Investment Grade Credit Low Risk but Not Risk Free

VIEWPOINT

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Declining credit quality in the investment grade corporate universe means the need for bottom-up credit research is now more important than ever

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Nearly a decade has elapsed since the financial crisis and the ripple effect continues to be felt across credit markets.

Extraordinary monetary stimulus and accommodative central bank policy have combined with an increasingly strict regulatory regime to alter the investment landscape. These trends have filtered through into the corporate credit market, driving down yields and distorting valuations.

Developed market investment grade corporate credit has not been immune to these changes. Credit quality is declining and leverage increasing, highlighting growing credit risk in what was previously considered a risk-neutral asset class.

Concurrent with signs of a pick-up in global growth, central banks are becoming more hawkish in their rhetoric, with growing signs that central bank monetary policy is becoming less accommodative on both sides of the Atlantic. As investment grade corporate bonds tend to have longer duration profiles than sub-investment grade, we could be on the cusp of a sea change in the performance of the investment grade corporate bond market.

These twin headwinds of duration and credit risk highlight the need for rigorous credit analysis in the investment grade corporate universe. It is no longer a 'risk-free' haven.

The Devil is in the Detail

The ultimate aim of a credit investor is to ensure the company to which they lend money can effectively service their debt. As we shall explore, the investment grade credit market has become increasingly credit sensitive. This means the need for bottom-up analysis is now more important than ever.

While we believe the investment grade corporate universe offers a multitude of attractive investment opportunities, investors should ensure they have a deep understanding of a company's underlying business model prior to making an investment decision.

Fundamentally-focused credit specialists with dedicated resources are able to carry out thorough, in-depth credit analysis. They can identify companies with solid fundamentals able to withstand exogenous shocks as well as mis-rated bonds which do not reflect the underlying fundamentals of a company.

In addition, investors who already have exposure to the high yield market have an in-depth understanding of certain nuances and the covenants within each debt instrument. In the current environment where valuations within high yield are stretched, we believe it is also beneficial to be able to identify the relative value of investment grade versus high yield.

The fastest-growing segment of the investment grade market is the BBB space. We believe this ratings spectrum can offer the greatest return potential given greater chance for excess spread compression dependant on the economic cycle.

Ratings agencies do play an important role as they define the investible universe. However, investors must keep in mind that markets, which have become very discerning in their ability to assess situations, tend to react to developing credit trends well before rating agencies change their ratings.

We believe isolating the market into investment grade and high yield without factoring both can lead to an incomplete assessment for selecting the best risk-reward. Depending on an investor's mandate, Rising Stars (where a company is transitioning from high yield to investment grade) are an opportunity inaccessible to more 'traditional' investment grade investors; the spread pick-up on these types of credits can be considerable. Solid credit analysis can also help avoid Falling Knives/Fallen Angels (where a company is downgraded following a risk event and subsequent rapid decline in value).

Some corporates may also choose not to be rated due to the associated costs, or be too small for index inclusion, meaning they would fall under the radar of a large investment grade credit investor. Smaller, nimbler credit specialists can have regular, face-to-face meetings with these types of companies and make their own decision on a company's creditworthiness. They can also react more swiftly to changes in the investment environment and identify the underlying impact of exogenous shocks far more quickly (e.g. falling oil/commodity prices).

Credit Risk is Rising

The developed market corporate investment grade universe is vast, with over 7000 issues in the US and over 2500 in Europe.[1] While the universe continues to grow (the US market has doubled over the last 20 years), the underlying credit quality is declining (Figs. 1 & 2).

In the US the number of BBB rated credits now comprise half the total index (up from a third in 1997), AAA rated credits have fallen from 5% to 2% and the number of AA rated companies has virtually halved (from 17% to 10%).

