Investment Insights

When the stars align:
Opportunities in global investment grade corporate bonds

September 2024

FOR PROFESSIONAL / QUALIFIED INVESTORS ONLY
Marketing communication

Flavio Carpenzano
Investment Director

Peter Becker
Investment Director

When the stars align: opportunities in global investment grade corporate bonds

Key takeaways

- The turn in the interest rate cycle toward lower rates potentially provides a strong backdrop for fixed income. Global investment grade (IG), with its high credit quality, attractive yields and duration, is, we believe, particularly well placed to capture this opportunity.
- Credit spreads are close to historical minimums but, we believe, not as tight as they optically seem. Our analysis shows that, if adjusted for the evolution of the global IG market in terms of credit quality and duration over the past 20+ years, it can be observed that spreads stayed at current or tighter levels for longer time periods.
- It is about more than just duration. As policy rates are cut, history suggests investment grade corporate bonds are likely to outperform US Treasuries. Since 2000, global IG has delivered superior results to USTs in most years. The only exceptions have been during periods of severe recession or market stress.
- Year-to-date, strong demand has kept IG credit spreads from widening, despite record issuance. Many of the factors that have underpinned this demand are likely to continue as pension funds will likely continue to invest and benefit from the high starting yield.

We believe investment grade credit could be well positioned to provide investors with strong returns over the coming investment cycle. Yields are significantly higher than their historical averages and so offer investors the chance to lock in attractive levels of relatively secure income over the long term; corporate fundamentals are, in our view, solid; and the macroeconomic backdrop could provide a duration tailwind to the asset class as central banks ease policy.

These arguments are well known and have helped IG absorb record levels of issuance year-to-date. The pushback we often hear from clients is that while all the above is true, spreads are well within historical averages, and so with all the good news already priced in, the asset class is simply too expensive.

In this paper, we take a closer look at investment grade corporates and explain why we do not think spreads are as tight as they seem, why we believe IG credit is still an attractive area of the fixed income market to capture the opportunity from the US Federal Reserve's (Fed's) easing of policy, and why the technical backdrop could remain supportive.

IG corporate valuations are not as tight as they seem

A review of credit spreads over time shows they are lower than their historical average, particularly in the US. However, this simple read through of the data ignores the fact that the IG market has changed significantly over the past 20 years and even in recent years.

One change is the increased level of leverage as a consequence of companies seeking to optimise their capital structure during the post-global financial crisis (GFC) period of very low interest rates. This means BBB-rated bonds now represent a higher proportion of the index than they did in the past.

