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THE SUSTAINABLE FUTURE PROCESS

Attractive entry point to corporate bonds

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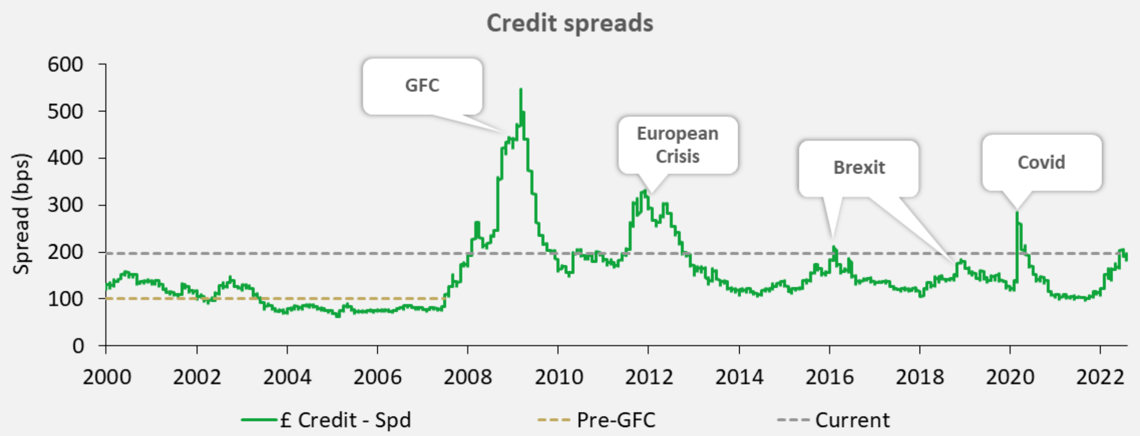
Aitken Ross and Kenny Watson explain why investment grade corporate bonds look attractive despite the potential for rising default rates as a tough economic backdrop bites.

The ICE BofA Sterling Corporate Index has returned -18% this year (as at 31.08.22) due to a combination of rising government bond yields and widening corporate bond spreads.

While an outlook of persistent inflation, higher interest rates and a cost of living squeeze suggests that some businesses face a very challenging operating environment, we think the average investment grade company is in reasonable shape to face this and, as a result, spreads on corporate debt have now widened – as shown in the chart below – to what we believe are attractive levels.

ICE BofA Sterling Corporate Index

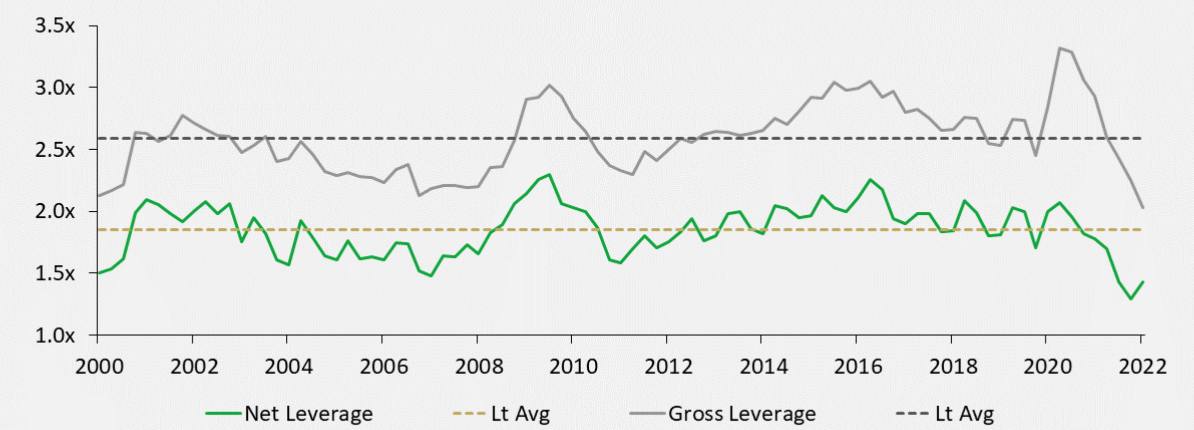


Source: Liontrust, Bloomberg, as at August 2022

Looking at balance sheets, corporates are in a healthy position. Over the course of the pandemic, many corporate treasurers took advantage of favourable refinancing conditions to lock in low funding rates over longer time periods.

