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Global Insight

Focus Article

Don’t wait for fear to do the work of reason

Build defense by dialing back risk in fixed income portfolios.

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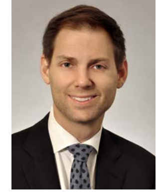
All values in U.S. dollars and priced as of November 6, 2018, market close, unless otherwise noted.

Don’t wait for fear to do the work of reason

Prepare for choppier waters while the seas remain calm by charting a course to de-risk portfolios. Reducing credit risk in fixed income portfolios is a good place to start.



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You can’t predict, but you can prepare

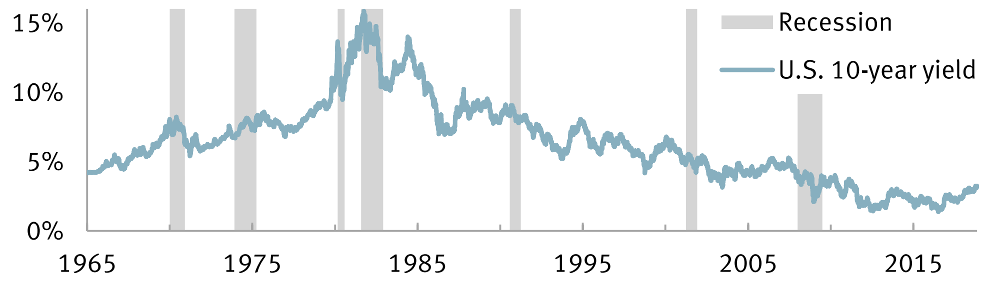
The later stage of the economic cycle is the time to start formulating a game plan to de-risk portfolios. Well-regarded high-yield investor Howard Marks famously says, “You can’t predict, but you can prepare.” Economic growth remains solid and most indicators we monitor suggest a recession is still some ways off, but it’s best to prepare for choppier waters while the seas remain calm. We believe reducing credit risk in fixed income portfolios is a good place to start this process because compensation for taking those risks is currently minimal and credit quality has weakened.

Higher interest rates are usually a feature of the late cycle

Interest rates tend to rise for a considerable period of time in the later part of an economic cycle in response to a strong economy and rising inflation. This process is now well underway; the Fed has moved its benchmark rate from 0.0% to 2.25% over the past three years. Meanwhile, the 10-year U.S. Treasury bond yield is up by almost 200 basis points (bps) since July 2016.

While interest rates rise in response to a strong economy, those higher rates eventually slow down the economy—often pushing it into a recession, ushering in a period of shrinking corporate profits in the process. Bond investors typically experience poor performance as yields rise to a peak prior to a recession, while stocks

Government bond yields typically move higher later in the economic cycle



Source - Board of Governors of the Federal Reserve System, St. Louis Federal Reserve

tend to head into a bear market around the time when the recession actually arrives. The bonds of low-quality issuers often suffer a “double whammy,” losing value as rates rise and then losing even more value when the recession pressures these companies’ already comparatively weak finances and calls their ability to service their debts into question. Conversely, higher-quality bonds tend to perform well in this environment as investors seek more secure cash flow streams.

It is difficult to determine the exact point where higher interest rates will slow down the economy. However, higher bond yields and an eventual recession are two possible scenarios that some of the lower-quality segments of the bond market are poorly positioned for. We believe some of these riskier parts of fixed income portfolios that investors have crowded into in search of higher yields are an appropriate place to start the overall de-risking process.

A better way to de-risk: Reduce low-quality credit exposure

Full valuations for so-called high-yield bonds (defined as bonds rated below BBB) mean that the yield pickup on this debt is modest relative to yields available on higher-rated bonds. We believe this leaves this asset class segment in the unappealing place of being vulnerable to both higher interest rates and a recession. Similar logic can be applied today beyond just High Yield. Lower-rated bonds generally—for example, BBB rated corporate bonds versus A rated corporate bonds—are likely to experience larger price declines as rates rise, and their low rating by definition means that they have less financial capability to cope with an economic slowdown.

This diminished yield advantage offered by high-yield bonds means they offer a smaller margin of safety in the event credit or business conditions deteriorate. Government-backed bonds and high-quality corporate bonds typically experience price gains when central banks reverse course and start lowering rates to support a faltering economy. But low-quality borrowers often experience business dislocations in economic downturns that may call into question their ability to make interest payments and repay principal. This market segment often performs poorly when a recession hits and default rates inevitably rise.

Reducing exposure to lower-rated corporate bonds could leave some money on the table until economic conditions actually deteriorate. But we believe this is a tolerable outcome for investors who maintain equity exposure. The conditions that are supportive of high-yield bonds typically are also supportive of stocks, but stocks offer upside potential that is less constrained. The table below underscores this point. The

S&P 500 outperforms HY bonds when credit spreads are narrow

Data for when spreads fall under 425 bps until the move back above 425

Time frame	S&P 500 return	High-yield bond return	Outperformance of S&P 500
Jan. 1994 – Aug. 1998	120%	44%	76%
Dec. 2003 – Aug. 2007	49%	31%	18%
Nov. 2013 – Dec. 2014	20%	5%	15%
Jan. 2017 – Sep. 2018	35%	10%	25%
Average	56%	23%	34%

Source - Bloomberg, FactSet; data calculated using Bloomberg Barclays US Aggregate High Yield Index total return

upside in high-yield bonds is capped because many are trading near, and in some cases actually above, their call price, which means issuers can redeem the bonds if they are able to refinance that debt on more favorable terms, with investors receiving little benefit.

