



March 20, 2025

Global Credit Weekly:

A more constrained
reaction function

BlackRock

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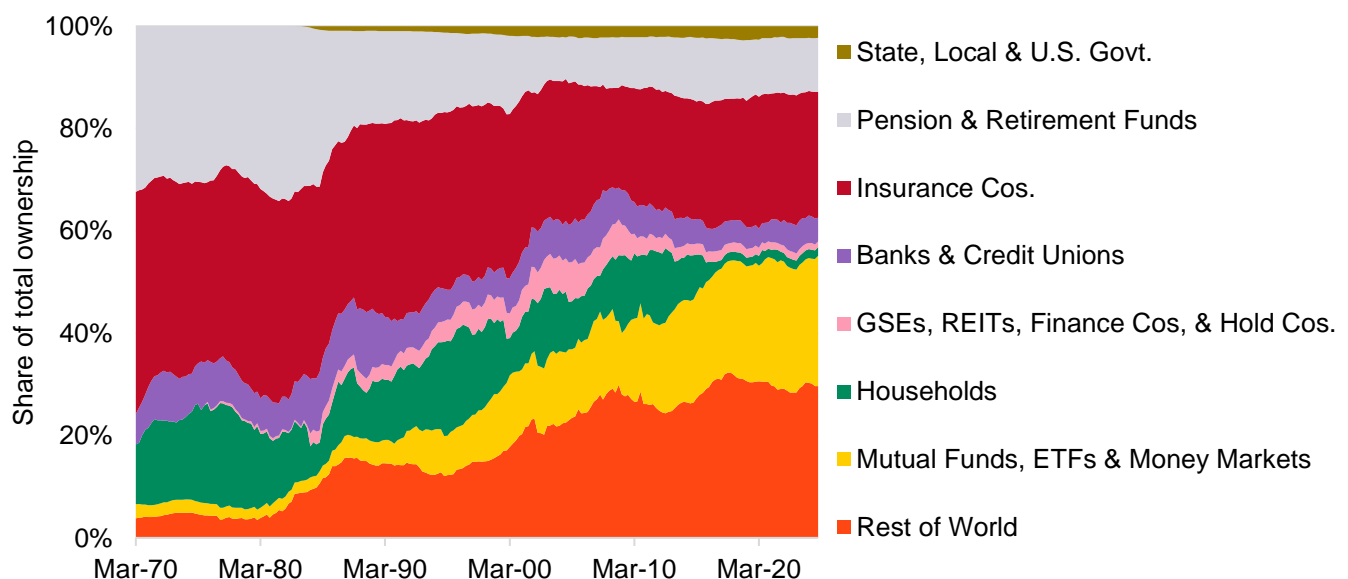
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Key takeaways

- While the Federal Open Market Committee's (FOMC) decision at the March meeting to hold its monetary policy rate unchanged at (4.25%–4.5%) was widely expected, the refreshed quarterly projections and press conference provided further confirmation of: (1) a more challenging growth-inflation mix, and (2) the uncertainty influencing the Federal Reserve's reaction function. In our view, the meeting was not as hawkish as it could have been, which we believe helped contribute to a post-decision rally in risk assets. That said, with inflation likely remaining above target through 2025 and the Federal Reserve constrained in their ability to normalize policy further, the growth backdrop becomes even more critical to support risk asset valuations.
- For corporate credit investors, there is a significant degree of uncertainty related to the interaction between growth, inflation and policy. For now, we continue to view a Fed rate cut in 1H2025 as unlikely, given the outlook for inflation and our base case of a moderation in growth (as opposed to a sharp decline). The most likely catalyst for the next rate cut (if one materializes in 2H2025), in our view, is a deterioration in the labor market. As a result, we will be watching high-frequency data on the labor market closely, alongside company-level commentary. The backdrop underscores the importance of positioning investment portfolios for a wide range of growth, inflation and policy scenarios. As we discussed last week, we expect some additional spread widening from current levels, which could provide opportunities to selectively add risk.
- Separately this week, we take stock of another theme which has been top of mind for market participants: foreign demand for USD corporate credit (Exhibit 1). Recent compression in the yield differential between the USD IG and EUR IG Corporate indices, coupled with higher hedging costs, has made EUR IG credit incrementally more attractive for European yield-based investors. While this may lead to some moderation in foreign investors' appetite for USD credit, we nonetheless expect foreign-based demand to remain robust due to the structural characteristics inherent in the USD IG market, such as its size, breadth, and depth.