Average leverage (debt as a multiple of earnings) is also very conservative across the market. Both gross and net leverage are at, or close to, record lows, as illustrated in the following chart; net leverage simply offsets cash on the balance sheet against gross debt.

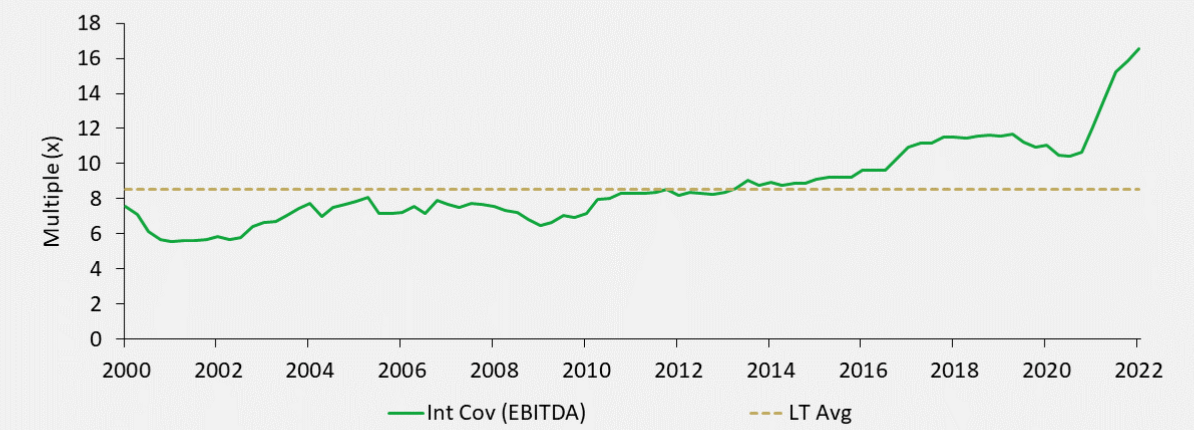
Leverage



Source: Morgan Stanley, as at March 2022

In combination with the favourable interest rates locked in during refinancing, this means that interest payments are much reduced. At the same time, earnings have been relatively resilient, meaning that interest payments as a percentage of EBITDA (earnings before interest, tax, depreciation and amortisation) have fallen or – viewed conversely – the interest coverage ratio of earnings to interest payments has risen, as shown below.

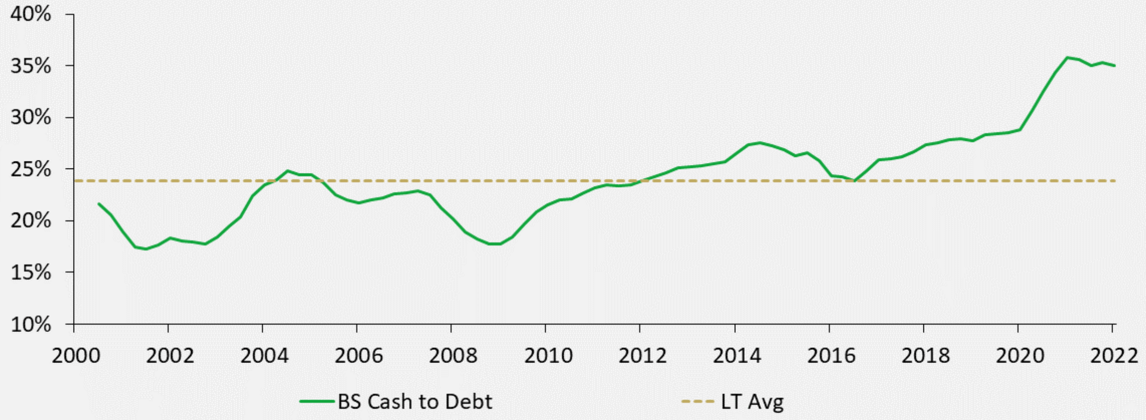
Interest Coverage (EBITDA)



