underwhelming new-issue market, provided a strong technical backdrop for the broader market rally. The most startling surprise was the corporate spread rally, which occurred despite the sharp decline in Treasury yields. The last time the Bloomberg Barclays U.S. Corporate Bond index traded at the current spread of 119 basis points, in November 2018, the corresponding yield was 4.29 percent, well north of the 3.63 percent registered at the end of the quarter.

The bearish rhetoric around BBB credit—including concerns over sector leverage, a looming recession, BBBs' disproportionately high representation in the Bloomberg Barclays U.S. Corporate Bond index, and the ability of the high-yield corporate bond market to absorb a potential deluge of downgrades—drove the dramatic widening of spreads in the fourth quarter of 2018. This widening promptly reversed in the first quarter, as a result of the dovish stance of the Fed, which suggested a return to lower-for-longer rate projections. As a result, BBB corporates outperformed single-As by 12 basis points year to date. Notwithstanding the strong first quarter for BBB spreads, the spread ratio of BBBs to single-As reveals plenty of room for further compression (see chart, bottom right). As both domestic and foreign buyers add corporate risk, investors now have a renewed opportunity to clean up their portfolios, shed riskier securities, and shift their portfolios to higher-quality investments better suited to a recessionary environment.

GUGGENHEIM

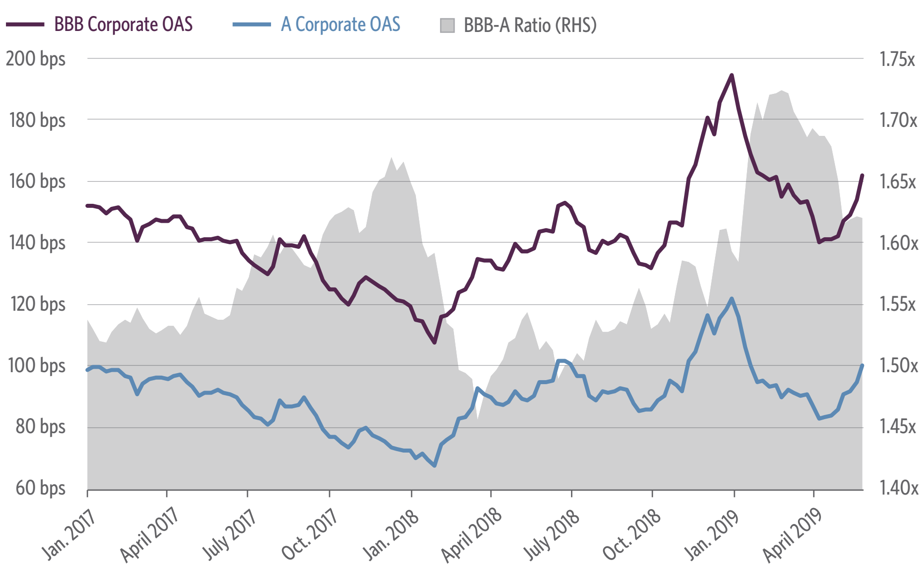
Investment-Grade Corporate Bond Fund Flows See Sharp Reversal



Source: Guggenheim Investments, Investment Company Institute, Bloomberg. Data as of 3.31.2019. Includes flows of investment-grade corporate mutual funds as reported by ICI and of the iShares iBoxx $ Investment-Grade Corporate Bond ETF (LQD), the largest U.S. Investment-Grade Corporate ETF.

The market experienced strong inflows into investment-grade funds during the first quarter of 2019, a sharp reversal from the fourth quarter.

Plenty of Room for Further BBB Spread Compression



Source: Guggenheim Investments, Bloomberg Barclays. Data as of 5.31.2019. Note: OAS = option-adjusted spread.

Despite a strong first quarter for BBB spreads, the spread ratio of BBBs to single-As reveals plenty of room for further compression.