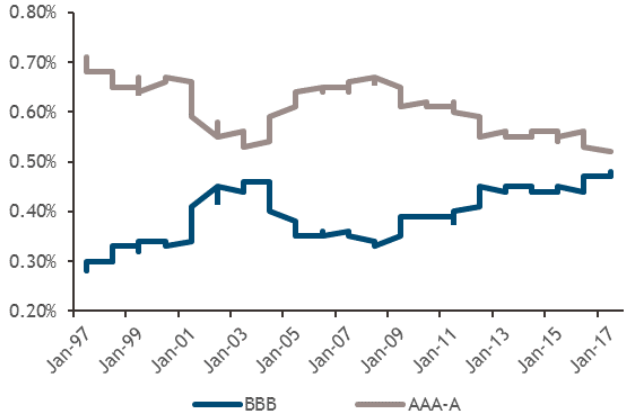
In Europe the change is much more pronounced with the number of BBBs rising from 6% in 1997 to close to 50% in 2017. AAA and AA rated issuers have tended to slip to the "A" level, which now accounts for 40% of the investment grade universe versus 17% twenty years ago.[2]

Leverage is Increasing

With the amount of cheap money available for borrowers, weakening credit metrics are adding to the degradation of credit ratings. In the US, leverage has picked up dramatically (Fig. 3) and balance sheets are becoming increasingly stretched.

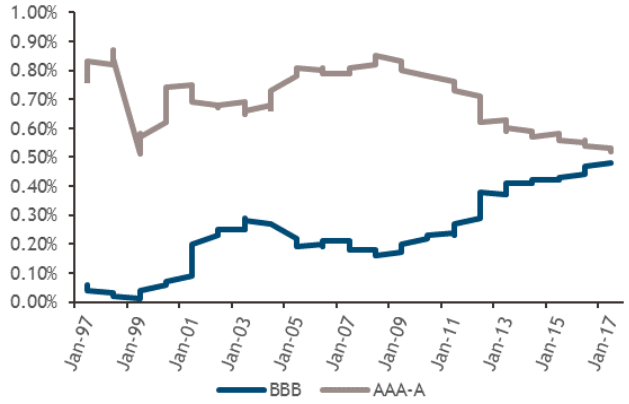
1. BofA Merrill Lynch US Investment Grade Corporate Index, BofA Merrill Lynch European Investment Grade Corporate Index.
2. Ibid. As of June 30th 2017.
Note: Full index breakdowns as follows: European Investment Grade Corporate Index. 1997: BBB – 6%, AAA – 31%, AA – 30%, A - 17%, NR – 14%. 2017: BBB- 48%, AAA – 1%, AA – 11%, A – 40%, NR – 0%.
US Investment Grade Corporate Index. 1997: BBB – 28%, AAA – 5%, AA – 17%, A – 49%. 2017: BBB – 48%, AAA – 2%, AA – 10%, A – 40%.

Fig. 1 – US Corporate Credit Quality



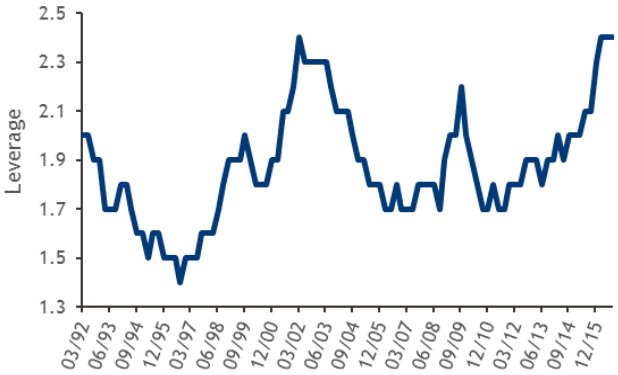
Source: BofA Merrill Lynch US Corporate Index as of June 30th 2017.

Fig. 2 – European Corporate Credit Quality



Source: BofA Merrill Lynch Euro Corporate Index, as of June 30th 2017.

Fig. 3 – US Corporate Leverage is Rising



Source: Morgan Stanley, as of September 30th 2016. Gross leverage ratio for US investment grade companies.

Some of the lower-rated areas of the investment grade market are taking on increasingly large debt burdens. The issuance by AT&T, whose US$22.5bn corporate bond sale was the third-largest on record, was close to three times oversubscribed, highlighting investor appetite.* This was despite the debt's BBB rating and that the company is on watch for a potential downgrade by two ratings agencies due to its increase in leverage to fund acquisitions.

