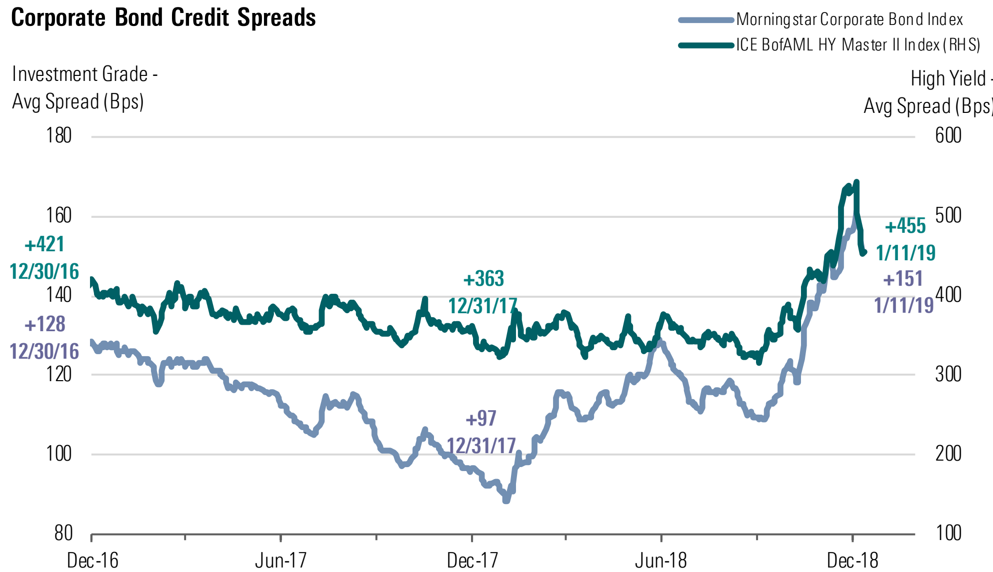
Corporate Bond Markets Rebound in New Year

Morningstar Credit Ratings, LLC
14 January 2019

Dave Sekera, CFA
Managing Director
david.sekera@morningstar.com
+1 312 696-6293

Risk assets surged higher last week as investors returned from holiday vacations and put cash to work. In the equity markets, indexes rose across both the developed and emerging markets, with the S&P 500 rising 2.52%. Among the industrial commodities, oil increased by over $3 per barrel and copper rose by $0.02 per pound. In the corporate bond market, the average spread of the Morningstar Corporate Bond Index tightened 8 basis points to +151 and the average credit spread of the ICE BofAML High Yield Master Index gapped 50 basis points tighter to +455.

Corporate Bond Credit Spreads



Source: Morningstar, Inc., ICE BofAML Global Indexes. Data as of 01/11/2019

The volatility in the corporate bond market that surged at the end of last year has settled down and the dislocations across trading levels that occurred during the November/December sell-off have largely corrected. Trading activity has normalized toward historical averages, and for the most part, corporate bond traders have cleaned up their books. The new-issue calendar is expected to spring back to life this week and should continue to build as issuers report year-end earnings and exit quiet periods. A large portion of the expected new issuance may be brought to market in conjunction with tender offers for short-term debt. The combination of a flat yield curve and the pullback in long-term interest rates late last year have provided companies with an attractive opportunity to extend their debt maturities. Because of the flat yield curve, issuers are able to tender for short-term bonds at interest rates that are not that much lower than where they can refinance these bonds with long-term debt.

Yield Curve Continues to Flatten as Rates Bounce

As risk assets rose, investors no longer felt the need to hide in the safety of U.S. Treasuries, and interest rates rose slightly as prices softened. The yields on the 2-year, 5-year, 10-year, and 30-year U.S. Treasury bonds rose 5, 2, 3, and 5 basis points, respectively. The yield curve continued its multiyear flattening trend, and the spread between the 2-year and 10-year Treasury bonds dropped to 16 basis points, rivaling its lowest levels since before the credit crisis.

10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity

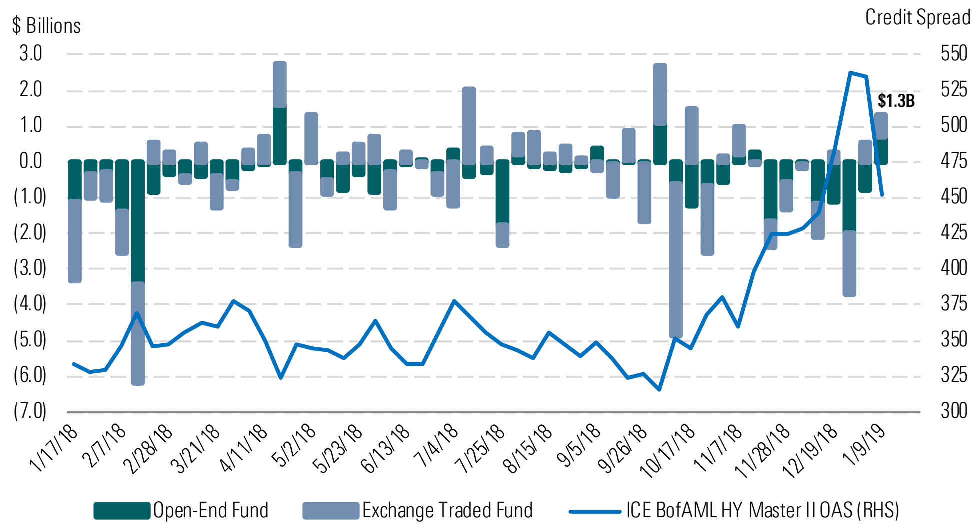
Source: Federal Reserve of St. Louis and Bloomberg. Data as of 1/10/2019.

Although interest rates bounced slightly higher as risk assets recovered, the sell-off late last year has led to a dramatic shift in expectations in the amount that the Federal Reserve will hike the federal-funds rate in 2019. According to the CME's FedWatch Tool, the market-implied probability that the federal-funds rate will end 2019 unchanged at the current range of 2.25%-2.50% is 71% compared with a 35% probability one month ago. Currently, there is only a 14% probability that the Fed will hike short-term rates over the course of the year, whereas last month there was a 56% probability that the Fed would increase rates at least once. The most dramatic change is that the market has become much more concerned that weak economic activity or a slide in inflation would lead the Fed to reverse course and reduce interest rates. The probability that the Fed will cut interest rates this year has increased to 14% from only 8%.

Weekly High Yield Fund Flows

As asset volatility dwindled and equity markets surged higher, investors were attracted to the wide credit spreads offered by junk bonds and flocked back into the high-yield asset class last week. Overall, $1.3 billion of funds were allocated to the high-yield space as net inflows into open-end mutual funds registered $0.7 billion and net new unit creation across exchange-traded funds totaled $0.6 billion.

Estimated Weekly High-Yield Bond Fund Flows and High Yield Credit Spreads



Source: Morningstar, Inc. and ICE BofAML Global Indexes.

Morningstar® Credit Research

For More Information
Todd Serpico
+1 312 384-5488
todd.serpico@morningstar.com

22 West Washington Street
Chicago, IL 60602 USA