For Investment Professionals only

After the storm: seeking opportunities in bond markets

M&G Public Fixed Income

November 2022

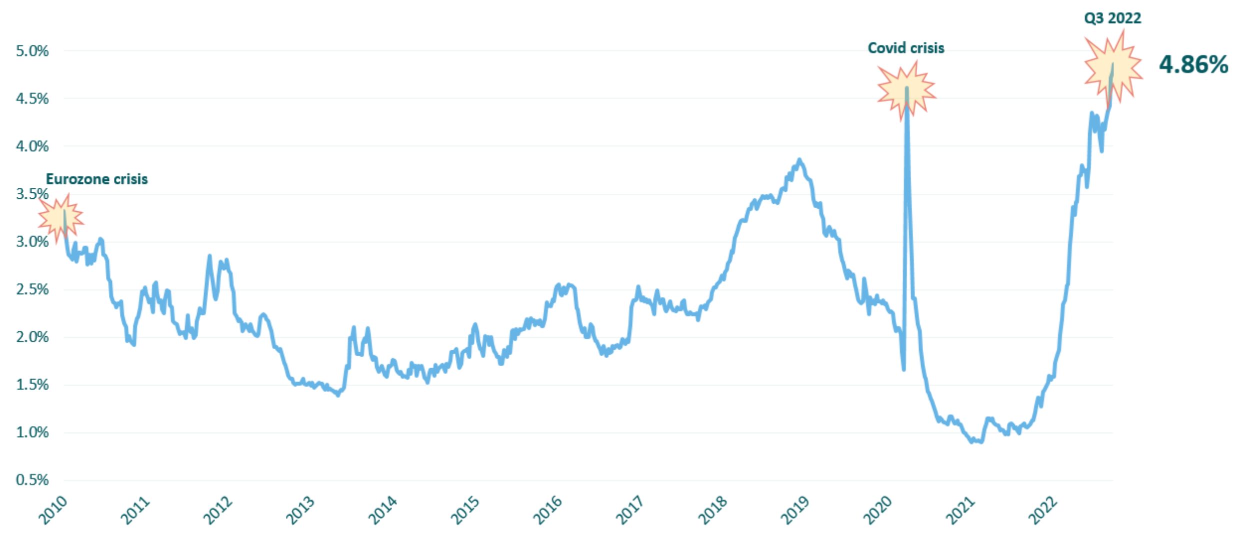
- Following a significant repricing in fixed income markets this year, corporate bond yields are trading at multi-year highs, while credit spreads are pricing in a severe recession. We believe this reflects an excessively gloomy outlook and that most companies should be well-placed to withstand even a protracted economic slowdown.
- For perhaps the first time in a decade, bond investors are being well paid, in our opinion, to take both credit and interest rate risk. The prospect of easing inflation and slowing growth should allow central banks to slow the pace of monetary tightening, which could provide a tailwind for bond markets next year.
- Recent market volatility has created significant dislocation in corporate bond prices. We believe this provides a rich source of opportunities for active managers, who can draw on their credit expertise to uncover attractive pockets of value.

A dramatic re-pricing in bond markets

One of the sharpest bond market sell-offs on record took place in 2022, as concerns over persistently high inflation and an aggressive tightening in monetary policy have pushed government bond yields to their highest levels in over a decade. Credit valuations have also come under severe pressure as markets have started to factor in the impact of slowing economic growth and higher borrowing costs on corporate earnings.

This has led to a significant re-pricing in both credit spreads and the 'risk-free' rate (as represented by government bond yields). Investment grade bond yields are now at multi-year highs, with five-year US investment grade corporate bonds yielding 6.2%. Notwithstanding the challenges facing the global economy, we believe these levels represent highly attractive value for bond investors, both in absolute terms and relative to other asset classes.

Figure 1. Bond yields over time – five-year USD investment grade yield to maturity



Past performance is not a guide to future performance. Source: Bloomberg, 20 September 2022

