M&G Retail Fixed Interest

The case for credit: technicals, fundamentals, valuations

March 2015

While fixed income markets generally delivered strong returns in 2014, M&G's Retail Fixed Interest team believes that three key factors at play in the current outlook suggest value can still be found in the corporate bond markets. In particular, market technicals are supportive, fundamentals are attractive in a 'lowflation' world, and valuations are appealing with credit spreads currently being off the tights they reached in 2014.

QE pushes search for yield

In the busy macroeconomic backdrop for global bond markets in recent months, huge stimulus programmes from the European Central Bank (ECB) and Bank of Japan (BoJ) have been among the biggest headlines. Both central banks were responding to the low growth and inflation outlooks in Europe and Japan, aggressively expanding their quantitative easing (QE) measures in ways that have important implications for bond investors.

Government bond yields, already at or near historic lows, have been pressed down further against the prospect of these central bank bond buying programmes. Indeed, in Europe yields have even fallen into negative territory in the shorter dated segments of the German government bond market.

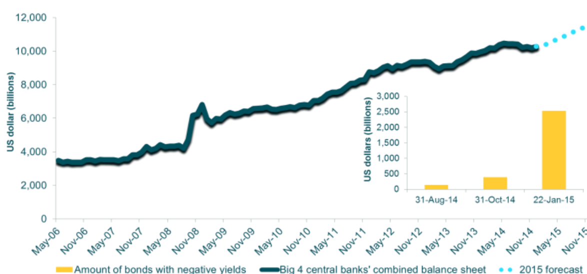
For M&G's Retail Fixed Interest team, this environment is expected to provide a highly supportive technical driver towards other areas of the bond markets. This originates from the massive expansion of the combined balance sheet of the Federal Reserve, Bank of England, ECB, and BoJ as a consequence of their respective QE packages (see figure 1). These 'big four' central banks effectively represent a new and very sizeable investor class, with further large expansion of this combined balance sheet set to follow from the latest moves by the ECB and BoJ. Largely due to the ECB's purchases, eurozone government bond markets face a particularly marked reduction of net supply in 2015, which should contribute to keeping yields low.

Not only has this QE activity supressed government bond yields, but the amount of government bond assets whose yields have turned negative has continued to rise steadily since last year's fourth quarter. By late January this year, the total size of these assets had reached over US$2.5 trillion. The potential for investor outflows from these bonds as their yields have turned negative should notably reinforce demand for riskier, positive-yielding assets including investment grade and high yield corporate bonds. In turn, this compelling technical factor should help to move credit spreads tighter.

Improving economy, good for credit

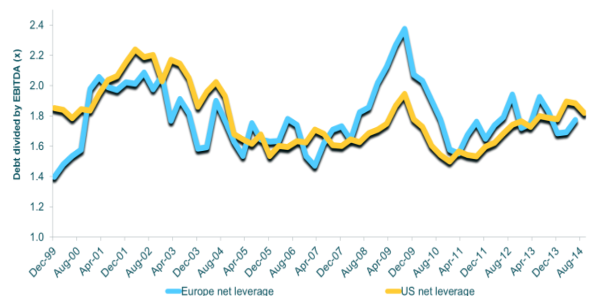
Looking at the fundamentals of the corporate bond asset class, the Retail Fixed Interest team notes that corporate net leverage in both the US and Europe remains at levels that do not cause concern (see figure 2). In terms of the wider economic outlook, the US economy continues to strengthen, oil prices have collapsed, and the ECB's looser monetary policy should stimulate the eurozone economy with a time lag, making concerns about recession and deflation in

Figure 1. 'Big four' central banks' combined balance sheet



Source M&G, Deutsche Bank, Bloomberg, 22 January 2015.

Figure 2. Credit fundamentals still look healthy



Source: Morgan Stanley, 30.06.2014 (Europe) and 30.09.2014 (US)

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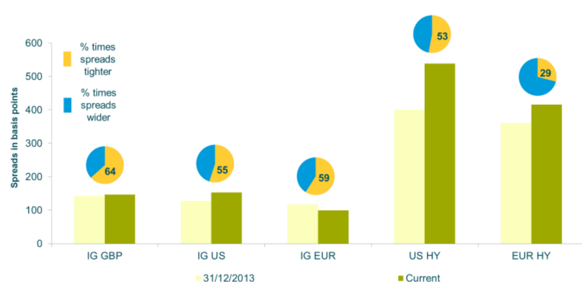
the region over-exaggerated. Importantly, the team believes that such key macro themes provide reasonable grounds for optimism in weighing up global economic prospects for the year ahead. Helped by these conditions, corporate bond default rates should remain low.

Events in the oil market also provide a potentially important tailwind for the global economic outlook. During 2014, the price of oil halved and the knock-on benefits of this huge move should be significant on economies that are big users of the commodity, such as in the G7 countries. An indication of the US economy's sensitivity to the price of oil may be seen from the correlation that every US recession since the 1970s has been preceded by a spike in oil prices. This supports the case for expecting further economic strengthening in 2015 as much cheaper oil has the reverse effect.

Figure 3. Credit valuations remain attractive



Source: Bloomberg, BoFA Merrill Lynch indices, 19 January 2015 (the chart considers data starting from 31 December 1995).

A similar relationship has existed among G7 gross domestic product (GDP) growth and changes in oil prices. It is worth noting, for example, that while the global recession of 2009 was brought on by the global financial crisis, it was not helped by a large increase in the price of oil to a peak of around US$150. In conclusion, the team expects the current very low oil price levels to help limit recessionary risk in the outlook for these key industrialised nations – helping to provide an environment that tends to favour corporate bonds.

In assessing corporate bond valuations, the team believes that there is room for spreads to narrow from what are elevated levels in the investment grade and high yield corporate bond markets. Spreads are currently wider compared to the end of 2013 across these asset classes in the US and Europe, with the exception of European investment grade bonds (see figure 3). Importantly, however, the latter is still considered to offer value as within this period spreads were tighter than their current levels for nearly 60% of the time. As always when investing in the corporate bond markets, selectivity and thorough credit research are key in seeking to maximise returns, while the value of liquidity should not be ignored in an environment of heightened volatility.

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