Exhibit 1: More than 25% of USD corporate debt is held by foreign investors

Ownership distribution of the USD investment grade and high yield corporate bond market



Source: BlackRock, Haver Analytics, Federal Reserve Board. Captures data as of 4Q2024 (most recent available).

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March FOMC: forecast “inertia” and “unusually elevated” uncertainty

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In our view, the meeting was not as hawkish as it could have been, which we believe helped contribute to a post-decision rally in risk assets. That said, with inflation likely remaining above target through 2025 and the Federal Reserve constrained in their ability to normalize policy further, the growth backdrop becomes even more critical to support risk asset valuations.

Below, we outline additional takeaways for corporate credit investors:

- **A more challenging growth-inflation mix.** The March 2025 Summary of Economic Projections (SEP) reflected weaker growth, higher inflation, and higher unemployment for 2025, relative to the projections as of December 2024 (Exhibit 2). Notably, these median forecast revisions occurred alongside an *unchanged* median policy rate forecast for year-end 2025. When asked why two cuts were still reflected for 2025 (despite above target inflation), Chair Powell cited “remarkably high” forecast uncertainty, some “inertia” which influenced the projections, and the somewhat offsetting impacts of higher inflation and weaker growth. FOMC participants’ assessments of the uncertainty and risks around their economic forecasts increased relative to the December SEP, and the range of forecasts for the funds rate in 2025 also shifted higher (even though the median forecast still pointed to two cuts in 2025).
- **The reaction function: Not in a hurry, and “adapting as we go.”** Chair Powell said he believes “policy is in a good place to react to what comes” and the right thing to do is “to wait... for greater clarity about what the economy is doing.” The costs of waiting “are very low”, echoing his remarks from a recent event at the University of Chicago. Chair Powell further added the likelihood of recession “has moved up, but it’s not high.” As for what could cause a cut, Chair Powell cited two factors: (1) if the labor market were to “weaken unexpectedly” or, (2) if inflation were to fall more quickly. We view labor market weakness as the more likely catalyst, given the limited prospects for further improvement on inflation (discussed later). We continue to view a rate cut in 1H2025 as unlikely but will be watching high-frequency data on the labor market closely (also discussed later).

Exhibit 2: The March SEP reflected a more challenging growth inflation mix vs. December

The median economic projections of the 19 FOMC members, for the 4th quarter of each year shown, per the March 2025 Summary of Economic Projections (SEP)

| | 2025 | 2026 | 2027 | Longer-run |
|---------------------------|------------|------------|------------|------------|
| Real GDP growth | 1.7 | 1.8 | 1.8 | 1.8 |
| December 2024 projection | 2.1 | 2.0 | 1.9 | 1.8 |
| September 2024 projection | 2.0 | 2.0 | 2.0 | 1.8 |
| Unemployment rate | 4.4 | 4.3 | 4.3 | 4.2 |
| December 2024 projection | 4.3 | 4.3 | 4.3 | 4.2 |
| September 2024 projection | 4.4 | 4.3 | 4.2 | 4.2 |
| PCE inflation | 2.7 | 2.2 | 2.0 | 2.0 |
| December 2024 projection | 2.5 | 2.1 | 2.0 | 2.0 |
| September 2024 projection | 2.1 | 2.0 | 2.0 | 2.0 |
| Core PCE inflation | 2.8 | 2.2 | 2.0 | |
| December 2024 projection | 2.5 | 2.2 | 2.0 | not given |
| September 2024 projection | 2.2 | 2.0 | 2.0 | |
| Federal funds rate | 3.9 | 3.4 | 3.1 | 3.0 |
| December 2024 projection | 3.9 | 3.4 | 3.1 | 3.0 |
| September 2024 projection | 3.4 | 2.9 | 2.9 | 2.9 |

Source: Federal Reserve, BlackRock. As of the Federal Reserve’s Summary of Economic Projections published on March 19, 2025.