Source: Morgan Stanley, as at March 2022

Added to this, a conservative approach to M&A and growth capital expenditure has placed less stress on corporate balance sheets. Cash to debt levels are high, providing corporates with ample liquidity buffers to navigate short-term uncertainties.

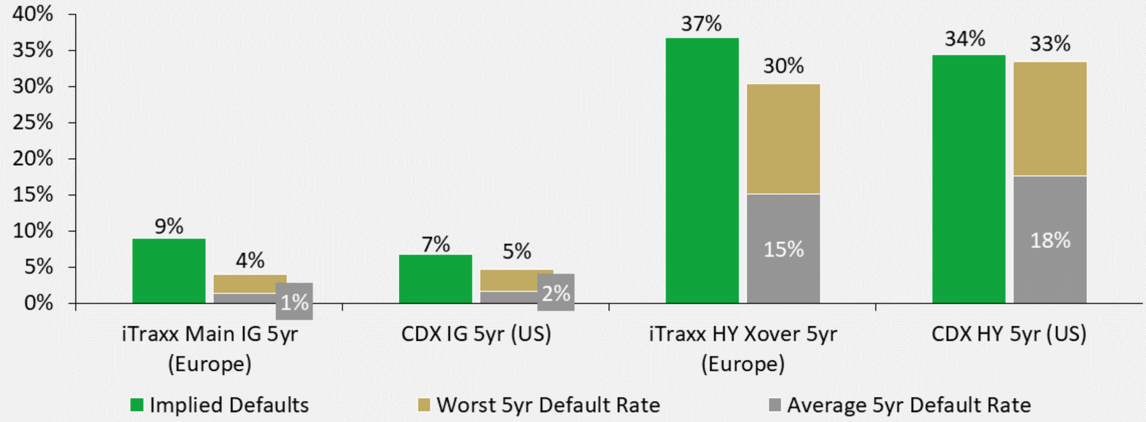
Cash-to-Debt, European companies



Source: Morgan Stanley, as at March 2022

Default rates are currently low but credit spreads have widened to around 200bps, as high as they've been in the last decade aside from the shocks associated with the eurozone crisis, Brexit and Covid-19 outbreak. At these levels, the investment grade market is pricing in a 5-year default rate of 9%, according to Bloomberg data.

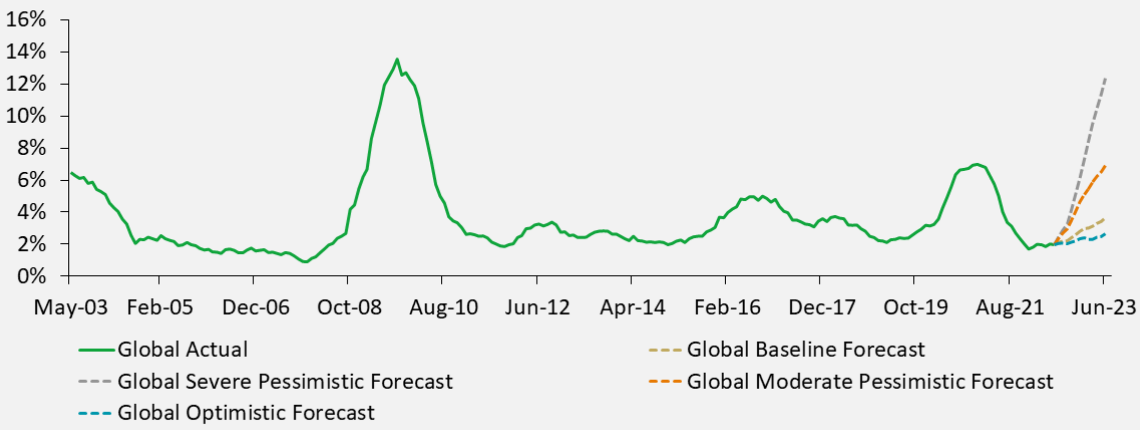
5 year cumulative default rate (%)



