

Corporate bond market eyes rate cuts as spreads drop

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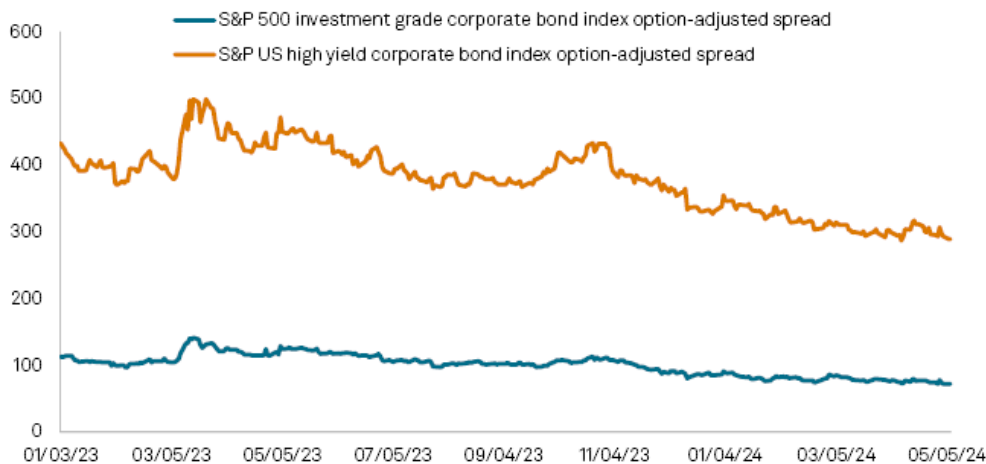
Corporate bond spreads are contracting as investors eye cuts to benchmark interest rates later this year.

The option-adjusted spread in the S&P investment-grade bond index stood at 72 basis points May 7, its lowest reading since the index's launch date in 2015 and down 14 points year to date. The spread measures the difference in premiums paid to investors in corporate debt rather than government debt. For riskier high-yield debt, the spread was 289 bps May 7, the lowest in nearly three years and 49 bps lower than the start of the year.

The contraction comes amid relatively stable yields in both categories of corporate bonds that are below their recent highs, indicating less pressure on companies' borrowing costs. Rising US Treasury yields have also contributed to declining spreads as investors have pushed back expectations of rate cuts until later in the year.

"With the exception of a few sectors that are being driven by inflation concerns, tightening US corporate bond spreads [suggest] investors are not too concerned about higher for longer [rates] and the impact on overall credit quality," said John Polinski, vice president in the international fixed income group at Federated Hermes Inc.

Spreads on high-yield and investment-grade bonds have been declining (basis points)



Data as of May 7, 2024.
Source: S&P Dow Jones Indices.
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Corporate borrowing resilience

The most intense recent pressure on corporate borrowing costs has waned as benchmark interest rates have held steady for nearly a year.

The yield on the S&P 500 Investment Grade Corporate Bond Index settled at 5.52% on May 7, down from a recent peak at 6.35% on Oct. 19, 2023. Speculative-grade bond yields have also fallen compared to October levels but have seen minimal movement since the beginning of the year. The S&P US High Yield Corporate Bond Index settled at 7.91% on May 7, down from 9.7% on Oct. 20, 2023, but just slightly above 7.87% on Jan. 2.

Higher rated corporate bond yields have dropped from October peak

S&P 500 investment grade corporate bond index (%)



