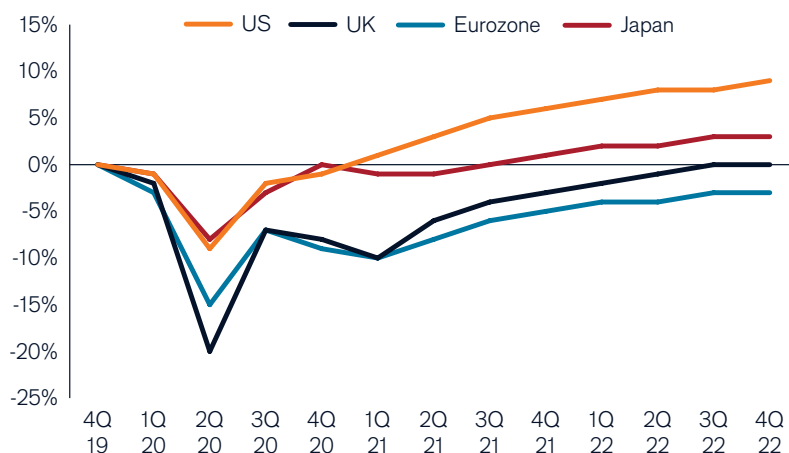


THRIVING IN THE BOND MARKET

In recent months, macro and micro fundamentals have broadly improved as the market anticipated, while longer-maturity US Treasury bond yields have fallen and credit markets have generally rallied. Economic growth, globally, is accelerating and corporate bond markets are largely priced for it to continue. This begs the question: what could go wrong and how might fixed income markets respond?

The US is leading the global economic recovery but is also spurring fears of rising inflation. Recent inflation data has been concerning, with the year-on-year US Consumer Price Index (CPI) surging 5.4% - the highest since 2008. But outside of the US, and some of the other dollar bloc economies, there is relatively little need for investors to worry about policy tightening in the next few years. Not only are the recoveries expected to be more tepid outside the US, there are few signs of sustained inflationary pressure in China, Japan and Europe – other economies in various stages of recovery from the COVID-19 recession.

Figure 1: GDP levels relative to the end of 2019



Source: Bloomberg, calculated using consensus GDP data, 2 June 2021. Forecasts are estimates only and are not guaranteed.

In the US, there are reasonable and understandable factors behind the recent surge in inflation. The much-discussed “base effect” is one. Supply bottlenecks creating price pressures is a second. Low inventories combined with a surge in spending from pent-up demand is yet another. But all of these indicators are essentially cyclical. Bottlenecks clear, inventories rebuild, and pent-up demand is relieved.

To have sustained inflation – the kind that should worry the Fed and the markets – there must be a persistent push on costs. In our view, the key variables are wage pressures and private credit creation. Spending on ever higher-priced goods is not sustainable without commensurate wage increases. Both wages and home prices could end up fuelling more sustained inflation, but it is not yet clear. The US still has a large output gap.

KEY TAKEAWAYS

- ▶ Markets can readily digest an orderly policy tightening. The US Federal Reserve (Fed) is determined to cement the recovery and will avoid preemptively raising rates. Tapering of asset purchases will take place first but this will be gradual in the face of uncertainty surrounding the strength of growth in the economy and the success in tackling COVID.
- ▶ Our traffic light credit crisis signal points to low distress in credit markets as companies have access to capital and borrowing costs are low. Valuations are reflective of an environment of excess savings anchoring bond yields at low levels and, in our view, continue to favour high yield bonds.
- ▶ Default cycles are likely to become less pronounced as central bankers, alert to high debt loads, maintain supportive policy accommodation.

There is still spare capacity in the labour market, wages have shown inconclusive evidence of turning to a sustained trend higher, and home prices are heavily influenced by demographic changes post-COVID. While fiscal policy has replaced lost income, it is now fading at the near-perfect time in the second half of the year as the economy returns to “normal”; the positive fiscal thrust is expected to turn negative in future quarters.

The Fed is back in play – should we worry?

In June, the Fed appeared more hawkish in tone, with more FOMC members suggesting rate hikes in 2023. Volatility in equity markets did not spike, and longer-maturity Treasury yields rallied. What the Fed did accomplish was putting something of a lid on the more aggressive “reflation” trades – and made its eventual reduction in quantitative easing (the direct purchase of bonds in the open market) a topic of conversation. The market now believes the Fed will reduce the volume of its bond purchases sometime between the fourth quarter of this year and the first quarter of 2022. Bond market volatility remained contained because the Fed’s evolving stance is both consistent with market data and sends the message that they will be incremental in their actions.

