Institutional Focus

RPIA
Global Fixed Income Experts

An Opportunity in Credit

The first quarter of 2020 brought the most violent and high velocity repricing in credit markets that we have ever seen. In this piece, we discuss:

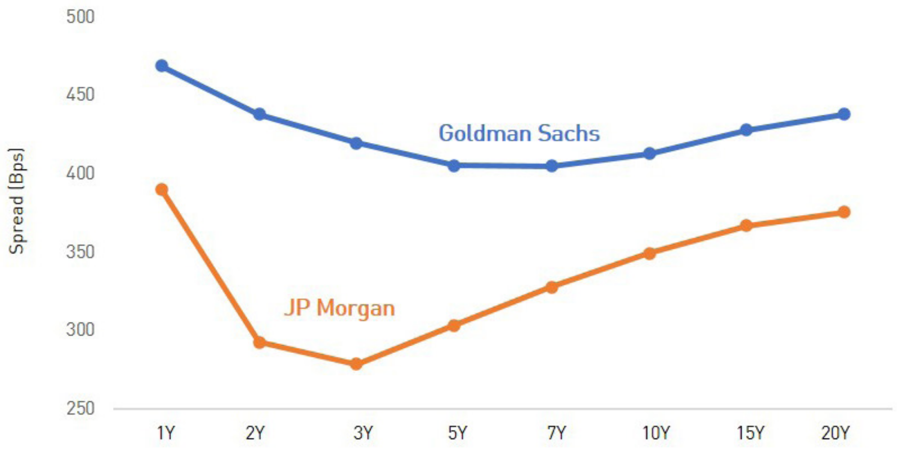
- the factors which drove the size and speed of the spread widening we witnessed in Q1,
- how these factors pushed investment grade valuations to levels which should attract rebalancing from institutional investors,
- and why persistent fundamental risks require a different implementation of this rebalancing towards credit.

What Drove Investment Grade Spreads in Q1 of 2020?

The repricing of credit risk in Q1 of 2020 may come to be known as the "fastest crisis in history." Two key dynamics played into the Q1 sell-off. The first was a repricing of fundamental risks within corporate bonds. Sudden supply and demand shocks caused by global shutdowns required an immediate repricing of the underlying default risk of all issuers. This element of repricing occurred much faster than in previous crises as markets faced sudden exogenous shocks. Consider that global investment grade spreads took only 33 days to widen by 335% (covering the trough-to-peak move in credit spreads) between February and March of this year. That same degree of spread widening took over nine months during the Financial crisis.

While fundamental risks were repriced, the speed with which this occurred led to a second dynamic which exacerbated the sell-off in credit – a lack of liquidity. The velocity with which markets had to reprice risk led to a liquidity squeeze, which made price discovery impossible. As we have experienced in past crises, when liquidity leaves the system, pricing mechanisms break down and credit suffers regardless of fundamentals. This occurred again in our current crisis where we saw many issuers' credit curves invert - a curve shape that was highly distorted by front-end selling as participants sold any bonds which offered liquidity. Inverted curves appeared across all industries, ratings, and issuers. For example, the curves of Goldman Sachs and JPMorgan Chase pictured below. Both issuers held A ratings and were well capitalized thanks to post-financial crisis regulatory requirements. However, unlike the last crisis, the short-term bonds of these issuers were the easiest to sell, causing extreme curve distortion.

Credit Curves in Many High-Quality Issuers Inverted on Illiquidity



As of March 23rd, 2020
Source: Bloomberg

Disentangling the impact of fundamental and liquidity dynamics is a difficult exercise. However, it is useful to understand how much of Q1's spread widening can be attributed to each. To isolate liquidity's impact on spread markets we can look at some measures which point to how much of Q1's spread widening and total return was driven by a lack of liquidity. Below, we analyze a sample of some variables which give us an idea of the impact of liquidity on market movements over fundamentals:

SIGNPOST	RATIONALE
Investment Grade Basis	"Basis" refers to the differential between credit default swap levels and the underlying cash-bond market. This differential can be partially explained by liquidity where CDS contracts trade more readily than the underlying bonds they represent. Assuming like-credit risk, the "basis" is a signpost for liquidity premiums as well.
Bond ETF Discounts	Bond ETF prices reflect real-time transactable levels whereas ETF NAVs are indicative and do not represent actual transactions in underlying bonds. The former includes the cost of sourcing liquidity whereas the latter does not.
Liquidity Weighted Portfolios	Comparing the spread movements between market weighted indices versus those weighted by liquidity metrics also provides perspective into the differential between risk premiums driving markets.

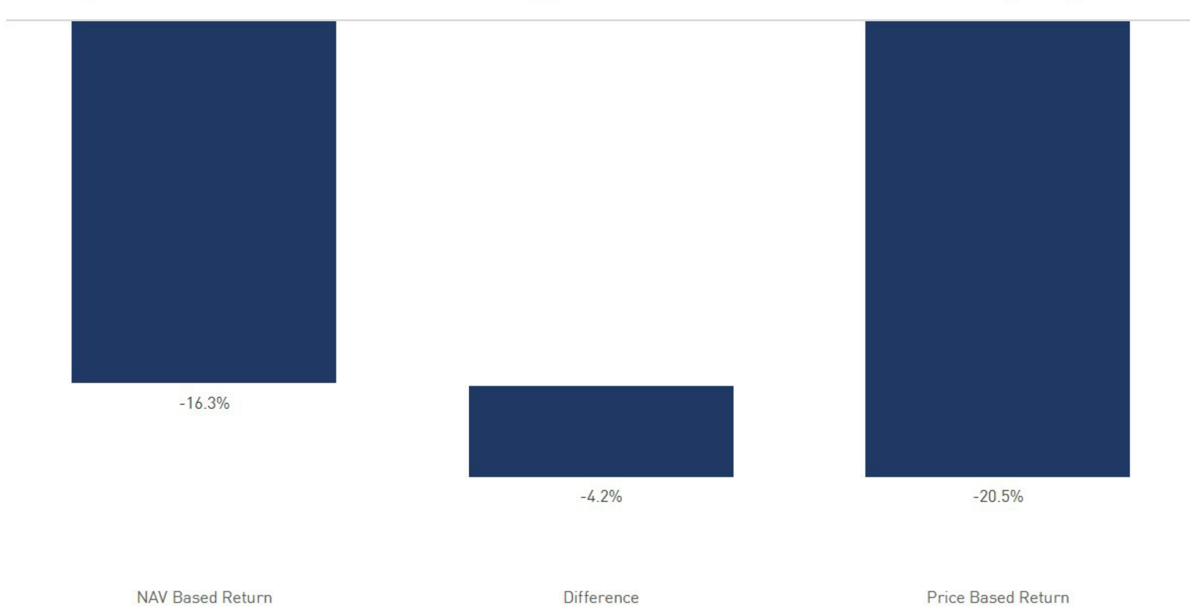
Using these different elements as signposts for liquidity risk, we can see that while markets aggressively repriced fundamental risk, liquidity was also a large driver of the sell-off in credit spreads. Our first factor, Investment Grade Basis, shows that the basis between issuer matched CDS contracts moved to nearly 218 bps, about 70% of the peak levels we hit during the Financial Crisis. In March, this translated to 36% less spread premium found in liquid CDS contracts versus their cash-bond equivalents. This suggests a large percentage of March's sell of was liquidity driven.

Investment Grade Basis Moved to Levels Not Seen Since 2008 on Liquidity Crunch

Source: Barclays

Like CDS, corporate bond ETFs provide insight into how markets were pricing liquidity in real-time, although with a total return view. For this analysis, we use the iShares iBoxx $ Investment Grade Corporate Bond ETF as a proxy for investment grade credit. From the beginning of March to the peak NAV discount, market participants were willing to "pay-away" almost 420 bps in total return to access immediate liquidity (an additional 26% discount from the NAV based return).