Compensation for assuming credit risk is modest

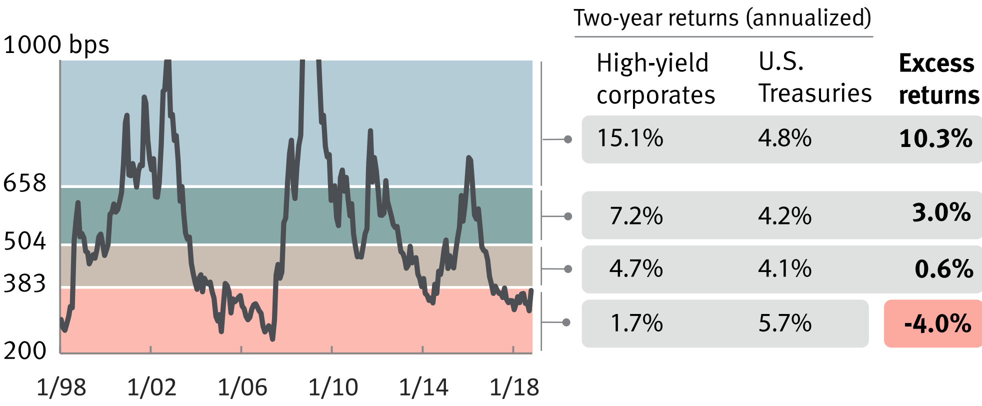
The differential between the yield on a riskier (normally lower rated) category of bonds and that offered by a safer (normally more highly rated) category is referred to as the credit spread. Credit spreads between higher- and lower-quality bonds are extremely narrow today as the amount of incremental yield offered for proportionally more risk is historically modest. This comes after a significant move higher in government bond yields and means a larger portion of the total yield on a bond derives from the government bond component rather than the compensation for assuming greater credit risk.

The chart below highlights that investors typically fare better not reaching for the modest amount of incremental yield in the high-yield bond market when credit spreads are this narrow.

Narrow credit spreads provide investors a number of opportunities to switch into higher-quality, often more liquid bonds at a very modest sacrifice in yields. We think

Credit spreads have been compressing

Range of high-yield credit spreads since 1998 divided into quartiles and historical performance



Source - Bloomberg, FactSet; Data calculated using Average Bloomberg Barclays US Aggregate High Yield Index and Bloomberg Barclays US Aggregate Treasury Index 2-yr total return data

investors should move to take action on this before economic growth eventually stalls, because the yield that is given up to upgrade quality will likely be more substantial at that point.

Reduced compensation has come with weaker investor protection

As riskier bonds have fared well over several years, investors have been open to accepting offerings from a much broader and lower-rated group of issuers. The number of both European corporate bond issuers and emerging market sovereign issuers has doubled since 2003. Meanwhile, in the U.S., BBB issues account for almost 50% of the investment-grade market today, up from only 32% in 2009.

The average term to maturity on U.S. investment-grade new issues has also doubled since 2006, from 7.5 years to 15 years, shifting significant interest rate risk to investors at a time when over $1T of corporate bonds needs to be refinanced over the next few years. For the first time in a number of years, a wide swath of borrowers are refinancing at rates higher than where they issued debt five years ago.

High-yield investors are also contending with more issuer-friendly (i.e., less investor-friendly) terms on new offerings. Given the weakest borrowers are transacting in the high-yield bond and loan markets, investors have usually demanded the greatest protections on these deals. This can be done by including provisions in the loan terms or the bond indenture that limit the borrowers’ flexibility in one of the following ways:

- Bonds or loans can be secured by a priority claim on assets
- Prohibiting the incurrence of additional debt or the securing of assets against future borrowings
- Dictating that minimum levels of cash flow are used to reduce debt
- Requiring that cash flow exceeds interest coverage by a set threshold
- Restricting allowable debt to a multiple of cash flow
- Preventing a borrower from selling assets without redeeming debt
- Controlling or limiting the adjustments that borrowers can make to reported cash flow when calculating ratios

Lately, issuers have been able to reduce the protections offered to investors hungry for yield; nor have investors demanded them. Moody’s estimates roughly 80% of loans issued in Q1 2018 were considered “covenant-lite”—i.e., not requiring borrowers to uphold certain financial standards, such as a maximum level of indebtedness. Recent examples include borrowers adjusting current reported cash flow figures to include cost savings that are expected to be realized over the next few years and allowing issuers to sell assets and use the proceeds to fund special dividends for shareholders rather than reducing debt.

Start de-risking process with low-quality credits

It’s always challenging to gauge the level at which higher interest rates lead to a slowdown in economic activity, but it appears that we are moving into a higher volatility regime as we reach a more advanced stage of the economic cycle. As the maxim goes, “fear does the work of reason,” and we think a small dose of fear—perhaps instilled by a few of the spikes in volatility in 2018—might actually provide a healthy “jump-start” for investors to look to their fixed income portfolios as a place to start the de-risking process and move up in quality.

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