We think the Fed will continue to display patience, will err on the side of stronger economic growth and will not look to “preemptively” raise interest rates. With the Treasury market currently pricing future inflation around 2.3%, it seems the Fed and the bond market are on the same page.

The June Fed meeting has put rate hikes back in play, but most likely not until 2023. While this pricing will affect front end government bond rates, looking at the data, historically, credit market spreads and equities do well in the early phase of a tightening cycle. The damage usually comes because of the eventual (and some would say inevitable) “over-tightening” that comes, by definition, near the end of the cycle. As a result, two potential hikes in 2023 should not be a big worry. Bond investors need to look ahead, but not so far ahead that they miss the opportunity to capitalise on opportunities in the early phase.

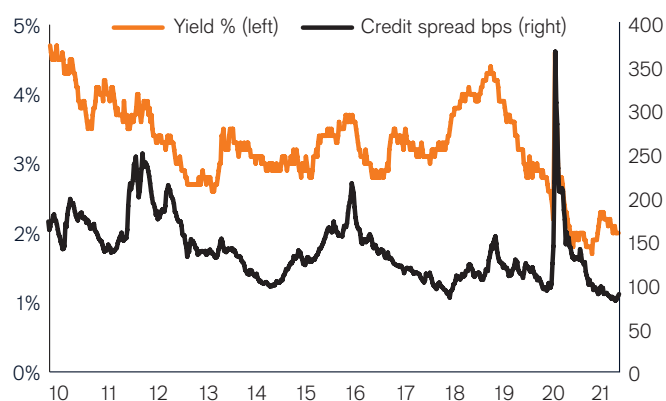
In our view, the biggest risk for bond markets is a policy mistake by central banks. If inflation proves persistent, and central banks are seen to have acted too late, nominal and real rates would likely rise substantially, raising volatility and hurting returns across bond markets. Keeping in mind all of the difficulties of forecasting in this unusual time, the Fed seems to have struck the right balance for now.

Do corporate bond valuations make sense?

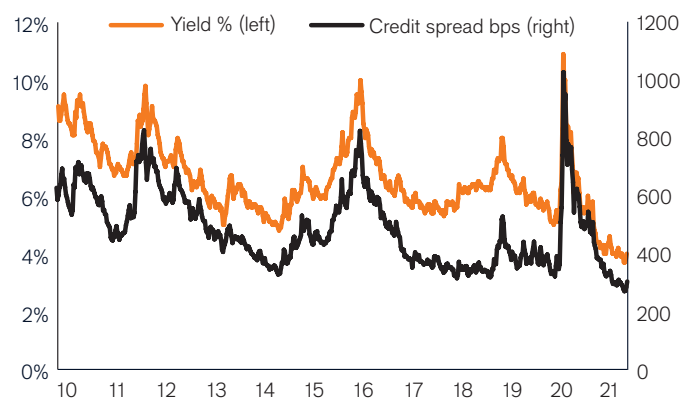
The economic recovery is reflected across markets. Global equities are up strongly, with some markets reaching new highs. Commodities have rebounded strongly from the recession lows. The price of oil is up 65% from a year ago and trading above the level at the start of 2020, while copper prices have climbed 43% in the past year.¹

It is no surprise then that risk assets within fixed income are exhibiting similar strength, with corporate bond spreads at or near all-time lows. Rallies of these magnitude are not uncommon in the early phase of an economic recovery. But where do they go from here? Where are we now in the business cycle? Do these aggressive valuations make sense at this stage?

Figure 2: Credit spreads and yields are historically low
US investment grade



US high yield



Source: Bloomberg, Bloomberg Barclays US Corporate Index (Investment Grade), Bloomberg Barclays US Corporate High Yield Index, option-adjusted spreads (OAS) to Treasury, yield to worst, 1 January 2010 to 20 July 2021. bps = basis points. 1 basis point (bp) equals 1/100th of a percent, 100 bps = 1%.

¹ Source: Refinitiv Datastream, West Texas Intermediate Oil Price, LME Copper Grade A Cash US\$ per metric tonne, figures as at 20 July 2021.

It is unusual for spreads to be near cyclical lows so early in a recovery, and even more unusual to be near historic lows so early in a recovery, but these are unusual times. Even in normal times, using history as a guide to valuation is problematic, but the current cycle is very different to previous ones in several important respects.

