

# The Changing Seasons in Investment-Grade Corporate Bond Supply-Demand Technicals

At U.S. Bancorp Asset Management, we use both a top-down and bottom-up process to make investment decisions. Our top-down approach drives sector allocation, credit quality, and duration decisions, while our bottom-up approach is responsible for industry allocations and individual security selection decisions.

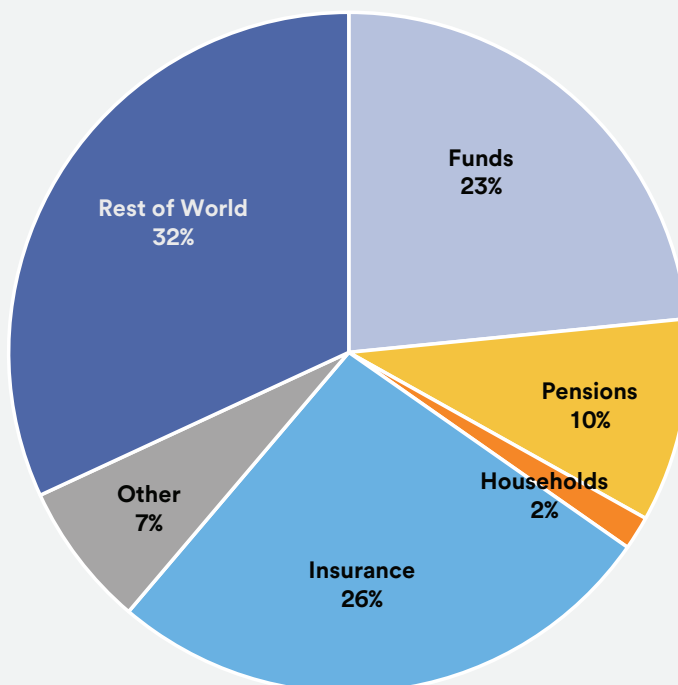
Central to our top-down process is an evaluation of overall business cycle dynamics, credit market fundamentals, and valuations, as well as the use of “market technicals,” such as issuance (supply) and investor appetite (demand). In this report we will explore our use of various technical factors influencing our top-down analysis of the investment-grade corporate bond market.

The technical backdrop – the balance of investor demand versus the supply of bonds – within fixed income assets in general and the investment-grade corporate bond market in particular has been extremely strong over the past few years. While technicals within the corporate bond market have modestly deteriorated to start 2025, they remain relatively strong, underscoring the persistently high investor demand for the sector following the pandemic-era. The strong technical backdrop within corporate bonds must be weighed against our assessment of broad credit market fundamentals and valuations to ultimately form our top-down sector allocation weighting for corporates as well as our overall quality and credit curve positioning within a diversified multi-sector fixed income portfolio.

Technicals for corporate bonds are influenced by both supply and demand factors. On the demand side, the investor base includes institutional investors, retail investors (including mutual funds and ETFs), and foreign buyers.

- **Retail (mutual fund and ETF) demand** for investment-grade corporate bonds has been strong given attractive all-in yields. For example, the Bloomberg U.S. Corporate Bond Index had an average yield of 5.15% as of March 31, 2025 while bonds within the index were yielding between 4.5% and 6.0%. Prior to the elevated rate environment we’ve been in since mid-2022, the last time the yield on this index exceeded 5% was in 2009. Additionally, since 2010 the yield on this corporate index has been greater than its current level only 11% of the time. Furthermore, the Bloomberg U.S. Corporate Bond Index yield exceeded the S&P 500 equity index dividend yield by approximately +3.7%, a historically wide margin since the 2008 financial crisis.

**Corporate Bond Ownership by Investment Type**



Source: Federal Reserve, as of December 31, 2024.



These attractive yields, on both an absolute and relative basis, have encouraged demand for corporate bonds from retail investors. According to EPFR data, retail flows into investment-grade fixed income funds reached a record last year. Fund flows have decelerated in 2025 due to increased uncertainty but remain strong in short (0-5 years) and intermediate (5-10 year) maturities.

