Finding Opportunities in Investment-Grade Credit

With corporate fundamentals weakening, security selection is key.

April 2019

Lauren Wagandt, CFA
Co-portfolio manager for U.S. investment-grade corporate bond strategies

KEY INSIGHTS

- With corporate fundamentals generally weakening as global economic growth slows, the opportunity to generate gains through broad allocations to investment-grade corporate bonds has diminished.
- We think that short-maturity Asian investment-grade corporates denominated in U.S. dollars offer an attractive risk/reward trade-off and diversification away from the elevated leverage in BBB rated U.S. credits in particular.
- Our credit analysts are also finding pockets of opportunity in select U.S. investment-grade credits that appear to be mispriced across a range of sectors; the automotive and tobacco sectors, in particular, appear attractive.

Strong security selection matters more than ever in investment-grade corporate bond portfolio management in the current late-cycle credit environment. With corporate fundamentals generally weakening as global economic growth slows, the opportunity to generate gains through broad allocations to the asset class has diminished. Relying on the insights of our team of global credit analysts, we are finding select opportunities that offer relative value and fundamental strength within investment grade, particularly in Asian credits as well as the automotive and tobacco sectors.

Late-Cycle Economic Conditions

The current U.S. expansion, which began following the end of the global financial crisis 10 years ago, is already lengthy by historical standards, and U.S. economic data softened noticeably late in 2018. European growth appears to have stagnated at a very low level, and the Chinese government may not be willing to add enough stimulus to allow China to lift the global economy. The Federal Reserve has noted these late-cycle conditions and shifted toward a much more dovish stance since the end of 2018, likely putting rate hikes on hold for the remainder of this year. Corporate fundamentals have broadly weakened from their midcycle strength as revenue and earnings growth slows. For example, corporate leverage, as measured by debt-to-EBITDA,[1] is lofty.

Against this backdrop, we generally favor exposure to shorter maturities in investment-grade corporate bonds.

[1] Earnings before interest, taxes, depreciation, and amortization.

Among U.S. issuers, our credit analysts are finding pockets of opportunity in select investment-grade credits that appear to be mispriced.

This relatively defensive posture would allow portfolios to better withstand a widening of credit spreads[2] in the asset class, which we expect as investors increasingly price in deteriorating corporate fundamentals.

Asian Credits Offer Attractive Risk/Reward Characteristics

Select non-U.S. credits also provide defensive characteristics relative to the broad U.S. investment-grade corporate debt asset class. For example, we think that short-maturity Asian investment-grade corporates denominated in U.S. dollars offer an attractive risk/reward trade-off. Our exposure to the segment adds diversification away from the elevated leverage in BBB rated U.S. credits in particular. Asian investment-grade bonds also have historically demonstrated more attractive Sharpe ratios[3] than U.S. investment-grade corporate debt and currently provide more spread relative to their volatility.

Asian technology is a particularly attractive sector. For example, we favor A rated Asian tech companies over BBB rated U.S. telecommunications issuers, a more volatile segment characterized by high leverage and challenged growth. The A rated Asian tech credits have little to no net debt and strong growth profiles, yet they offer wider spreads than BBB rated U.S. telecom companies.

Pockets Of Opportunity In Automotive And Tobacco Sectors

Among U.S. issuers, our credit analysts are finding pockets of opportunity in select investment-grade credits that appear to be mispriced. The automotive and tobacco sectors, in particular, appear attractive, but we have also identified idiosyncratic relative value opportunities across a range of sectors.

Slowing global auto sales, lingering trade war concerns, and a slow industrywide transition toward electric vehicles have created attractive valuations for some of the higher-quality credits in the automotive sector. While we anticipate that negative news headlines will continue to impact the sector, we believe that some automotive credits (particularly some high-quality European issuers) have strong, well-managed balance sheets that should allow them to withstand volatility from negative headlines. However, our positions in the sector are mostly short-maturity to moderate our exposure to negative credit news.

Select Tobacco Credits Offer Strong Cash Flow, Robust Balance Sheets

The tobacco sector has suffered from weak investor sentiment, but we believe that the problems that have been weighing on sentiment apply more to equities than debt. Recent large mergers and acquisitions in the sector worried investors, and an overhang of regulatory uncertainty and declining consumption has further dampened enthusiasm for tobacco companies. However, we think that some tobacco companies present opportunities because of their strong free cash flow and balance sheets that are robust enough to withstand negative news and maintain their investment-grade credit ratings. In fact, we are comfortable with exposure to longer maturities in these select tobacco credits.

In the automotive and tobacco sectors as well as Asian issuers, we rely on the insights of our credit analysts to find credits with dislocated prices that do not reflect their fundamentals. This analysis is essential for success in a late-cycle environment where the entire asset class is not benefiting from the broad improvement in fundamental credit quality that characterizes the early stages of the economic cycle.

[2] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.
[3] The Sharpe ratio is a measure of return relative to risk, calculated as an asset's return above the risk-free rate, divided by the standard deviation of the asset's excess return. Sharpe ratios for Asian investment-grade corporate bonds as measured by the Bloomberg Barclays Emerging Market Asia USD Investment Grade Corporate 1–5 Year Index and for U.S. investment-grade corporate bonds as measured by the Bloomberg Barclays U.S. Corporate Investment Grade Index. See Additional Disclosures.

Additional Disclosures

INVEST WITH CONFIDENCE℠

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T. Rowe Price®

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Brunei—This material can only be delivered to certain specific institutional investors for informational purpose upon request only. The strategy and/or any products associated with the strategy has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

China—This material is provided to specific qualified domestic institutional investor or sovereign wealth fund on a one-on-one basis. No invitation to offer, or offer for, or sale of, the shares will be made in the People's Republic of China ("PRC") (which, for such purpose, does not include the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the PRC. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the PRC. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the PRC that are expressly authorized under the laws and regulations of the PRC to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the PRC. Potential investors who are resident in the PRC are responsible for obtaining the required approvals from all relevant government authorities in the PRC, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the PRC, or nationals with permanent residence in the PRC, or to any corporation, partnership, or other entity incorporated or established in the PRC.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA ex-UK—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea—This material is intended only to Qualified Professional Investors upon specific and unsolicited request and may not be reproduced in whole or in part nor can they be transmitted to any other person in the Republic of Korea.

Malaysia—This material can only be delivered to specific institutional investor upon specific and unsolicited request. The strategy and/or any products associated with the strategy has not been authorised for distribution in Malaysia. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

New Zealand—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—THE STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING OFFERED OR SOLD HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan—This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

ID0002173 (04/2019)
201904-799116