U.S. Investment Grade Credit: Quality (Still) Comes with Yield

With yields materially higher as a result of elevated interest rates, high-quality markets such as U.S. investment grade corporate bonds offer attractive income and total return potential. The asset class can also offer low correlation to other risk assets, as well as help mitigate downside risk.

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Key takeaways

- Why U.S. investment grade (IG) credit now? With today's high rates, an improved U.S. economic growth outlook and solid corporate fundamentals, high-quality corporate bonds offer attractive income and total return potential.
- Why U.S. IG for the long term? It's one of the largest and most liquid asset classes in the world (Exhibit 4), leaving it ripe for active managers to capture opportunities. And it has historically demonstrated low correlation to equities, U.S. Treasuries and riskier fixed income segments (Exhibit 7).
- IG credit can also help mitigate downside risk, having generally preserved capital better during periods of crisis than other risk assets and even U.S. Treasuries (Exhibit 8).

Why U.S. investment grade now?

We see multiple reasons why, in the current market environment, U.S. investment grade (IG) bonds offer an attractive, high-quality opportunity for investors.

- **A supportive macro outlook in the U.S.** Strong economic data suggest corporate fundamentals will remain solid, and the U.S. Federal Reserve will be able to provide a backstop of rate cuts should economic growth slow.
- **Attractive current yields.** While current spread levels are tight, yields for IG corporate bonds offer a compelling opportunity for investors to lock in long-term income and total return potential. Despite sitting slightly off their October 2023 peak, yields for U.S. IG corporate bonds remain above 5% and are nearly 160 basis points above their 10-year average.
- **A good backdrop for long-term return potential.** There is a strong correlation between starting yield and future returns (Exhibit 1)—which is notable given current yield levels in the U.S. investment grade corporate bond market. It's easy to forget the important role that income plays in long-term total returns for bonds, given that rates were so low for so long.

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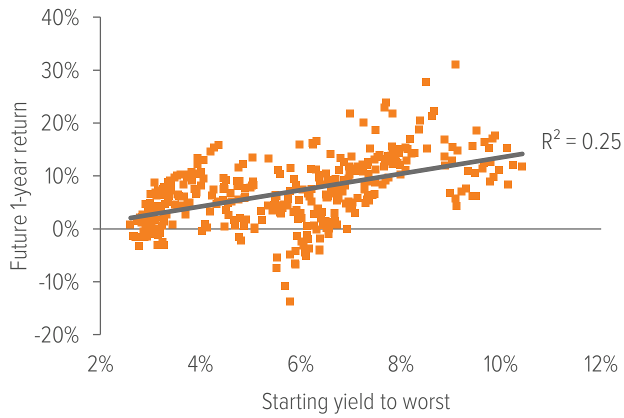
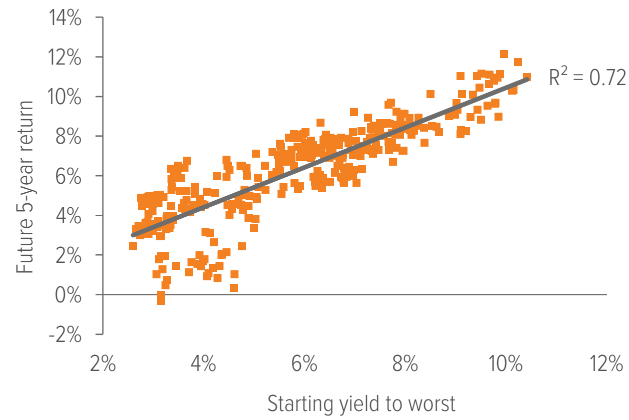
Exhibit 1: As time horizons lengthen, starting yield becomes a stronger indicator of returns

Over one-year periods, the relationship between starting yield and future IG market returns is weak



Over five years, the relationship between starting yield and returns becomes stronger



As of 12/31/23. Source: Bloomberg. Chart shows rolling periods from 1989 to 2023. Information shown is for the Bloomberg U.S. Corporate Index. See back page for index definitions.

