2023 will be a credit-picker's market

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Our Q&A covers the drivers of investment grade returns in 2023, where the opportunities might lie, US Federal Reserve policy and positioning for a potential recession, and emerging industry themes

What drove investment grade returns in 2022?

The performance of essentially all fixed income markets was historically bad, driven primarily by the aggressive tightening of monetary policy by the US Federal Reserve. Its actions have moved interest rates from what were record low levels in 2020, following the Covid-19 pandemic, to what most of us would view as more normal levels. But the bond maths in that movement from point A to point B have been incredibly painful. The average yield on a 10-year Treasury since 1990 has been just north of 4% – in other words, about where we are now. However, that is quite a change in a relatively short period of time; it was as low as 0.5% in mid-2020. It is important to note that by November 2022 around 80% of the poor total returns year-to-date in investment grade (IG) corporate bond indices were a result of interest rate moves, and less than 20% is a function of spread widening on credit concerns[1].

Thankfully most of the interest rate pain seems to be behind us and, importantly, fixed-income asset classes – including IG corporate bonds – now offer attractive yields, which can provide a buffer against any further rate moves higher.

What do you think the drivers of return in investment grade will be as we head into 2023?

Company fundamentals. As the market shifts its focus from the Federal Open Market Committee (FOMC) aggressively tightening monetary policy to the impact of those actions, we will see dispersion pick up. In particular, how resilient companies are in this environment. This plays into the strength of our bottom-up credit selection/alpha generation engine. We believe it will remain a credit picker's market into 2023.

I also want to comment on the technicals of markets. Demand out the credit maturity curve has been relatively strong and demand in the short and intermediate parts of the IG corporate

[1] Columbia Threadneedle analysis of Bloomberg data, November 2022

market has been relatively weak, and as a result credit curves have flattened. We believe this is a function of the sizeable pension fund and insurance account buyer base drawn by the yields on offer out the curve (with discount US dollar prices as a nice sweetener) versus heavy selling by mutual funds and exchange-traded funds (ETFs), which are mostly concentrated in the short end and belly of the curve.

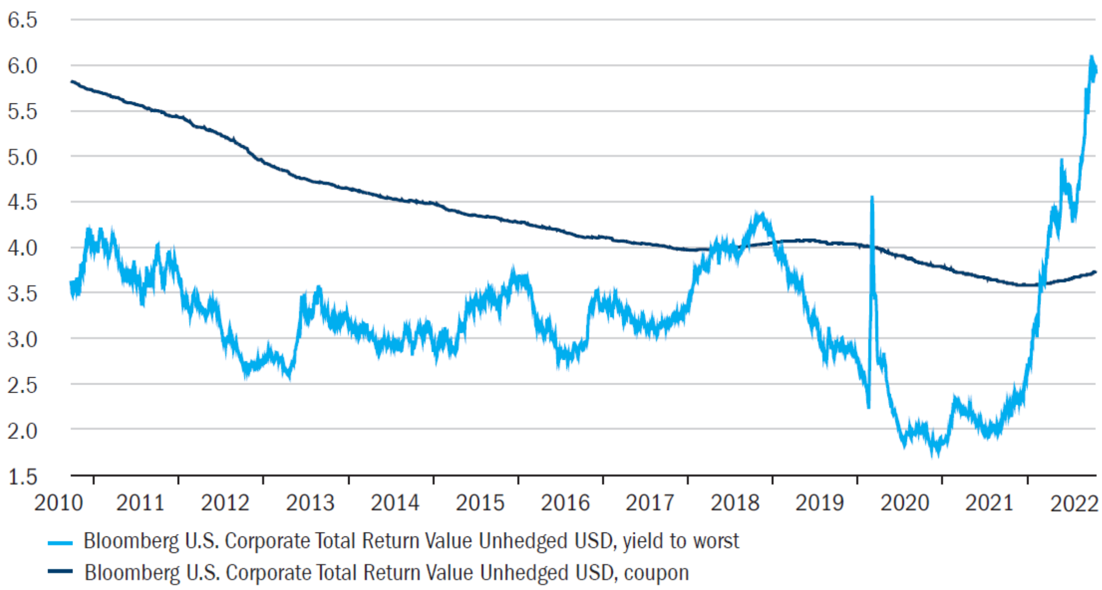
How long will the IG opportunity last in 2023?

