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Corporate Bond Market Insight | February 2025

New Year, New Policies, but the Same Themes for Corporate Bonds

Key takeaways

» The Fed removed language about inflation progressing toward its target in its accompanying announcement to rates remaining unchanged. This indicates to us that progress toward the target has faltered.

» The Fed is waiting to see which policies are enacted under the new administration. Then it will begin to assess what the implications for the economy will be before the next meeting in mid-March.

» Both ISM surveys suggest continued growth in the economy but also a risk that inflation could reaccelerate.

» Our favorable view of IG credit is supported by strong earnings, healthy balance sheets and still high all-in starting yields.

Recap

January saw a continuation of many of the same themes that characterized the last quarter of 2024. The economy showed signs of accelerating, inflation remained well above the Fed's target and financial assets were stable. The inauguration of a new president and a flurry of executive orders began to reshape the US economy and government. Though some policies came into focus, ambiguity around the final shape of tariffs, immigration and fiscal policy are bound to produce volatility over the coming months. Large banks reported strong earnings, and optimism around a reduction in the regulatory burden suggests the potential for stronger earnings to come. The rally in tech appeared to falter, with the Chinese AI model DeepSeek possibly changing the spending calculus around AI infrastructure.

The Fed left rates unchanged at its January meeting and removed the language indicating inflation was progressing toward its 2% goal in the statement accompanying the announcement. By removing the language, the Fed acknowledged that progress toward the target has faltered. However, it reiterated that the risks to the two sides of its dual mandate—employment and inflation—are still roughly balanced. The Fed went on to say that the "extent and timing" of additional adjustments are data- and outlook-dependent.

In the hawkish press conference following the meeting, chair Jerome Powell made it clear that the Fed wasn't skipping a meeting but pausing due to uncertainty over how new fiscal policy could change its outlook for the economy. He said "The committee is very much in the mode of waiting to see what policies are enacted" and "We need to see the policies be articulated before we can even begin to make a plausible assessment of what their implications for the economy will be." There's no meeting until mid-March, giving the Fed time to assess the impact of last year's 100 basis point (bps) cuts and gain clarity into new economic policy.

Against this backdrop, the 10-year Treasury yield declined three bps for the month, and credit spreads narrowed three bps for the month. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned 0.65% for the month and 4.84% for the trailing 12 months as a result. Over the month, sectors were mixed in a narrow range, and lower-quality investment-grade (IG) credit outperformed higher-quality IG. The best performing sector was transportation, and the worst performing sector was utilities.

Strong economic growth was again apparent. The Institute of Supply Management's Manufacturing Purchasing Managers Index rose to its highest level in 11 months. While still modestly below the 50 level signaling outright expansion, the trend higher is clear. The forward-looking new orders index was at a strong 52.5%, suggesting more growth is coming. Manufacturing purchasing managers reporting higher prices also rose to 52.5%. The services prices paid index also had price increases, which increased from 58.2 to 64.4, the first reading above 60 since January 2024. The sudden rise in both prices paid indexes suggests inflationary pressures might increase while the economy improves.

Payroll growth was also strong. After rising 212,000 in November, December saw nonfarm payrolls (NFP) rise an additional 256,000, the vast majority of which were in the private sector. This represented the strongest growth in nine months and brought the three-month average NFP gain to 170,000. The US economy added 2.2 million jobs in 2024. Average hourly wages also posted strong gains, rising 0.3%. This brings the year-over-year growth rate to 3.9%, well in excess of the inflation rate. Strong job and wage growth continue to contribute significantly to consumer strength.

Strong retail sales and consumption also hint consumers remain upbeat. The first estimates for Q4 2024 GDP suggest the economy grew at a 2.3% annualized rate. Strong consumption drove much of the growth. If the initial estimate holds, the 2024 growth rate was a respectable 2.5%, much stronger than early 2024 estimates envisioned.

As acknowledged by the Fed, the decline in inflation toward the Fed's 2% core PCE target is grudging. Headline CPI increased 0.4% in December, the largest monthly increase since March 2024. The largest increase was in energy at 2.6%, which accounted for 40% of the monthly increase. Core inflation increased 0.2% over the same period. This brought year-over-year (YOY) headline inflation to 2.9% and YOY core inflation to 3.2%. Core inflation, which is inflation without food or energy, decelerated slightly for the first time since July. Annual core PCE inflation—the Fed's preferred inflation gauge—remained at 2.8% for the third consecutive month, matching its highest reading in the last eight months.

Shelter, particularly rents, is still the largest component of inflation. Assuming that price increases in energy and food remain still, forward-looking indicators of future CPI rent inflation appear poised to continue their slow decline. Of particular concern is the impact of tariffs on inflation, which could represent an immediate step higher in the underlying inflation rate. Tariffs don't create the kind of persistent inflation that the Fed's tools are designed to combat, so it remains to be seen if the Fed will raise the federal funds rate in reaction.

Looking forward

Our favorable view of IG credit is still unchanged. Earnings are strong, balance sheets are in good shape and refinancing activity undertaken during the period of low rates continues to provide a solid cost of funds cushion for corporate treasurers. Corporate fundamentals continue to support narrow credit spreads, and high starting all-in yields provide a solid return cushion for rules-based ladder investors.

We continue to have concerns around the economic outlook, but economic momentum is increasing again for now. This could change rapidly while new tariff, immigration and economic policies come into focus. Tariffs are particularly worrisome, since they both increase inflation and decrease near-term growth, as was the case in 2019. There's also growing potential for a bruising fight around the debt ceiling. The investment mechanics of the rules-based ladder structure continues to function as an uncertainty hedge.

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