Allianz Global Investors

MAY 2024

US investment grade credit: quality (still) comes with yield

With elevated interest rates widely expected to start coming down in the coming months, healthy yields in high quality markets like US investment grade corporate bonds could represent a timely opportunity to target income.

In the current market environment, we believe US investment grade (IG) corporate bonds are an appealing asset class.

With growing expectations of a soft landing – both in the US and elsewhere – the macro outlook is supportive for these high quality bonds, which thanks to recent interest rate rises are still offering elevated yields. Strong economic data suggest corporate fundamentals will remain solid, and the US Federal Reserve has indicated it will be able to provide a backstop of rate cuts should economic growth slow.

While current spread levels are tight, yields for US IG corporate bonds remain above 5% and are nearly 160bp above their 10-year average. With rate cuts widely expected to begin as early as June, US IG corporate bonds look to offer a compelling opportunity for investors to target long term income and total return potential.

Georgios Georgiou
Global Head Product Specialists, Fixed Income

Hans Sapra
Client Portfolio Manager, Voya Investment Management

KEY TAKEAWAYS

- With today's elevated interest rates and bond yields, high quality fixed income segments such as US IG corporate bonds offer attractive income and total return potential.
- As one of the largest and most liquid asset classes in the world,[1] US IG credit may offer relative value opportunities that can be captured via active portfolio management.
- US IG corporates can be an effective diversification tool, having historically demonstrated low correlation to equities, US Treasuries and riskier fixed income segments.[2]
- The asset class can also help mitigate downside risk, having generally preserved capital better during periods of crisis than other risk assets and even US Treasuries.

1) See Exhibit 2
2) See Exhibit 5
3) See Exhibit 6

Navigating Rates

Why US IG corporate bonds now?

When analysing current yield levels for the US IG corporate bond market, one can see a strong correlation between the starting yield and future returns. Given rates were historically low for a long period of time, it is easy to forget the important role that income plays in long term total returns for bonds. As Exhibit 1 shows, the starting yield for the US IG Index has historically been a good indicator for longer term returns.

Given the solid growth environment and strong expectations of Fed rate cuts for 2024, IG corporate spreads – the extra yield they pay over US Treasuries – are at relatively tight levels, with the option-adjusted spread (OAS) of the index sitting at 96bp at the end of February.[4] However, today's higher yields can help to defend portfolios by acting as an extra cushion if spreads move wider. This cushion also acts to protect investors from further increases in rates – as rates increase to more normalised levels, the negative impact of additional rate moves higher starts to wane.

Exhibit 1: With longer time horizons, starting yield has been a stronger indicator of returns

Over one-year periods, the relationship between starting yield and future IG market returns is weak

Over five years, the relationship between starting yield and returns becomes stronger

Source: Bloomberg. Data as at 31 December 2023, showing rolling periods from 1989 to 2023. Information shown is for the Bloomberg US Corporate Bond Index. Investors cannot invest directly in an index.

In fact, the Bloomberg US Corporate Index could absorb an 85bp increase in its yield and investors would still break even, meaning that the income generated would fully offset the decline in price. Exhibit 2 shows our analysis of different scenarios to illustrate how US IG credit may perform in different spread and rate environments.

- Our base case for 2024 is for spreads to trade in a relatively tight range and for the Fed to likely begin cutting in the second half of the year, which would produce a total return of 7.78% (scenario 1)
- Should spreads tighten further and rates continue to rally, US IG credit would see total returns of over 10% (scenario 2)
- Should economic growth slow further than expected and spreads widen materially, a decline in rates would still outweigh the negative impact of wider spreads and produce total returns of 6.89% (scenario 3)
- And if both rates moved higher and spreads wider, investors would still achieve 1.85% in total return (scenario 4)

4) Bloomberg, AllianzGI, data as at 29 February 2024

Exhibit 2: Our base case scenario shows attractive estimated total return projections for IG bonds

