The Investment Podcast

Episode 24: The Investment Podcast: The case for adding to risk in credit markets

11 November 2022

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Speaker 1: *The Investment Podcast*, brought to you by M&G.

Speaker 2: This podcast is for investment professionals only.

David: Welcome to the latest M&G Fixed Income podcast. My name is David Parsons, and I'm joined once again by Richard Ryan, lead portfolio manager for our multi-asset credit strategy within the institutional public debt team here at M&G. Welcome, Richard.

Richard: Thanks, David. Good to be here.

David: There's been quite a lot going on this year. It's been a very challenging year for credit markets – inflation rising to multi-decade highs, we've seen central banks responding with tighter policy, and all this compounded with the Russian invasion of Ukraine. Obviously, credit has been front and centre for everything that's really been going on at the moment. I wondered how do you see the investment environment for fixed income right now?

Richard: Well, David, I think the way to put it really is one of opposing forces and those forces being the economics, the fundamentals of the world around us, and the valuations that confront us in markets. If you focus solely on the economics, then you would expect higher rates as flagged by central banks. You'd expect that to lead to weaker activity, potentially weaker earnings, all in the attempt to tame inflation.

If that was your sole focus, you'd really step away until the macro picture resolved itself. Valuations have moved a very, very long way. Markets are pricing in significantly higher interest rates with the US peaking around 5% middle of next year, the EU peaking somewhere around 3%, and the UK in the middle around 4.5% by the middle of next year.

Bond yields have gone with that, and they're reflecting that higher rate environment. We've seen roughly 2.5% of additional yield put on 10 year government bonds this year with the US now, again, around 4%, German bunds around just above 2%. The UK, again, in the middle of that, somewhere around the 3.5% level.

That move, that 2.5% of extra yield that's been put on those markets this year is akin to something like a 20% capital price fall on a 10-year bond. Really significant valuation shifts that's, in some part, been mirrored by credit spreads. Credit spreads have widened out as well, and there's less uniformity to how they've widened out, actually.

The Europe and the UK have probably done the most work with BBB spreads, maybe 130, 140 basis points wider, and the US being somewhat more resilient, actually, with spreads maybe moving half that around the 70 basis point mark. That puts the UK and Europe at or close to the wides that we saw during the Covid pandemic back in Q1, Q2, 2020 and wider actually than previous risk episodes like the 2015/16 growth slowdown.

We're not nearly as wide as we were in the financial crisis or the sovereign debt crisis of 2011/12. Those were very particular environments that called into question the survivability of the financial system or, indeed, large trading blocs like the eurozone. At these levels, severe defaults are priced in, and so we'd look at this and say at the aggregate level, credit spreads and credit looks to be an interesting asset class.

David: How should investors be responding in this environment? Is now a good time to be building into risk? Are we being sufficiently compensated for taking it at these levels?

Richard: Yes, David, we certainly think so at the moment, that now is a good time to be adding to risk in credit markets. A lot of bad news is priced in, and that means that for credit to continue to underperform or credit spreads to continue to widen, we need new negative news to build on those expectations that are already there.

If we think about this relatively simplistically, if spreads were to go back to five-year averages, so that's not an outrageous ask, it's not a heroic assumption, but it just says that valuations are reasonable where they are today, and you're being compensated for risk.

Well, if those spreads go back to five-year averages, then the excess returns that can be generated through credit begin to look really quite attractive. Those prospective excess returns in Europe, you can easily generate 8% to 12% in BBBs or BBs, less so in the US, where it's more like 3% to 5%. That's just a reflection of how far credit spreads have gone in Europe versus those in the US.

I guess the other thing here is that each selloff, each episodic selloff in the market, is different. You have a different driver, different impact on sectors, different outcomes as a result of that, and therefore different opportunities.

This time around, that inflation-fighting move by central banks to raise rates, change that cost of funding, bring economic activity down, has really highlighted a couple of areas in the marketplace which we certainly think look attractive, areas like financials held back by a heavy-weight of issuance, concerns over exposures to weaker parts of the economy. Although we would point out the positive impact of higher interest rates here.

Senior spreads on European banks have more than doubled this year. They've gone from about 80 basis points to over 200. First rank of subordination here with lower tier twos have gone from about 130 basis points to something like 340, so over 200 basis points of spread widening. These types of spreads were last available at the depths of the Covid pandemic induced in Q1, Q2 2020.

Other areas but also interest rate sensitive things like real estate. Here, the impact of higher rates on long-term valuations is important. That sector has sold off really aggressively this year. Not only are spreads well beyond where they were in the depths of the Covid pandemic, but also the differential to, for example, BBB-rated industrials are at levels that were only surpassed in the financial crisis in 2007 to 2009.

You don't need to necessarily go into those areas that are interest rate sensitive to pick up opportunities, longer spread duration assets in industrials and utilities where they sit outside of the marginal buyer's remit. These marginal buyers are people like central banks, who aren't profit-motivated, passive investors, rule-based investors, maybe ETF's, buy and maintain etc. where you have a concentration of flow into relatively narrow areas of the marketplace.

If you looked at, for example, US issuers that issue in euros, you can pick up long-dated assets for good quality issues. So, there's a lot of opportunity out there to be had in the marketplace today. We do think, David, that it's a good time to be adding risk.

David: Doesn't sound to me like the opportunities are necessarily uniform, though. What are the risks that investors need to be aware of in the current environment?

Richard: I think, as ever with credit, when you look at the marketplace top down, you can become a little complacent, I guess, about that opportunity. As I said, you're right, it's not uniform. We have had, over the last decade or so, the involvement of, for example, central banks in marketplaces, but we've had the rise of passive investors, low-cost investors, ones that are driven by static rules that tend to focus their investments into quite narrow parts of the market.

Maybe that single A, core, non-financial industrials or long-dated A, BBB corporates and utilities in sterling. These are viewed as core marketplaces, and they're viewed as low-risk. They may very well be low-risk from a credit fundamental perspective. From a default risk, they may be low-risk but actually, when you look at them, the spreads that are available are not overly attractive. Actually, some of those spreads are close to the tights that we've seen over the last few years.

In effect, what you're getting is you might be getting something of reasonable quality, low default risk, but you're not capturing the opportunity in the marketplace. You're not capturing the cheap credit in the marketplace. Instead, what you're capturing is the expensive beta.

Ironically, the safer asset, from a credit perspective, might be the riskier asset from a financial returns perspective. That really talks to having a flexible approach or an active or a more active approach to this opportunity set here.

We think it's a good time to be building risk. We think there's plenty of opportunity out there that's really well priced and attractively priced, but it isn't blanket, and therefore taking a blanket approach to it doesn't necessarily capture that. Having the flexibility to pick and choose, I think today is of critical importance to get those outsized returns and to get those excess returns over the next 12, 18 months.

David: Pulling it all together then, there are certainly troubling times economically, but a lot of that bad news now is in the price and looking ahead, pockets of value in the marketplace that we can already identify and potentially good entry levels to start to begin to grow risk, to build risk back into positions from these kinds of levels. Even if there is further volatility, it still seems to me what you're saying is that it's a good point to start to accumulate risk.

If you get the opportunity to add risk at even more attractive levels, you are surely being compensated for the risk if that occurs. From here, then, perhaps the takeaway is maybe the next moving credit isn't necessarily all doom and gloom. Would you say that's a fair summation?

Richard: Yes, I think that's spot on.

David: Excellent. In that case, I think I'll quit while I'm ahead. Thank you very much indeed for your time today, Richard. Greatly appreciate your thoughts and insight and look forward to the next podcast with you.

Richard: Thanks, David.

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