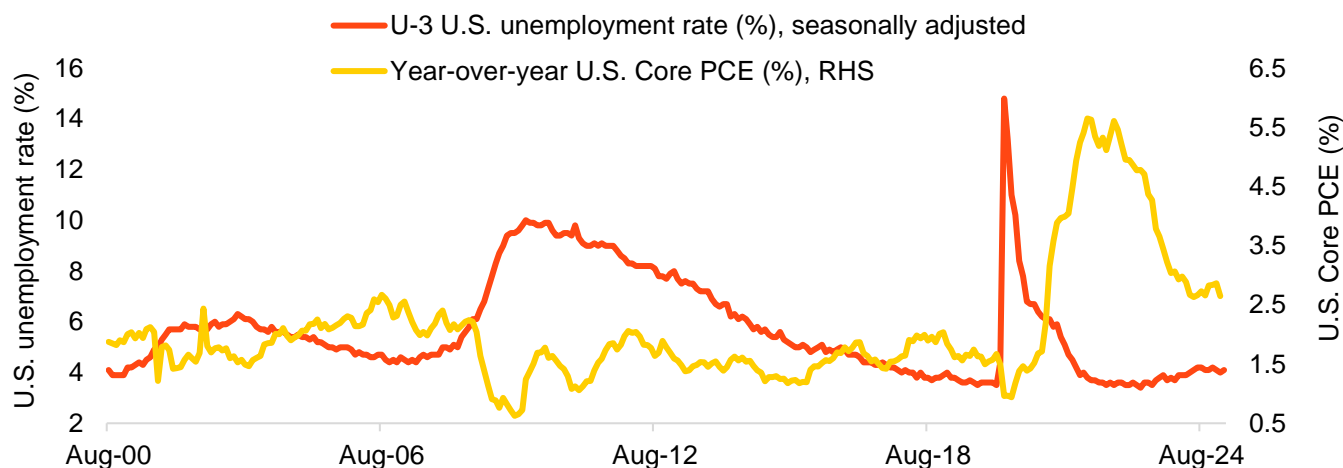
There is no guarantee any forecasts may come to pass.

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- **Soft vs. hard data divergence (for now).** Chair Powell pointed to a disconnect between so-called “soft” (survey/sentiment) data, and the “hard” economic data: household and business survey data have reflected a significant rise in uncertainty and concerns about downside risks, while the “hard data are still in reasonably good shape.” He added that if the soft data are going to affect the hard data, “we should know it very quickly.” Chair Powell noted the inconsistent relationship between the two, at times.
- **Inflation progress delayed, for now.** Chair Powell acknowledged that inflation remains “somewhat elevated” relative to the FOMC’s 2% longer-run goal and “further progress” appears to be delayed for the time being. As evidence of this, he pointed to the increase in goods inflation over the past two months. He added that “clearly some of it” is driven by tariffs, and that it was “too soon to say” whether it will be appropriate to “look through” such tariff-related inflationary pressures. This extended timeline for a return to target inflation is directionally consistent with the recent messaging from the ECB.
- **Longer-term inflation expectations must be anchored.** Near-term measures of inflation expectations have increased, with consumers and businesses mentioning tariffs “as a driving factor.” That said, it is *longer-term* inflation expectations remaining anchored that is key, per Chair Powell. He also noted the disconnect between a recent “outlier” reading (University of Michigan) and most other longer-term, market-based inflation expectation measures which are consistent with the 2% goal.

Exhibit 3: The path to 2% inflation may be longer than expected

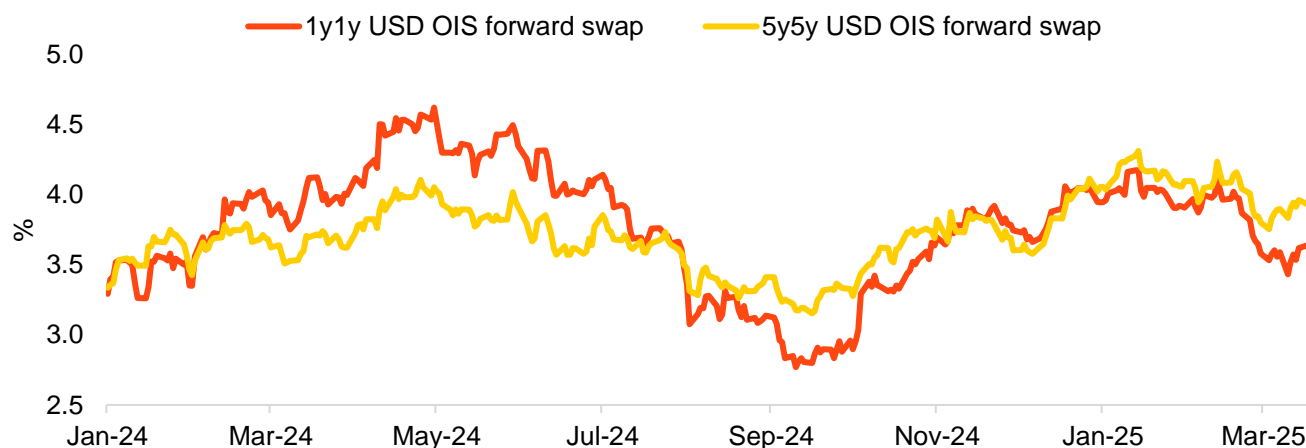
U-3 U.S. unemployment rate (%) seasonally adjusted, and year-over-year U.S. Core PCE inflation (%) seasonally adjusted, RHS