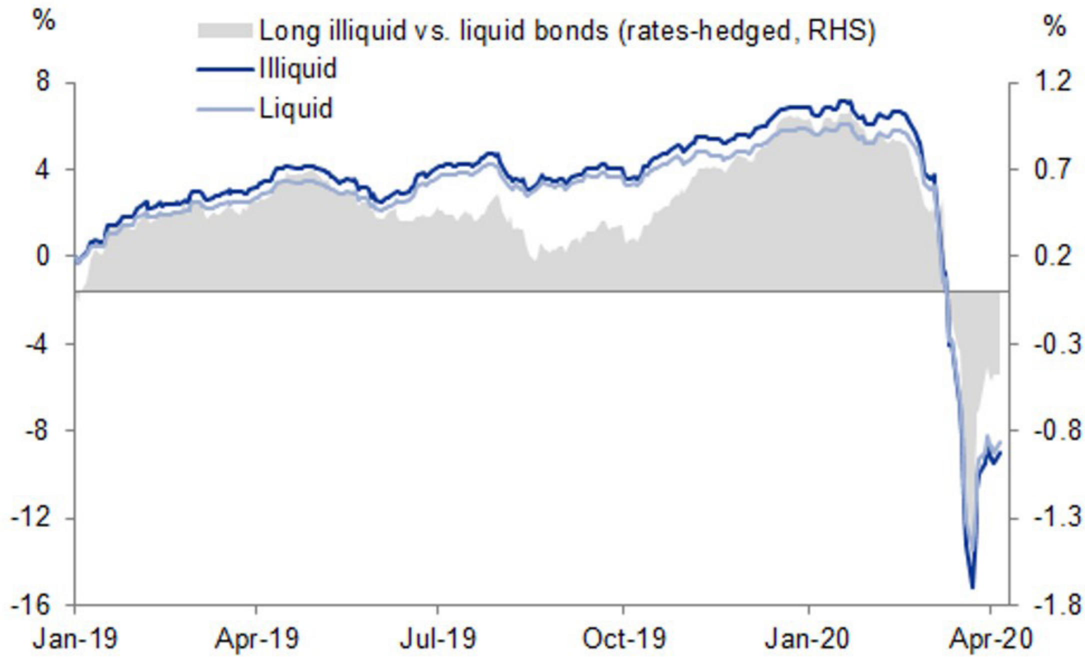
Corporate Bond ETFs Provide Insight Into Real-Time Pricing of Liquidity Risk



Based on NAV & Price returns of iShares iBoxx $ Investment Grade Corporate Bond ETF (LQD) from March 1 through March 19
Source: iShares

Finally, building portfolios based on liquidity scores can also help isolate the impact of fundamental risk versus market liquidity. This analysis shows that an illiquid portfolio underperformed the liquid portfolio by roughly 1.5% up until the March 23rd peak in credit spreads.

Relative Performance Between Liquid and Illiquid Bonds Based on Liquidity Scoring



Source: Goldman Sachs

With all three signposts, we find that a considerable proportion of the March corporate sell-off can be attributed to the lack of liquidity that occurred as investors repositioned for a recession and corporate bond desks could not take on principal risk to absorb the selling deluge.

Looking forward, we think investors need to consider the interplay between these two dynamics in weighting their allocation to credit and in how they implement that allocation.

The Case for Increasing Allocations to Credit

As we noted, both fundamental and liquidity factors pushed corporate spreads to levels we have not seen since the Financial Crisis. While fundamental repricing was certainly warranted, liquidity factors helped exaggerate the move in spreads and pushed any-and-all markets to attractive valuations. Having repriced risk premiums substantially, investment grade spreads can now benefit from certain tailwinds despite the economic unknowns that lay ahead.

