Investment grade credit – is it time for a comeback?

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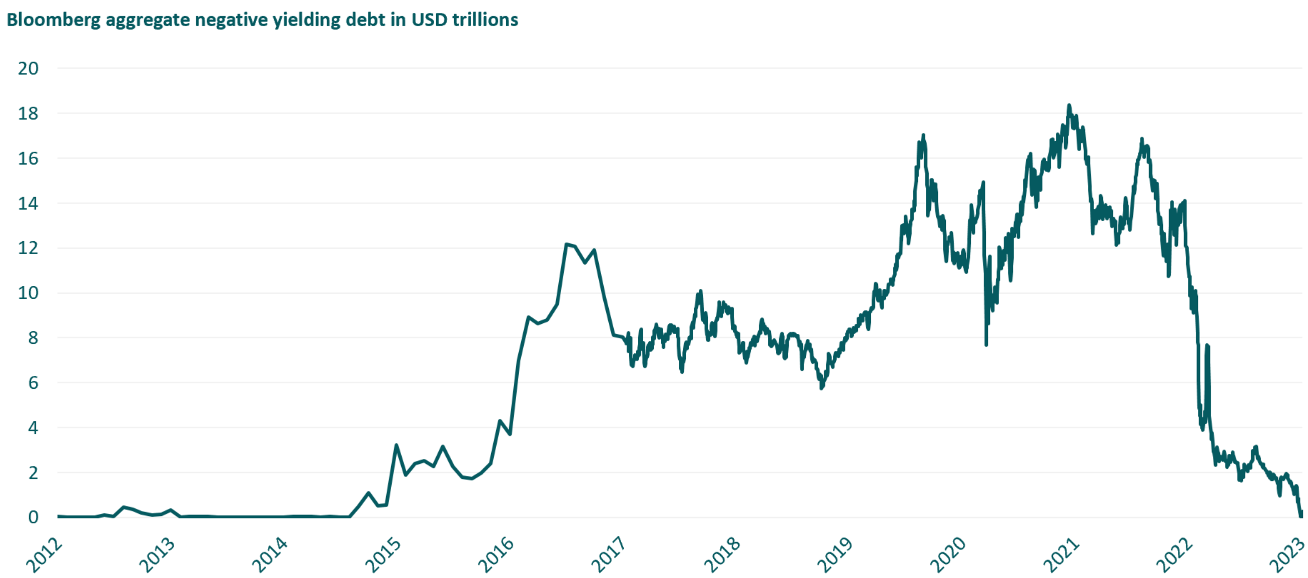
After last year's significant re-pricing in bond yields, we see compelling value in investment grade credit. For perhaps the first time in over a decade, we believe investors are being well paid to take both credit and interest rate risk. By providing exposure to both credit spreads and interest rates, we believe corporate bonds should also be well-equipped to withstand a variety of different market conditions, from a prolonged economic slowdown to a faster-than expected return to growth.

Back in positive territory

This current window of opportunity is perhaps best illustrated by the fact that corporate bond yields are today all in positive territory – the era of negatively yielding corporate debt is finally at an end (Figure 1).

Figure 1. End of an era – corporate bond yields are all in positive territory

Past performance is not a guide to future performance



Source: M&G, Bloomberg, 04 January 2023

Low expected default rates

Investment grade corporate bonds also look well placed to withstand a more recessionary environment – despite the uncertain economic outlook, corporate fundamentals remain strong, and we expect default rates to stay low. While spreads have tightened a little in recent weeks, implied default rates remain well in excess of the worst default experience (Figure 2). This is especially in the BBB space, where we believe investors continue to be very well-compensated against the risk of default.

