Global Fixed Income Experts

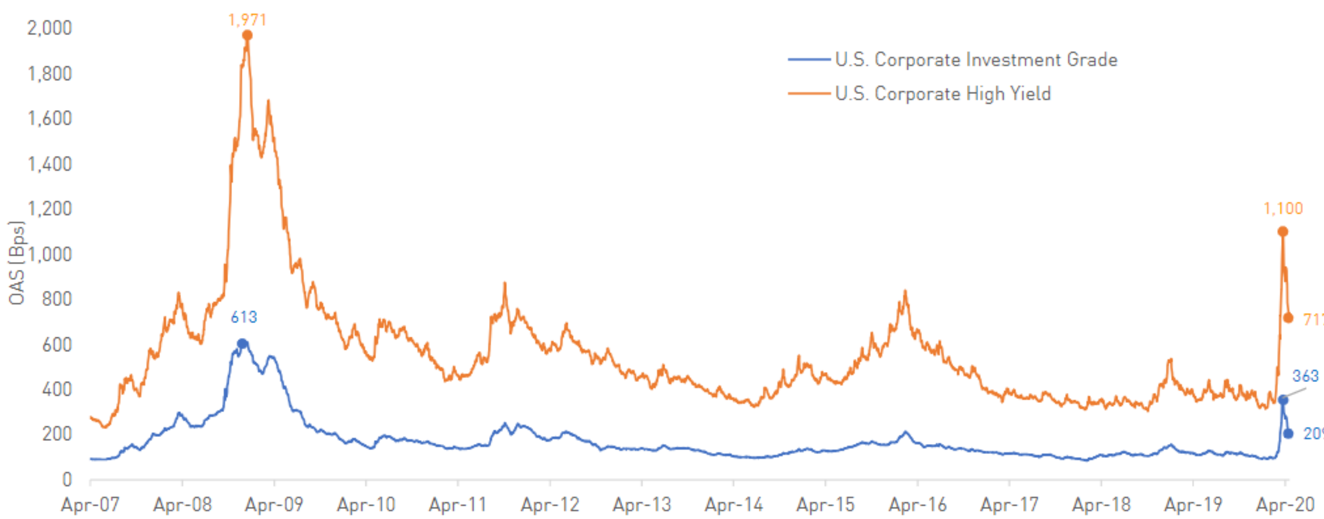
Seizing the Opportunity in Corporate Bonds

The recent sell-off in risk assets has caused steep price declines in corporate bonds in a manner not seen since the great financial crisis. The key drivers of this decline were an expectation of greater bond defaults and a repricing of liquidity.

The liquidity premium refers to the ability to sell your bonds at a price that reasonably approximates its real value without being unfairly punished by a lack of buyers. The breakdown of liquidity was the key driver of price declines in high-quality bonds during this latest sell-off as trading volumes declined and investors were willing to sell bonds to raise cash at any cost.

The two factors above are reflected in a bond's credit spread which reflects how much yield investors demand from their corporate bonds above government bonds. US Investment grade bonds were hit very hard and adjusted in price very quickly as illustrated in the chart below. Some of the credit spread widening has been retraced, but levels are still considerably wider than those prior to this crisis.

March 2020 Liquidity Crisis Caused Highest Velocity Move in History



Source: Bloomberg

What is the Opportunity?

The impact of Covid-19 has been extraordinarily hard to measure thus far, and that uncertainty will continue to exist. But lack of clarity also creates opportunity and we think corporate bonds present advisors with a chance to lock in very attractive risk-adjusted returns for many years to come.

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High Running Yields and Finite Maturities

The risk-reward profile of credit has improved such that it offers considerable upside, while the higher priority claim on assets offers enhanced downside protection compared to equities. During March 2020, the yield differential between IG bonds and government bonds increased from a historically narrow spread of 1% to over 3% while the yield advantage on HY bonds increased from 3.5% to over 9%.[1]