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, BlackRock. Captures unemployment rate data through February 28, 2025, and inflation data through January 31, 2025 (most recent available as of March 19, 2025).

Exhibit 4: Market pricing reflects a terminal rate for this cycle above 3.6%

1y1y Overnight Indexed Swap (OIS) forwards, as a proxy for the terminal rate of this cycle, and 5y5y OIS as a proxy for the long-term neutral rate



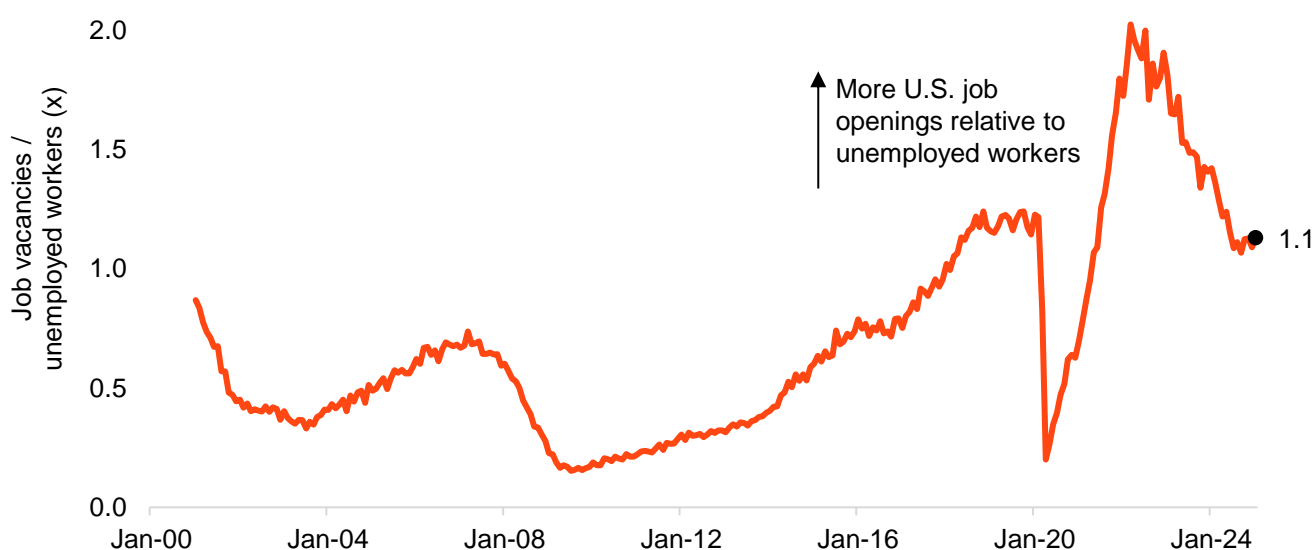
Source: Bloomberg, BlackRock. As of March 19, 2025.

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- **Labor market is currently “solid” but warrants close monitoring, in our view.** Related to the point on the hard data, Chair Powell referenced a wide set of indicators suggesting labor market conditions are broadly “in balance”. These include an unemployment rate that remains low by historical standards (4.1%), a stable jobs-workers gap (Exhibit 5), and a low layoff rate (Exhibit 6). That said, the “low firing, low hiring” environment that Chair Powell characterized suggests a meaningful increase in layoffs could translate into an increase in unemployment (as job seekers take longer to find jobs). As we noted in our *1Q2025 Global Credit Outlook*, a spike in layoff activity would likely cause the weakness evident among the low-income consumer cohort to expand more broadly. Because consumer spending generates roughly two-thirds of U.S. GDP, this warrants close monitoring. And of course, growth-sensitive asset classes such as corporate credit would face a headwind from a deterioration in growth momentum (which is generally not reflected in the current level of spreads – even after recent widening).

