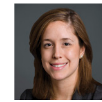
Focus on Higher-Quality Investment-Grade Corporate Bonds

June 2021

We are finding opportunities to add yield despite narrow spreads.



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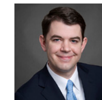


Matt Lawton, CFA
Sector portfolio manager, US Investment-Grade Credit

KEY INSIGHTS

- Investment-grade corporate bond valuations are expensive, and fundamental and technical conditions in the sector are still positive but becoming more fragile.
- Although risks appear skewed to the downside at current valuation levels, we see the potential for the rally in the asset class to continue.
- We are still finding opportunities to add yield to portfolios in more liquid, higher-quality segments of the investment-grade corporate market.

Investment-grade corporate bond valuations, measured by credit spreads,[1] are expensive relative to history, and fundamental and technical conditions in the asset class are still positive but becoming more fragile. At the same time, "fear of missing out" amid an unusually strong economic recovery and massive government stimulus may continue to drive interest in the market, possibly moving credit spreads even tighter. While we are taking a relatively conservative stance toward risk in investment-grade corporates, we are still finding some opportunities to add incremental yield in higher-quality, more liquid segments of the market.

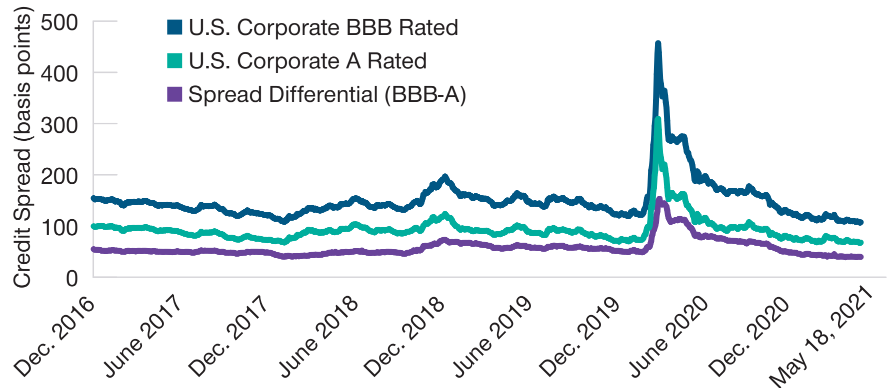
Credit Spreads at Record Lows After Adjusting for Quality and Duration

Adjusted for changes in credit quality composition and duration[2] over time in the U.S. investment-grade corporate market,[3] credit spreads are at record-low levels as of mid-May. The difference in spreads between A rated and BBB rated credits is also low, so investing in lower-quality bonds within the sector does not provide much additional spread. Credit curves—the amount of additional spread gained by investing in longer

[1] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.
[2] Duration measures a bond's sensitivity to changes in interest rates.
[3] As measured by the Bloomberg Barclays U.S. Corporate Investment Grade Bond Index.

Compressed Spread Differentials

(Fig. 1) Credit spreads for A rated and BBB rated bonds*



As of May 18, 2021.
Source: Bloomberg Barclays
*Within the Bloomberg Barclays U.S. Corporate Investment Grade Bond Index

"...the upward trajectory in balance sheet strength now appears to be past its peak."

maturities of similar issuer types—are also relatively flat, removing some of the spread advantage of moving to longer-term bonds.

Near-Term Technicals Less Supportive

Technical conditions, which gauge trends in supply and demand, are somewhat less supportive in the near term for investment-grade corporates. Issuance was higher than expected for 2021 through April, although the level of new supply was still down from the same period in 2020 when companies rushed to issue bonds to raise cash amid the onset of the pandemic. We expect merger and acquisition activity to increase as 2021 progresses, potentially adding to supply pressure as acquirers often bring new debt to market to fund their deals.

On the demand side of the equation, foreign flows into the asset class have slowed. However, we think that a material widening of credit spreads would draw renewed demand into the investment-grade corporate market to try to take advantage of the more attractive valuations. We observed this behavior in March, when credit spreads widened modestly but then narrowed fairly quickly as buyers moved back into the market. The asset class still provides attractive yields for global buyers, which we believe should help limit some of the downside risk.

Fundamentals Still Improving but Past Peak

Fundamentals in investment-grade corporate issuers are still improving, supporting their ability to maintain their credit ratings, but the upward trajectory in balance sheet strength now appears to be past its peak. After the second quarter of 2021, we expect the rate of growth in sales and earnings for companies in the Standard & Poor's 500 Index (many of which issue investment-grade bonds) to decrease from the robust levels seen in the first half of the year.

In 2020, investment-grade corporate issuers substantially boosted their cash reserves by issuing new bonds. Our investment-grade corporate credit analysts expect excess cash levels of the companies that they cover to fall by about 80% from the end of 2020 to the end of this year as companies put their cash stockpiles to work. We have also noticed that more issuers have started to use their cash reserves to buy back stock or increase dividends rather than making capital investments or fortifying

their balance sheets, supporting their equity prices.

Opportunities to Add Yield in Higher-Quality, More Liquid Segments

With these risk factors in mind, we also recognize that the current economic expansion is atypically strong and that the amount of monetary and fiscal stimulus in the economy easily surpasses any past period. Although risks appear skewed to the downside at current valuation levels, we see the potential for the rally in the asset class to continue. As a result, we favor maintaining exposure, even at the current narrow credit spreads, while maintaining a relatively conservative stance in investment-grade corporate credit.

We still see opportunities to add yield to portfolios in more liquid, higher-quality segments of the investment-grade corporate market, including credits in industries such as banks and telecommunications. We also tend to prefer short- and intermediate-term maturities, which typically offer more spread relative to their duration risk. This is particularly true in the current environment, where longer maturities provide only a limited spread premium and entail considerable duration risk.

We have also found that indexes of credit default swaps,[4] known as CDX, tend to be meaningfully more liquid and attractively valued than the underlying cash bonds and can be useful tools for efficiently adding or removing exposure to investment-grade corporate credit.

WHAT WE'RE WATCHING NEXT

The potential for higher inflation as the economy more fully reopens has received considerable attention in the media. While inflation erodes the value of bond coupon payments over time, it can also eventually drive labor costs higher. This can crimp profit margins at investment-grade corporate issuers, weighing on their credit quality.

[4] A credit default swap involves regular payments from the buyer to the seller in exchange for repayment of principal value to the buyer if the issuer experiences a credit event such as default.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material:

Debt securities could suffer an adverse change in financial condition due to a ratings downgrade or default, which may affect the value of an investment. Fixed income securities are subject to credit risk, liquidity risk, call risk, and interest rate risk. As interest rates rise, bond prices generally fall.

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