The quickest factor to renormalize thus far has been liquidity thanks to the unprecedented stimulus announced by the Federal Reserve, Bank of Canada and European Central Banks. Since their announcements in late March, and without having put an actual dollar of balance sheet to work, their intentions have helped to ease liquidity pressures. The investment grade basis has retraced a portion of its move wider, bond ETFs moved to premiums versus NAV and illiquid bonds deviated less from their liquid counterparts. While this risk premium has retraced substantially since the central bank announcements, we still see attractive embedded upside from a continued renormalization of liquidity as dealing desks return to work in the U.S. and central banks begin to actually add credit risk to their balance sheets via primary and secondary markets as well as ETF buying.

From the perspective of fundamental risk, central banks cannot completely offset all the effects of the pandemic. However, they have now positioned themselves as "lenders of last resort" for investment grade issuers, effectively reducing left-tail risk for markets. Thus, corporate bonds still sit at attractive valuations with further embedded upside as spreads retrace with the added safety net on spreads created by central bank support. This dynamic is unlike those to be found in any other return seeking asset class, including equities. Consider that equities have now retraced 65% of their sell-off from March and are reaching valuation levels that look relatively expensive versus past crises.

Despite April's Rally, Corporate Spreads Still Offer Considerable Value

Based on Bloomberg Barclays Global Agg. Corporate Bond Index
Source: Bloomberg

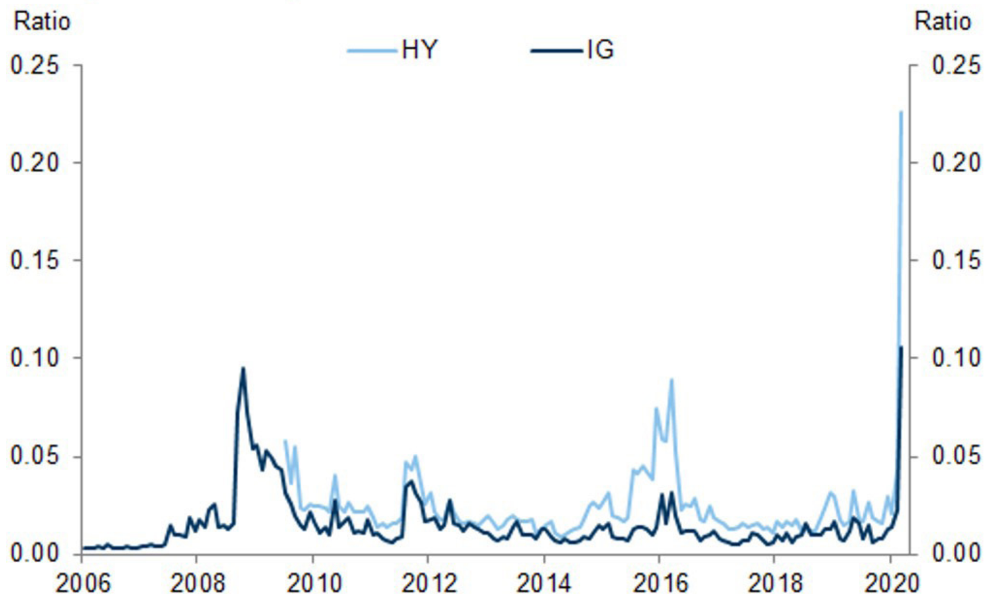
This upside potential can also be accessed within an asset class that still has many liability-hedging characteristics, making it an ideal candidate for increased allocation from liability-aware investors such as pension plans, insurance companies and foundations. Rather then stretch for return by re-allocating to risk assets such as equities, which could only increase funded status volatility, we believe credit offers similar upside without deviating significantly from liability-hedging properties.

The Case for A Dynamic Approach

Having highlighted the excess premiums available to investors in corporate bond markets, we now discuss the optimal way through which an asset owner should implement this exposure. While normalization in liquidity could be the "tide that lifts all boats", fundamental risks will remain highly idiosyncratic, demanding a higher degree of active management by portfolio managers.