	Scenario 1	**Scenario 2**	**Scenario 3**	**Scenario 4**
	Base case: Neutral spreads, bullish rates	Bullish spreads and rates	Bearish spreads, bullish rates	Neutral spreads, bearish rates
Starting yield	5.41%	5.41%	5.41%	5.41%
Current spread (bp)	+96	+96	+96	+96
Rate change	-0.50%	-0.75%	-0.75%	0.50%
Spread change (bp)	+10	-15	+50	+10
New yield	5.01%	4.51%	5.16%	6.01%
New spread (bp)	+106	+81	+146	+106
Price return	2.77%	6.24%	1.73%	-4.16%
Total return	**7.78%**	**10.75%**	**6.89%**	**1.85%**

Source: Bloomberg. Starting Yield, Current Spread, and Duration as of 28 February 2024. Calculations based on the Bloomberg US Corporate Index current duration of 6.9 years and assume immediate parallel shift in yield curve and the new yield is then earned for the 12-month period. Investors cannot invest directly in an index.

A key reason to own investment grade corporate bonds is to diversify equity and lower-rated credit risk. While that assumption didn't hold up well in 2022, the good news for fixed income investors is that interest rate normalisation means income can be a meaningful component of return once more.

Furthermore, with US growth rates expected to outpace global growth rates, the US IG market provides an attractive opportunity for investors seeking a high quality asset class that can benefit from a strong fundamental backdrop. The expectation of a recession in 2023 led management teams to shore up balance sheets, leaving corporate fundamentals on solid footing heading into an improved economic outlook for 2024.

Additionally, while the asset class has seen record new issuance to start the year, spreads have tightened slightly amid exceptional demand for US IG from investors seeking high quality yields. Against this backdrop, we believe that in current markets, US IG corporate bonds remain an appealing asset class that can provide strong, long term risk-adjusted returns and diversification in investors' portfolios.

What's the long term case for US investment grade credit?

In a diversified portfolio comprising stocks, bonds, cash and alternative investments, for most investors the fixed income allocation can help protect capital in volatile periods and provide a reliable source of income over time.

For over a decade of low interest rates, balancing principal protection with the need to generate sufficient yield was a significant challenge. With interest rates having risen materially, higher-rated, lower-risk segments of fixed income such as US IG corporate are now offering higher all-in yields, meaning investors have less need to sacrifice credit quality in pursuit of returns.

An allocation to US IG corporates also has potential diversification benefits, given the market is more than double the size of its European counterpart and differs in terms of both composition and duration. Technology companies, for example, make up 9.4% of the US market versus just 3.0% for Europe.[5] The US market also features a much higher proportion of longer-dated bonds than its European counterpart, making its average duration 6.93 years versus 4.38 years for Europe.[6]