Credit spreads pricing in a severe downturn

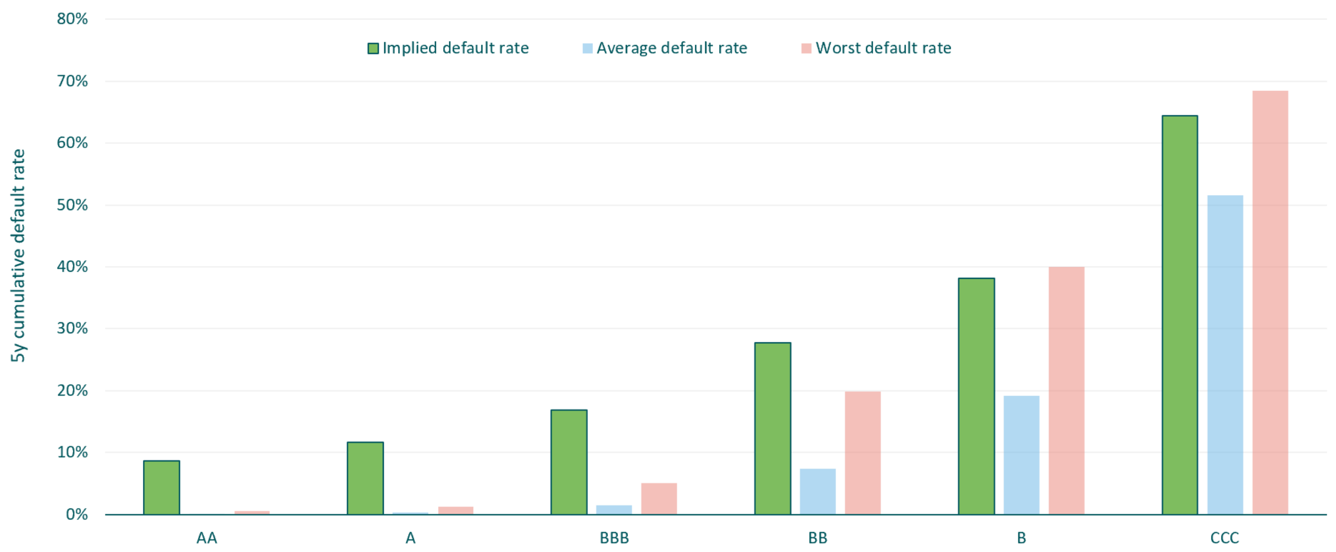
Global investment grade credit spreads are already pricing in a severe recession and a meaningful uptick in corporate defaults. While we expect the global economy to continue to slow over the next year, we do not think the contraction will be anywhere near as severe as what markets are currently pricing in. In particular, we think that the very low levels of unemployment, healthy consumer balance sheets and government support packages should limit the severity of any economic downturn.

Furthermore, corporate balance sheets are generally in good shape in our view, with many businesses having limited re-financing needs in the near-term. While careful credit analysis and a focus on fundamentals are always crucial, we think most companies should be well-placed to withstand even a more protracted economic slowdown.

We therefore believe that markets are more than pricing in the bad news, and that investors are well-compensated for taking credit risk. This is especially the case in the investment grade space, where credit spreads reflect an implied default rate well in excess not only of average default rates, but also of the worst default rates. For instance, corporate bonds rated BBB are pricing in a five-year cumulative default rate of 17%, which compares with an average default rate of 1.5% and a worst default rate of 5.1%.

We believe this reflects an excessively gloomy outlook for default rates, and we have been taking the opportunity to add credit risk across our portfolios. However, given the uncertain economic environment, it is important to remain selective, and we generally favour higher-quality, more defensive names which should hold up better if we do see a more recessionary scenario. In contrast, we remain much more cautious on more speculative areas, such as high yield bonds rated CCC, where we think defaults could rise quite significantly.

Figure 2. Market implied default rates v historic default rates



Source: Bloomberg, Deutsche Bank, ICE indices, S&P, 30 September 2022.

Investors are paid to take interest rate risk

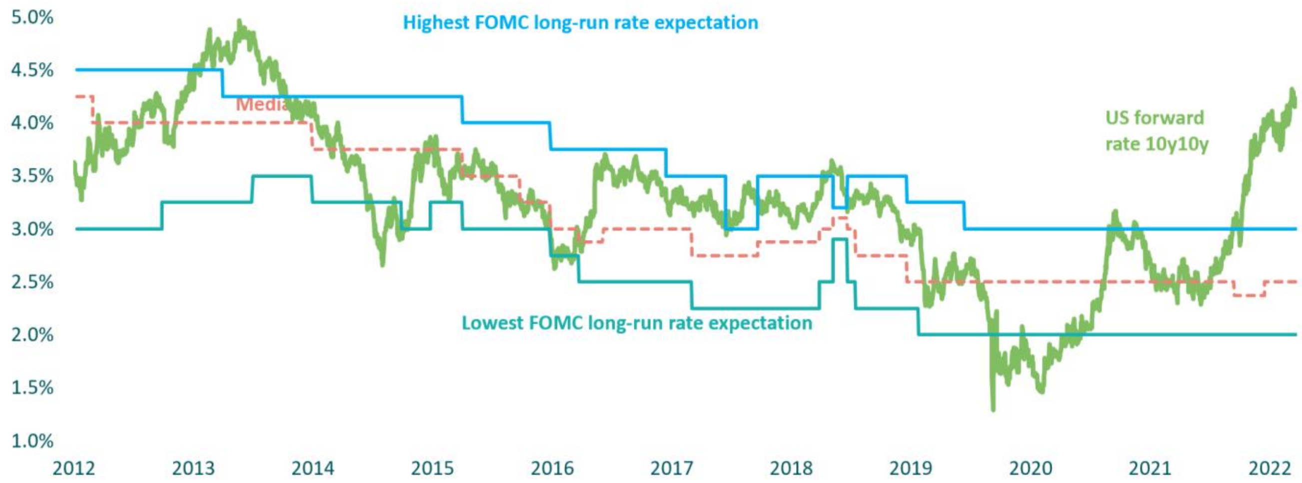
The rise in global yields means that for first time in a decade we think bond investors are being well paid, not only for taking credit risk, but also for taking interest rate risk. We believe this makes corporate bonds an especially attractive investment proposition, and we have been taking the opportunity to add both credit and duration (interest rate) risk across many of our fixed income portfolios.

