The case for credit

Mark Kiesel | PIMCO | 01 September 2015

While the US economy continues to grow at a decent, though not stellar, rate of roughly 2.5% real GDP, softer global manufacturing activity, concerns over emerging markets growth and China's recent move to devalue its currency have led to a pickup in market volatility and a tightening in financial conditions. Although the global outlook may be slightly more uncertain, US economic fundamentals remain healthy, and growth above potential is causing the U.S. labor market to tighten, as evidenced by a greater-than 2% decline in the unemployment rate over the past two years to 5.1%. Over the past year, the US economy added 2.8 million private-sector jobs and over one million job openings, a 21% increase in openings.

With labor market slack declining, investors are sensing that the Federal Reserve will eventually raise short-term interest rates. Not surprisingly, companies have been issuing corporate debt aggressively to get ahead of an anticipated Fed "liftoff," forcing debt markets to digest what is on pace to be a record $1.15 trillion in new investment grade corporate bonds in 2015, an increase of 15% from last year. While heavy new issuance has caused credit spreads to widen, equities have also come under pressure due to a slowdown in corporate profit growth as well as the heightened market volatility and uncertainty surrounding global growth and Fed liftoff.

Despite these concerns, the outlook for developed credit markets, and in particular the US credit market, remains constructive. Here are three reasons supporting the case for credit now.

1. THE ECONOMIC EXPANSION WILL LIKELY KEEP DEFAULTS LOW

Credit markets tend to do well in economic expansions and poorly in recessions. In the US, a real rate of 2.25% to 2.75% economic growth is "not too hot, not too cold," and credit spreads are near the "sweet spot" as well, given the market is in an economic expansion. Importantly, credit spreads today look attractive relative to historical levels, in light of today's economic growth rate (Figure 1).

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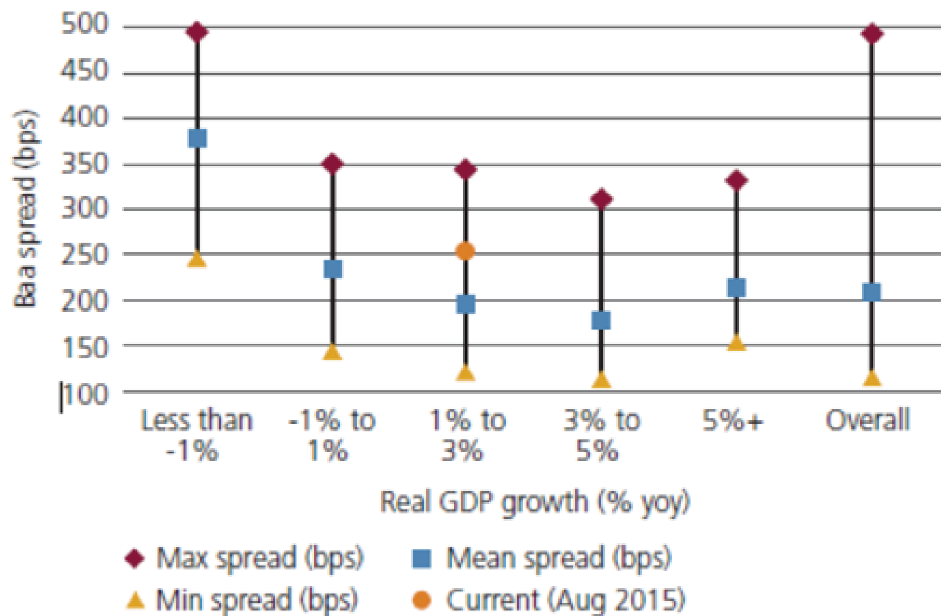
Figure 1: Triple-B credit spreads (20-Years+) versus real GDP growth



Sources: Federal Reserve Board, Bureau of Economic Analysis, Haver Analytics. 1967 - 31 August 2015.

Furthermore, the outlook for economic growth in developed markets remains supported by stable-to-improving fundamentals, a well-capitalised global banking sector and low imbalances in the private sector. While the Fed is expected to raise short-term rates at some point, it will likely remove policy accommodation at a gradual pace. Importantly, global central bank policy across most developed markets, including Europe and Japan, should remain highly accommodative, and policy is likely to ease in emerging markets in Asia, notably China. With healthy private-sector fundamentals and supportive global central banks, the economic expansion should continue to support a low default environment for the credit markets outside of a likely rise in the default rate in some higher risk credits in energy and commodity-related sectors.

The higher spreads in the high yield market today are implying an increase in the default rate, primarily caused by commodity-related sectors (Figure 2). The overall high yield market outlook away from this sector remains healthy based on a constructive view on developed market economic growth. Importantly, yield levels in high yield ex-energy and metals have risen, and they are attractive, particularly in the US market where fundamentals remain supportive (Figure 3).

