RBC BlueBay
Asset Management

Opportunities in investment grade bonds

For sophisticated investors

Powered by
intelligent partnership

July 2024

Contents

Credits

Editorial
Lisa Best

Creative
Mar Álvarez

Marketing
Chloe Fry

Acknowledgements

We'd like to thank RBC BlueBay Asset Management for making it possible for us to produce and distribute such important educational content by lending their expertise and sponsorship. We're also grateful to each of our distinguished contributors.

Provide feedback

Intelligent Partnership actively welcomes feedback, thoughts and comments to help shape the development of our guides. To give your feedback please email: *publications@intelligent-partnership.com*

Foreword

by Matthew Rawlings

Head of Financial Institutions - UK & Ireland, RBC BlueBay Asset Management

Active investment managers like RBC BlueBay use their experience of reading and interpreting economic data accurately to give direction on the most attractive asset class at any given point in time.

Right now, our analysis suggests it's time to invest in Investment Grade (IG) bonds. They are those with a high-quality rating, such as government bonds, that generally signifies a relatively low risk of default, although often with a relatively low return. It is worth noting though, that the credit risk of IG bonds ranges from the lowest level of credit risk to moderate credit risk, so a diversified approach can push up returns while still offering strong capital preservation characteristics.

In 2022 equities and credit both struggled. Investors moved away from risk assets and heavily into cash in a more stagflationary environment. Many investors allocated to money market funds and fixed-term securities, as interest rates climbed higher and the yield on cash became much more attractive.

Since the US CPI inflation rate peaked in June 2022 at 9.1%, inflation has fallen to more manageable levels. Investors have backed more defensive growth stocks as the Fed contemplates cutting rates.

The current environment of falling inflation and potentially lower rates supports bond prices. In bond markets, we have seen strong appetite for IG issues, as investors continue to 'play it safe' following the rate hikes of the last few years. Many still do not want to take on credit risk at a time when IG bonds are paying out levels of yield comparable with those available from cash deposits.

Matthew is Head of UK Financial Institutions (FIG) within Global Business Development. He joined BlueBay Asset Management (which is now part of RBC Global Asset Management) in April 2020 with responsibilities across UK Wholesale, Global Bank and Family Office. Prior to BlueBay, Matthew worked at M&G Investments for 23 years and held the position of Senior Sales Director within UK Discretionary Sales. BA (Hons) Economics, FPC, IMC

But, with the right investment selections, investors in IG bonds have an opportunity to lock in good income for years to come as this phase will eventually give way to a period of economic recovery. We also see pockets of additional value in investment grade bonds that can be exploited.

Asset classes or sectors won't always perform strongly in a particular phase of the economic cycle. However, our deep understanding of credit markets tells us that investment grade bonds make a lot of investment sense right now.

Now is the time for investment grade credit

by Mike Reed, Head of Global Financial Institutions, RBC BlueBay Asset Management

Mike is Head of Global Financial Institutions at RBC BlueBay. He joined the firm in 2007 as a Senior Portfolio Manager to establish the Convertible Bond Team and became Head of Strategic Partnerships in July 2018. Mike was previously a partner at Pendragon, where he ran the company's convertible arbitrage strategies. Before joining Pendragon he worked at Salomon Brothers from 1989 to 2002 where he was a Managing Director. He joined Salomon's Japanese warrant arbitrage desk in 1989 and spent two years in Tokyo before returning to London in 1994 to run the international convertible bond trading desk. Mike holds a Bachelor of Engineering from Southampton University.

Opportunities and challenges abound in fixed income investment grade (IG), with the current market backdrop ripe for investors to reengage with this asset class.

However, understanding the relationship between inflation and interest rates is crucial in order to make informed investment decisions within this space.

Within IG, core rates are a key driver of returns and inflation can have a significant impact on this.

