Investment-Grade Corporate Bonds

Tax Changes Enhance Technicals

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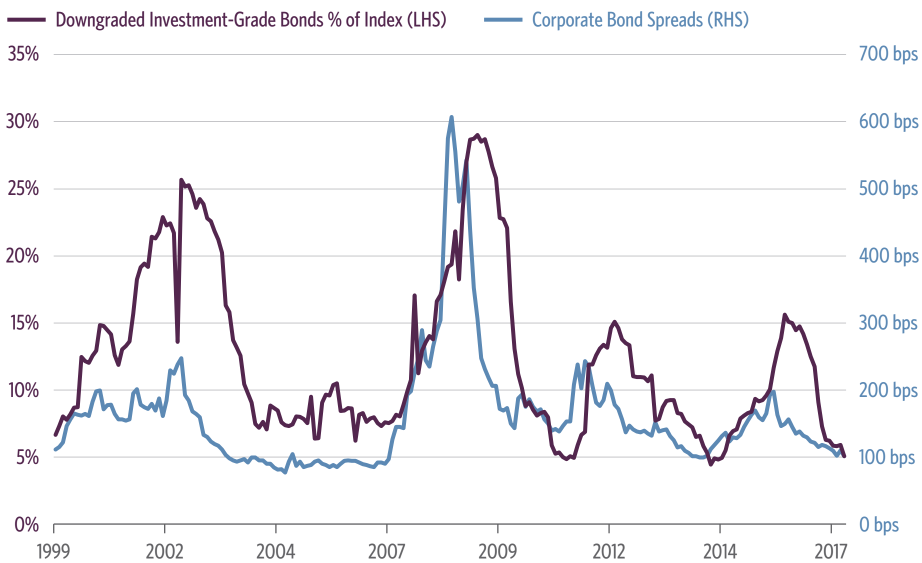
Clarity on tax policy helps drive spreads to 10-year tights, but headwinds remain.

The passage of the new tax plan was a significant driver for investment-grade corporate credit spreads, which tightened to levels not seen in over a decade. We anticipate corporate credit spreads to remain at similar levels or tighten over the first quarter of 2018 despite multiple headwinds, such as quantitative tapering, geopolitical risks, and what many believe is the tail end of a virtuous credit cycle (see chart, top right). The firm tone will remain intact as the technical picture, driven by domestic and foreign demand, should persist in the near term. Net issuance for 2017 fell by 6 percent from 2016, and early estimates suggest net issuance will fall an additional 12 percent this year. If Treasury yields stay range-bound or back up in an orderly manner, we expect foreign and domestic demand to limit any spread widening in corporate credit (see chart, bottom right). The net effect of tax policy implementation on investment-grade credit at the industry level remains somewhat unclear, but is expected to be mostly positive and could lead to significant cash repatriation. All else equal, this could result in decreased supply from perennial issuers as it would create a steady wave of cash earmarked for reinvestment within the sector, further enhancing the technical picture.

The Bloomberg Barclays Investment-Grade Bond index returned 1.2 percent during the fourth quarter. Spreads tightened by 8 basis points quarter over quarter and 30 basis points since the beginning of the year, ending December at 93 basis points. Returns were mixed by rating, with AAA-rated bonds returning 8 percent in 2017, compared to returns of 4.6 percent for AA-rated bonds, 6 percent for A-rated bonds, and 7.1 percent for BBB-rated bonds. It is important to note that AAA-rated corporates represent only 2 percent of the index.

Tail risks in the market continue to creep higher, which should result in more cautious investor behavior later in the year. With that in mind, we still favor the up-in-quality trade as we move closer to the end of the credit cycle. We will look to add risk opportunistically if selling in long-dated high-quality corporates materializes, perhaps on the back of foreign selling. We remain constructive on bank preferred securities with higher floating-rate back ends, but we believe better entry levels will present themselves later in the year.

Investment-Grade Corporate Bond Spreads Should Remain Stable in Q1



Source: Bank of America Merrill Lynch Research, Guggenheim Investments. Data as of 9.30.2017.

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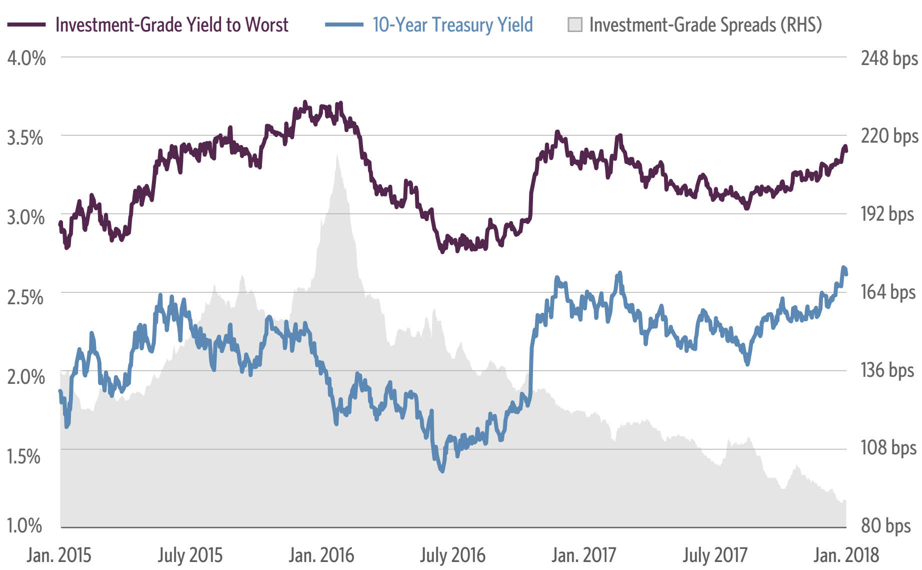
Investment-Grade Corporate Bond Spreads Cushioned the Treasury Selloff



Source: Bloomberg Barclays, Guggenheim. Data as of 1.23.2018.

Investment-grade corporate bond spreads have tightened since September despite a selloff in U.S. Treasurys that caused the yield on the 10-year Treasury note to rise 70 basis points. The passage of the new tax plan was a significant driver, helping spreads to tighten to levels not seen in over a decade.