Attractive Valuations in Short Dated Investment Grade Credit

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SUMMARY

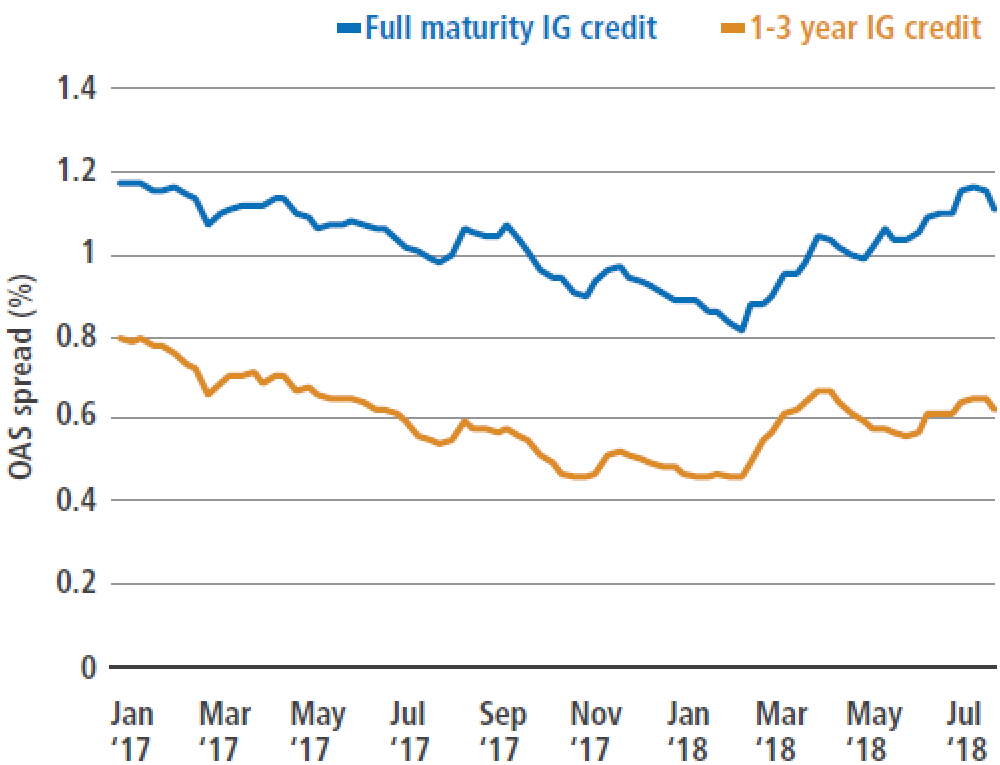
- In short-dated (one- to three-year maturity) U.S. investment grade (IG) credit, supportive technical factors have combined with fundamental strength to create attractively priced entry points.
- Short-dated IG bonds have historically tended to offer more stable returns and lower volatility than full-maturity corporate bonds, as well as lower actual default risk. They also tend to be less sensitive to interest rates.
- Active credit research, including thoughtful, rigorous analysis of individual issuers and securities, is critical. This remains an environment for selectivity in credit.

Corporate credit is a market where we believe investors should be selective and exercise caution as the global economy reaches the later stages of a long expansion. Within the broader credit sector, however, we find pockets of value – particularly among short-dated (one- to three-year maturity) U.S. investment grade corporate bonds, where technical factors have combined with fundamental strength this year to create attractively priced opportunities.

One reason we see value now is the relative underperformance. U.S. IG corporate bonds overall have underperformed both high yield bonds and equities year-to-date on a beta-adjusted basis (as of 30 June 2018, as proxied by the Bloomberg Barclays U.S. Aggregate Credit Average OAS (Option-Adjusted Spread) Index, the Bloomberg Barclays U.S. Corporate High Yield Average OAS Index and the S&P 500, respectively).

Further, relative to full maturity IG credit, short-dated IG credit spreads over like-maturity U.S. Treasuries have widened in a similar magnitude as full maturity credit since the beginning of 2017, while offering a lower risk profile and thus underperforming on a beta-adjusted basis (see Figure 1).

