Spotlight on Credit

Reflation – The end of inflation's "great moderation"?

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The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested. When interest rates rise, the value of assets within a portfolio is likely to fall. The value of credit investments may fall if the issuer of a fixed income its debt, and if a strategy invests in asset backed securities, the assets backing them may be repaid earlier than required, resulting in a lower return. Past performance is not a guide to future performance.

US and European recoveries not in alignment

The US recovery appears to have been running ahead of Europe's for several months. The relative strengthening of US economic data has been reflected in a widening spread between US Treasury yields and German Bund yields, and steadily rising US breakeven inflation rates (the difference between nominal and inflation linked US Treasury yields).

US – Germany: Spread on 20-year government bonds

Source: M&G, Bloomberg as at 18 February 2021

Information is subject to change and is not a guarantee of future results.

Breakeven inflation rate on 30-year US Treasuries

Source: M&G, Bloomberg as at 18 February 2021

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The US yield curve has also steepened as the market anticipates reflation, which may be expected to drive higher inflation, in future. The yield differential between five-year and 20-year US Treasuries, has reached its widest level since July 2015.

US yield curve (20-5 years) has been steepening

Source: M&G, Bloomberg as at 18 February 2021

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Tighter US policy is not yet priced in

However, the market appears to remain relaxed about the possibility of the US Federal Reserve (Fed) tightening monetary policy, with little expectation of any movement in official rates reflected in markets for several years to come. To us, the evidence for this can be seen in the yield on three year US Treasuries, which has remained largely unchanged over the last 12 months, while five-year Treasuries have not yet built a significant premium over the historically low Fed Funds rate. Nonetheless, there is a risk that the Fed may move to increase rates earlier than we envisage, which could further undercut market values of US Treasuries and put pressure on the values of corporate bonds.

US Treasury yields at short maturities remain low

Source: M&G, Bloomberg as at 18 February 2021

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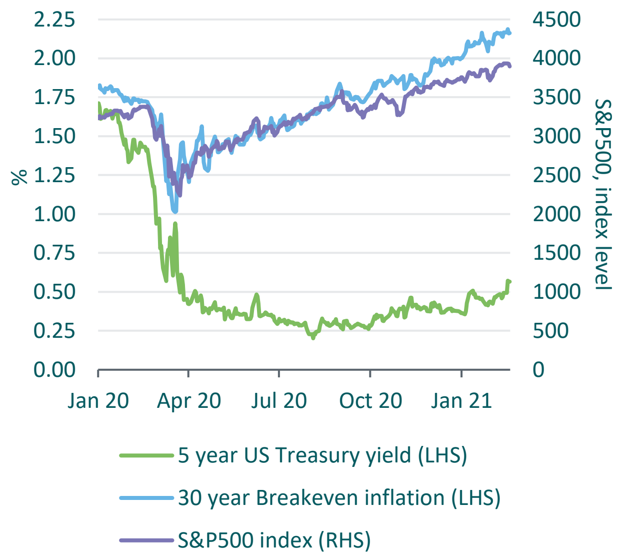
One may ask whether this represents the calm before an impending inflationary storm? The Fed now gives itself some latitude to allow inflation overshoots, following a period of inflation undershoots. However, we believe it is judicious to consider how much reflation one should be able to observe in the prices of risk assets before beginning to question the assumption that the Fed will not raise rates for some time yet.

Reflation is being priced in, without monetary tightening



Source: M&G, Bloomberg as at 18 February 2021

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Credit's yield has remained a central attraction

In credit markets, investment strategies appear similarly anchored in a belief that current monetary policy, which is supportive of the market, is here to stay. Indeed, so ingrained is this belief that the rationale for investing in credit has been given its own acronym, "TINA" – There Is No Alternative. As a result, investors have driven spreads towards the low levels seen in recent years once again. There is no guarantee this sentiment is correct, however.

Investment grade credit: Index spreads to Govt bonds

Source: M&G, ICE BofA indices (Ref C0A0, ER00), Government option adjusted spread (OAS), as at 31 December 2020

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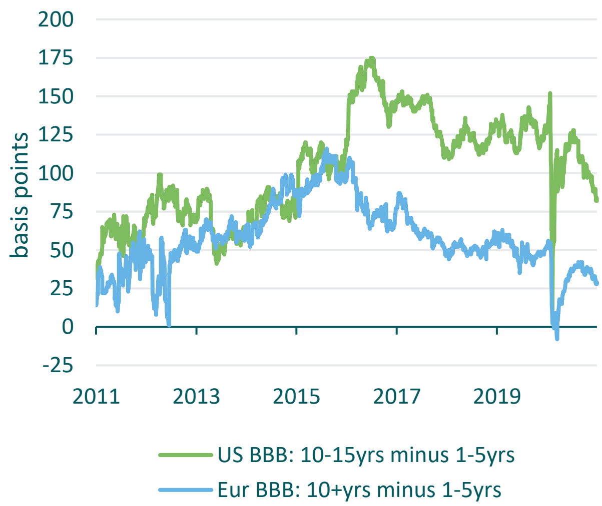
The hunt for yield continues to drive investors to extend to longer maturities in an effort to capture greater yields. This continues to drive curves credit curves flatter.