Figure 2. Fearing the worst – implied level of corporate defaults is higher than historical levels

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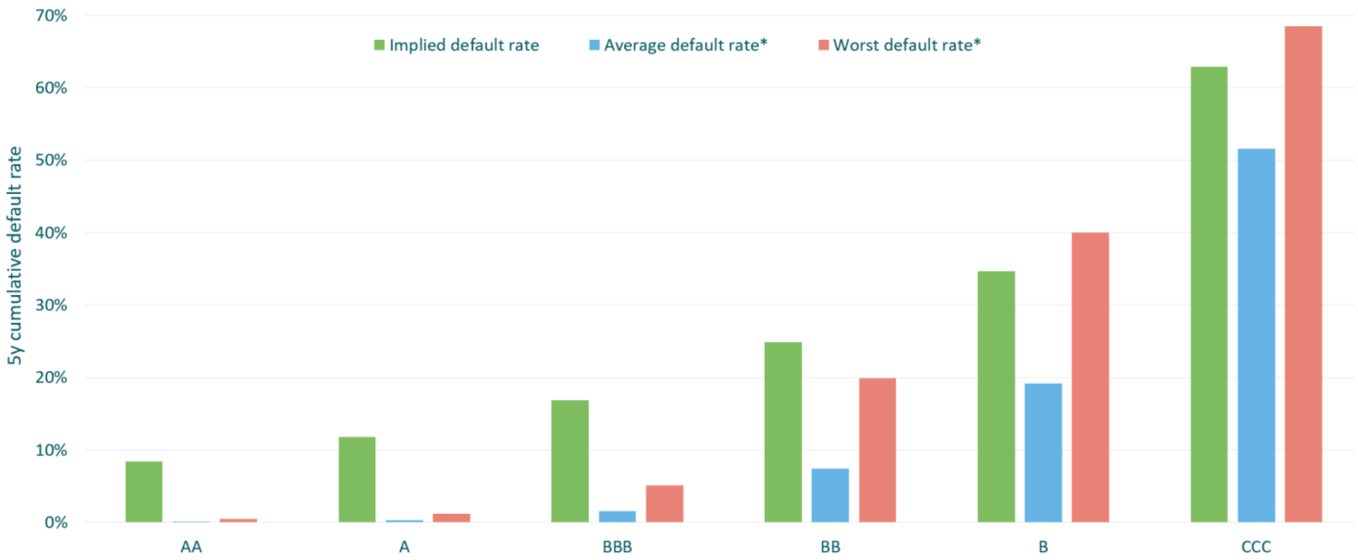


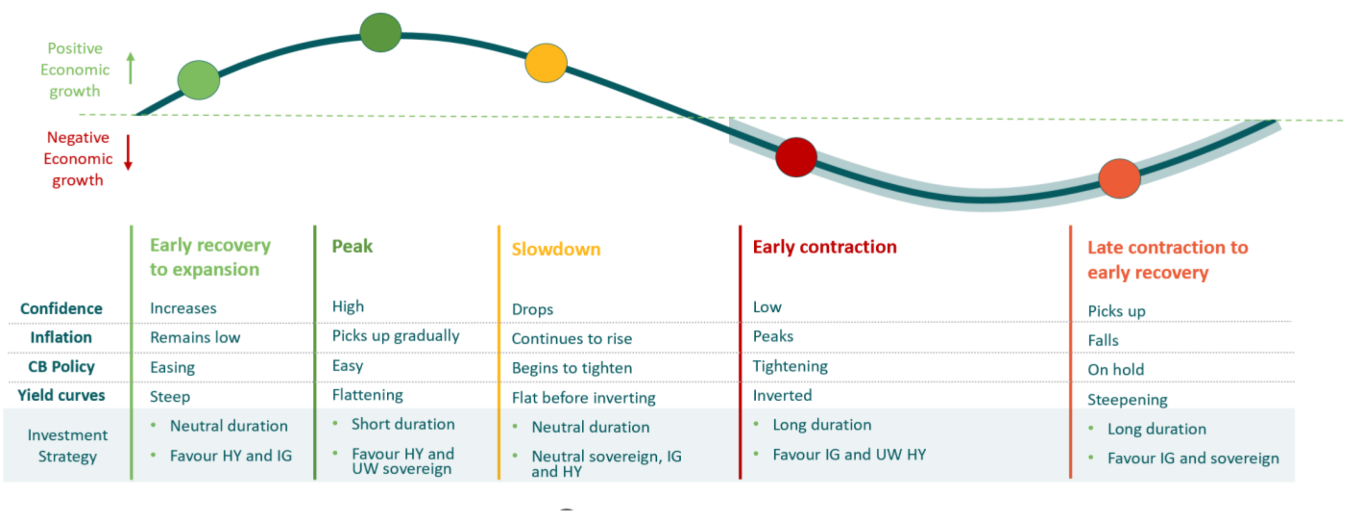
*assuming 40% recovery rate for IG and 30% recovery rate for HY