While March saw credit spreads across all markets gap wider and April brought a similar, indiscriminate retracement, it is worthwhile to note that underneath index averages credit markets are facing unprecedented levels of dispersion across all dimensions - geographies, ratings, industries and issuers. The below chart shows that dispersion in investment grade credit hit all-time highs, even surpassing the levels reached in 2008. While in normal times investment grade markets are highly homogenous, we do not believe this will be the case going forward.

Dispersion Amongst Investment Grade Credit Remains Elevated

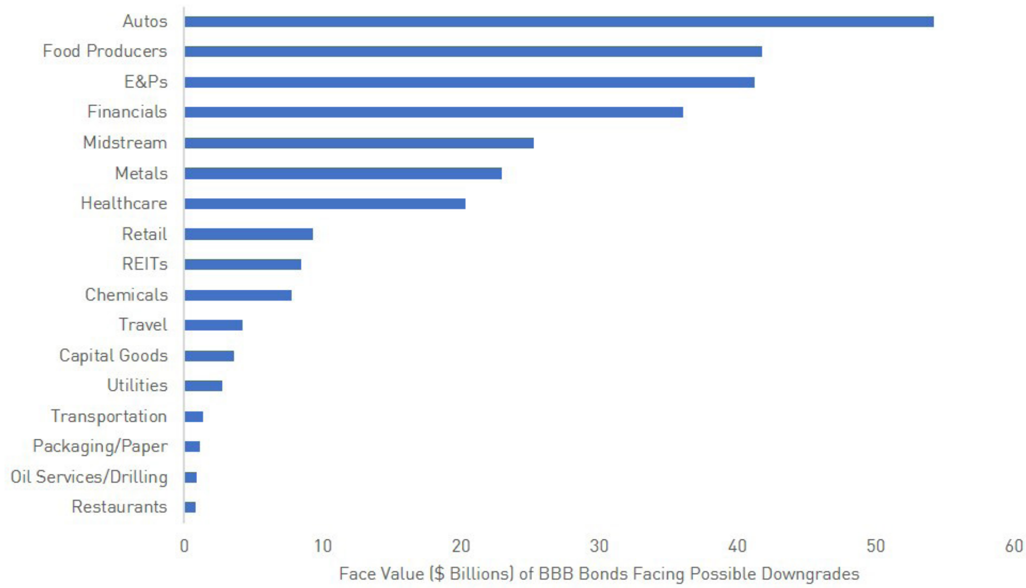


Source: Goldman Sachs
Based on US markets

So, while we recommend an increased allocation to high grade credit, the level of dispersion across markets makes a passive/beta implementation sub-optimal from both a risk and reward perspective.

Consider the volume of credit rating migration that will make both passive and benchmark-constrained managers forced sellers of credit risk. Fallen angel volumes (amount of BBB rated bonds downgraded to BB) reached almost $90B and $12B in March and April, respectively. In addition, many BBB bonds still sit on negative watch with further downgrades all but certain. Analysis by Bank of America suggests that $280B of BBB's face possible downgrades to high yield, representing 8.3% of the BBB market and spread across multiple industries. The size of downgrade risk highlights the dispersion in fundamentals that will persist for some time, making passive and constrained managers forced sellers.

Investment Grade Markets are Less Homogenous With Downgrade Risk Varying Across Industries