5) Bloomberg Indices, data as at 29 February 2024

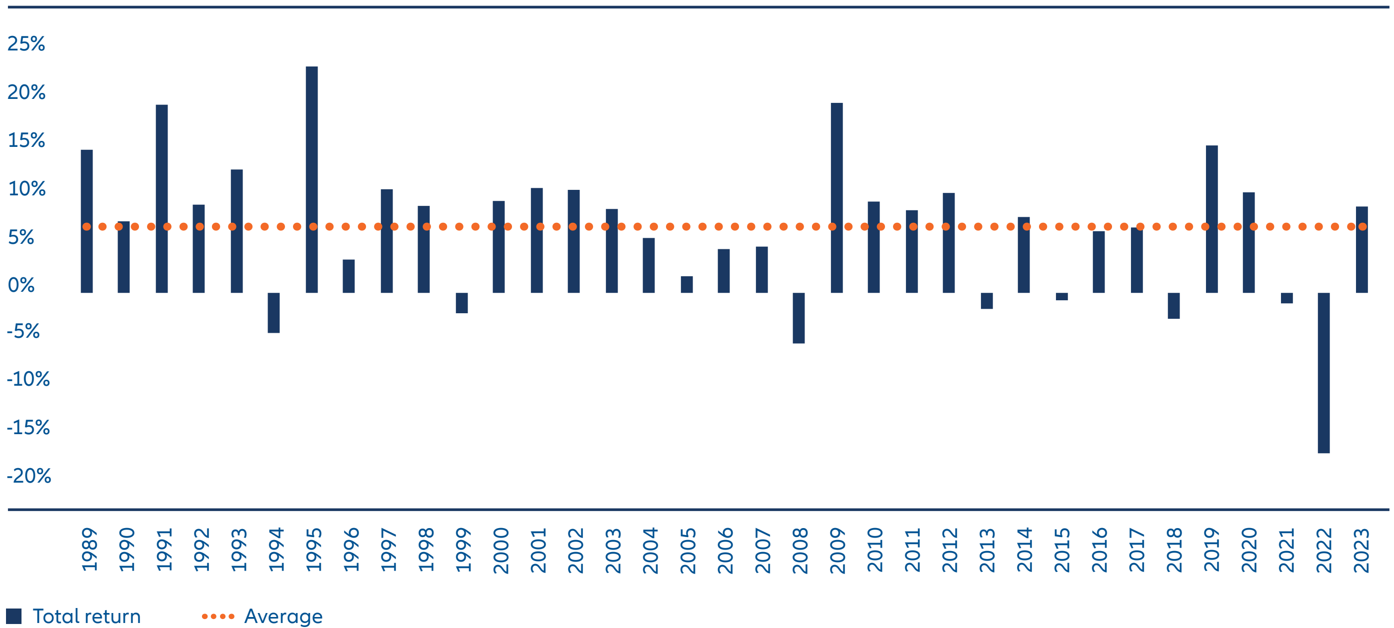
6) Bloomberg Indices, data as at 29 February 2024. Note that we believe "pure" investment grade credit investing is about managing credit risk rather than duration risk, and there may be better ways for investors to manage interest-rate sensitivity in their portfolios, such as using interest-rate derivatives or allocating to more dedicated short-duration bond strategies.

While yields have risen significantly across developed markets since early 2022, US IG corporates have historically offered more all-in yield on an unhedged basis (ie, nominal yields) than European IG corporates. This remains the case today: the average yield-to-worst on the US IG corporate index is 5.41% versus 3.86% for the Euro IG corporate index.[7]

To qualify as investment grade, or IG, an issuing company must receive a credit rating of between Aaa and Baa3 from Moody's or AAA and BBB– from Standard & Poor's. As Exhibit 3 demonstrates, the relative financial stability of these companies has helped the US IG corporate segment generate long-term positive returns through multiple credit cycles.

