For professional clients

AA View

Credit Market Turmoil

A focus on investment grade and portfolio responses

Summary

- Credit matched equities last month – the most rapid fall into a bear market on record. US investment grade spreads went to levels not seen outside the financial crisis.
- Surging downgrades, the BBB overhang risk of falling angels and illiquidity drove spreads. The pandemic policy responses and Fed buying has calmed things recently.
- Deteriorating credit quality in investment grade indices overstates the valuation improvement, though the US stands up well even after this is accounted for.
- An elusive post-pandemic recovery, and its impact on credit risk premiums is likely to keep volatility high and spreads under pressure for longer. Against this, central bank buying and the continued global search for yield does cushion credit to a degree.
- Current valuations are clearly much improved from pre-virus scare levels for longer-horizon investors, providing an accumulation opportunity. However, the likely volatile market path suggests caution, with an 'averaging in' approach better for navigating these conditions. High dispersion points to a greater need for active approaches.

Credit Bear Market (BAML indices OAS, bp)	**Spread pre-scare***	**Spread highs***	**Spread Apr 7**	**Move from pre-scare**
US Investment Grade	105	408	292	+187
US long credit (10+ years)	143	375	296	+153
US AA	56	276	170	+114
US BBB	131	488	383	+252
US Asset backed (ABS/CMBS)	71	470	284	+213
US High Yield	356	1087	888	+532
US CDX (North America)	44	151	112	+68
UK Non-Gilt Investment Grade	105	225	197	+92
UK Corporate Investment Grade	122	285	241	+117
UK AA	59	138	122	+63
UK BBB	158	335	286	+128

**Spread pre-scare approx. 21 Feb, Spread high approx. 23 March*

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The big hit to credit markets

Credit markets behaved similarly to equities as the corona virus scare swept through markets from around February 21. Much as equities fell into a bear market (a decline exceeding 20%) in the shortest time on record, so credit notched up the fastest rise in spreads on record. There is no similar consensus on what a credit bear market really is, but if we take a doubling of credit spreads over government bonds as a ready reckoner, we can see that in less than a month, spreads doubled, tripled or even quintupled from their pre-virus scare levels. We have shown the US and the UK key credit segments in the table above as shorthand, but European, Canadian, Asia-Pac spreads generally moved similarly, typically moving less than the US.

The reasons for the larger extent of US spread moves are not entirely clear. The US high yield market has greater sensitivity to energy, which took a tumble because of the crash in oil prices, but this does not hold good for the other segments. Clearly credit markets suffer from a structural illiquidity issue which comes to the fore quickly in times of market stress, and it may be that US markets being larger and deeper markets suffered the brunt of the large sell-off. A similar period of US underperformance was noticeable in the early stages of the financial crisis in 2008/9.

After a very big hit, credit markets were given a reprieve a month or so after the sell-off began. The Federal Reserve announced a major new and accelerated round of quantitative easing (QE) on March 23, and soon after made clear that it would also be buying investment grade corporate bonds this time, not done in previous QE rounds. This helped credit markets globally recover some lost composure which we show in the column showing moves since the Federal Reserve's 23rd March announcement.

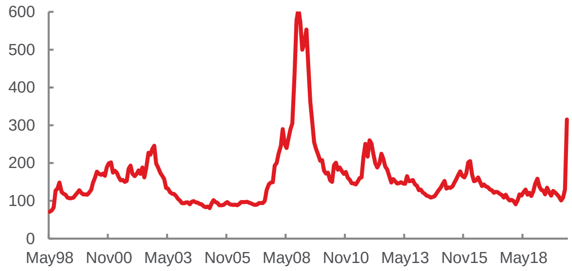
Credit spreads versus previous sell-offs

This sell-off was ultra-speedy. How does it compare in terms of magnitude and spread levels compared with previous credit bear markets? As the charts below show, the US sell-off was stronger than all previous sell-offs bar the financial crisis. By contrast, the UK sell-off (on the chart that follows) was smaller than the one seen at the time of the Eurozone crisis.

