Invesco

Investment Insights

Investment grade looks attractive as Fed's tightening cycle winds down

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Overview

- We see light at the end of the tunnel in terms of Fed rate hikes.
- Nevertheless, the Fed will likely keep rates elevated to gauge how tight policy has flowed through the economy and to ensure that inflation is on a sustained downward path.
- In the meantime, investment grade valuations look attractive, in our view.
- Once markets gain confidence that the Fed is winning the war against inflation, we expect increased investor interest in investment grade.

The Federal Reserve's (Fed's) November rate hike brought us closer to the end of its rate hike cycle than the beginning. We expect the federal funds rate, now at 3.75%-4%, to top out at around 5% next year. Our base case expectation is for a further 50-basis point hike in December and a 25-basis point increase in March - though we could see another hike in June if the inflation data are more stubborn than we expect. At that point, we would not be surprised to see the Fed pause to take stock of how its policy tightening has flowed through the economy.

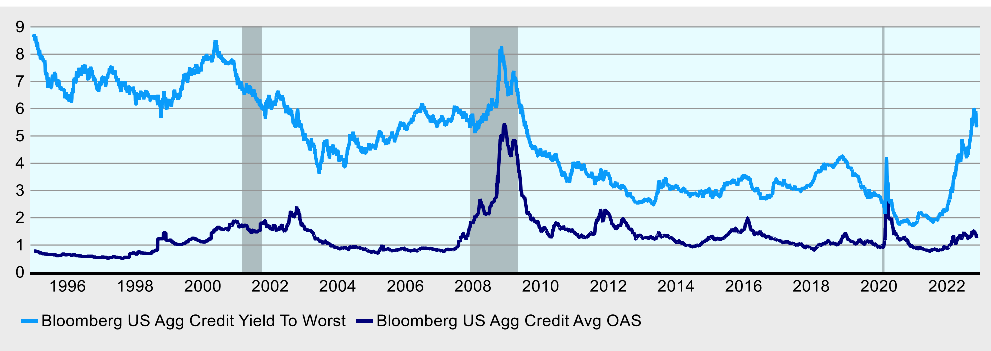
Closing in on the end of the rate hiking cycle is potentially good news for risk assets like investment grade bonds. For the last several months, market action has centered around high inflation and the Fed's aggressive tightening response. The lack of clarity around inflation and little forward guidance from the Fed has created investor uncertainty and pushed up interest rate volatility as the future path of interest rates has become less certain.

But we recently received good news on the inflation picture in the US. Annual inflation measured 7.7% in October, down from 8.2% in September. As IFI Chief Strategist, Rob Waldner recently commented, "This is only one data point, but it points toward the peak in inflation being behind us. We expect we are getting close to the end of the Fed's aggressive rate hiking cycle. The Fed has been very responsive to inflation data, and we would expect it to take some comfort from this week's data. While we will likely get additional rate hikes, the pace of hikes will likely slow, and we believe we will see a peak in the federal funds rate in the first quarter of 2023, as inflation pressure continues to moderate."

Attractive value created in investment grade

With an end to interest rate hikes in sight, we believe investors are also taking stock of the attractive value recently created in assets like high quality investment grade bonds. But valuations alone are not sufficient to drive a rally. We believe we will need a catalyst to drive returns. In our view, that catalyst would be evidence that the Fed is making convincing headway against price pressures and that we are on a clear path to lower inflation.

Figure 1: Value has been created in investment grade bonds



Source: Macrobond. Data as of November 11, 2022.

1. Source: Policymaker uncertainty begets volatility – Forward guidance please! Rob Waldner, Chief Strategist and Head of Macro Research, Oct. 31, 2022.
2. Source: US Bureau of Labor Statistics. Data as of Nov. 10, 2022.
3. Source: October inflation takes some pressure off the Fed, Nov. 10, 2022.

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By mid-spring, we expect to see inflation slow on an annualized basis. By then, prices may not have fallen, but we believe they will have stopped rising as rapidly, and that should help bond markets. The Fed will likely keep rates elevated for some time to ensure that prices have stabilized. But seeing price pressures level off will likely instill confidence that aggressive monetary tightening has been successful and is reaching its end.

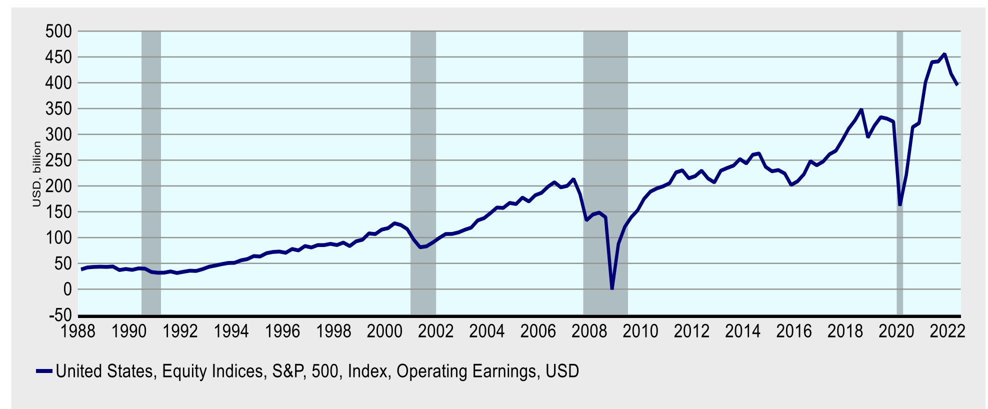
Watching the labor market and rents

One indicator we are watching to judge the future path of inflation is the labor market. The number of job openings remain high, as many companies still look for workers. We would like to see the ratio of job openings to unemployed workers come down so that wage pressures don't feed through to goods and services prices. Another indicator we are watching is rent inflation, which has climbed during the pandemic with sharply rising housing prices.

Corporate fundamentals are solid, and a soft landing is possible

While inflation still needs to cool for a sustained recovery in risk assets, in our view, corporate credit fundamentals, in the meantime, are healthy and nominal earnings have been strong. Strong nominal earnings growth has allowed companies to service debt with inflated dollars, keeping their balance sheets in good shape, and asset quality in the banking sector remains healthy. So far this year, more companies have been upgraded to investment grade than downgraded to high yield and defaults are close to zero. In terms of credit fundamentals, we recognize that the best may be behind us, as higher interest rates bite. But if the Fed is successful against inflation, which we believe it will be, we could experience a soft landing, allowing us to avoid credit problems down the road.

Figure 2: Nominal corporate earnings have been strong



Source: Macrobond. Data as of November 11, 2022.

Looking ahead

The neutral interest rate is probably, in the Fed's estimation, somewhere between 2% and 3% - and perhaps closer to 3% in a post-pandemic world. A level above the neutral rate is contractionary, meaning the Fed has only been in contractionary territory for a short time. Since monetary policy works with a lag, we expect the Fed to keep rates elevated for some time, especially given its target of 2% inflation. Once markets see the Fed achieve some success at slowing inflation, as we may have already, we believe investors will price in a lower inflation environment and realize that investment grade valuations are attractive relative to recent history. The market may also price a pause in Fed tightening in advance of it doing so. But for this chain of events to occur, we believe we need more evidence that the Fed is winning the war against inflation. In the meantime, investment grade valuations are attractive, in our view, and further signs that inflation is slowing is likely to drive investor follow-through and positive returns in the investment grade bond market..

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