Insights
Fixed Income

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Investment Grade Credit: Protected by the Central Bank Safety Net

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While it has been a volatile year for investment grade credit, we still see a variety of factors that could support the asset class in the coming months, including yield premium, a degree of protection from central banks and easing supply.

Overview

It has been a volatile year for investors in investment grade (IG) credit. The early 2020 surge in returns on the back of strong equities reversed sharply in March as the pandemic-induced panic saw the market seize up. However, the proactive stance taken by central banks, both in terms of a monetary policy response and actions to free up markets, caused financial assets to bounce back.

With central bank buying acting as a backstop, IG credit seemed to make sense for investors stuck between the rock of very low yields on government debt and the hard place of taking on high levels of credit or duration risk.

Spreads to government bonds tightened over the summer but have been more volatile since the start of September as the second wave of the pandemic has de-stabilised risk appetite. Investors now must consider the degree to which spreads can continue to narrow given the resurgence of COVID-19 is hampering what already looked like a slowing economic recovery.

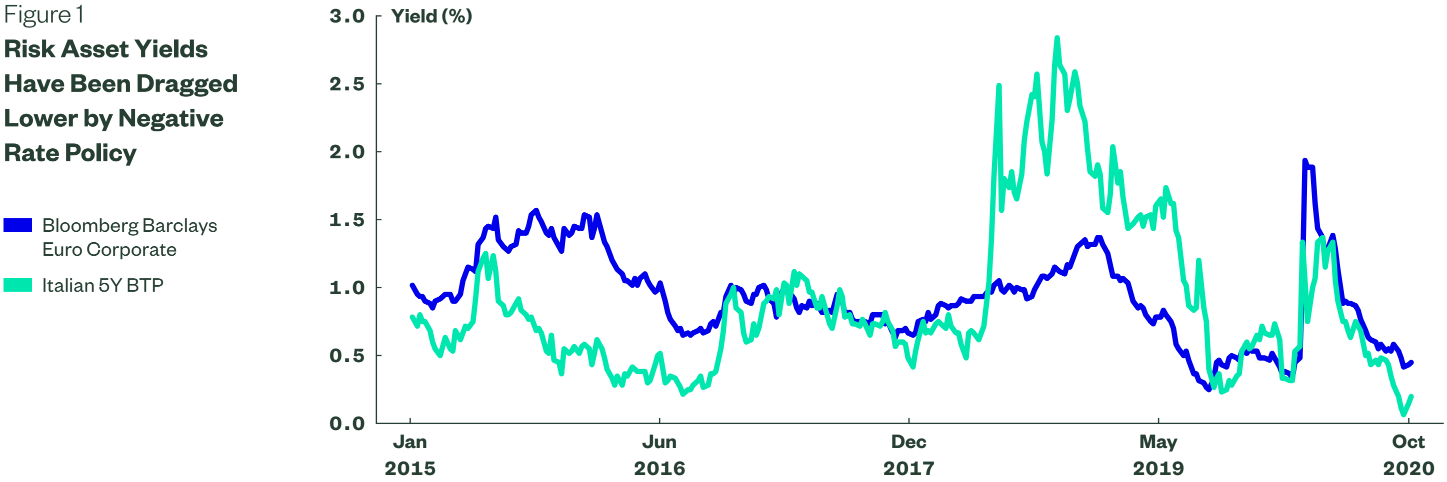
Against this backdrop, and as we noted in the **Q4 Bond Compass**, there are four main reasons why we like IG credit exposures: yield premium, the degree of protection offered, stable corporate conditions and easing supply.

A Yield Premium

Generating outright returns remains a key challenge for fixed income managers. There continues to be a chance that central banks cut rates further but, given many central banks consider they are close to their effective lower bound for policy rates, this is likely to be limited. With the opportunity for capital appreciation constrained, yielding assets are going to be increasingly important. IG spreads to government bonds have tightened significantly since March but still provide a meaningful yield pick-up with an option-adjusted spread (OAS) for an all-maturities index typically above +100bp.[1]

Risk spreads are likely to gradually compress as investors reach for additional pick-up. It is clear that, in Europe at least, this is already in play. ECB buying combined with the (ongoing) creation of the EU's Recovery and Resilience Facility has seen risk spreads compress significantly. Figure 1 shows the yield-to-worst on the Bloomberg Barclays Euro Aggregate: Corporate Index against the 5Y Italian BTP yield; both have headed lower, with BTPs at an even faster pace. Over the past 10 years it has been unusual for the 5Y BTP to trade with a yield below that of Euro IG credit. The only sustained period was in 2015–16 while the ECB bought government debt but not corporate bonds — CSPP (Corporate Sector Purchase Programme) purchases of credit started in June 2016. With the seeds of debt mutualisation for the Euro area well and truly sprouting, it may become the norm that Italian debt trades far tighter to core yields than before. However, this merely reduces yet another source of portfolio running yield and makes IG credit look relatively more attractive.

