What now for sterling corporate bonds?

12 October 2018

Summary

- Even after their mini sell-off this year, sterling high grade corporate bonds are difficult to like.
- Structural drags come from the market's weak trading depth, keeping transactions costs higher than other comparable markets.
- It is possible but rather unlikely that sterling corporate bonds will deliver excess returns over their current yields in the next two years.
- Spread valuations are so-so versus our long-term fair values but unattractive on our medium-term credit views. This leaves us indifferent versus gilts for now, though our next move will probably be to prefer gilts.
- Part of the problem here is that global credit quality has worsened significantly in general.
- We look at Credit Default Swaps (CDS) as an alternative to cash corporate bonds for those with execution capacity here. There is no strong valuation case for this now, but in a credit downturn, CDS will perform better.
- Reallocating sterling credit to global exposure is also worth considering. The global bond return case is not compelling near-term but looks the better option for the longer-term.

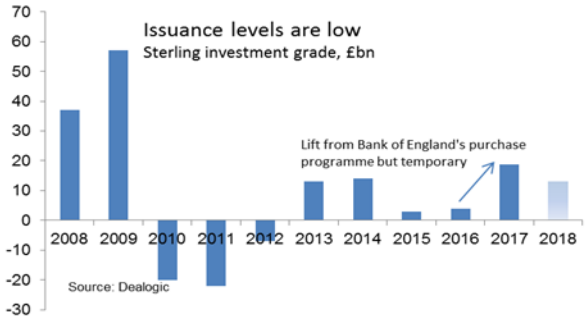
Why is it so difficult to like sterling corporate bonds?

When we refer to 'sterling corporate bonds', using the common short-hand expression, we are of course referring to sterling investment or high grade corporate bonds.

It is difficult to like sterling corporate bonds as an investment at this time. These are the key considerations below:

1. Structural factors are negative

Structurally, the sterling corporate bond market seems challenged by its weakening depth – seen in relatively weak issuance trends and strained liquidity over the past decade or so. Issuance was particularly weak in the 2010-2016 period, the market barely maintaining its nominal value. Over 1998-2008, the market's face value approximately quintupled. Over 2009-16, it only grew 7%. The Bank of England's £10 billion corporate bond purchases, and arguably, weaker sterling (boosting foreign demand) thereafter spurred a better trend. 2018 looks to have been a good issuance year (see chart below and 2018 estimate).



It looks likely, however, that the longer-term pattern of limited growth in this market is likely to re-assert itself. Limited new issue activity implies liquidity challenges and potential concentration in sectors and even single names. Just for comparison, net annual issuance in the euro high grade market averages 400bn euros.

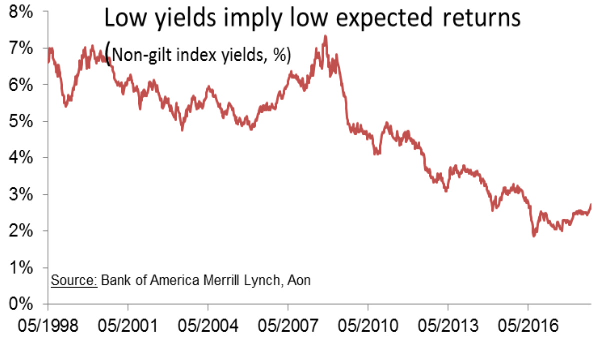
This is why liquidity and trading cost aspects are a disadvantage. Barclays recently estimated that the 'round trip' trade costs in sterling investment grade bonds averages 75bps, smaller issues costing in excess of 1%. By comparison, US dollar investment grade round trip costs are just above 50bps typically and Euro denominated corporate bonds traded in France, Germany, Italy Spain or the Netherlands cost in the range of 35 to 50bps. Sterling corporate bond trading costs have been on a gentle rising trend unlike other high grade markets as documented by an FCA paper from 2017[1]. Brexit is unlikely to provide much help to these structural trends.

