U.S. Investment Grade Credit Update

After a bumpy start, 2024 emerged as a year of resilience for fixed income markets, with strong returns and a promising outlook for U.S. corporate bonds.

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Key takeaways

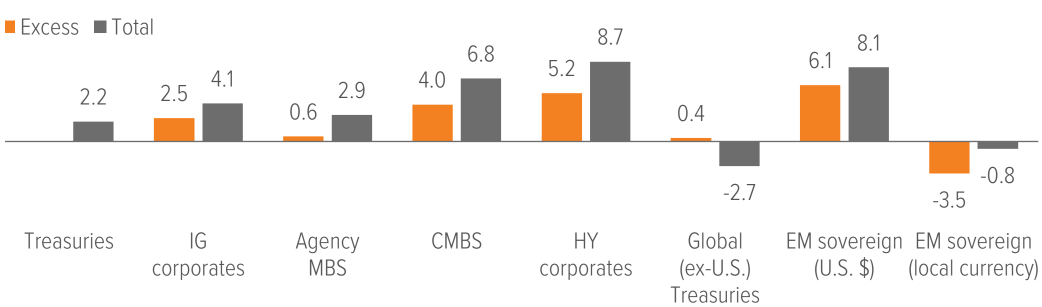
- **The U.S. investment grade market continues to offer a good entry point for long-term investors.** Falling rates provide an upside scenario to returns, while still elevated yields provide a cushion against wider credit spreads in the event of a more pronounced slowdown in economic activity.
- **Supportive market technicals remain a key driver of spreads as investors seek to lock in yields.** Fundamentals remain stable due to improved earnings, positive ratings trends and continued discipline among company management teams.
- **Nonetheless, spikes of volatility could emerge from a range of risks,** including slower macro and earnings growth, rising geopolitical tensions, and uncertainties around the timing and prioritization of policy changes introduced by the incoming Trump administration. We may add risk following spread-widening events.

2024 in review

Despite some volatility early in 2024, fixed income markets delivered strong returns through November. After markets priced in front-loaded rate cuts, early inflation indicators surged in the first quarter, delaying expectations for rate cuts. In subsequent quarters, inflation eased into a favorable trend. However, concerns about economic growth and the labor market, particularly after a weak July nonfarm payroll report, became a primary focus for investors.

Exhibit 1: Risk assets have performed well

YTD returns (%)



As of 11/30/24. Source: Bloomberg Index Services Limited, J.P. Morgan, Voya IM. Excess returns for the U.S. Agg, Treasuries, IG Corp, Agency MBS, CMBS, HY Corp and Global ex-U.S. Treasuries are represented by the excess returns for the respective Bloomberg indexes. Excess return for EM sovereign (U.S. $) is represented by the spread return for the J.P. Morgan EMBI Global Diversified Index. Excess return for EM sovereign (local currency) is represented by the total return for the J.P. Morgan GBI-EM Global Diversified Index (Tax-Adjusted Local Return) less the total return of the Bloomberg U.S. Treasury 3-7 Year Index. See endnotes for index definitions and additional disclosures.

With greater confidence about inflation, the Federal Reserve responded to these weaker labor market trends by enacting a 50-basis-point (bp) rate cut at its September meeting, announcing that it was recalibrating policy in response to a "changing balance of risks."

Importantly, a soft-landing scenario continued to remain the central market theme despite no shortage of evolving—and, at times, conflicting—economic signals. As a result, U.S. risk assets broadly delivered positive returns through Nov. 30 (Exhibit 1), boosted by falling Treasury yields and tighter spreads.

