JUNE 2020

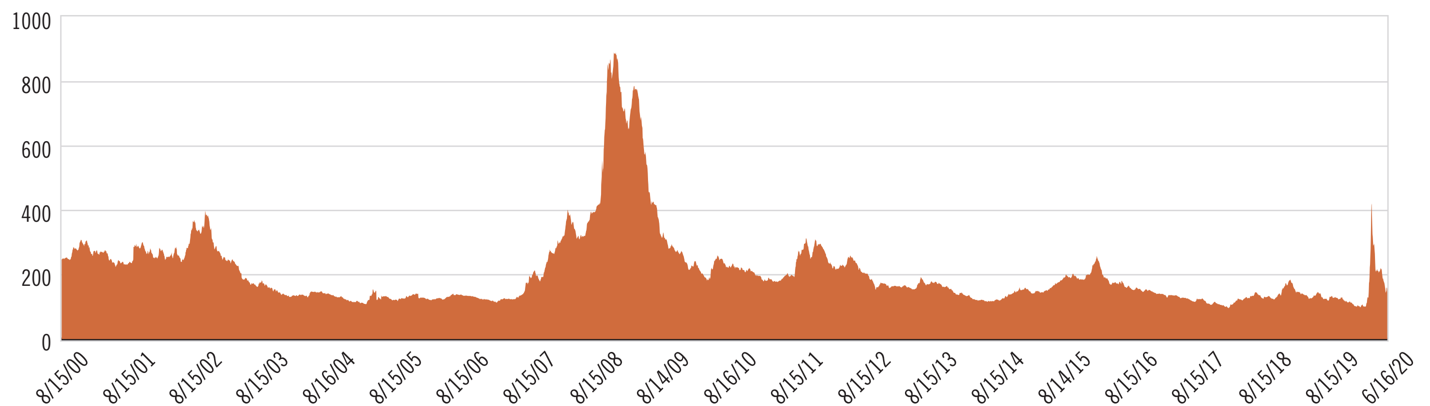
The Ratio of People to Cake Is Too Big

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

THE CASE FOR NEW LOWS IN INVESTMENT GRADE SPREADS

In a famous scene from the 1999 movie "Office Space," the extremely passive office collator, Milton Waddams, timidly observes that the birthday cake they're dividing won't be big enough for everyone to have a piece. He looks around the room, does the math, realizes he's seen this before, but just can't muster a stand. He dutifully passes along the cake slices until there's nothing left. With so much yet to understand in this market, we feel a similar timidity in making a case for record-low spreads in investment grade credit. We're early, we don't have all the information, but as we look around the room and do the math, we think investors should reconsider using prior lows as an anchor, lest they regret passing along the yield too soon.

INVESTMENT GRADE SPREADS (DURATION-ADJUSTED)



Source: Bloomberg Barclays. Based on Bloomberg Barclays U.S. Investment Grade Corporate Index.

We believe investment grade spreads are likely on the path to set new record lows. Again, we are saying this prematurely in an environment where all predictions are premature. As such, this is hardly a prediction. We view this scenario analysis as a useful framework for investors in extrapolating current trends.

