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Investment grade credit: how cheap are credit spreads?

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From the middle of February to late March was one of the worst periods of performance for risk markets in general and for investment grade (IG) credit in particular. This was in response to the Covid-19 crisis and was marked by both the speed and extent of the spread widening.

Specifically, global IG bonds went from trading with a spread over government bonds of 100 basis points to 340 bps in what has been the fastest ever sell-off in IG credit. It also marks the widest spreads since the global financial crisis (GFC) in 2008 when they got close to 500 bps[1].

March recorded a -9% excess return[2], worse than the -6% and -5% recorded in September and October 2008 during the GFC[3]. At 340 bps, global IG spreads were around three standard deviations wide of their long-run average of 130 bps. During April, spreads retraced some of that widening and are now 1.2 standard deviations cheap to their long-run average.

Questions we needed answering

The widening in spreads threw up a number of questions: are credit markets cheap enough to warrant an increase in portfolio risk? If so, how much of our risk budget should we use? And is this the once in a decade opportunity to add risk – the so called “fat pitch”?

Given our bottom-up, fundamental approach the answer starts with an assessment of corporate fundamentals before we can truly decide whether or not valuations are over-compensating for the risks. There is no doubt markets have cheapened a lot, but there is

[1] ICE BofA Global Corporate Index, 1 May 2020
[2] Excess returns: the return differential between a corporate bond and a duration-matched government bond
[3] Bloomberg, 10 April 2020

also no doubt that we face an unprecedented situation where entire sectors are shut down, populations are quarantined and unemployment is hugely impacted. For example, the non-farm payroll number released last week showed that nearly all the job creation we have witnessed in the US since 2009 has been undone, losing about 21 million jobs in two months.

The response to the crisis

As we started 2020 our assessment of the credit cycle was "cautious". This was driven by the increasing focus on shareholder returns, elevated leverage, tightening financial conditions (although Europe was the exception with ECB-driven quantitative easing), and valuations were only close, if not below, their long-run average.

Today the world looks very different. Central banks and governments have thrown out the rule book and embarked on game-changing programmes to prevent defaults. Central bank facilities are providing near-unlimited liquidity to the financial system, while unprecedented fiscal support has been rolled out for both corporates and households to prevent economic meltdown and allow for the economy to recover from this pandemic shock. This is significant. As such we have upgraded our assessment of the technical backdrop to "supportive".

Negative economic background, worsening corporate health

Our assessment of the economic outlook, however, has been downgraded to "negative". We think a significant global recession is inevitable. Initial PMI (business sentiment) data alongside labour data in the US look particularly alarming, and Q1 earnings are highlighting the abrupt fall in revenues across the economy. Our base case is for a "U-shaped" recovery where it takes around 10 quarters to return to 2019 growth levels after a deeply negative 2020.

On the corporate side, we were negative about fundamentals going into the year and that assessment has now worsened. At the outset, leverage was elevated and we were concerned corporate balance sheets would be weakened by an eventual economic shock. Central bank and government responses to provide liquidity and support to the economy have been unprecedented, but the fact that the support is in the form of loans means that most corporates are taking on even more debt at a time when their revenues have dropped significantly.

As a result we are likely to see leverage increase across our market. Admittedly interest rates are low so serviceability of this debt is manageable, but the fact remains that corporates with already elevated leverage are having to borrow even more to shore up their balance sheets to weather the storm and avoid bankruptcy. The measures are designed to prevent an avalanche of defaults, which is positive, but we believe it is likely that the quality of corporate balance sheets will be significantly weakened. The IG market has been an A-rated universe, but it is becoming our base case that the overall quality of this universe is likely to migrate towards a BBB-rated universe. Indeed, we have already seen downgrades from rating agencies.

Are you over-paid for the risks?

The global IG universe has on average been rated single-A since 2000 with net leverage of around 1.2x in the US and 2.3x in Europe. The BBB-rated names within that universe have on average had a net leverage around 2x in the US and 2.6x in Europe. When we aggregate our analysts' bottom-up expectations in our downside Covid-19 scenario, we see net leverage rising from 1.7x to 2.2x in US IG and higher in Euro IG.

So in a stressed scenario we see net leverage for the global IG universe increasing to levels more commensurate with BBB-rated corporates. To adjust for the potential credit deterioration and to gauge what is already priced in, we compare global IG to the history of the BBB-rated index.

Global IG finished April with spreads at 209 bps, making it 1.2 standard deviations cheap to its own long-term average of 130 bps; however, it is only 0.2 standard deviations cheap compared to the long-run BBB average of 190 bps. Admittedly this is a rather stressed downside and not our base case, but it helps frame our risk taking. Spreads are indeed cheap, trading wide of BBB average, but perhaps not "once-in-a-lifetime" cheap given the extent of the potential deterioration in borrowers' fundamentals.

What have we done in portfolios?

We increased the risk profile of our funds in late March from roughly neutral to about 75% of our risk budget[4], predominantly through an increased exposure to defensive sectors that we think will weather the crisis well and, in some cases, come out stronger.

We have added to technology, utilities, beverage companies and consumer staples, and have rotated within the banking sector to favour those based in countries with a strong fiscal position.

We may well see management teams focus on paying down debt post-Covid-19, but for now we continue to build our exposure via relatively defensive sectors, are comfortable being overweight credit risk, but do not feel valuations are cheap enough to warrant using the full risk budget.

[4] That is, we are 75% of the way between neutral and the maximum risk for a given mandate