Insights
Fixed Income

Q2 2020

Technicals to Drive Further Tightening in US Investment Grade Corporate Spread

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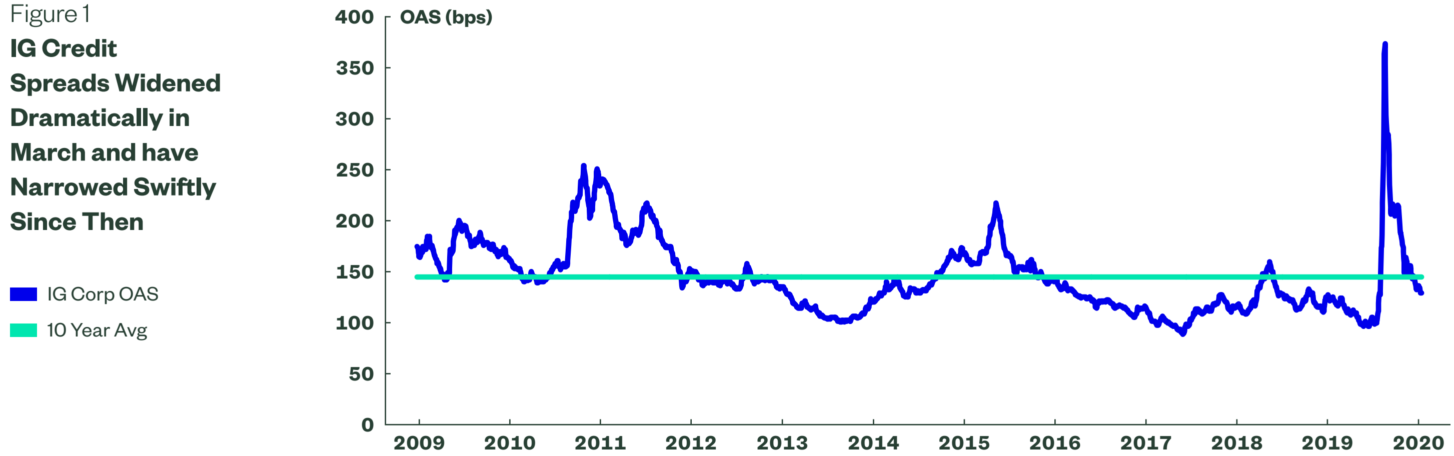
Strong Technicals Reinforce Investment Grade Credit, Limiting Downside Risk and Overshadowing Some Weakening in Fundamentals

Strong technical factors are supporting investment grade (IG) credit, including expansive Federal Reserve (Fed) actions and fiscal stimulus, inflows into IG from investors following the Fed (including renewed demand from foreign investors), and expectations of new supply tailing off for the remainder of 2020. Although certain company fundamental ratios are deteriorating given reduced operating cash flows and increased levels of debt, the latter should be viewed as a positive for corporates as it has enabled them to add cash to their balance sheets. By doing so, companies place themselves in the best position to weather the sharp recession and heightened uncertainty from COVID-19. We expect credit spreads to grind tighter for the remainder of 2020 absent any dramatic new developments on the health, policy or geopolitical fronts.

Landscape and Outlook

Investment grade corporate spreads have narrowed significantly — now under their 10-year average and about 30 basis points (bps) from 2020 tights. Where do we go from here?

Figure 1
IG Credit Spreads Widened Dramatically in March and have Narrowed Swiftly Since Then



Source: Bloomberg as of August 11, 2020.

We pause to take stock of the current landscape and the outlook moving forward for IG credit. The policy backdrop is supportive of the US economy and various fixed income sectors (including credit), with $3 trillion of fiscal stimulus since March and another at least $1 trillion likely on the way. In addition, the Fed has committed to keeping rates at zero through 2022 and implemented open-ended quantitative easing as well as a multitude of liquidity and lending programs. Significant variation in both the response to and the effects of COVID-19 among states in the US and among countries around the world suggests heightened uncertainty around corporate earnings for the foreseeable future until we have proven vaccines and/or treatments at scale. Nonetheless, we believe IG credit will be well supported in the near-to-intermediate term by technical factors as well as strong balance sheets, despite deteriorating fundamental optics.

