Bank of England buybacks: the show cannot go on

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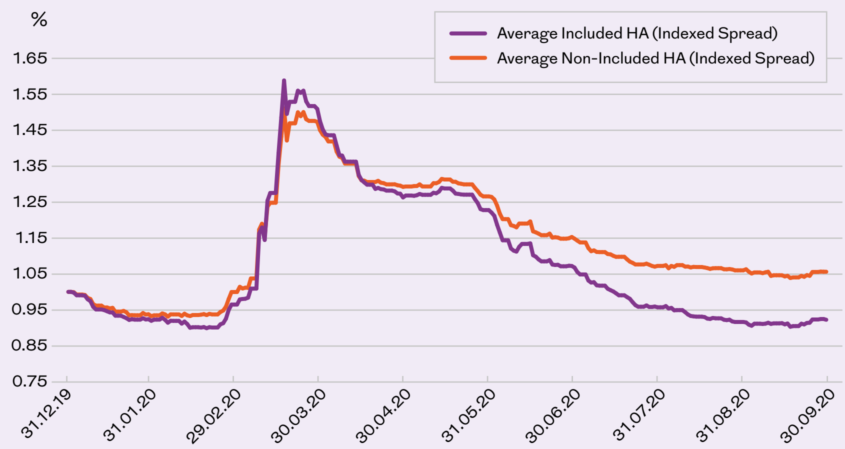
Sterling credit investors have enjoyed a buoyant few months since the market crash in March. Aside from the dramatic improvement in market liquidity, credit spreads (the yield difference between corporate bonds and government bonds) have nearly halved from a high of 2.25% in late March to 1.29% at the end of September.

A major factor in this positive change of circumstances has been a £10bn Bank of England (BoE) buyback programme, known as the Corporate Bond Purchase Scheme. The Scheme dates back to August 2016, when the BoE sought to deal with the aftermath of the Brexit vote. The BoE restarted it in April this year in an effort to allay fears over the impact of the Covid-19 pandemic.

The programme involves the purchase of selected corporate bonds to lower the cost of borrowing for companies. All of the eligible debt is investment grade and issued by companies that the BoE deems important for economic activity in the UK. Crucially, it does not include financial bonds and secured bonds are largely ignored.

The Scheme has been distortive for the sterling credit market, with eligible bonds (representing approximately 28% of typical credit indices) strongly outperforming the wider market, as can be seen in chart 1 looking at spreads in housing association bonds. This raises an intriguing question for investors. Should investors pile into bonds solely on the basis that the BoE is likely to purchase them at a later date?

Chart 1: Distortions in Housing Association sector spreads



Source: RLAM as at 30 September 2020

Past performance is not a reliable indicator of future results.

It is helpful to remember that this is not the first version of the Scheme, we can look to history for guidance. When it was launched in 2016, the Scheme had the same initial effects on the market, providing a major boost to generic unsecured corporate bonds. However, when market conditions started to normalise in 2017, and after the end of quantitative easing, the distortive effect was unwound, as investors realised that they could not build portfolios purely based on what the BoE would purchase.

An obvious catalyst for a similar unwinding this time might be the ending of government intervention measures, such as the furlough scheme and credit buybacks. Companies are certain to face increased stress once that support is withdrawn, both directly and indirectly as disposable incomes decline amid rising unemployment.

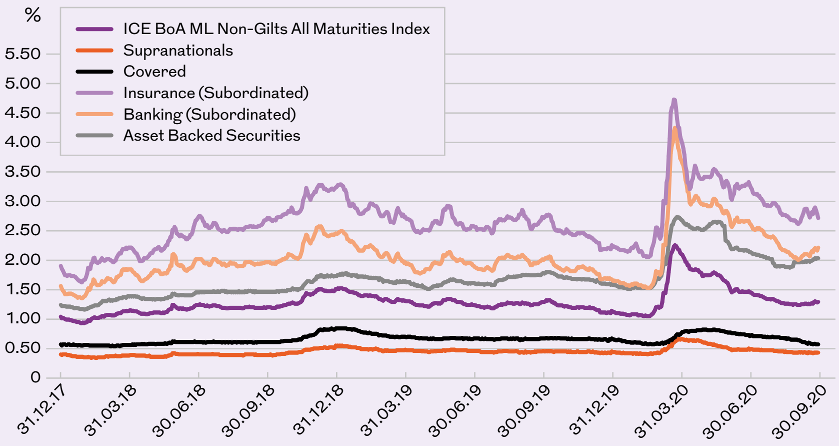
BBB unsecured debt, where the risks of downgrades to sub-investment grade are greatest, will be under particular threat. As companies run into trouble and seek lifelines from banks, they will likely have to pledge assets to secure emergency funding, downgrading existing 'senior' unsecured bondholders in the pecking order for recovery proceeds should the company subsequently default. This makes diversification and targeting within the BBB area essential, with stockpicking a key focus.

It is, of course, difficult to predict any timeframe for this. The 2016 impact took several quarters to unwind, and while we might envision a similar timeframe today, we have to recognise that the Covid-19 crisis is far from over, with spreads still higher than they were at the start of the year, despite BoE buying (chart 2). We certainly cannot rule out further purchases from the BoE in the event of a meaningful second wave of the pandemic.

Regardless, the BoE eligible bonds are not riskless and often feature low levels of protective covenants and a lack of security. If they fall off 'buy lists' due to downgrades or the end of buybacks they could severely underperform. Meanwhile, many secured bonds with strong downside protection remain very attractive both fundamentally and from a valuation perspective because their pricing has not been distorted by BoE buying.

In these uncertain times, active managers have a responsibility to stick to the fundamentals and maintain a 'lender not trader' approach to portfolio construction.

Chart 2: Spreads still higher than at start of crisis



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