Inflation picked up dramatically in 2021 as during COVID there was a build-up of household savings after central governments eased financial conditions to counter the detrimental economic impact of the virus. Legislation such as the Inflation Reduction Act in the US pumped fiscal stimulus into their domestic market, with similar initiatives undertaken across the UK and Europe. As the pandemic faded many consumers rushed to spend their savings leading to a huge increase in demand and a consequent jump in prices as suppliers struggled to adjust.

Then followed the Russian invasion of Ukraine in 2022, which drove up prices for domestic staples like food and energy – causing a massive spike in inflation, and in reaction central banks raised interest rates on both sides of the Atlantic. As the world adjusted to these shocks and the impact of higher interest rates it affected both companies and consumers, and inflation began to ease.

This type of action doesn't mean prices reverse and start falling, but it does dampen the speed with which they rise to a more sustainable level although inflation levels in both the US and eurozone still remain elevated in comparison to their pre-2021/22 levels.

What does this all mean for bond yields?

At the start of 2022, 10-year Euro government bonds were below zero, and 10-year US government bonds were at 1.5%; with rates sharply rising through 2022 and into 2023. Both US and Euro bond yields have now returned to pre-2008 financial crisis levels, i.e. around 3% in the eurozone and 5% in the US, presenting a much more attractive entry point for investors than at any other point over the last 15 years.

US and German 5-Year Bond Yields

Source: Bloomberg

At the start of this year, market consensus forecast a significant number of rate cuts for 2024 on both sides of the Atlantic, this pace of reductions would normally only be seen if these economies were entering a severe recession.

This isn't the scenario that has played out, and core rates have risen having a negative impact on bond prices, however, total returns over this period have been supported by the coupon income and also, in the case of IG credit, tightening credit spreads as the economic backdrop began to look less worrying.

Looking at today, the market is now pricing in that the European Central Bank (ECB) will start to cut rates before the US Federal Reserve (Fed); and that the ECB will cut three times before year-end.

Why should investors care?

We believe many investors are currently cautiously positioned in their asset allocation, with a large proportion of their portfolios in money market funds (MMFs), with some reports estimating USD$9 trillion[1] is presently allocated to MMFs globally.

In the current investment environment, this makes sense in terms of the income profile of these investment vehicles, which is between roughly 3% and 5%[2] dependent on the MMF currency of choice. However, if the monetary policy and inflation backdrop shifts as anticipated in the second half of this year, we would expect the income on these investment vehicles to drop significantly lower, presenting a far less attractive investment for investors.

For fixed income, the nature of bonds means that investors are "paid to wait" by virtue of the ongoing coupon stream. Over the last 12 months even though core rates have risen, we have seen some IG strategies generate total returns of 8%[3], with investors benefitting from coupon payments and alpha generation.

Why now?

Credit spreads widen when markets appear strained and there are heightened default concerns. However, recent economic data and the subsequent movement in government bond yields suggest that the global economy is not entering a recession.

We research and analyse many companies who have IG credit ratings and the vast majority are painting a healthy picture when it comes to their current business activities. The broader market conversation has moved on from a soft or hard landing to no landing at all; and this scenario can result in tightening credit spreads that can benefit investors in IG bonds.

By taking an active approach, it allows investors to gain exposure to the bonds of companies that should benefit from the current economic environment. It also allows greater flexibility to potentially avoid those companies that could have their business models challenged by the increase in interest rates that has occurred over the last three years. In contrast, if investors take a passive approach, by investing in a benchmark-tracking fund, they will not benefit from this analysis that attempts to sift the winners from the losers and thus their investments could underperform an actively managed fund.

In the current backdrop, investors may want to consider gaining an exposure to actively-managed investment grade fixed income funds.

