A New Dynamic in the Bond Market

Bonds are offering more yield, but companies are facing record debt. To benefit, investors need to be selective.

For more than a decade, the bond market operated in an extraordinary environment with interest rates hovering near zero percent. Those attractive rates led corporate borrowers and governments to take on record amounts of debt, but forced investors to accept low yields or take on more risk.

Today, it's a whole new world. A dramatic spike in interest rates has meant higher costs for government and corporate borrowers. This changed dynamic will create opportunities for — and present risks to — fixed income investors. While investors can potentially find more income from fixed income, the market could see more downgrades and rising defaults as issuers struggle with the rising cost of their debt burden. "Across the credit marketplace, today's environment leaves less margin for error," says Brian Funk, global head of private capital at MetLife Investment Management. "I believe we will see more volatility — and there will be winners and losers. If you are not careful, that can create problems, but if you are being thoughtful, this environment is attractive for bond investors."

More Debt, Higher Rates

After the financial crisis of 2008, policymakers engaged in an unprecedented campaign of low rates to support the economy. Rates spent 13 years

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near zero with sovereign and corporate bonds at times offering negative yields. For governments and companies, it was a unique opportunity to access capital and lower debt service costs.

"For more than a decade, the best strategy for companies was to take on as much debt as possible, since the borrowing cost was so low," Funk says.

Indeed, that's what happened: Government debt reached $26 trillion in 2023, equaling roughly 96% of GDP, the highest level since World War II. Under present law, the Congressional Budget Office projects that ratio will reach 166% of GDP in 2054. Corporate debt issuance also rose, with the corporate bond market growing from $5 trillion to more than $10 trillion from 2008 to 2021.[1]

Then came the Fed's aggressive rate hiking cycle. Designed to slow inflation, the rapid change in borrowing rates changed the math for bond issuers. The current target Fed rate is 5.25%, and corporate bonds trade at a spread above that. As bonds mature, companies are being forced to either pay off debt or refinance it at much higher cost. At the same time, the global economic environment remains uncertain, which could mean pressure on corporate margins and falling demand for debt.

"The new bond market dynamic comes with more income, but requires more skill."

— Brian Funk, Global Head of Private Capital, MetLife Investment Management

Today's higher rates are increasing the attractiveness of bonds. Yields on the 10-year Treasury surpassed the dividend yield on the S&P late last year for the first time in years. However, as companies and governments face higher debt servicing costs, investors need to be selective about what debt they invest in.

Diverging Outcomes

Funk believes investors need to fully incorporate changing dynamics into any analysis of debt securities. Today's market creates a scenario for increased downgrades and defaults. However, the effects will be felt issuer by issuer, which means this environment will favor deep credit analysis.

"I don't think we have had a default cycle since 2008, but looking forward, we expect a more normalized default cycle," says Funk. "Low rates muted volatility, driving spreads lower across the bond market. Even the worst companies were able to issue new debt. As volatility returns, the cost of capital goes up, and then capital gets more discerning. Companies that are highly levered, in cyclical sectors, or lower quality, may not even have access to capital."

The rising cost of capital and higher yields could drive a greater dispersion in outcomes, with more opportunity for price discovery and higher absolute returns for investors who find the winners.

"There are many layers you have to look at to find the right opportunities in this new environment," Funk says. "Has the company used its debt to grow revenues and build its intrinsic value? Has it extended maturities, or do you face the risk of higher cost of debt in the near near-term? Is the business positioned to withstand cyclical economic fluctuations?"

Funk says MIM is looking for well-positioned businesses by carefully analyzing business models, fundamentals, debt and management to estimate a company's intrinsic value, then deciding where in the capital structure to participate in debt. The company is also experimenting with AI tools

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to help provide underlying risk assessment and distribute insights and research throughout the organization to drive faster and better decisions.

MIM believes fixed income analysis must also include a view on sustainability. As the economy transitions to less carbon-intensive business practices, companies must have a strategy to adapt. Early adopters may gain competitive advantages, while laggards may face risk, including regulatory and competitive pressure.

For both governments and corporations, this new interest rate environment will demand a change in tactics. If investors can identify the winners, they stand to benefit from higher yields.

"The extreme market dynamics of the zero interest rate environment, with low defaults, narrow spreads and little income, has gone," Funk says. "The new bond market dynamic comes with more income, but requires more skill."

Source

1. "Fixed Income Outstanding (2-Yr. Interval)," Securities Industry and Financial Markets Association, 2021.

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