PUBLIC FIXED INCOME

Longing for Corporates

February 12, 2024

In many ways, it's only fitting that the presumed "Year of the Bond" closed with a dramatic and technically driven spread rally into levels unseen for over two decades. The Long Corporate Index closed 2023 as the 6th best calendar year ever on an excess return basis in the face of recessionary lending standards and restrictive monetary policy. Fundamentals have yet to materially deteriorate as the economy continues to outrun the "recession in 6 months" narrative, but we believe the all-in compensation for risk fails to account for the risks to credit moving forward. Admittedly, we have held this notion on all-in spread risk for a decent chunk of the recent rally and believe it's prudent to step back to dissect exactly how the Long Corporate market found its way to such tight levels. Even last quarter's rally in both rates and spreads, Long Corporate Index yields remain two standard deviations above their average for the last decade, which has deterred long end issuance.[1] CFOs have been reluctant to lock in the higher yields and shifted funding in on the curve when issuing debt. In many cases, companies simply do not have to issue after terming out their maturities or opportunistically borrowing at record low yields during the Covid period. On the M&A front, some companies are opting to fund deals with equity, and some companies who have historically borrowed to buy back shares have gone quiet. This has amounted to less debt issuance at the aggregate level versus two years ago, and an even smaller portion of debt issuance in the 30-year space.

[1] JP Morgan.

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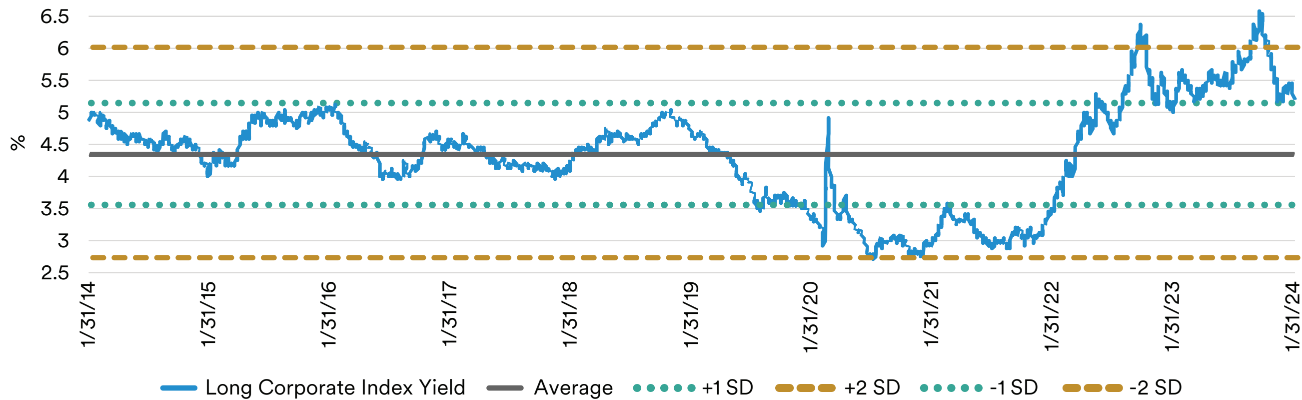
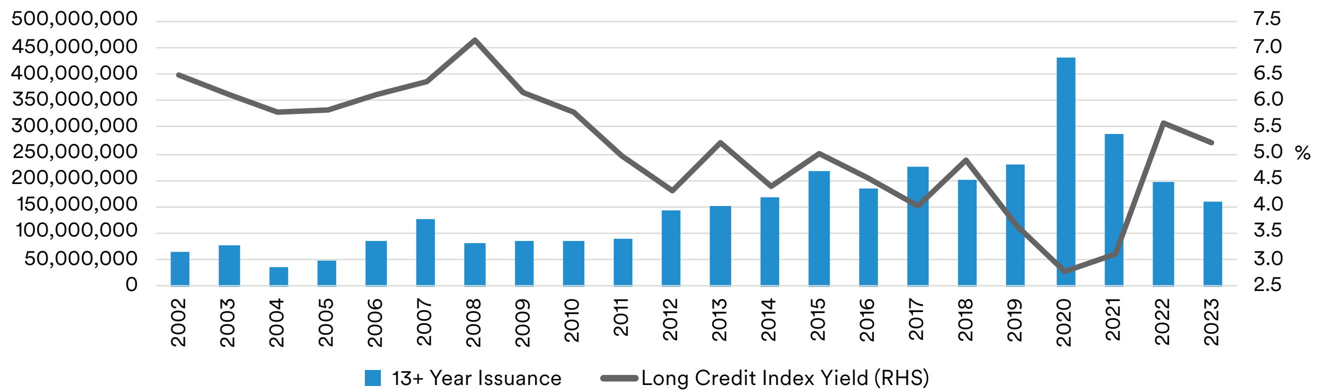
Figure 1 | Long Corporate Funding Costs Remain Near Decade Highs



