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Dynamics and Opportunities of Investment-Grade Credit in 2022

While yields are likely to continue rising, credit fundamentals in the investment-grade market look strong. Earnings and balance sheets look healthy, and higher yields could attract institutional investors.

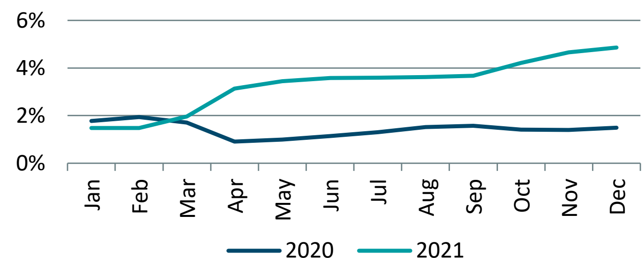
Executive summary

_ Inflation recently hit a 40-year high and is no longer considered "transitory." In response, the Federal Reserve and other central banks have shifted to a tightening stance with several increases expected this year.
_ Yields in the rates market have risen as a result of rising inflation, and yields are expected to continue climbing in the investment-grade market as well.
_ Credit fundamentals in the investment-grade market appear strong, and companies would appear to have plenty of financial flexibility. How they will use this flexibility remains to be seen, but some increase in M&A activity would seem most likely.
_ Supply and demand factors are likely to have a significant effect on the investment-grade market in 2022. New supply could reach the record level of 2021, and supply will also be augmented by "rising stars" migrating up from high-yield status.
_ Demand will likely be hindered by high hedging costs for international investors. It may also be weakened by the near-absence of negative-yielding sovereign debt in the global market. Higher yields in non-U.S. markets could be an attractive alternative to U.S. investment-grade debt.
_ But demand could benefit from higher yields in the U.S. investment-grade market, which could present an opportunity for institutional investors who need to employ liability matching programs and strategies.

Inflation: Not transitory

In February 2022, the Bureau of Labor Statistics reported that inflation, as measured by the Consumer Price Index

CORE INFLATION HAS SOARED — AND PERSISTED



Source: St. Louis Federal Reserve, FRED Database, Personal Consumption Expenditures excluding food and energy (Chain-type Price Index).

(CPI), accelerated to a 7.5% annualized rate in January 2022, a 40-year high. Prices for food, electricity, and housing were the largest contributors to the rise. The latest increase continues a trend that began in April 2021, when the CPI jumped to an annualized rate of 4.2%.

The Fed's preferred measure of inflation is the core Personal Consumption Expenditure (PCE) Index, which excludes volatile food and energy prices. The core PCE has increased, jumping from 2.0% in March 2021 to 3.1% in April 2021 and climbing steadily to 4.9% in December 2021.

The "Powell Pivot"

In response, Federal Reserve Chairman Jerome Powell has acknowledged that inflationary pressures are no longer "transitory," and officials have indicated that increases in the federal funds rate are coming in 2022. But this "Powell Pivot" is not unique to the Fed as the rise in inflation is not present just in the U.S. but also overseas, resulting in a shift in thinking from those Central Banks as well.

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These concerns about inflation have worsened in recent months, in part due to stronger-than-expected employment data. New jobs totaled 467,000 in January 2022, easily surpassing the median forecast of 150,000.

This data is contributing further to a belief that inflation is not transitory. It remains uncertain how long pricing pressures will persist, but we have all seen inflation in our personal lives, and economists now believe that serious, persistent inflation is here.

In response to rising prices the market appears to be starting to factor in various sizes and pace of future Fed rate hikes. Furthermore, we are seeing a significant lift in yields on longer-duration assets; the reaction to inflation data released in February, which surprised to the upside, saw the yield on the Two-year Treasury note break 150 basis points and the yield on the 10-year Treasury temporarily exceeding 2%.

Fundamentals looking strong

Based on DWS's analysis, credit fundamentals in the investment-grade market appear healthy. Earnings have been strong, and we have not seen too much credit damage. That is, we have not seen any leveraging or other trends that are diluting credit holders although there is some growing concern that we could see some more leveraged M&A activity.

During the pandemic, companies engaged in significant deleveraging, and leverage has come down considerably meaning that corporate financial flexibility is strong. The question is, how will companies manage that flexibility? Will they put it into capital expenditures and organic growth, or will they opt for external growth, that is, mergers and acquisitions? And will these transactions be bolt-on acquisitions, or will they be mergers or larger acquisitions?

What we hear from our credit analysts is that "everyone is looking," but high equity valuations are another factor to consider. Therefore, companies may opt to use their cash in another way, such as stock buybacks.

How the supply/demand dynamic can impact yields?

While credit fundamentals appear strong, investor should also be very mindful of the role technical factors can have this year. Supply has been robust, with 2021 being a record year, and the expectation is that 2022 may be strong as well.

Ratings upgrades could also affect supply. The number of "rising stars"–companies moving from the high-yield market into investment-grade–is likely to be larger than the number that dropped from investment-grade into high-yield status during the pandemic. These rising stars would, therefore, be a hidden source of supply, and demand for investment-grade bonds will need to be quite strong to absorb the new issue supply along with the supply coming from rising stars.

While demand has been strong, the sentiment is that yields will be going higher. Investors should take note of several factors affecting demand. First, hedging costs are going up. So, the appeal of investment-grade bonds to foreign investors who need to hedge their exposure to the U.S. Dollar may be hindered by these hedging costs. Consequently, we do expect some softening of this source of demand.

Second, while it was not that long ago that large portions of the global fixed-income market had negative yields, that has been dissipating. Real yields on 10-year sovereign bonds are flirting with positive territory (as of the middle of February 2022). Subsequently, the amount of debt in the market that carries a negative real yield is coming down. This creates an alternative to U.S. Dollar debt, potentially decreasing the demand for investment-grade bonds from non-U.S. investor set.

This could in turn, however, prove to be a "silver lining." Given the supply and demand dynamics mentioned, DWS's view is that this could increase yield on credit and in turn bring other investors to the market. The asset class has a dedicated investor base comprised of a large number of institutional and pension plan investors. Given the forecasts of creditworthiness and higher yields, interest can be rekindled from longer-dated bond holders, such as insurers or even certain pensions looking for liability matching options, as they seek higher-quality options.

When might investors take advantage of that opportunity? That will depend on the volatility of the market, their inflation expectations, and view on the future path of interest rates. From our March 2022 vantage point, the most likely scenario where institutional investment criteria and yield opportunities converge will be in the second half of the year.

Conclusion

The investment-grade credit market is not immune to the headwinds facing the bond market in the near future. Inflation, rate hikes by the Fed, and a migration of alternative credit options will weigh on the asset class. Nevertheless, credit fundamentals look strong, and the market is likely to benefit as a rise in yields increasingly draws institutional investors into the market.

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