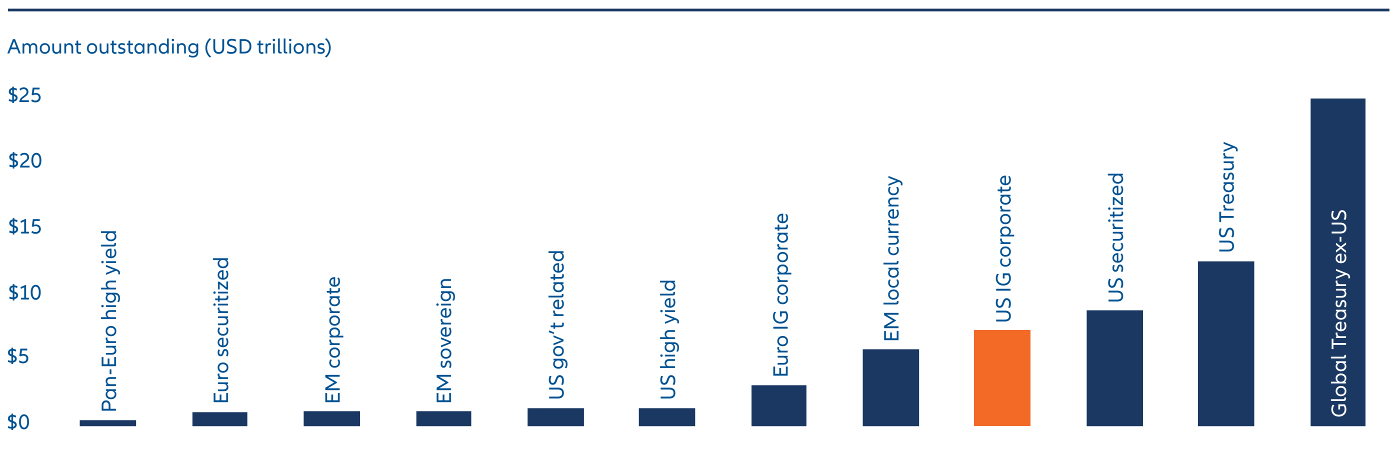
US IG corporate debt is one of the largest and most liquid markets in the world, having tripled in size since 2007 to stand at USD 7.0 trillion as of 31 December 2023 (see Exhibit 4 below).[8]

Exhibit 3: Relative stability of issuing companies has contributed to long term positive returns for IG bonds



Source: Bloomberg, data as at 31 December 2023

Exhibit 4: US investment grade is one of the largest bond markets



Source: Bloomberg, data as at 28 February 2024

7) Bloomberg Indices, data as at 29 February 2024. Currency-hedging costs can eat into nominal yields, particularly at a time of exchange-rate volatility. Investors may