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Investment grade credit: Strategy update

Fixed Income | Q1 2020

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While investment grade (IG) credit market returns were significantly negative and spreads materially wider by the end of the first quarter, IG market valuations are now much more attractive than at the start of the year. We entered the year conservatively positioned in our IG portfolios, and as we re-visit valuations and the policy response to the COVID-19 crisis, we have become more constructive about future prospects for the market.

Q1 market review

The likelihood of economic recession in many developed markets following COVID-19 related economic shutdown and isolation measures met with rising risk aversion and market illiquidity to force credit spreads significantly wider.

Dislocation was evident in the differing performance of markets. The US dollar market led spreads wider, with short-dated bonds especially weak and higher quality credit (e.g. AAA) underperforming lower-rated debt on a percentage or risk-adjusted basis. At the sector level, industries in the frontline included more cyclical areas of the market such as autos and energy, as well as transport & leisure and non-food retail. Better performance was seen in those with less exposure to the cycle, such as utilities and telecoms.

A week ago, in the wake of an immense policy response (both fiscal and monetary) that has impressed with its swiftness, scope and scale, markets regained some poise while the weaker areas described above have led the charge tighter in spreads into the month end.

This comes at a time of higher new issuance, decent levels of subscription and attractive new issue premia. Liquidity is, of course, a double-edged sword and just as dealers were unable or unwilling to buy bonds a week or so ago so they are reluctant to offer up inventory they might struggle to replace - as we ended the quarter.

Activity and outlook

Global spreads are now some 2.5 standard deviations wide of the long run (20-year) average from around -0.5 at the end of 2019.

Meanwhile, the policy measures described above will help ameliorate the significant (though temporary) interruption to economic output and employment. More specifically, much of the policy response is specifically targeted at keeping the credit channel open. Policymakers want to avoid an economic shock turning into a financial crisis. Policies such as the US Federal Reserve directly buying IG corporate bonds, for example, are designed with credit spreads in mind.

Credit ratings agencies have also been quick to act, and the likelihood of further downward rating action will hang over the market for the next few months. We note, however, that authorities have asked banks and some corporate issuers to cease the payments of dividends and share buybacks - which is credit positive in isolation.

In summary, at present we feel spreads offer material compensation for rising credit risk.

We entered the year conservatively positioned in our portfolios

The amount of absolute and relative credit risk in our portfolios was much lower than was the case a year ago. We favoured late cycle defensive areas of the market including regulated utilities and infrastructure as well as ‘credit improvement stories’ (e.g. AT&T, Verizon, GE, Fidelity National AB InBev Bacardi and Becton Dickenson) in areas of lower cyclicality.

As we revisit valuations and the policy response to the crisis, we have become more constructive of the market’s prospects

We feel we are being well compensated with potential return for investment risk. Notably at current spread levels, markets are compensating investors at many multiples of the worst historic default experience. As a result, we are increasing credit risk in our portfolios. We have added to the beta of portfolios from closer to home at the start of the year to above that of the index.

In light of the difficult liquidity conditions this has been transacted through areas of the market that allow us to build risk without paying an excessive price to do so - such as the credit derivatives market and more recently from attractively priced new issues (e.g. P&G, Microsoft, Intel and AB InBev).

Performance summary

Broadly speaking, the European and global long-only IG portfolios have performed well for reasons documented above.

Areas of weaker performance include our UK Short Dated strategies. We typically run high levels of credit risk in light of the specific characteristics of this market (including the effect of ‘pull to par’). Short-dated credit has also performed poorly on a risk-adjusted basis as investors seek liquidity. The US Fed’s policy actions are deliberately targeting shorter maturity debt so this trend has reversed somewhat and we believe will continue to do so as we enter the second quarter.

For our absolute return strategies, it has been a difficult period. We entered the year having de-risked the portfolios to around half the credit risk of our investment universe. With total returns from global IG of around -12% and total returns from European high yield of around -14% over the quarter, you can see the context in which we have had to operate.

Note: all data as at 31 March 2020, unless otherwise specified. Source: Bloomberg.

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