Is now the right time to invest in credit?

Ewan McAlpine, Senior Client Portfolio Manager, looks at the performance of sterling investment grade credit over recent weeks and answers the question that many clients are asking.

The real start of the 'coronavirus crisis' was in December 2019 when the Chinese authorities informed the World Health Organisation of pneumonia cases in Wuhan due to, at the time, "unknown causes". Financial markets paid relatively little attention to the breakout until shortly before it was recognised as a pandemic on 11 March; even at the end of February, global markets had moved little in response or anticipation of what would develop from a public health crisis to an economic and financial one.

The extended Lunar Year shutdown in China had caused global growth expectations to be cut as investors feared an outbreak more akin to the SARS epidemic, with severe implications for supply chains given Wuhan's importance as a global manufacturing hub. February was a transitional month in which the risks seemed to be getting greater, but were still thought to be manageable.

For this discussion, however, we define the beginning of the resultant financial crisis as the end of February. Since then, the performance of most asset classes has been negative. The main exceptions have been 'safe haven' assets, including government bonds such as gilts, now up almost 4%, or commodities such as gold, now over 6% up. Yet, even they were down by 5% and 7%, respectively, at one point. Nonetheless, risk assets have been badly affected; UK equities are now down 13% (having recovered from -25%), high yield bonds are 8% down (-19%), and investment grade credit is now down 2% (-9%).*

The timing of the low point has been different in each case, although all are within a few days. And within them, in the case of equities and bonds, the response will have been different for each sub-sector, and each individual stock or issuer. And this will continue to be the case; the pace of recovery of any portfolio will be different depending on its underlying exposures.

* All data in this article as at 16 April unless otherwise stated.

Is the worst over?

Many of our clients are asking whether we have seen the worst from an investment perspective. However, perhaps a better question is: what is the process for the market to deal with the crisis and how are portfolios positioned to see the crisis through to recovery? To answer this, we must consider both the underlying companies, which haven't been at fault for their poor performance, and the wider global economy, which is being supported by governments and central banks. This will help to answer the more obvious question: is now a good time to invest? **Or, more particularly, is now the right time to invest in credit?**

As the downturn has progressed, there have been real opportunities in the credit market. These have mainly arisen as many areas have suffered significant credit spread-widening. Since the end of February, the average spread of sterling investment grade credit issues has widened from 120 basis points (bps) to as far as 225bps, from where it has tightened to just over 180bps (an overall yield of 2.1%). It was below 100bps at one point in January.

It is useful to remember that credit spreads mostly represent the yield (long-term return to maturity) premium over risk-free government bonds as a reward for taking on the risk of the credit bond defaulting on its payments and, at worst, having zero value. Therefore, the market appears to believe that the risk of default across the market has significantly increased – indeed, that it has almost doubled. Do we believe that the default risk has increased so much?

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How we manage credit portfolios

Analysis, judgement and skill in evaluating this risk and managing the risk-reward pay-off across a portfolio are what credit portfolio management is all about. At Royal London Asset Management, our approach is to optimise the pay-off by identifying securities that combine more favourable yield with a lower risk of not being paid. We seek to reduce the risk on the portfolio by continuously looking for opportunities (not just during market downturns) to buy bonds whose value is secured by assets or cashflows. For bonds, the value comes from income payments constituted by coupons and redemption payments.

As secured long-term lenders to issuers, we have a claim over these so that, in the case of a default, we can recover the value that we are owed. This approach sets us apart not just from equity investors, who may be left with nothing after creditors such as bankers and bond holders have been paid, but other bond holders who do not see the value in such an emphasis on security. The result is a portfolio that has a more attractive yield and better returns than the broader market, with lower volatility of returns over the medium to long term.

Not all of our credit portfolios are, or even necessarily should be, solely invested in secured assets; there are opportunities to be had in unsecured bonds too. But some examination of the responses of secured and unsecured bonds in the recent market downturn is useful. At their lowest point since the end of February, the performance of unsecured bonds in the banks & financials and insurance sectors were down by 11% and 14%, respectively; average spreads widened from 130bps to 350bps and 170bps to 390bps – the respective yields of these sectors reached 4.5% and 3.5%. And yet the issuers behind these bonds are in a much better, stronger and more resilient financial condition than they were at the end of the global financial crisis. Spreads have recovered to around 250bps, with performance now only down 3%. However, we still see the extent of the widening of spreads as an indication of the probability of default as excessive; just as they have done many times in the past, markets have again overreacted.

Meanwhile, the performance of secured assets has been little different from the market overall. While this may paint a lacklustre picture of secured assets, one should remember that the sterling credit market indices contain supranational issues that have performed far more favourably and in line with government bonds. Comparison of secured assets with non-supranational credit issues (i.e. true non-government debt) is perhaps a more useful one: secured bonds registered a fall of 9% at their low point, with spreads widening from 100bps to 260bps, with non-secured bonds seeing a trough of 11% and spreads widening 150bps to 270bps.

In summary, while exposure to banks and insurers will have brought portfolios some volatility, an emphasis on secured assets will have brought stability. Careful selection of issues within these sectors will have brought even more. Furthermore, our portfolios have been less exposed to those sectors more directly-sensitive to the economic impact of the crisis – discretionary consumer sector areas, such as travel, leisure and hotels – and have minimal exposure to the oil price collapse, which was an additional complication in recent weeks.

So is now the right time?

Investment grade credit assets are now broadly down 2% since the start of the crisis and yield around 2.1%. Those assets that were hit most in the downturn are recovering fastest, while those that were less-badly hit are recovering more steadily. From a longer-term perspective, the recent drop in performance experienced by the market and our portfolios is a fairly small setback. But this is nonetheless an opportunity to invest in the asset class for the medium to long term.

We say this, however, on the basis that one takes the right investment approach, focusing on value and security to protect the investor as much as possible while enjoying an attractive income stream as the principal driver of returns. Although markets could deteriorate further should the health crisis and wider economic crisis persist, our credit portfolios are well positioned to benefit from a further and fuller recovery in the market, and we believe the current moment represents a good entry point.

Contact us

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