AXA Investment Managers

MARKETING COMMUNICATION
Capital at risk

US Investment Grade Outlook

The backdrop for US Investment Grade (IG) credit in 2023 has been dominated by the market's underestimation for the peak in interest rates. At the end of 2022, the December 2023 Fed Funds futures contract pointed to a Fed Funds rate of 4.5% – a full 100bps from where the actual Fed Funds rate sits at the end of 2023.

USD (H) Currency	2023 Total Return (As of December 31st, 2023)	2023 Q4 Total Return (As of December 31st, 2023)	Yield to Worst (As of Jaunary 3rd, 2024)	Option Adjusted Spread (As of Jaunary 3rd, 2024)
US Corporates BBB Rated	9.46	8.24	5.47	134
Bloomberg US Corporate	8.52	8.50	5.17	105
US Corporates 1-10 yrs	7.34	5.56	5.16	102
Bloomberg US Corporate Intermediate	7.29	5.86	5.09	97
US Corporates 1-3 yrs	5.61	3.30	5.25	80
Bloomberg US Aggregate	5.53	6.82	4.61	44
US Treasury 10 year	2.83	6.60	3.90	1

Source: ICE BofA, Bloomberg

The failure to anticipate both the higher peak and "higher for longer" narrative that was behind October's steep increase to the risk-free rate, led to negative returns for US treasuries in Q2 and Q3. For US IG credit, however, 2023 has been a good return year – driven for the most part by higher coupon income at the front-end until a strong rally into year-end saw price return turn from negative as of October into a significant positive contributor for the full year's return. For corporates, although higher rates have put pressure on financing costs, leading to a decline in interest coverage ratios, EBITDA growth has remained relatively stable – buoyed by a resilient US economy and stronger labour market than many were predicting heading into 2023.

After recording two consecutive negative return years for the first time, a positive year in 2023 for US corporate bonds sets the stage for a more favourable environment for credit investing moving forward. With an increasing consensus that US growth should remain positive, inflation should continue to fall and interest rate cuts are likely, 2024 could be another good year for corporate bonds.

US Investment Grade key focus points for 2024

It starts with the macro…

In 2024, we expect US economic growth to moderately decelerate as the US Federal Reserve (Fed) tightening leads to tighter credit conditions, particularly showing up in the banking system. We believe that we have likely seen the end of the Fed tightening cycle, with the Fed itself signaling at the end of 2023 that rate cuts are expected in 2024. While much will depend on the timing and extent of future cuts, thecombination of still attractive yields and potential price appreciation in the event of rate cuts should lead to a much improved macro backdrop for credit.

1 The risk of higher rates has diminished

Our base case macro forecast is for a soft landing in the US, having revised up our expectations for growth in 2023 – in line with cooling inflation and a resilient labor market. This should be supportive of sentiment and corporate spreads while, in turn, allowing the Fed room to start cutting rates in the second half of the year. While risks to inflation remain, notably if the US economy remains too hot, the macro winds have shifted towards lower rates once more.

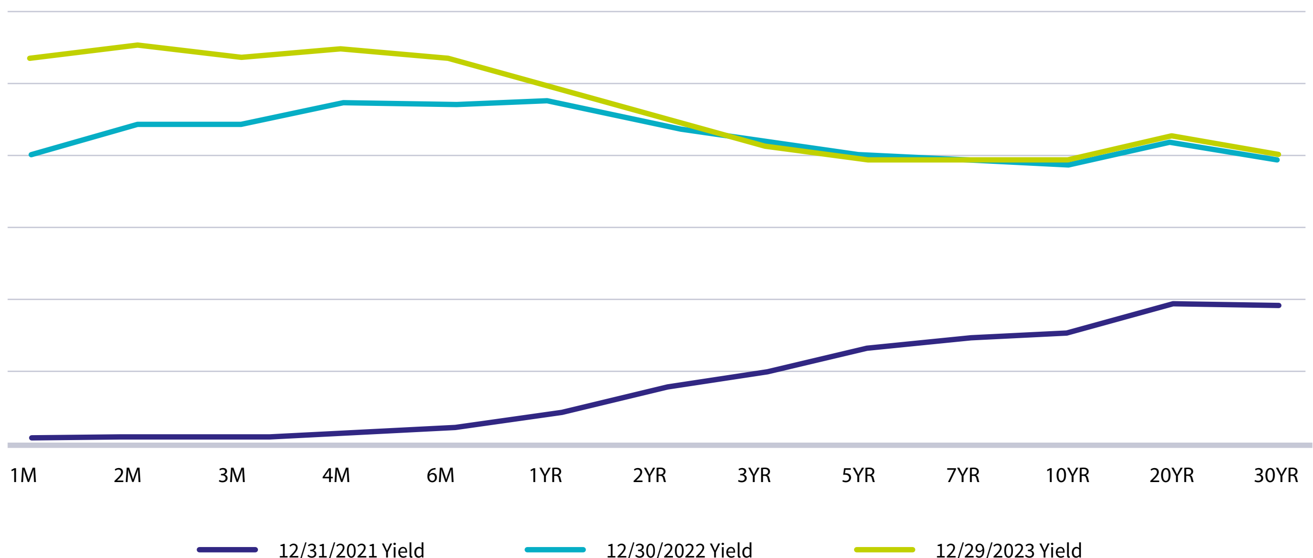
2 Higher for longer should make a return