Source: Bloomberg, as of January 31, 2024

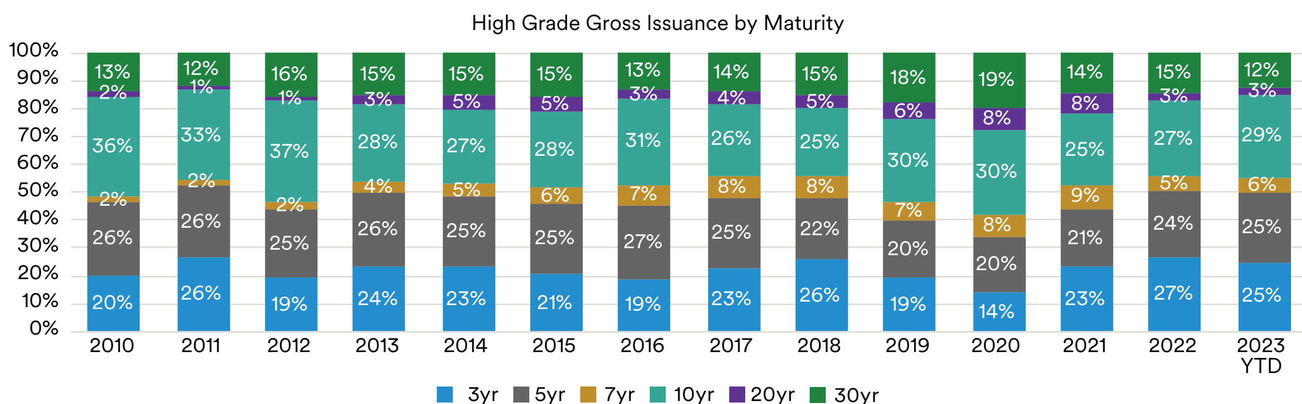
Figure 2 | Which Has Dried Up Long End Issuance



Source: Barclays, MIM, as of December 31, 2023

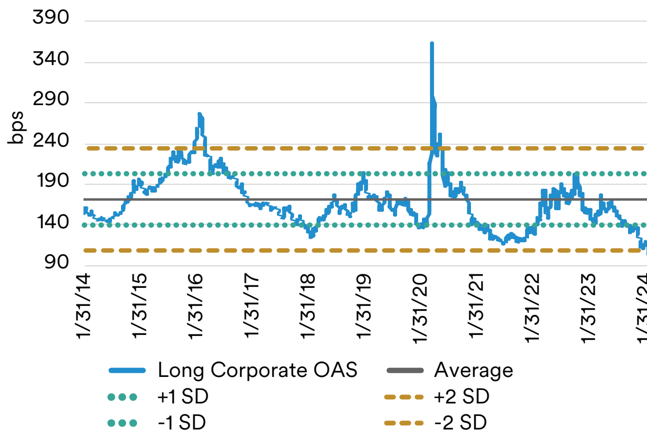
While higher yields have stymied long corporate issuance, they have also bolstered demand for long investment grade credit from the insurance community and overseas buyers. The mismatch between supply and demand has forcefully compressed index spreads, flattened spread curves, and led to broadly positive excess return for all subsectors of the index.