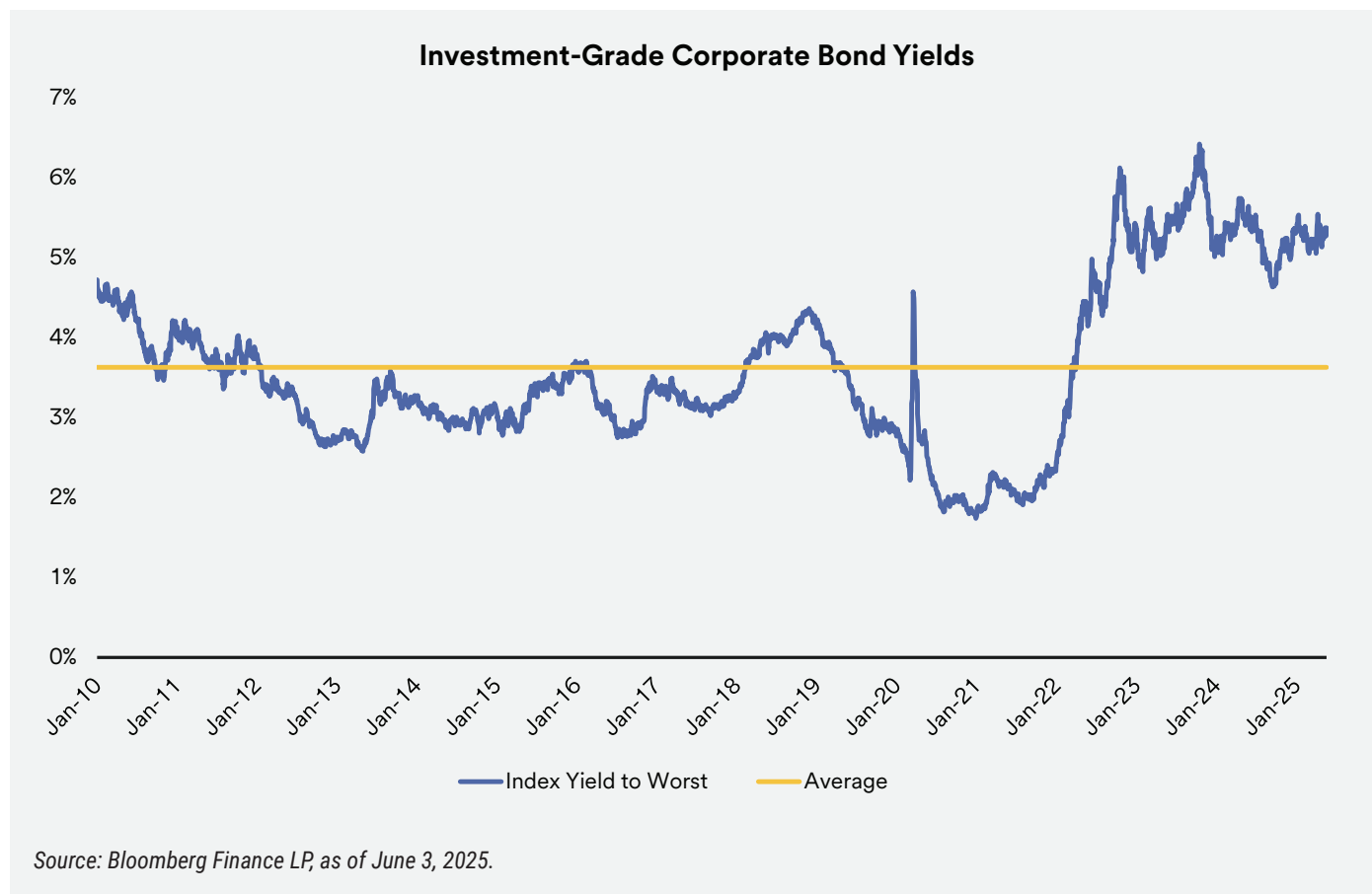
- **U.S. institutional** demand for investment-grade corporate bonds is dominated by interest from insurance companies, pensions, and banks. Pensions and insurance companies tend to buy longer maturity bonds to match their liabilities, which are typically longer term, while banks tend to buy short and intermediate maturity bonds.

With corporate bond yields near their highest levels since 2010, today's yields exceed the hurdles for pensions (which need to meet actuarial discount

rates) and insurance companies (which need to support pricing of life insurance and other products) to buy long maturity bonds. Pensions have had stronger demand for fixed-rate investments as historically high funded ratios<sup>1</sup> – 105% for private pensions and 81% for public pensions – have increased the attractiveness of immunization. Demand from life insurance companies has been bolstered recently as strong annuity sales has necessitated the purchase of longer-dated assets. However, both pension and life insurance companies have been reducing allocations to public market corporate bonds while increasing purchases of privates and alternative credit.

Given the importance of the overall yield level for both insurance and pension investors, we believe lower future yields are the largest risk around pension and insurance demand over the near term.

<sup>1</sup> As of the end of February 2025 according to Milliman.