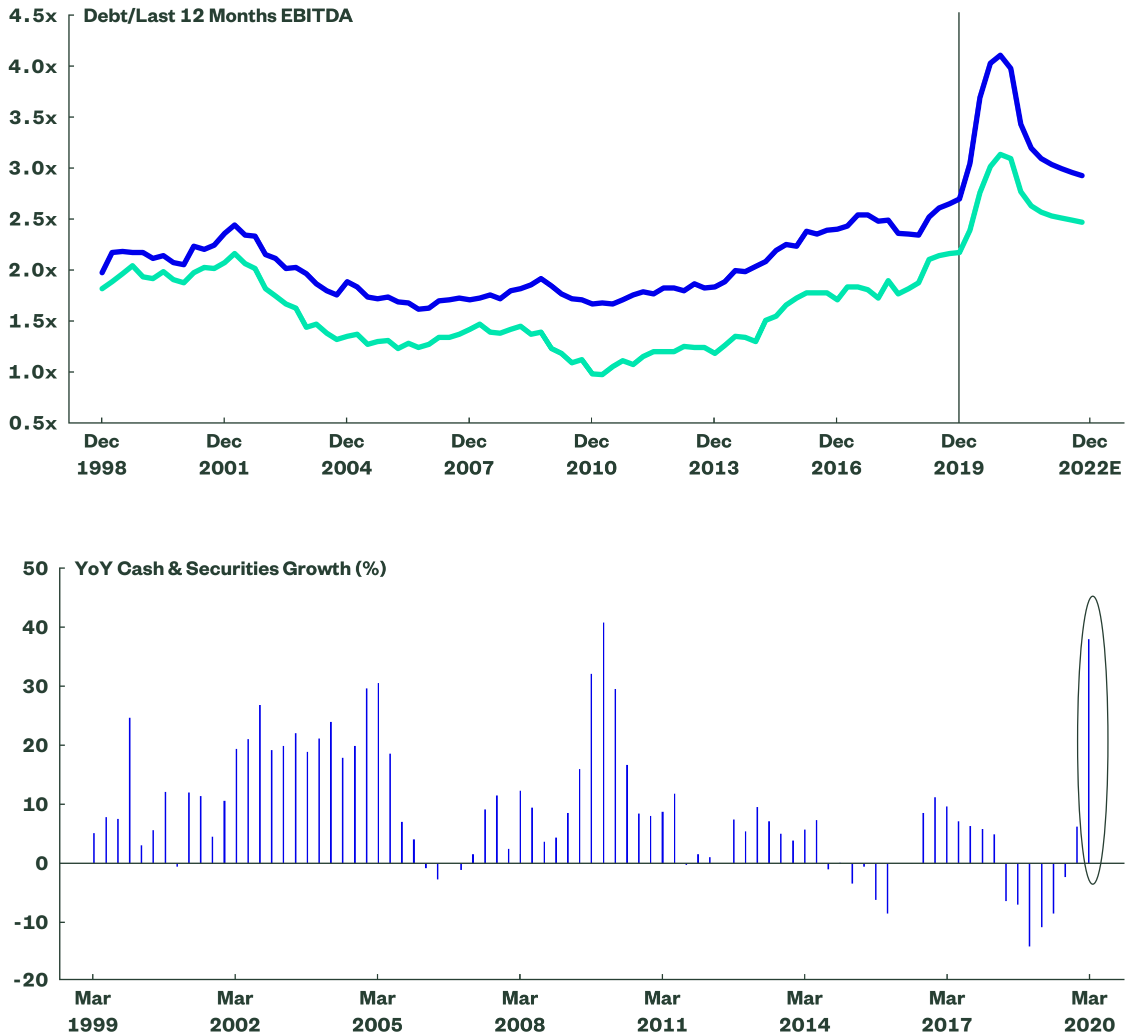
Some Deteriorating Corporate Fundamentals Suggest Longer-Term Uncertainties but Shorter-Term Resilience

IG companies have issued record amounts of debt of $1.47 trillion through July 2020 (+88% year-over-year) to secure cash on their balance sheets and stave off liquidity issues due to COVID-19-related shutdowns.