The higher yield earned on today's bonds will likely serve as an extra cushion against price deterioration if rates continue to rise or if spreads move wider. Our research shows that, historically, as rates increase to more normalized levels, the negative impact of additional rate moves higher starts to wane—and this is the environment we are in today. Furthermore, given the solid growth environment and an increase in expectations for Fed rate cuts in 2024, investment grade spreads are tight, with the option-adjusted spread (OAS) of the Bloomberg U.S. Corporate Index sitting at 96 basis points as of Jan. 31, 2024. The index could absorb an 85-basis-point increase in its yield and investors would still break even, meaning that the income generated would fully offset the decline in price.

Exhibit 2 shows our analysis of different scenarios to illustrate how IG credit may perform in different spread and rate environments.

- Our base case for 2024 is for spreads to trade in a fairly tight range and for the Fed to begin cutting in the back half of the year, which would produce a total return of 7.78% (scenario 1).
- Should spreads tighten further and rates continue to improve, IG would see total returns of over 10% (scenario 2).
- Should economic growth slow further than expected and spreads widen materially, a decline in rates would still outweigh the negative impact of wider spreads and produce total returns of 6.89% (scenario 3).
- And if both rates moved higher and spreads wider, investors would still achieve 1.85% in total returns for IG (scenario 4).

Exhibit 2: Our base case scenario shows attractive estimated total return projections for IG bonds

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
	Base case: Neutral spreads, bullish rates	**Bullish spreads and rates**	**Bearish spreads, bullish rates**	**Neutral spreads, bearish rates**
Starting yield	5.41%	5.41%	5.41%	5.41%
Current spread (bp)	+96	+96	+96	+96
Rate change	-0.50%	-0.75%	-0.75%	0.50%
Spread change (bp)	+10	-15	+50	+10
New yield	5.01%	4.51%	5.16%	6.01%
New spread (bp)	+106	+81	+146	+106
Price return	2.77%	6.24%	1.73%	-4.16%
Total return	**7.78%**	**10.75%**	**6.89%**	**1.85%**

As of 2/28/24. Source: Bloomberg. Calculations are based on the Bloomberg U.S. Corporate Index current duration of 6.9 years and assume immediate parallel shift in yield curve (with the new yield then earned for the 12-month period). Investors cannot invest directly in an index.

A key reason to own investment grade corporate bonds is to diversify equity and lower-rated credit risk. While that assumption didn't hold up well in 2022, the great news for fixed income investors is that interest rate normalization has returned us to a world in which income is a meaningful component of return. Furthermore, with U.S. growth rates expected to outpace global growth rates, the U.S. investment grade market provides an attractive opportunity for investors seeking a high-quality asset class that can benefit from a strong fundamental backdrop. The expectation for a recession in 2023 led management teams to shore up balance sheets, leaving corporate fundamentals on solid footing heading into an improved economic outlook for 2024. Additionally, while the asset class has seen record new issuance to start the year, spreads have tightened slightly amid exceptional demand for U.S. IG from investors seeking high-quality yields. Against this backdrop, we believe that U.S. investment grade corporate bonds remain an appealing asset class that can provide strong, long-term risk-adjusted returns and diversification in investors' portfolios.

What's the long-term case for U.S. investment grade credit?

In a diversified portfolio comprising stocks, bonds, cash and alternative investments, the fixed income allocation can—for most investors—help protect capital in volatile periods and provide a reliable source of income over time.

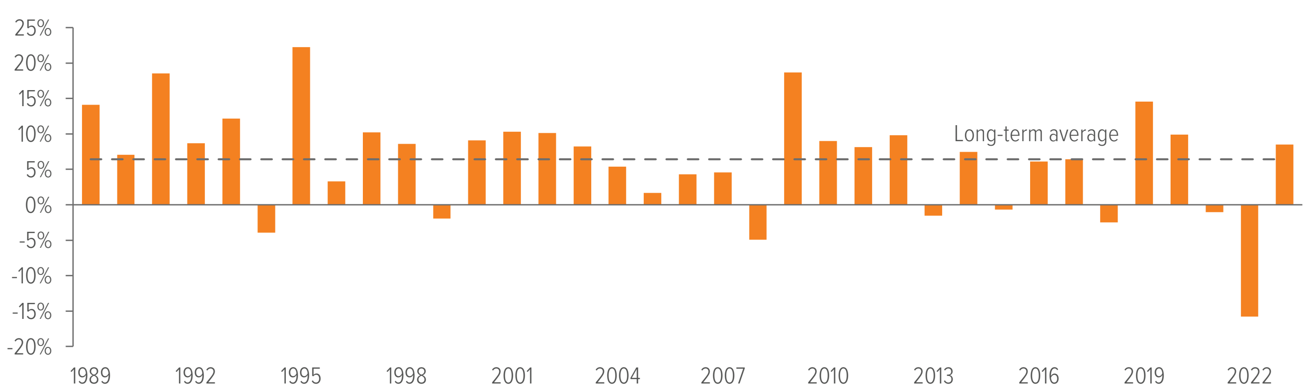
During the prior decade of low interest rates, many investors felt they needed to increase credit risk so they could protect principal while generating sufficient yield and income. But today, with interest rates having risen materially, higher-rated, lower-risk segments of fixed income such as U.S. IG corporates are now offering higher all-in yields. That means investors have less need to sacrifice credit quality in pursuit of returns. In addition, U.S. IG corporates can offer attractive diversification benefits, thanks to their low correlations with equities and riskier segments of the fixed income market (such as high yield bonds and bank loans).

