

HISTORY DOESN'T REPEAT ITSELF, BUT IT OFTEN RHYMES

Now is the time to buy corporate bonds

COVID-19 (formerly known as “the Coronavirus”) has seen an unprecedented response to an unprecedented emergency. This health crisis will touch each and every one of us, and as such, this health crisis has exponentially morphed into an economic one. Globally, governments and central banks have acted to bridge our respective economies to weather this ferocious storm. Historical empirical evidence that is available for analysis is challenging given the magnitude and extent of the pandemic.

We can, however, analyse scenarios. We estimate that as a base case, we shall see a global recession with a ‘U’ shaped recovery from Q3 2020. Against this backdrop we are positive on credit, which means maintaining existing credit exposure. We expect total returns in credit to be significant in the recovery, as has been the case historically following a period of substantial credit spread widening. Current credit spreads more than compensate for historical defaults and recovery levels. Breakeven spreads now offer a much larger buffer to further widening. We are beginning to see some green shoots regarding our positive view, as there may be evidence that the spread of COVID-19 can be slowed and eventually recede (China & South Korea to date). Moreover, there is traction on government and Central Bank Policy actions (Dow Jones up over 11% on 24th March 2020, the largest move since 1933), and that social distancing measures have proven effective to the point that they can, in time, be relaxed.

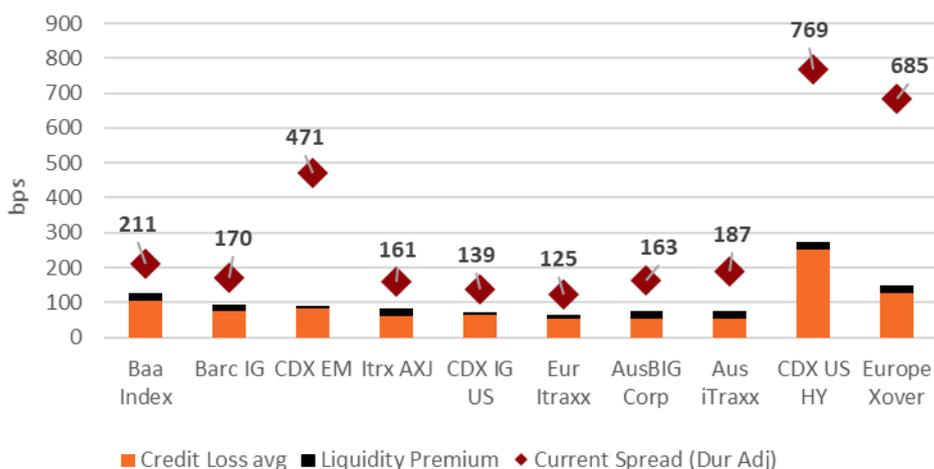
As a caveat to the above, there must always be a worst-case scenario. This would entail COVID-19 not being contained in 2020, leading to a longer and deeper global recession. This in turn will lead to a significant increase in corporate defaults. In this situation we see credit spreads widening to levels that haven’t been seen since the Global Financial Crisis of 2008 and the Great Depression of 1929.

It is with this backdrop, that we recommend overweight credit exposures within fixed income funds.

The default cycle is coming

Our rock bottom spread base case analysis shows that spreads are rewarding comfortably for long term average default, downgrade and liquidity risks. Current high yield spread levels are assuming a significantly higher level of defaults compared to historical averages. The current CDX HY spread (synthetic credit index for US high yield corporate bond spreads) implies a default rate of 41% assuming a 30% recovery rate according to Bloomberg. The current Itraxx Xover spread (synthetic credit index for European high yield corporate bond spreads) implies a default rate of 42% assuming a 40% recovery rate according to Bloomberg.