Exhibit 5: The “jobs-workers gap” has rebalanced to the pre-pandemic level

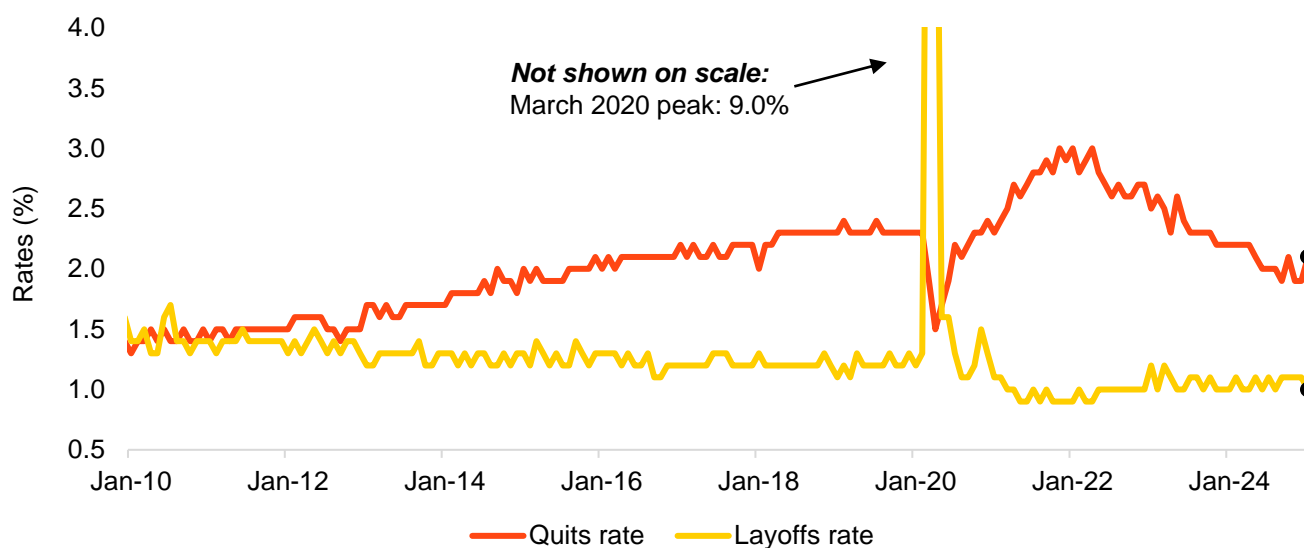
The ratio of U.S. job vacancies to U.S. unemployed workers, both seasonally adjusted



Source: BlackRock, Bureau of Labor Statistics. Captures data through January 31, 2025 (most recent as of March 19, 2025).

Exhibit 6: The low hiring rate could pose a risk, if layoffs accelerate

U.S. Layoffs & Discharge Rate (%) and the U.S. Quits Rate (%), both seasonally adjusted



Source: Bureau of Labor Statistics, Bloomberg, BlackRock. Captures data through January 31, 2025 (most recent as of March 19, 2025). The Layoffs & Discharge Rate tracks involuntary job separations initiated by the employer, while the Quits Rate tracks voluntary job separations initiated by the employee.

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- **The *net effect* of policy changes.** Chair Powell again referenced the four distinct areas for anticipated policy changes: trade, immigration, fiscal policy, and regulation. It is the *net effect* of these policy changes, he added, that will matter for the economy and for the path of monetary policy. The FOMC is focused on separating “signal from the noise” as the outlook evolves. In our view, this highlights the broad range of outcomes that investors need to be positioned for – including various growth, inflation, and policy outcomes.
- **Slowing the pace of balance sheet run-off (QT).** The pace of decline in the size of the Fed’s balance sheet was also slowed, owing to signs of increased tightness in money markets, per Chair Powell. Beginning in April, the monthly cap on Treasury redemptions will be lowered to \$5 billion (from \$25 billion). The cap on agency mortgages was unchanged, as the “desire” remains for the mortgages to roll off the Fed’s balance sheet. Chair Powell said this slower pace of balance sheet run-off (after securities holdings have already declined by more than \$2 trillion) should not impact the size of the balance sheet over the medium term, nor should it impact the “intended stance of monetary policy.”