The return of inflation has been the root cause for this year's rout in bond markets, although as supply chains normalise[1] to some extent and tighter monetary conditions take hold, we expect inflationary pressures to gradually ease over the coming months. This in turn should allow the Federal Reserve and other central banks to take the foot off the brake, which could potentially provide a powerful tailwind for bond markets next year.

[1] Global Supply Chain Pressure Index (GSCPI) - FEDERAL RESERVE BANK of NEW YORK (newyorkfed.org)

A key measure we use to asses value in fixed income markets is the 10-year US Treasury yield 10-year forward – this shows what the market expects 10-year Treasury yields to be in 10 years' time. We compare this with the Federal Reserve's long-term expectations for interest rates. The 10-year forward rate is currently well in excess of the Fed's long-term expectations for rates, which has traditionally been a strong signal to start adding some duration.

Figure 3. Forward-looking Treasury yields versus the Fed's long term expectations



Source: Bloomberg, Federal Reserve, 19 September 2022.

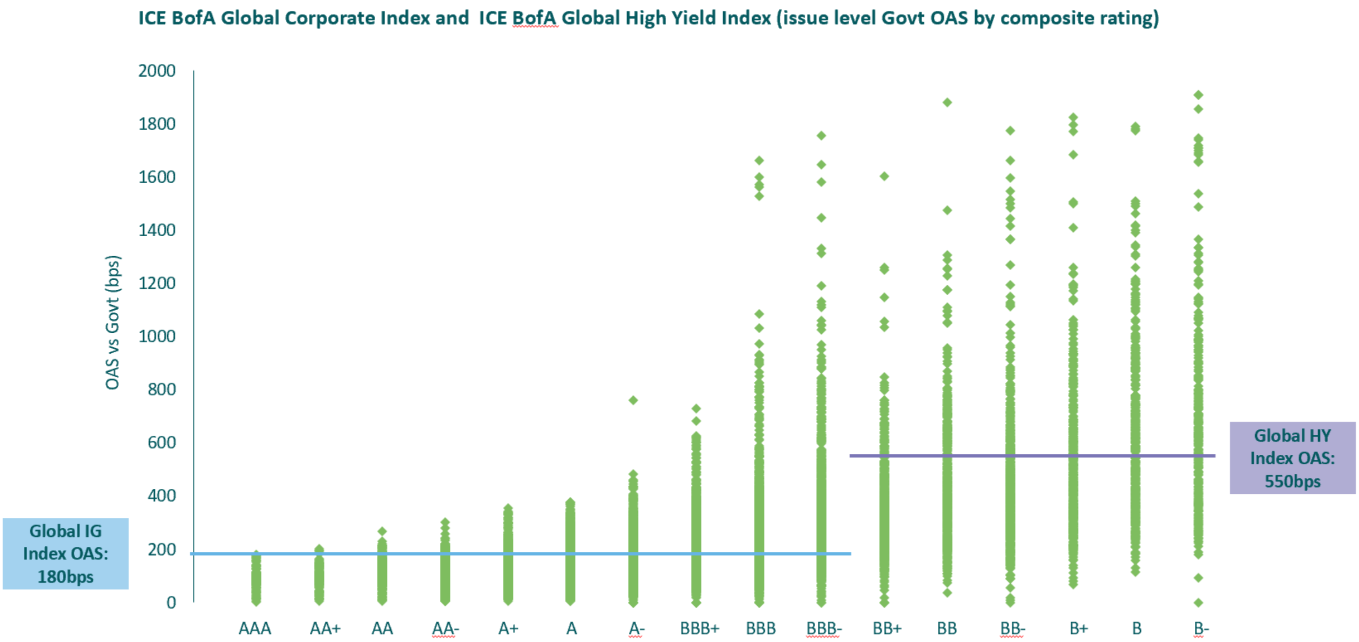
Past performance is not a guide to future performance. Information is subject to change and is not a guarantee of future results.