Credit curves have been flattening



Source: M&G, ICE BoA indices (Ref US BBB 10-15yr, C7A4; US BBB 1-5yr, CVA4; EUR BBB 10+yr, ER49; EUR BBB 1-5yr, ER4V), as at February 2021

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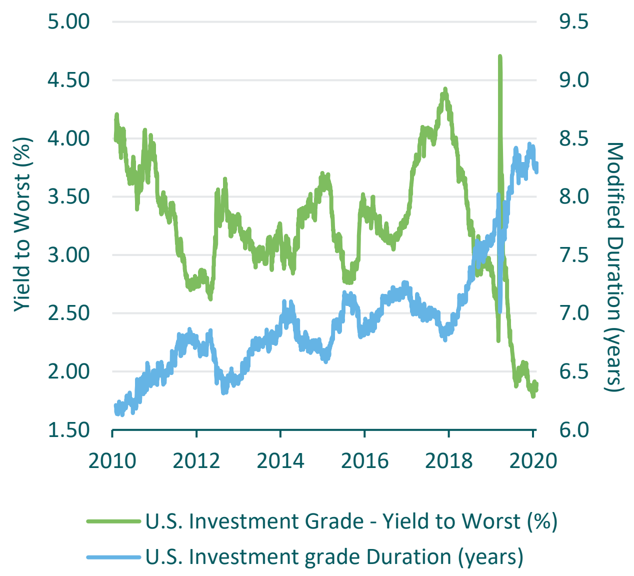
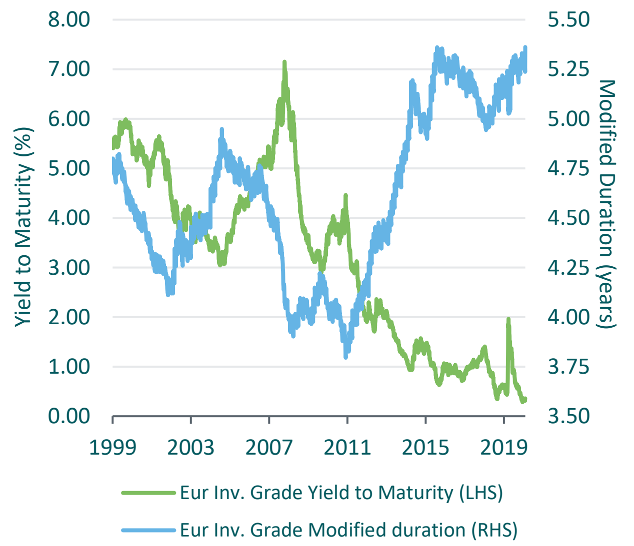
Are risks within credit building for investors?

All of this is occurring at a time when both the interest rate and credit spread durations of the investment grade markets has been increasing, and corporate leverage is rising even as credit spreads tighten. We believe the risks associated with credit are rising, at the same time as the prospects for returns (seen in yields) have continued to decline.

Investment grade credit: Yields down, duration up



Source: M&G, ICE BofA indices (Ref C0A0), as at 31 December 2020



Source: M&G, ICE BofA indices (Ref ER00), as at 31 December 2020

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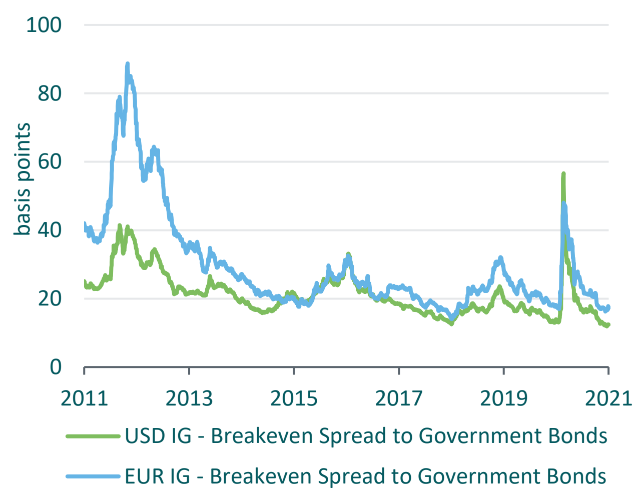
As assets carry less interest, or provide a lower yield (often referred to as 'carry'), to cushion them from declining prices, credit investors are even more exposed to changes in yields and spreads. This effect may be compounded by longer durations, which increases the price sensitivity to those yield or spread changes.

On an absolute basis, using Euro Investment Grade markets as an example, a small change in yields over a 12 month horizon could result in a capital loss that would be considered significant by an investor.

Similarly, on a relative basis, breakeven spreads – the extent to which credit spreads can widen before an investor would be better served in holding an equivalent government bond, have fallen back to levels that prevailed when the pandemic began.

Breakeven credit spreads to governments are low



Source: M&G, ICE BofA indices (Ref. C0A0, ER00), data updated to 31 January 2021

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Be prepared for the faith in credit to be tested

We believe this means that the path for achieving positive excess returns from credit has become narrower. There is less yield cushion to offset the risks of falling bond prices. That risk is building on both sides of the macro argument:

- The reflation trades could continue to gather pace, with central banks responding with monetary policy by moving interest rates higher or withdrawing direct intervention in markets. In that case, investors lose the core argument of their "TINA" strategy if a viable alternative to satiate their appetite for yield arises.

- Reflation could falter, leading to weaker economic performance, and with it a cycle of deteriorating corporate earnings putting further strain on the balance sheets . By extension, that may mean credit spreads are considered to be too tight for the underlying, and possibly increasing, credit risk.

It could be argued that investors focusing on the "TINA" situation, are relying on a steady state ahead for the world. Events from 2020, in which the initial drawdowns were followed by a strong recovery in the midst of the pandemic, suggest that expectations for steady state conditions ahead may not be borne out.

In our opinion, the potential for either of the alternative outcomes reinforces the attraction of focusing on selecting issuers and issues that represent appealing value opportunities, over having ongoing faith in credit generally.

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