DIAMOND HILL

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Corporate Bond Market Dynamics Amid Fed Tightening

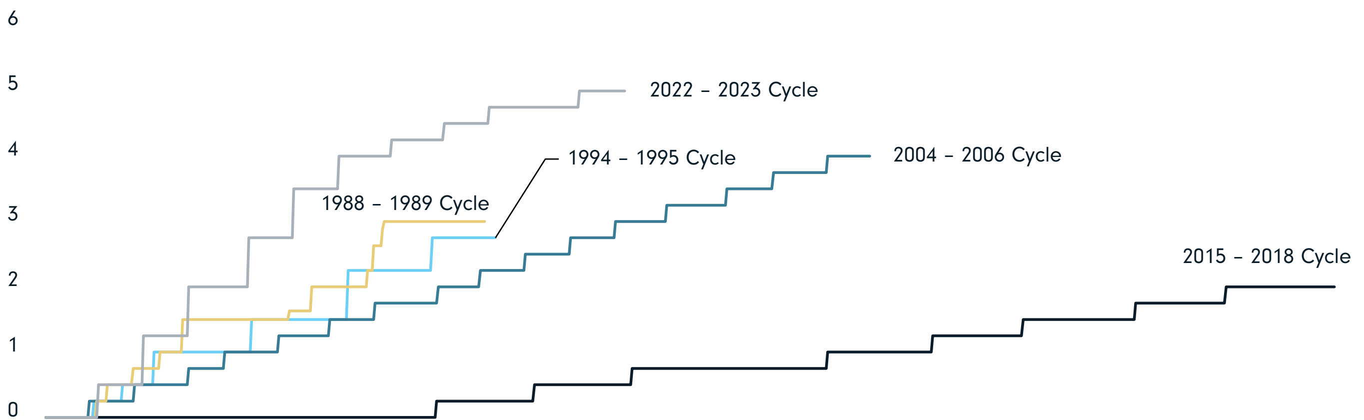
Aug 2023

In recent months, our market updates have focused on the impact of the current interest rate cycle on various areas of the fixed income markets, ranging from commercial mortgage-backed securities to asset-backed securities to the residential mortgage market. One area we have yet to cover is the corporate market, so this month, we'll dive into the investment grade corporate market to see how it has held up during this historic tightening cycle from the Federal Reserve.

A Brief Recap of the Tightening Cycle

We all know the story at this point. The Fed launched its most aggressive tightening cycle since the late 1970s – early 1980s, pushing the fed funds rate higher by 5.25% or 525 basis points (bps) from its pandemic-fueled low of 0.00% to 0.25%. The process began on March 16, 2022, with the first rate increase from the Fed since November 8, 2018. March's initial rate move was an increase of 0.25%, but the Fed quickly ramped up efforts to slow inflation by raising rates at an accelerating pace (Exhibit 1) before slowing but (potentially) not stopping the pace of increases.

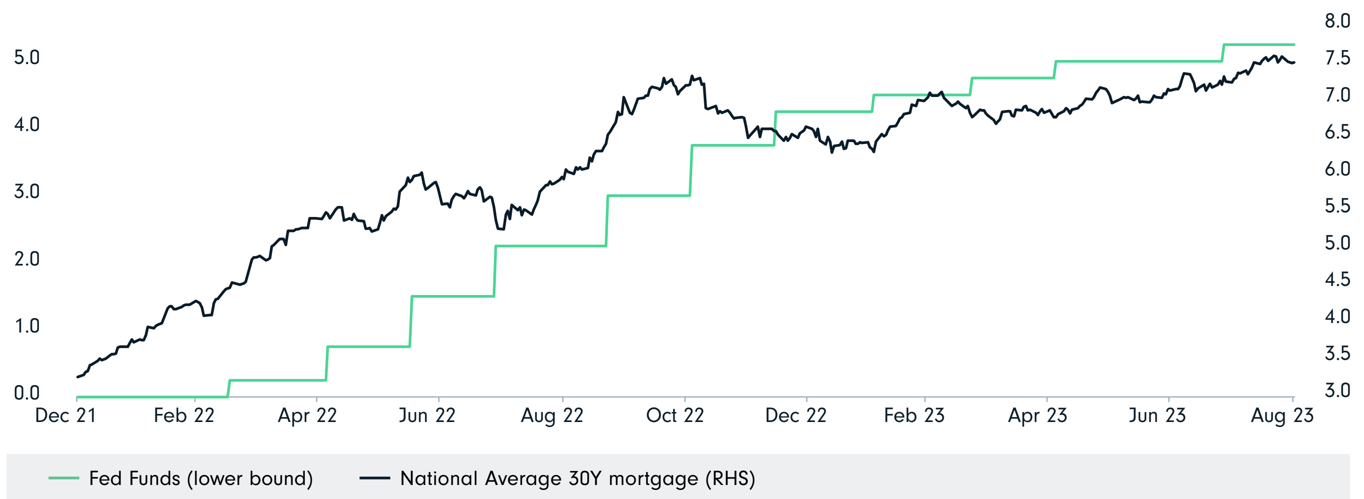
Exhibit 1 — Pace of Fed Rate Hiking Cycles



Source: US Federal Open Market Committee and Federal Reserve Bank of St. Louis.