Exhibit 7: Financial conditions have tightened modestly in recent weeks

Goldman Sachs U.S. Financial Conditions Index



Source: BlackRock, Bloomberg, Goldman Sachs Global Investment Research. As of March 18, 2025.

Framing foreign demand for USD credit

Recent fiscal developments in Europe have focused investors on the potential for a narrowing growth differential between the U.S. and Europe over the next several quarters. Additionally, the recent increase in Bund yields (since late February) has introduced some additional “yield support” into EUR corporate credit (although the impact to all-in yields has been somewhat offset by tighter spreads).

Some market participants have questioned the potential for incrementally more attractive yields on EUR corporate credit (relative to its USD peer) to soften foreign investors’ demand for USD corporate credit. This could take two forms: (1) encouraging European yield-based investors to focus on opportunities in their domestic credit markets, and/or (2) incentivizing a wider range of foreign investors to allocate more to the EUR corporate credit market (instead of the USD universe).

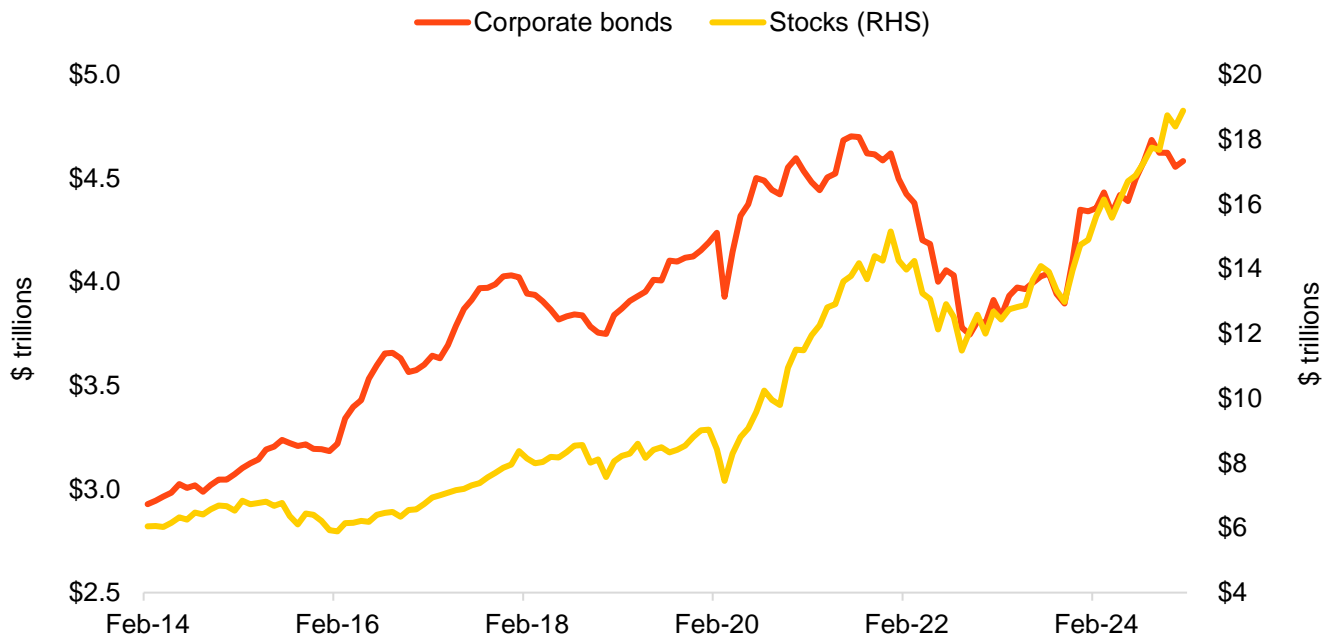
The theme warrants monitoring, in our view, as foreign investors’ appetite for USD corporate credit has been a technical demand tailwind in recent years. Indeed, foreign investors have served as an important buyer base for U.S. risk assets in recent years, as shown in Exhibit 8. In the USD corporate bond market, non-U.S. investors own more than 25% of the universe, as illustrated in Exhibit 1.

