Insights
Fixed Income

May 2020

Cliff Edges and Corporate Risk

Jason Simpson
Senior Fixed Income ETF Strategist

- With markets now more stable, the need for yielding assets is likely to push fixed income investors to take on credit risk.
- Despite the current heavy pipeline of issuance, euro-denominated IG corporate bonds should ultimately benefit from the combination of this reach for yield and ECB buying.

The Cost of Playing It Safe

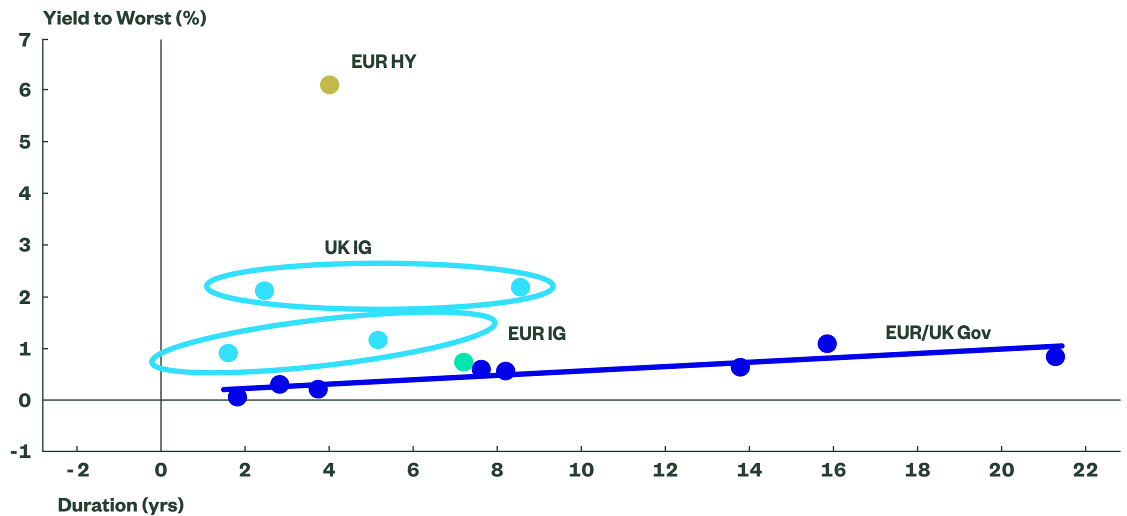
There remains a high degree of uncertainty around the COVID-19 pandemic and its economic impact. However, the markets see some light at the end of the tunnel:

- From a medical standpoint, the number of infections and deaths in the G10 are coming down. China's experience suggests risks of secondary spikes can be contained.
- Economies are starting to re-open. This process is clearly in its very early stages in Europe and is only the first step on a long road, but nonetheless such a step will allow some economic activities to resume.
- The market breakdown in March saw the world's key central banks deploy significant programmes to restore order. These measures seem to have been successful and, the further markets move from that scare, the more confidence they are likely to have that things are back to some sort of normal. For instance, the ICE BofA MOVE index of Treasury volatility is back to the average level seen for 2019.

We may not be in an environment conducive to making high conviction calls on the market but, at the same time, there is a 'running cost' to remaining in safe assets. This is especially the case for Europe, where ECB rates are heavily negative, while the BoE is at just 0.1%. Figure 1 illustrates the situation by showing the impact that central bank policies have had on government bonds (lowest set of dots).

The yields on even the longest European government bond funds remain below 1% (15Y+ gilt fund). Government funds will continue to appeal to those investors seeking to preserve capital, until the economic outlook becomes a little clearer, and to those that need to hedge underlying liabilities. However, returns will likely remain limited or, in some cases, negative.

Figure 1
Yield vs. Duration of European Investment Funds



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 28 April 2020.

Pushing Out Along the Curve

Low government yields, even out along the yield curve, mean that to get a meaningful pick-up investors will need to edge out along the credit curve. Investment grade (IG) credit has had a sobering crisis, with spreads initially blowing wider on fears of weaker corporate earnings before the market almost completely seized up. Central bank actions have helped markets return to a more normal footing. The iTraxx Europe index of IG CDS has narrowed off its crisis wides but spent the month of April in the 75–115bp range against just 41–46bp for January and much of February.

A further narrowing could occur, driven by:

- ECB buying, which picked up pace in March to nearly EUR 7 billion, its highest since November 2017. Given the ECB's Pandemic Emergency Purchase Programme (PEPP) only started its purchases on 26 March 2020, volumes are likely to be higher in April and subsequent months until the end of 2020.