Volatility brings opportunities for active managers

Volatility tends to create dislocation in credit markets, and following recent market turbulence we are seeing high levels of spread dispersion across corporate bond markets – this is where bonds with the same credit rating trade at a different credit spread over government bond markets.

This type of environment can be a rich source of opportunities for active managers, who can draw on their credit expertise to identify market inefficiencies to uncover attractive pockets of value. Having access to an unparalleled global research capacity across the US, Europe and Asia allows us to thoroughly scrutinise global credit markets, focusing on all aspects of a company's credit profile and to assess whether bond investors are being adequately compensated for the potential risks.

Figure 4. Spread dispersion by credit rating category



Source: M&G, BofA ML Indices, Bloomberg, 31 October 2022

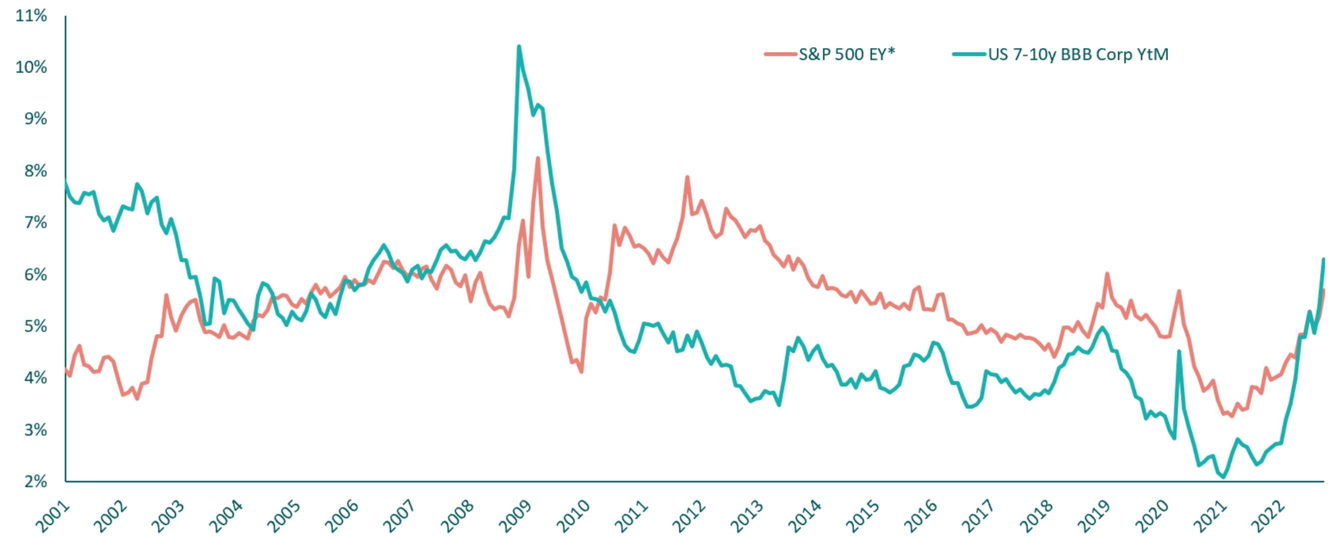
Global investment grade - a source of resilience in uncertain market conditions

In contrast to the sell-off during the pandemic in 2020 – which was almost entirely driven by a spike in credit spreads - this year's sell-off in investment grade corporate bonds has been the result of a re-pricing in both spreads and government bond yields. For investors, this provides a more balanced mixture of credit and interest rate exposure, which we believe should offer greater resilience to withstand a variety of economic environments.

On a medium-term view, we believe investment grade bonds offer highly attractive value, with investors being well paid to take both credit and interest rate risk. Credit fundamentals remain strong and we see a limited risk of default, even in the event of a more severe recession. Furthermore, current elevated yields should provide a good cushion against any further rise in yields in the short-term. As a result, we remain highly constructive on the asset class, where the risk/reward prospects currently look very favourable to us.

As well as offering attractive value in absolute terms, we believe corporate bonds also represent good value relative to other asset classes, such as equities. A common way to gauge the relative value of bonds and equities is to compare the yield to maturity on bonds against the earnings yield on equities (the inversion of the price earnings ratio). Comparing USD BBB rated corporate bonds against the S&P 500, we can see that corporate bonds are yielding more than equities for the first time since the financial crisis, indicating potential value in the former.