Figure 1
Risk Asset Yields Have Been Dragged Lower by Negative Rate Policy



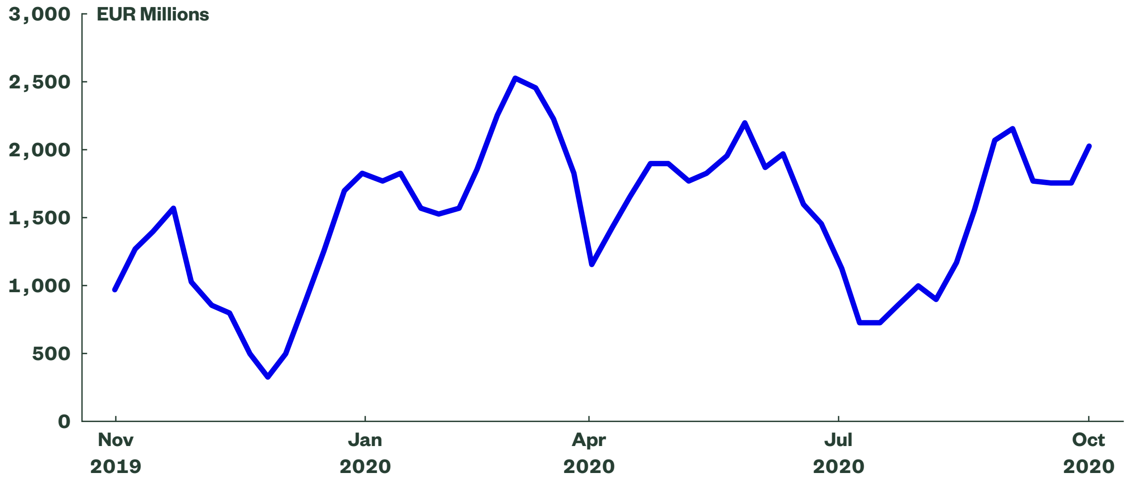
Source: Bloomberg Finance L.P., as of 30 October 2020.

A Degree of Protection

While it cannot be classified as a 'safe asset,' IG credit does benefit from support from central banks. The ECB in particular has been a major buyer of IG paper (see Figure 2), with buying accelerating during the September sell-off. While the Fed has been less involved, only buying credit out to five years of maturity and having pulled back from buying ETFs for now, it does stand ready to intervene if market conditions deteriorate.

This central bank backstop was likely a factor behind the modest reaction to the market going risk-off in September. The OAS on the Bloomberg Barclays Euro Aggregate: Corporates Index widened 7bp, a move that took just 12 working days to reverse as markets stabilised. We believe central bank support will remain an important backstop in Q4 given the potential for event risk.