We see several reasons for investors to consider allocating to U.S. IG credit:

- **Financial stability:** To qualify as investment grade, an issuing company must receive a credit rating of between Aaa and Baa3 from Moody's or AAA and BBB- from Standard & Poor's. As Exhibit 3 demonstrates, the relative financial stability of these companies has helped the U.S. IG corporate segment generate long-term positive returns through multiple credit cycles.
- **Size and liquidity:** U.S. IG corporate debt is one of the largest and most liquid markets in the world, having tripled in size since 2007 to stand at $7.0 trillion as of Dec. 31, 2023 (Exhibit 4).
- **Relative value:** The size and scope of the market may offer investors relative value opportunities and inefficiencies that may be captured via active portfolio management. We believe active management, driven by rigorous fundamental analysis and a keen awareness of how corporate management teams respond through various stages of the credit cycle, is key to exploiting these inefficiencies and generating consistent potential performance while mitigating downside risk.
- **Attractive pricing:** U.S. IG corporate debt yields are above their long-term average (Exhibit 5). Higher-quality, lower-risk assets such as U.S. IG corporates may help investors meet their yield requirements without needing to take undue credit risk in lower-rated segments of fixed income.

Exhibit 3: Strong long-term returns over multiple market cycles

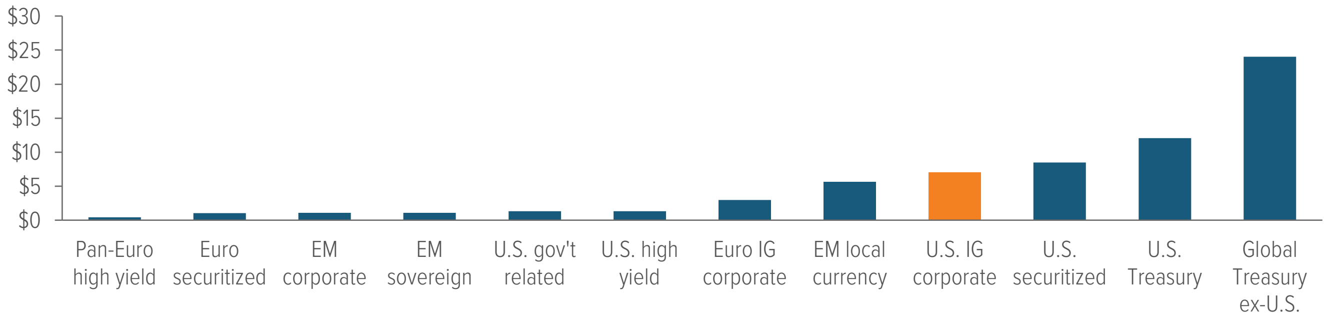
U.S. investment grade corporate index total return



As of 12/31/23. Source: Bloomberg. Investment grade bonds are represented by the Bloomberg U.S. Corporate Index. See back page for index definitions.

