Macquarie Investment Management

Value remains after investment grade credit selloff, but security selection is crucial

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It is no secret that investment grade markets have been under pressure so far in 2018. After enjoying a strong run in 2017 amid positive market sentiment, anticipation around successful tax reform legislation, strength in commodity prices, and strong demand from global investors, investment grade credit (as measured by the Bloomberg Barclays US Corporate Investment Grade Index) generated the weakest first-half-of-the-year total return (-3.27%) since 2013 and the weakest first-half excess return (-1.76%) since 2008. Geopolitical headwinds, driven in large part by the growing threat of a global trade war, have compounded weak technicals in the investment grade market in the United States amid rising hedging costs for global investors and heavy supply driven by merger and acquisition (M&A) activity.

However, we believe there could be a silver lining to this gloomy start to the year. The underperformance in the US investment grade corporate market to date has largely been technically driven, in our view, and not rooted in any fundamental weakness. Corporate earnings growth remains robust, as evidenced by S&P 500® Index companies reporting a 7.8% increase in revenue year over year and a 24.3% increase in earnings per share for the first quarter of 2018. While debt levels remain elevated, leverage has stabilized, and we continue to expect earnings growth to support deleveraging in the near term. Tax reform has also been a tailwind to fundamentals with benefits accrued across all sectors. In fact, we are already seeing early signs of a turnaround in US investment grade technicals with supply slowing and global investor demand improving. And with US investment grade credit spreads (year to date) having retraced virtually all the tightening that occurred in 2017, we believe there is room for further spread compression and performance in the second half of 2018.

The key to unlocking this value and guarding against losses as we approach the end of a historic era of US Federal Reserve market support will be individual security selection and deep, bottom-up fundamental research.

What drove spreads wider in the first half of 2018?

Corporate bond spreads have come off their cyclical tights in the first half of the year, widening 40 basis points from trough to peak, although current levels are still below their long run average.

Investment grade corporate bonds OAS

Source: Bloomberg Barclays. Option-adjusted spread (OAS) measures the average difference in yields between a bond security (in this case, investment grade corporate bonds) and Treasurys

A number of factors have contributed to this recent cheapening:

- **Declining foreign demand.** Investors from Asia and Europe have been marginal buyers of US credit for the past several years as the global reach for yield has pushed investors to the US market. However, widening interest rate differentials between the Fed, the Bank of Japan, and the European Central Bank, combined with a stronger US dollar, have driven up foreign exchange (FX) hedging costs for non-US investors. Although recent Fed data show that international investor holdings of US corporate bonds are still near all-time highs (29% as of the first quarter of 2018), that number has declined over the past few quarters. Recent fund flow data also indicate that demand, including that from US investors, has waned, with inflow volumes down 30% year over year.[1]
- **Trade.** The on-again, off-again trade dispute between the US and China and other trading partners has been one of the main drivers of market volatility, with increasingly hostile and vacillating rhetoric moving sentiment in alternating directions. Although the US and China have each issued only $US34 billion in tariffs year to date, tensions have ramped up significantly with President Trump warning he is ready to implement tariffs on all $US500 billion of Chinese goods imported into the US. While much of this rhetoric is likely posturing to negotiate better terms for trade relationships, we expect trade tensions will continue to dominate headlines and market sentiment in the near term.
- **Supply.** Although issuance is down slightly year over year for the first half of 2018, US investment grade supply has been robust, after coming off a record year in 2017. M&A financing continues to play a major role in the ongoing heavy supply, which has led to some buyer indigestion and reduced pricing power for issuers in the form of rising new-issue concessions. This is especially evident in the large megadeals that have required significant concessions to clear the market.

What could drive spreads tighter in the second half of 2018?

Our base-case view was that there would be a meaningful decline in supply this year, driven by the implementation of tax reform and the reduced need for companies to issue additional debt due to the effect of repatriating offshore cash. And aside from the surge in M&A-related financing in the second quarter of 2018, this view has begun to play out, with issuance for the month of July down approximately 50% from the same period last year. The technology sector is a particularly good barometer of the effects of tax reform on issuance given the significant number of offshore holdings in the space. Year-to-date technology issuance is roughly $US12 billion, compared to $US148 billion of total issuance from this industry in 2017 (source: Bank of America). We believe this trend will continue into the second half of 2018 and cause overall US investment grade supply to be down for the year, providing technical support for the secondary market.

More importantly, demand has rebounded as wider spreads and higher all-in corporate yields have increased the attractiveness of US dollar credit to European and Asian investors. Hedging costs have marginally improved, which has been beneficial given the growing influence that non-US investors have on the US investment grade credit market. However, we are not expecting a significant decline in FX hedging costs in the near term, as the policy divergence between the US and the rest of the world shows little signs of changing. Liability-driven investing is another area where we expect demand to increase, as long corporate bond yields approach the psychologically important 5% threshold. We have begun to see evidence of this as the recovery in equity markets has improved corporate pension funding status — which in turn has driven demand for long duration corporate bonds, as plans derisk by shifting from equities to long-dated fixed income.

Investment implications

Despite the weak start to the year, we believe the US investment grade corporate market still offers value and the repricing that has occurred in the first half of 2018 presents an opportunity for spread compression and performance in the second half of the year. However, with the current business cycle seemingly in the late innings and central bank policy normalization under way, we believe fundamental credit analysis and security selection will be the key differentiator for relative outperformance over an entire investment cycle.

1 UBS and Lipper, data through July 25, 2018.

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