It is important to note that direct comparison with previous market periods risks a significant oversimplification in being able to compare current spreads with those around the time of the financial crisis or before. As the two charts on index composition that follow the spread charts point out, the market has changed. The UK chart uses S&P ratings and the US uses the Moody's equivalent, but both convey the same message. The higher grades have dropped in share, and the lower grades, particularly BBB (S&P) or Baa (Moody's), have increased their share. All else being equal, we would expect sell-offs to be more marked for BBB (or equivalent) now since the price reaction will convey the higher risks of moving down to sub-investment grade level (see below). From the viewpoint of comparing with past spread levels during sell-offs, we can say the following:

- the AAA and AA share of the sterling corporate bond market have flipped shares with BBB's by about 25% from a decade ago. The US is not that different in this respect.
- Since the BBB spread premium over AAA and AA is somewhere about 80-100bps on average in normal markets, this ought to imply that all else being equal, *index spreads ought to be about 25bps higher on average compared with a decade ago on a grade-adjusted basis.*
- This means that current index spreads are on average, about 25bps lower on a like-for-like basis than the pre-financial crisis levels if we are comparing across time in this way. From this perspective, current spreads, while looking high, are not as much of a high outlier as we might think, still good for the US given spreads currently in the 90's as a percentile of historic distributions, but less so for the UK.

US Investment Grade spreads highest level since the financial crisis (OAS spreads, basis points)

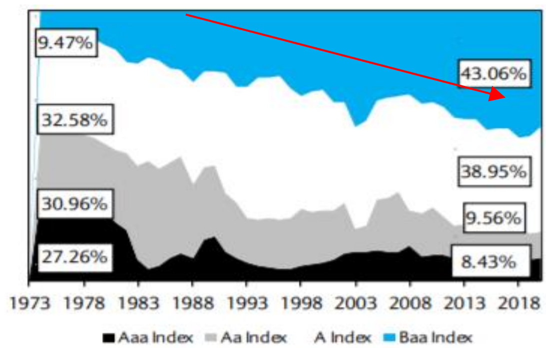


UK equivalent looks less of an outlier (Non-gilt index, OAS spreads, basis points)

Source: BAML indices, ICE

Lower quality of indices: US (Moody's) and UK (S&P)

US



Source: Bloomberg Barclays Indices, Barclays Research

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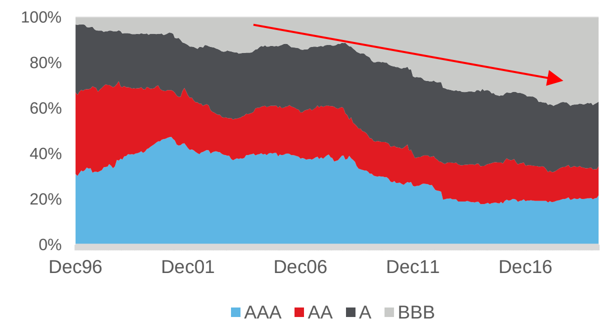
UK

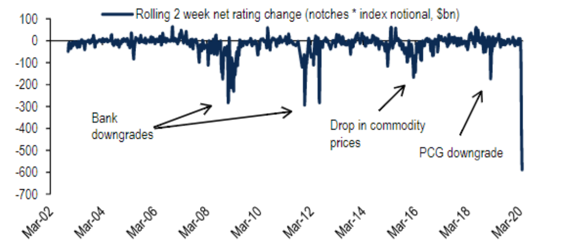


Sources for ratings charts: Barclays Capital, BAML, ICE

Fear of credit losses and Illiquidity

Any economic downturn leads to a fear of impaired corporate cash flows, with some unable to service debts and so going into default. However, in investment grade, defaults are typically rare and inflict less than 20bps of default losses per annum generally. Downgrades are the bigger enemy of the market, and the pace of downgrades accelerated very considerably in March (see chart below). Rating downgrades were faster than in 2008/9.