Historically, leverage ratios have tended to rise going into recessions due to declining operating cash flows, as we saw leading up to the dot-com bubble and the Global Financial Crisis; COVID-19 has predictably accelerated this trend. Under other circumstances, credit spreads would typically widen as investors view increased leverage as credit-negative, all else equal. However, in the context of a global pandemic, investors would be well served to look behind the ratios. That corporate debt levels are rising is due to record levels of issuance in order to add more cash to balance sheets, making companies better able to withstand high industry and operating uncertainties in the short and medium term. Looking over a longer time horizon to solvency-related issues, higher leverage will likely have some negative ramifications down the road, but the priority is for companies to stay afloat until then. History has shown though that companies tend to de-lever coming out of recessions, as they did in 2002 and 2010. We expect the same once a sustained recovery from COVID-19 is underway.

Figure 2
Corporate Leverage Ratios have Risen, but Also Enabled Companies to Bolster their Cash and Liquidity Positions

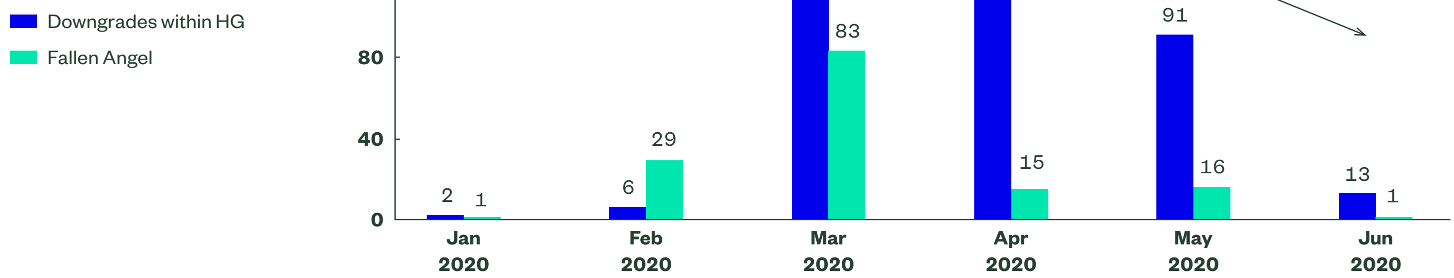
Gross Leverage
Net Leverage



Source: Bank of America Global Research, State Street Global Advisors as of June 30, 2020.

The downgrade picture is yet another reflection of deteriorating fundamentals and the challenging outlook for IG. Fallen angels (downgrades from investment grade to high yield) rose sharply in March but have been trending downward since then. There have been almost $150 billion of fallen angels year to date, and our IG Credit Research team forecasts that we will see an additional $100 billion in fallen angels in H2 2020. Downgrades within IG also fell sharply in June. Downgrade risk has declined relative to where it was during the most acute period of March, a positive for IG. However, a fair amount of uncertainty remains around downgrades for the remainder of 2020 and beyond.