Exhibit 4: One of the largest, most liquid bond markets in the world

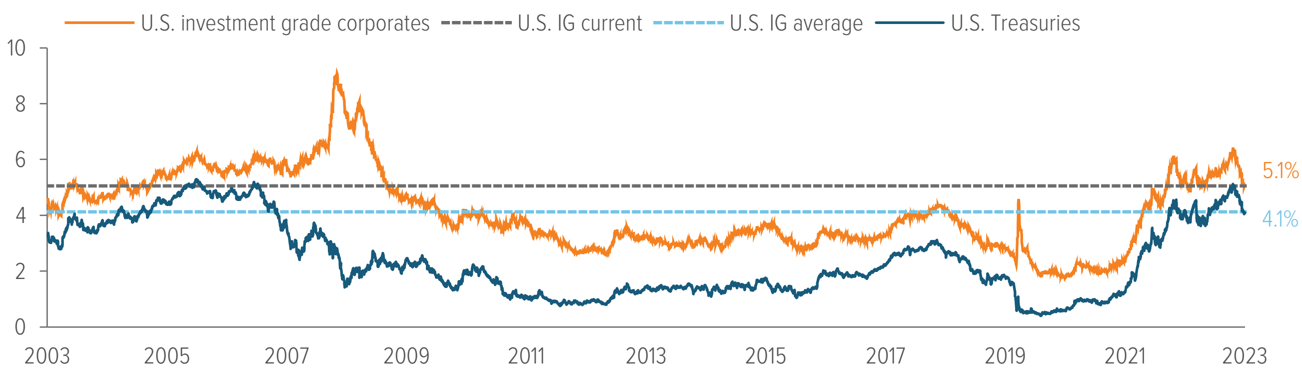
Size of global bond markets, trillions



As of 02/28/24. Source: Bloomberg. Pan-Euro High Yield: Bloomberg Pan-European High Yield Index; EM Corporate: Bloomberg EM USD Corporate & Quasi-Sovereign Index; Pan-Euro Securitized: Bloomberg Pan-European Securitized Index; U.S. High Yield: Bloomberg U.S. High Yield Index; U.S. Gov't Related: Bloomberg U.S. Government Related Index; EM Sovereign: Bloomberg USD EM Sovereign Index; Pan-Euro IG Corporate: Bloomberg Pan-European Corporate Index; U.S. IG Corporate: Bloomberg U.S. Corporate Index; EM Local Currency: Bloomberg EM Local Currency Government Index; U.S. Securitized: Bloomberg U.S. Securitized Index; Pan-Euro Treasury: Bloomberg Pan-European Treasury Index; U.S. Treasury: Bloomberg U.S. Treasury Index; Asia Pacific Treasury: Bloomberg Asia Pacific Treasury Index. See back page for index definitions.

Exhibit 5: Yields of IG bonds are above their long-term average

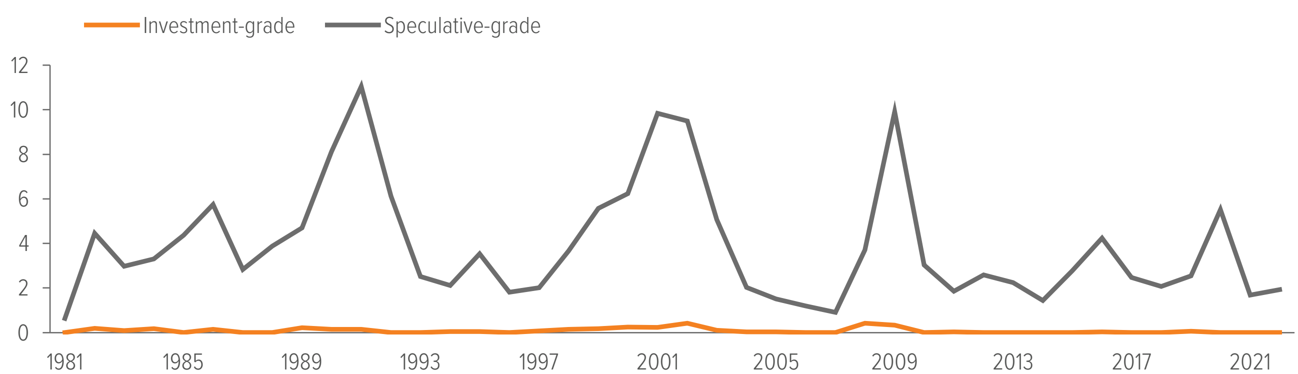
Yield to worst



As of 12/31/23. Source: Bloomberg Index Services Limited, Voya IM. U.S. IG Corporate: Bloomberg U.S. Corporate Index; U.S. Treasuries: Bloomberg U.S. Treasury Index. See back page for index definitions.

