Insights on the Investment-Grade Corporate Bond Market

U.S. corporate bonds start the year with attractive yields and overall healthy fundamentals.

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Key Points

- Healthy balance sheets and low leverage remain supportive of corporate fundamentals, but we are closely monitoring interest-rate coverage ratios and the consumer in the higher-rate environment.
- Lower policy rates may be a potential tailwind, although some of the positive effect from declining rates may be somewhat checked by wider spreads.
- Given monetary policy uncertainty, we continue to emphasize up-in-quality and up-in-liquidity positioning within an actively managed approach.

Market Recap

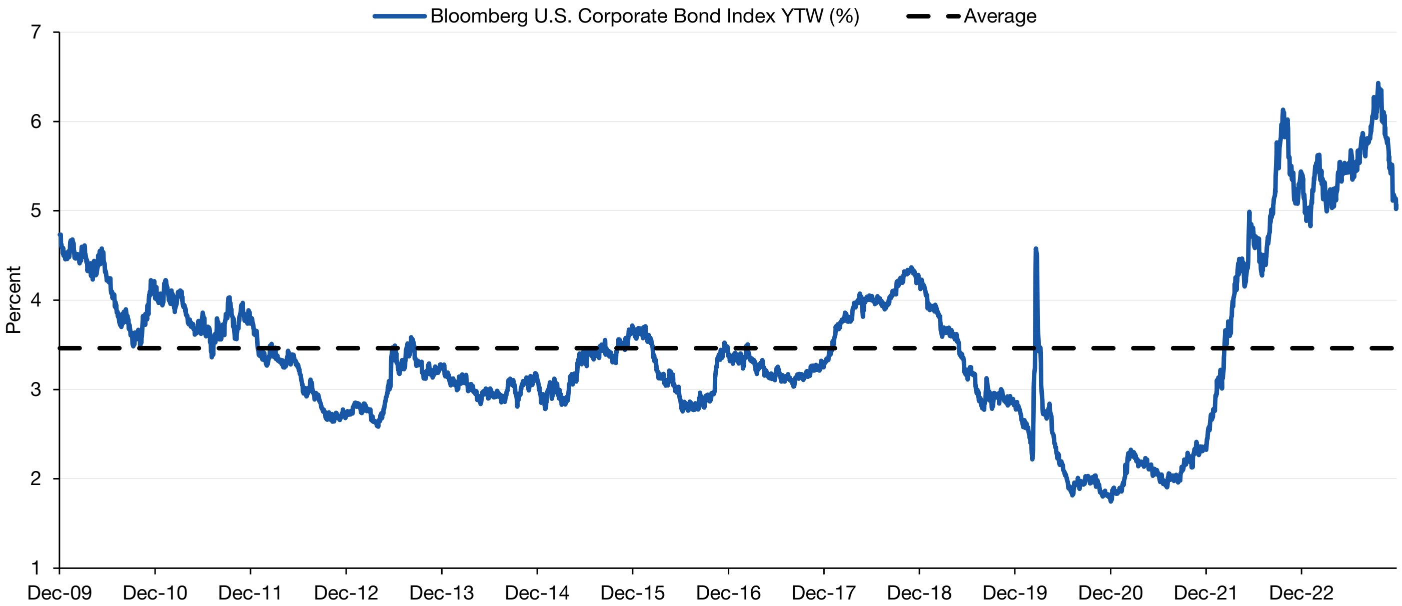
Despite some volatility, investment-grade corporates generated strong performance in 2023. The Bloomberg U.S. Corporate Bond Index returned 8.52% for the year, outperforming the Bloomberg U.S. Aggregate Bond Index by 299 basis points (bps), more than doubling the return of the Bloomberg U.S. Treasury Index, and outperforming the Bloomberg U.S. Treasury Bill Index. Past performance is no indication or guarantee of future results. Please see the performance summary table at the end of this commentary.

Compared to a year ago, inflation pressures have eased, and the U.S. Federal Reserve's (Fed's) concern has decidedly shifted from price levels to full employment and economic growth. We believe the Fed may well stay in restrictive territory for much of 2024, as growth continues to be steady, with quarterly gross domestic product (GDP) readings above 2%, and the labor market remains strong, with the unemployment rate still below 4%—according to the U.S. Bureau of Economic Analysis and the U.S. Bureau of Labor Statistics. We believe this makes for an attractive environment for high-quality credit, but we continue to watch the U.S. consumer very closely, along with the impacts from higher rates.