consider potentially cost-efficient ways of managing exchange-rate moves cost such as through derivatives-based hedging strategies.
8) Bloomberg Indices, data as at 31 December 2023

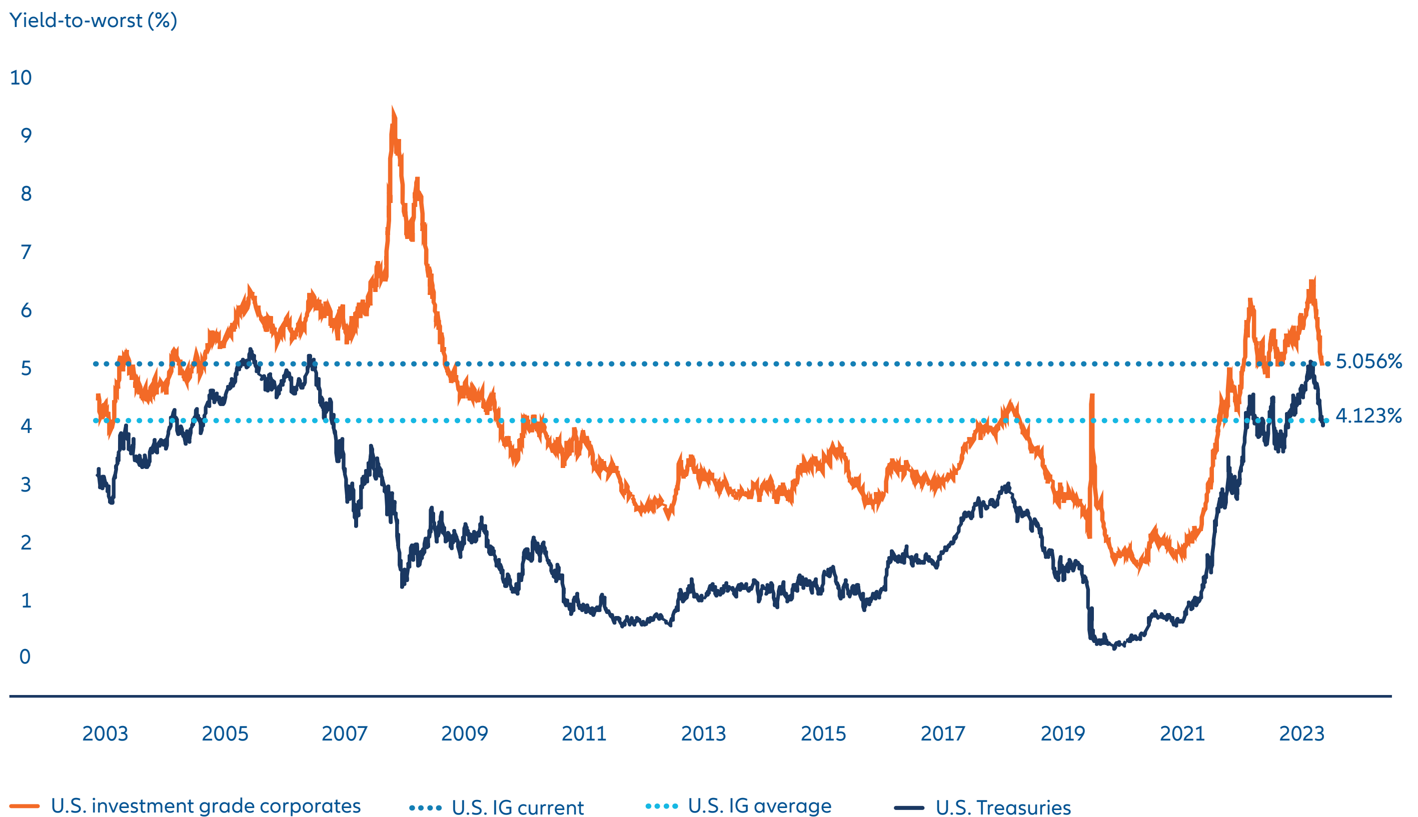
The size and scope of the market may offer investors relative value opportunities and inefficiencies that may be captured via active portfolio management. We believe active management, driven by rigorous fundamental analysis and a keen awareness of how corporate management teams respond through various stages of the credit cycle, is key to exploiting these inefficiencies and generating consistent potential performance while protecting to the downside.