Speed of downgrades sharper than the financial crisis



Note: net rating change equals upgrades less downgrades. Based on the average of Moody's, S&P and Fitch, if available. We also include the watch as 2/3 of a notch and the outlook as 1/3 of a notch. Restricted to bonds in ICE BofA IG corporate index C0A0.
Source: BofA Global Research

These downgrades inflict mark to market losses on portfolios, though in some instances, 'buy and maintain' portfolios will be able to avoid these by simply holding downgraded bonds to maturity[1]. With the overhang of a much larger share of BBB rated bonds in the investment grade universe, the potential losses will be larger, because price falls for BBB bonds facing downgrades into 'fallen angel' status are large. The data we have pulled together below shows the scale of downgrades and the tally of fallen angels. The scale of downgrades and the tally of fallen angels In March go a long way to explaining the unprecedented sharpness of the sell-off in credit markets.

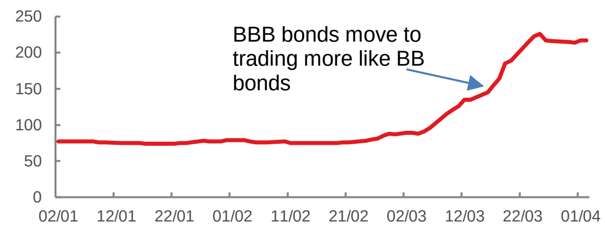
US Investment Grade Ratings Moves in March (to March 31)

	Number of issues	Share of market (%)	Market Value ($ billion)
Downgrades	31	3.0	198
Of which: Fallen Angels	11	1.4	91.5

Source: BAML Indices, ICE

Markets generally move ahead of ratings agencies, and many of the downgrades came after big price falls. Low graded bonds have been in many instances traded like the top tier BB rated bonds in the high yield universe (see chart below). In the financial crisis, these downgrades carried on for quite some time and fallen angels ultimately amounted to about 7% of the investment grade universe. What will it be this time? There are uncertainties on the depth and duration of this downturn and the scale of the ultimate recovery is also unknown. Since the BBB element of global investment grade universes is rather higher than 2008, the attrition rate will also tend to be higher so long as economic conditions are tough. Against this, there are government cushions to help companies, though their effectiveness will not be known for some time. If conditions improve late this year, it is possible that the BBB problem could still be contained to manageable levels but will still very likely be in the $200-$300bn range taking 2020/21 together. Current pricing in markets suggests this anyhow. Much depends on how quickly economies recover. More downgrades especially a pick-up in fallen angels, given their negative impact on credit returns, are a key risk for investment grade markets as we look ahead.

BBB bonds trading like fallen angels (BBB bonds less AA (US investment grade, bp)



Source: BAML Indices, ICE

Finally, liquidity matters, or rather the lack of it in corporate bonds. The backdrop to the liquidity difficulties in markets has been discussed in a recent note[2]. It is in sell-offs that the structural illiquidity of corporate bonds becomes apparent. This stems from the massive growth in amounts outstanding over the past decade, and such holdings vastly outstripping low broker-dealer inventories and limited market making capacity in credit markets. We see it now again. Using Barclays' data on liquidity cost scores (LCS), the approximate average round trip cost of a US investment grade corporate bond transaction, went up from under 0.5% in February to about 2% by end March. A similar rise, though less extreme, was seen in both Euro and Sterling

[1] There will be question over whether a downgraded bond that is moving towards or in danger of moving towards high yield status has a place in this kind of portfolio. Most investors, particularly insurers, place limits on the size of non-investment grade holdings permitted.

[2] AA View: *Liquidity Collapse* (April 2020)

investment grade markets[3]. Part of the risk premium assigned to corporate bonds stems from illiquidity or high trading costs in difficult markets. This means that though the bulk of the rise in spreads is explained by fear of downgrades and fallen angel risk, there is also more of an illiquidity price discount now that may explain the sharpness of the sell-off.