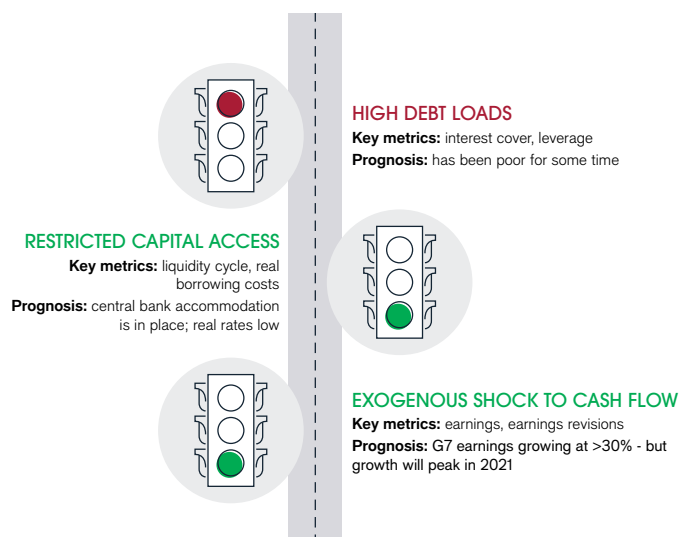
Most recessions see a permanent loss of income and jobs. It usually takes many quarters for these to recover. But in the 2020 recession, the government replaced a great deal of the lost income almost immediately. Economic output ground to a halt, but the consumer's confidence in their future income did not. And there are not just cyclical reasons for relatively tight spreads, but more structural ones as well. Across the globe, excess savings have increased demand for investments, pushing corporate bond spreads lower. Many investors, and institutions bemoan the lack of yield available in bonds. Some (like banks and insurance companies) have capital constraints which give them little choice but to keep buying bonds. Additionally, the Fed's bond purchasing programs have both contributed to demand and provided historic levels of liquidity into the market. Put simply, that money has to go somewhere, and the financial markets are the easiest and quickest way to allocate it.

Valuations may be high, but the risk of a credit crisis is low

A glance at bond prices might suggest that the upside in the current economic cycle is over. But timing the market is notoriously difficult. We think it can be helpful to step back and look at what, albeit historically, creates the conditions for credit markets to widen materially.

In our experience three things are needed to create the potential for a significant, cyclical, correction in the corporate bond markets: high debt loads; restricted access to capital; and an exogenous shock to cash flows. If all three are present, the chance of a crisis is highly likely.

Figure 3: Traffic light credit crisis signal



Today, only debt loads are an issue. The amount of corporate borrowing is high and has risen. But it is important to adjust the volume of debt by its cost. When borrowing costs are low companies should borrow, assuming the cost of the debt is less than their ability to generate the revenue to pay it. Today, we see little to suggest that companies are likely to have a debt problem. Second, access to capital is ample. Between zero interest rates, quantitative easing, record bond issuance and direct fiscal programs to support companies it is hard to detect evidence that companies are struggling to access capital. Finally, there was an exogenous shock (COVID) to cash flows that triggered the correction in 2020 but net earnings are now rising sharply as revenues recover and this is feeding into healthier cash flows.

Of the conditions required for a credit crisis, maybe we currently half meet one of the three. While we can debate the meaning of current valuations, it is very hard to argue that corporate credit could be at a cyclical turning point. So, carry on.

Valuations appear relatively more attractive in high yield

Investment grade corporate bond spreads are near historical lows, raising justifiable questions around valuation. The average credit quality of the investment grade index has deteriorated, raising further concerns. As interest rates have fallen over the last decade, and the cost of borrowing declined with it, companies have grown more comfortable with lower credit ratings. Before the Global Financial Crisis (GFC) in 2008, around one-third of the corporate bond index was rated BBB. Today, it is just above half and we expect it will continue to rise.

The table below shows the steady rise in the percentage of the US investment grade corporate bond market that is now rated BBB, the lowest rating cohort within investment grade. The deterioration in quality is significant. The spread of the overall index today (81 basis points at end June) is about the same (82 basis points) as it was at the low in 2007. But today's investment grade index is lower quality. If we adjust for this, we find that a spread of 81 basis points today is the equivalent of a spread of 133 basis points in 2007. On a credit-quality adjusted basis, corporate credit spreads today are trading well through the 2007 lows.