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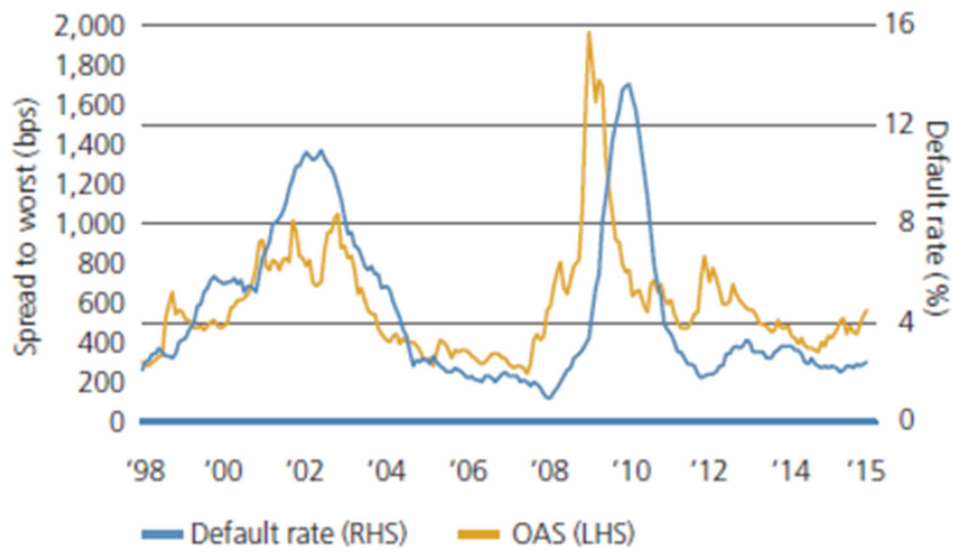
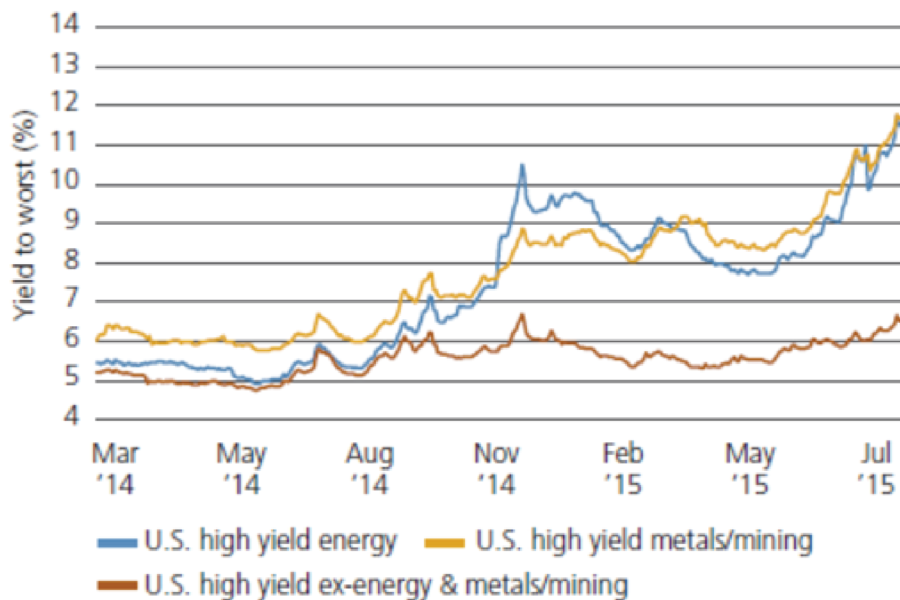
Figure 2: High yield spreads lead defaults



Source: Moody's (default) and BofA Merrill Lynch US High Yield Index (spreads), as of 31 August 2015.

Figure 3: Energy and metals/mining have significantly underperformed



Source: Barclay's US high yield indexes, as of 31 August 2015.