Figure 2
4-Week Rolling Average of ECB Corporate Bond Purchases



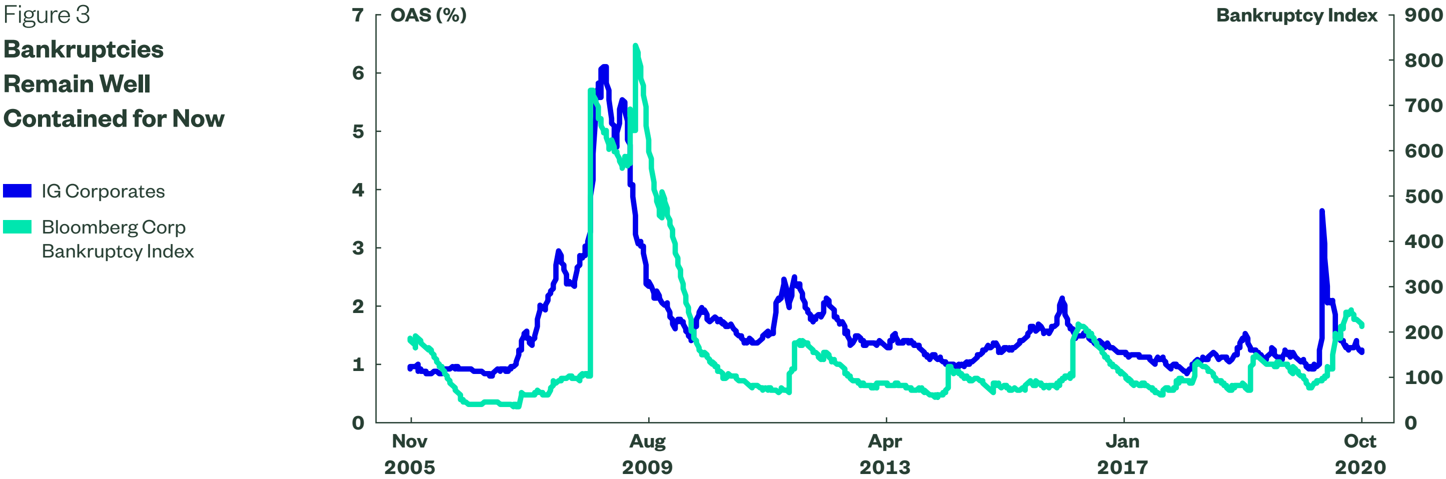
Source: ECB, State Street Global Advisors, as of 30 October 2020.

Corporate Conditions Stable for Now

There was a material down-shift in the pace of ratings downgrades from Q2 to Q3 2020. This stemmed both from the economic rebound and because heavy issuance has allowed companies to get their finances in better shape. For instance, in Western Europe, Moody's made 149 downgrades to IG-rated companies in Q2 against 47 in Q3; in North America, downgrades dropped from 173 to 67.[2] The picture is slightly more mixed for Q4, with North America having seen 40 downgrades while for Europe it has picked up pace to 50.

Downgrades could pick up but indications are that measures put in place by governments and the ability to fund businesses have provided support. As an example, there has been no explosion in US bankruptcies, with filings actually having come down from their August peak (see Figure 3). Importantly, from a credit perspective, better growth has enabled a rebound in oil prices, which should alleviate some of the pressure on energy companies that make up 7.4% of the Bloomberg Barclays U.S. Intermediate Corporate Index.[3]

Figure 3
Bankruptcies Remain Well Contained for Now



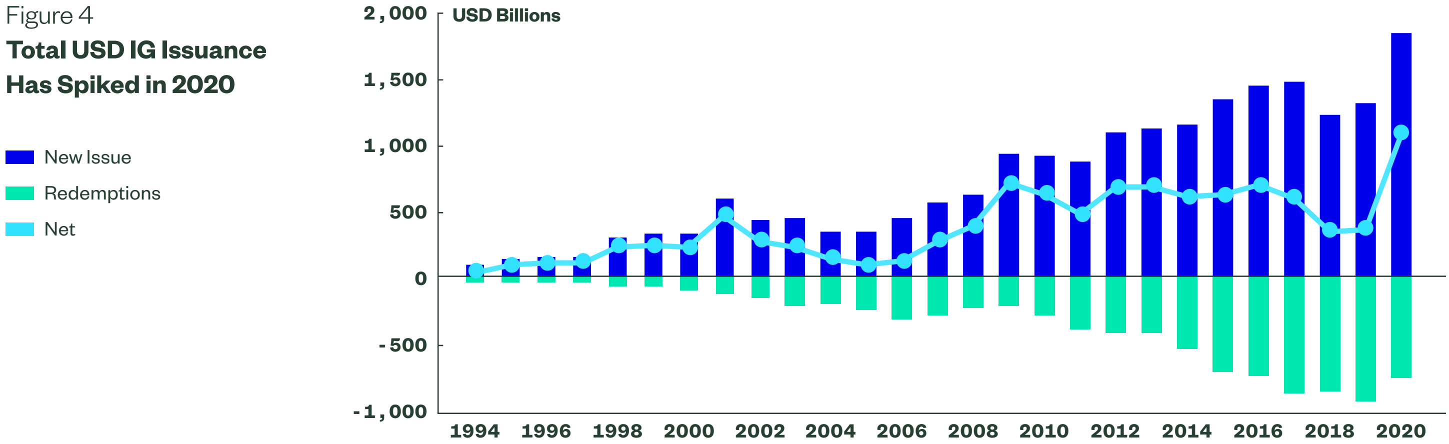
Source: State Street Global Advisors, Bloomberg Finance L.P., as of 30 October 2020.

