Key Questions

January 11, 2022

# The Fed is Nervous About Inflation. Should you be Nervous About Your Bond Portfolio?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

The Fed is poised to raise interest rates and remove liquidity as the bond market has become riskier and more sensitive to interest rates. In this environment, careful security selection, robust monitoring and hands on portfolio management are necessary ingredients to bond investors' future success.

Since the global financial crisis in 2008, there has been an unprecedented amount of stimulus supporting the markets. At the same time, interest rates have remained very low. As a result, large amounts of debt have been issued. Moreover, issuers willingly accept a lower credit rating that typically accompanies increased levels of indebtedness because they are no longer being penalized when their credit ratings slip.

The result has been a pronounced shift in the overall makeup of the U.S. corporate bond universe regarding credit quality, duration, and interest rate sensitivity over the last ten years. The table below shows that the number of AA- and A-rated issues have declined, while BBB-rated issues have grown to over 50 percent of the corporate bond market. The table also illustrates that the duration of the corporate bond market increased from 6.75 to 8.64 years[1].

| US Corporate Bond Market Sliced by Credit Quality | Weighting as of October 2011 | Weighting as of October 2021 |
|---|---|---|
| AAA | 1.17% | 1.48% |
| AA | 13.81% | 7.03% |
| A | 48.41% | 36.11% |
| BBB | 36.27% | 54.33% |
| Duration (years) | 6.75 | 8.64 |

Source: Bloomberg LUACTRUU index

Will this trend continue?

One place to look to see if this trend will continue is in the new-issue market. Out of the $1.41 trillion in new issuance in 2021, 53 percent of the new issues have been in the BBB space. This compares to 2020's new issuance of $1.8 trillion with 49 percent in the BBB space.

Do we see a substantial increase in yields when we move from A- to BBB-rated securities?

BBB-rated securities offer investors the opportunity to gain additional yield when compared to higher-rated securities. The additional yield is commensurate with the wider credit spreads associated with BBB-rated securities. However, the market has seen a steady tightening of the spread differential between A- and BBB-rated securities over the past two years. In 2019, an additional 50 basis points could be achieved when moving from A- to BBB-rated issues. 2020 was an interesting year, to say the least, but in March of 2020, A to BBB spreads widened out to around 130 basis points. This quickly contracted, and by the end of 2020, the spread between A- and BBB-rated credits fell to 40 basis points. Today that spread is around 30 basis points on average for issues in the two-to-10-year maturity range.

### Will we see more volatility in the BBB sector versus the A sector?

Even though we know that the spread between A and BBB credits has been contracting over the last few years, the question becomes whether BBB issues are more volatile than A-rated ones. For that, we look at the month-over-month change of A-rated spreads and BBB-rated spreads. Here, the month-over-month change in both A-rated and BBB-rated spreads is very consistent and maintains very low volatility. Where we saw this deviate was in early 2020 when spreads on both A-rated and BBB-rated securities widened significantly due to the difficulties faced at the beginning of COVID-19. Volatility spiked in March of 2020, during this spread widening, but regained its low levels as spreads tightened to their pre-March 2020 levels. The takeaway from this is that there is little to no increase in volatility when you move from A to BBB issues.

### What types of issuers are included in the BBB space?

One common misconception is that the BBB-rated section of the broad investment grade market comprises obscure and illiquid issuers. However, many large well-known issuers comprise the bulk of the $4.4 trillion BBB market. Over the past eight years, we have seen 10 extremely large issuers migrate into the BBB bucket, with half of those making the move to BBB since early 2020. These are large multi-national companies within the telecommunications, financial services, consumer goods, and technology sectors. These 10 issuers also make up a large portion of the broad investment grade market, and their current outstanding debt makes up roughly 12 percent of the entire investment grade market.

Despite the attractive attributes of BBB-rated securities, we reiterate that investors also need to recognize that they can entail additional risk. These risks could become apparent in light of recent changes in policy expressed by the Federal Reserve. More specifically, later this year, the Fed is planning on removing stimulus injected into the economy at the height of the pandemic, and also raise interest rates in order to quell incipient inflation pressures. As such, bonds could become volatile, further placing a premium on security selection and hands on management. These attributes are hallmarks of our process and should continue to serve our clients well.

For more information, please contact your advisor.



Publish Date: January 11, 2022

1 - A duration of 8.64 years implies that for a 1 percent increase in interest rates, one's bond portfolio would fall 8.64 percent. Conversely, for a 1 percent decrease in interest rates, one's bond portfolio would rise by 8.64 percent. As the duration of the overall bond market has increased, the market has become more sensitive to fluctuations in interest rates.



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