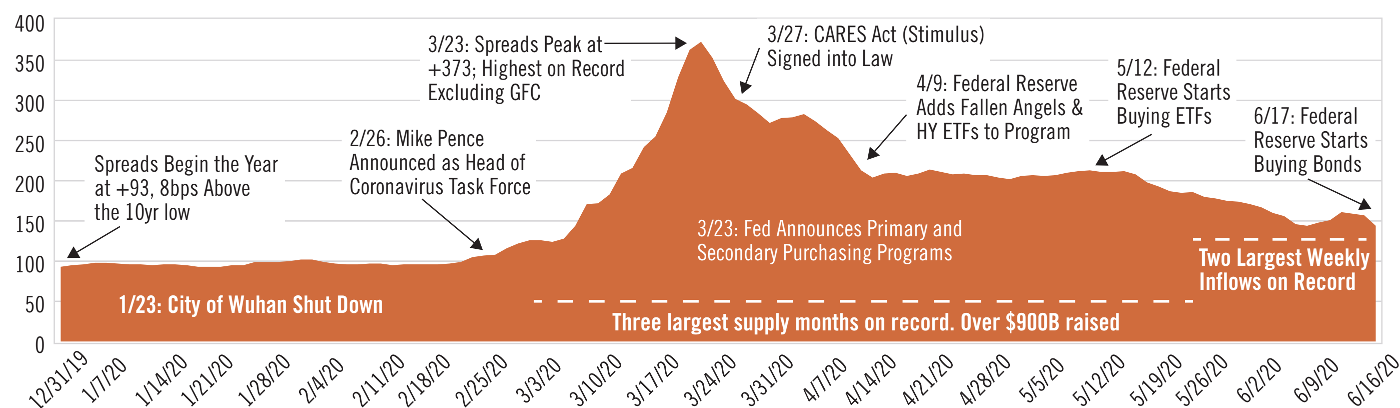
Investment grade credit spreads reached their wides over the span of just 30 days from the start of the sell-off and have taken approximately 85 days to retrace 82% of that move wider. Given the rapid sell-off and more gradual (though still extremely fast by historical standards) recovery, we believe there is a tendency to view the rally as in its final stages. We caution investors against this mentality. We believe this rally is unlikely to stop when the retracement ends.

In this piece, we highlight where we are and where we've been, establish a framework for how low spreads can go, and make the case for setting new 20-year lows in investment grade spreads.

WHERE ARE WE NOW?

The spread over U.S. Treasuries for the investment grade index is currently 144 bps. After peaking at 373 bps in late March, corporates have retraced 82% of the sell-off widening and now sit atop the 10-year average spread of 141 bps. Spreads were at "recessionary levels" (>200 bps) for a total of 46 days, a fairly short trip in the context of prior sell-offs (Euro Debt Crisis – 145 days, Great Financial Recession – 490 days, Tech Bubble – 90 days). This quick reversal stems in large part to aggressive Federal Reserve (Fed) intervention, which we'll discuss in a later section.

YTD SPREAD PERFORMANCE



Source: Bloomberg Barclays. Based on Bloomberg Barclays U.S. Investment Grade Corporate Index.

At the start of the year, with spreads at 93 bps, valuations were well through recent and historical averages. The 10-year low for spreads was only 8 bps lower, the 20-year low just 17 bps lower. Yields hit an all-time low of 2.22% in March (only to be surpassed again on June 16th). As the index has experienced both an extension in duration (from 5.5 years to 8.5 years) and a degradation in credit quality (35% BBB to 50% BBB) over the past two decades, spread per unit of risk was essentially at an all-time low.

HOW LOW CAN SPREADS GO?

The maximum credit loss sustained in any one year for the investment grade market was 41 bps in 2008. In other spread sectors, investors are typically not compensated for maximum loss outcomes, but in investment grade, investors have **always** received a spread that was sufficient to cover credit losses, even in the most adverse scenario.

	Investment Grade	High Yield
Average Annual Credit Loss	0.053%	2.53%
Maximum Annual Credit Loss	0.41% (2008)	7.65% (2009)
Average Spread (2000-2020)	1.57%	5.46%
Low Spread (2000-2020)	0.77% (2005)	2.38% (2007)
Average Spread to Average Loss	29.6x	2.2x
Average Spread to Maximum Loss	3.8x	0.7x
Low Spread to Average Loss	14.5x	0.9x
Low Spread to Maximum Loss	1.9x	0.3x

Source: Moody's Annual Default study for the period 1938-2018.

While we would highlight that the average credit quality of the asset class has declined over the past decade, it is important to note that this would not change the previous statement. The maximum loss for BBB rated securities was 0.71% in 2002 (WorldCom – fraud). Since 2002, BBBs have grown from 36% of the market to 49% today. At today's index weights, the implied maximum historical credit loss is 48 bps. This is not to say that excess returns are always positive, but for buy and hold investors, which dominate the buyer base, the market has provided a reliable source of risk-adjusted returns.