2. Total return prospects are challenged

The more immediate reason for not liking sterling credit is that return prospects remain low at best. Our views have not changed on this. Year to date, returns have been negative, reflecting some rise in intermediate duration gilt yields and a small upward creep in credit spreads too. The current index yield to maturity, 2.7% and 3.2%, on the Bank of America Merrill Lynch Sterling Investment Grade index (BAML) and the equivalent Iboxx index, respectively, tell us quite a lot about

[1] *New evidence on liquidity in the UK corporate bond market*, FCA, February 2017

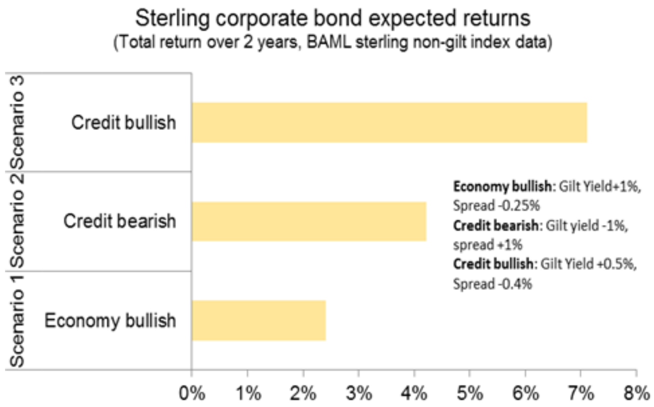
potential returns (see chart). They do not allow for the losses from defaults or losses from downgrades as bonds migrate down to lower ratings over time creating price drops. Together, these account for at least an expected 50bps in annualised losses, on average over time, which would need deducting. Our ten year capital market assumptions for sterling corporate bond returns are in the vicinity of 2% p.a.



Of course, much depends on whether underlying gilt yields move in line with what is priced into the current yield curve and whether current credit spreads over gilts stay as they are. If they do not, returns will diverge from current yields. As we have seen this year, yields can rise faster than market expectations pushing returns down and spreads can widen too.

Over the long-term the expectation is that corporate bond spreads decline when gilt yields are rising (improving economic conditions) and vice versa (working conditions). However, this relationship does not always hold. There are prolonged periods when they may head in the same direction, as they have to some extent this year. If they do, then returns drop as gilt yields and corporate bond spreads rise together.

All this makes it now quite hard to draw a picture of corporate bonds returning much uplift over cash over the medium-term (here taken as the next two years). To take a range of 'good' and 'bad' in corporate bonds, we show three scenarios for returns in the chart below using the BAML non-gilt index (see chart). The specifics of each scenario are unimportant. What matters is that in the conditions we find ourselves today, corporate bonds are unlikely to be outperforming cash by much. Yes, the 'credit bullish' scenario shown does deliver reasonable returns, but this is looking to be the least likely among the three paths shown. Otherwise, it is returns of the 1-2% annualised that appear to be in store. Negative returns, as in the year to date, continue to be very possible.



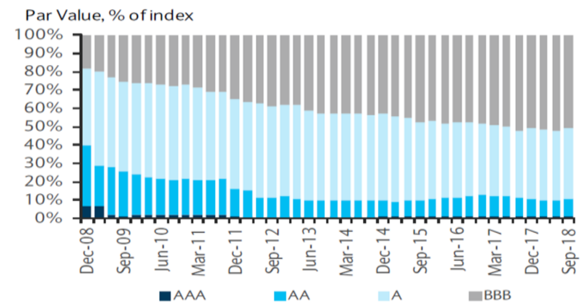
One of the problems for investors in corporate bonds is that return sensitivity to interest rates has risen with the decline in yields. The index duration is currently at about 8 years compared with 6 years a decade ago.

Spread valuations versus gilts are mediocre at best

On a simple historical look-back basis, current credit spreads for sterling corporate bonds (120 basis points or thereabouts on a typical OAS or option adjusted basis[2]) do not look too bad. On a 20 year look-back, this spread is, in fact, only a few basis points above the median credit spread. So what is there to dislike?

The first reason is that it is not a like-for-like comparison, since credit quality has deteriorated within the sterling corporate bond indices over this time. This chart showing a grade composition of the Barclays sterling corporate bond index shows this clearly (using S&P ratings). As we note later, this is a global not just a sterling market trend.

Weaker credit grade mix (Barclays sterling high grade index)



Source: Barclays Research

Using the BAML sterling non-gilt index, the average Moody's rating has slipped from AA2 to A2, a drop of three notches. It is therefore

[2] OAS spreads allow for the value of embedded (put or call) options on corporate bonds and so can be different to the yield pick-up versus equivalent duration gilts.

misleading to compare current spreads with past history without making allowance for this. We do this with our spread fair value methodology discussed in the box below, explaining why our fair value credit spread is 130bps.