Figure 3 | Issuance Has Been Focused in on the Curve



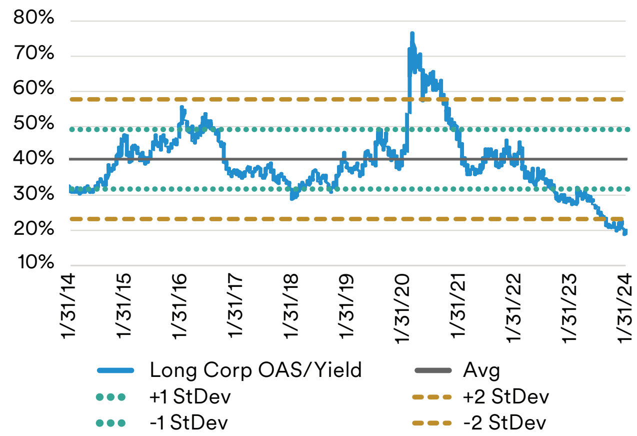
Source: JP Morgan, as of December 31, 2023

Figure 4 | Which Has Supported Long End Spreads



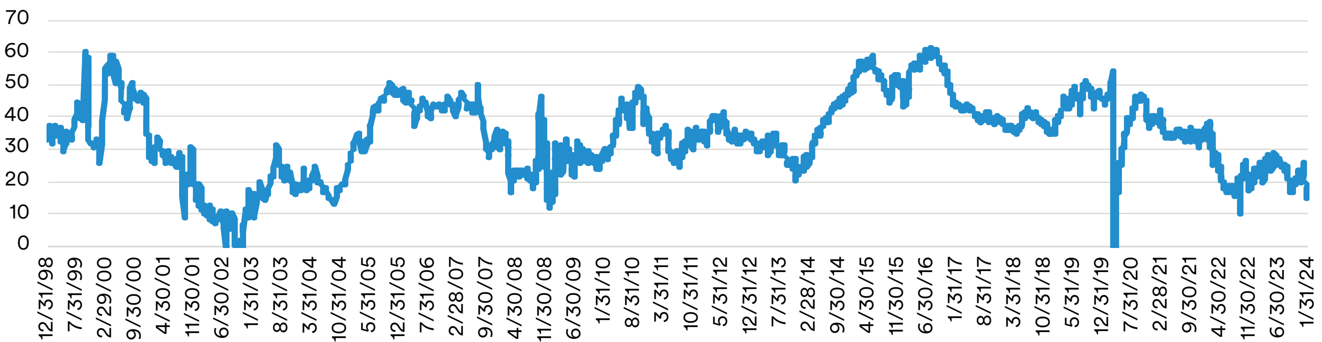
Source: Bloomberg, as of January 31, 2024