The dynamic is different in Europe where average corporate leverage has declined (Fig. 4), due to positive cash-flow-generation as well as a lower cost of financing/refinancing due to quantitative easing.

Nevertheless, we have also witnessed record-sized new issuance deals in the European market focused on the lower-quality end of the investment grade ratings spectrum; Volkswagen came to market late in the first quarter with an €8bn issuance, its first since the emissions scandal.** This was also heavily over-subscribed, with investors keen to re-engage with the firm, despite its BBB+ rating by S&P and that it is on negative outlook.

This trend can be regarded in different ways. Either corporates are becoming greedy in the amount of debt they are accumulating because it is so cheap to acquire, or they are being prudent in their debt management and wish to take advantage of low rates before they start to rise.

Corporates are Choosing a Lower Rating

However, it can also be argued that the decline in higher-rated credits (particularly in the US) is in part due to corporates choosing to take a lower rating to ensure more balance sheet flexibility. Many companies take the view that the benefits of having a higher rating are de minimus to funding costs.

Meanwhile, although we have seen an increase in leverage, corporate earnings before interest, tax and amortisation (EBITDA) and cash flow generation remain strong within the investment grade space. Many corporates are taking on higher leverage because they are comfortably able to maintain an increased level of debt on their balance sheet, underpinned by their strong cash flow and EBITDA.

If base interest rates turn upwards, we believe many of these levered companies can comfortably work on deleveraging due to a strong ability to pay back down debt. However, this trend does not apply across the board and again highlights the need for careful credit analysis to ensure a company is able to meet its debt obligations in a worst-case scenario.

Financial Crisis Fallout

While the decline in US credit quality can be somewhat attributed to increasing leverage, there are different dynamics at work in Europe where the financial periphery crisis has had an impact on issuer ratings.

Bank disintermediation following the financial crisis has had a marked effect, both in terms of the size of the corporate market and how it is financed.

With banks shoring up balance sheets and tightening capital requirements, their willingness to provide liquidity and financing (specifically in Europe) has significantly declined. At the same time, corporate funding requirements have grown and many corporates have turned to debt capital markets in their quest for financing.

The rise in lower-rated credits in Europe can be partly attributed to the increase in first-time borrowers; first-time issuers tend to be riskier due to lower credit metrics, smaller size and their lack of track record as publicly-listed companies.

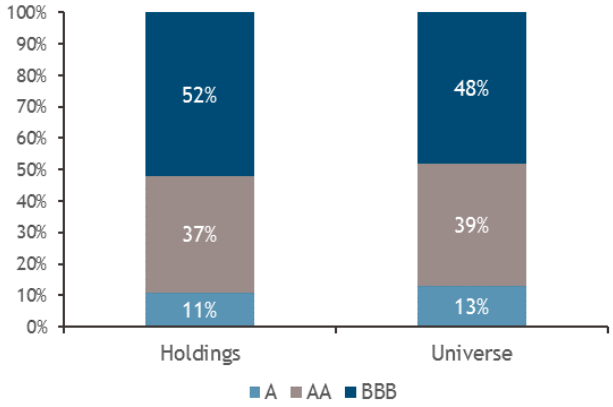
Source: Financial Times. July 27th 2017

** Source: Financials Times. March 23rd 2017

Fig. 4 – European Leverage is Declining

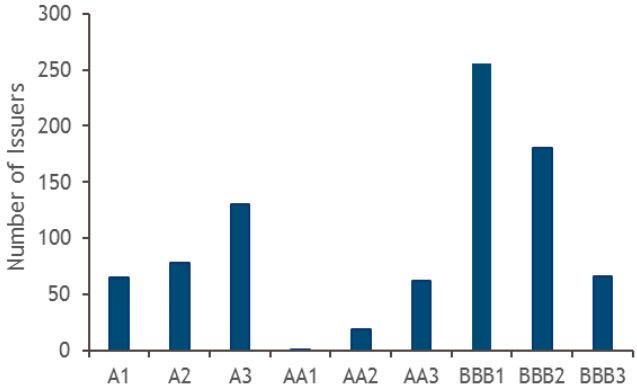
Source: BofA Merrill Lynch, as of February 28th 2017. Median gross leverage ratio for European investment grade companies.