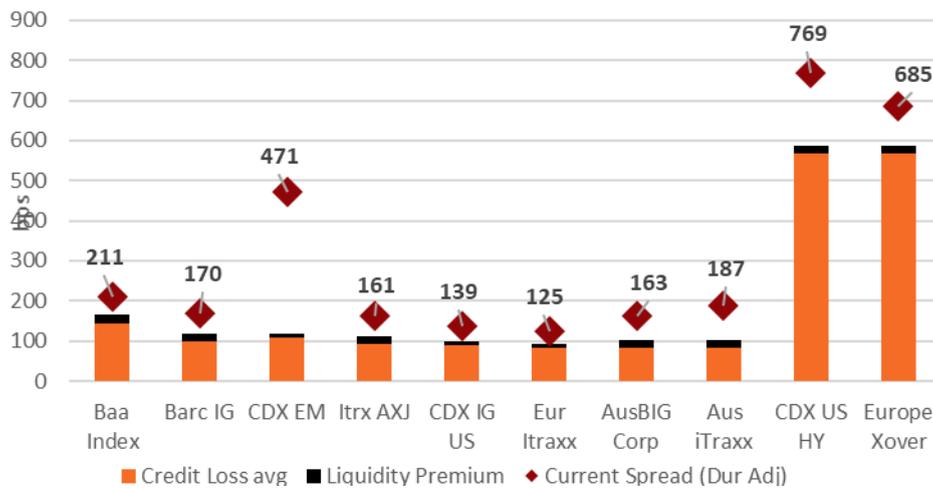
QIC Dur Adjusted Rock Bottom Spread Estimates – Base Case



Source: QIC, Bloomberg, FTSE, S&P, Moody’s Rock bottom spread calculated as the spread required to cover for defaults based on S&P’s historical average cumulative default risk for that rating band, ratings transition rates AND the bid/ask spread estimate on that index. Forecast results are predictions only and may be affected by inaccurate assumptions and/or by known or unknown risks and uncertainties. Forecast results may differ materially from results ultimately achieved.

In our severe case we assume cumulative default rates are at historical maximum levels with recovery rates reduced to 20%. According to S&P data, the maximum historical 5-year global corporate default rate among all speculative-grade ratings from 1981 to 2018 was ~30% in 1999. S&P’s maximum historical 5-year cumulative default rate for all investment grade ratings over the same period was 2.4% in 1998. Even under this severe scenario, current spreads are still compensating for the increased loss given default and downgrade risk.

QIC Dur Adjusted Rock Bottom Spread Estimates – Severe Case



Source: QIC, Bloomberg, FTSE, S&P, Moody's Rock bottom spread calculated as the spread required to cover for defaults based on S&P's historical average cumulative default risk for that rating band, ratings transition rates AND the bid/ask spread estimate on that index. Forecast results are predictions only and may be affected by inaccurate assumptions and/or by known or unknown risks and uncertainties. Forecast results may differ materially from results ultimately achieved.

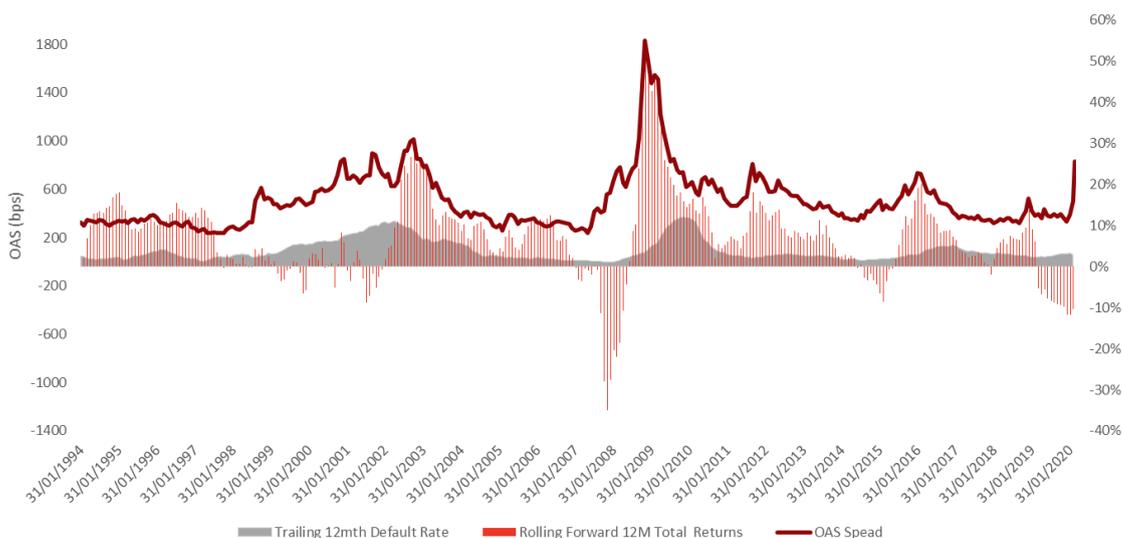
Is this the right time?