Source: Bloomberg, Moody's, Morgan Stanley Research, as at 15.07.22

This compares against a long-run average default of around 4% and Moody's baseline scenario of a 3.7% default rate.

Investment Grade default rates (actual and forecast)

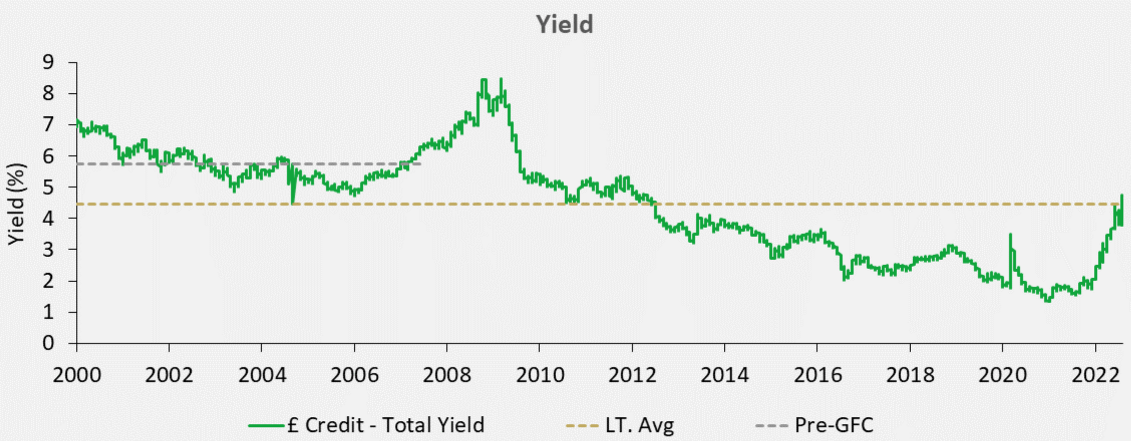


Source: Moody's Investors Service, June 2022

As the chart above shows, only under the most severe, pessimistic forecasts do we get default rates which justify today's spreads.

With corporate spreads at such wide levels and underlying government bond yields having risen to fair value this year, the yield available on corporate bonds looks very attractive at over 4.5%.

ICE BofA Sterling Corporate Index



Source: Liontrust, Bloomberg, as at August 2022

Supply dynamics within the market also look supportive of current valuations: following the glut of refinancing during the pandemic, rising yields now mean that new issuance is starting to fall. Consensus estimates are that issuance is down 18% so far this year. With investors still having cash to invest, we think it is unlikely yields will go much higher than current levels.

These conditions are creating attractive investment opportunities for the funds, allowing us to generate a yield of around 5% currently without deviating from our high-quality, sustainable approach to credit selection. For example, we have healthy allocations to sectors offering some of the highest yields – including banks and insurance – as well as to those likely to prove most resilient to inflationary pressures, such as telecoms. In turn, we are underweight cyclical areas that are vulnerable to a downturn in the economy or which may struggle to pass on cost increases; these include consumer-facing companies and industrials.

Although the economic outlook is challenging, we believe the prospects for corporate bond investors are very good. Company balance sheets are, on average, much healthier than long-run averages, while bond valuations price in a level of default that we don't see materialising. We think investors should view current yields as an attractive entry point, which also offers the real potential for capital upside should spreads tighten if default rates beat the very pessimistic levels currently priced in.