Our approach to long-term fair value (LTFV) takes account of the changing grade mix, and brings in a few other necessary elements.

LTFV credit spread = Expected Default Loss + Expected Downgrade (Credit Migration) loss + Credit Risk Premium + Liquidity Risk Premium

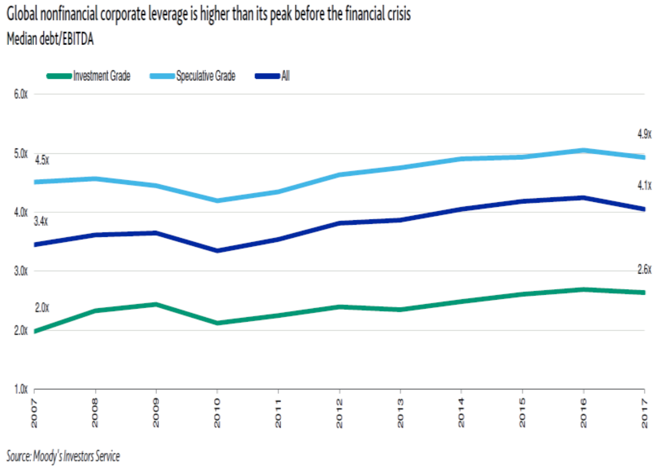
Our 130 bps long-term fair value sterling corporate bond spread allows for some 50bps of default and downgrade losses, as observed over a long history (Moody's data). We then add on a risk premium of 0.8% which aggregates both credit risk and liquidity risk. This is to allow for the difference between spreads and expected credit losses. This is a little above what has been historically observed. Why are we doing this? It is of course true that disentangling the credit risk premium from liquidity is virtually impossible since they are not separately observable. It is likely, however, given CDS (credit default swap) pricing versus cash bonds (see page 4) that more than half of the observed historical risk premiums are about liquidity than credit risk – the risk that it is not possible or very expensive to sell in particular market conditions. Given higher liquidity risk with corporate bonds globally coming from reduced market making in recent years and the specific challenges in the sterling market, a small mark-up in the risk premium over history is reasonable.

Let us bring all this together. Against our long-term fair value, current spreads of approximately 120 bps are a little short of our long-term fair value, but cannot be argued to be 'expensive'. But this is not all. Given that we are in the latter stages of the economic and credit cycle it is logical to expect significant credit deterioration over a finite time period such as the next three years. If this is the case and credit downgrade losses increase (amidst a few defaults too), spreads would have to rise from current levels. This makes current spreads unattractive for buying credit taking a medium, as opposed to a long-term view.

The bottom line is this. Our medium-term view remains indifferent between sterling corporate bonds and gilts now (a weak 'hold'). However, the next move, as credit conditions likely worsen, will be to prefer gilts over corporate bonds.

3. Global credit quality is worse

The global behaviour of credit spreads is well known. Directionally, the outlook for spreads in the sterling market depends far more on credit fundamentals at large of companies globally, rather than just those that have issued in the sterling market (even though they may perform better or worse than the global average). Credit quality has deteriorated globally as shown by the changing grade mix of indices and as also shown below by leverage ratios that are higher than pre-crisis levels (see chart below).



The outlook for spreads into more difficult economic conditions – rising interest rates, weaker economic growth, and especially if both come together, make the broader credit outlook and current spreads look a bit vulnerable.

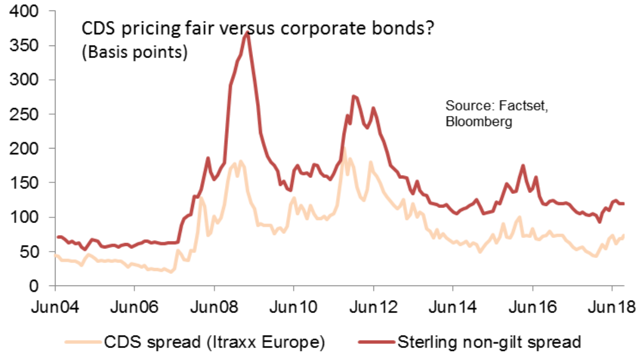
The view shapes this way. Spreads are mediocre for the long-term investor, but for those thinking about the outlook over the next year or two, there is a clear risk of a back-up. We do not expect to see the 400bps plus in sterling credit spreads seen in the financial crisis, but it would not surprise at all to see spreads cross 200bp. We had approached these levels as recently as early 2016 triggered by the problems posed by a sharp fall in the oil price. In turn, this explains the relatively low probability of our 'credit bullish' scenario above, the only combination of factors delivering still quite reasonable looking returns for corporate bonds.