Figure 4: Accounting for changes in the market, IG valuations are more expensive than high yield

Investment grade	2007	2014	2018	Jan 2020	June 2021
Actual spread (bp) (a)	82	97	85	93	81 (c)
BBB %	35%	43%	48%	50%	52%
Leverage	1.60x	1.91x	2.29x	2.39x	2.25x est
Quality-adjusted spread (bp) (b)	133	130	118	98	81
Difference (b-a)	52	33	34	5	0
Difference versus June 2021 (b-c)	52	49	37	17	0

High yield

Actual spread (bps) (d)	233	323	303	315	311 (f)
Quality-adjusted spread (bp) (e)	214	293	275	293	311
Difference (e-d)	-18	-30	-28	-22	0
Difference versus June 2021 (e-f)	-97	-18	-35	-18	0

Source: Janus Henderson Investors, Morgan Stanley Research, ICE US IG and HY indices, Bloomberg, BBB % as % of total investment grade market, Leverage = median gross leverage (Total debt/earnings before interest, tax, depreciation and amortisation), 29 June 2021. est = estimate and is not guaranteed. 1 basis point (bp) equals 1/100th of a percent, 100 bps = 1%.

However, the opposite is true in the US high yield corporate bond market, where the average credit quality has been stable to improving. Today's spread (311 basis points in June 2021) is 78 basis points wider than the low in 2007. And, on a credit-adjusted basis it is even wider, at 97 basis points.

On a credit-adjusted basis, there is a clear disparity between investment grade and high yield. For investors who agree with us that the credit cycle shows little signs of changing direction, who believe the Fed is likely to remain supportive, and who are eager for yield, the high yield markets of the world may merit a closer look.

Absolute yield levels are low, but so are expected defaults

Default rates on high yield bonds largely follow the credit cycle. But all the unique factors affecting the current cycle are also changing the likelihood of future defaults. The forecast default rate spiked as the COVID-19 crisis unfolded, only to moderate in the latter half of 2020. Today, default rates are predicted to hit new lows. JPMorgan is currently forecasting a default rate of 0.65% for the US high yield market in 2021.² In June 2021, only two companies rated by Moody's, the credit rating agency, defaulted, bringing the global default tally to 28 in the first half of the year, roughly a quarter of the 114 defaults in the same period last year. This also compares favorably with 2019 when Moody's recorded 49 defaults in the first half of the year and 56 in the second half.³

To get a sense of how historic these forecasts are, the high yield market has a theoretical "frictional default rate" which is the rate that companies are likely to default at regardless of the cycle. In theory, no matter how positive the environment, some percentage of high yield bonds will run into trouble (examples might include outmoded products/services, overburdensome debt, rapid competitor disruption or outright fraud). We would estimate the frictional rate to average between 1-2% per annum over time. More than twice the current forecast default rate. High yield bonds could settle into a period of record-low defaults for the foreseeable future.

Low real rates are helping

The conundrum of how we can have low government bond yields while concurrently being afraid of inflation really reflects the puzzle of how we can have (very) low real yields. There is an old saying that when everybody in the market is talking about something, its risk is already priced in. Sure enough, the breakeven inflation rate currently assumed in 5-year Treasury inflation-protected securities (TIPS) has hovered between 2.3% and 2.5% through June and July 2021. That is, the market is already expecting inflation over the next five years to be >2%, which is in excess of the Fed target, even accounting for the difference between CPI and core PCE measures.⁴ So the bond markets have already priced in some inflation premium.

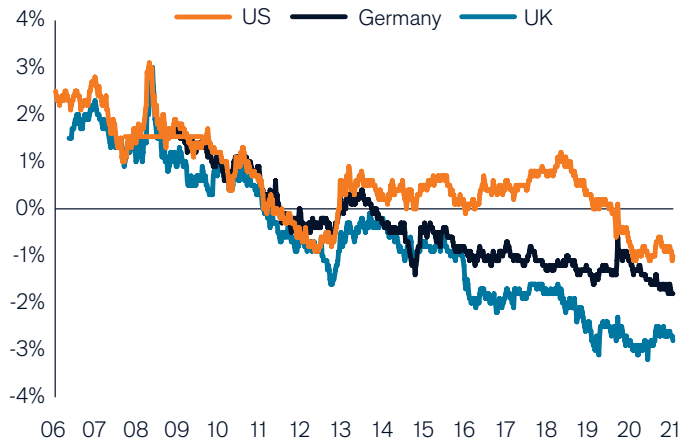
² Source: JPMorgan, 2021 Mid-year High yield Bond and Leveraged Loan Outlook, 28 June 2021.