Though fixed-income markets closed out the year with one of the strongest rallies in decades, we believe the case for corporate credit remains compelling. Credit spreads have tightened, given a resilient U.S. economy and a potential Fed pivot, but overall investment-grade corporate yields are historically high since the Great Financial Crisis and outyield the level of high yield corporates from two years ago.

Figure 1. U.S. Corporate Bond Yields Remain Historically High

Bloomberg U.S. Corporate Bond Index YTW (yield-to-worst) and historic average, 31/12/2009-31/12/2023



Source: Bloomberg. Data as of 31/12/23. YTW=yield-to-worst. **Past performance is not a reliable indicator or guarantee of future results.** For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

While the risks of sticky inflation or an economic contraction remain, we believe that corporate fundamentals are entering the new year in a position of strength. Balance sheets are at healthy levels, and leverage remains relatively low, as corporate America has acted prudently over the last few years. Revenues have held up throughout 2023, and more importantly, companies have shown the ability to pass along higher costs to maintain margins. Therefore, we believe high-quality corporates are well prepared should the U.S. enter an economic slowdown or mild recession. One area we have been watching closely is interest-rate coverage, which has deteriorated somewhat with higher rates, but it's down from record levels in mid-2022 and still near long-term averages.

It is important to note that high-quality corporate bonds have historically performed well in recessions from a total return perspective, particularly if the Fed cuts rates to support the economy—although some of the returns from falling rates would be given back by wider spreads.

Positioning

As we enter the new year, we believe the front end of the credit curve is showing attractive relative value. While underperforming in 2023, the short end is almost unchanged from a year ago from a spread perspective, and we feel it represents one of the best segments of the curve from a risk/reward standpoint. In terms of technicals, we think that issuance may pick up in the new year, given lower rates relative to the last few months.

We maintain our up-in-quality, up-in-liquidity stance, given macroeconomic uncertainty. We believe many companies in the Utility sector are trading at compelling valuations, given elevated supply, to finance environmental initiatives, and we have been buying in at attractive spreads in this non-cyclical, highly regulated industry. We remain conservatively positioned in the financials sector, favoring U.S. money centers and European national champions. Larger European banks are particularly compelling as we feel that the resolution of the Credit Suisse overhang has not been fully priced in. The Energy sector also provides an attractive opportunity set, in our view, and we continue to focus on companies that are deleveraging with solid operating fundamentals.

Past Performance of Selected Indicies (calendar year)

	Bloomberg U.S. Corporate Bond Index	Bloomberg U.S. Aggregate Bond Index	Bloomberg U.S. Treasury Index	Bloomberg U.S. Treasury Bill Index
2023	8.52	5.53	4.05	5.13
2022	-15.76	-13.02	-12.46	1.30
2021	-1.04	-1.54	-2.32	0.05
2020	9.89	7.51	8.00	0.72
2019	14.54	8.72	6.86	2.34

NOTE: Return data expressed in percent. **Past performance is no indication or guarantee of future results.** Source: Bloomberg. Data as of 31/12/2023.

Unless otherwise noted, all discussions are based on U.S. markets and U.S. Important Information

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Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets.

No investing strategy can overcome all market volatility or guarantee future results.

The value of investments and any income from them is not guaranteed and may fall as well as rise, and an investor may not get back the amount originally invested. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon, and risk tolerance.

Market forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

Equity Investing Risks

The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

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Glossary & Index Definitions

The **U.S. Federal Reserve (Fed)** is the central bank of the United States. The federal funds (fed funds) rate is the target interest rate set by the Fed at which commercial banks borrow and lend their excess reserves to each other overnight.

Bloomberg U.S. Corporate Bond Index is the corporate component of the U.S. Credit index and is comprised of U.S. dollar-denominated, investment-grade corporate debt securities publicly issued in the U.S. domestic market and registered with the SEC (Securities Exchange Commission).

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

A **basis point** is one one-hundredth of a percentage point.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value. **Yield-to-worst** refers to the lesser of a bond's (a) yield-to-maturity or (b) the lowest yield-to-call calculated on each scheduled call date.

Bloomberg Index Information

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