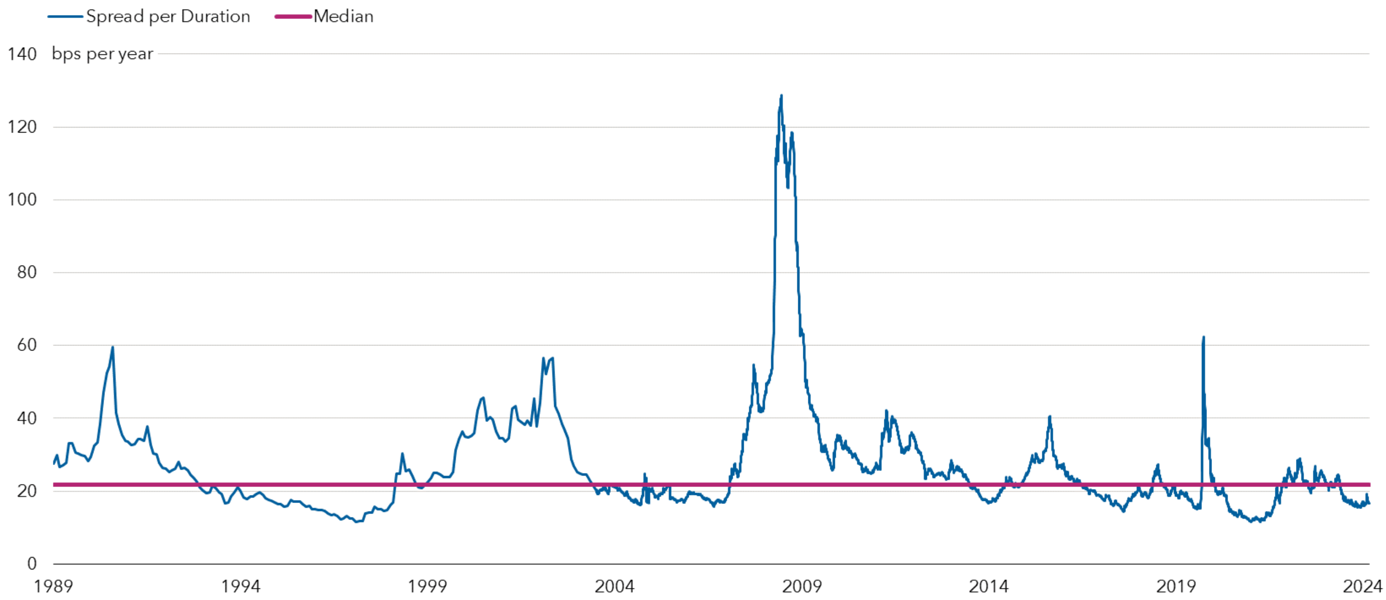
Also, post the GFC, duration increased steadily as companies issued bonds with longer maturities to lock in the low cost of funding for longer; however, duration significantly dropped post-COVID as interest rates increased dramatically (i.e. the second order effect of changes in rates is change in duration itself).

To account for this, and the change of duration in the corporate bond market over time, we undertook historical comparison of spreads per unit of duration of BBB-rated US corporate bonds[1] to evaluate spreads of the same credit quality over duration.

As the following chart shows, on this basis, while spreads per unit of duration have fallen below their long-term average since late last year, they are not that tight. Indeed, they are not far off the median for the period. They are also wider than the pre-GFC era and much wider than the mid to late 1990s, a period when the Fed engineered a soft landing and spreads bottomed at close to 50 basis points (bps). Both of these periods were characterised by higher growth and inflation.

[1] Bloomberg USD BBB Corporate Index

Spreads per unit of duration



Data as of 31 Aug 2024. Source: Bloomberg. Time period: 30 Jun 1989 to 31 Aug 2024
Index: Bloomberg BBB Corporate Total Return Index (LCB1TRUU Index).
Spread: Option Adjusted Spread (OAS). Duration: Option Adjusted Duration (OAD).

Looking more closely at the period since 2022 (shown in the chart below) when the Fed began hiking rates, we can see that spreads are lower. Importantly, however, as mentioned above, duration has also fallen by two years from its peak during the pandemic and is now at its lowest level at any point over the past decade. In other words, investment grade credit now offers investors similar spreads to the pre-COVID era, but with less duration risk. The current higher spread per unit of duration can therefore potentially better protect a portfolio should rates sell-off.