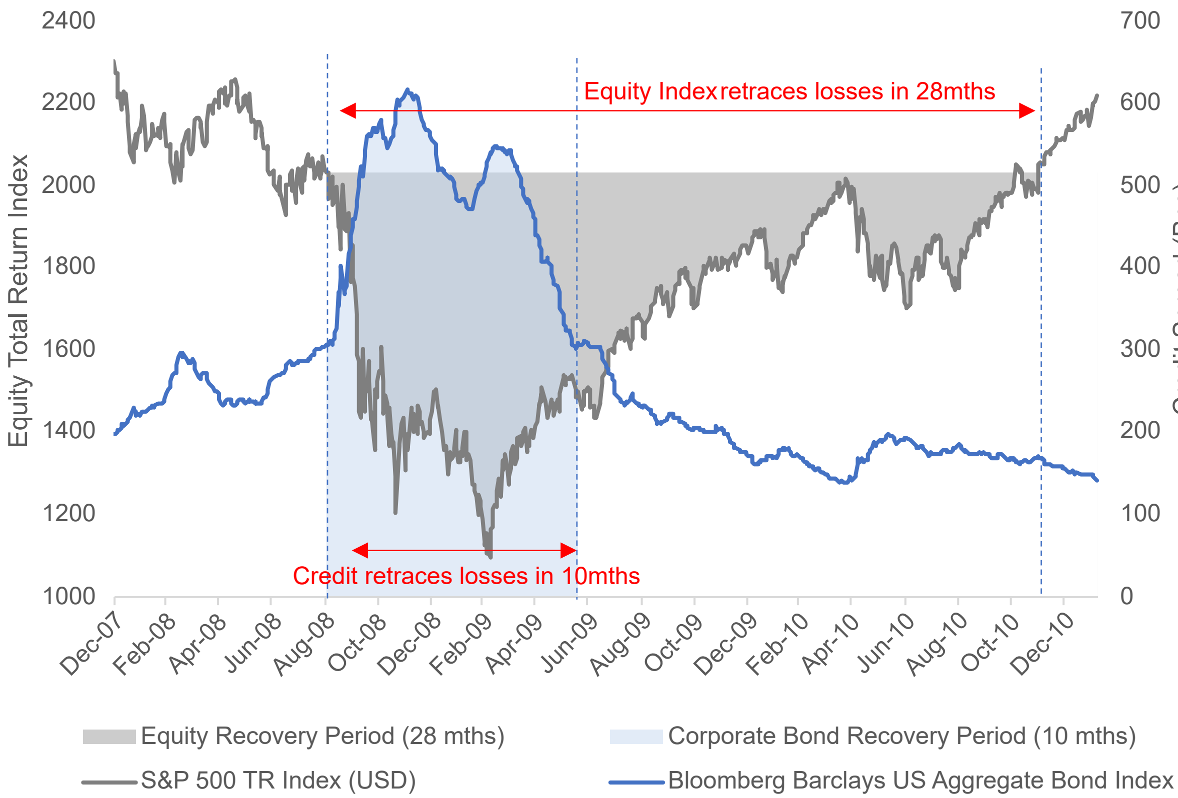
Corporate bonds have a finite term and the obligations are mandatory, unlike dividends and buybacks from stocks that can be decreased or suspended in times of stress. We believe focusing on bonds that have shorter maturities can help limit payment uncertainty and defaults.

Government Stimulus

Monetary and fiscal stimulus by policy makers was employed quickly and in record amounts. The central banks are using lessons learned from 2008/09 to do everything they can to stem the tide of a deep recession. Liquidity has been restored and we believe improvement will continue in the months ahead.

Corporate Bonds Typically Recover Faster than Equities after a Crisis

Corporate bond markets typically recapture losses faster than equity markets. This was observed during the great financial crisis and other drawdown periods. We believe this phenomenon will occur again as investors look for the safety of coupons and the potential for capital appreciation while providing less drawdown risk if we retest the March lows.



1 Bloomberg; Based on minimum and maximum credit spreads of Bloomberg Barclays U.S. Agg. Corporate Bond Index and Bloomberg Barclays U.S. High Yield Index from March 1st to March 31st, 2020

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Government Bonds are Relatively Unattractive

Government bonds typically act as a ballast during periods of equity volatility and play an important role in portfolios. But they have seen a diminished ability to buffer losses against equity markets in the latest sell-off. The yields on 10-year Canadian or U.S. bonds today are unattractive as they pay less than 0.75% with the potential for significant losses if interest rates adjust upwards from these levels.