As the Fed continued to move rates higher, the impact was felt across financial markets. Mortgages secured at historically low rates became immovable due to homeowners' reluctance to refinance. Subsequently, the price of lower coupon mortgage-backed securities dropped to reflect that new reality (Exhibit 2).

Exhibit 2 — Federal Reserve Tightening Pushes Mortgage Rates Higher (%)



Source: Bloomberg.

The work-from-home trend that started during the pandemic continued to evolve as some companies encouraged employees to return with varying levels of success. However, the shifting nature of the office dynamic resulted in stress in the commercial mortgage-backed sector, specifically in the office component. And, despite the drastic shift in the interest rate landscape, the consumer continued to carry the economy, willing to spend in the face of rising inflation while burning through pandemic-era savings and stimulus checks.

Understanding spreads and what they imply

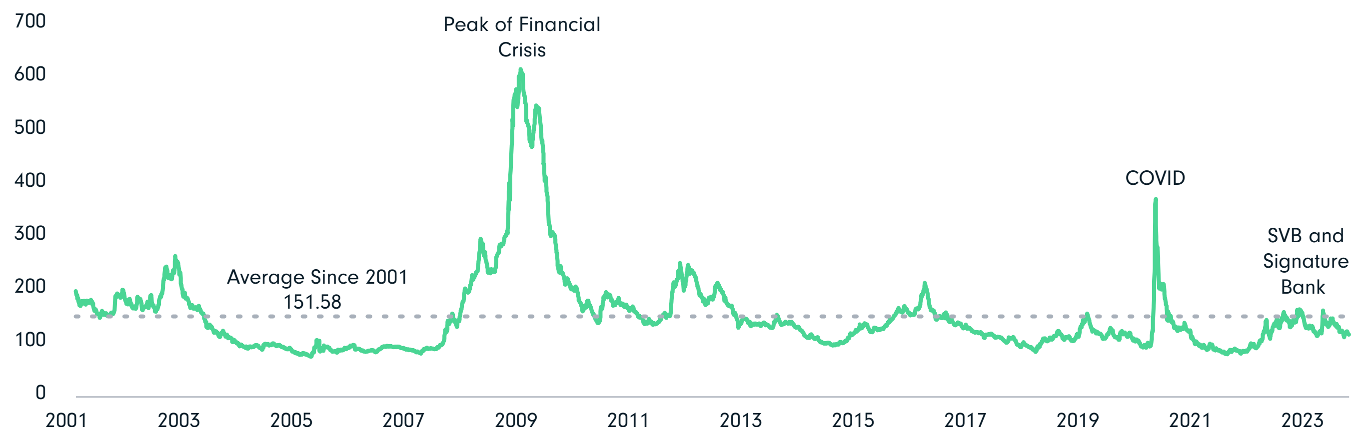
Risk is a key component of investing and ensures that an investor receives adequate compensation for their investment. When evaluating the fixed income market, one measure of risk is the risk premium, a method of measuring how much risk an investor is taking on relative to Treasuries by investing in other market segments such as mortgage-backed securities, asset-backed securities or corporate debt.

Despite the noise surrounding the Fitch's downgrade of the US earlier this summer, Treasury debt continues to be perceived as the safest and most liquid security available to investors. If the market perceives that risks are growing, spreads will widen as investors demand additional compensation (yield) over the risk-free investment (Treasuries) to justify their investment.

During the 2008 financial crisis, investment grade corporate spreads relative to Treasuries (as measured by the Bloomberg US Corporate Bond Index) jumped from 327 option-adjusted spread (OAS) the day before Lehman Brothers filed for bankruptcy to 618 OAS by early December 2008. This jump in OAS reflected the perceived risk premium in corporate debt due to the upheaval caused by the Lehman bankruptcy and ongoing financial uncertainty.

The OAS for the financials sector (as measured by the Bloomberg US Financials Index) breached 500 bps following the Lehman bankruptcy and peaked at over 800 bps by mid-March 2009. In contrast, the average spread level for financials from late 2002 to the day before the Lehman bankruptcy filing was 119 OAS — illustrative of the substantial rise in perceived risk as the financial crisis unfolded. Even during the darkest days of COVID, spreads did not approach the levels seen during the financial crisis. And as volatile and uncertain as the financial markets were during the short-lived regional bank crisis earlier this year, spreads for investment grade corporates barely pushed higher than the average level since the turn of the century (Exhibit 3).

