FLASH: 20 MAY 2022

Corporate bonds: not out of the woods yet, but...

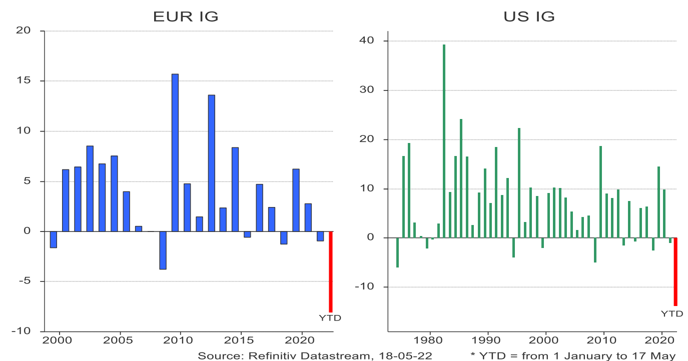
Summary

- Corporate bonds have been performing very badly since the beginning of the year, in Europe and the US, for both the Investment Grade and High Yield categories.
- Indeed, performance has been hurt by the rise in risk-free rates and the widening of risk premiums. As a result, corporate bonds now offer much more attractive yields than before. However, they are still not cheap.
- The macroeconomic environment is deteriorating, as are technical supply/demand factors. Fears of long-term high inflation are beginning to dissipate, giving way to fears of an economic slowdown.
- Credit spreads may widen further, but not substantially as corporate fundamentals are solid and default rates are expected to remain low.
- We are Neutral on the Credit segment. We prefer to have a defensive approach in view of the current macroeconomic environment and high volatility. We favour quality bonds, Investment Grade rather than High Yield, short maturities in Europe, and short to intermediate maturities in the US.

A calamitous start to the year

The performance of corporate bond returns has been very poor year-to- date: -8.3% for European Investment Grade (IG) corporate bonds as at 17 May, -13.8% for US IG, -8.1% for European High Yield (HY) and -10.4% for US HY. This is the worst performance for the period running from 1 January to 17 May since the creation of the indices (between 1973 and 2000 according to the indices), with the exception of European HY, which had fallen by 10.8% from 01/01/2020 to 17/05/2020.

ANNUAL TOTAL RETURN OF INVESTMENT GRADE CORPORATE BONDS



Source: BNP Paribas Wealth Management

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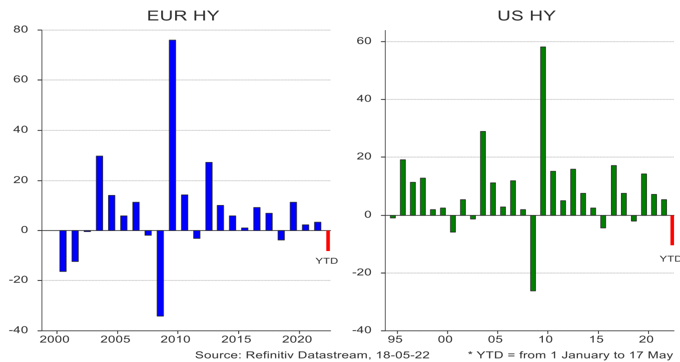
ANNUAL TOTAL RETURN OF HIGH YIELD CORPORATE BONDS



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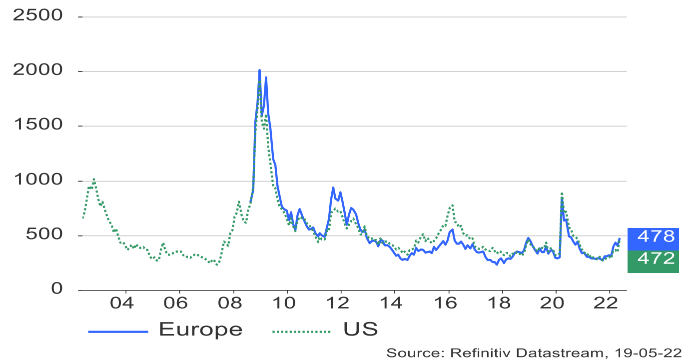
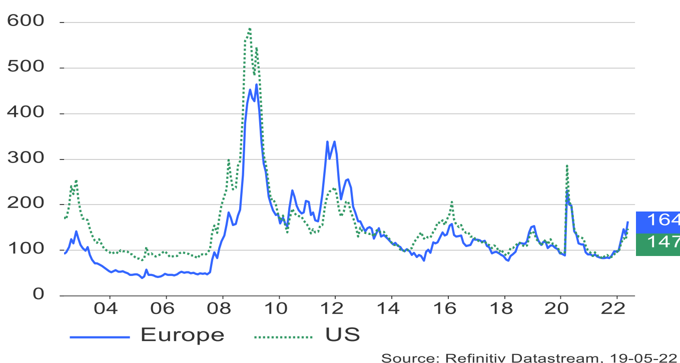
HIGH YIELD CORPORATE BOND SPREADS (IN BPS)



