RBC BlueBay
Asset Management

Where can investors find returns, as Fed rate cuts edge nearer?

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Markets anticipate Federal Reserve rate cuts later in 2024 as recession fears fade and inflation is likely to moderate further. Strong financial position of investment grade issuers should spur demand for credit. Despite valuations looking less appealing than they once were, investors can still find pockets of value in the asset class, says Andrzej Skiba.

With the fear of recession firmly in the rearview mirror, investor focus shifted towards incoming inflation data. With US inflation moderating over the course of the recent months, markets are now expecting the Federal Reserve to cut interest rates in the latter half of this year.

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While comparatively high level of interest rates may persist for longer and potentially trigger an economic slowdown, the underlying financial health of investment grade issuers, including those that are more growth sensitive, is expected to stay strong.

The more clarity that investors have that the Fed will be normalising policy – keeping in mind that we are deeply in restrictive territory and there is a long way to go to what normal rates should be – the more they will be more strongly incentivised to move out of short duration securities and further out the curve.

Indeed, adding to duration exposure is one of the keyways that investment grade credit investors can see forward returns increase from roughly mid-single digits to potential double-digits. As they become increasingly comfortable with the prospect of regular rate cuts and believe that interest rates will not stay at elevated levels, so the demand for credit will rise. We are already seeing evidence of this in the form of consistent positive inflows into the asset class.

Potential for strong returns requires synergy between rates and credit

A repeat of the stronger returns investors saw at the end of 2023 could be a possibility over the next 12 months, but spreads and rates need to co-operate. Without a rally in government bond yields, it will be very difficult to achieve those double-digit returns. However, if rate cuts materialize and Treasuries move towards 4% across the curve, that will be sufficient to generate those strong double-digit returns.

Additionally, investors will need to see some modest spread tightening of around 10-15bps. Spreads have already rallied quite a long way, so expecting more may be difficult. However, we see multiple pockets of value that together should be sufficient to create an environment where spread tightening is sufficient.

Most prominent among these, we see a scope for tightening to happen within the financials space because, compared to non-financials, senior US financials are trading at levels that are wide by historical standards. While there is a lot of cautious debate around US regional banks, this is a relatively small portion of the US bank complex, and we believe the fears are overstated.

"Additionally, in a busy primary issuance market, active managers can generate value by identifying attractively priced offerings."

There is also value and opportunity in the media and technology sector, where we see many cash-generative companies with solid balance sheets. Currently, spreads are trading wider than their ratings would imply. While TMT has already been a good performer over the recent months, we expect further normalisation and still see some value within the segment, especially compared to many growth-sensitive industrial issuers.

Finally, we see in the subordinated debt of investment grade rated issuers. As generic spreads rally, we expect that investors will look to add exposure to subordinated debt of these issuers because they can often lock in better yields compared to identically rated generic high yield offerings.

Whether that is in the corporate hybrid space or subordinated financials space, there is scope for spreads between senior and subordinated bonds to compress over the coming months, as the market is reflecting on the resiliency of many of these investment grade credits.

Passive investing is leaving returns on the table

As generic spreads become less enticing, active managers can help boost returns by avoiding areas of the market where valuations are complacent and instead focusing attention on pockets of value that are bound to outperform the market. This stands in contrast to passive solutions, which are very unlikely to deliver meaningful returns from spread tightening opportunities.

Additionally, in a busy primary issuance market, active managers can generate value by identifying attractively priced offerings. The primary market for investment grade issuers has been particularly busy across both developed and emerging markets, and that also gives investors the opportunity to gain exposure to new names that have spread tightening potential and can help generate alpha.

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