- Market participants are likely to resume the grab for yield if markets remain relatively stable. While there may be economic setbacks, the powerful support that central banks and governments have provided seems to have calmed markets for now.

Embedded Risks

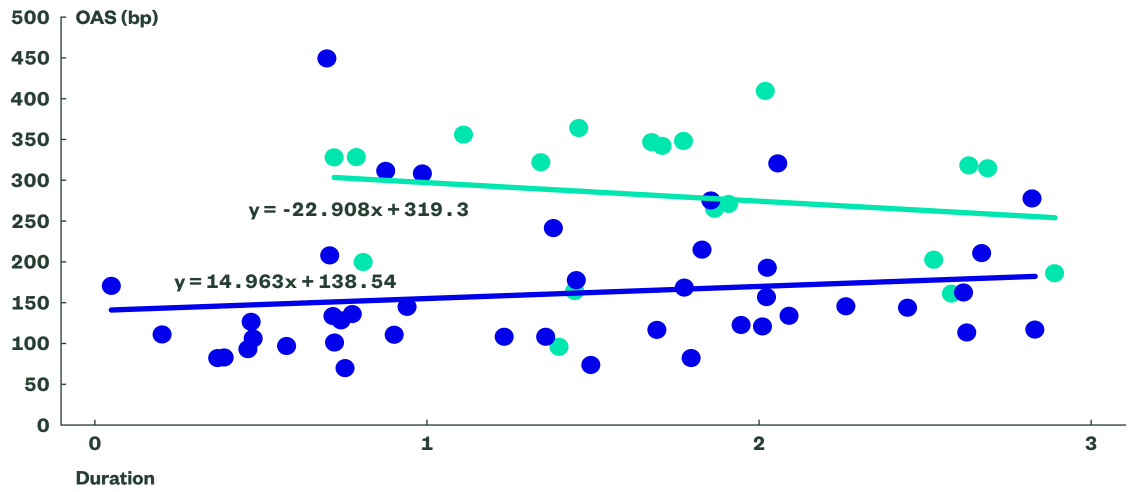
The ECB's 'whatever it takes' attitude is a reassuring backstop for the market. Policy actions taken so far should at least ensure the orderly functioning of markets. Policy actions cannot, however, fully offset the economic weakness, and this will remain a key concern to credit investors.

Corporate earnings are expected to be considerably weaker for Q2 but, even when shutdowns have ended, there are concerns that it will not be back to 'business as usual' for some time to come. In addition, much of the support package from the government comes in the form of loans, which means corporate leverage will rise. So downgrades seem inevitable. This process already appears underway, with Moody's making 134 IG downgrades in Europe so far in 2020, comfortably the highest number since 2013.[1]

From the perspective of an index fund, the real concern is less about potential moves in ratings within the fund and more that it becomes a forced seller in the event that a bond is downgraded below IG. Therefore, understanding to what degree this event risk is already priced in is important.

Figure 2
Baa3 Bond Duration vs. Spread 0–3Y Euro Corp — Watch Neg vs. Stable/Pos

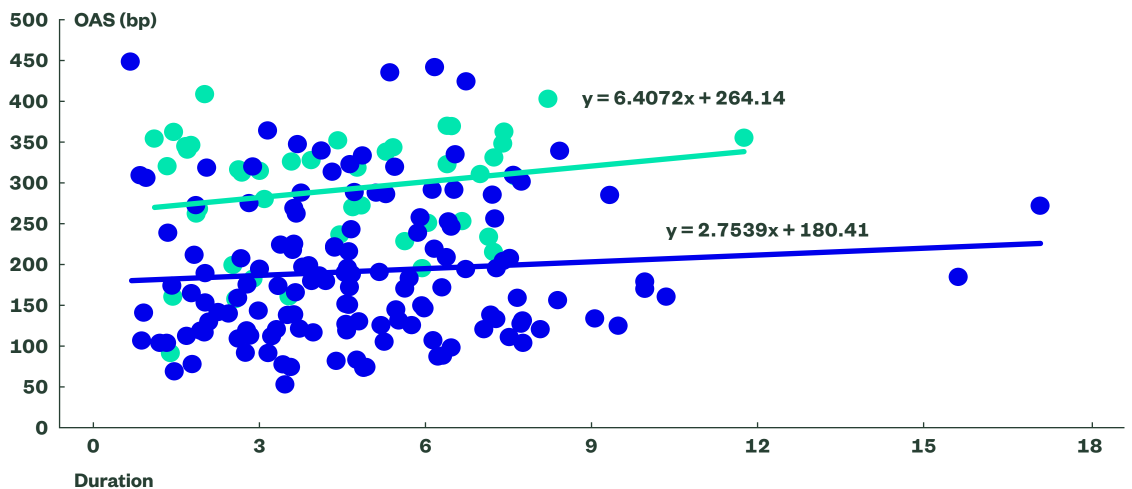
Baa3 Other
Baa3 Neg Watch



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 28 April 2020.