Spreads have remained resilient in the investment grade (IG) corporate space. They spiked briefly in early August, with levels reaching roughly 111 bp on an option-adjusted spread (OAS) basis. Once the markets digested the U.S. presidential election outcome—anticipating higher growth, tax cuts and deregulation—spreads moved to the tightest levels seen since the late 1990s, reaching the mid 70 bp range in November.[1] We attribute these tight spreads primarily to supportive technicals, given strong demand from yield-based buyers, the healthy economic backdrop and stable issuer fundamentals. While spreads aren't historically cheap, current market dynamics could continue to keep them in a relatively tight range. Strong demand, positive ratings trends and modestly positive economic growth should benefit spreads. Historically, credit has done well when growth is 1-2%, as excessive growth raises monetary policy uncertainties, while insufficient growth widens spreads due to heightened recession risk.

Digging into market subcategories, several themes emerged in 2024 (Exhibit 2). BBBs outperformed higher-quality issues, benefiting from the positive economic backdrop. Across the curve, the long end lagged the front and intermediate segments as the credit curve steepened. Financials underperformed in 2023 due to sensitivity to rising front-end rates and the regional banking crisis, and have since traded atypically wide relative to industrials and utilities. Given expectations for rate cuts in 2024, financials have outperformed, led by select Yankee and U.S. regional banks.

Outlook

Looking ahead, U.S. corporate bonds seem appealing in the current environment, which may offer a good entry point for long-term investors. While downside risk exists, elevated starting yields provide protection. Despite recent declines, U.S. IG corporate bond yields remain above 5% and are more than 140 bp above their 10-year average.[2] In a downside scenario with slower-than-expected growth and aggressive Fed rate cuts, total returns from lower rates would offset some potential spread widening. If inflation stays high, higher yields should continue attracting strong inflows into IG, supporting valuations.

Exhibit 2: Positive macro backdrop has been supportive for BBB rated corporate issuers

YTD returns (%); OAS (bp)

		YTD OAS	YTD change in OAS	YTD total return	YTD excess return
	IG corporates	**78**	**-21**	**4.14**	**2.52**
Industry	Industrials	76	-14	3.44	2.11
	Utilities	81	-24	4.37	3.46
	Financials	79	-33	5.30	3.00
Quality	AA	42	-6	2.52	1.30
	A	66	-19	3.69	2.06
	BBB	95	-26	4.88	3.18
Maturity	1-5yr	54	-23	5.08	1.48
	5-10yr	86	-22	4.81	3.09
	10-25yr	97	-21	3.33	3.34
	+25yr	101	-12	1.07	2.96

As of 11/30/24. Source: Barclays, Bloomberg. See endnotes for index definitions and additional disclosures.

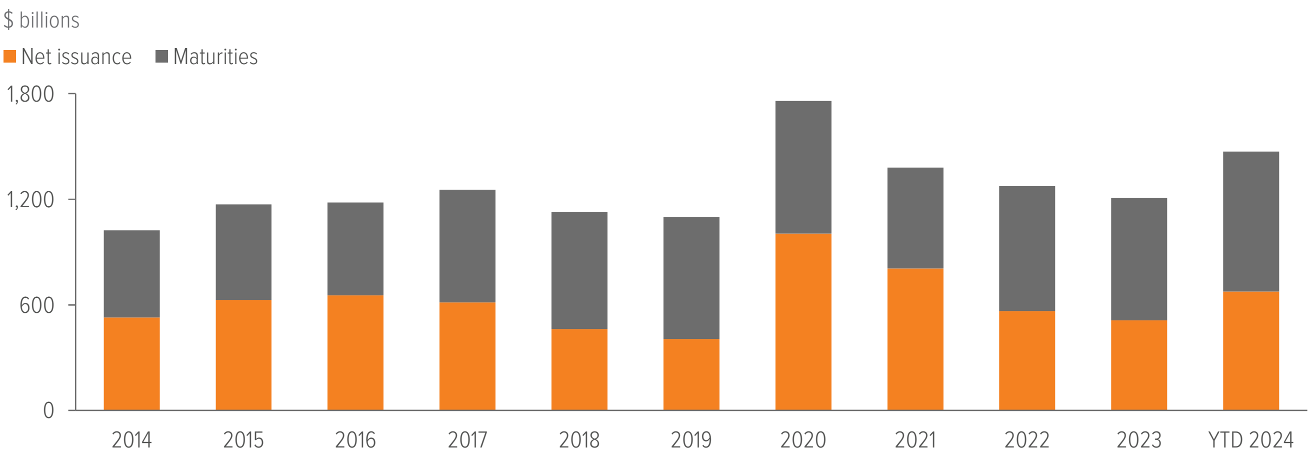
[1] Bloomberg, 11/30/24.
[2] Bloomberg, 11/30/24.