Fig. 5 – ECB's CSPP Holdings by Rating, Versus CSPP-Eligible Universe



Source: BoA Merrill Lynch, ECB Economic Bulletin (Issue 4/2017). Distribution according to nominal values. July 2017.

Fig.6 The ECB is Buying Lower-Quality Credits



Source: ECB, BofA Merrill Lynch, as of August 4th 2017. List of securities held under the ECB CSPP by BofA Merrill Lynch composite rating.

An ongoing period of exceptionally low interest rates has also made financing/refinancing extremely cheap, resulting in higher issuance levels. This dynamic is being enhanced by an increasing number of US corporates issuing in euros, attracted by the cheap levels of debt refinancing.

Meanwhile initiatives such as the European Central Bank's (ECB) Corporate Sector Purchase Programme (CSPP) and Public Sector Purchase Programme have resulted in an increase in opportunistic issuers coming to market, with corporates also targeting and tailoring issuance specifically to be ECB eligible. This has been exacerbated by the ECB's appetite for issuers at the lower-quality end of the IG credit spectrum (Figs. 5 & 6).

The Future Looks Rosy, But…

Over the last 18 months, risk assets have remained resilient in the face of largely unexpected and unpredictable events such as Brexit and the election of President Trump. Investors appear reassured by expectations of a slow and measured path towards higher interest rates by central banks and a gentle unwinding of central bank balance sheets, ongoing indications of economic growth recovery, commodity price stability and better-than-expected data from China. As such, the current investment environment appears rosy for corporate credit investors who expect this benign and positive backdrop to continue.

Nevertheless, we believe investors should retain a certain amount of caution and be cognisant of risks on the horizon. These include the possibility of faster-than-anticipated monetary policy tightening, the impact and speed of tapering and fears for the Chinese economy. Should any of these materialise, we could see an end to the 35-year bull market in fixed income or, at the very least, a period of heightened volatility.

The Case for Credit Analysis

Looking ahead, a key buttress of investment grade credit will soon be removed as central banks unwind their asset purchase programmes. While the effect of this is uncertain, it's likely to lead to temporary volatility in Europe for those bonds on the ECB's balance sheet and thus have a knock-on effect on the wider investor base. We believe this makes a strong case for investors to discount these bonds from their investible universe and that it is important to look beyond this short-term technical.

Investors should also bear in mind that any sharp or unexpected increase in interest rates in the US could hurt some of the more highly-levered US corporates who have weaker business models and are unable to service their debt.

Liquidity, leverage and duration all have their part to play in a bond investor's decision-making process and, for much of the investor base in the investment grade corporate universe, rating is also a major consideration.

Yet investors should not be lured into commoditising investment grade investing. It is not a homogenous asset class and there are differences in ratings quality within the universe. The combined headwinds of duration and credit risk mean all credits warrant the same level of thorough analysis.

Credit analysis should be a central component to the investment process in both investment grade and sub-investment grade debt. We believe investors should look beyond the rating and focus on the fundamentals of each credit story. This will ensure they are comfortable with the quality of the underlying business, its ability to withstand technical shocks and ultimately honour its debt obligations. That, we believe, is the key to the generation of solid returns in investor portfolios over the course of the credit cycle.

About the Authors

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Tatjana manages the Muzinich Enhancedyield Short-duration Fund and the Muzinich Bondyield ESG Fund. Tatjana joined Muzinich in 2007 and has 19 years' corporate credit experience. Tatjana came to Muzinich from Metlife Investments, where she served as an Associate Director of the Higher Return Unit. Prior to that she worked for Fortis Investments and Legal & General Investment Management. She has a Ph.D. from the London School of Economics, a Masters from the Kiel Institute of World Economics in Germany and an M.Sc/B.S. in Economics from the University of Vienna.

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Prior to joining Muzinich, Anthony was an investment grade credit trader at Société Générale for four years focusing on the consumer, retail and industrial sectors. Previously, he spent 11 years in debt capital markets at Barclays Capital and Deutsche Bank where he advised corporations on financing and solution strategies. Anthony earned a B.A. in Economics from Cornell University.

About Muzinich

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