The same spread for less duration risk

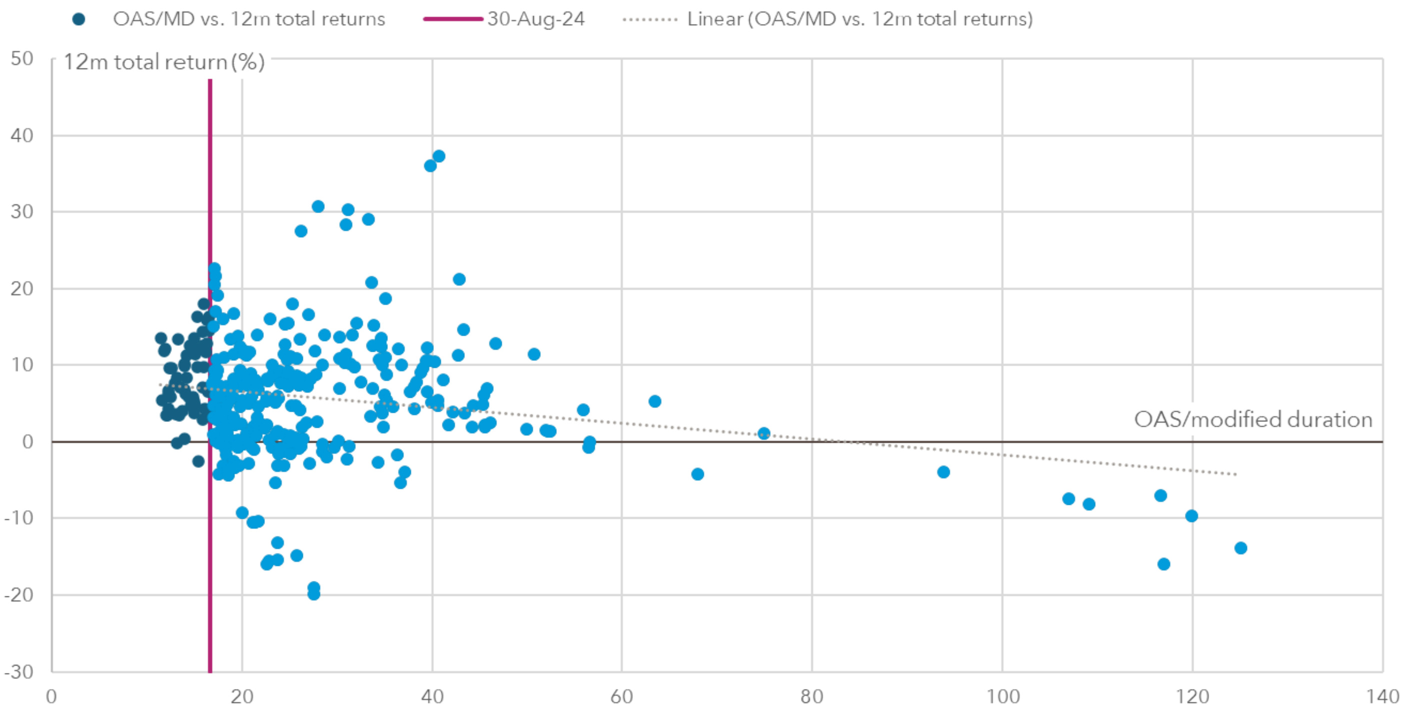
Data as at 30 August 2024. Index is the Bloomberg Baa Corporate Total Return Unhedged USD Index. OAS is option adjusted spread. OAD is option adjusted duration. Source: Bloomberg

Furthermore, for investors who doubt the total return potential of IG corporates at current spread levels, analysis reveals an interesting feature of the asset class. When looking at total returns as a function of the spread per unit of duration metric, it turns out that, historically (over the past 30 years), when this metric has been at or below current levels, the total return in the following 12-month period has been positive 96% of the time. This compares to 78% positive 12-month total returns for all periods.

An explanation for this could be that the total return outcome for IG corporate credit has, in the absence of stress or a crisis in the financial system, historically been more driven by the path of interest rates than spreads. As such, tighter spreads could be pricing in a more favourable future monetary policy environment. The association between low spread to duration levels and positive total returns over the following 12 months is shown the below chart.

Lower spread to duration levels are associated with a higher likelihood of positive total return outcomes

Comparison of spread per unit duration and 12-month returns for US IG BBB corporates



Data as at 30 August 2024. Monthly data from September 1991 to August 2024. Index is the Bloomberg USD BBB Corporate Total Return Index. OAS is Option Adjusted Spread.

Prices have fallen

Unlike in previous periods when spreads were at cycle tights, today's investment grade market is priced below par. The discount reflects the fact that the increase in IG yields was primarily the result of rising interest rates rather than a deterioration in credit risk.

The discount is significant, because as the below-par bond approaches maturity, the pull-to-par impact on prices, and therefore fall in yield, should have a tightening effect on spreads. Also, the impact of dollar prices on spreads is not to be underestimated. The market typically commands a risk premium for higher dollar prices and so historical cycle tights when prices traded above par, on average, need to be adjusted down for that premium, making the current spread level more attractive.