Supply Should Start to Ease

It has been a heavy year of supply with over $1.5 trillion in US IG paper issued year to date. Bloomberg estimates that this is 68% ahead of the 2019 total on a like-for-like basis and should mean that company funding plans are well advanced. With little primary issuance likely to be planned around the US election or over the Thanksgiving holiday, the supply pipeline is likely to ease during the remainder of Q4. There were already signs in September that issuers were becoming more tactical with some primary issuance being postponed during the more volatile price action seen in the latter part of the month.

In Europe, there was a similar situation with strong investor and ECB demand throughout the summer months encouraging issuers to accelerate funding plans.

Figure 4
Total USD IG Issuance Has Spiked in 2020



Source: State Street Global Advisors, as of 30 September 2020.

Avoiding the Pitfalls, Focusing on ESG Investing

The final quarter of 2020 was always going to be a challenging one with the resurgence of COVID-19 as well as specific risk events like the US election and the UK's exit from the single market all having the potential to move markets. Indeed, the lack of clarity around the US election result is not a positive backdrop for risk assets generally. Non-investment grade paper, in particular, may suffer from the Democrats' failure to obtain decisive control over Congress and push through a large stimulus bill. The upside for corporates is that it looks unlikely that there will be a heavy agenda ultimately of new legislation.

While the immediate threat of a slew of new regulations may have been avoided, a longer-term focus on ESG-orientated investments continues to make sense, in our opinion. On the demand side, it is unwise to ignore the march of the more ethical skew to investing. As we explore in a recent paper, **ESG Fixed Income: Growing Steadily and Entering the ETF Space**, investment strategies based around Environmental, Social and Governance themes have been growing strongly during the past 10 years.

In Europe, there is clearly pressure on institutions to integrate ESG into their investment objectives and this also goes for the ECB. ECB President Christine Lagarde recently highlighted that the ECB's strategy review will look at whether it should continue to buy corporate bonds on a 'market neutral' basis or whether the purchases should take environmental considerations into account. Environmental groups have criticised the ECB for providing cheap funding to big polluters such as oil companies and airlines.

ECB support for the European market has proved crucial. Throughout the crisis, spread widening in the Bloomberg Barclays Euro Corporate Bond Index was more muted than its US equivalent on the back of substantial buying of credit by the ECB. Purchases have picked up since the end of the summer and should provide a degree of protection to investors in the event markets become risk-averse into year-end. Clearly a shift in ECB buying patterns in 2021 has the potential to skew IG corporate bond market pricing.

The Bloomberg SASB Euro Corporate ESG Ex-Controversies Select Index and Bloomberg SASB U.S. Corporate ESG Ex-Controversies Select Index exclude issuers from the parent index that are involved in or that derive significant revenue from operations related to extreme event controversies, controversial weapons, UN global compact violations, thermal coal extractions, tobacco and civilian firearms. From the remaining issuers in the parent index, those without an ESG score available are removed. The index is then optimised by selecting securities and their corresponding weights to maximise the ESG score while maintaining similar risk-return characteristics of the parent index.

This should make the Bloomberg SASB Euro Corporate ESG Ex-Controversies Select Index and Bloomberg SASB U.S. Corporate ESG Ex-Controversies Select Index less vulnerable to changes in either ECB or wider investor buying patterns. Importantly, the optimisation process to bring the characteristics of these ESG indices into line with their respective parent index allows each ESG strategy to be used as either a complement to or instead of a core allocation for benchmark-aware and ESG-focused investors.

Endnotes

1 The option-adjusted spread for the Bloomberg Barclays Euro Aggregates: Corporate index +115bp, the Bloomberg Barclays U.S. Corporate +125bp and the Bloomberg Barclays Sterling Corporate index +145bp as at 30 October 2020.

2 Source: Bloomberg Finance L.P., Moody's as of 2 November 2020.

3 Source: Bloomberg Finance L.P., as of 30 September 2020.

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