Figure 3
Pace of Downgrades has Slowed, But Downgrade Risk Remains in 2H 2020

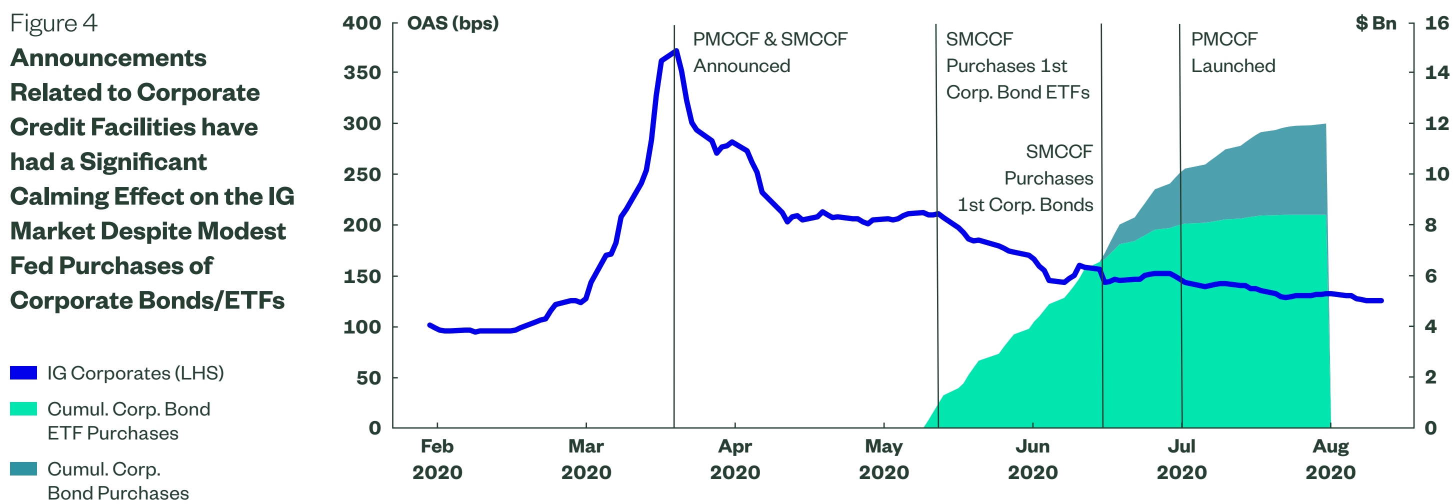


Source: J.P. Morgan, State Street Global Advisors as of June 30, 2020.

Strong Technicals Led by a Proactive Fed Keep IG Credit Well Supported During the Crisis

The technical factors supporting investment grade credit are anchored by a Fed that is directly supporting IG corporates through their Primary- and Secondary-Market Corporate Credit Facilities (PMCCF and SMCCF). These facilities, with combined lending capacity of $750 billion, are designed to support the flow of credit for large corporations and provide liquidity in the secondary IG market. Since the announcement of these programs on March 23, when IG credit spreads hit their 2020 wides of 373 bps, spreads have narrowed substantially back to under 130 bps in August.

Figure 4
Announcements Related to Corporate Credit Facilities have had a Significant Calming Effect on the IG Market Despite Modest Fed Purchases of Corporate Bonds/ETFs