Figure 3
Baa3 Duration vs. Spread Euro Corps — Watch Neg vs. Stable/Pos

Baa3 Other
Baa3 Neg Watch



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 28 April 2020.

The Figures show plots of the option-adjusted spread (OAS) against option-adjusted duration (OAD) of the (Moody's) Baa3-rated bonds in the Bloomberg Barclays 0–3y Euro Corporate and the Euro Corporate indices. Baa3 bonds, being the final rung on the IG ladder, are the most at risk of a downgrade. The bonds are then further differentiated according to whether they are on negative watch (light dots) or not (dark dots).

- No surprises, the average OAS of the bonds on negative watch is higher than for those that have either a stable or positive outlook. The average OAD of the Bloomberg Barclays Euro Corporate Index is 5.1. Pricing this notional 'average bond' off the regression line that runs through the bonds on negative watch puts its fair value at 295bp against 195bp if valued using the 'other bonds' regression coefficients.

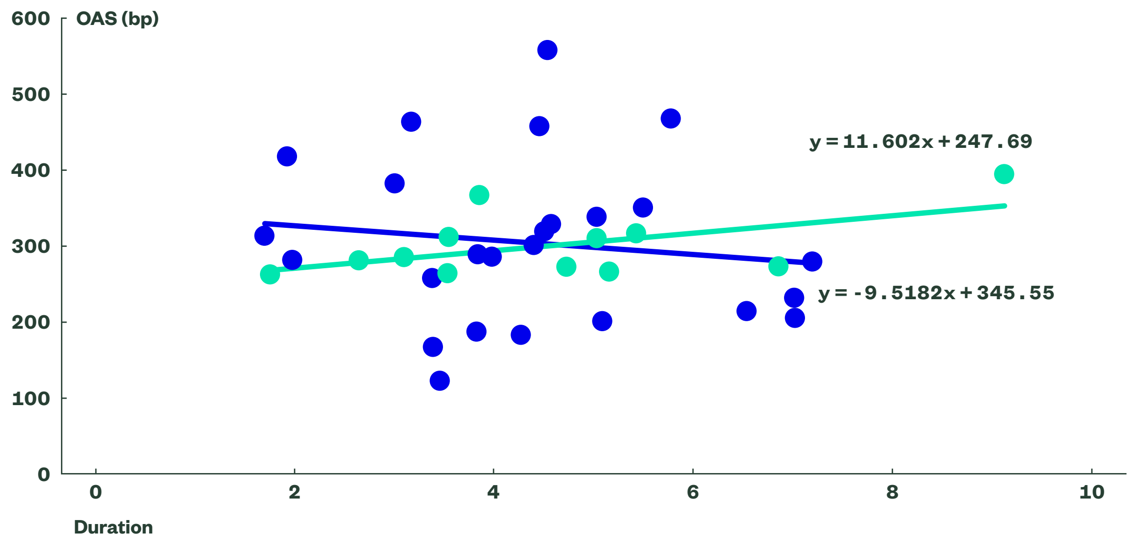
- What is notable is that for the 0–3Y corporate index, the line of best fit for the bonds on negative watch is actually downward sloping. This suggests a market that believes any downgrades will come in the next 12 months, i.e. during the current crisis, rather than in the longer maturities.

- Conducting a similar bond-by-bond analysis on the Bloomberg Barclays Euro High Yield Bond Index, but focusing on the upper end or Ba1 slice of bonds, presents a considerable contrast (see Figure 4). There is little spread differentiation between those Ba1 bonds on downgrade watch and those that are not. There is little by way of a term structure to the OAS either.

Resorting back to our notional average bond with a duration of 5.1, but using the high yield index to price it, gives an OAS of 295-300bp. In short, the bonds that are rated Baa3 and are on negative outlook in the IG funds trade at levels that are already broadly consistent with a downgrade to Ba1. So it would appear that the 'cliff edge' pricing of a move out of IG into high yield is already well accounted for within the IG portfolios.

Figure 4
Ba1 Duration vs. Spread High Yield — Watch Neg vs. Stable/Pos

Ba1 Other
Ba1 Neg Watch



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 28 April 2020.

Conclusion

With markets now more stable, the need for yielding assets is likely to push fixed income investors to take on credit risk. Despite the current heavy pipeline of issuance, euro-denominated IG corporate bonds should ultimately benefit from the combination of this reach for yield and ECB buying. The key risks now look like economic ones, with weak growth likely to cause an increase in downgrades.