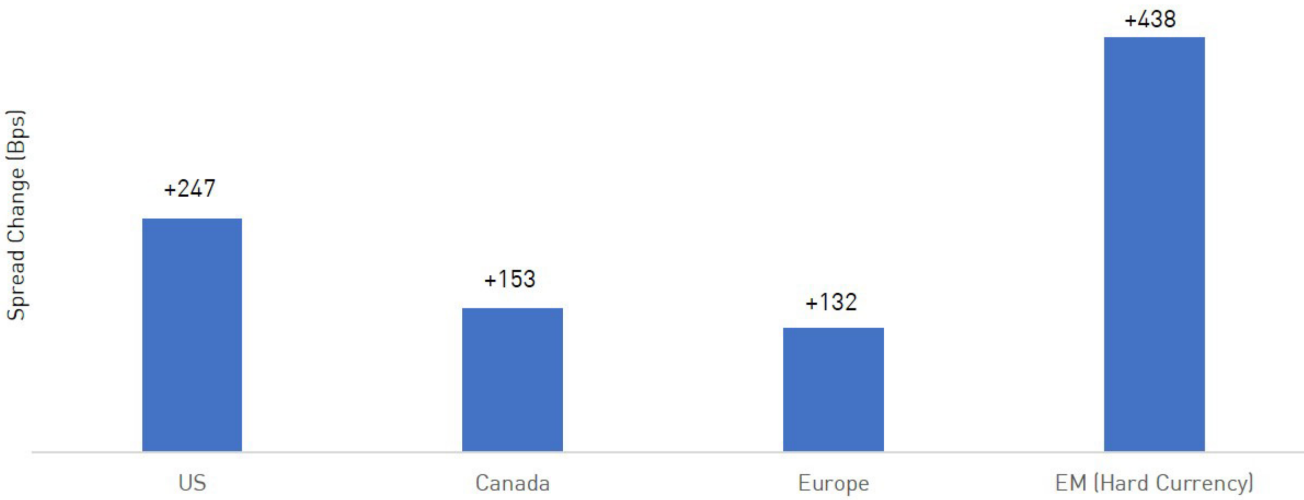


Source: BofA Merrill Lynch

Ratings migration and even defaults will continue to reshape the investment grade landscape much more than past periods. Thus, a beta-exposure today may look very different in a short amount of time. A truly active and flexible strategy can avoid these unintended risks and will not become forced sellers at extreme levels of mispricing as we just experienced in March.

This high level of dispersion and change will also translate into more opportunities to capture relative value. The ability to explore relative value across all available industries and geographies within the investment grade universe should help managers to dynamically allocate to areas where recovery may be faster than others. They will also be able to source diversification from the greatest breadth possible.
On the other hand, passive vehicles and benchmark constrained managers will be, by definition, highly leveraged to the general beta of their respective markets. If, as we believe, recoveries will play out quite differently across countries and sectors, these constraints will hinder performance and risk management rather than assist. Take, for example, the relative value seen across geographies after the spread widening experienced in March. While one would expect emerging market credit to be hardest hit during a risk-off environment, U.S. credit spreads saw considerable weakness relative to Canadian and European credit. This is despite Canada's high concentration in energy and financial sectors and Europe's lackluster economy which faced structural headwinds even before the pandemic.