I think there will be opportunity for investors who can pick credits. Right now, when we look at measures like cash flow generation, margins and leverage, in aggregate across our research coverage universe or opportunity set these metrics are near their best levels over the past 10 years. Recent rating agency trends affirm this view: the past two years have had the lowest amount of fallen angels (IG companies downgraded to high yield) since 1997. As a portion of the BBB index, the two-year total currently equates to the lowest amount on record as well.

Rating agency actions are also heavily skewed towards potential upgrades as opposed to potential downgrades. In addition, IG companies borrowed $2.1 trillion in 2020 to increase their liquidity given the uncertain business conditions as a result of the pandemic, and then borrowed a further $1.8 trillion in 2021 as both the rates and spreads backdrop were favorable. Much of this incremental liquidity is still sitting on company balance sheets, providing them tremendous financial flexibility as they navigate these uncertain economic times. Combined with spreads right around long-term averages and corporate yields at their highest levels since 2009, we see a bevy of solid relative value opportunities from which to construct client portfolios.

Figure 1: IG yield versus the index

The average yield of newly issued investment-grade debt is currently ~230 basis points higher than the average coupon of the Bloomberg index, which may be weighing on new supply.



Source: Columbia Threadneedle Investments based on the Bloomberg US Corporate Bond Index, a measure of the US investment grade market. Data as of 9 November 2022.

What do you expect to happen once the market begins pricing for a Fed pivot?

Well, the markets are supposed to function as a forward-looking discounting mechanism. I think the more appropriate "p" word as it relates to the Fed is pause not pivot. I feel folks are beginning to think about positioning for a post-Fed rate hike cycle, which should be good for credit. That is, unless one feels the Fed will go so far that they "break" something – in which case Treasury yields will rally, benefiting longer duration securities. We have seen wider wides and wider tights in IG spreads over the course of 2022, but spreads have rallied 10% since their early October wides. And don't forget we now have higher yields and spreads as a cushion against further widening.

What is the historical performance of IG in a recession?

Spreads go wider in recessions – probably not a surprise there. However, the fact pattern is different for each episode, so I think we need to be cautious about looking at a line on a chart and saying index spreads need to go to "x". I think markets are nearing maximum pessimism and, anecdotally, it appears that positioning across risk assets is fairly defensive. In addition, at the issuer level we find plenty of bonds that have widened much more than the circa 60bps of widening the index has experienced, and in many instances we find that widening unwarranted based on the specific fundamentals of those issuers.

What are the relative risks/opportunities for US v non-US IG as we head into 2023?

We feel the US economy is in a better place than the European economy as we head into 2023 for myriad reasons. That being said, many of our favored issuers have non-US based operations so our research analyst partners are very focused on the impact of potentially weaker demand from European customers as well as the headwind of a stronger US dollar.

What are your expectations for volatility as we head into 2023?

We don't anticipate the volatility we saw in 2022 ending anytime soon, but this environment suits our investment style. All asset classes have seen a heightened level of volatility given the shifting and unsettled macro backdrop. The MOVE index, which measures Treasury rate volatility through options pricing, is at levels we haven't seen in the past 20 years outside of briefly in March 2020 and during the global financial crisis. When you get that extreme level of volatility in the "risk-free asset" it spills over into the rest of the fixed income asset classes and the IG credit market has definitely been impacted. Importantly, the new issue market remains open for business, but far fewer companies are willing to access this liquidity given the higher rates they have to pay – again due mostly to moves in Treasury yields and to a much lesser extent due to spread changes.

Are there specific industries within IG that you think offer opportunity or risk?

We build our portfolios from a bottom-up perspective based on the intersection of well positioned companies with excellent management teams executing a credible strategy that offer good relative value versus other opportunities. As a result we don't really think in terms of "this is a good industry" or "this is a bad industry". That said, through the process of identifying specific companies that fit those criteria, industry themes emerge, and these themes have been expressed in portfolios for some time now: overweights in electric utilities, life insurance, banking, healthcare, food and beverage, aerospace/ defense, media and entertainment.

How do you approach responsible investment in managing IG?

Our focus has always been on investing in management teams that are good stewards. As we have integrated responsible investment into our process over the past few years, it has become readily apparent that this analysis often correlates with ESG (environmental, social and governance) considerations. This means these factors have long been considered in what we do, even if it wasn't in the context of an explicit ESG framework. We view ESG as another important lens through which to view risks and opportunities for companies and industries.

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