

Corporate Bond Market Insight | August 2025

# What July's Downgrades, Dissent and Trade Deals Did to Corporate Bonds

## Key takeaways

- » The typical light summer supply and reasonable earnings have helped investment-grade credit spreads recover close to the tightest levels year to date.
- » For the first meeting since December of 1993, two of the seven governors dissented from the majority and advocated for an immediate rate cut, but the Fed left rates unchanged.
- » Both GDP growth and retail sales bounced back this month, but it's a sign that economic growth is increasing in volatility.
- » Japan, the European Union and several other major trading partners announced tentative deal frameworks. And with tariff revenues incrementally increasing, companies are becoming less reluctant to pass tariff costs along to consumers.

## Recap

The administration announced tentative frameworks for five major trade deals, Congress passed a massive budget reconciliation bill and the economy continued to perform well in July. Inflation increased more than expected, and the underlying details suggest that tariff related price increases are beginning to work their way into the economy. Large capitalization equity indexes reached new all-time highs, rates rose modestly and investment-grade (IG) corporate spreads narrowed. The Fed left rates unchanged despite enormous pressure from the Trump administration.

IG fundamentals are supportive, and current yields are attractive in our view. The typical light summer supply and reasonable earnings have helped IG credit spreads recover close to the tightest levels year to date. However, July is the first month in the last seventeen when the dollar amount of downgrades exceeded the dollar amount of upgrades. The downgrade of a single large media name drove the one month change in the upgrade to downgrade ratio. We expect that upgrades will again exceed downgrades in coming months.

The President signed the budget reconciliation bill early in July. The bill permanently extended the 2017 tax cuts, doubled the standard personal deduction and added temporary deductions for tips, overtime pay and auto loan interest. The impact on the national debt will be large. The Congressional Budget Office (CBO) estimates the bill will add \$4.1 trillion to the projected baseline deficit over the next decade. This includes \$700 billion in additional interest costs to the projected baseline deficit over the next decade. This would bring the total deficit to \$24.5 trillion and the total debt to \$54 trillion or 124% of the GDP. Private estimates of its impact are lower, but it seems assured that Treasury financing needs will continue to grow. The CBO also estimates that tariffs could raise as much as \$2.8 trillion over the decade, offsetting a sizable portion of the deficit.

It's important to note that the actual impact will depend on economic growth, and the bill contains incentives to draw manufacturing to the US, which could boost growth. The administration is also making a concerted effort to reduce domestic regulatory burdens. If those efforts are successful, the deficit could be significantly less than the CBO estimate.

In a 9 to 2 vote, the Fed left rates in the same 4.25% to 4.50% range. There seems to be no immediate reason to reduce rates with a 4.1% unemployment rate, stronger-than-expected growth, the refusal of inflation to decline closer to the Fed's 2% target and risk markets well bid. In his comments following the meeting, Chair Jerome Powell emphasized that policy remains "modestly restrictive." He went on to say that the next move in rates will be guided by "incoming data, the evolving economic outlook and the balance of risks."

This meeting was particularly contentious in that two of the seven governors, Michelle Bowman and Christopher Waller, dissented from the majority and advocated for an immediate rate cut. This was the first meeting since December of 1993 at which two Governors dissented. Waller gave a well-reasoned defense of his dissent. There's suspicion though that he and Bowman are working to prove their dovish credentials in anticipation of Powell's term ending in May 2026. All the regional Fed Presidents notably voted to keep rates steady.

The administration continues to push hard for lower rates. Jawboning rates lower isn't unusual. However, this administration's pointed criticism and the threat of early termination of Powell's tenure have been particularly antagonistic. On July 16, the President asked several Republican lawmakers their opinion of a draft letter terminating the Powell chairmanship. Long rates moved sharply higher in response, the 2s-30s curve steepened 14 basis points (bps) and the S&P 500® declined 1.5%. We believe the market reaction convinced the President not to send the letter. We believe that a change of leadership would probably result in short rates moving lower, but the loss of focus on inflation would likely move intermediate and long rates higher. This could harm businesses and add more pressure to an already weak housing market.

July also saw more tariff headlines, and their effects became clearer. Several major trading partners announced tentative deal frameworks with the August 1 deadline for individual deals quickly approaching, most notably, Japan and the European Union. Morgan Stanley estimates that business has only passed about 30% of the tariff costs through to consumers. But tariff revenues have been incrementally increasing and the inventory buildup that occurred pre-tariff is reversing. The last Consumer Price Index report indicated that increases are beginning to pass through to consumers as a result. We believe that the effects will become broadly clear over the last half of the year. We subscribe to the idea that tariffs will function like a tax, slowing economic activity, while increasing the inflation rate.

Against this backdrop, the 10-year Treasury yield rose 15 bps on the month while 1-10 year US IG credit spreads narrowed eight bps on the month. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned 0.18% for the month, and 5.89% for the trailing one year as a result. Credit spreads in all sectors narrowed over the month. Autos, leisure and transportation performed best while healthcare and consumer goods lagged. Lower quality again outperformed higher quality.

The economy continues to expand, but the expansion has become increasingly uneven. For instance, retail sales rebounded 0.6% in June after declining 0.9% in May.

The unevenness is also apparent in the GDP report. After declining 0.5% in the first quarter, second quarter GDP grew at an annualized 3% rate. Inventory accumulation distorted both quarters since businesses and consumers rushed to buy imported goods before tariffs were implemented. Averaging the two quarters removes much of the distortion and suggests that GDP grew at a slow 1.25% over the first six months of the year.

On a brighter note, the employment economy continues to surprise to the upside. The 147,000 non-farm payroll jobs added were stronger than expected, and the 4.1% unemployment rate is low by historic standards. However, when the unemployment rate does begin to rise, it does so very quickly. The slump in home sales is also notable. The economy has historically struggled when home building and ancillary industries struggle.

## **Looking forward**

Late summer and early fall should begin to provide more definitive information in terms of the impact of tariffs on the economy and inflation. There's no Fed meeting until September, giving them two months of data to assess. We continue to expect at least an economic slowdown and perhaps even a mild recession. We continue to believe that strong IG corporate balance sheets and the yield advantage of owning IG corporates offer significant protection against economic volatility.

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