Is there value in sterling credit?

by Paola Binns

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Paola is responsible for the management of corporate bond portfolios. She brings some 20 years' experience in bond markets to RLAM, having joined in August 2007 from Credit Suisse Asset Management where she was responsible for managing sterling credit assets. Paola has developed a wide range of bond asset classes having held a number of roles specialising in European corporate bonds, government bonds and emerging market debt. Paola has a MA degree in History and Spanish Literature from Oxford University.

2022 was a terrible year for most fixed income investors. The causes are well known: rising inflation, higher bank rates, the impact of Covid and the Ukrainian war, ballooning government debt.

So, will 2023 be better? Our view is that the outlook for sterling credit is the best it has been for some time. There are several factors at play here. Most importantly, valuations are attractive and this has two component parts. Gilt yields have risen and now factor in a lot of monetary policy tightening whilst credit spreads are nearly 1% higher over the year.

A key question is whether the widening in credit spreads is justified. In our view there will be a pick-up in defaults over the next year. However, this will predominantly be a sub-investment grade event. We do not expect to see much change in investment grade defaults, reflecting the size and nature of these companies. Downgrades to sub-investment grade will be a threat to valuations but we believe that the current spread of 1.75% (figure 1) for non-gilt sterling bonds provides more than adequate compensation. If we look at historic default rates and assume zero recovery from defaulted bonds, current spreads offer significant opportunities. Assuming a 20-year timeframe, investment grade investors require less than 30bps of excess yield to compensate for this risk. There is an argument that the nature of credit markets has changed, with a much higher weighting to the riskiest part of the investment grade universe (BBBs). However, when we look at this cohort over a 20-year timeframe, less than 50bps is required as compensation over government bonds.

Figure 1: Average investment grade sterling credit spread

Chart shows option-adjusted spread for the ICE BoA ML Non-Gilts All-Maturities index, Source: RLAM to 31 October 2022

There are challenges to face

The Autumn Statement in November confirmed that the supply of government bonds through the course of 2023 will be elevated and we believe that this will put upward pressure on yields. With over £200bn of gilt issuance to absorb there will be heightened competition for investors' attention. Quantitative tightening, which will see both gilts and sterling corporate bonds sold by the Bank of England, will add to this pressure. However, we do see scope for renewed interest in fixed income at these yield levels. Long-term investors will be attracted to current valuations and it is possible that pension funds that have benefitted from the move higher in government yields will look to increase their exposure to corporate debt as they de-risk. Similarly, we see room for asset allocators to increase weightings – which have generally drifted to low levels in recent years.

But we see value in several areas

Last year saw some significant sector de-ratings. This was most noticeable in banks and financial services, where relatively heavy supply, coupled with concerns about an uptick in bad loans – both commercial and residential – saw senior unsecured bond spreads widen by around 120bps in the case of sterling credit indices. We now see banks and insurance as two of the most attractive areas with yields, in some cases, higher than those recorded during the Global Financial Crisis.

Investors familiar with RLAM will know that we continue to favour asset backed and secured bonds. This reflects our view that we are over-compensated for risk when compared with unsecured debt. Recovery rates, typically, are materially higher on secured bonds and whilst liquidity tends to be lower, we feel it to be an attractive trade-off. Additionally, asset backed and secured bonds offer a material diversification, being less exposed to common economic factors that impact certain sectors, such as banks.

The economic background, globally and domestically, will be an important factor in returns from sterling credit in 2023. The UK has entered recession and it is likely that other major economies will follow. This will cap the upside on short-term rates. If we look at what is reflected in the sterling yield curve we can see that UK interest rates of 4.5%-4.75% are priced in for mid-2023 with a small reduction reflected for later in the year. This is a pattern repeated in the US, albeit with a higher peak. We think these profiles look reasonable. From a positioning viewpoint we think short duration strategies look good value, reflecting the government bond pricing and the significant credit spread premiums available. Further along the curve medium-dated credit has attractions, especially in some financial bonds, whilst we remain cautious at the longer end of the market where gilt yield curve inversion reduces the attractions of credit.

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