Global corporate bonds: Prediction power of the yield curve

What is the yield curve? What signals has it been giving recently? And what does this mean for corporate bonds? David Blackman explains.

It doesn’t occur often, but is an unhappy harbinger when it does.

We’re talking about inversion of the yield curve. It’s the scenario where long-term rates are lower than short-term rates.

First of all, how does the yield curve work?
The curve will generally slope upwards, which reflects how investors will tend to be rewarded with higher yields in return for locking into debt for longer periods of time.

Steve Ellis, chief investment officer, fixed income at Fidelity International, says: “Normally, you would expect rates to be higher, the longer the duration.”

Jeff Boswell, head of alternative credit at Ninety One, says that the shorter-term “front end” of the yield curve is “very driven” by the interest rate policies of central banks.

Antoine Lesne, head of strategy & research at SPDR ETFs, says the front end is usually “anchored” on short-term expectations of the interest rates central banks will be setting in one or two years’ time.

He adds that longer-term back-end yield levels are normally higher to reflect market expectations of economic growth and inflation.

The curve in reverse
A flattening or even inversion of the yield curve means that investors are receiving little or no compensation for holding on to debt for longer. Says Boswell: “If I am getting paid no more for the ten-year than two-year bond, I will take the two-year bond.”

For financial markets, it was a worrying portent when the global benchmark US yield curve inverted briefly in early April. This meant that yields on offer for ten-year US government bonds, known as Treasuries, were higher than for those with a two-year maturity.

Research carried out in 1986 by Professor Campbell Harvey of Duke University revealed how the inversion of the yield curve on two- and ten-year bonds has been a leading indicator of recessions since the 1960s.

The theory was given ballast by subsequent inversions, which have happened in the run-up to more recent recessions. An inversion in December 2005 heralded the Great Recession of 2007, which metamorphosed into the 2008 financial crisis. There was also an inversion before the tech bubble burst in 2001.

The curve inversion is a “good indicator that something is going to change,” says Boswell. That something is now being experienced by the key protagonists in the global fixed income market by the end of 2021.
Pesquès believes there is a case for being “slightly more cautious” about relying on the inverted curve as a recessionary indicator, given that yields were “significantly impacted” by the ultra-low interest rate and quantitative easing (QE) policies pursued by major central banks post-financial crisis. US Federal Reserve chair Jerome Powell downplayed the importance of the inversion last month.

The impacts of QE and recession risks on yields are difficult to unpick. Pesquès says: “There is very little visibility about the impact of QE. We can’t split out in the yield curve what is coming from this and the anticipation of recession.”

However, he acknowledges that there is enough evidence to indicate that the risk of recession has increased materially from a “very, very low level” just six months ago.

**“Worst start to a year”**

This risk of a downturn is particularly heightened in Europe, where surging energy prices resulting from the Ukraine conflict have fuelled already high levels of inflation. This in turn has put pressure on central banks to curb inflation by hiking interest rates from the abnormally low levels that have prevailed for more than a decade.

The European Central Bank alone holds an estimated $20 billion (€19 billion) of corporate debt as a result of QE, which it will be expected to shed as part of monetary tightening.

Boswell at Ninety One says: “The more aggressive central banks get, the more risk there is to economic recovery. The risk for credit investors is the potential rollover and the credit risks that come with that.”

2022 has already been the “worst start to a year” for corporate bonds in nearly 30 years and could turn out to be worse than the market’s previous lowpoint of 1994, says Lesne. “Some of the bleeding has not finished yet in fixed income.”

Investors are reported to have withdrawn nearly €14 billion from European corporate debt funds during the first three months of the year. In the same quarter, returns on European investment grade and high yield debt were down.

Boswell says total returns across the European investment grade down around 4% last year. (Looked at another way, the
The lower risk premium enjoyed by investment grade debt means that it offers more protection in uncertain economic times than higher yield options, he adds.

Within this context, US investment grade debt is more attractive than European thanks to “relatively strong” financial and consumer data in the world’s biggest economy, says Ellis.

Boswell agrees that US has outperformed European corporate debt, thanks in part to being relatively insulated from the Ukraine war by distance and a lower reliance on Russian oil and gas.

The uncertain economic climate means that most markets have seen significant reduction in new issuance, with very few new issues currently coming to the market. Pesquès says: “Market conditions are difficult and there is less activity.” Even in the relatively cushioned US, high yield issuance is down “quite substantially”, he says. In the year to date, the level of new such issues and refinancing has shrunk from £200 billion (£236.5 billion) to around £50 billion.

The lack of appetite for new debt means companies that were able to secure borrowing at rates of 5% last year would now have to accept 9%, meaning an effective near-doubling in rates. Pesquès says: “You have to incentivise investors to buy debt. There haven’t been many issues.”

Issuers coming to the market are having to pay more, says Boswell, adding: “New issuance has been markedly down on last year apart from financial investment grade and have had to pay a concession to get anything done.”

There are bright spots, such as US financials, where new issuance remains “surprisingly high”, agrees Pesquès. He adds that corporates don’t need to issue unless they have substantial capital expenditure programmes.

The subdued state of the corporate debt market means prices may be higher than if new issuance had carried on at the same rate as last year, says Boswell. “It slightly supports the market.”

**Disappearing negative yields**

However, this increase marks a big change from the last decade when low or even negative yields pushed investors to hunt for spread.

Rates on bonds are currently “quite decent” that became a feature of financial markets.
become less competitive because they didn’t generate that much income.”

However, rates – which have reached 7% for US high yield – make corporate debt potentially more attractive for income-hungry investors than six months ago, when they would have struggled to secure a yield, he says. “Because of the sell-off and reset of yields, they have arguably become a lot more attractive.

“From an investor standpoint, credit can arguably fulfil an income-generation role.”

And there are upsides in getting back to a market where the “driving force” for investors is fundamental economic conditions rather than central banks’ rate-setting, says Pesquès. “Some people are not used to it, which is not necessarily bad news for active fund managers.”

However, bond investors need to see a reduction in the “extremely high” levels of volatility in the market, which explains a significant part of the outflows from the sector. Pesquès says: “For appetite to come back, the market needs to see this volatility decrease and we need to see the first few hikes of central banks and how the end of QE unfolds in the market.

“This is a prerequisite of a significant comeback of appetite for corporate debt: we need to see the beginning of a normalisation cycle and some stabilisation of inflation.”

And a more recessionary environment means a greater risk of default on corporate debt. Boswell says: “The flipside is that part of the reason you are getting paid more is increased uncertainty. There is a lot of tail risk in terms of whether recession is coming, how deep it will be and from a credit investor standpoint, what that will mean for defaults. Default rates are at ridiculously low levels, but there is no such thing as a free lunch: part of credit seeming more attractive is that there are uncertainties out there.”

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