³ Source: Moody's, defaulted corporate issuer count, July 2021.

⁴ Note there is normally a small "wedge" between the consumer price index (CPI) used in TIPS calculations, and core personal consumption expenditures (PCE), which is the Fed's target.

With inflation expectations already elevated and the nominal 10-year government bond yields averaging around 1.4% in the last couple of months, the real (nominal – inflation) yield is around -1.1%. This level of negative real yields is relatively new to US investors but has been around for a decade in Europe.

Figure 5: Real 10-year government bond yields



Source: Bloomberg, generic 10-year real yields, 21 July 2006 to 21 July 2021.

The trend in real yields is important, because they are a medium-term predictor of defaults and credit stress. With real rates negative, many companies can essentially borrow at rates which are below their expected revenue growth. To put it plainly, it would take an unusual number of management mistakes to fail when you have access to capital and can borrow at current rates.

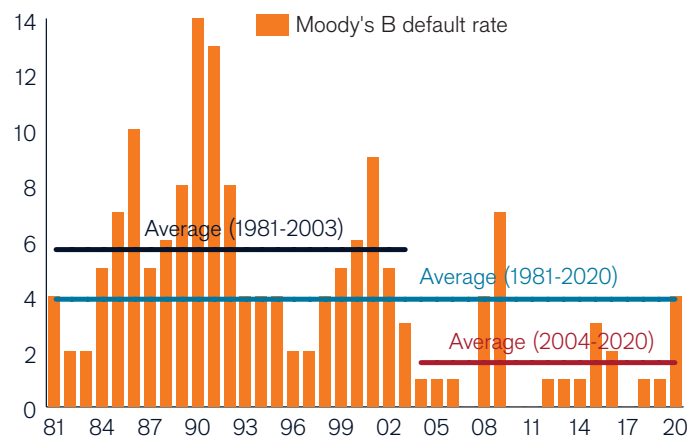
A sustained move higher in real yields would change this, but it would require a reversal in long-term structural factors that have depressed equilibrium rates, such as excess global savings, ageing demographics, and technological productivity. For now, these structural disinflationary trends remain intact.

Is there now a Fed “put” for corporate debt?

Central bank policy evolves over time but the trend has been to provide ever greater support for financial markets. The famous Greenspan “put” gave confidence to equity markets that there was some level of drawdown that the Fed would not tolerate. If things got too bad, Alan Greenspan (Fed Chairman at the time) would bail them out with aggressive monetary easing. Subsequent central bankers during and after the GFC echoed this approach, extending it to the banking system, and “quantitative easing” became acceptable. Central banks around the world engaged in buying corporate bonds in addition to government bonds. With COVID-19 the Fed even began buying high yield bonds, albeit on a small scale. We believe that central bank policy may have crossed a tipping point. Corporations today have so much debt, they are – in aggregate – too big to fail.

Figure 6: Default cycles are less pronounced

Central banks are fearful of high debt loads and their ability to engineer an orderly unwind



Source: Deutsche Bank, Moody's, 1981 to 2020, Deutsche Bank Default Study, 26 April 2021. Default rates per calendar year and average default rates over specified time periods.

Recessions, from a central banker's perspective, are healthy. Companies with poor business models or too much debt are weeded out through “creative destruction”. But the COVID-19 recession introduced Fed-sponsored capital programs to lend to troubled companies. The result was even higher corporate debt levels. Does the Fed provide even more support in the next crisis? Is there a corporate bond put? If so, default rates can and should be permanently lower.

Our conclusions:

- **Orderly tightening can be digested:** The Fed is determined to cement the recovery and will avoid preemptively raising rates. Tapering of asset purchases will be the first course of action but this will be gradual in the face of uncertainty surrounding the strength of growth in the economy and the success in tackling COVID. The biggest risk is that inflation turns out to be persistent and central banks are forced to play catch-up through more aggressive tightening.
- **The low probability of a credit crisis should support valuations:** Our traffic light signal points to low distress in credit markets as companies have access to capital and

borrowing costs are low. Valuations are reflective of an environment of excess savings anchoring bond yields at low levels. This is likely to lead to ongoing demand for high yield bonds as investors seek yield, and chimes with our view that spreads in high yield offer greater attraction than investment grade on a historical credit-quality adjusted basis.

- **Default cycles less pronounced.** Central bankers, alert to high debt loads, are likely to maintain accommodative monetary policy. Low real yields and low default rates may persist for some time. The Fed may have established a corporate bond put option.

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