Technicals should remain supportive, driven by investor flows

Through the first 11 months of 2024, the IG market saw near record-breaking gross issuance, offering new supply and buying opportunities for managers. For context, overall gross volume reached roughly $1.47 trillion by November, surpassing any calendar year outside of 2020 (Exhibit 3). Much of this issuance was likely pulled forward to avoid potential late-year volatility. While banks were heavy issuers early on, non-financials accounted for approximately 60% of total volume. M&A issuance, representing 13%, partially drove the increase.[3] Lower funding costs led to more opportunistic issuance. Looking ahead, falling rates should support M&A supply, but we don't anticipate a significant near-term pickup. Additionally, net issuance is expected to remain low given the large number of 2025 maturities. This should be supportive for spreads.

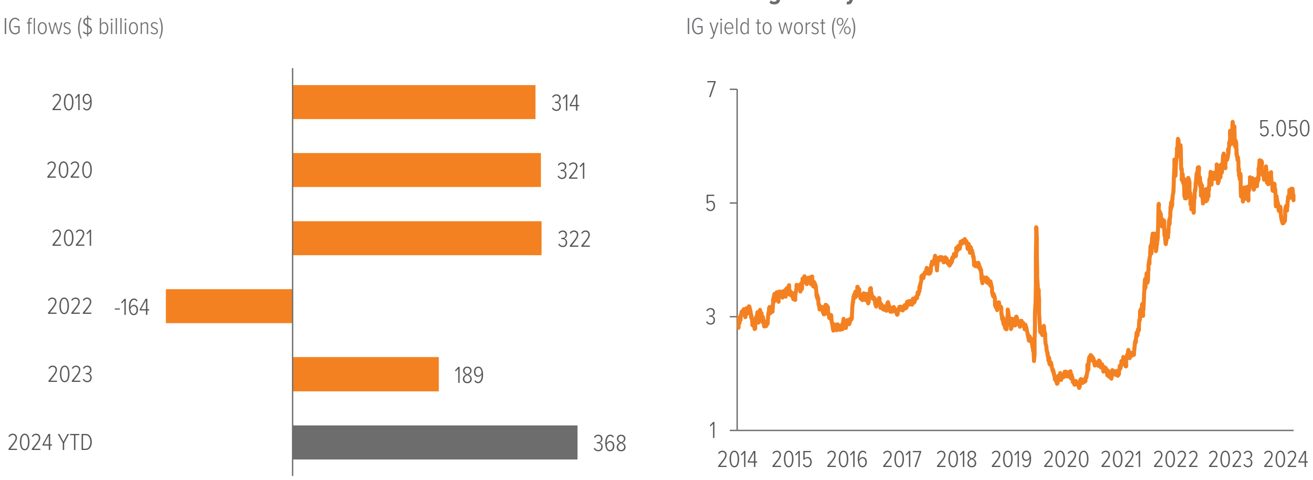
Despite elevated new issuance, spreads have remained relatively stable due to strong investor demand. Investment grade mutual funds and ETFs have seen significant inflows this year (Exhibit 4). With the start of the Fed cutting cycle, we believe the IG market is set to attract more flows as investors seek to secure appealing yields and add duration. Additionally, a steeper Treasury curve should enhance hedging costs, potentially boosting demand from overseas investors. These factors should continue to support demand despite falling rates.