Corporate Default Anticipation is High

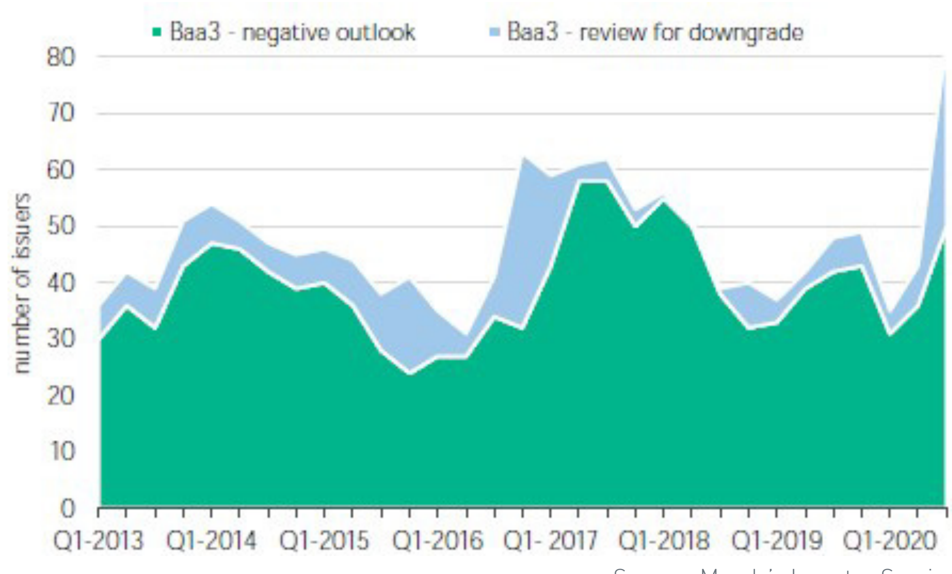
Despite the recent tightening in bond spreads, markets are still pricing in relatively high cumulative five-year default rates of 20% for USD IG and 40% for HY when assuming a 40% recovery[2]. Historically, IG bond defaults rates over 5-years have been less than 1% while HY bonds have been less than 16%[3]. We believe the Fed and other policy makers purchases of corporate bonds can help abate these estimates and support bond prices and liquidity to avoid these scenarios.

Seizing the Opportunity

We believe combining bottom-up fundamental analysis with an active trading approach is vital to maximizing the opportunities in these credit markets. This latest bout of volatility has shown yet again how inefficient and opaque bond markets can become and we believe the best way to navigate them is with a flexible, globally agnostic approach and use a broad toolkit of strategies.

Investment Grade and High Yield bonds both present unique opportunities today. We see value in high quality investment grade names, but also believe selectively adding high yield credits where the compensation is sufficient to justify the additional risk**.**

Fallen Angels are companies whose debt rating has fallen below investment grade. As a rule, passive IG bond funds cannot hold such assets, but an active manager who can accurately analyze the long-term financial picture of an issuer can derive significant value from these bonds.



Source: Moody's Investor Service

2 Source: Deutsche Bank; as of 23 March 2020
3 Source: Moody's Investors Research as of 30 January 2020. Average cumulative 5-year issuer-weighted global default rates from 1970-2019

Hedging and Shorting to Manage Risk can be important tools when maximizing opportunities. For example, a long-only manager might see an attractive corporate bond that is mispriced but unwilling to purchase it because its maturity is long. A manager with a broader toolkit can purchase that bond and simultaneously offset the interest rate risk with shorts or derivatives. Such strategies can also be applied to control portfolio duration or sector risk and ensure only the most attractive bonds are purchased.

Avoiding Sector Concentration in Canada where 80% of the IG universe consists of three sectors (financials, energy and communications). The top 80% of the European universe is spread across five sectors and the U.S. universe across six. This concentration is especially relevant considering that Canadian banks are exposed to an economic downturn, an overleveraged consumer or the realization of the much-discussed housing correction.

Final Thoughts

The ability to lock in yields at such attractive levels in investment grade corporate bonds has not been available to clients in a decade. Advisors that seek conservative returns of 4-6% per year over the next 5 plus years, but who do not want to be overexposed to uncertain equity markets could benefit greatly with an allocation to corporate bonds through an expert active credit manager.