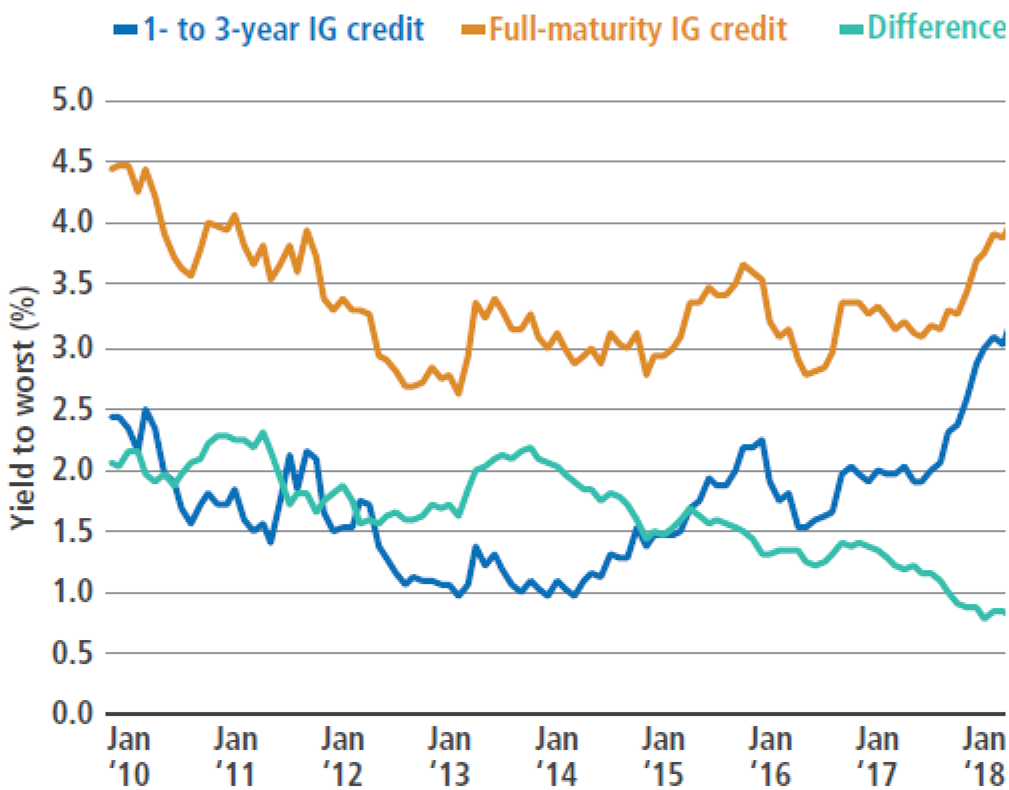
Figure 1: Short-dated IG credit spreads over Treasuries have moved generally in tandem with full maturity IG credit despite lower risk



Bloomberg as of 13 July 2018

In addition, the front end (one- to three-year) of the IG credit index has underperformed the full IG index from a yield perspective (see Figure 2), primarily due to selling by non-U.S. holders as the costs of currency hedging have risen. We believe these trends point to an attractive relative value for short-dated IG credit today.

Figure 2: One- to three-year investment grade corporate bonds have underperformed the broad credit index



Source: Bloomberg as of 29 June 2018. **Past performance is not a guarantee or a reliable indicator of future results.** One- to three-year investment grade (IG) credit is represented by the Bloomberg Barclays U.S. Corporate 1-3 Year Average OAS (option-adjusted spread) Index; full-maturity IG credit is represented by the Bloomberg Barclays U.S. Aggregate Credit Average OAS Index. It is not possible to invest directly in an unmanaged index.