Figure 5 | Spread as a % of Yield Has Collapsed



Source: Bloomberg, as of January 31, 2024

Figure 6 | 10s/30s Credit Curves Have Flattened Dramatically



Source: Bank of America, as of January 31, 2024

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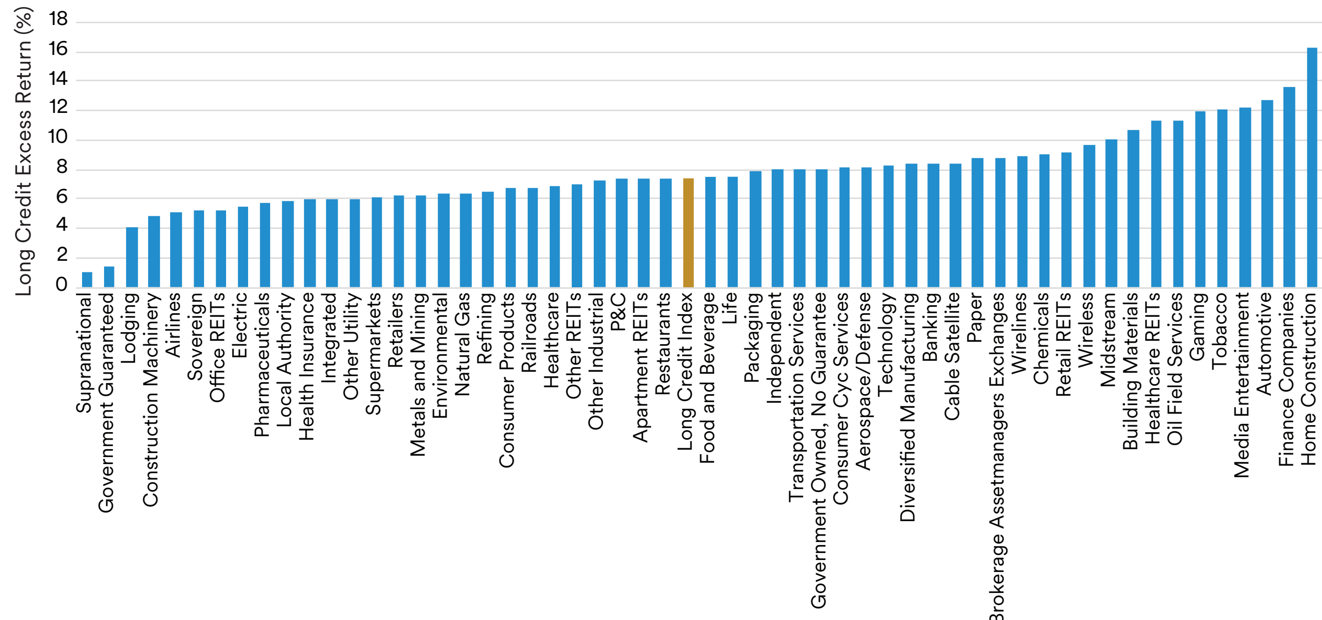
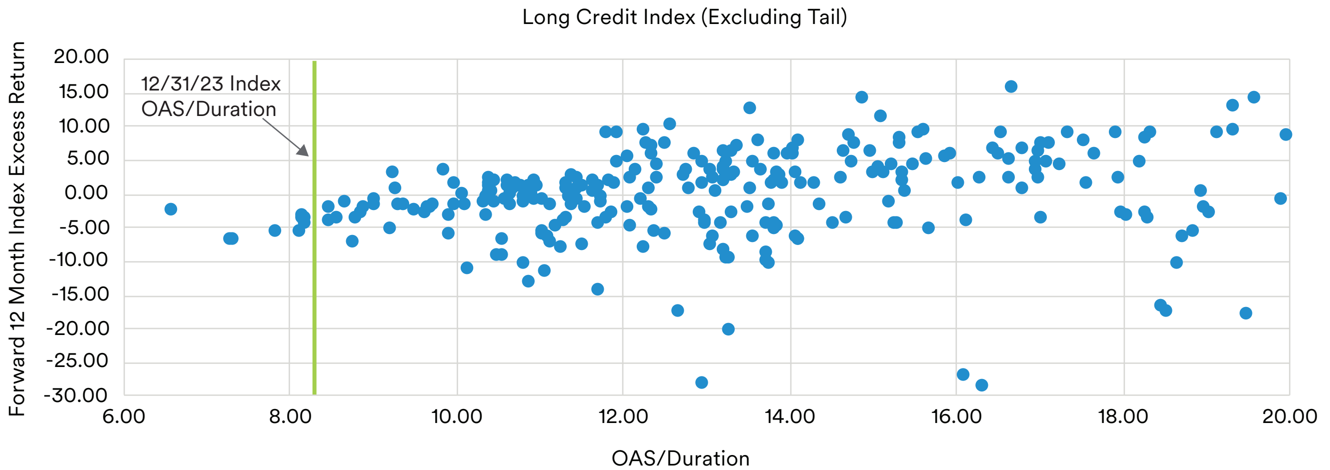
Figure 7 | 2023 Performance by Subsector



Source: MIM, Bloomberg L.P., as of December 31, 2023

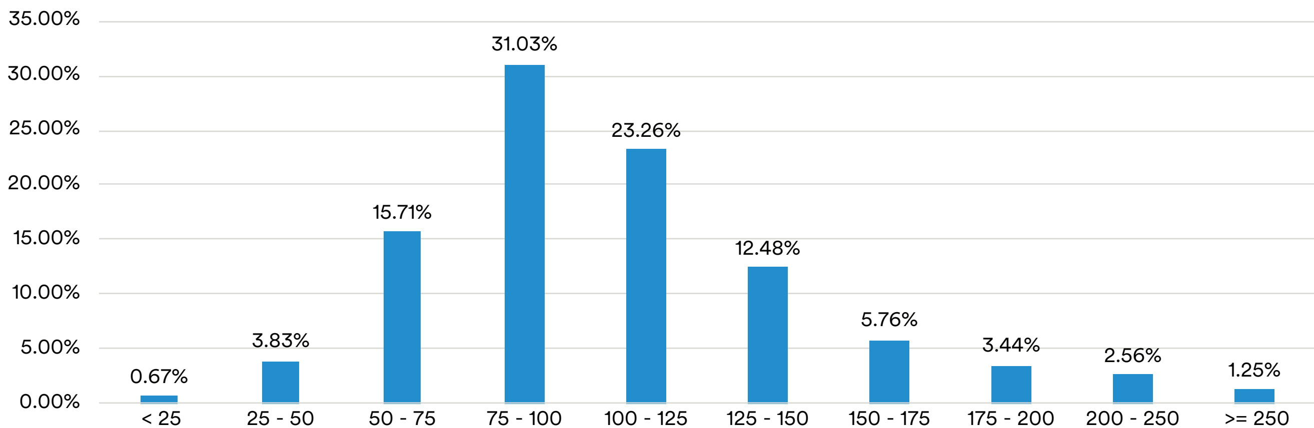
Given how far spreads have come, we are not enamored with spread valuations and believe history would suggest that these levels of spread skew Long Credit Index excess return potential to the downside (Figure 8). While much of the Long Corporate index is very high quality, it is difficult to find value in some of the tightest trading names, with north of 10% of the index inside of a 60 OAS. As an example, one AA rated technology name tightened from already low levels of 60 OAS to just 5 basis points over treasuries from the start of this year without any notable shift in fundamentals.