Exhibit 3: Gross issuance set to reach highest level since 2020



As of 11/30/24. Source: J.P. Morgan.

Exhibit 4: Flows into IG have been robust as investors look to lock in long-term yields



As of 11/30/24. Source: J.P. Morgan, EPFR, Barclays, Bloomberg. Right side: IG represented by the Bloomberg U.S. Corporate Index. See endnotes for index definitions and additional disclosures.

[3] J.P. Morgan, 11/30/24.

Fundamentals have remained healthy

In the post-Covid tightening cycle, corporate fundamentals have remained robust, bolstered by a strong starting position. Companies built substantial cash reserves during a period of exceptional economic growth and secured low long-term financing costs. This provided a lengthy runway for issuers and a buffer against slower earnings growth. Although recent quarters saw some decline in credit metrics—such as lower EBITDA growth, primarily in commodity sectors, and reduced interest coverage due to higher rates—companies have reacted by cutting shareholder payouts and moderating capex spending, both of which are favorable to creditors.

Fundamentals have been further supported by positive credit ratings trends (Exhibit 5), enhancing the ratings skew of the investment grade market. Upgrades have surpassed downgrades by about $466 billion through the first three quarters, with modest fallen angel activity. Leverage continues to decline as management teams gain confidence in the economic outlook. Companies reported solid earnings in the third quarter, as S&P 500 earnings grew by 8.7% on 5.4% revenue growth.[4] Technology firms were the main driver, while financials and utilities also saw steady earnings growth. With above-trend growth expected, year-over-year earnings growth rates should continue to rise in the coming quarters.

Key risks we're monitoring

The macro environment remains supportive, with our base-case view calling for a gradual slowing of economic growth towards trend levels and a more balanced labor market. This should alleviate inflation pressures without a significant rise in unemployment, allowing the Fed to continue cutting rates closer to the terminal rate, which will benefit both consumer spending and business investment. Consequently, the outlook for the near term is positive for IG, with spreads expected to remain relatively tight.

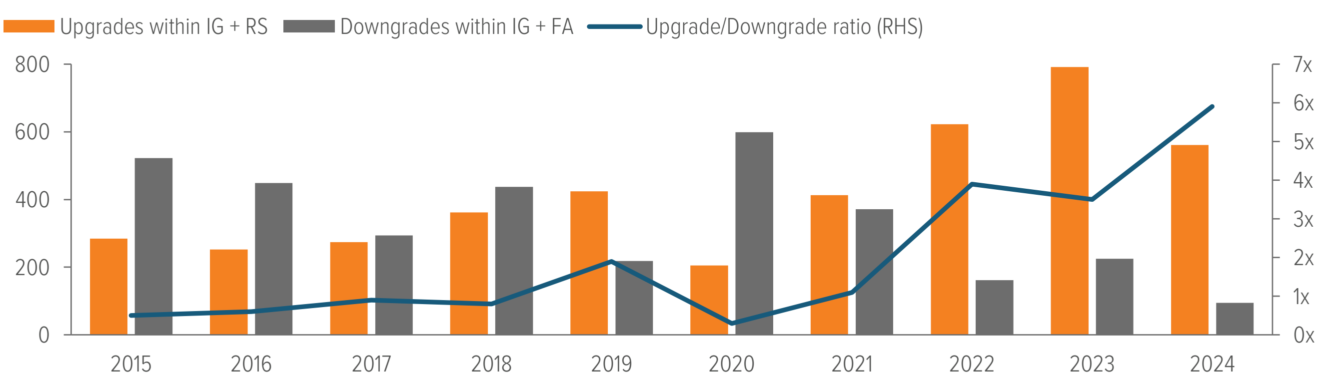
With that said, we'd be remiss to not acknowledge potential risks that could raise near-term volatility—primarily a sharper-than-expected growth slowdown due to lagged monetary policy effects, which could strain earnings and fundamentals. Negative surprises in fourth-quarter earnings might also widen spreads. Finally, although election cycles typically have minimal impact on investment grade corporates, the fallout from the U.S. presidential election—alongside ongoing geopolitical tensions—could have implications for fiscal and trade policy. This may cause modest spread widening.