Exhibit 6: Infrequent, minimal defaults over time

U.S. corporate default rates



As of 12/31/22. Source: S&P Global Ratings research, S&P Global Market Intelligence's CreditPro®.

While the breadth of the market and the yields available can look compelling, on their own, U.S. IG corporates also possess several features that may help investors mitigate downside risk.

First, U.S. IG corporate bonds have generally been a relatively safe asset class over time. As Exhibit 6 shows, corporate defaults within U.S. IG credit have been infrequent and minimal over time compared with other credit-sensitive asset classes.

Given the minimal default risk over time, one key risk in the IG corporate market is idiosyncratic downgrade risk. While companies being downgraded to below investment grade (so-called “fallen angels”) is a relatively rare occurrence, a passive approach to investing in the IG corporate market may expose investors to this unnecessary additional downgrade risk, which is a key driver of spread volatility. Active managers aim to manage downgrade risk through credit selection—meaning that active strategies, unlike passive strategies, may be able to avoid certain downgrades.

Second, a dedicated U.S. IG corporate sleeve can serve as an effective diversification tool. As Exhibit 7 shows, the asset class has historically demonstrated low correlation to both equities and U.S. Treasuries, as well as riskier segments of the fixed income market—such as emerging market debt, high yield bonds and leveraged loans.

Third, as shown by Exhibit 8, U.S. IG corporate bonds have historically delivered compelling risk mitigation during periods of significant market stress.

Looking at market returns in crisis periods over the last 20-plus years, the U.S. IG corporate market outperformed senior bank loans and U.S. stocks during the dot-com crash, the 2008 financial crisis, the European sovereign debt crisis, the 2015 energy crisis, the U.S. Federal Reserve’s 2018 hiking cycle and the Covid-19 pandemic. Even allowing for a rebound year following each crisis, total returns for the U.S. IG corporate market through all the combined crisis and rebound years exceeded those of the aforementioned markets.

U.S. IG corporates did underperform U.S. high yield bonds in five of the six crisis-and-recovery periods, but the underperformance across all periods was a modest 7% (cumulative). When accounting for the significantly lower volatility profile (a standard deviation of 1.74% vs. 2.70%), the underperformance versus high yield does not look too drastic.

Perhaps even more surprising is that over same periods of crisis and recovery, U.S. IG corporate bonds delivered a better outcome than U.S. Treasuries, a typical safe haven during volatile periods when investors are looking to conserve capital.

