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In a tough market, high quality Global Corporate Bonds appeal

M&G Investments

Signs of quality in Global Corporate Bonds

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As we approach the end of a challenging year for investors, the dominant themes remain that of accelerating inflation, matched with rising interest rates to try and mitigate this threat. Meanwhile, international events – essentially Russia's war on Ukraine – have reinforced the malaise of investors in 2022. Overall, the appetite for some exposure to a basket of high-quality ('investment grade') global corporate bonds, diversified across regions, possibly currencies and industry types, is low amongst bond investors. But against the clear headwind of a global economic slowdown, we believe there are solid reasons to consider investing in global investment grade corporate bonds in 2023.

First, let us look at the market environment today. We have seen heightened uncertainty across all corners of the bond market, with all fixed income assets delivering negative returns year to date. Bond investors especially have become increasingly concerned that interest rates would be raised more aggressively by central banks to tackle surging inflation – with the rising cost of energy and food the core drivers. A noteworthy move was by the European Central Bank, as it raised interest rates by a record margin in September. By the end of that month, the rate of inflation was above 8% in the US, 10% in the UK and a similar high rate across the eurozone. Inflation risk is especially bad for bonds. The purchasing power of money invested in a bond is eroded despite coupon and principal flows. This could leave a diminished positive real return, resulting in lower purchasing power than the investor had to start with.

Improving valuations

One reason we believe a basket of global corporate bonds may be worth considering is comparative valuations. In this context, valuations are measured by the difference between the respective yields of global corporate bonds compared to the average yield of core government bonds (eg US Treasuries or German bunds). This is called the 'credit spread'. We think the average credit spread on an index of global investment grade corporate bonds is currently at a perceived 'attractive value'. Excluding the Covid-19 crisis - arguably a one-off event - this is the first time we have seen these type of bonds at attractively valued levels in a decade.

Is the risk of default overstated?

But does the fact that investors want a larger risk premium for holding global investment grade corporate bonds mean the default for the asset class is set for lift-off? Not necessarily, and we think this is another reason why investors may want to re-examine global corporate bonds in 2023. For a basket of BBB rated ('investment grade') corporate bonds, the market is currently pricing in a default rate of over 16%, based on data from leading indices. However, the 5-year cumulative default rate is actually averaging 1.5%. Moving up in terms of credit quality, the market is currently pricing in a default rate of over 11% for A rated corporate bonds. The 5-year cumulative default rate is averaging just 0.3%. Overall, we feel this difference between what the market expects in terms of the number of high quality bonds defaulting, versus what generally has happened based on historical data, can be seen as a positive for the asset class.

Relative value opportunities

Exposure to global corporate bonds could also provide investors with the opportunity to take advantage of the best ideas that such a large and liquid asset class has to offer (€9.6trn as at May 2022; Bloomberg). For instance, it is possible to exploit something called 'relative value' in global corporate bonds. Relative value is based on the idea that bonds with the same level of risk should have the same expected returns. This may mean having exposure to bonds issued by the same company (eg, a US technology provider) yet across bonds based in different currencies (US dollar and euro-denominated bonds), and then between different maturity dates (a bond maturing in two years versus one maturing in 10 years).

Aside from relative value opportunities, another key feature of investing in global corporate bonds is the potential to have some diversification based on being able to take different investment views across areas like

inflation, interest rates, and business and employment outlooks. Due to varying macroeconomic factors, economies globally find themselves at different stages of the economic cycle, often requiring a tailored monetary and fiscal policy response. As a result, investors may be able to move towards regions and markets where more monetary and fiscal stimulus is coming, and away from regions where it is likely to be withdrawn. They can do this by managing the exposure of a bond to both interest rate risk ('duration' in bond terms) and credit risk ('spread duration').

Looking ahead

It remains a challenging time for the asset class in an environment of strong inflation and central banks raising interest rates urgently and by relatively large margins in order to try and stem escalating prices. At M&G Investments we are of the view that recession may be coming soon in Europe and UK, so we are careful not to add too much corporate bond exposure in these markets, unless valuations look very compelling. Finally, as we head into the final months of a tough year, we maintain a preference for solid companies and sectors, those that in our view have the potential to outperform in a downturn – utilities are a good example.

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