Pull to par should benefit spreads

Data as at 30 August 2024. Index is the Bloomberg USD BBB Corporate Total Return Index. OAS is option adjusted spread. OAD is option adjusted duration. Source: Bloomberg

This analysis of historical spreads and prices underlines that while spreads have fallen, they are not at historical tights. That does not mean we expect them to significantly tighten from current levels, but it does suggest the bar for spreads to widen is perhaps higher than a simple read through of average spread levels might suggest.

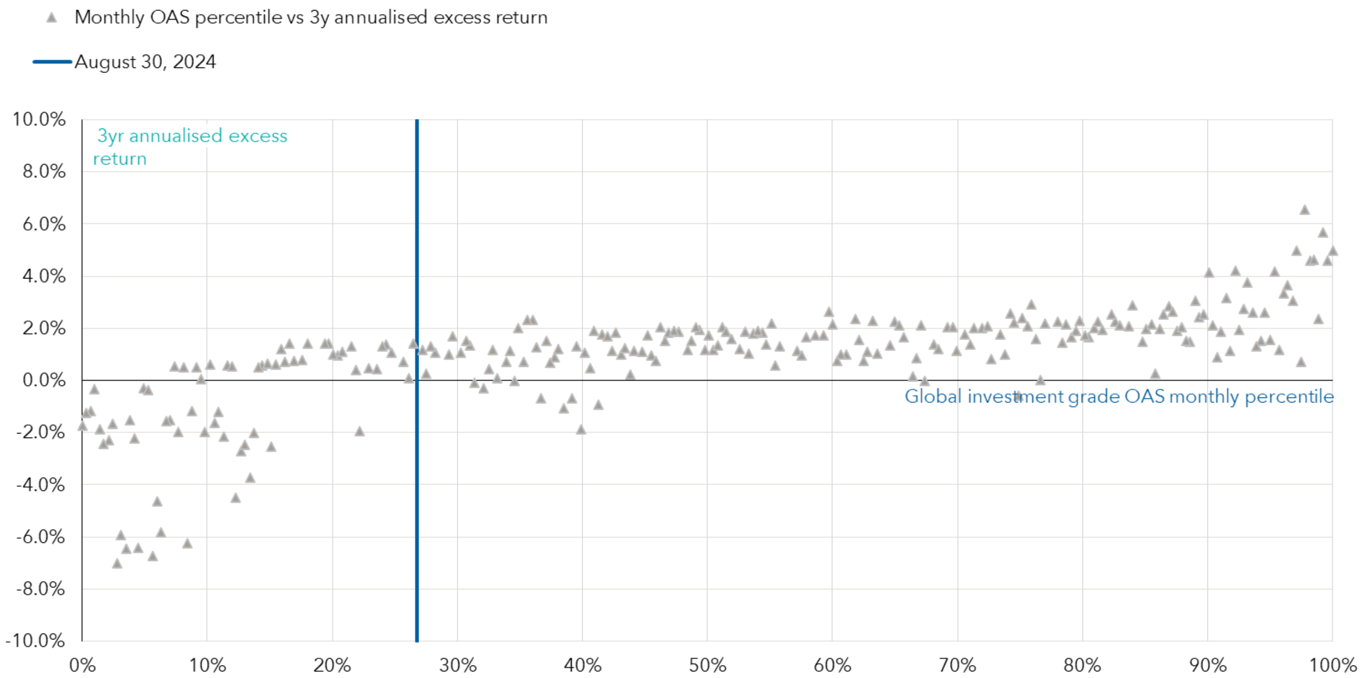
Global corporate bonds are preferable to US Treasuries (USTs)

The Fed's pivot toward easing monetary policy provides a clear duration benefit to fixed income. However, although global IG credit has around six years of duration – which will add around 3% of price appreciation per 50bps fall in yields – the main driver of total return for credit is the yield. This yield compounds over time and has historically led to strong excess results for corporate bonds.