Source: BNP Paribas Wealth Management

Corporate bonds have been badly affected by i) the sharp rise in interest rates, with the yield on the German bund jumping by 124bps (basis points) or 1.24% since the beginning of the year and the yield on the US Treasury by 147bps and ii) the widening of risk premiums (credit spreads) by around 68bps for euro IG, 50bps for US IG and 165bps for euro HY and US HY.

INVESTMENT GRADE CORPORATE BOND SPREADS (IN BPS)



Source: BNP Paribas Wealth Management

As a result, yields offered at maturity (the YTM) have become significantly more attractive than before. The days when euro corporate bonds had negative yields at maturity is almost over. IG bonds offer average yields of around 2.3% in Europe, 4.5% in the United States, and HY bonds offer 6.7% in Europe and 7.6% in the US.

Is now the time to buy?

More attractive valuations

Valuations were very tight last year. Corporate bond spreads have now returned close to their long-term average or even slightly higher for European bonds. Credit is therefore no longer expensive, but it is not really cheap either. In addition, other valuation models, which take into account volatility and leading indicators of economic activity (PMIs), suggest that euro and dollar HY spreads could widen further. This would also be consistent with the credit cycle.

Credit cycle

Indeed, credit returns and risks are highly cyclical. The credit cycle is now in the late phase. The recovery phase is behind us and we are now in an expansion phase at the end of the cycle. In this phase, credit becomes a risky asset. Companies are re-leveraging, central bank monetary policies are becoming restrictive and investors are complacent. Volatility is high and performance is falling into the red.

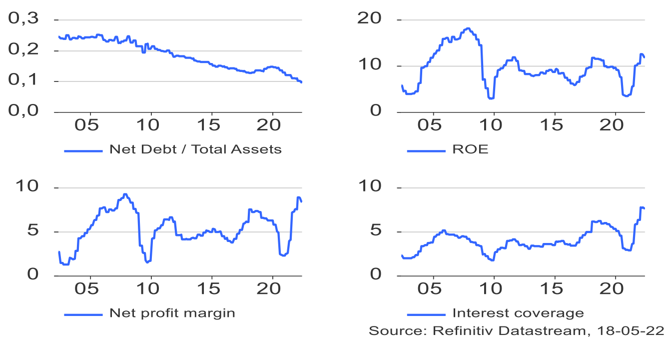
Strong fundamentals

Companies, on the other hand, are much stronger than in the past. They took advantage of the economic growth of previous quarters to shore up their balance sheets, build up cash reserves, reduce debt and improve their interest coverage ratio. Furthermore, they took advantage of last year's extremely low interest rates to refinance themselves with very advantageous terms and extend the maturity of their debt.

The Q1 earnings season is not yet over but more than two-thirds of companies have already published their results. Earnings have surprised to the upside on average, but less so than in the last reporting period, in the US but above all in Europe. It is therefore likely that credit quality has peaked.

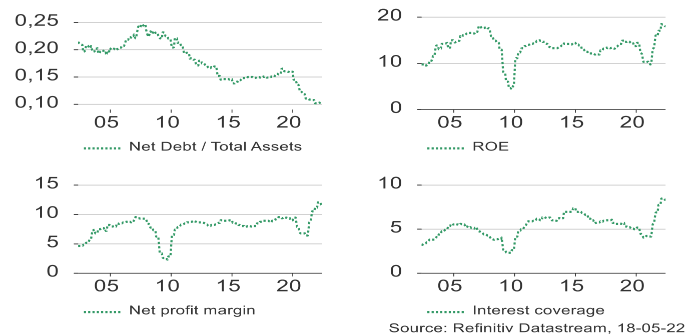
However, companies are in a better position than in previous cycles to face the deterioration of the macroeconomic environment and technical factors.