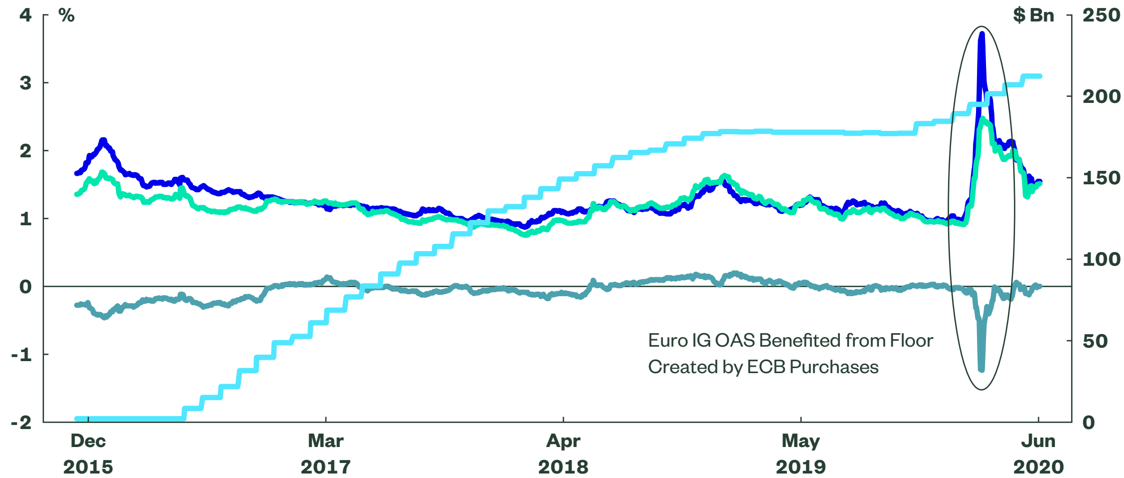


Source: Federal Reserve, Bloomberg as of August 10, 2020. Note: The Fed has released SMCCF purchase data through July 30.

We believe that the Fed's corporate credit facilities, which were recently extended through December 2020, have put a ceiling on the extent of potential spread widening, limiting left tail risk in the IG market. We saw this dynamic play out in the first quarter in Europe where, after 3.5 years of the European Central Bank's (ECB) corporate bond purchases, spreads on EUR IG corporates widened by only half the magnitude that US IG corporate spreads did. Even before this scenario has a chance to play out, Fed action that we believe curtails left tail risks should support tighter US credit spreads, all else equal.

Figure 5
Fed Corporate Purchase Programs Should Support US IG Spreads Moving Forward, as ECB Corporate Purchases did for EUR IG Spreads in Q1

- US IG Corp OAS
- EUR IG Corp OAS
- EUR IG OAS — US IG OAS
- ECB Corp Purchase (RHS)

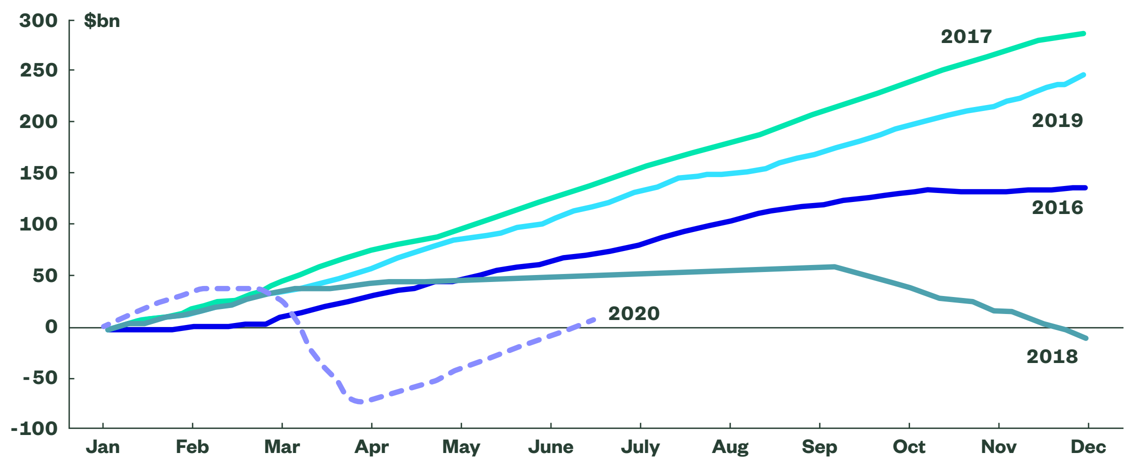


Source: European Central Bank, Bloomberg as of June 30, 2020.

High grade (HG) bond funds have seen strong inflows since the announcement of the corporate credit facilities in March, as bond investors have duly "followed the Fed." After dramatic outflows in March, HG bond funds have seen strong inflows returning to net positive cumulative inflows for the year as of June.

