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Bond Bites

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Fiscal fantasia and the corporate bond comeback.

The depth and breadth of fiscal support has supported corporate bond markets but investment risk still remains

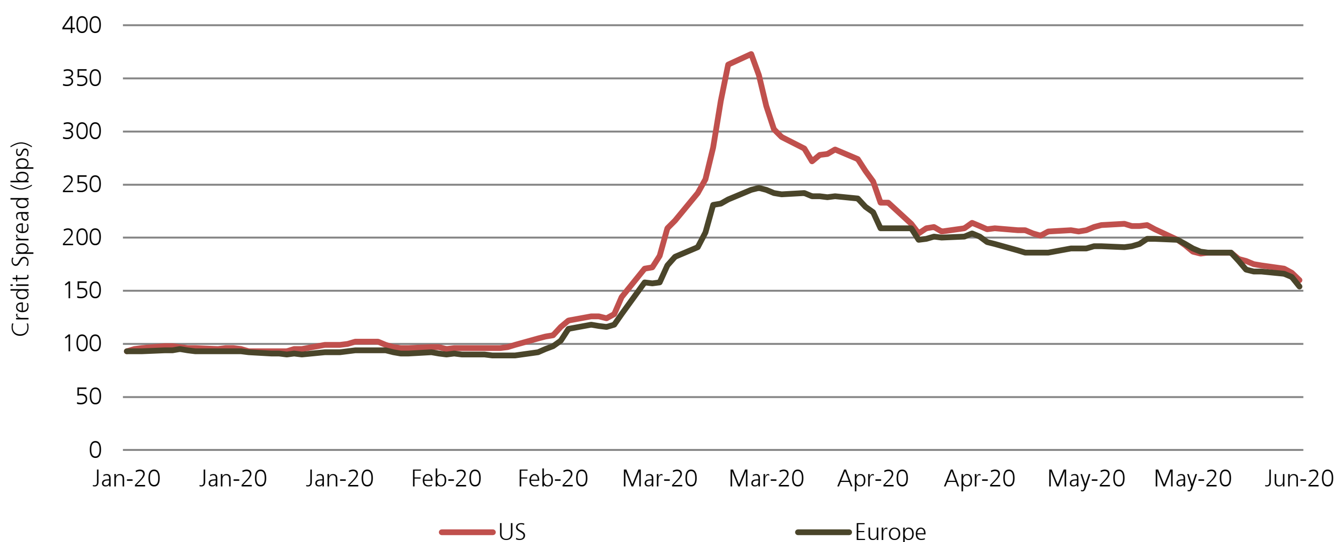
In 1910 British composer Ralph Vaughan Williams premiered his work 'Fantasia on a Theme by Thomas Tallis' to immediate critical acclaim. He chose an unusual name for his score, but for good reason. Thomas Tallis had been a composer of the royal chapel of Queen Elizabeth I over 300 years earlier. Vaughan Williams borrowed the Renaissance melody of a Tallis composition but combined it with his own music and with extreme tempo and dynamic changes that were thoroughly modern. He also added a novel musical arrangement by including three separate string sections to imitate the sound of an organ. The result was a composition with a depth, richness and intensity that places it among the greatest music ever written[1].

The legacy of Vaughan Williams's 1910 score retains a special poignancy today given its appearance at the end of the Belle Époque. Just a few years later Europe convulsed with the horrors of the First World War. To listen to this music today is almost to feel the sands of a lost time slip through your fingers.

In fact this idea of creating dramatic new forms by revitalizing very old themes with fresh arrangements is common practice, not just in the arts, but across disciplines. We can even see the process fully at work today in government policy. To limit the damage unleashed by COVID-19, governments today combine massive fiscal spending with the full cooperation of central banks to help suppress bond yields. But now policy comes with some added modern twists such as loan guarantees for a swathe of corporate entities and wage subsidies for furloughed workers.

The legacy of this creative burst of monetary and fiscal activity will not be clear for many years but the impact for investors has been startling. Consider the corporate bond market; as COVID-19 ravaged economies in March the price shock was enormous. In the US, credit spreads over Treasuries repriced from +1% to nearly +4%, virtually overnight. Chart 1 shows a near identical trajectory in the Eurozone, and the pain for investors was severe. The ICE Bank of America Merrill Lynch Global Corporate Index underperformed government bonds by over 9% on the month – its worst single month on record[2].