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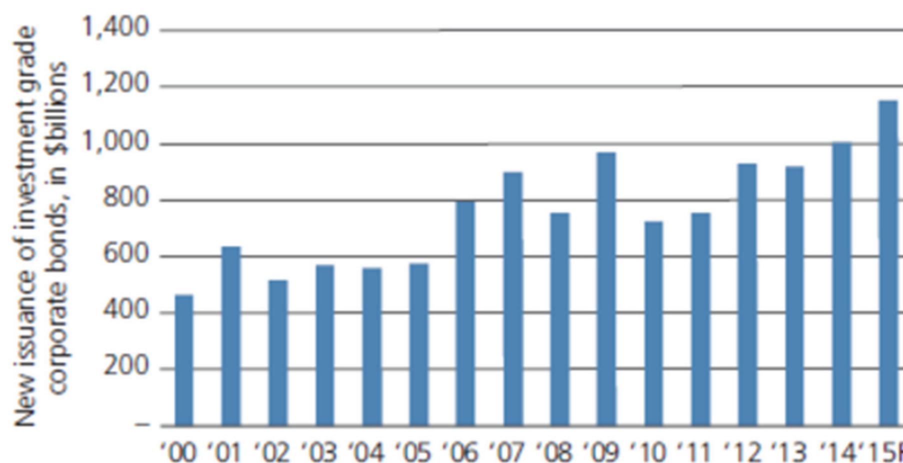
2. HIGHER INTEREST RATES SHOULD TIGHTEN CREDIT SPREADS

Low rate environments tend to lead to an increase in new corporate bond issuance as companies look to lock in cheap funding and, over the past several years, companies have in fact issued a significant amount of new corporate bonds to refinance and term out their balance sheets (Figure 4). At the same time, a low absolute level of interest rates typically attracts less demand as many investors have minimum yield and return targets.

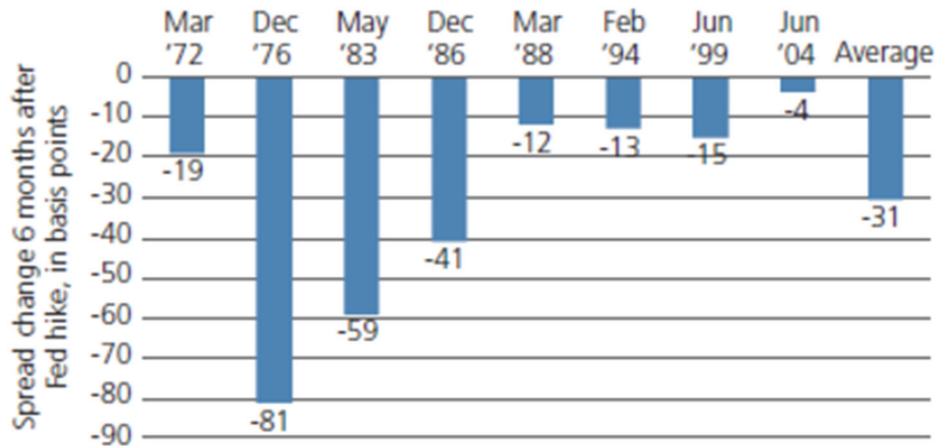
Figure 4: Recent high issuance of new corporate bonds



Source: JP Morgan, as of 11 September 2015.

Over the next year, however, higher interest rates are likely due to improving private-sector fundamentals, modestly higher inflation and a gradual tightening of monetary policy by the Federal Reserve. In a higher interest rate environment, new corporate bond issuance should decline while demand for credit-related assets from investors will likely increase due to higher yields. Historically, credit markets tend to outperform after Fed rate hikes, with tighter credit spreads as soon as six months after the first rate hike (Figure 5).

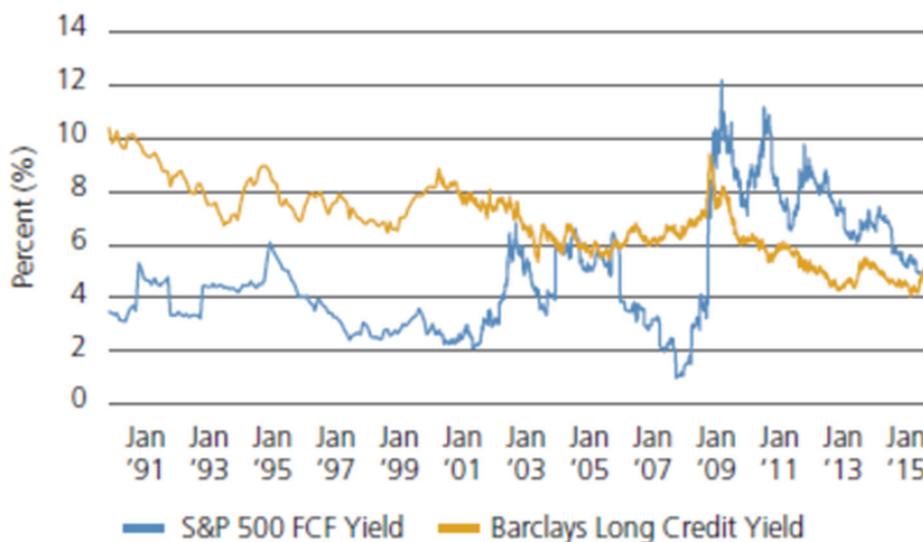
Figure 5: Triple-B corporate bond spread changes after first fed rate hikes



Source: Moody's Investors Service, as of 11 September 2015.