Figure 6a
Bond Investors, "Following the Fed," have Flocked to IG Credit Since March

- 2016
- 2017
- 2018
- 2019
- 2020



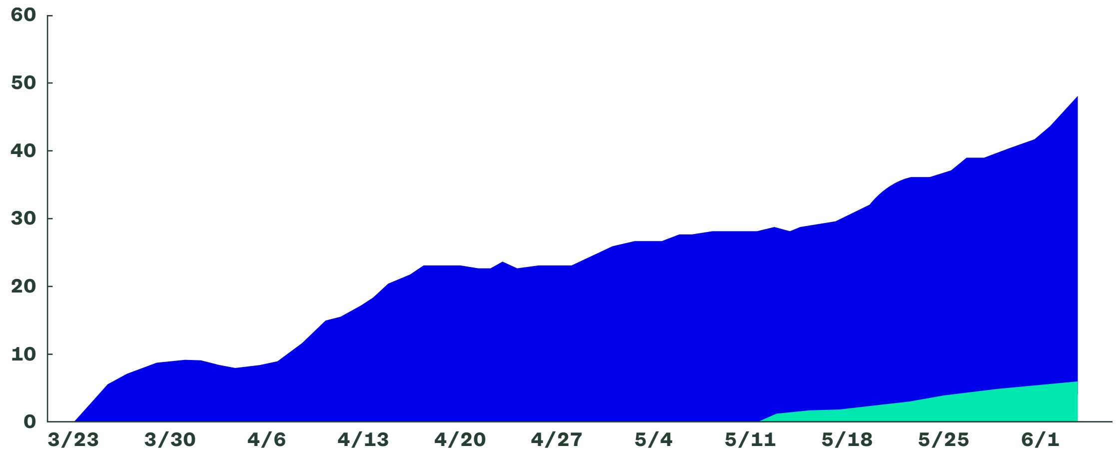
Source: J.P. Morgan, EPFR Global.

Figure 6b

Bond Investors, "Following the Fed," have Flocked to IG Credit Since March

Flows to credit ETFs Purchased by the Fed ($bn)

Fed ETF Holdings ($bn)



Source: J.P. Morgan and the Federal Reserve.

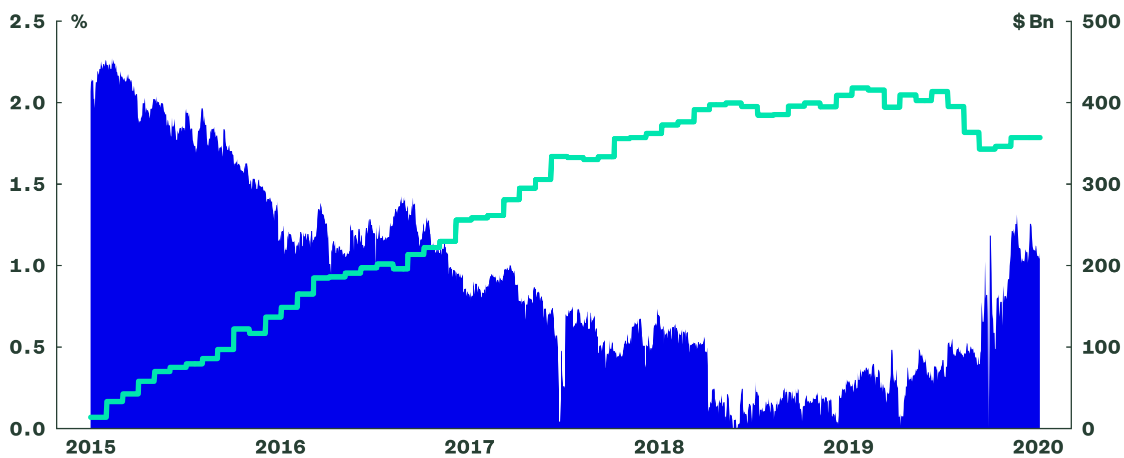
Likewise, foreign buyers of US IG Corp have been a renewed source of demand in Q2 given attractive hedged yields, after being net sellers in Q1 to the tune of over $50 billion.

