Investment-Grade Corporate Bonds

Exit Strategy

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Tight spreads present an opportunity to move up in quality and liquidity.

Investment-grade corporate bond spreads tightened by 17 basis points to 106 basis points in the third quarter, supported by the backup in Treasury yields, increased demand for risk from traditional buyers, lower levels of supply over the summer, and record-breaking highs in equities. Despite this rally, however, unsustainable leverage in the BBB universe warrants heightened scrutiny. Risks have grown exponentially in both quantity and quality: Not only has the corporate bond market doubled in size over the past decade to $5.2 trillion, but BBB-rated debt has ballooned 227 percent to $2.5 trillion since 2009, according to Morgan Stanley. Global access to liquidity has fueled this explosion of BBB issuance, largely to fund mergers and acquisitions (M&A). Since 2015, $752 billion in high-grade corporate bonds have been issued to fund M&A, accounting for almost one third of all nonfinancial bond issuance, according to JP Morgan.

Our concern is that these highly levered companies will be unable to achieve the leverage targets set forth by the rating agencies. On average, leverage increased from 2.4x to 4.0x since 2015, and with recession on the horizon, the eventual decline in earnings will push up leverage further. Meanwhile, rising funding costs will see interest coverage erode and access to capital markets become more exclusive (see chart, top right). This perfect storm will result in downgrades to junk status: The average BBB-rated corporate bond has an 18 percent chance of being downgraded to noninvestment grade within the next five years, according to Moody's data. The high-yield market may not be able to absorb this potential glut of fallen angels without significant dislocations, causing the current tight spread between A and BBB bonds to widen at a pace that could shock the market.

The investment-grade market mentality remains "buy the dip," which should absorb the first few waves of broad-based weakness. There is no escaping the inevitable collision of growing leverage and looming economic recession, however, which makes for a poor risk/reward environment for prudent investors. We view the current compression in A–BBB spreads as an opportunity to move up in quality and liquidity ahead of what could soon become an extremely hostile environment for investors in investment-grade corporate credit (see chart, bottom right).

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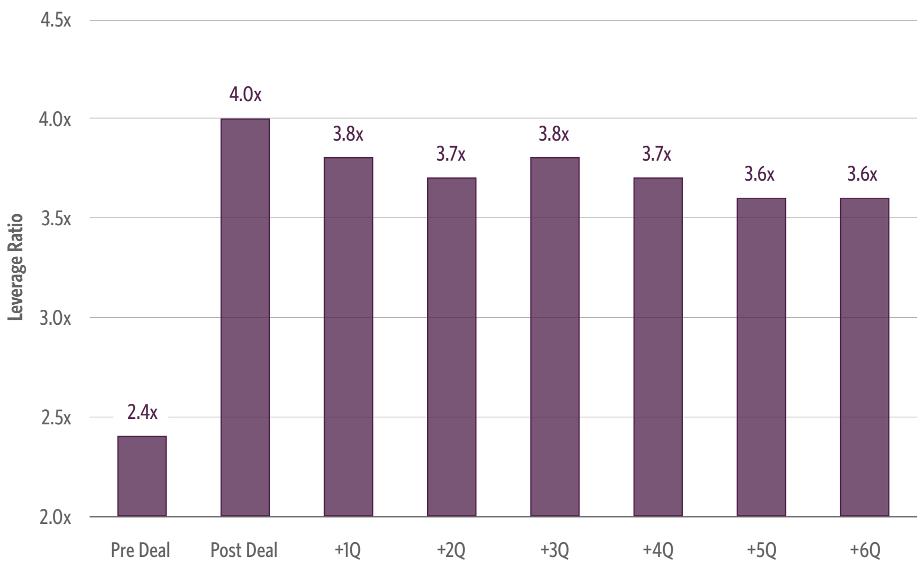
Post-M&A Deleveraging Trends Have Been Weak Despite Economic Strength

Average Total Debt / EBITDA Ratios Before and After M&A Transactions



Source: Morgan Stanley Research. Data as of 9.21.2018. Based on a list of 32 M&A transactions since 2015 reviewed by Morgan Stanley Research.

On average, leverage increased from 2.4x to 4.0x since 2015 for companies involved in M&A deals. With recession on the horizon, increasing funding costs will see interest coverage erode and access to capital markets become more exclusive.

BBB-A Industrial Spread Is Below the Historical Average

Source: Bloomberg Barclays, Guggenheim Investments. Data as of 10.24.2018.

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