Relative Widening in Credit Spreads Was Not Equal Across Geographies

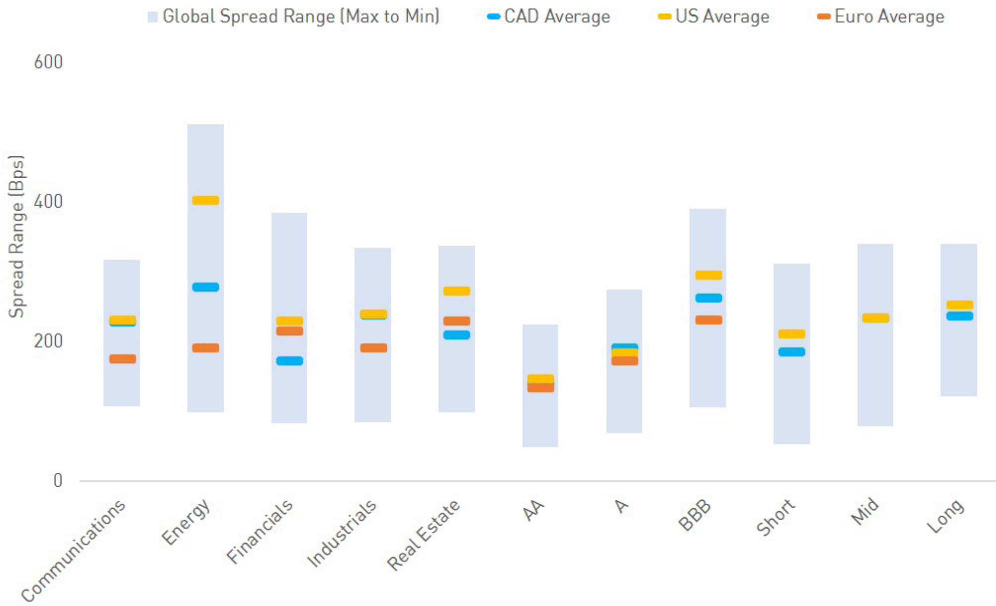


Based on spread change from March 1, 2020 to March 23, 2020
US = Bloomberg Barclays US Corporate Bond Index / Canada = Bloomberg Barclays Canada Corporate Bond Index / Europe = Bloomberg Barclays Europe Corporate Bond Index / EM (Hard Currency) = Bloomberg Barclays USD Emerging Market Corporate Bond Index
Source: Bloomberg

The recovery from these levels will also be highly dependent on the idiosyncratic risks of each geography, placing a premium on a manager's ability to capture relative value between these markets. For example, while emerging market corporate bonds may look relatively "cheap" in valuation, we believe they will face serious headwinds as they look to refinance dollar-denominated bonds against U.S. dollar strength (emerging market non-financial corporates issued $66.4B in hard currency debt in the first two months of 2020) . Similarly, Canada and Europe, which saw less spread widening relative to the U.S. and emerging markets may face considerable macro-driven risks going forward thanks to an over-indebted consumer and energy concentration (Canada) or a central bank with less monetary policy tools available to fight the current crisis (Europe). Conversely, the U.S. market saw substantial spread widening during March but has specific tailwinds that could see spreads compress significantly (for example, a Federal reserve back-stop, a de-levered consumer and access to issuers that occupy industries best suited to perform in the current COVID-19 world of work-from-home and social distancing).

As illustrated below, current spread levels are elevated but sit at different valuation levels based on geography, industry, rating, and term relative to the range of spread levels experienced across the global investment grade universe. As this dispersion persists, the breadth afforded credit managers will be key to both finding sections of the market that can perform over the medium-to-long-term while avoiding the inherent concentrations and mis-allocation of capital that come with passive and highly constrained mandates.

Spreads Show Value Versus Longer-Term Averages But are Highly Dispersed



Global Spread Range based on Bloomberg Barclays Global Agg. Corporate Bond Index from Jan. 2020 through April 2020
CAD, US and Euro Averages based on average spread levels of March and April 2020
US = Bloomberg Barclays US Corporate Bond Index / Canada = Bloomberg Barclays Canada Corporate Bond Index / Europe = Bloomberg Barclays Europe Corporate Bond Index
Source: Bloomberg

Note on Interest Rate & Duration Exposures

While we believe that dynamic credit strategies are best positioned to provide risk-adjusted returns going forward, we do not hold the same view for rates markets. Central banks have set their effective rates to the lower-bound, pushing yields down across the curve. There is also discussion around yield curve control measures which may cap curve steepening levels despite record setting budget deficits in the near-term and possible inflation in the medium-to-long-term.

We continue to view active duration trading as an uncompensated activity and think liability sensitive investors such as pension plans and insurance-related companies are best served by maintaining a duration profile that is based in their home market and targeted to the overall level of duration that best matches liabilities (for example a duration profile that matches the FTSE Canada Universe or Long Corporate Bond indices).

There is no doubt that the first quarter market dynamics have shone a bright light into the benefits and pitfalls of investors asset allocations across return-seeking and liability-hedging assets. With seismic shifts in macro-economic outlooks, company fundamentals and future return potential, institutional investors will be well served to revisit their current exposures considering new cross-asset valuations. We believe that investors will be rewarded by revisiting their weighting to corporate bonds which, for the first time in over a decade, now offers attractive upside potential over the long-term while maintaining liability-hedging characteristics. However, the success of such a shift may be highly reliant on the mode through which asset owners implement this change and we continue to emphasize flexibility to hedge against the many unknowns that still exist.

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