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Active Quantitative Equity

Credit Resiliency at a Reasonable Price

Investors who are concerned about a further deterioration in credit conditions won't have to overpay for stocks that are resilient to widening credit spreads.

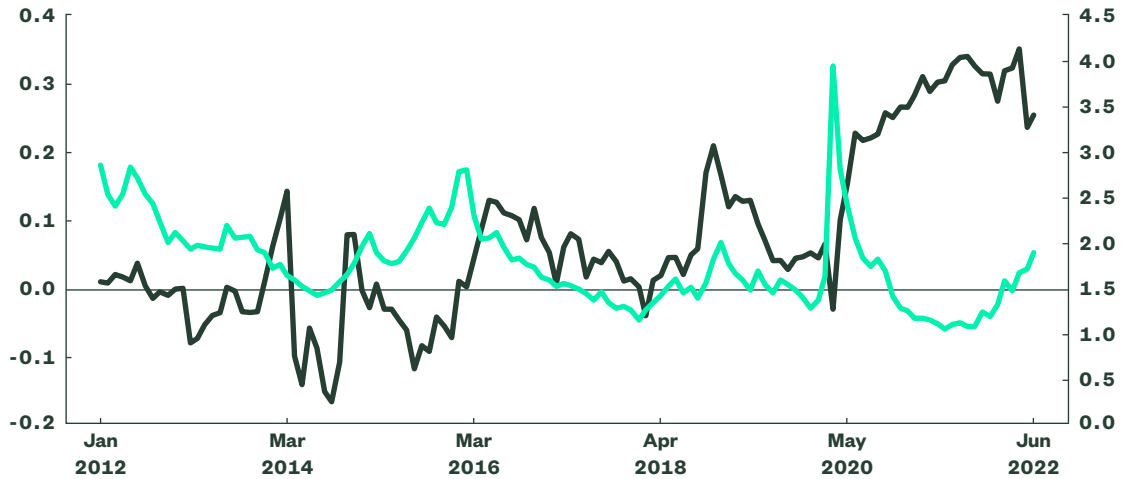
Since the beginning of the year, credit spreads¹ have risen sharply² and equity markets have tumbled, leading many investors to seek safety. They have bought defensive stocks, low beta stocks, low volatility stocks, and stocks with demonstrated immunity to increasing credit spreads. That said, we believe that investors haven't bought enough of these stocks to make them expensive, which means that investors who are concerned about a further deterioration in credit conditions won't have to overpay. Put another way, we believe that protection from credit risk in the equity market is available at a reasonable price.

How do we know this? Using a proprietary risk model, we calculated the sensitivity of all stocks in the equity market to many macroeconomic risks, including credit spreads. Figure 1 shows credit spread levels over time, as well as the correlation between credit spread sensitivity and valuation. The higher the correlation, the cheaper the stocks that are most resilient to changes in credit spreads become. Interestingly, for much of the last 10 years, the correlation between credit spread sensitivity and valuation has been close to zero — i.e., there has been no correlation.

When credit spreads briefly widened in March and April of 2020, those companies that were most resilient to spread widening were at first bid up slightly, driving the correlation down (i.e., they became more expensive). But then the Federal Reserve unleashed liquidity into markets at a rate that caused the companies which were most resilient to widening credit spreads to become cheaper and cheaper (it also caused the companies that were most likely to underperform during a credit crisis to become more expensive). This trend continued until inflation started to appear in the second half of 2021, when market participants began to forecast monetary tightening. When the US BBB credit spread reached historical lows of around 100 basis points, companies with the best credit spread sensitivity were historically cheap.

Figure 1
US BBB Option-Adjusted Spreads and the Correlation between Credit Spread Sensitivity and Valuation
 2012–2022

■ Correlation (LHS)
 ■ Credit Spread (%) (RHS)



Source: State Street Global Advisors and ICE Data Indices, LLC, as of May 31, 2022.

The Bottom Line

During May and June of this year, the stock prices of companies most vulnerable to widening credit spreads fell at a much faster rate than those of more resilient companies. If you are worrying that it's too late to position your equity portfolio for better exposure to possible further credit spread widening, it isn't. Companies with credit spread resiliency are still good value, as are those segments of the market that typically outperform when credit spreads widen (see Figure 2).

You don't need to be able to forecast credit spreads or recessions to position yourself favorably for that eventuality. We believe that investors can still find companies with strong credit resiliency without having to overpay. It can be a win-win proposition — if market concerns about a recession are overblown, there will be no harm in positioning safely because you'll still be holding companies that are good value. If a recession occurs, and credit spreads reach historic highs, then your portfolio will be positioned more safely for that risk event.

Figure 2
Sectors That Are Resilient, and Vulnerable, to Credit Spread Widening

	Good Value	Neutral Value	Expensive
Resilient to Credit Spreads Widening	Telecoms Energy	Food and Beverage/Retailing Utilities Pharmaceuticals	Household Products
Vulnerable to Credit Spreads Widening	Autos Consumer Durables	Diversified Financials	Consumer Services Software Semiconductors

Source: State Street Global Advisors as of June 23, 2022.

Endnotes

- 1 The difference in yield between a US Treasury bond and corporate securities of the same maturity.
- 2 The US BBB option-adjusted spread began June at 1.7% and was at 1.94% as of June 23, 2022.

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* Pensions & Investments Research Center, as of December 31, 2020.

† This figure is presented as of March 31, 2022 and includes approximately \$73.35 billion USD 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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