In addition, US IG corporate debt yields are above their long-term average (see Exhibit 5). Higher-quality, lower-risk assets like US IG corporates may help investors meet their yield requirements without needing to take undue credit risk in lower-rated segments of fixed income.

While the breadth of the market and the yields available can look compelling, US IG corporates possess several features that may help investors protect their portfolios to the downside.

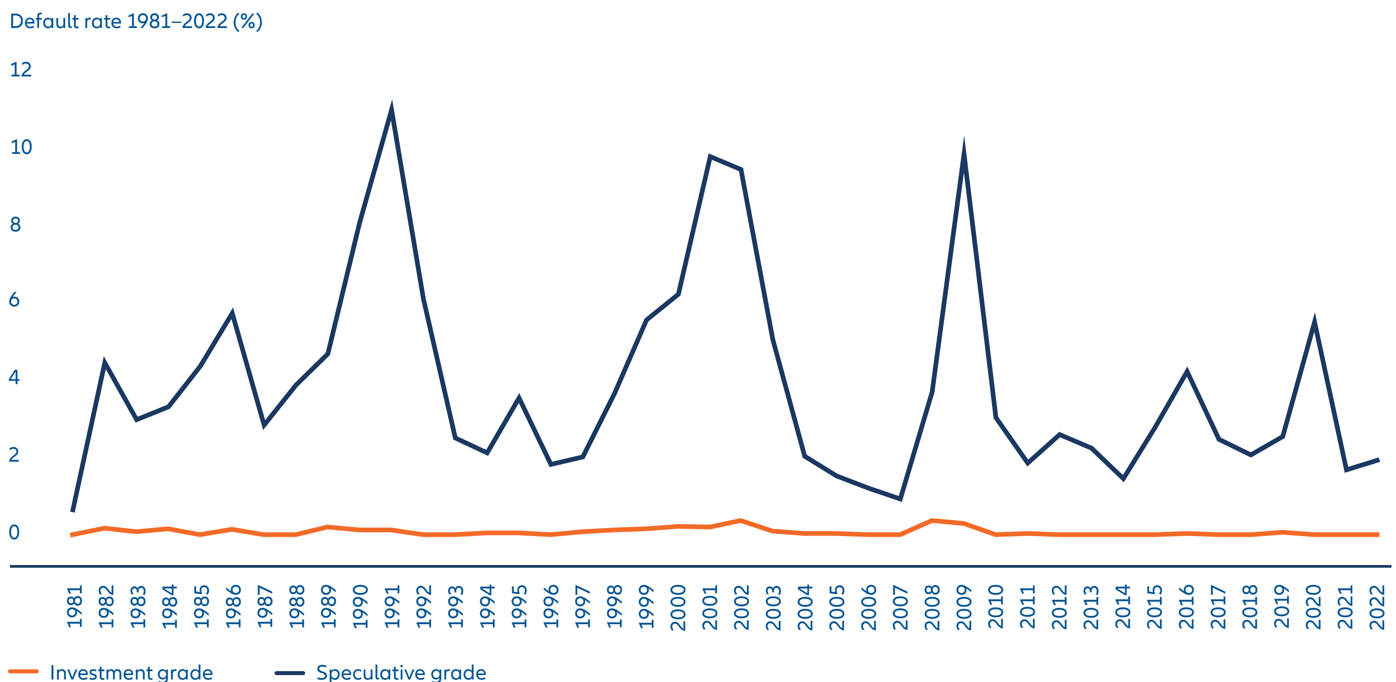
First, US IG corporate bonds have generally been a relatively safe asset class over time. As Exhibit 6 shows, corporate defaults within US IG credit have been infrequent and minimal over time compared to other credit- sensitive asset classes.

Exhibit 5: Yields of IG bonds are above their long-term average



Source: Bloomberg Index Services Limited and Voya Investment Management. Data as at 31 December 2023. US Treasuries represented by the Bloomberg US Treasury Index.

Exhibit 6: IG defaults have been infrequent and minimal compared with speculative grade



Source: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®, data as at end-2021

Given the minimal and infrequent default risk over time, one key risk in the IG corporate market is idiosyncratic downgrade risk. While companies being downgraded to below investment grade—so-called "fallen angels"—is a relatively rare occurrence, a passive approach to investing in the IG corporate market may expose investors to this unnecessary additional downgrade risk, which is a key driver of spread volatility. Active managers aim to manage downgrade risk through credit selection—meaning that active strategies, unlike passive strategies, may be able to avoid certain downgrades.

Second, a dedicated US IG corporate sleeve can serve as an effective diversification tool. As Exhibit 7 shows, the asset class has historically demonstrated low correlation to both equities and US Treasuries, as well as riskier segments of the fixed income market like emerging market debt, high yield bonds and leveraged loans.

Exhibit 7: US IG corporates have low correlations to selected asset classes

	US Investment Grade	US Aggregate Index	US Treasuries	Agency residential MBS	US asset backed securities	US commeri-cal MBS	US high yield	US senior loans	Emerging markets debt	S&P 500
US investment grade	1.00	0.86	**0.57**	0.68	0.60	0.54	**0.67**	0.44	0.82	**0.48**
US Aggregate Index		1.00	0.89	0.92	0.48	0.44	0.35	0.07	0.62	0.23
US Treasuries			1.00	0.82	0.23	0.21	-0.06	-0.33	0.29	-0.09
Agency residential MBS				1.00	0.39	0.27	0.23	-0.04	0.49	0.18
US asset backed securities					1.00	0.43	0.58	0.61	0.58	0.25
US commerical MBS						1.00	0.68	0.48	0.52	0.42
US high yield							1.00	0.85	0.79	0.75
US senior loans								1.00	0.60	0.59
Emerging markets debt									1.00	0.63
S&P 500										1.00

