

CREDIT SPREAD TIGHTENING HAS FURTHER TO RUN - MAYBE TO THE LOWEST LEVEL SINCE THE GFC

Investment-grade credit spreads are going back to the low levels seen pre COVID-19 over the next 12 months. That is our base case. The question is, how do we get there after the strong recovery in spreads we saw following the significant sell-off in March? We view the main driver as being the unprecedented level of Central Bank support and government fiscal actions. Corporate balance sheet resilience and a declining trend in downgrades and fallen angel activity will also provide a boost. Finally, with some of the higher quality, defensive names already nearly back to the tight levels seen pre COVID-19, we expect the compression of cyclical sector spreads that lagged in the initial rally to drive further index spread narrowing.

If we add a V-shaped economic recovery and a vaccine for COVID-19 into the mix, we could even see spreads rally to well inside the previous low point of the post-GFC era, which is our bull case. The risk to our view is a severe second wave of COVID-19, leading to a more prolonged economic slump and higher levels of corporate stress. In this case, we see spreads back to normal recessionary levels.

In the context of our strong base case outlook for a continued rally in spreads, we expect to see spreads in select cyclical sectors outperform.

US Credit Spread Review and 12 Month Outlook



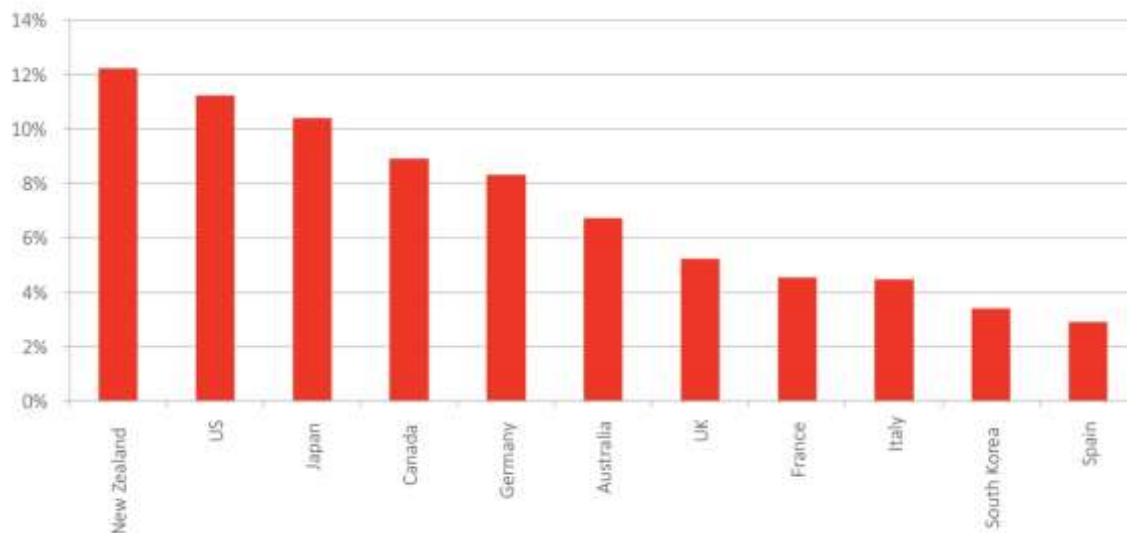
Source: FTSE, QIC as at June 2020

Don't fight the Central Banks or Governments

The extraordinary actions by global central banks, particularly the Fed and the ECB, are set to continue providing a strong tailwind for credit spreads. The most apparent tailwind is through the commitment to purchase corporate bonds through the ECB's Corporate Sector and Pandemic Emergency Purchase Programmes and the Fed's Primary and Secondary Market Corporate Credit Facilities. Notably, the Fed has indicated it is looking to facilitate "sustained improvement in market functioning, to levels at or near those prevailing prior to the COVID-19 dislocation". Also, the significant amount of excess liquidity created through central bank actions must go somewhere, and the low or negative interest rate environment means holding it in cash for an extended period is not an attractive option, fostering a hunt for yield. The quest for yield has already been evident through the recent strong inflows into investment grade credit funds and ETFs. Central banks have indicated they anticipate keeping supportive monetary policy measures in place for an extended period.

Government fiscal measures have also helped to ease concerns in credit markets in a variety of different ways including direct actions to prevent the defaults of viable businesses through bailouts, government guarantees and by working with banks to facilitate loan and forbearance programmes. Additionally, measures to support the recovery in economic growth are generally supportive of credit markets.