Exhibit 3 — Bloomberg US Corporate Bond Index Option-Adjusted Spread (OAS)



Source: Bloomberg.

What are corporate spreads telling us today?

Market expectations for 2023 ranged from a hard-landing recession to a soft-landing recession to a no-landing recession, all of which are possible but relatively impossible to predict. As the year has marched on, the general expectation has been leaning more and more towards a soft landing as employment (though softening) continues to hold up while inflation continues to cool down.

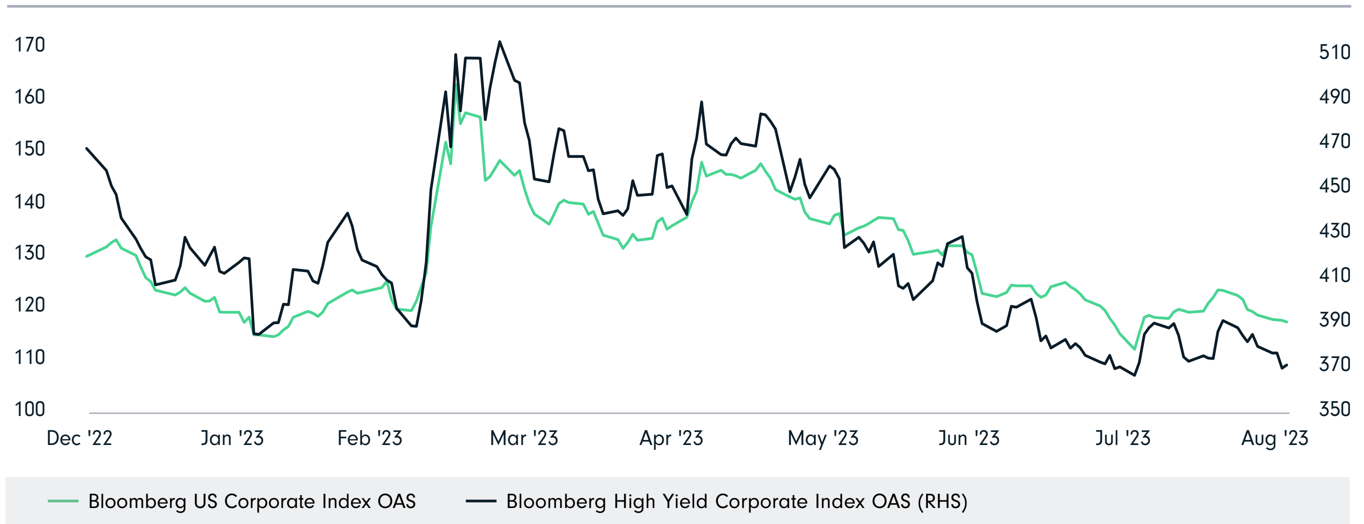
As history illustrates, a drop in inflation is never in a straight line — there will be ebbs and flows — but the general direction continues to be lower. Since the end of Q1, the yield on the 10-year Treasury has risen nearly 1.0% or 100 bps as "higher for longer" becomes more ingrained in market expectations for the foreseeable future. And, as illustrated in Exhibit 2, mortgage rates have moved directionally with the fed funds rate, but in the corporate market, it's quite a different story.

Outside the short-term volatility generated by the regional banking crisis in mid-March, spreads have held below the average over the past two decades. Spread levels have steadily declined since mid-March, even as Treasury market yields have been moving higher.

As markets move further away from the short-lived angst of the regional banking crisis, credit markets reflect a strong belief in a soft landing, with spreads moving well below the historical average. Even in the high-yield corporate market — considered the most vulnerable to rising rates and potential economic struggles — spreads on these bonds have compressed similarly to their investment grade counterparts.

It has become more expensive for companies to borrow, reflecting the increase in Treasury yields across the curve. But spread levels (additional yield over comparable duration Treasuries) have continued to contract, reflecting the notion that markets are shifting expectations around the risk associated with corporate debt.

Exhibit 4 — Corporate Option-Adjusted Spread (OAS)