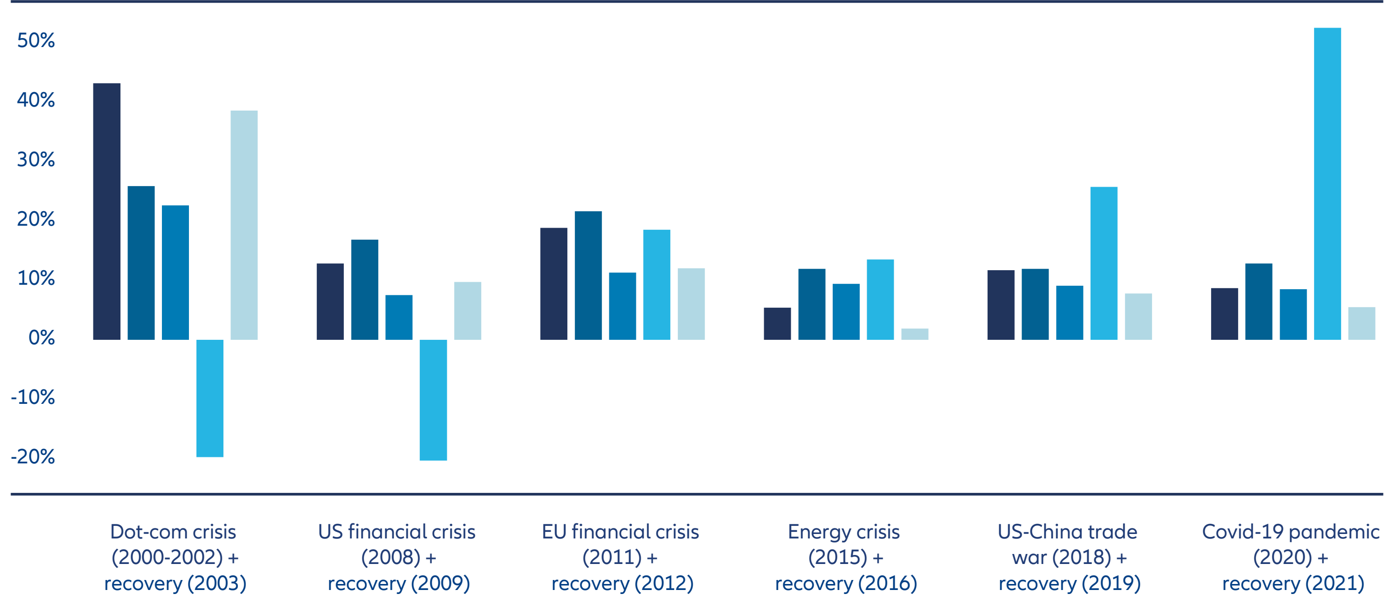
Source: Bloomberg, data as at 31 March 2023. Based on monthly returns from 31 January 2007 to 31 March 2023.

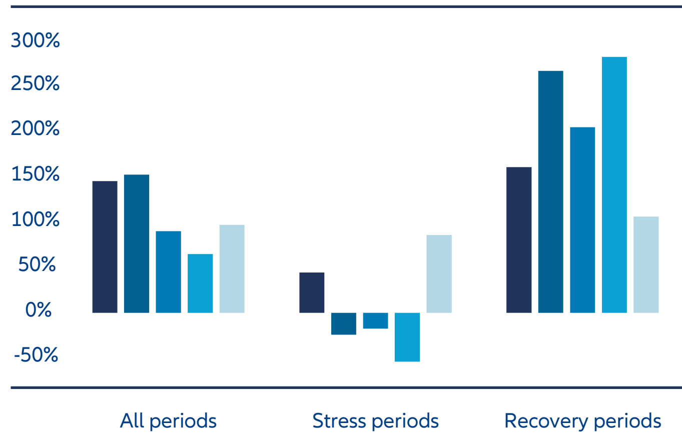
Third, as shown by Exhibit 8 below, US IG corporate bonds have historically delivered compelling downside risk mitigation during periods of significant market stress.