History illustrates that once corporate bonds yield over 800 basis points (bps) above government bonds or more, the 12-month forward total returns are increasingly attractive. Over a 12-month period, when corporate bonds yield over 800bps, investors can assume positive returns over the next year. This measure also held throughout the Global Financial Crisis of 2008.

The chart below illustrates that high yield corporate bonds in the USA are above 800bps. This has caused significant negative returns for the high yield index over the last 12 months. We can also expect to see the annual corporate bond default rate to rise above historical levels to those not seen since 2008/2009, of over 10%.

We are now at levels at which corporate bonds offer yields that compensate investors sufficiently for the risk they are assuming. The 12-month forward returns are set to become positive. In a period of significant widening, the following period of excess yield generation substantially outweighs the negative contribution from further spread widening.

US HY Spreads vs. 12m Rolling Forward Total Returns vs Trailing 12m Default Rates



Source: QIC, Bloomberg. As at 24 March 2020

This holds true to varying degrees across investor risk appetites. Below we show 12-month forward return for US Investment Grade (IG) corporate bonds. Although we may not be at the cheap levels seen in 2008, given the momentous fiscal and monetary reaction functions, we expect 12-month returns to become attractively positive.

Bloomberg Barclays US AGG Corp OAS Spreads vs Rolling 12mth Forward Total Returns



Bloomberg Barclays US AGG Corp OAS Spreads vs Rolling 12mth Forward Excess Returns



Source: QIC, Bloomberg. As at 24 March 2020.

What does this mean for Australian corporate bonds?

Our base case for Australian corporate bond spreads is based on the 2012 widening due to the mining industry-related downturn. US corporate bonds are based on the worst levels in 2008, prior to the Lehman default. Here we again assume virus containment around the end of Q3. There will also be a global recession at least until the end of 1H2020. At the current corporate bond spread of 373bps, US IG spreads now stand at their 97% percentile rank when compared to the last two decades. Australian spreads at 153bps are at their 63% percentile when compared to the last 16 years.

US and Australian Credit Spread Review and Outlook – Base Case (70%)



Source: QIC, Bloomberg. Forecast results are predictions only and may be affected by inaccurate assumptions and/or by known or unknown risks and uncertainties. Forecast results may differ materially from results ultimately achieved.

As shown above, our base case 12-month forward returns have become increasingly attractive. Investing overweight in corporate bonds versus government bonds are now adequately compensated.

Given the strong capitalisation of the Australian major banks, robust government backing, and the prominent role they will play in the fiscal and monetary deployment packages, we favour major banks versus other corporate bonds.

Conclusions

Proprietary fundamental credit research remains as imperative as it always has been. One must focus on generating yield, allocating between fixed income asset classes and extracting value from selective bottom-up credit selection. Prior to this crisis, we had been increasing portfolio resilience by letting maturity profiles run down and preferring defensive industries over cyclical industries.

At the beginning of 2020, we asked where the surprise & volatility would come from? Volatility across all asset classes had become suppressed, the financial markets had become complacent. There are always a plethora of risks facing investors as we head into the unknown future, but this is a reality that must be navigated. Therefore, we maintain that investors should take a nimble approach in the current market environment. Investors who concentrate on a liquid and flexible approach, will have the ammunition to take advantage of dislocations and opportunities that arise in the coming months ahead.

We will look to concentrate on corporate bonds offering high quality interest income opportunities, choosing issuers that have a clear ability to effectively manage refinancing risk during this crisis, have access to more-than-ample liquidity sources, and flexibility over costs and capital expenditure. This will allow issuers we select to weather through the COVID-19 crisis and will prove to be good value credit opportunities for the medium term. With the attractive returns and break-evens offered by corporate bonds, now is the time to start selectively adding to positions.

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