Exhibit 7: Low correlations can help diversification

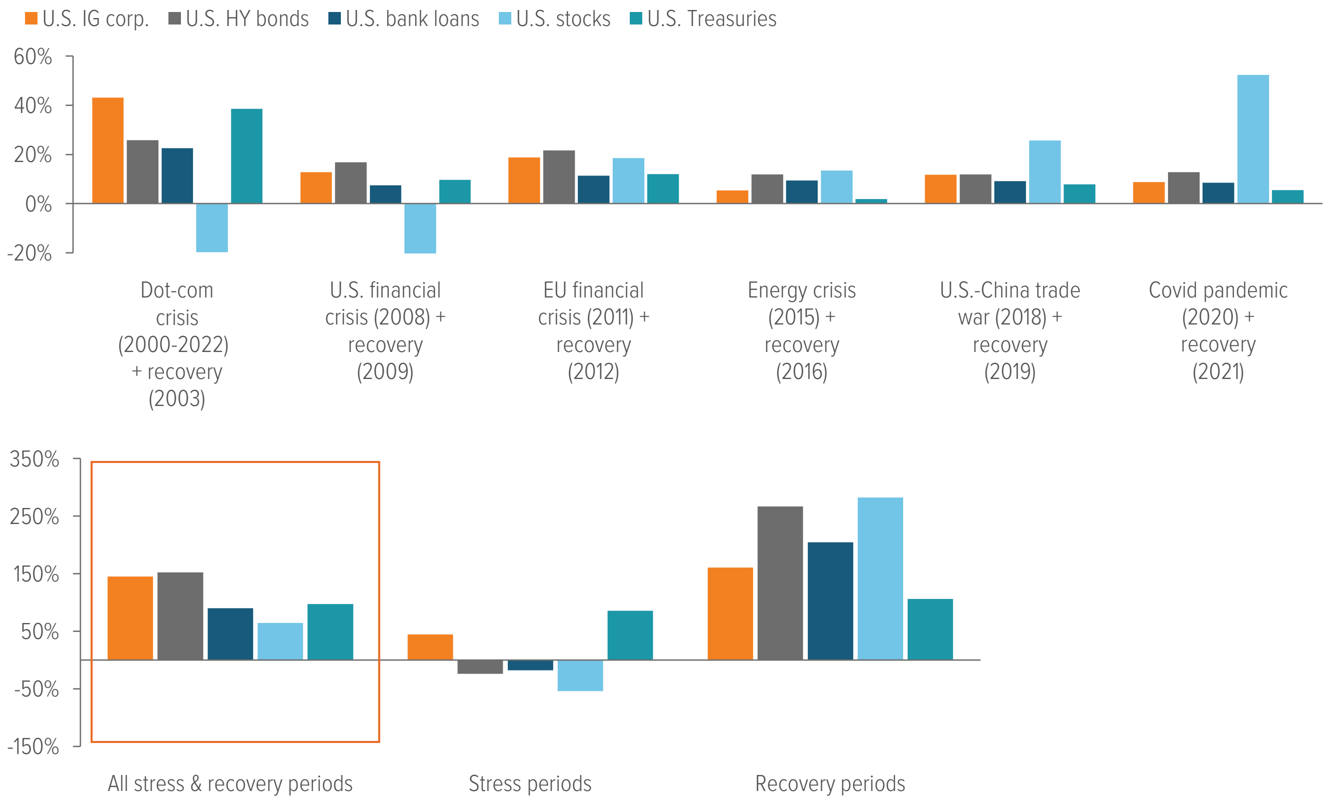
Correlations, 1Q 2007 through 4Q 2023

	U.S. investment grade	U.S. Aggregate Index	U.S. Treasuries	Agency residential MBS	U.S. asset-backed securities	U.S. commercial MBS	U.S. high yield	U.S. senior loans	Emerging market debt	S&P 500
U.S. investment grade	1.00	0.86	0.57	0.68	0.60	0.54	0.67	0.44	0.82	0.48
U.S. Aggregate Index		1.00	0.89	0.92	0.48	0.44	0.35	0.07	0.62	0.23
U.S. Treasuries			1.00	0.82	0.23	0.21	-0.06	-0.33	0.29	-0.09
Agency residential MBS				1.00	0.39	0.27	0.23	-0.04	0.49	0.18
U.S. asset-backed securities					1.00	0.43	0.58	0.61	0.58	0.25
U.S. commercial MBS						1.00	0.68	0.48	0.52	0.42
U.S. high yield							1.00	0.85	0.79	0.75
U.S. senior loans								1.00	0.60	0.59
Emerging market debt									1.00	0.63
S&P 500										1.00

As of 12/31/23. Source: Bloomberg. Correlation of monthly total returns. U.S. investment grade: Bloomberg U.S. Corporate Index; U.S. Aggregate Index: Bloomberg U.S. Aggregate Index; U.S. Treasuries: Bloomberg U.S. Treasury Index; Agency residential MBS: Bloomberg U.S. Mortgage-Backed Securities Index; U.S. asset-backed securities: Bloomberg U.S. Asset-Backed Securities Index; U.S. commercial MBS: Bloomberg U.S. CMBS Investment Grade Index; U.S. high yield: Bloomberg U.S. High Yield Index; U.S. senior loans: Morningstar LSTA Leveraged Loan Index; Emerging market debt: J.P. Morgan EMBI Diversified Index; S&P 500: S&P 500 Index. See back page for index definitions.