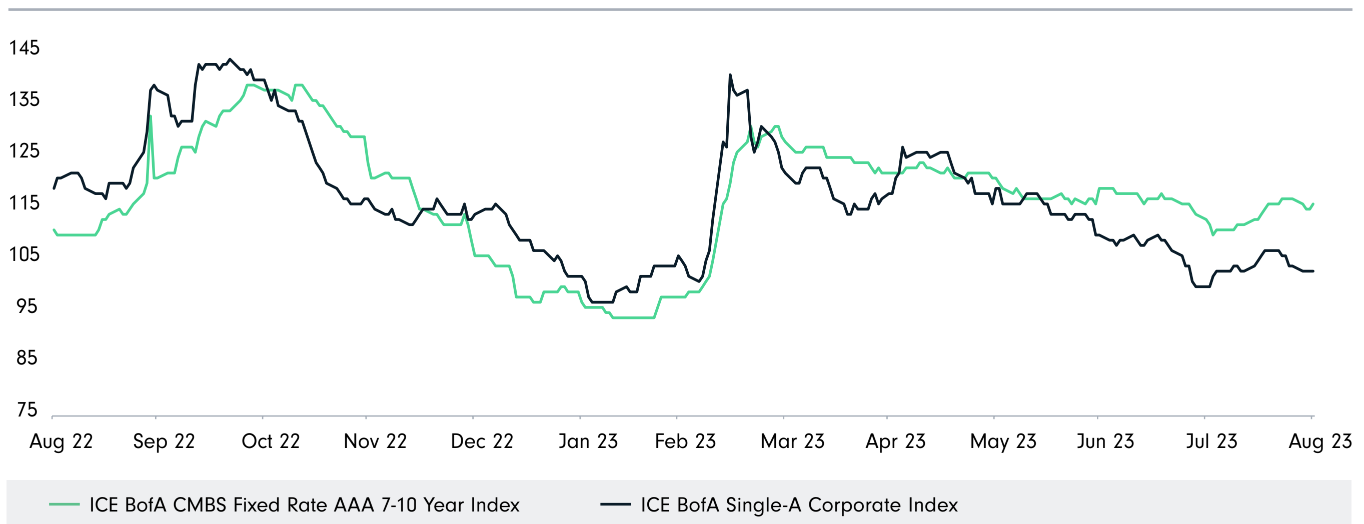


Source: Bloomberg.

How does this impact investors in the current environment?

Investing is all about relative value and deriving the best value for the amount of risk assumed when purchasing a particular bond. In the current environment, we see more attractive spread levels in areas outside of the corporate market (Exhibit 5), such as in commercial mortgage-backed securities (CMBS), short-term asset-backed securities (ABS) and residential mortgage-backed securities (RMBS).

Exhibit 5 — High-Quality CMBS Spread Pick-up Relative to Single-A Corporates



Source: Bloomberg.

The ICE BofA CMBS Fixed Rate AAA 7-10 Years Index and the ICE BofA Single-A Corporate Index are comparable in duration: between 6.6 to 6.9 years range as of month end. However, they offer very different risk characteristics.

For example, CMBS are structured with various credit enhancements such as overcollateralization, subordination, excess spread and a reserve account. Additionally, CMBS deals allow investors to select the specific tranches in which they invest, providing flexibility to the investors depending on their needs. Investors looking for more safety can stay higher up in the capital structure to gain more protection in exchange for less yield — conversely, they can invest in lower-rated tranches if they desire more yield.

The CMBS AAA market (using the ICE BofA index as a proxy) delivers a more attractive spread (116 bps vs. 103 bps for the Single-A Corporate market) for what can be deemed a higher-quality investment. If an investor is looking to add more risk, the ICE BofA CMBS BBB 7-10 Years Index has an OAS of 845 bps (and only one step down from the Single-A Corporate index), which reflects concerns about certain areas of the commercial real estate market but contains the aforementioned credit enhancements.

Diamond Hill's investment process heavily focuses on securitized products regardless of the interest rate environment because we believe the securitized market provides more opportunities to achieve higher credit quality while maintaining a yield advantage compared to those invested in government or corporate credit-focused strategies. Today's market environment emphasizes this dynamic as fixed income investors generally stand to benefit from looking beyond traditional areas of fixed income benchmarks to identify higher-yielding opportunities.

Bonds rated AAA, AA, A and BBB are considered investment grade.

Bloomberg US Corporate Index measures the performance of the US investment grade fixed-rate taxable corporate bond market. **Bloomberg US Corporate High Yield Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. **Bloomberg US Financials Index** measures the Financial Institutions component of the Bloomberg US Credit index. **ICE BofA CMBS Fixed Rate AAA 7-10 Year Index** measures the performance of US dollar denominated AAA-rated commercial mortgage-backed securities with a remaining term to maturity of greater than or equal to 7 years and less than 10 years in the US domestic market. **ICE BofA CMBS Fixed Rate BBB 7-10 Year Index** measures the performance of US dollar denominated BBB-rated commercial mortgage-backed securities with a remaining term to maturity of greater than or equal to 7 years and less than 10 years in the US domestic market. **ICE BofA Single-A US Corporate Index** measures the performance of US dollar denominated A-rated corporate debt publicly issued in the US domestic market. The indexes are unmanaged, include net reinvested dividends, do not reflect fees or expenses (which would lower the return) and are not available for direct investment. Index data source: Bloomberg Index Services Limited. See diamond-hill.com/disclosures for a full copy of the disclaimer.

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