[1,2&3] Bloomberg, April 2024

Investment Grade Strategies

GLOBAL SOVEREIGNS: THE OPPORTUNITY ★

- Core government bonds yields are close to decade highs
- Valuations are creating investor demand
- Global sovereigns can offer risk adjusted returns with good yields for a longer-term horizon than just buying gilts short term
- Ongoing policy and political uncertainty continues to drive potential volatility creating opportunities for active investors

Potential investment route:

→ BLUEBAY INVESTMENT GRADE GLOBAL GOVERNMENT BOND FUND
Actively managed, UCITs with daily liquidity established in 2022, looking to achieve a return in excess of 150bps (gross) 1 over the benchmark on an annualised basis with an expected tracking error of 0–3%. Seeking to generate excess returns from investment decisions in Global interest rates, sovereign credit and currencies based on high quality forensic proprietary research and a strong focus on policy and politics analysis along with more traditional balance sheet & ESG analysis.

GLOBAL CORPORATES: THE OPPORTUNITY ★

- Underlying core government yields are close to decade highs, driving likely investor demand and helping to offset the end of QE buying
- IG corporate spreads are currently overcompensating for default risk
- Corporate balance sheets generally look strong, resulting in low risks of high yield migration
- Ongoing policy and political uncertainty continues to drive potential volatility creating alpha opportunities for active investors

Potential investment route:

→ BLUEBAY GLOBAL INVESTMENT GRADE CORPORATE BOND FUND
Actively managed, UCITs with daily liquidity established in 2012 and aiming to deliver a total return in excess of the Barclays Global Aggregate Corporates Bond Index (USD Hedged). Top-quartile performer (using Morningstar peer group) within the 'Global IG corporates' category over 1yr, 5yrs and since Inception (as at 31 December 2023) with tracking error well below the upper expected level of 3%. Disciplined risk management and capital preservation focus.

FINANCIALS: THE OPPORTUNITY ★

- Analysis suggests Bank debt, with the growing resilience of enhanced regulatory oversight, remains relatively undervalued, despite improving credit fundamentals
- Banks are enjoying the tailwinds from higher rates and vastly improved profitability
- The differential in spreads between Senior Financials and Corporates remains at elevated levels
- There is potential for equity-like returns with lower volatility
- Ongoing growth, policy and political uncertainty continues to drive volatility and varied issuer performance, creating a rich opportunity for active management

Potential investment route:

→ BLUEBAY IG FINANCIALS PLUS BOND FUND
Actively managed, UCITs with daily liquidity established in 2023, looking to achieve a total return of 4–8% gross per annum with a Sharpe ratio close to 1, with an emphasis on downside risk mitigation. ESG considerations are fully integrated into research, decision making and portfolio construction.

IMPACT IN INVESTMENT GRADE: THE OPPORTUNITY ★

- Impact investing is often associated with private, illiquid market investments where 'additionality'[1] can be more readily evidenced and which either target at, or below, market rate returns.
- An opportunity exists for investing thematically in public debt markets whilst targeting attractive market rate returns

Potential investment route:

→ BLUEBAY IMPACT-ALIGNED BOND FUND
Actively managed, UCITs with daily liquidity established in 2021 and predominantly investing in corporate issuers, but may also invest in Sovereign, Supranational and Agency (SSAs), meeting the Fund's sustainability themes. The fund aims to generate capital appreciation and income by identifying global issuers whose core economic activities offer investment opportunities whilst enabling solutions as defined by RBC BlueBay's sustainability themes.

For further terms related to the objective, investment policy and overall risk and reward profile please refer to the KEY INVESTOR INFORMATION DOCUMENT for each Fund.

[1] An increase in the quantity/quality of an enterprise's social/environment outcomes beyond what would otherwise have occurred.

Pointers for IFAs when considering investment grade bonds

by Dan Cartridge, Fund Manager, Hawksmoor Fund Managers
and Darius McDermott, Managing Director, FundCalibre

Dan Cartridge joined Hawksmoor in October 2016 and was promoted to Assistant Fund Manager in 2018. In February 2024 Dan became Fund Manager for the Vanbrugh, Distribution and Global Opportunities Funds. He has a BSc (Hons) in Mathematics with Finance, has completed his Investment Management Certificate and has passed Level 1 of the CFA programme.