Fiscal stimulus (ex loan guarantees, % of GDP)



Source: QIC, UBS as at June 2020

Corporate behaviour favouring bondholders, downgrades on the decline

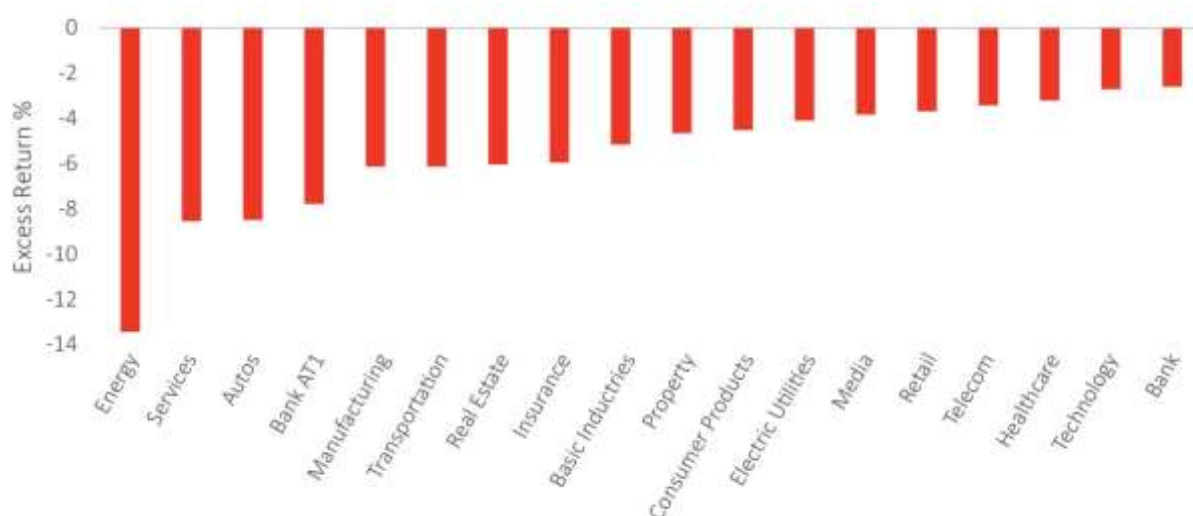
Throughout the crisis, corporates have focused on building balance sheet resilience and a war chest of liquidity to survive the crisis. The response was initially evident through the drawdown of bank facilities and then through record amounts of issuance in the investment-grade primary markets. Companies cancelled share buybacks and cancelled dividends when it was prudent to do so. As economies reopen and business begins to return to normal, companies will continue to focus on repairing balance sheets by reducing leverage at the expense of shareholder returns (e.g. Qantas equity capital raise in June 2020). The focus on deleveraging will have a secondary impact of reducing new issue supply going forward as companies look to deploy excess liquidity towards debt reduction by paying down maturities or tendering for shorter-dated bonds. Reduced net new issue supply will provide a supportive technical for credit spreads.

In recent weeks there has been a significant deceleration in the pace of investment-grade rating downgrades with fallen angel activity also drying up. Several investment banks have even recently begun revising down their forecasts for high yield peak default rates in recent weeks. This all points to the increasing recognition that the permanent damage to corporate balance sheets is likely to be more modest than initially anticipated.

Further compression of cyclical names to come

While investment-grade spreads have rallied significantly from the sharply wider levels seen in March/April, most of the tightening to date has been in the higher quality defensive sectors that have either been beneficiaries of the COVID-19 lockdown situation or not directly impacted. These spreads are now very close to or already at pre-pandemic levels. With the overall index levels still being roughly 50bps wider than the tightest year to date level in January, going forward we expect to see compression of the cyclical names that have lagged the rally to bring the index back to pre-pandemic levels. With this in mind, we will look to implement a measured increase in exposure to select cyclical sectors, using robust bottom-up analysis to identify issuers and securities with the best risk versus reward profiles.

US IG YTD Excess Return Dispersion by Sector



Source: Credit Suisse as at June 2020

Conclusion

Our overweight credit view initiated in March has played out well for our clients. Despite the significant rally in spreads since then, we still see strong reasons why credit spreads will continue to tighten back to pre-pandemic levels within the next 12 months. Under the right conditions, it would also not be out of the question to see spreads tighten to well inside the lowest levels recorded post-GFC. While risks remain that could cause spreads to widen out to recessionary levels, we see a lower likelihood of this playing out. Hence, we continue to have high conviction that our overweight credit view will deliver meaningful excess returns over the next year. This will be enhanced by sector and security selection opportunities which warrant a measured increase in exposure to select cyclical sectors and issuers. In and beyond a world impacted by COVID-19, bottom-up credit research is as important as ever and will be critical to capturing optically attractive returns and avoiding issuers with under-priced COVID-19 challenges.

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