Figure 8 | OAS/Duration Would Suggest Risk Reward is Skewed



Source: MIM, Bloomberg L.P., as of December 31, 2023

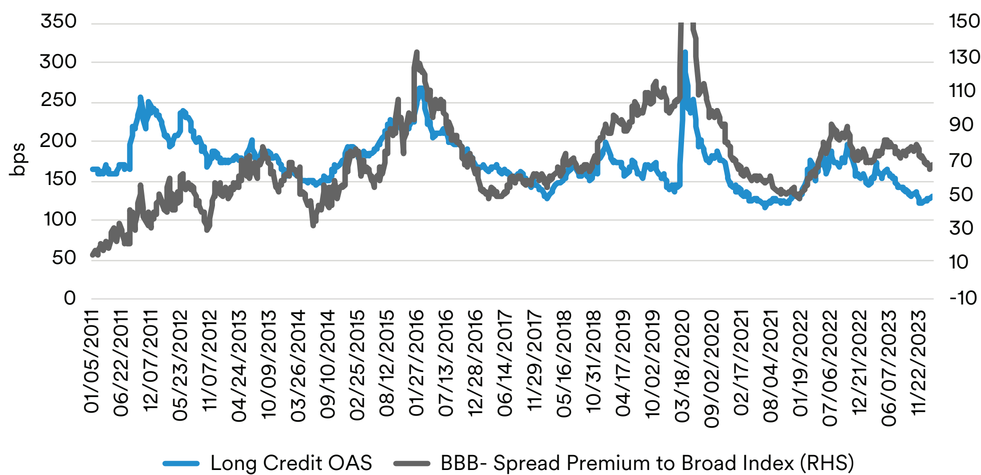
Figure 9 | Long Credit Index Spread Distribution



Source: MIM, Aladdin Solutions, as of January 31, 2024

That being said, the behavior of buying that has driven the most recent technical rally has opened up pockets of relative value opportunity. One area is low BBBs, that have been largely orphaned as insurance buyers, keen for AA risk at spreads inside of 50, do not want to introduce downgrade risk into their portfolios. As a result, the lowest rung of investment grade corporates in the long-end have not compressed into the market, shown in the left-hand chart below. Low BBBs as a cohort have outperformed, but largely due to their carry advantage and not to the extent we would expect. We believe our bottom up, fundamentally driven process is primed to sift through the space and find stable or improving credit stories unduly punished for their rating. Another interesting trend we've noticed has been compression of recently issued par bonds into comparable notes trading at a dollar discount. The rapid increase in yields over the past two years has called into question the true value of a discount bond relative to a par bond. The primary market has put some value on a dollar discount given the better convexity profile of the discount bonds and downside protection in the case of a negative credit event. Insurance companies, however, usually prefer to get their long yields from semiannual coupon payments, and not a 30 year pull to par from a discount. The outperformance has been noticeable and presents opportunities to swap into more defensive bonds in the same capital structure with comparable yields.