After a strong bond rally into 2023 year-end, questions are being asked whether the "higher for longer" narrative communicated by the Fed in October is already dead. We expect that market pricing for rate cuts in the early part of 2024 may have gone too far. The risk of a Fed policy error remains prevalent if it is unable to effectively signal when it expects to start cutting interest rates and to what extent, given that inflation is likely to remain above its 2% target for the time being.

3 All eyes on the yield curve

The yield curve remains inverted despite briefly steepening in October, ending 2023 even more inverted than it started. For 2024, the relative attractiveness of the front end for carry will remain a theme, with shorter duration credit still out yielding long duration. However, further out the curve, despite a lower starting yield, extending duration will likely make sense at some stage if the Fed is cutting rates, which should lead to a fall at the front end. While short duration strategies should continue to deliver positive returns in this scenario, intermediate and full duration strategies will look more attractive, with potential for greater price appreciation in addition to coupon income.

US Treasury Cuve: 2021, 2022 and 2023



But sector trends and corporate fundamentals warrant close attention

Despite higher financing costs, US IG corporate fundamentals remain in decent shape and the maturity wall for refinancings remains manageable. That said, we expect dispersion across sectors and individual issuers to pick up in 2024 as corporates feel the effects of a slowing economy at different times. Key themes to watch in 2024 will be:

- ### Banking stabilization, but still uncertainty ahead

  After a volatile year for the Banking sector in 2023, recent earnings reports confirmed a more stable environment with deposit bases holding up after the collapse of several US regional banks in the first half of 2023. That said, we expect that profitability across the sector may witness pressure in 2024 from higher rates and a slowing economy, together with an uncertain impact from expected regulatory changes relating to long-term debt funding.

- ### Uneven sector trends

  Away from Banking, we continue to see varying sector trends in line with our view that a US economic slowdown should be an uneven one across sectors and industries. In this environment, defensive sectors (e.g. Telecoms, Healthcare, Utilities) should continue to offer stability and some value, whilst more cyclical sectors (e.g. Retail, Capital Goods, Leisure) may suffer from declining operating trends as the fight for the consumer wallet intensifies.

- ### A high focus on analyzing mixed company earnings and EBITDA

  After strong momentum in recent years, EBITDA growth has moderated in line with tightening conditions for corporates. A selective, bottom-up approach to portfolio construction will be crucial in identifying companies that have strong balance sheets heading into a period of weaker growth and are able to adjust their capital structures to the higher rate environment. On the flip side, there will be an increase in companies suffering from margin pressure who are unable to reduce the quantum of debt on their balance sheets to keep interest cost at similar levels to when rates were low. We expect leverage trends to remain at healthy levels and below long-term averages, although some further deterioration is anticipated.

- ### Credit rating trends to remain positive but possibly losing some steam

  The US IG market continues to benefit from positive rating momentum after 2023 where total upgrade volumes vastly exceeded downgrades. Rising stars from the HY market has remained an important theme, notably with the upgrade of Ford, the largest issuer in the US HY market, upgraded to IG towards year-end. At the same time, fallen angel activity has remained muted. After record years of rising stars, we anticipate that 2024 might see a quieter period for upwards rating momentum, although we do not expect tighter conditions to lead to a wave of downgrades and fallen angels.