Source: Bloomberg, Deutsche Bank, ICE indices, S&P, 31 October 2022.

Well-placed in a late cycle environment

While investors will have their own views on precisely where we are in the economic cycle, the direction of travel seems clear and most would expect to see a period of slowing global growth over the coming months. In this environment, we believe it makes sense to start moving up the credit spectrum by switching from high yield to investment grade. Investors may also consider adding duration as we move into the early contraction phase, the period where inflation peaks and investor confidence starts to wane. (Figure 3).

Figure 3. Riding the economic cycle



Source: M&G, 2022

Natural diversification qualities

One of the most attractive features of corporate bonds is that they provide exposure to both the risk-free rate (government bond yields) and a risk premium (the spread between the yield of government bonds and corporate bonds). These two elements typically – though not always – move in opposite directions to each other, providing almost an in-built hedge against adverse market conditions.

By 2020, the risk-free rate had largely disappeared and, as a consequence, we were very cautiously positioned over that period (Figure 4). The good news is that the risk free rate is back today and this makes us much more positive on the asset class. In the event that the economic slowdown turns out to be more severe than anticipated, we would expect the risk-free rate to fall, and this should at least partly offset any weakness in credit markets.

Figure 4. Natural diversification elements of corporate bonds – rate and spread components provide separate drivers

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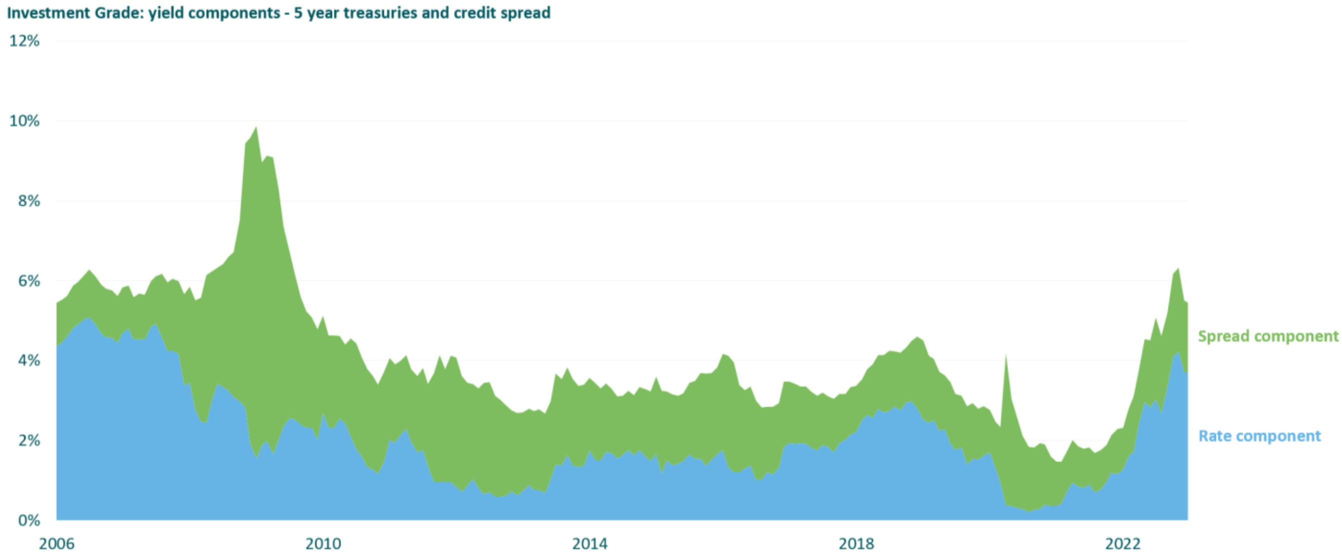