Given this general dislike for sterling corporate bonds, two potential actions could be considered.

Corporate bonds to CDS?

This addresses liquidity considerations with sterling credit (or indeed with corporate bonds at large). One alternative is to gain credit exposure using wholly liquid and low cost Credit Default Swaps (CDS) instead or in part replacement. Implementation using these swaps will not be possible for everyone, but it is worth considering if possible. The widely traded European Itraxx credit default swap market is the obvious choice, though not 'like-for-like' exposure with sterling corporate bond indices given its pan European coverage and the equal weighting structure of the index.

While hardly precise, the changes in relative pricing between the CDS and the cash bond index give an indication of the way the market is trying to price the liquidity premium. As is readily apparent, this fluctuates, with periods of stress in credit markets widening the implied liquidity premium significantly (see chart).



Current pricing is not signalling any overly favourable valuation advantage for moving to CDS in terms of spread differentials. To the extent that cash corporate bonds may move into a much less attractive environment, however, those who are apprehensive over liquidity risk (the ability to sell when a need to sell arises) could still look at the CDS option. It will, very likely, be less volatile and potentially outperform through any large down markets in credit. As expected, cash bonds will struggle through weak liquidity periods which go with down markets.

Moving sterling credit to global?

Given the weak attractions of sterling credit, another possibility is to look to switch to, or increase exposures in global credit as an alternative. This could be done in a variety of ways – to invest in globally unconstrained return-seeking bond approaches such as a multi-asset credit or absolute return looking for active managers to add value, particularly through the coming more challenging credit market environment. Alternatively, if passively held, some or all of direct exposures to sterling credit could be switched into direct global credit.

There are catches here. The yield advantage is significant for the US against sterling, but much less so elsewhere. Additionally, there are of course currency considerations. Currency hedging of US dollar exposure is currently fairly expensive and fully offset the additional returns earned in US credit markets. Finally, the cautious credit view applies everywhere not just to the sterling market.

Even so, the longer-term arguments for moving to a global approach, given the limitations of the sterling market, continue to apply. This argument is stronger for medium to large-sized current direct holdings in sterling corporate bonds.

Contact Information

Global Asset Allocation
+44 (0)20 7086 9076
tapan.datta@aon.com

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

Aon Hewitt Limited
Registered in England & Wales No. 4396810
Registered office: The Aon Centre | The Leadenhall Building | 122 Leadenhall Street | London | EC3V 4AN

Disclaimer

This document and any enclosures or attachments are prepared on the understanding that it is solely for the benefit of the addressee(s). Unless we provide express prior written consent, no part of this document should be reproduced, distributed or communicated to anyone else and, in providing this document, we do not accept or assume any responsibility for any other purpose or to anyone other than the addressee(s) of this document.

Notwithstanding the level of skill and care used in conducting due diligence into any organisation that is the subject of a rating in this document, it is not always possible to detect the negligence, fraud, or other misconduct of the organisation being assessed or any weaknesses in that organisation's systems and controls or operations.

This document and any due diligence conducted is based upon information available to us at the date of this document and takes no account of subsequent developments. In preparing this document we may have relied upon data supplied to us by third parties (including those that are the subject of due diligence) and therefore no warranty or guarantee of accuracy or completeness is provided. We cannot be held accountable for any error, omission or misrepresentation of any data provided to us by third parties (including those that are the subject of due diligence). This document is not intended by us to form a basis of any decision by any third party to do or omit to do anything.

Any opinions or assumptions in this document have been derived by us through a blend of economic theory, historical analysis and/or other sources. Any opinion or assumption may contain elements of subjective judgement and are not intended to imply, nor should be interpreted as conveying, any form of guarantee or assurance by us of any future performance. Views are derived from our research process and it should be noted in particular that we can not research legal, regulatory, administrative or accounting procedures and accordingly make no warranty and accept no responsibility for consequences arising from relying on this document in this regard.

Calculations may be derived from our proprietary models in use at that time. Models may be based on historical analysis of data and other methodologies and we may have incorporated their subjective judgement to complement such data as is available. It should be noted that models may change over time and they should not be relied upon to capture future uncertainty or events.