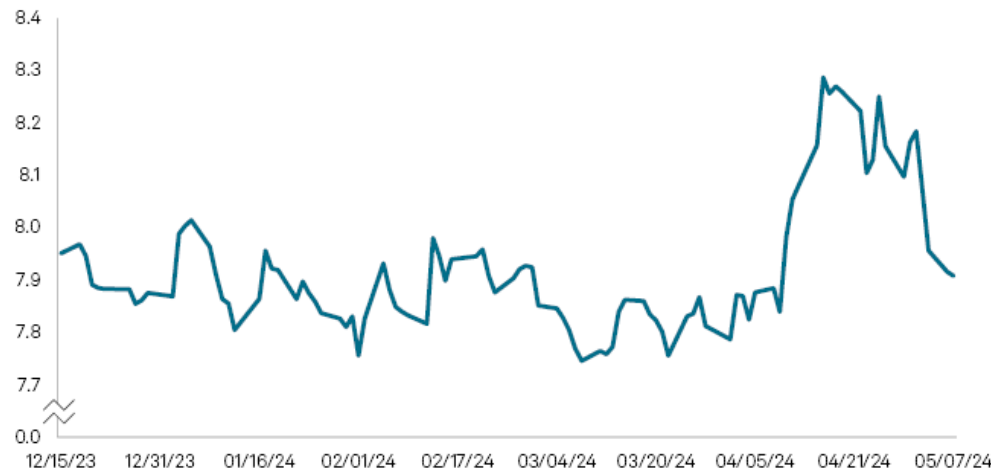
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Yields move opposite to bond prices. The run-up in yields coincided with the Federal Reserve's push to raise benchmark interest rates by 525 bps from March 2022 to July 2023.

"Many corporations have been able to withstand the rise in borrowing costs given the resilient US economy and rise in corporate profits," said Collin Martin, director and fixed income strategist at the Schwab Center for Financial Research.

High-yield bond yields have stagnated since mid-December 2023

S&P US high yield corporate bond index (%)



Data as of May 7, 2024.
 Source: S&P Dow Jones Indices.
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A rise in new debt also shows that companies have largely taken higher borrowing costs in stride. Nonfinancial bond issuance was up more than 20% in the first quarter of 2024 compared to a year earlier, according to S&P Global Ratings.

"Bond issuance has been fairly buoyant in recent months," said Gavan Nolan, executive director, fixed income pricing and research at S&P Global Market Intelligence. "Even with changing rate cut expectations, corporates have been locking in lower refinancing rates compared to where they were a few months ago."

Rate cut expectations signal potential widening ahead

Rising yields on US government debt, driven by the Fed's interest rate hikes, have underpinned much of the increase in corporate bond yields.

The yield on the benchmark 10-year Treasury bond settled at 4.47% May 7, down from its peak at 4.98% on Oct. 19, 2023, yet up from 3.95% at the start of the year. Yields have been rising as the expected timing of the Fed's interest rate cuts moves to later in the year due to [hotter-than-expected inflation](#) and employment data.

Benchmark government bond yield has steadily increased since the start of the year

US Treasury 10-year bond yield (%)



Data as of May 7, 2024.

Source: S&P Global Market Intelligence.

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"This significant tightening of credit spreads over the past six months can be attributed more to anticipation of interest rate cuts than to changes in credit risk," said Althea Spinozzi, head of fixed income strategy at Saxo Bank.

Credit spreads could fall even further if the US economy achieves a [soft landing](#), steering clear of a recession even in the face of high interest rates. Still, a widening is likelier in the near term, said Spinozzi.

"With the Federal Reserve maintaining rates on hold and the economic activity showing signs of deceleration, it's prudent to anticipate a widening of credit spreads," said Spinozzi. "Yields in the credit sector could rise to levels akin to those witnessed last autumn, given their sensitivity to rising US Treasury yields and the broader macroeconomic landscape."

Any widening in credit spreads would have the greatest impact on riskier high-yield corporate bonds.

"If the economy begins to slow, then spreads should rise a little bit, but we think any rise in investment grade spreads should be relatively limited," said Martin with the Schwab Center for Financial Research.

In the meantime, investor confidence remains a bright spot for corporate borrowing.

"The corporate bond market is strong today," said Martin. "We don't expect yields to rise to October levels based on our outlook for Treasury yields and our expectation for the next move by the Fed to be a cut."

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