THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

31 October 2019

The continued case for credit

Valuations for high quality credit may seem slightly stretched in the context of outperformance so far this year, but with various catalysts ahead, we believe the asset class will remain in favour.

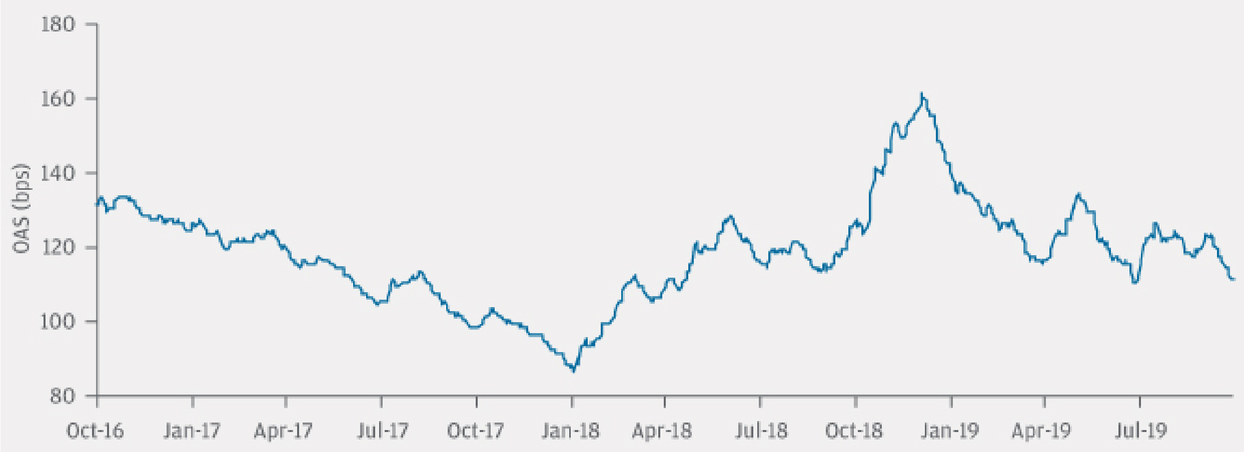
Fundamentals:

The third-quarter reporting period is well underway, with more than half of listed companies now having reported earnings. Results so far have positively surprised – albeit versus low expectations. Results from US banks, which tend to report first and set the tone for the earnings season, were favourable for credit investors and generally ahead of expectations, driven by better-than-expected revenues and credit costs, and continued expense discipline. On the other hand, construction machinery company Caterpillar, which is often used as a bellwether for the health of the US economy, reported earnings that fell short of expectations and cut its guidance for 2019. This is no surprise, though, given the recent weakness in manufacturing purchasing managers' indices. On the whole, weaker results have come from energy and materials-related industries or from companies that are more export-driven and are suffering from the slowdown in growth in China, as is the case with Caterpillar. As well as corporate results, credit has benefited from receding fear of a no-deal Brexit and from anticipation of the start of the European Central Bank's (ECB's) second corporate sector purchase programme (CSPP 2.0).

Quantitative valuations:

US investment grade has been the best-performing credit asset class so far this year, returning 12.73% and seeing its yield fall from 4.25% to 2.98%. In an environment in which rates have been edging lower globally, investors have increasingly been attracted to asset classes that offer a significant amount of duration (almost 7.5 years for US investment grade) as well as sufficient carry. In Europe, the prospect of CSPP 2.0 has led CSPP-eligible bonds (non-bank bonds with at least one BBB rating) to outperform certain parts of the high yield market. For example, looking at single-B spreads versus BBBs, the preference for higher quality credit is clear: the ratio, which started the year at 3.68x, has increased to 4.41x. As the cycle extends and investors maintain a preference for high quality credit and duration, we believe that this theme can continue. (All data as of 29 October 2019).

Investment grade credit spreads continue to rally



Source: ICE BofA Merrill Lynch Global Corporate Index (GOBC); data as of 29 October 2019. OAS = option-adjusted spread; bps = basis points.

Technicals:

Technical conditions remain supportive for investment grade. Fund flows continue to be strong according to EPFR, with October's weekly average flow into US high grade, at over USD 3.5 billion, far exceeding the three-year seasonal average for the month of around USD 2 billion. Following a short lull, foreign demand for the asset class seems to have picked up again, particularly from Taiwanese investors. On the supply side, gross issuance in the US is running 4% below last year's levels, and net supply even lower. Supply levels in Europe have been higher than average, but we expect this to continue to be well digested as the ECB commences CSPP 2.0. (All data as of 25 October 2019).

What does this mean for fixed income investors?

The macroeconomic backdrop is yet to show signs of improvement, and valuations in credit markets have become tighter. However, we believe there are arguments for staying invested in high quality credit. Corporate fundamentals remain manageable, with the latest earnings better than expected, and Brexit uncertainties have eased for now. Given the strong technical backdrop as CSPP 2.0 begins, we see a strong case for high quality credit to outperform the broader credit market.

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