Darius studied at the University of Birmingham, graduating with a BSc (Hons) in Chemistry. He has clocked up almost thirty years within the financial services industry, all of which have been spent with Chelsea Financial Services where he's been managing director since February 2000. He became managing director of FundCalibre at its launch in 2013. Darius is the Chairman of the Association for Independent Discount and Non-Advisory Brokers (AIDB) and a member of the IA sectors committee as well as a judge on most fund manager awards including Investment Week and Portfolio Adviser.

Investment grade (IG) credit can be a useful investment within a portfolio. Dan Cartridge explains, "thought of in two parts, an IG bond consists of a risk-free return component represented by the local government bond yield of an equivalent maturity, plus extra yield that compensates investors for the credit risk and liquidity profile of the bond. The risk-free component tends to perform well in more difficult market environments as investors seek safety in government bonds, driving their yield down. In more positive market environments, investors benefit from the additional yield pick up over government bonds and may benefit from credit spread tightening to bolster total returns."

Dan goes on, "a key consideration when investing in IG credit is understanding how much of the return is coming from the risk-free component relative to the credit component. If most of the return is coming from the former, then there may be little point in taking on the additional risk of buying credit over government bonds. Currently, global IG credit spreads are tight relative to long term history, at less than 1% additional yield pick up over government bonds. At the same time, the yields on government bonds are the highest they have been in the past 15 years. This means that the vast majority of return you will achieve from IG credit is coming from the risk-free component."

Darius McDermott agrees that financial advisers should pay careful attention to the credit spread they receive. He offers the difference in yield between a 10-year corporate bond and a 10-year Treasury bond as an example, "A healthy difference in spread is generally favourable for the attractiveness of corporate bonds, as it means investors are being better compensated for taking the risk of providing loans. However, it also indicates that the market has become more cynical of the credit conditions and the ability of companies to pay these loans back. When spreads are tighter, it lessens the attractiveness of investing in investment-grade corporate bonds as you can guarantee a similar return by choosing the risk-free option."

For Dan the next thing to consider is the level of dispersion within the asset class. With current valuation dispersion very wide, he argues that the ability of an active manager to build portfolios that have a wider credit spread than available in aggregate, without taking on meaningfully more credit risk, is an important investor consideration.

This also plays into diversification and Darius asserts that, "by employing a global lens, financial advisers might find opportunities to lock into higher yields for the longer term in sovereign debt markets outside the UK, depending on the yield curves of different countries."

Finally, Darius highlights that it's prudent for financial advisers investing in IG corporate bonds, "to be cognisant of the increased risk of companies defaulting in this higher-rate environment" by considering, for example, the amount of debt on their balance sheets and cash available to service the debt.

Changing US rate outlook unlikely to fuel Fallen Angel trends

by Patrick Drury Byrne

Global Head of Credit Market Research, S&P Global Ratings

Patrick Drury Byrne is Managing Director and Head of Credit Market Research for S&P Global Ratings.

In this role, Patrick leads a global team responsible for the creation and publication of high frequency research on global rating performance and credit market trends. This research covers ratings performance indicators, default and issuance forecasts and financing conditions. Patrick is also Country Manager for S&P Global Ratings in Ireland, supporting the Irish-based Ratings team and working closely with local stakeholders.

Rising stars currently outweigh fallen angels. But as geopolitical risk rises and the timing of rate cut expectations are pared back, the question is, for how long?

'BBB' rated issuers in general have weathered inflation and higher interest rates in recent years. In 2023, for instance, there were twice as many financial and non-financial rising stars (speculative-grade issuers that moved up to investment grade: 'BBB-' or higher) as fallen angels (investment-grade issuers downgraded to speculative grade, 'BB+' and lower). Amid market expectations for a soft landing and lower interest rates, this trend continued into 2024, with 10 rising stars and only four fallen angels in the first quarter.