Looking at market returns in crisis periods over the last 20-plus years, the US IG corporate market outperformed senior bank loans and US stocks during the dot-com crash, the 2008 financial crisis, the European sovereign debt crisis, the 2015 energy crisis, the US Federal Reserve's 2018 hiking cycle and the Covid-19 pandemic. Even allowing for a rebound year following each crisis, total returns for the US IG corporate market through all the combined crisis and rebound years exceeded those of the aforementioned markets.

US IG corporates did underperform US high yield bonds in four of the five crisis-and-recovery periods, but the underperformance across all periods was a modest 7% and when accounting for the significantly lower volatility profile (a standard deviation of 1.74% vs. 2.70%), the underperformance versus high yield does not look too drastic.

Exhibit 8: Relative US IG corporate performance during crisis periods (see below for accumulated)





Source: Bloomberg and Voya Investment Management, 31 December 2022. Crisis and recovery years shown are estimated and include 12 months of data (from Jan-Dec) for each of the years shown.

Perhaps even more surprising is that, as Exhibit 8 shows, over the same periods of crisis and recovery, US IG corporate bonds have typically delivered a better outcome than US Treasuries, a typical safe haven during volatile periods when investors are looking to conserve capital.

The bottom line: US IG credit is an appealing asset class

We believe that in current markets, US investment grade corporate bonds may be an appealing asset class.

Years of low interest rates may have tempted many investors into lower-rated parts of fixed income in pursuit of yield, but with rates having risen materially, US IG corporate debt is arguably more attractively priced today than it has been for more than a decade. Additionally, with an improved US economic outlook for 2024, solid corporate fundamentals, and the prospects of Fed rate cuts later in the year, US IG corporate debt is well positioned to provide strong, long-term risk-adjusted returns and diversification in investors' fixed income portfolios.

Connect with Us | hk.allianzgi.com | +852 2238 8000 | Search more

Like us on Facebook 安聯投資 – 香港

Connect on LinkedIn Allianz Global Investors

Subscribe to YouTube channel 安聯投資

Follow HK WeChat AllianzGIHK

Allianz Global Investors and Voya Investment Management (Voya IM) have entered into a long-term strategic partnership as of 25 July 2022 to deliver a range of investment capabilities to investors worldwide. Voya IM is not an affiliate of Allianz Global Investors.

Diversification does not guarantee a profit or protect against losses.

A rating provides no indicator of future performance and is not constant over time.

Information herein is based on sources we believe to be accurate and reliable as at the date it was made. We reserve the right to revise any information herein at any time without notice. No offer or solicitation to buy or sell securities and no investment advice or recommendation is made herein. In making investment decisions, investors should not rely solely on this material but should seek independent professional advice. However, if you choose not to seek professional advice, you should consider the suitability of the product for yourself. Investing in fixed income instruments (if applicable) may expose investors to various risks, including but not limited to creditworthiness, interest rate, liquidity and restricted flexibility risks. Changes to the economic environment and market conditions may affect these risks, resulting in an adverse effect to the value of the investment. During periods of rising nominal interest rates, the values of fixed income instruments (including short positions with respect to fixed income instruments) are generally expected to decline. Conversely, during periods of declining interest rates, the values are generally expected to rise.

Liquidity risk may possibly delay or prevent account withdrawals or redemptions. Investment involves risks including the possible loss of principal amount invested and risks associated with investment in emerging and less developed markets. Past performance of the fund manager(s), or any prediction, projection or forecast, is not indicative of future performance. This material has not been reviewed by any regulatory authorities.

Issuer:
Hong Kong – Allianz Global Investors Asia Pacific Ltd.

May 2024

ADM-3562510