The same problem surfaces in the widening of spreads between cash corporate bonds and CDS (see p.1) which is really a liquidity discount on cash bonds[4]. Much the same goes for the large size of ETF discounts to Net Asset Value (NAV) in many bond funds in the past month, widely commented on, a reflection of the growing liquidity mismatch between the large increase in ETF popularity and trading amidst a much more limited increase in trading volumes and liquidity in underlying fund constituents. As we look ahead, the extremes of the liquidity squeeze in credit markets will ease, but it may be difficult to put the clock entirely back on the liquidity issue. It seems possible that an effect of the poor liquidity in this sell-off could be to bring this in as a larger element of the credit spread, even after conditions improve. This would keep the risk premium (over and above the normal expected default and downgrade allowances) somewhat higher than would be the case otherwise. We cannot observe this directly, of course, but it is none the less real for that.

The credit outlook: 3 key drivers

We see the outlook for spreads as being driven by three drivers:

How quickly will economic conditions and corporate profits normalise?

This is the all-important question that is central to the fate of all risky assets as we look ahead. In the past two weeks, markets have responded to an improved tone of news on the virus progression and stronger monetary and fiscal responses. Credit markets have also responded positively, though it is less marked than in equities, arguably because the (ill)liquidity unwind needs to be seen first before more normal business resumes.

We agree that the policy response from fiscal and monetary stimulus is impressive. This is why we changed our views to become less negative in late March[5]. Equally, economic recoveries will take longer to come through than currently being assumed in the markets. Because of the deep loss of employment, output and capacity in most sectors, even after viral lockdowns ease (and they may not ease completely anyhow), recoveries will be slow and gradual. Consequently, corporate cash flow impact may also be slower to recover assumed. There should still be improvement on a 12-month basis, but it will not take us to the starting point before the viral lockdowns started to come in. The upshot of that is that credit impairment will be slow to fully ease, given the tendency of credit impacts to come through well after economic conditions have passed their toughest point. *The bottom line is that the economic drivers for credit markets should improve gradually, but with the damage over the first half of 2020 not easily or fully unwound.*

Have valuations adequately allowed for credit impairment?

The key question here is whether credit spreads have adequately discounted likely damage to corporate cash flows and profits. Has the market's implied view of default and downgrade probability (along with some illiquidity discounting) allowed enough of a valuation cushion to base a recovery?

Our long-term fair value for investment grade corporate bond spreads is between a range of 1.2% and 1.8% depending on market attributes such as duration or credit quality. Spreads are obviously some way above these levels at present – about 60bps above for Sterling corporate bonds, but much more for the US – a rather larger 110 bp for US long credit for example. The excess over fair values simply reflects the credit risk premium at work, now much higher owing to the fear of credit impairment and the growth in illiquidity. The relative attributes of the Sterling and US credit markets makes the US looks better value today.

Fair values do not mean that much in stressed times, however. This is for two reasons. First, credit losses will be higher over the next year or two than normal (we are working on estimates that are 30-50% higher over the next two years, largely from higher downgrade losses). Second, and far more important, high uncertainty keeps risk premiums high too. Though this implied risk premium in spreads now is higher than what we normally assume, it can stay high or go higher. The call on credit risk premiums is what really drives the cycle in spreads. Typically, it has been an overshoot in risk premiums that has created the strongest buying opportunity in credit.

In that context where are we today? It is certainly true that current spreads, especially in the US, have allowed for considerable credit impairment, but on the basis that the news-flow on economic and corporate pain will worsen for quite some time and then not improve in a straight line as we look ahead, it is easy to see spreads pushing up again, to, or even beyond, levels seen before central bank buying helped sentiment about two weeks ago. We are working on the view that the valuation adjustment through higher risk premiums may not yet be complete. In other words, risk premiums and spreads do not suggest a big overshoot yet, though they did arguably get to those levels before the Federal Reserve's rescue program began. At the very least, we think it likely that bouts of high spread volatility are likely to keep returning. If we are wrong, and credit staged a V shaped recovery soon, it would be the shortest ever market cycle. This is possible, but not very probable.