From a fund perspective, the main concern is that a bond gets downgraded to speculative grade paper, as this would result in forced selling. However, a granular analysis of the pricing of lower-rated bonds within euro IG indices suggests that those that are the most at risk of a downgrade already trade at prices that are consistent with non-IG rated paper.

Endnote

1 Bloomberg data for Moody's downgrades for Western Europe. H1 2013 recorded 197 downgrades.

ssga.com/etfs

Marketing communication.
For professional client use only.

Important Information

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor. All information is from SSGA unless otherwise noted and has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

Australia: State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services Licence (AFSL Number 238276). Registered office: Level 14, 420 George Street, Sydney, NSW 2000, Australia T: +612 9240-7600. F: +612 9240-7611. **Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036. F: 32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Ireland Limited. State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **France:** State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière- Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92. **Germany:** State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89-55878-400. F: +49 (0)89-55878-440. **Hong Kong:** State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Ireland:** State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Israel:** No action has been taken or will be taken in Israel that would permit a public offering of the Securities or distribution of this sales brochure to the public in Israel. This sales brochure has not been approved by the Israel Securities Authority (the 'ISA'). Accordingly, the Securities shall only be sold in Israel to an investor of the type listed in the First Schedule to the Israeli Securities Law, 1978, which has confirmed in writing that it falls within one of the categories listed therein (accompanied by external confirmation where this is required under ISA guidelines), that it is aware of the implications of being considered such an investor and consents thereto, and further that the Securities are being purchased for its own account and not for the purpose of re-sale or distribution. This sales brochure may not be reproduced or used for any other purpose, nor be furnished to any other person other than those to whom copies have been sent. Nothing in this sales brochure should be considered investment advice or investment marketing as defined in the Regulation of Investment Advice, Investment Marketing and Portfolio Management Law, 1995 ("the Investment Advice Law"). Investors are encouraged to seek competent investment advice from a locally licensed investment advisor prior to making any investment. State Street is not licensed under the Investment Advice Law, nor does it carry the insurance as required of a licensee thereunder. This sales brochure does not constitute an offer to sell or solicitation of an offer to buy any securities other than the Securities offered hereby, nor does it constitute an offer to sell to or solicitation of an offer to buy from any person or persons in any state or other jurisdiction in which such offer or solicitation would be unlawful, or in which the person making such offer or solicitation is not qualified to do so, or to a person or persons to whom it is unlawful to make such offer or solicitation. **Italy:** State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 10495250960 - R.E.A. 2535585 and VAT number 10495250960 and whose office is at Via Ferrante Aporti, 10 - 20125 Milano, Italy. T: +39 02 32066 100. F: +39 02 32066 155. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. T: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **For use in Singapore:** State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. **Switzerland:** State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350.

Standard & Poor's, S&P and SPDR are registered trademarks of Standard & Poor's Financial Services LLC (S&P); Dow Jones is a registered trademark of Dow Jones Trademark Holdings LLC (Dow Jones); and these trademarks have been licensed for use by S&P Dow Jones Indices LLC (SPDJI) and sublicensed for certain purposes by State Street Corporation. State Street Corporation's financial products are not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates and third party licensors and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability in relation thereto, including for any errors, omissions, or interruptions of any index.
All forms of investments carry risks, including the risk of losing all of the invested amount. Such activities may not be suitable for everyone.
All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.
The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA's express written consent.
This communication is directed at professional clients (this includes eligible counterparties as defined by the **appropriate EU regulator or applicable Swiss Regulator**) who are deemed both knowledgeable and experienced in matters relating to investments. The products and services to which this communication relates are only available to such persons and persons of any other description (including retail clients) should not rely on this communication.
ETFs trade like stocks, are subject to investment risk and will fluctuate in market value. The investment return and principal value of an investment will fluctuate in value, so that when shares are sold or redeemed, they may be worth more or less than when they were purchased. Although shares may be bought or sold on an exchange through any brokerage account, shares are not individually redeemable from the fund. Investors may acquire shares and tender them for redemption through the fund in large aggregations known as "creation units." Please see the fund's prospectus for more details.
Past Performance is not a guarantee of future results.
The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the Markets in Financial Instruments Directive (2014/65/EU). This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.
International Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns.
Investing in foreign domiciled securities may involve risk of capital loss from unfavourable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.
The views expressed in this material are the views of SPDR EMEA Strategy & Research and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

© 2020 State Street Corporation.
All Rights Reserved.
ID209693-3072153.1.1.GBL.INST 0520
Exp. Date: 31/05/2021