Figure 10 | Lack of Compression in Low BBBs



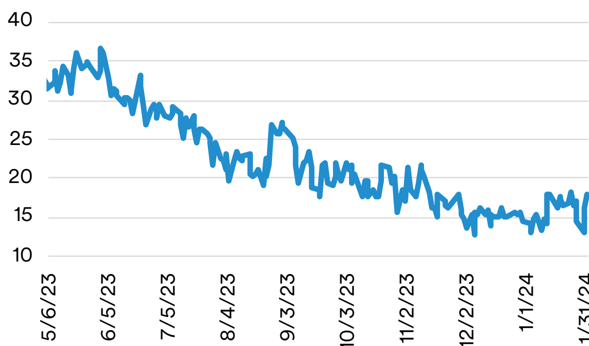
	2023 Excess Return
Total	**7.41**
AAA	5.08
AA	5.44
AA+	4.80
AA	5.86
AA-	5.49
A	6.29
A+	4.80
A	6.16
A-	7.16
BBB	8.88
BBB+	8.10
BBB	8.67
BBB-	10.52

Source: Bloomberg, as of January 31, 2024

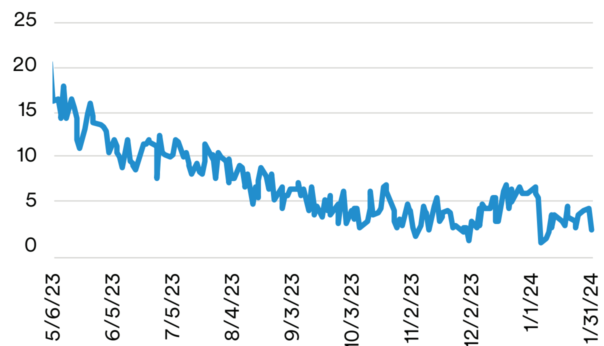
Figure 11 | Par Bond Compression Presents Some Opportunities

(bps)

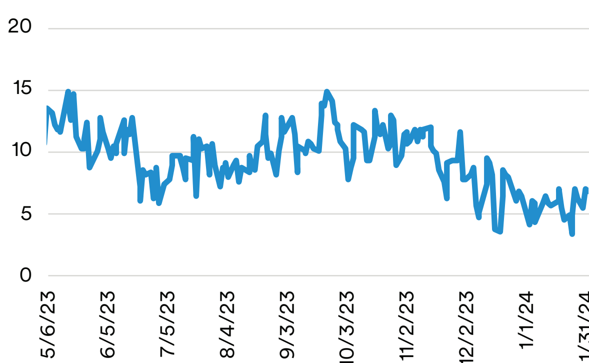
INTC 5.7 02/10/53 - INTC 3.05 08/12/51 Spread



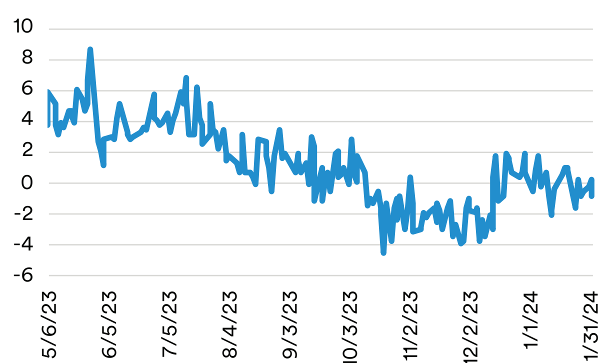
META 5.6 05/15/53 - META 4.45 08/15/52 Spread



ORCL 5.55 02/06/53 - ORCL 3.6 04/01/50 Spread



CVS 5 5/8 02/21/53 - CVS 5.05 03/25/48 Spread



Source: Bloomberg, MIM, as of January 31, 2024
For illustrative purposes only.

We believe it makes sense to sell into a technically supported market. Even with the imbalance of supply and demand, we find it difficult to make the case that investors in generic Long Corporate spreads are being appropriately compensated for the incremental credit risk over treasuries and remain underweight. We continue to favor a barbelled approach of BBBs and treasuries, and believe strong security selection and our active management can help traverse some of the overwhelming market technicals. Risk assets have happily settled into a goldilocks, soft landing path forward, but we still believe at some point fundamentals will matter for spread assets. In today's market, if it has a spread, a maturity and an investment grade rating you're "supposed" to buy it. In our opinion the Long Corporate market is plagued by a pervasive disregard for credit risk. When the economic tide goes out, we believe positioning down to the issuer and even bond level will materially differentiate returns for portfolios and our investment style is primed to navigate the opportunity set.

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