The election outcome could benefit some sectors over others

The incoming administration will have an impact on every industry within investment grade credit, and each will face its own challenges and opportunities. The recent rally provides an opportunity for active managers to reduce exposure to names that may be adversely affected by potential policy changes under the new administration. The uncertainty in the timing and prioritization of any changes is key. For example, although deregulation may initially be positive for corporate credit, it could also increase risk over the long term.

Exhibit 5: Upgrades have exceeded downgrades at an increasing pace

IG upgrades and downgrades (left axis in $ billions)



As of 09/30/24. Source: J.P. Morgan.

[4]Bloomberg, 11/30/24.

Nonetheless, we view certain industries to be potential beneficiaries of the incoming administration's policies. Among them include energy and airlines, thanks to a more favorable regulatory environment. Meanwhile, retail and building products could come under some pressure from the impact of tariffs. Another area we're watching is banking, where potential regulatory relief and tax cuts may be outweighed by concern about aggressive growth strategies from lower capital environments and the uncertain impact of tariffs. Similar offsetting factors are contributing to a more mixed outlook for some sectors—such as technology, media, telecom, healthcare, utilities and autos.

Summary

- We remain constructive on investment grade, based on attractive starting yields and our expectations for a modest growth environment.
- We expect fundamentals to remain healthy, as earnings continue to benefit from the stable backdrop.
- Any episodes of spread widening would provide attractive opportunities to add risk.

A note about risk

The principal risks are generally those attributable to bond investing. Holdings are subject to market, issuer, credit, prepayment, extension and other risks, and their values may fluctuate. Market risk is the risk that securities may decline in value due to factors affecting the securities markets or particular industries. Issuer risk is the risk that the value of a security may decline for reasons specific to the issuer, such as changes in its financial condition.

An investor cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations, as volatility and other characteristics may differ from a particular investment. Index definitions are as follows: Treasuries as represented by Bloomberg U.S. Treasury Index, which measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. IG corporates as represented by Bloomberg Corporate Bond Index, which measures the performance of investment grade, USD-denominated, fixed-rate, taxable corporate bond market securities. Agency MBS as represented by Bloomberg Securitized – U.S. MBS Index, which is an unmanaged index composed of fixed income security mortgage pools sponsored by GNMA, FNMA and FHLMC, including GNMA Graduated Payment Mortgages. CMBS as represented by Bloomberg Securitized – CMBS Index, which measures the market of U.S. agency and U.S. non-agency conduit and fusion CMBS deals with a minimum current deal size of $300 million. HY corporates as represented by Bloomberg U.S. Corporate High Yield: 2% Issuer Cap Index, which is an unmanaged index that measures the performance of fixed income securities generally representative of corporate bonds rated below investment grade. Global (ex-U.S.) Treasuries as represented by Bloomberg Global Treasury Ex-US index, unhedged, which is a subset of the flagship Global Treasury Index that does not have any exposure to U.S. debt. EM sovereign (U.S. $) as represented by J.P. Morgan EMBI Global Diversified Index, which is a uniquely weighted version of the EMBI Global, limiting the weights of index countries with larger debt stocks by including only specified portions of these countries' eligible current face amounts of debt outstanding; EMBI Global measures the performance of USD-denominated emerging market sovereign/quasi-sovereign bonds and uses a traditional, cap-weighted method for country allocation. EM sovereign (local currency) as represented by J.P. Morgan GBI-EM Global Diversified Index (Tax-Adjusted USD Return); the GBI-EM series, launched in June 2005, was the first comprehensive global emerging markets index of EM local government bond debt.

A rating provides no indication of future performance and is not constant over time.

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