We don't believe higher for longer rates will trigger a spike in fallen angels. The results of our analysis suggest that 'BBB' downgrade ratios are nearly uncorrelated with 10-year benchmark yields during upcycles. In contrast, we see relatively high positive correlations at speculative grade, especially at 'B' and below. This implies rising interest rates could drive up speculative-grade downgrades, especially combined with sector- or company-specific factors. 'BBB' rated issuers in contrast can typically withstand such rate increases.

While an increase in rates is not necessarily negative, a drop in rates isn't necessarily positive. Our analysis shows a negative correlation during downcycles, meaning that downgrade ratios still tend to rise during periods when benchmark yields are falling, likely because of sector-specific factors. Moreover, downcycles typically (but not always) coincide with slowing economic growth. Yet, for 'BBB' rated issuers, the negative correlations are still far lower than those for speculative-grade issuers.

It's no surprise that 'BBB' rated issuers typically exhibit better relative credit strength, but they also have structural advantages, which come to the fore during periods of rising interest rates. Investment-grade companies tend to borrow at fixed rates, so changes in interest expense typically occur only at maturity, significantly expanding the time frame for rising rates to have an impact. Such companies also typically have diverse capital structures, including large cash balances, and thereby also a range of options for interest-rate management. In addition, they tend to have healthy margins and more steady cash flows than speculative-grade issuers. This reduces the likelihood of a company-specific shock or rising rates eroding interest coverage ratios enough to put pressure on ratings.

'BBB' issuers exhibit relative stability through interest rate cycles. Yet they aren't immune to wider rating pressure, and we ultimately expect fallen angel numbers to rise. Since 2000, if total nonfinancial fallen angel debt dips below $40 billion in a particular year, this is usually followed by the downgraded debt amount more than doubling the next year. For example, the number of potential fallen angels (in the U.S and EMEA) rose to 28 by March 2024 from 12 in July 2023, with total debt of those potential fallen angels increasing to $118 billion from $30 billion.

Spread differentials in Investment Grade portfolios

by Mark Preskett, Senior Portfolio Manager, EMEA, Morningstar Wealth

Mark serves as lead portfolio manager for a number of Morningstar portfolios. He chairs the EMEA Investment Selection sub-Committee and is head of the EMEA Fixed Income Research team.

Mark has over 15 years investment experience, joining Morningstar Investment Management in 2011 from AIG Life. There he worked as an investment analyst on the group's unit-linked multi-asset portfolio range.

Mark holds a BA in Politics from UWE, Bristol, the Chartered Financial Analyst designation and the Investment Management Certificate (IMC).

Understanding what is driving credit spreads has become a key area of research for our team. Get the analysis right, and it can lead to attractive gains for our clients. Get it wrong, and the asset class can deliver material losses despite its perceived safe-haven status.

Before digging into where we see value in corporate bonds today, it is worth sharing our key tenets on which we base our analysis.

First, the fair level of credit spreads can vary between regions; in other words, there are structural reasons why one market may trade wider or narrower than another region, based on a market's credit quality or sector make-up. For example, a market with a higher weight to BBB-rated bonds should trade wider than a market with more single A-rated issuers.

Second, credit spreads vary between maturity buckets. There is a simple logic to this; investors lending to Apple or Dell for ten years demand a higher yield than if they were lending to the same companies for two years.

These two tenets mean we would expect to receive a higher spread for an investment in a US corporate bond strategy compared to a European IG fund. US IG bonds, on average, have a lower credit quality due to a higher percentage of BBB-rated debt. In addition, the US index duration is around two years longer, at eight years, than standard European credit indices, again meaning they should trade at a higher spread.

History shows that credit spreads can trade materially wider or narrower than these 'base rates', for a variety of reasons such as flows, macro-economic events, or corporate news. For example, in and around the ill-fated Liz Truss budget in late 2022, UK credit spreads widened materially and was an idiosyncratic event impacting the UK only.

It is also worth noting that a near-zero default rate for the asset class understates the risk of investing in IG credit. What is more typical is for a distressed credit to be downgraded to junk status. This credit migration event can lead to significant losses for investors despite the lack of a default.

