U.S. FIXED INCOME: GIVE THEM SOME CREDIT

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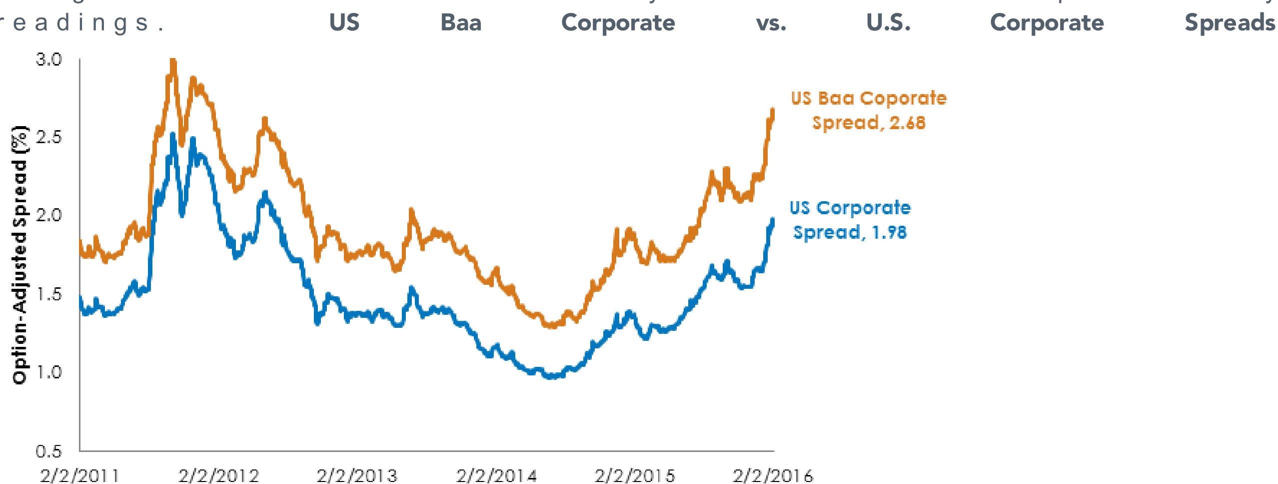
With the lion's share of headlines centered on the turbulence in the equity and crude oil markets thus far in 2016, some developments in the U.S. credit arena have moved to the back burner. Certainly, the decline in U.S. Treasury (UST) yields has garnered its fair share of visibility, and rightfully so, given the fact the 10-Year note seems once again to be testing technical levels to the downside on a regular basis. However, within corporate bonds, recent events in the investment-grade (IG) market appear to have flown under the radar. Since the calendar turned to the new year, IG spreads have seemingly been on a one-way trip to wider levels. Indeed, as of this writing, according to the Barclays U.S. Corporate Index, spreads have risen more than 30 basis points (bps) and now reside at levels we haven't seen since mid-2012. While all credit ratings within the IG sphere have participated in this widening phenomenon, the Baa sector has experienced the most pronounced move, almost doubling the moves that have been witnessed in both AA and single-A corporates. In fact, one has to go even a bit further back in time to the late 2011/early 2012 timeframe to have seen Baa spreads at these lofty readings.

US Baa Corporate vs. U.S. Corporate Spreads



Source: Bloomberg, as of 2/2/16. Option-adjusted spread: A measurement of the difference between a fixed income security rate and that of a risk-free rate of return, typically a U.S. Treasury security. This spread is adjusted to allow for the existence of an embedded option, or a provision attached to a security that gives the issuer or bondholder the right to take some type of action in the future.

At that time, the money and bond markets were dealing with negative news coming out of the eurozone, as fears of Greece leaving the single currency and the potentially negative ramifications associated with such an event were dominating the newswires. With IG spreads at such wide levels some four to five years later, it is natural to wonder what is behind this latest move. In fact, from a historical perspective, Baa spreads are now at readings that have only been witnessed a few times over the last 20 years. The average yield for an investment-grade corporate bond is more than double the yield of a similar-maturity Treasury.[1] This has happened only twice before: during the 2008 financial crisis and the aforementioned 2011–2012 period. Typically in the past, current levels would raise a red flag that a potential recession was looming, but as we saw in the 2011–2012 period, a one-sided "risk off trade" can also be a powerful force. So where do we stand this time around? We believe the widening in spreads, especially over the last month or so, reflects increasing investor concerns about developments abroad and how they may ultimately impact the U.S. economy. Although we do not envision any renewed momentum for the U.S. expansion,

we do expect the domestic economy to avoid a recession and continue to muddle through around the +2% growth threshold. In fact, the case could be made that the current landscape within the IG market has “discounted” quite a bit of negative news already. The recent rate cut from the Bank of Japan and the expectation that China’s policy makers will succeed in avoiding too hard of a landing are two important factors in our base case. In addition, as European Central Bank (ECB) president Mario Draghi stated in his “Whatever It Takes” speech in July 2012, the ECB looks like it will deliver another round of policy easing at its next meeting in March. Against this backdrop, we believe IG corporates offer fixed income investors an opportunity to increase credit allocations within their core and core plus fixed income portfolios.

[1]Source: Bloomberg.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer’s ability to make such payments will cause the price of that bond to decline.

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Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

U.S. 30-year bond : A debt obligation issued by the United States government that matures in 30 years.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

10-year government bond : a debt instrument backed by a government guarantee with an original maturity of 10 years.

Investment Grade : A rating given to a municipal or corporate bond. It is a relatively favorable rating by either Moody's or Standard & Poor's indicating a higher chance an issuer performs interest and principal obligations as promised by the terms of the debt issuance.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Widen : an increase in the amount of compensation bond holders require to lend to risky borrowers. When spreads widen, the market is implying that borrowers pose greater risk to lenders.

Barclays U.S. Corporate Index : is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers that meet specified maturity, liquidity, and quality requirements.

Basis point : 1/100th of 1 percent.

Credit ratings : An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor's, Moody's or Fitch.

Baa : Moody's credit rating that implies the borrower has capacity to meet financial commitments, but may be more vulnerable to adverse economic conditions. This rating includes the lowest level of credit risk while still being investment-grade.