In addition, higher yields for corporate bonds in the context of a range-bound equity market should result in an asset allocation shift out of equities and into corporate bonds, particularly if profit growth slows next year, given that overall yields for corporate bonds are attractive today relative to the free cash flow yield on equities (Figure 6).

Figure 6: Long maturity corporate bond yields attractive vs. equities



Source: Bloomberg and Barclays, as of 11 September 2015.

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Bank loans are also attractive in an environment of rising interest rates. As a floating-rate instrument, bank loans tend to perform well because the all-in coupon rises as rates increase. Further, demand for floating-rate loans historically rises during rate hike cycles, as investors shift from more interest-rate sensitive strategies and equities to strategies that benefit from a rise in rates.

3. CREDIT SPREADS ARE ATTRACTIVE AT TODAY'S VALUATIONS

For investors, the main benefit of the significant amount of new corporate bond supply is that credit spreads have widened materially in 2015 (Figure 7).

Figure 7: Credit spreads have widened

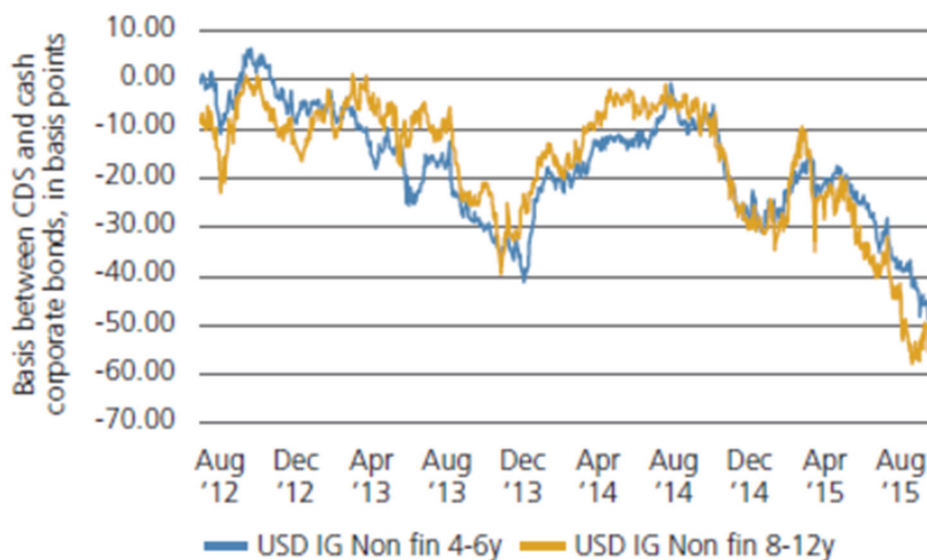
Source: J.P. Morgan US Liquid Index (Juli), as of 11 September 2015.

Large new corporate issuance has served a valuable purpose for companies in helping to keep future defaults low as balance sheets have been improved through the "terming out" of debt maturities into longer-maturity debt. With low near-term debt maturities and supportive economic growth, there are limited near-term catalysts outside of commodity-related areas for defaults to pickup. Given that current valuations are "pricing in" a pickup in defaults (Figure 2), the case for credit is compelling and investors should consider taking advantage of today's attractive valuations to add select credit risk.

An investor has two options to gain exposure to credit markets: 1) buying corporate cash bonds or 2) adding synthetic exposure via credit default swaps (CDS). CDS spreads essentially price the credit/default risk of a credit and are usually unaffected by the technical dynamics of the corporate bond market. However, corporate bond spreads are usually affected by demand/supply technicals in addition to the credit/default risk. In 2015, heavy

new issue supply has put pressure on cash corporate bond spreads and caused them to widen relative to CDS spreads (Figure 8). For these reasons, favour cash corporate bonds and new issues to selectively gain exposure now to the credit markets.

Figure 8: Cash corporate bonds have underperformed credit default swaps (CDS)



Source: IDC and Markit, as of 11 September 2015.

At current valuations, the credit market is attractive, given an outlook for supportive economic growth and low defaults. There are numerous opportunities today in US housing and housing-related industries, consumer, telecom and healthcare sectors, and in banks and financials. Any credit spread widening or market volatility that occurs around anticipated Fed rate hikes should provide attractive entry points for investors in the credit markets.

Mark is a Deputy CIO and managing director of PIMCO, and a member of the PIMCO Investment Committee. He is a generalist portfolio manager and the global head of corporate bond portfolio management, with oversight for the firm's investment grade, high yield, bank loan, municipal and insurance business as well as credit research. He has written extensively on the topic of global credit markets, founded the firm's Global Credit Perspectives publication and regularly appears in the financial media.

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