The benefits of compounding outperformance can be observed by looking at three-year annualised excess returns of investment grade corporate bonds over government bonds relative to their spread level. The chart below shows a positive linear relationship between the two factors. Intuitively, lower valuations (wider spreads) have historically led to the strongest long-term results. However, it is worth noting that even at today's relatively low level of spread (indicated by the blue vertical line), global investment grade corporates have, based on past observations, materially outperformed USTs.

One of the few periods where credit underperformed is the three-year period that ended with the GFC. In the years before 2008, spreads were very tight (below today's levels) and so could not absorb the surge in credit risk. However, in the three years following the GFC, spreads had widened significantly, and excess results were once again positive.

Global Investment grade OAS monthly percentile and three year annualised excess return



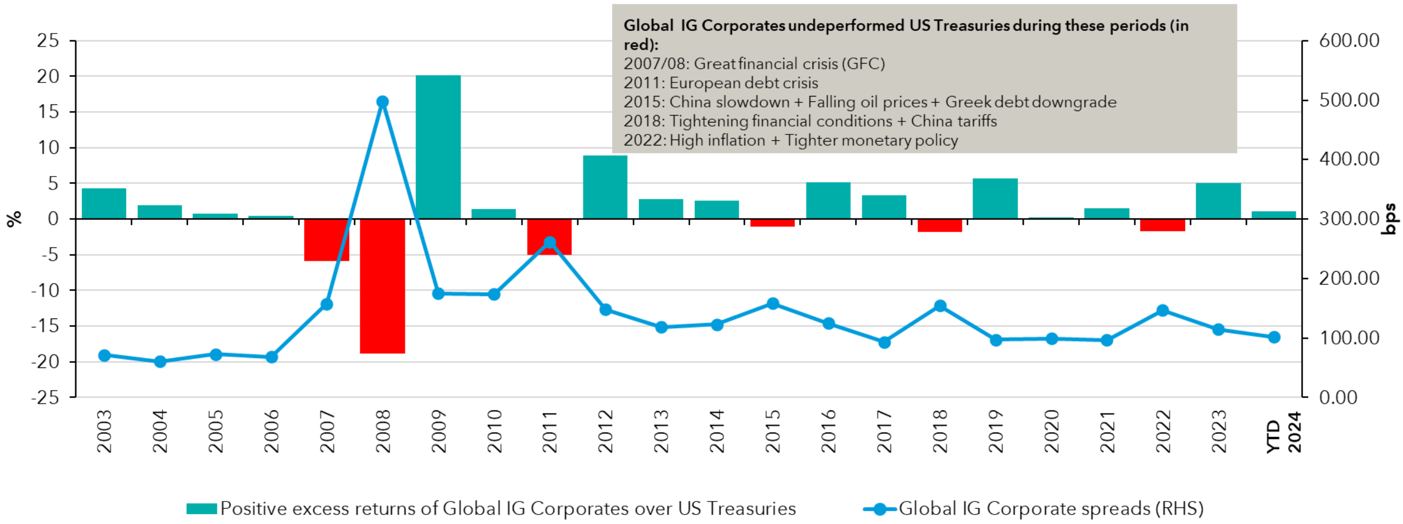
Past results are not a guarantee of future results

Excess return in USD terms vs. Treasuries. Monthly data from 31 January 2001 to 30 August 2024. Source: Bloomberg Global Aggregate Corporate Index. OAS: Option-adjusted spread.

Looking at excess results on a calendar year basis provides further clarity. As the following chart highlights, during most periods, global IG corporate bonds have delivered better results than UST. The only exceptions are in periods of deep recession or heightened financial volatility. Importantly, such periods are temporary and are followed by periods of excess returns that outweigh the prior periods of underperformance.

Furthermore, it is worth noting that while we are seeing signs of growth slowing, we do not anticipate the kind of economic or market distress that has historically led to negative excess results for credit. In our view, a soft landing remains the most likely outcome.