Investors should also be compensated for ratings downgrades and liquidity. This is top of mind in a year in which projections call for a potential $300 billion in fallen angels. Our analysis suggests that required compensation for downgrade risk is 10-15 bps in an average year and up to 50 bps in a downside scenario. We believe the intervention by the Fed has capped the maximum compensation investors should require for this risk. The Fed specifically targeted fallen angels in their April 9th update to the corporate bond buying facilities in recognition of their potential risks to the broader system. While idiosyncratic downgrades will persist, we do not envision a scenario where a disorderly mass downgrade wave will be unmet by Fed liquidity.

Between credit loss risk, downgrade risk, and liquidity risk, we believe a theoretical floor for investment grade spreads is approximately 40 bps. We believe that to be compensated for maximum loss and downgrade potential, investors should be compensated closer to 90-100 bps, which is close to the actual historical duration-adjusted lows.

As such, spread levels of 93 bps at the start of 2020 were roughly commensurate with the **maximum** compensation investors should require for typical credit risks. While well through historical levels, we believe owning the asset class inside of this level is completely justifiable in a vacuum (ignoring relative value with other sectors).

WHY WOULD WE TRADE THROUGH PRIOR LOWS IN THIS ENVIRONMENT?

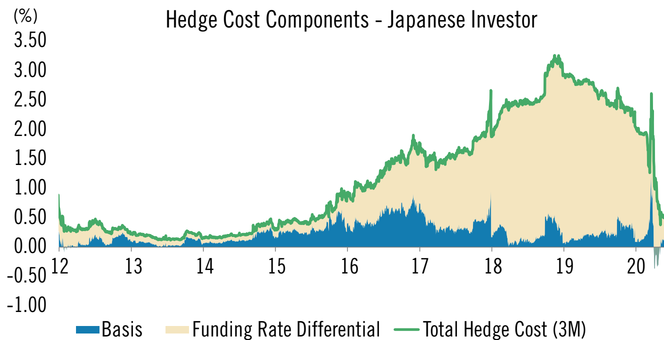
The overarching driver for lower spreads is the renewal of the global hunt for yield. Negative-yielding debt has risen from the start of the year; currently $12.9 trillion and trending higher. Short term rates are anchored to zero for the foreseeable future. Investors still need to find yield. The U.S. investment grade market punches well above its weight in this area. It represents 27% of the Bloomberg Barclays U.S. Aggregate Bond Index (by market value), but pays 49% of the yield. On a Global Aggregate Index basis, it is just 11% of the index, but pays 26% of the yield.

Domestic investors have been pouring back into the asset class in recent weeks with record inflows. They won't be alone. Lower hedging costs have increased the attractiveness of the asset class for foreign investors. Yields of 2.2% in the U.S. compare favorably to 0.82% and 0.55% in Europe and Japan, respectively. On a hedged basis, this is an accretive trade for foreign investors who now represent over 30% of the buyer base.

Alongside a setup for increased demand is an equally important setup for reduced supply. It is remarkable that the market has retraced 82% of the sell-off with the amount of supply it has experienced. The three heaviest months for net new supply in history have been the last three. On a year-to-date basis, net issuance is over $800 billion, nearly double an average figure for a full year. Borrowers have stocked up on cash across the board (46 of the top 50 issuers have issued this year). A typical investment grade company was generating >20% free cash flow to debt and will cut operating costs, capital expenditures, and possibly shareholder returns amid the uncertainty. We believe a deleveraging phase is likely **if** issuers avoid the more pessimistic scenarios where they would burn cash. Without the cash burn, the net supply we've experienced is instead a pull-forward of future supply as we do not expect issuers to maintain higher leverage levels following a market-wide scare.