Chart 1 – Evolution of US and Europe credit spreads during 2020



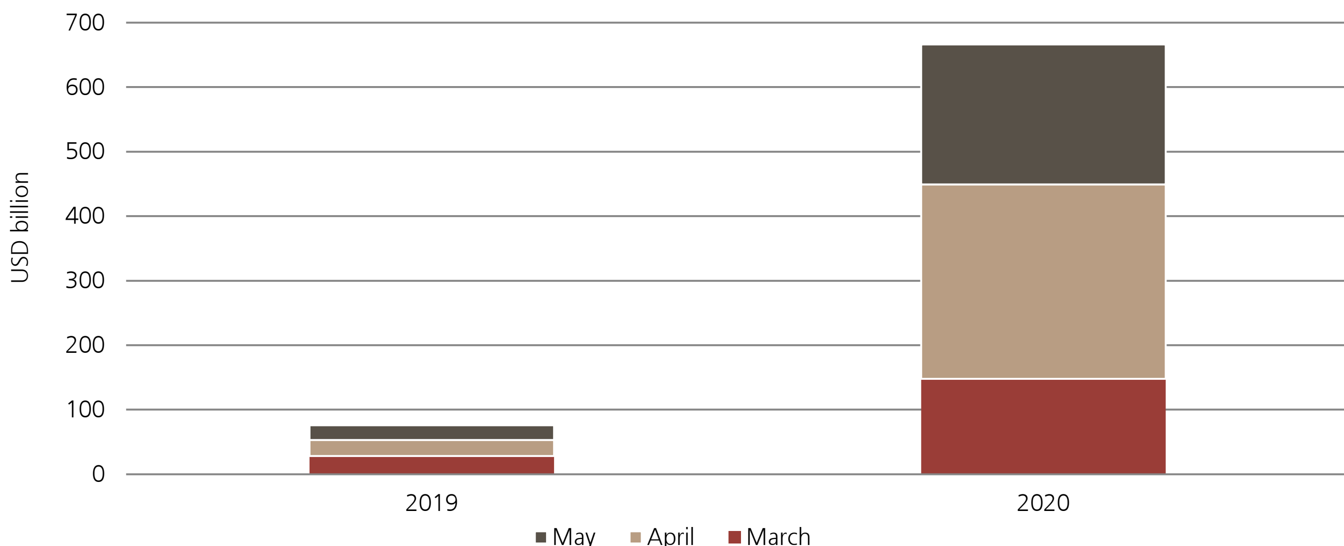
Source: Bloomberg, ICE BofA Merrill Lynch indices, as at 31 May 2020

A dramatic encore

But now the recovery has been almost as rapid, following the Federal Reserve's (the Fed's) announcement that it would effectively underwrite US credit markets with substantial bond purchases. The Fed's approach is wide ranging and, unlike past crises, it will include some high yield bonds and Exchange Traded Funds – new themes in the Fed's orchestration of crisis response.[3]

The speed at which this intervention has unlocked markets is impressive. Credit spreads have now almost returned to their pre-crisis level and activity has burst back into life. Chart 2 shows that in 2019 net new US corporate bond supply averaged just USD 25bn in March, April and May but this shot up to nearly *USD 220bn* in those same three months in 2020, even in the depths of the crisis. Total net issuance in these three months alone is greater than the whole of 2018 and 2019, and on average new deals were oversubscribed 2–3 times. Clearly central bank support for credit markets has meant no shortage of demand for corporate bonds, even as investors adjusted to the much weaker growth outlook.

Chart 2 – Net new US investment grade corporate bond issuance



Source: Barclays, as at 31 May 2020

At one level this is not a surprise; US high quality corporate bonds that yield 2.5% overall are still an attractive opportunity now the US Treasury market as a whole yields just 0.53% and the Eurozone government bond market just 0.18% at the time of writing.

So with plenty of new issuance to choose from, plenty of demand for assets that offer a higher yield than government bonds and central banks using plenty of firepower to underwrite credit and liquidity risks, is it all music to investors' ears?

Not entirely. We wrote recently about the potential risks. Particularly noteworthy is the large number of companies that are in imminent danger of credit downgrades. The rating agency S&P Ratings currently has 111 borrowers rated BBB- with a negative outlook (potential fallen angels), the highest since March 2009[4]. Our own credit analysts predict nearly USD 300bn of debt downgrades across 63 issuers to high yield in the US and EUR 140bn across 27 issuers in the Eurozone. You can read our recent article on fallen angels and the impact on fixed income markets here.

So while central banks still provide plenty of support for markets, and there certainly *are* attractive opportunities in an asset class which could have further upside, investors need to manage the inherent risks very carefully. Our global bond strategies remain overweight corporate bonds and we actively manage these risks while delivering an attractive total return to investors. Through careful bond selection, driven by extensive credit research, we aim to avoid the companies and sectors that offer an unattractive risk/reward profile in the economic challenges ahead. And with our global outlook and top-down driven approach to portfolio construction, we can target the best value opportunities around the world. You can find out more information on our global fixed income capabilities here

1 The power of modern technology; great music at the click of a mouse. https://youtu.be/0U6sWqfrnTs

2 Bloomberg, June 2020

3 The ECB was ahead of the Fed because its asset purchases have included corporate bonds since 2018. And this was part of the monetary policy toolkit before it was even thinking about an emergency response to the threat posed by COVID-19.

4 S&P Ratings, 14 May 2020

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