Exhibit 8: U.S. IG credit resilience in periods of stress

Asset class returns during crisis periods (top); accumulated (bottom)



As of 12/31/22. Source: Bloomberg, and Voya IM. Periods covered correspond to the chart above. Stress periods: 2000-2002, 2008, 2011, 2015, 2018, 2020. Recovery periods: 2003, 2009, 2012, 2016, 2019, 2021. Crisis/recovery/stress years shown are estimated and include 12 months of data (from Jan-Dec) for each of the years shown. U.S. investment grade corporate bonds: Bloomberg U.S. Corporate Index; U.S. high yield bonds: Bloomberg U.S. High Yield Index; U.S. bank loans: Morningstar LSTA Leveraged Loan Index; U.S. stocks: S&P 500 Index; U.S. Treasuries: Bloomberg U.S. Treasury Index. See back page for index definitions.

The bottom line: U.S. IG bonds are an appealing asset class

We believe that, under current market conditions, U.S. investment grade corporate bonds may be an appealing asset class.

Years of low interest rates may have tempted many investors into lower-rated parts of fixed income in pursuit of yield, but with rates having risen materially, U.S. IG corporate debt is arguably more attractively priced today than it has been for more than a decade. Additionally, with an improved U.S. economic outlook for 2024, solid corporate fundamentals, and the prospect of Fed rate cuts later in the year, U.S. IG corporate debt is well positioned to provide strong, long-term risk-adjusted returns and diversification in investors' fixed income portfolios.

Risks of investing

The principal risks are generally those attributable to bond investing. Holdings are subject to market, issuer, credit, prepayment, extension and other risks, and their values may fluctuate. Market risk is the risk that securities may decline in value due to factors affecting the securities markets or particular industries. Issuer risk is the risk that the value of a security may decline for reasons specific to the issuer, such as changes in its financial condition.

Diversification does not guarantee a profit or protect against losses.

A rating provides no indicator of future performance and is not constant over time.

The Bloomberg Asia-Pacific Treasury Index contains fixed-rate, investment-grade securities denominated in Australian dollar, Chinese yuan, Hong Kong dollar, Indonesian rupiah, Japanese yen, Malaysian ringgit, New Zealand dollar, Singapore dollar, South Korean won and Thai baht. The Bloomberg Emerging Markets Local Currency Government Index is designed to provide a broad measure of the performance of local currency emerging markets (EM) debt. The Bloomberg EM USD Corporate & Quasi-Sovereign and Bloomberg USD EM Sovereign indices are subindices of the Bloomberg EM USD Aggregate Index, which is a flagship hard currency Emerging Markets debt benchmark that includes USD denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The Bloomberg Pan-European Corporate, Pan-European High Yield, Pan-European Securitized and Pan-European Treasury indices are subindices of the Bloomberg Pan-European Aggregate Bond Index, which is a broad-based flagship benchmark that measures fixed-rate, investment grade securities in the following European currencies: Swiss Franc, Czech Koruna, Danish Krone, Euro, British Pound, Hungarian Forint, Norwegian Krone, Polish Zloty, Romanian Leu, Russian Ruble, and Swedish Krona. The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities. The Bloomberg U.S. Asset-Backed Securities Index is the ABS component of the Bloomberg U.S. Aggregate Index. It has three subsectors: Credit and charge cards, Autos, Utility. The Bloomberg U.S. CMBS Investment Grade Index measures the market of U.S. Agency and U.S. Non-Agency conduit and fusion CMBS deals with a minimum current deal size of $300mn. The Bloomberg U.S. Corporate Index measures the performance of investment grade, USD-denominated, fixed-rate, taxable corporate bond market securities. The Bloomberg U.S. Government Related Bond Index is composed of the U.S. Agency Indices. The index includes U.S. dollar-denominated, fixed-rate, nominal U.S. agency debentures (securities issued by U.S. government owned or government sponsored entities, and debt explicitly guaranteed by the U.S. government). The Bloomberg U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets are excluded, but Canadian and global bonds of issuers in non-EMG countries are included. The Bloomberg U.S. MBS Index measures the performance of the agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The Bloomberg U.S. Securitized Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC); investment grade debt asset backed securities; and investment grade commercial mortgage backed securities. The Bloomberg U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. The EMBI Global includes only USD-denominated emerging markets sovereign/quasi-sovereign bonds and uses a traditional, market-capitalization weighted method for country allocation. The Morningstar LSTA U.S. Leveraged Loan Index is designed to deliver comprehensive, precise coverage of the U.S. leveraged loan market. The Standard and Poor's 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Index returns do not reflect fees, brokerage commissions, taxes or other expenses of investing. Investors cannot invest directly in an index.

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