Annual global corporate bond versus US Treasury results



Past results are not a guarantee of future results

Data as at 30 August 2024 in USD terms. Global IG Corporates are represented by Bloomberg Global Aggregate Corporate Index. US Treasuries are represented by Bloomberg US Treasury index. Spread statistics are as of each calendar year. Source: Bloomberg

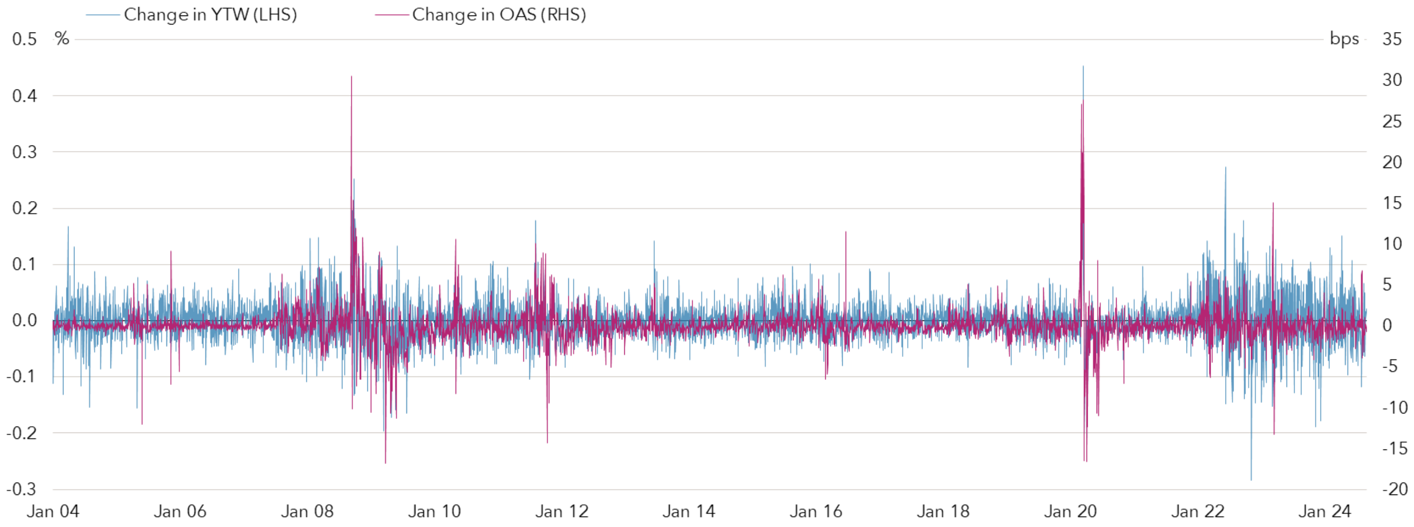
While the historic return profile of investment grade corporate credit in various spread and interest rate environments favours corporate over government risk, the divergence in fundamentals between private borrowers and governments since the GFC further supports this preference in future. The GFC reflected unsustainable levels of private sector debt but, since then, banks and households have deleveraged while borrowing in the corporate sector has stabilised.

In fact, more recently, improvements in corporate balance sheets have led to favourable upgrade/downgrade ratios and better overall credit quality of the corporate bond market. On the other hand, government borrowing has materially increased, particularly in the post-COVID era. This is one of the reasons why rates volatility is now higher relative to previous periods and dominates spread volatility for IG corporates.

Given the shift in the macroeconomic environment towards one where inflation is structurally higher and volatile and growth is more variable than during the great moderation[2], we can expect rates volatility to remain elevated and probably higher than credit spreads.

[2] The period starting from the mid-1980s until at least 2007, characterised by the reduction in the [volatility] of [business cycle] fluctuations in developed nations compared with the decades before.

Rates volatility is higher than spread volatility



Data as at 30 August 2024. Index is Bloomberg Global Aggregate Corporate Total Return Index. OAS is Option Adjusted Spread. YTW is Yield to Worst. Source: Bloomberg

The technical backdrop remains supportive

One of the key underlying reasons for the argument that spreads can potentially remain tight for longer is the continuing strong demand for investment grade credit. This demand includes multiple external sources as well as the internal reinvestment of coupon payments. The obvious question is whether it can be sustained.