HEALTH INDICATORS OF EUROPEAN COMPANIES



Source: BNP Paribas Wealth Management

HEALTH INDICATORS OF US COMPANIES



Source: BNP Paribas Wealth Management

Deteriorating macroeconomic environment

The geopolitical risk has increased in the wake of the Russia-Ukraine conflict. Inflation is very high. Companies' production costs are rising, some of which will be passed on to the end customer but some will need to be absorbed in the margins. In addition, monetary conditions (a measure of cost and ease of access to credit) are tightening under the influence of central banks and have now entered restrictive territory in the US and the euro area.

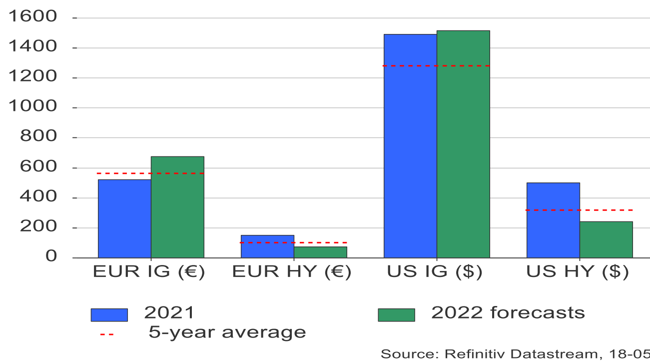
Deteriorating technical factors

Supply: the momentum of new issues should remain strong for IG issuers this year. We expect 2022 issuance to expand compared with last year (EUR 670 billion in Europe and USD 1.5 trillion in the US). Recently, new bond issues have been accompanied by attractive concessions to attract investors and have generated strong demand.

In contrast, the primary High Yield market is likely to be much less active than last year as it is correlated with volatility and risk appetite. In addition, refinancing costs are much higher than in 2021. The number of new issues has been very small since mid-February, and virtually non-existent in Europe. Companies are looking for windows of opportunity to issue bonds. Half of the issuance in April in the US took place in the space of four days, and about one-third of issuance in March took place over five days. We expect 2022 bond issuance to be half that of 2021, with EUR 72 bn of new issues in Europe and USD 240 bn in the US.

About one third of European and US corporate bonds, both IG and HY, will mature at the end of 2014. The "debt wall" is therefore still relatively far away.

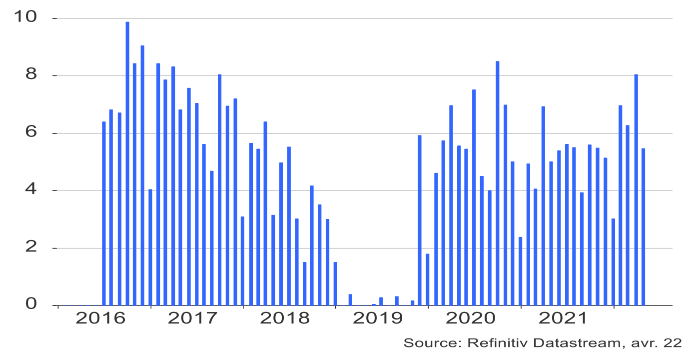
CORPORATE BOND GROSS SUPPLY (IN BN)



Source: BNP Paribas Wealth Management

Demand: compared to the supply dynamics described above, demand is expected to slow down. Long-term investors (pension funds, insurance companies, asset and liability managers) may be attracted by higher yields while other investors may fear the impact of the withdrawal of central banks. The American Federal Reserve should have an impact on the credit market by tightening financial conditions. The ECB will have a more direct impact as it stops buying corporate bonds probably towards the beginning of Q3. It has bought an average of EUR 6.6 bn of corporate bonds per month since the beginning of the year. And it started to slow down purchases from EUR 8.0 bn in March to EUR 5.5 bn in April. In recent months, it has bought between 15% and 20% of new issues. Private investors will need to step in to replace it.