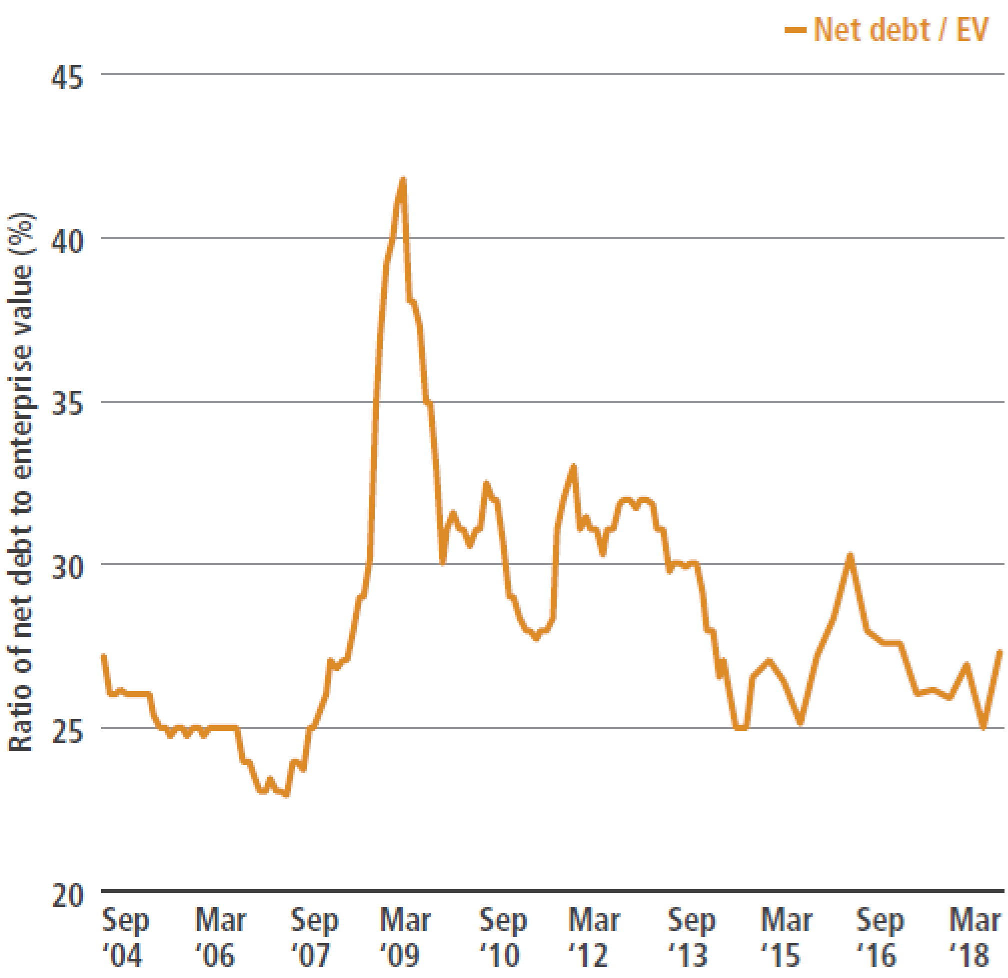
Relative valuations appear attractive as well, with average one- to three-year IG corporate bond yields trading 1.8 percentage points above equity dividend yields (the largest gap since 2010). They are also trading just 1 percentage point below the full-maturity IG credit index, which represents the flattest credit yield curve since 2010, primarily due to the significantly flatter U.S. Treasury yield curve and the underperformance of short-dated bonds.

Thus, one- to three-year IG corporates may appeal to investors who are concerned that the credit yield curve will begin to steepen, but do not want to give up their exposure to credit with its potential yield over traditional cash-like investments.

Fundamental improvement among investment-grade issuers

What about the health of issuers? Based on the most recent completed earnings round (Q1 2018) as reported by J.P. Morgan, U.S. investment grade companies overall continued to strengthen: Year-over-year, EBITDA (earnings before interest, taxes, depreciation and amortization) are up 10.7%, revenue has grown 8.3% and capital expenditures are up 4.4%. Despite rising interest rates, interest coverage is still decent at 10.2x and net leverage is relatively stable at 2.8x, particularly given the rise in equity market capitalization (the ratio of current net debt to enterprise value is 27% – see Figure 3). Many U.S. companies have also benefited from the Trump administration's recently enacted tax reform.

Figure 3: Among investment grade companies, the ratio of net debt to enterprise value is stable



Source: Bloomberg as of 31 March 2018

While merger-and-acquisition activity has been on the rise, as well as dividends and cash returned to shareholders (up 14.6% year-over-year), the impact on the fundamentals of IG companies has remained somewhat subdued given the overall strength of the U.S. economy and the private sector.

As always, credit research and thoughtful, rigorous analysis of individual issuers and issues are critical. This remains an environment for selectivity in credit.

Supportive supply/demand profile

Year to date in 2018, the average maturity of newly issued investment grade corporate bonds is around 1.2 years longer than it was last year. This is mainly because companies are taking advantage of the flat yield curve to term out their debt maturity profiles. Some companies (such as large-cap telecoms) have tendered or switched out of their front-end bonds, again due to the flatness of the yield curve. This dynamic should help ensure that short-dated IG corporate issues will remain well-supported. Historically, the supply of short-dated bonds (i.e., those with maturities under five years) has usually been lower than the supply of medium- and long-term bonds combined, and the current supply is significantly more constrained than in previous years.

We may see supply dwindle further as U.S. investors step into the market, drawn by the elevated yields and attractive valuations of short-term IG bonds. Rising hedging costs could translate into less demand from some non-U.S. investors, but overall yields – especially at the front end – have become more attractive to others due to recent spread underperformance. It should be noted that many non-U.S. institutional accounts exclude high yield and crossover bonds from portfolios, so demand is likely to be concentrated in IG credit.

Key takeaways

At current prices, short-dated investment grade corporate bonds offer an attractive risk/reward profile, in our view. They have historically tended to offer more stable returns and lower volatility than full-maturity corporate bonds. They tend to be less sensitive to interest rates, a potentially attractive feature in a moderately rising rate environment. And they tend to be more resilient in unexpected economic downturns given lower default risk and better earnings potential in the short term versus a longer horizon.

Considering such strong fundamentals and supportive technicals, we see a compelling argument for front-end IG corporates.

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