Source: Bloomberg, 22 December 2022

Compelling value in financials

The investment grade universe today is deep and diverse, and recent volatility has created significant valuation dispersion across both sectors and individual companies – as a result, we are currently finding a wealth of opportunities to identify mispriced securities through in-depth credit analysis.

One area where we are finding compelling value right now is in financials, especially in banks. We believe that banks today are in a much better shape than in 2008, being strongly capitalised and well placed to withstand a recessionary environment. Banks also generally benefit from higher interest rates, since they are able to capture a wider spread between their lending and deposit rates. Despite these positive factors, banks currently trade at a significant discount to other sectors having sold off sharply in 2022 (Figure 5).

Figure 5. Compelling relative value in financial sector

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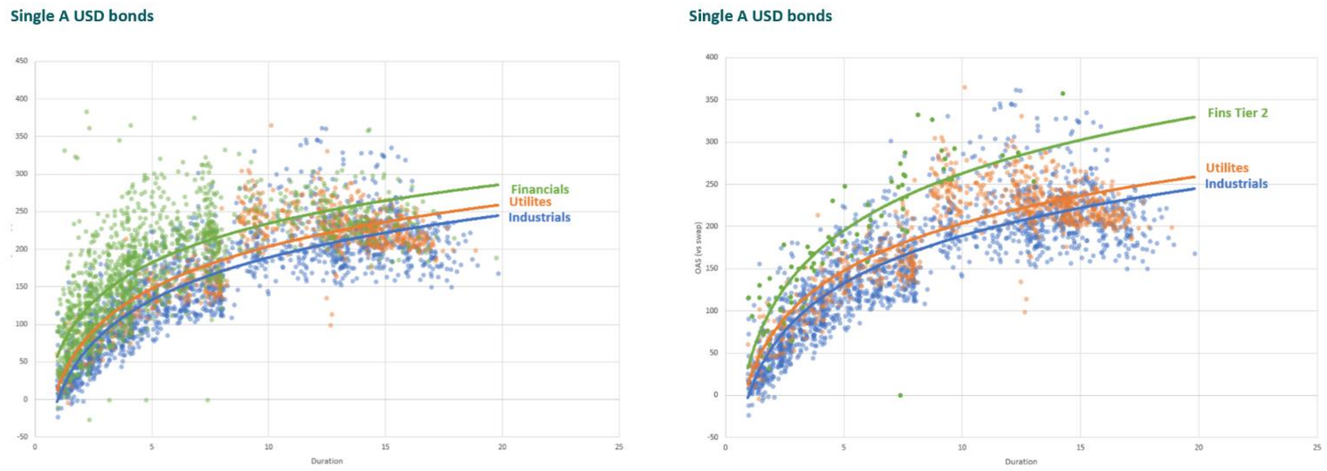

Source: Bloomberg, 22 December 2022

Time to look again at credit

We believe there is currently attractive value to be found in investment grade credit, with investors being well paid to take risk. By providing exposure to both credit spreads and interest rates, we believe corporate bonds should also be well-equipped to withstand a variety of different market conditions, from a prolonged economic slowdown to a faster-than expected return to growth.

While further volatility cannot be ruled out in the short term, from a long-term perspective we think highly rated corporate bonds provide compelling risk/return dynamics in a late cycle environment. As a deep and diverse investment universe, we are currently seeing significant spread dispersion in the investment grade market, and we believe well-resourced active managers should be well-placed to capture these value opportunities.

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.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Past performance is not a guide to future performance. The views expressed in this document should not be taken as a recommendation, advice or forecast.

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