How strong will the search for yield be after this setback?

Strong, is the obvious answer, and credit is clearly an obvious beneficiary of the hunt for yield as a lower risk option for some

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3 Sterling IG round-trip costs are typically much higher than in US or Europe using LCS data.

4 CDS and cash bonds spreads are not directly comparable because of index differences – a so called 'basis' difference, but a widening gap over a short period is still indicative of illiquidity, in the way seen in past crises.

5 AA View*: An update on our views,* March 31, 2020

yield pick-up compared with equities. While the current search for safety increases the popularity of cash and even low yielding government bonds, every type of investor will be aware that these are now largely return free assets: even long duration US treasury bond yields are not much above a 1% yield. Just as lower rates have supported all asset markets since the end of the financial crisis, the recent further lowering of interest rates globally helps and there is a low likelihood that they will be put up in the next few years – public finances will not withstand it[6].

The search for 'income' in many countries given their ageing demographic profile is already strong, and we suspect this will also keep demand high for corporate bonds from just about everyone. Central bank demand is already a help, here and now. So if there was one factor that supports credit markets and provides some upper limit to spreads through higher risk premiums, this is probably it. It is also another reason why we have taken a less negative stance on credit once central bank intentions became clear in late March. Once the viral scare subsides and there is less economic uncertainty, demand is the best ongoing source of support for credit markets there is.

Views and Actions

Pulling all this together, here is where we stand on the outlook:

- The economic drivers of credit markets are still mixed at best. Putting back the economic clock to the pre-virus scare period will be elusive.
- Valuations have adjusted, more so in the US than elsewhere, but the degree of credit impairment to come is largely unknown and a prolonged period taken to bring more normal economic conditions back into play means that credit news-flow could remain difficult. The risk premiums embedded in credit spreads could therefore stay high, or even more higher.
- Looking further out, the search for yield is likely to remain intense, keeping demand strong for corporate bonds. This provides a cushion to the upside on risk premiums and spreads. Direct central bank buying is important in helping avert large blowouts in credit, as their buying could be stepped up in that event.

How then should portfolios be reacting?

- **We see current credit market conditions as an 'accumulation' opportunity.** From the viewpoint of buy and hold investors or those looking for strategic entry points in credit-related opportunities, spreads offer better value than they have done for some years, as risk premiums are high enough from the longer-term or strategic viewpoint of those investors. If historical patterns are a reasonable guide, these are better entry levels on the view that spreads will move much lower in time.
- Since further periods of high volatility and credit market weakness arguably still lie ahead, it may be better to see this as a series of entry points for investors looking to enter or top up their allocations. **A 'tranched' or 'averaging in' policy remains the better course.** This also fits better with the likely lingering liquidity issues in credit markets.
- Given uncertainties are so large, and the rise in dispersion within credit markets, it probably goes without saying that **an active credit management approach is particularly important now**, relying on strong credit underwriting skills and experience in navigating difficult market conditions.
- For those who are looking for an outright buying opportunity to move into credit assets as an area that will deliver substantially above normal returns, we think that the opportunity set is improving, and better ones are likely to be on their way given the very choppy markets we expect as we look ahead. For the here and now, some selective securitised credit opportunities that have fared poorly in the sell-off already offer strong return potential now, and our manager research colleagues have some ideas on access for these. There will also be some sub-investment grade opportunities which would also become an important part of this opportunity set and we will follow up with views on those.

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[6] AA View: *Pandemic policy response – Fiscal is Monetary today* (March 2020)

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We believe that the medium term (1–3 years) has been under-exploited as a source of investment performance. Maintaining medium term views that complement our expectations for the long term, we help our clients to determine when to make changes to their investment strategy.

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