Global Matters Weekly

06 September 2021

Credit where credit's due

by Richard Stutley, CFA

Bonds remain expensive today, with yields across the ratings spectrum having tracked core rates lower. While core rates have lifted off their lows from last year (US 10 year yields got as low as 0.5% in August 2020[1]), they remain unattractive at current levels. However, there remain areas of relative value within short duration high yield and dollar-denominated emerging market debt, as well as floating rate credit. Elsewhere, while there is limited upside from further spread compression, spreads are not at extremes, and hence there is no clear reason, from either a valuation or a fundamental perspective, why spreads should suddenly blow out. As a result, we retain meaningful allocations to those aforementioned areas of value, as well as some core investment grade credit.

For parts of the credit market (investment grade as well as sub investment grade/ high yield debt) to be cheap, spreads would need to be significantly above historical norms in order to compensate for the risk that underlying interest rates move higher, and that is not what we see today. Dollar emerging market debt looks the best value at a headline level, with spreads at around 350 basis points[2]. They were below 300 for the full period between June 2005 and March 2008, which we think represents a level closer to fair value[3].

Credit fundamentals look reasonable, however. One of the lead portfolio managers at TwentyFour, our specialist credit manager, noted recently that the high ratio of upgrades to downgrades among US high yield issuers, combined with a falling default rate and shrinking volume of distressed debt, all combine to produce a strong fundamental backdrop for the asset class[4].

Corporate leverage is coming down, whilst interest coverage is at manageable levels. The picture has been helped by strong earnings and low funding costs. Arguably, this has made it easier for investors to keep buying the dip, which has supported equities and credit spreads.

With over $300 million of new issuance in the US high yield market this year, twice what we saw at this stage in 2019, and no rise in overall leverage, it is clear that firms are taking advantage of the low rate environment to refinance and reduce their interest bills[5].

We spend most of our time analysing fundamentals like these, as well as valuations, but it is important to also keep an eye on shorter term signals and market dynamics. From a technical perspective, while government bond yields have been less and less appealing in absolute terms, stretched equity valuations have been likewise less attractive, and have resulted in some forced buying of bonds alongside central banks.

Further, the "war chest" of cash in money market funds that was built up early in the pandemic has been barely dipped into, with plenty of cash available to mop up any new net issuance of bonds. High yield markets in both the US and Europe have readily absorbed record supply this year[6], indicating plenty of interest for this debt, and spreads have continued to trade in a narrow range[7] despite the Fed's decision to wind down its Secondary Market Corporate Credit Facility.

We continue to like opportunities in certain parts of the credit market. As a term product (compared to equities, which one can hold in perpetuity), timing is more important when it comes to credit selection, and we continue to see reasonable conditions for our holdings today.

1 US Generic Government 10 year yield, Bloomberg Finance L.P.
2 J.P. Morgan EMBI Plus Sovereign Spread, Bloomberg Finance L.P.
3 J.P. Morgan EMBI Plus Sovereign Spread, Bloomberg Finance L.P.
4 Chris Holman, 05/08/2021, "Don't Fight the Fundamentals on US High Yield"
5 Deutsche Bank, Dealogic. 27/08/2021, "Global Leveraged Finance Weekly Wrap"
6 Based on data going back to 2010. Deutsche Bank, Dealogic. 27/08/2021, "Global Leveraged Finance Weekly Wrap"
7 Bloomberg US Corporate Statistics Index, Bloomberg Finance L.P.

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