One of the most significant external sources of demand in this cycle is fixed annuity sales, which have reached record highs as a result of the rise in Treasury yields. Some of this demand for fixed annuities is likely to ease when the Fed cuts rates. However, with inflation approaching 2%, real yields are likely to remain attractive relative to recent history. In other words, we are likely to see a normalisation of annuity demand – higher than the post-GFC era when many bond yields were close to zero, but below the current record levels. This should provide ongoing support for IG credit.

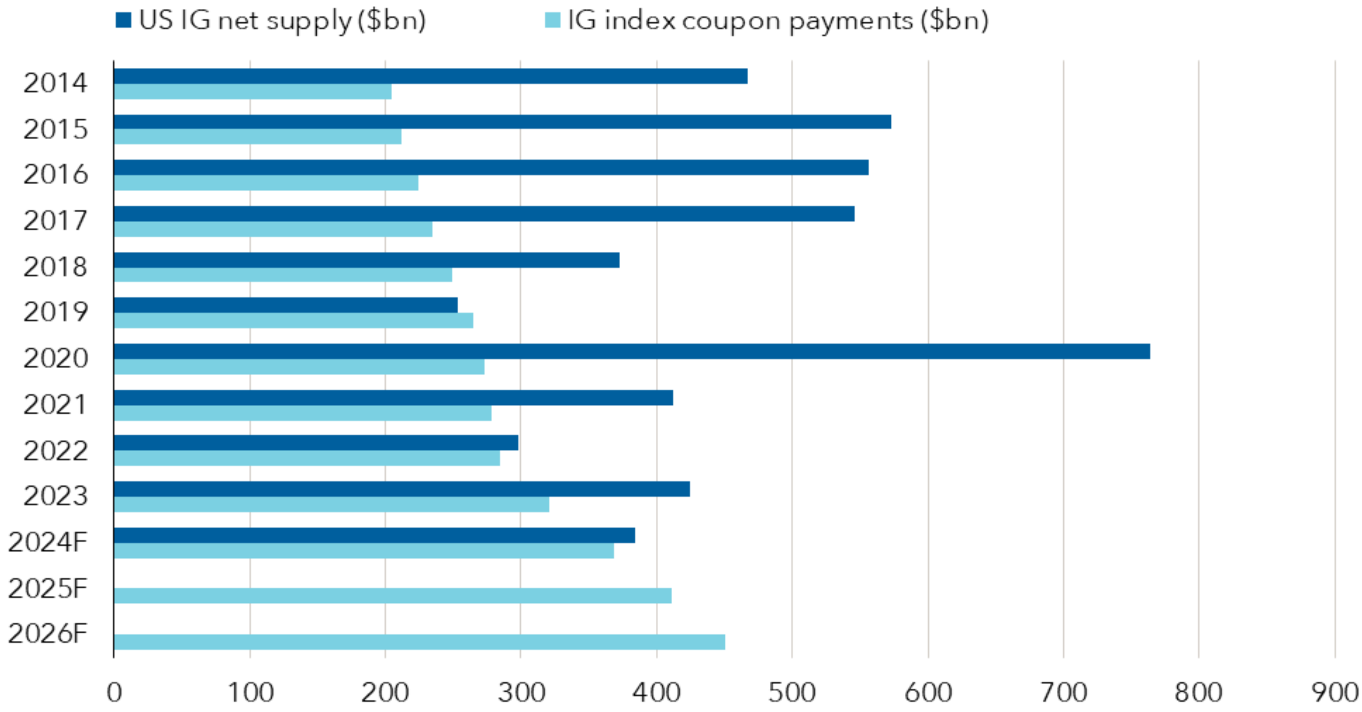
Pension funds are another important source of external demand for the asset class that has helped suppress spreads and is likely to continue. Rising interest rates mean that, after years of being in deficit, many pension funds are now in surplus. Historically, such funding levels have resulted in pensions increasing their allocation to fixed income. The high, and relatively secure, yields offered by IG credit provide an attractive opportunity for providers to meet their long-term obligations.