- **Foreign ownership** of U.S. dollar denominated corporate bonds accounts for roughly one-third of U.S. investment-grade corporate bond holders. Demand from foreigners can be a function of relative market sizes, the currency denomination of the buyer's liabilities, yield differentials between foreign and domestic markets, and foreign currency hedging costs. Since the U.S. dollar-denominated investment-grade corporate bond market is the largest in the world, it provides an array of investment opportunities for foreigners. For some foreign buyers, such as multinational corporations or insurance companies, dollar-denominated assets are attractive because some of their own liabilities are denominated in dollars. However, yield differentials net of foreign currency hedging costs tend to be the largest driver of incremental demand for foreign buyers. U.S. corporate bond yields currently exceed much of the developed market in Asia (Japan) and Europe (with the exception of the U.K.), but those yield differentials have been shrinking so far in 2025. In Asia, this is a result of higher yields in Japan given improving growth, increasing inflation, and a central bank actually raising short term rates. In Europe, excluding the U.K., this is a result of higher yields due to a loosening of deficit spending restrictions and an anticipated increase in defense spending. Concurrently, yields in the U.S. have fallen year-to-date due to significant government policy uncertainty as well as the potential result of diminishing economic growth prospects. In addition, a substantial and prolonged trade war could sour foreign appetite for U.S. corporate bonds.

Finally, for those foreign investors that hedge their U.S. dollar currency exposure, hedging costs, using 3-month forward agreements, are significantly higher year-to-date for Euro-based investors while relatively unchanged for Japanese investors. As a result, on the margin, the incentive for Euro-based investors and Japanese investors to buy U.S. dollar denominated bonds has diminished this year.

In summary, there are currently many cross currents on the corporate bond demand side. Although demand remains strong, it has weakened on the margin due to reduced foreign demand and weaker retail fund flows. Any substantial decline in the overall level of yields could hurt demand from yield-sensitive long duration buyers, such as pension funds and insurance companies. Further, a prolonged trade war may also reduce foreign demand for U.S. fixed income assets due to the falling value of the U.S. dollar or lower trade volumes. In this environment of uncertainty, general demand for shorter maturity corporate bonds has increased relative to longer maturity bonds given their lower credit spread risk.

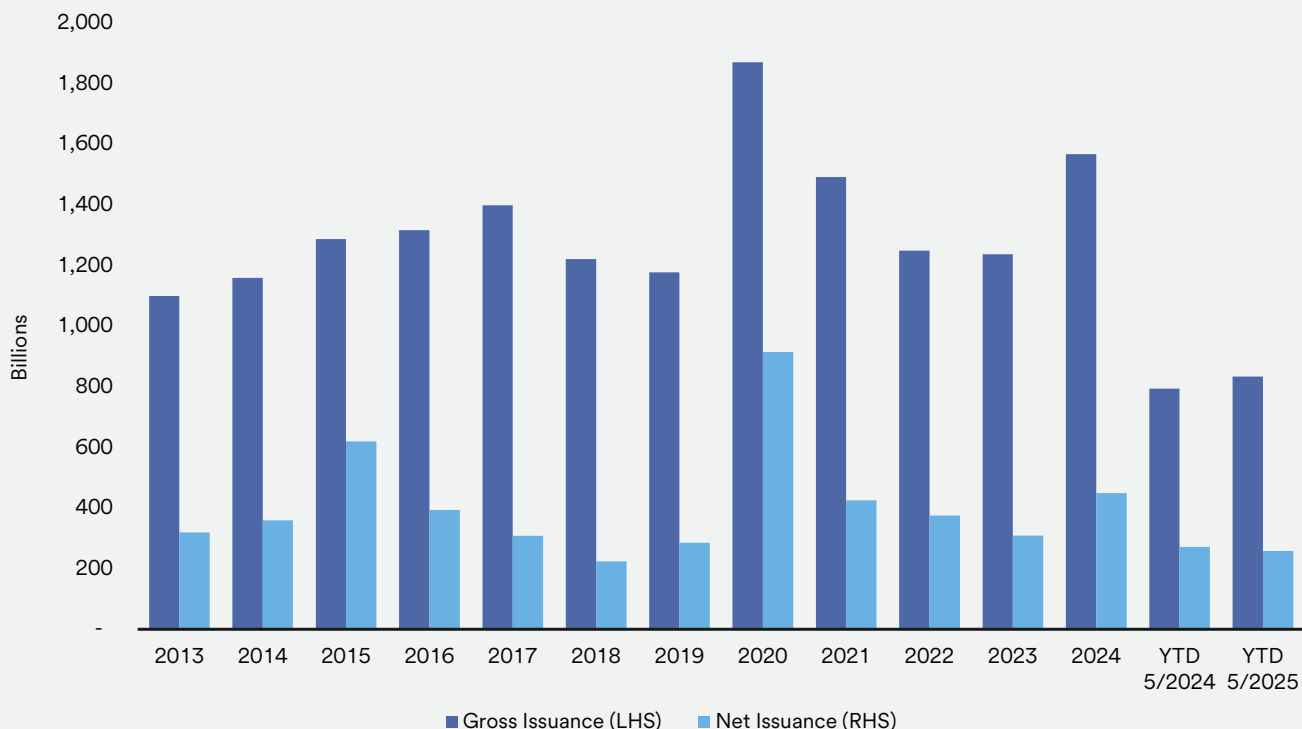
On the supply side, investment-grade corporate bonds are influenced by corporate financing needs, foreign issuance incentives, broker dealer balance sheets, and sales by existing holders. Corporate financing needs include things such as mergers and acquisitions (M&A), refinancing maturities, share repurchases, and capital expenditures.