Technical factors are likely to remain supportive in US IG

- ### Less supply from higher borrowing costs to support technicals

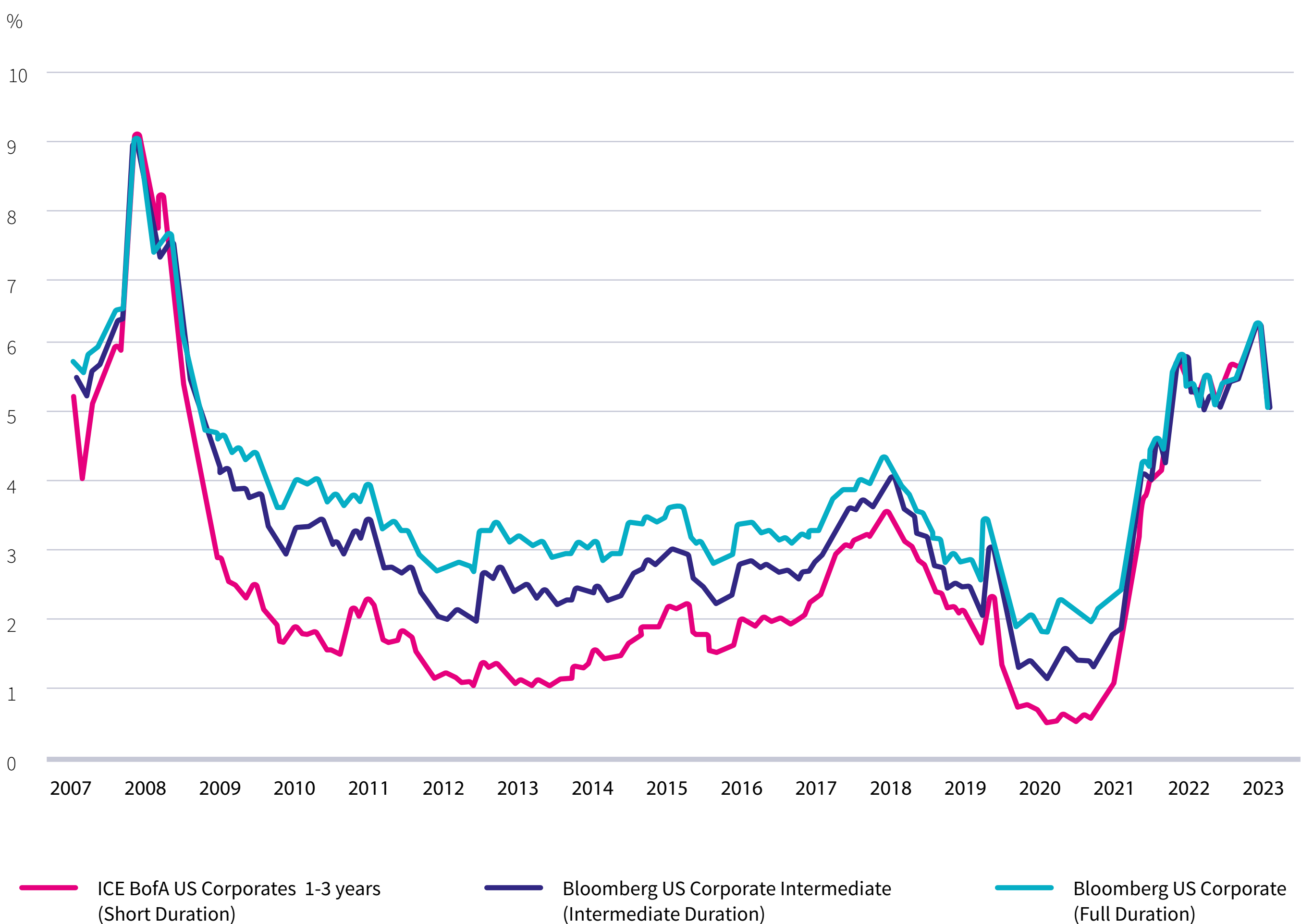
  Primary market forecasts for 2024 are on average down 0-10% on a net basis, although we may see some front loading to start 2024 following the positive rate move in Q4 2023. A pick-up in Financial issuance is expected given near term stability and regulatory changes, but this is likely to be offset by a decrease in non-Financial issuance as corporates grapple with higher borrowing costs. At the same time, we anticipate that a more stable rate environment should encourage potential flows into the asset class, influenced by better yield and return forecasts, thus providing a positive technical momentum. We expect liquidity to remain momentum-driven with wider bid-ask spreads and more off-the-run discounts.

Tighter spreads make valuation assessment tricky, but positive carry will remain a powerful driver of returns

• Valuations mixed but yields still attractive

US IG spreads surprised many and tightened over 2023 to end the year 36bps narrower than they started. However, due to the increase in the risk-free rate, the yield on the broad US IG Corporate Index is still 276bps higher than the immediate pre-Covid level[1] and trading in a range of 5-6% – not seen since 2009. Investors also get more yield and less duration in corporate bonds relative to underlying government bonds in the same maturity bucket. With money market rates set to decline in 2024 in line with lower rate expectations, entry points into US IG credit therefore remain attractive on a relative basis, even if a more cautious view on spreads is warranted. The biggest threat comes from a worse than expected growth environment, which could see spreads widen out further than we anticipate, although in this scenario credit returns should be supported by a lowering to the risk-free rate.

Yield Evolution of US IG Short, Intermediate & Full Duration Indices



1: Source: ICE BofA. Defined as February 28, 2020, compared to equivalent yield-to-worst as of January 3, 2024.

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