Anecdotal data also shows that IG credit might not be the crowded trade among the other large external buyers, asset managers, that marketing narratives suggest, with many large funds neutral or underweight IG as of 30 June 2024[3]. This not only means there is further potential demand for the asset class in case of spread widening (which would be supportive of spreads), but if the macroeconomic environment becomes less favourable, any unwinding of positioning should be relatively benign as portfolio managers have the capacity to add on weakness.

[3] Fund filings

In addition to these external sources of demand, there are also income-related flows generated by the reinvestment of coupon payments. These are substantial and expected to increase as low coupon bonds mature and are refinanced at higher yields. Bank of America estimates that 96% of the net supply in 2024 could be covered by simply reinvesting the coupons paid by these bonds. While not all of this income will be reinvested in IG credit, a substantial proportion is likely to be, and this, combined with continuing external flows, should support demand and help to keep spreads tight.

Reinvestment of coupon payments could significant offset net supply



Data as at June 2024. Source: BofA Global Research, ICE Data Indices

A clear illustration of the demand for IG credit can be seen by looking at activity in the primary market. Data from Barclays show supply in the first half of this year in US IG credit was the second highest on record. The only year it was higher was 2020 when companies took advantage of the extremely low yields during the COVID crisis. While there are suggestions this high run rate may be the result of companies bringing issuance forward ahead of US election, the fact it has been so readily absorbed is a clear illustration of the demand for credit.

Individual issuance further demonstrates the point. As an example, in May 2024, Boeing successfully raised $10 billion across multiple tranches to help manage its liquidity and refinance part of its existing debt. The well-known challenges at the aircraft manufacturer meant the bonds were offered to the market with significant concessions. Strong demand meant the deal was heavily oversubscribed with the company reportedly receiving over $70 billion of orders materially reducing the concessions offered.

Conclusion

This is potentially an exciting time for fixed income. Global investment grade, in particular, with its high credit quality, attractive yields and duration is, we believe, well placed to deliver for investors.

Our analysis shows that contrary to the prevailing narrative, credit spreads are still above their historical tights when we account for the changes in global IG indices over time. This does not mean we expect any substantial further tightening, but absent a significant deterioration in the macroeconomic environment, or other external shock, these factors could help keep spreads from widening. This suggests a relatively benign environment in which spreads remain stable and therefore carry should be a significant contributor to results.

As central banks begin cutting rates, fixed income is potentially set to benefit from a duration tailwind. History, however, shows us that purely focusing on duration and investing in government bonds to capture this return is unlikely to provide optimal results. Over the past 20 years, investment grade corporate bonds have consistently delivered superior results relative to government bonds except in periods of severe market stress – an outcome we view as unlikely. We believe this dynamic will hold in this cutting cycle and that, therefore, global corporate bonds could provide the better solution for investors.

Given the shift in the macroeconomic environment, and our expectation that rates will continue to be the dominant driver of fixed income volatility, we believe investors looking to harness the diversification benefits of the asset class should consider IG credit. All else being equal, our analysis suggests such an allocation could increase results without increasing volatility.

Flavio Carpenzano *is an investment director at Capital Group. He has 19 years of industry experience and has been with Capital Group for three years. Prior to joining Capital, Flavio worked as a fixed income senior investment strategist at AllianceBernstein. Before that, he was a product manager at PIMCO focussed on credit strategies. His early career also includes a role at the Bank of England as an analyst in the markets department. He holds a master's degree in finance and economics from Università Bocconi. Flavio is based in London.*

Peter Becker *is an investment director at Capital Group. He has 27 years of industry experience and has been with Capital Group for five years. Prior to joining Capital, Peter was a managing director in the fixed income product management team at Wellington Management. Before that, he was a portfolio manager at Aberdeen Asset Management. He holds a master's degree from The Ingolstadt School of Management. He also holds the Chartered Financial Analyst® designation. Peter is based in London.*