MONTHLY NET PURCHASES OF CORPORATE BONDS BY THE ECB (IN BN)



Source: BNP Paribas Wealth Management

Low albeit climbing default rates

The likely slowdown in future economic activity, coupled with soaring inflation and much higher refinancing rates, could lead to credit rating downgrades for some companies, or even defaults for the most vulnerable.

Credit ratings: the momentum of credit rating upgrades/downgrades (the ratio of increases/decreases of the three main rating agencies, S&P, Moody's and Fitch) remains very upbeat for US IG corporate bonds. The same applies to European IG bonds, but to a lesser extent. Conversely, the momentum for HY has deteriorated since the end of 2021. However, the US HY still records slightly more rating upgrades than downgrades, but this is not the case for European HY which has suffered more rating downgrades than upgrades year-to-date.

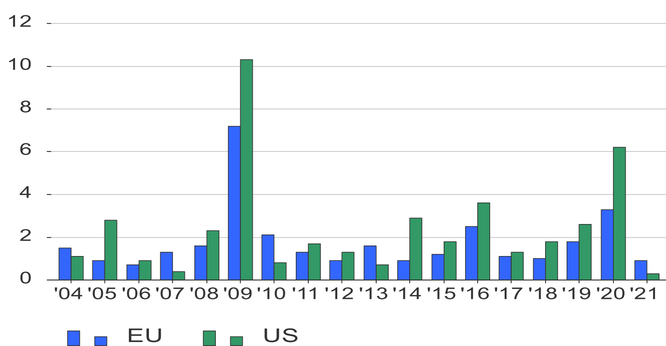
As for the IG-HY migration, since the beginning of the year, there have been more fallen angels (IG-rated companies downgraded to HY) than rising stars (HY promoted to IG) in Europe. The opposite is true in the US.

Default rates: default rates should rise but remain at extremely low levels, below the historical average of 2.2% excluding recessions. The rating agency Fitch estimates it will rise from 0.7% at the end of 2021 to 1.5% at the end of 2022 for European HY companies. In the US, it is expected to reach 1% by the end of 2022 and 1-1.5% by the end of

2023, compared with 0.5% in 2021. The default rate is expected to be lower in the US than in Europe due to less exposure to Russia and Ukraine and abundant liquidity. Moreover, rising energy prices are more beneficial to US HY, as this sector represents 13% of the index, compared with 2% for European HY.

Paradoxically, the risk premium for very low quality euro HY bonds (rated CCC) is low relative to the asset class, by historical comparison. Investors seem quite complacent about the default risk of European CCC bonds.

NOTIONAL-WEIGHTED DEFAULT RATES (IN %)



Source: BNP Paribas Wealth Management

Credit spreads could widen further

Credit spreads have widened massively since the lows of mid-2021, reflecting a multitude of risks, such as inflation, tightening monetary conditions, fears about economic growth, the ability of the US Federal Reserve to engineer a soft landing for the economy, the risk of rising default rates, volatility... Some risks already seem fairly-valued, but not all of them. The upcoming earnings season should shed more light on companies that can absorb rising refinancing costs and those which will be penalised by the market when they announce downward earnings revisions. In short, credit spreads may widen further, but the absence of a substantial rise in default rates should curb the rise.

Our opinion

We have a Neutral view on Credit. Credit spreads could widen further but the default risk remains limited. Break-even ratios have more or less returned to their historical averages, suggesting that carry once again provides a cushion for widening spreads.

We prefer to have a defensive approach in view of the current macroeconomic environment and high volatility. We favour quality bonds, and Investment Grade rather than High Yield.

We prefer short-term bonds in Europe due to the risks associated with the ECB's monetary policy. In terms of relative valuation, short-dated bonds are also cheaper at the moment than long-dated bonds in historical comparison. Yield to Maturity is around 1.5% for bonds with maturities of between 1 and 3 years, and 2.1% for bonds with maturities of between 3 and 5 years.

In the US, we favour short and intermediate maturities because the yield pickup offered by longer bonds is very low. In addition, short- and medium-term bonds are rather cheap in terms of relative valuation compared to long-term bonds in historical comparison. Yield to Maturity is 3.6% for 1-3 year maturities, 4.1% for 3-5 year maturities and 4.5% for 5-7 year maturities.

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