Investment-grade corporate bond new issuance has been higher than the year-to-date period in 2024. Calendar year 2024 was the second largest amount of new issuance on record, behind only 2020. This issuance trend has continued into 2025 as more supply came to market in the first quarter of 2025 than during the first quarter of any other prior year. A portion of new issuance from 2024 may have been pulled forward ahead of the election, while some of the new issuance from 1Q25 may be the result of lower yields and a pull forward ahead of tariff implementation. All things being equal, a further decline in U.S. yields would incentivize additional corporate bond issuance. When looking at net corporate bond issuance – total issuance less bond maturities – the supply picture in 2025 has been more subdued and far from breaking records.

The largest driver of new corporate bond issuance has been the need to refinance a substantial amount of bonds maturing, including some of the record amount of debt issued during 2020. Additionally, corporate



### Investment-Grade Corporate Issuance



Source: Bloomberg Finance LP.

M&A-related financing transactions have further increased supply, and the potential for reduced regulation under the new administration may continue to impact this trend. Finally, regular financing needs for capital expenditures and shareholder returns have also propped up issuance.

When issuing corporate bonds abroad denominated in foreign currency, the incentive for U.S. corporations declines as the yield differential between U.S. bonds and foreign bonds falls and as hedging costs increase. For example, the recent spike in the yield of the German Bund relative to the U.S. Treasury has decreased the incentive for U.S.-based issuers to issue foreign bonds denominated in Euros. As a result, this likely means more issuance in U.S. markets versus overseas.

Broker-dealer balance sheets also influence supply technicals. When broker-dealer balance sheets are relatively full, broker-dealers may have less capacity to

hold additional corporate bonds in inventory and may choose to be a net seller of corporate bonds as a result. While this influence can be short term in nature, it can still have an impact. As of March 31, 2025, broker-dealer balance sheets are relatively light in bonds maturing five years and less, near historical averages for bonds maturing in five to 10 years, and relatively heavy in bonds maturing in 10 years or more. On net, this is positive for short-maturity corporate bond technicals and negative for long-maturity corporate bond technicals.

Sales of corporate bonds by existing holders can also increase available supply within the market. This could be driven by a general reallocation out of corporate bonds and into cash, U.S. Treasuries, equities or other asset classes. This tends to occur during periods of significant market turmoil as investors decide to reduce portfolio risk. Should the recent tariff-induced global trade war escalate, a substantial increase in sale-related supply could follow.



Absent market turmoil, we expect new issuance supply to remain heavy, driven primarily by the need of corporations to refinance upcoming maturities. However, the expectation is that new issuance net of maturities will not reach the record levels of 2024, implying refinancing activity will be the primary driver of supply. Government policy is a wildcard as it relates to mergers and acquisitions (M&A) activity and associated bond supply following lofty expectations heading into 2025. Lower interest rates could also incentivize additional issuance in 2025. Additionally, a sustained market risk-off event could spark investor reallocations and drive the sale of corporate bonds into the market.

Investment-grade corporate bond technicals (supply and demand effects) remain strong by many historical standards. However, that strength may be modestly fading due to the factors described above. Last year, extremely strong investment-grade corporate bond technicals combined with stable credit fundamentals

helped drive credit spreads to their tightest levels in over two decades, weakening valuation metrics. Looking forward, the strong yet changing technical backdrop for corporate bonds must be weighed against potentially weaker credit fundamentals but modestly improved valuations to affirm or reassess credit allocation weightings, credit quality bias, and credit curve positioning within a diversified multi-sector fixed income portfolio.

For more any questions about this report, please reach out to your relationship manager.

### Sources

- Bloomberg
- Federal Reserve
- BBRG

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