Figure 7

Attractive Hedged Yields have Brought Foreign Buyers Back into US Corporates

IG Corp Excess Yield: US (EUR Hedged) vs. Eurozone

Cumulative Foreign Purchases of US Corporate Bonds Since 2015 (RHS)

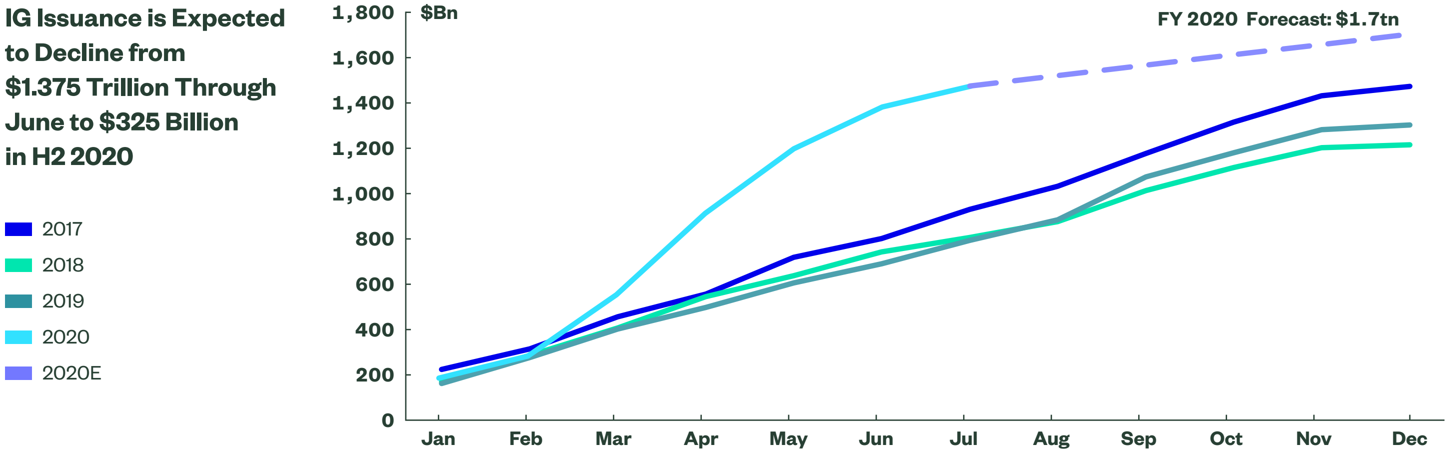


Source: Bloomberg, US Department of the Treasury, J.P. Morgan US Liquid Index as of June 30, 2020.

The record pace of investment grade debt issuance discussed earlier has been well absorbed by demand from both investors and the Fed. We expect issuance of $325 billion in H2 2020 for a full year total of $1.7 trillion. New issue concessions, which amid the crisis were as high as 75 bps, are now coming to market on top of, or under, secondary levels — demonstrating robust demand for IG spread. That new supply is expected to decline from here even as the Fed's buying of corporate bonds and ETFs continues further supports spreads as the aforementioned demand factors outweigh supply.

Figure 8

IG Issuance is Expected to Decline from $1.375 Trillion Through June to $325 Billion in H2 2020



Source: J.P. Morgan, Dealogic as of July 31, 2020..

Technicals to Drive Further Spread Tightening While Limiting Left Tail Risk

Technical factors on both the supply and demand side, in particular strong support from the Federal Reserve, should continue to drive spread tightening for the remainder of 2020 in our view. These factors will likely also limit left tail risk, effectively putting a floor underneath the investment grade corporate market. Our Active Fixed Income team continues to be constructive on investment grade credit, maintaining an overweight position.

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- Invest as stewards
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* This figure is presented as of June 30, 2020 and includes approximately $69.52 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates raise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities.

Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

The value of the debt securities may increase or decrease as a result of the following: market fluctuations, increases in interest rates, inability of issuers to repay principal and interest or illiquidity in the debt securities markets; the risk of low rates of return due to reinvestment of securities during periods of falling interest rates or repayment by issuers with higher coupon or interest rates; and/or the risk of low income due to falling interest rates. To the extent that interest rates rise, certain underlying obligations may be paid off substantially slower than originally anticipated and the value of those securities may fall sharply. This may result in a reduction in income from debt securities income.

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Exp. Date: 08/31/2021