So where do we see value today in IG markets? Firstly, the tightest spreads among the three key IG markets we assess are in the US. This reflects the robust economic data coming out of the country as well as higher profit margins in aggregate from US corporates. Interest coverage ratios are healthy and leverage levels low relative to history.

By contrast, corporate fundamentals are weaker in the eurozone and UK, but this is reflected with wider spreads than our base rates. This provides an opportunity for an investment in our opinion. A key feature of our multi-asset portfolios is our exposure to UK corporates. Here, shorter maturity bonds continue to trade at wider spread levels than our base rate, and we are taking advantage of this extra carry. For example, in the three-to-five-year maturity bucket, UK corporate spreads are 131bps, compared to 118bps in the eurozone and just 78bps in the US. This has led to dedicated holdings in UK corporate funds investing in the shorter maturity space. Not only are yields higher here due to the inverted yield curve, but spreads wider.

The value in Financials

by Marc Stacey

Senior Portfolio Manager, Investment Grade, RBC BlueBay Asset Management

Marc is a BlueBay Senior Portfolio Manager within the Investment Grade team focusing on non-sovereign debt and specialising in financials. Marc started at BlueBay Asset Management (which is now part of RBC Global Asset Management) in June 2004 as an operations analyst before joining the Investment Grade Debt Team in March 2006 as a trader. He moved to his current role in January 2011. As a lead portfolio manager, Marc has been instrumental in driving the success of the European IG credit strategies as well as the peer-leading performance of the Financial Capital Bond Fund. Prior to BlueBay, Marc spent two years at CSFB focussing on credit derivatives. He holds a Bachelor of Business Science (Hons) in Economics and Finance from the University of Cape Town, South Africa.

Over the past fifteen years we have observed a sea change in the way that European banks are both regulated and managed. On the regulatory front the quantum and quality of capital has been pushed to generational highs, liquidity management has been brought to the fore and risk taking has been curtailed through homogenised regulation and enhanced supervision practices. The self-fulfilling nature of this regulation has led the market to reward those banks that prioritise balance sheet strength, sustainable profitability and business models and better risk adjusted capital allocation. The consequence is a sector that now has more capital, liquidity and oversight than ever before. Non-performing loan levels at record lows and profitability levels on a par with those seen in the past but underpinned by much lower risk business models.

While these changes were a painful transition that led to a lost decade for bank equity investors, it has been an unambiguously positive period for bank creditors. With this in mind we find it somewhat ironic that bank credit spreads continue to offer an attractive pick up versus corporates, particularly as we enter a more normalised interest rate environment that is positive for bank profitability but more challenging for corporate financing. The asset class we see offering the most attractive risk return opportunity to take advantage of this anomaly is the most junior part of banks debt stacks; Additional Tier 1 (AT1) securities.

AT1 hybrid debt instruments were part of the regulatory response to the global financial crisis. Regulators sought to create a class of debt with going concern characteristics that could be used in times of stress. The features inherent in these instruments lead to their exclusion from traditional fixed income indices, creating large pricing anomalies that have been further compounded as they fall into the category of being largely highly rated investment grade issuers but high yield rated at a security level. While we remain supportive of the asset classes ability to provide going concern capital benefits to regulators, we strongly believe that many of the inherent features are unusable and are consequently mispriced by the market.

In our view the dramatic improvements in the sector fundamentals, attractive macroeconomic tail winds and pricing anomalies make AT1 securities the most attractive risk return opportunity available in the credit spectrum today. There is abundant opportunity to further enhance these returns on a sustainable basis through a dedicated active management approach.

RBC BlueBay
Asset Management

"The current healthy flow of funds into Investment Grade bonds is indicative of the resilience of this asset class, even among hopes for central bank interest rate cuts and ongoing drops in inflation. But, in a tight market, the maximised returns lie in pockets of value leaving active managers with the skills to identify and exploit the opportunities, in the box seat."

Guy Tolhurst, Managing Director, Intelligent Partnership

Powered by
intelligent.
partnership*