Figure 5. Bonds vs equities valuations - S&P 500 earnings yield vs USD Corp BBB YtM



Source: Bloomberg, 30 September 2022. *trailing 12 months earnings yield

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Financials – well placed to benefit from higher yields

One area where our credit analysts are currently finding attractive value is in financials. Banks in particular look well-placed to benefit in a rising rate environment due to higher lending margins, while their robust capital positions should provide a significant buffer in the event of sharper-than-expected losses. Current valuations suggest that markets are expecting heavy losses in the banking sector as the global economy slows, although we believe that market perception is some distance from the fundamental picture.

While some losses will clearly occur, we believe that the vast majority of large banks are in good shape to weather such storms, while the increase in interest rates should significantly improve their profitability. Moreover, bank bonds have not been directly impacted by quantitative easing, as central banks have focused their asset purchases on non-financial bonds. All things remaining equal, banks should therefore not suffer from central banks' ongoing quantitative tightening this year, in our view.

Global high yield - attractive income to help cushion downside risks

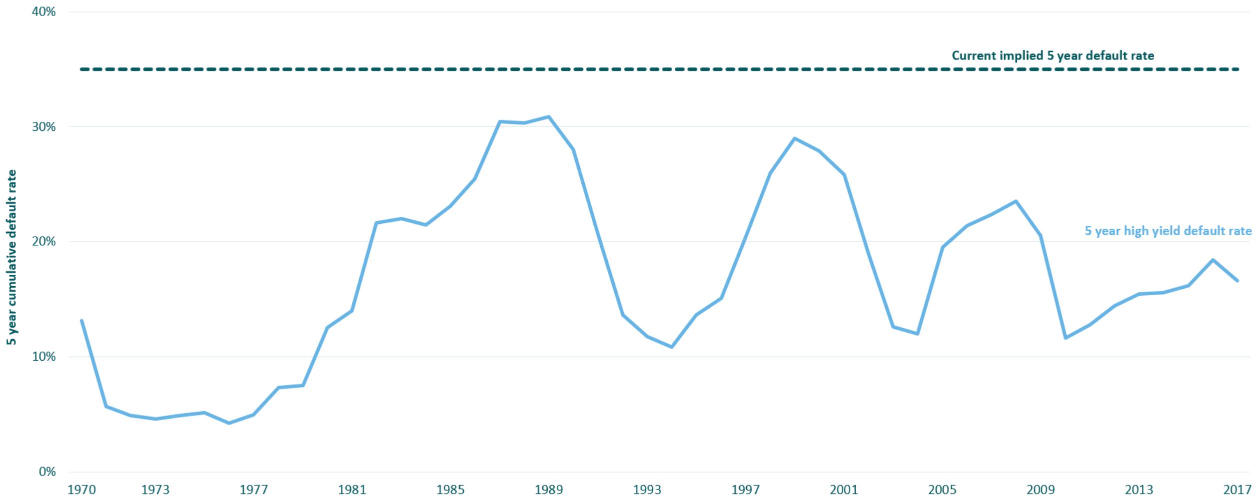
Global high yield spreads have recently touched the 600 basis point level, which we believe prices in a lot of the bad news and provides a fairly attractive entry point for the asset class. Whilst a global recession may prove unavoidable, we believe it will be less severe that what high yield markets are now pricing in.

Current spread levels translate to an implied five-year default rate of 32%, which is much higher than our expectation, and would be more extreme that the worst-ever default experience. We believe that corporate fundamentals are in generally good shape and expect company revenues to prove fairly resilient overall. Leverage across the asset class remains relatively modest, with many companies having taken the opportunity to reduce their debt or extend its maturity following the pandemic, which should significantly reduce re-financing risk.

As a result, we believe high yield indices represent a higher-quality universe compared to before the pandemic. While we expect default rates to rise from current very low levels, we do not expect to see a sharp spike in defaults. With all-in yields just under 10%, we believe the asset class offers an attractive income stream, which should provide a significant cushion against any further widening in spreads or a rise in defaults.

While further volatility is to be expected in the short-term, on a two-three years view we think investors have the opportunity to lock in an attractive level of income, with upside potential from any future decline in yields. That said, careful credit selection and a focus on credit fundamentals remain crucial when investing in this area of the market. This is even more so during the later stages of the economic cycle.

Figure 6. Five-year cumulative high yield default rates



Source: Deutsche Bank, Moody's Research, 30 September 2022 (latest data available). Calculated using the CDX HY index with 30% recovery rate assumption

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the portfolio. High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

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