What a Slowing Economy May Mean for Credit

In a preview of our 2022 Midyear Outlook, Lord Abbett Partner & Portfolio Manager Kewjin Yuoh assesses the fixed-income landscape amid recession concerns.

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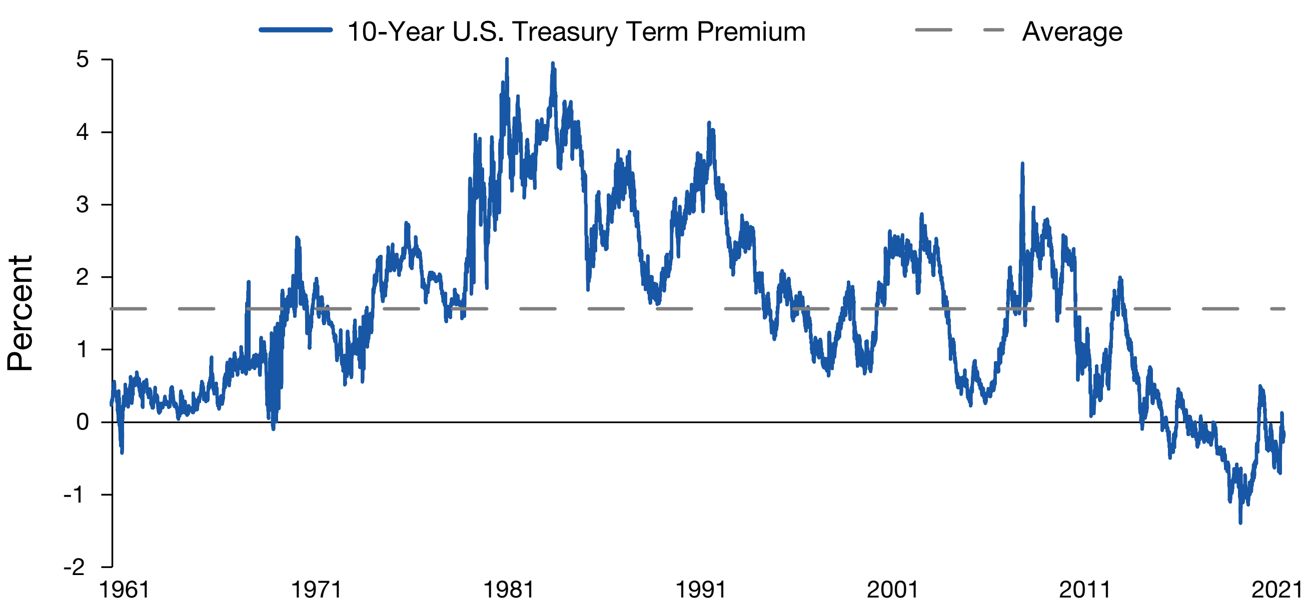
Figure 1. Term Premium Still a Long Way from Typical—and Potentially Set to Increase

10-year U.S. Treasury term premium for the period June 14, 1951-June 10, 2022



Source: Federal Reserve Bank of New York. As represented by ACMTP10. Data as of 06/10/2022. 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 and expenses, and are not available for direct investment.

Credit Outlook

Fixed-income investors faced a very challenging macroeconomic environment in the first half of 2022. Soaring inflation readings and the U.S. Federal Reserve's (Fed) pivot to a more restrictive stance induced a selloff paced by concerns over how quickly and aggressively the Fed would need to act to subdue inflation. Longer-duration bonds with more interest-rate sensitivity felt the brunt of the impact but short-maturity credit also declined on rate concerns.

We have entered this cycle of Fed tightening with relatively strong corporate balance sheets and a consumer base with significant liquidity built through COVID-driven fiscal support, housing wealth, and a continued tight labor market. And while this is supportive of economic momentum and growth, the potential for inflation persistence and increased Fed hawkishness mean that we must be wary of the increased probabilities of slowing economic growth and recession.

Most corporate high yield bond issuers entered 2022 with attractive credit metrics. Leverage ratios moved lower in the first quarter of 2022 following considerable declines in the previous three quarters, according to J.P. Morgan data. The credit profile of the high yield market also suggests a relatively benign default environment for the rest of 2022, which we believe is appropriate given the lack of a near-term maturity wall and overall corporate and consumer health. However, as long as uncertainty remains in the marketplace, performance for more levered companies may remain quite volatile.

The backdrop for bank loans represents a similar risk profile: the asset class offered the potential for rising income as floating-rate coupons adjusted to reflect rising benchmark rates, which was a positive technical factor which benefited the sector early in the year—limited interest-rate sensitivity in a rising-rate environment. But as expectations of rate hikes change and become larger, as evidenced by Bloomberg data on fed funds futures, the bank loan market has suffered from increased expectation of recession and attendant decline in credit fundamentals.

Credit risk valuations have widened, but in our view are not pricing in a worst-case scenario or hard landing. Given the many uncertainties around inflation, rates, and Fed policy, the near-term path for credit is also uncertain. While investors are likely to recoup any credit investments over time, given the still-benign outlook for defaults even in a hard landing scenario, we favor credit risk in certain higher-quality areas, where we believe valuations are more favorable. Current examples of these opportunities include investment-grade corporate debt and AAA-rated asset-backed securities, which offer high levels of liquidity and are better protected from market volatility.

In addition, term premium–the amount investors expect to be compensated for lending for longer periods–remains far from typical levels. (See Figure 1, first page.) A reversal in term premium, as investors demand higher yields to adjust for inflation risk on longer-maturity bonds, may potentially result in a continued environment of challenging absolute returns for longer-duration assets.

Register now to hear a replay of our June 22 webinar in which Kewjin Yuoh and other Lord Abbett investment leaders discuss the 2022 Midyear Outlook.

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

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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

Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

A **basis point i**s one one-hundredth of a percentage point.

Hawkish/dovish monetary policy: "Hawk" is a term for policymakers and advisors who favor higher interest rates to keep inflation in check. "Doves" prefer an interest rate policy that is more accommodative in order to stimulate spending in an economy.

A **debt maturity wall** refers to the total amount of debt that will mature during a specific period.

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.

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. Fed funds futures are derivatives based on the federal funds rate, and are traded on the Chicago Mercantile Exchange and are cash settled on a monthly basis.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates.

Higher/lower quality debt securities: Bonds with investment grade credit ratings (see definitions under "Fixed Income Investing Risks") are commonly referred to as "higher quality," while those with below-investment grade ratings are referred to as "lower quality."

A **leverage ratio** is a metric that expresses the degree to which a company's operations are funded by debt (borrowed capital).

Securitized products (also known as structured products) are pools of financial assets that are brought together to create a new security, which is then divided and sold to investors.

Term premium is a gauge of the level of risk inherent in holding a longer-term bond versus a series of shorter-term securities.

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