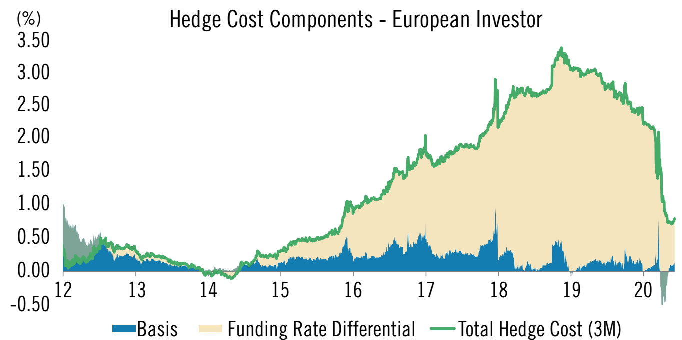
Finally, the Fed has changed both the technical and fundamental landscape of the asset class. On the technical side, it has committed to purchasing $250 billion of bonds and credit ETFs in the secondary market. While the program

USD CURRENCY-HEDGING COSTS AT FIVE-YEAR LOWS FOR JPY INVESTORS



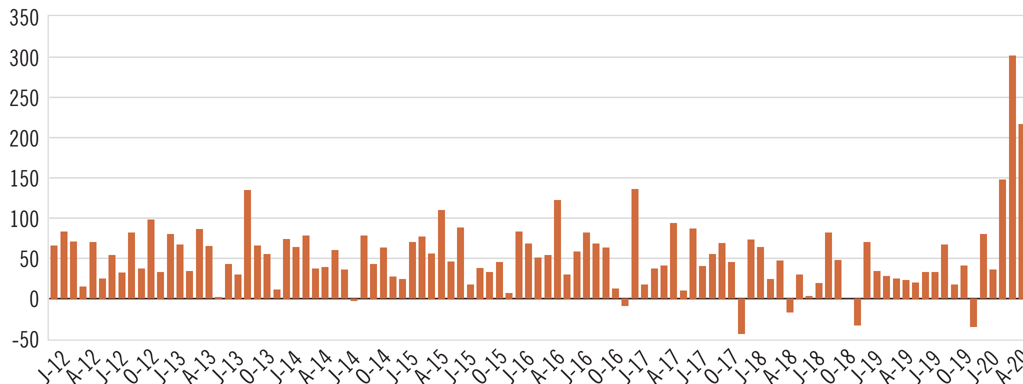
Source: Bloomberg, Morgan Stanley Research.

HEDGING COSTS FOR EUR INVESTORS HAVE ALSO DECLINED SHARPLY



Source: Bloomberg, Morgan Stanley Research.

MONTHLY NET SUPPLY (BILLIONS, 2012 - MAY 2020)



Largest Months of Net Supply – All Time	
April 2020	302
May 2020	217
March 2020	148
Jan 2017	136
Sept 2014	135
May 2016	122

Source: Barclays Research.

was announced in March and runs through September, the Fed has bought just 2% of this mandate so far (via ETFs). While we would question the necessity of following through on this program, the Fed has not indicated a desire to back down. Instead, it backed off the requirement to have issuers self-certify their eligibility for the program and began buying individual bonds as early as June 16th. Fundamentally, the Fed has reduced credit risk by injecting liquidity during a period of stress and have taken away one of the market's primary fears – that of a disorderly fallen angel wave.

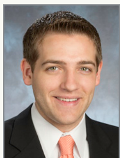
WHAT WE DON'T KNOW (BESIDES THE OBVIOUS)

- The actual cash burn of the underlying constituents, which will determine future supply.
- To what degree the Fed will follow through on its bond buying programs.
- How long U.S. short term rates remain at the zero lower-bound – influences hedging costs.
- How much "tourist" money is likely to exit the asset class – hedge funds, non-traditional buyers that were capitalizing on the dislocations experienced during the sell-off.

CONCLUSION

Investors should reconsider anchoring themselves to prior lows. We believe investment grade still offers more than adequate compensation for average default and downgrade experiences. While we await fundamental clarity, the technical outlook is increasingly favorable. We believe the combination of lower future supply, rising foreign demand, and Fed buying could cause the rally to overshoot investors' expectations.

AUTHORED BY



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The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. The **Bloomberg Barclays U.S. Corporate Bond Index** is a component of the U.S. Aggregate Bond Index. It measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers. The **Bloomberg Barclays Global Aggregate Index** is a measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

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