Foreign investors have allocated to USD corporate credit for a few key reasons in recent years, including relatively attractive all-in yields and a generally resilient U.S. growth backdrop. EUR-domiciled investors represent the largest cohort of foreign investors in USD corporate credit, per data from the U.S. Treasury Department’s Treasury International Capital System (TIC) dataset.

For a European investor, the attractiveness of EUR corporate credit, vs. USD corporate credit, is a factor of two inputs, in our view: (1) relative return potential on credit instruments and (2) hedging costs (or currency moves, if exposure is unhedged).

Exhibit 8: Foreign holdings of U.S. bonds and stocks have grown in recent years

Foreign portfolio holdings of U.S. securities



Source: Department of the Treasury, Haver Analytics, BlackRock. As of January 2025.

Using the IG market as an example, we find that recent compression in the yield-to-worst (YTW) differential between the USD IG and the EUR IG Corporate indices has made EUR IG credit incrementally more attractive on a relative basis (Exhibit 9).

And although spreads have tightened YTD in the EUR IG market, we still see scope for an *eventual* rebuild in risk premia, which may also support more attractive all-in yields. (Note: as we previously discussed, a variety of structural and fundamental factors have supported the resilience of European credit markets in recent years).

Hedging costs have also increased for European investors in recent months (Exhibit 10) due to a divergence in the ECB and Federal Reserve policy rates. These higher costs further diminish the excess premium that USD credit can provide to European investors (vs. EUR credit). That said, given the policy uncertainty in both economies, we see scope for further movement in hedging costs, including a potential decline in hedging costs if policy paths re-converge.

Exhibit 9: The EUR IG and USD IG yield differential has compressed YTD

Index-level yield-to-worst (YTW) differential (%) for the ICE-BAML USD and EUR IG Corporate indices



Source: ICE-BAML, Bloomberg, BlackRock. As of March 18, 2025. The figures shown relate to past performance. **Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Exhibit 10: Hedging costs have increased this year as Fed and ECB policy rates diverged

Bloomberg 3-month dollar hedge cost for Euro-based investors on an annualized basis



Source: Bloomberg, BlackRock. As of March 18, 2025.

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Despite the increased attractiveness in EUR IG yields, we expect that foreign-based demand for USD corporate credit will remain robust due to the structural characteristics inherent in the USD IG market, such as its size, breadth, and depth.

For example, using index-eligible debt for the ICE-BAML indices, the USD IG market is roughly double the size of the EUR IG market, with \$7.4 trillion in debt outstanding vs. €3.36 trillion, making the USD IG universe more liquid for investors. Further, the USD IG market is considerably more diversified in terms of industry exposures (Exhibit 11), allowing investors to capture more sector-level diversification within their allocation.

Finally, absent a sharp downturn in growth, we expect structurally higher interest rates in the U.S. to support attractive, absolute all-in yields for USD IG, leaving it as an attractive potential choice for yield-based buyers.

Exhibit 11: USD IG market is more diversified across sectors

Sector index weights for the ICE-BAML EUR IG and USD IG Corporate indices

| | EUR IG % weight | USD IG % weight |
|--------------------------|-----------------|-----------------|
| Banking | 27.9 | 17.8 |
| Utility | 10.6 | 9.5 |
| Consumer Goods | 6.2 | 5.4 |
| Financial Services | 6.2 | 9.8 |
| Healthcare | 5.5 | 9.8 |
| Real Estate | 5.1 | 3.2 |
| Automotive | 5.1 | 2.9 |
| Telecommunications | 4.8 | 3.4 |
| Transportation | 4.7 | 1.9 |
| Basic Industry | 4.3 | 3.5 |
| Capital Goods | 4.3 | 4.6 |
| Energy | 3.9 | 8.4 |
| Insurance | 3.9 | 4.8 |
| Technology & Electronics | 2.2 | 6.4 |
| Retail | 2.0 | 3.2 |
| Services | 1.4 | 1.5 |
| Media | 1.1 | 3.3 |
| Leisure | 0.6 | 0.4 |

Source: ICE-BAML, Bloomberg, BlackRock. As of March 18, 2025.

Unless otherwise stated, all reference to \$ are in USD.

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