Investment-Grade Corporate Bonds

The Easy Money Has Been Made

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Changes in monetary policy, rising corporate leverage, and a deteriorating technical landscape are taking a toll.

On Feb. 1, 2018, the Barclays Corporate Credit index spread reached 85 basis points, its tightest level since 2007. By the end of the first quarter, however, spreads had retraced by 25 percent to 110 basis points, a sign that the tightening trend in investment-grade corporate credit spreads appears to be approaching its natural conclusion. The positive technical backdrop that accommodative monetary policy supported for so long may be the very thing that unravels our fragile credit ecosystem as the market transitions from quantitative easing to quantitative tightening. Credit spreads will likely experience bouts of fatigue over the next quarter, though these episodes will likely be met with support as rising rates drive demand from pension funds. Foreign holdings of corporate debt remain high, but rising foreign exchange hedging costs could stymie the technical support bid for U.S. dollar-denominated corporate bonds (see chart, top right).

Meanwhile, the path of rising rates, as well as the recent widening of credit spreads, should call into question the ability of some companies to manage their increased debt loads. Corporate debt structures have enjoyed low financing for the better part of a decade. This, along with favorable corporate tax reform, has resulted in increased M&A activity so far this year. Leverage for the investment-grade universe has steadily risen from about 1.7x in 2012 to 2.5x in 2017, which could pose problems as the windfall from tax cuts dissipates (see chart, bottom right).

The Bloomberg Barclays U.S. Corporate Bond index lost 2.3 percent during the first quarter of 2018 as a result of a duration-driven selloff plus some spread widening. Excess returns were -0.8 percent and spreads widened 16 basis points quarter over quarter. Returns were negative for all ratings, with AAA-rated, AA-rated, A-rated, and BBB-rated bonds losing 3.1 percent, 1.8 percent, 2.6 percent, and 2.2 percent, respectively.

All told, the easy one-way trade in investment-grade corporate spreads is nearing its end. The path forward will require that investors better understand the credits they own, and determine the appropriate duration for their portfolios. As spreads come under pressure and negative technicals become more pronounced, we believe deep fundamental analysis will be key to identifying the pitfalls and the opportunities of a more challenging investment environment.

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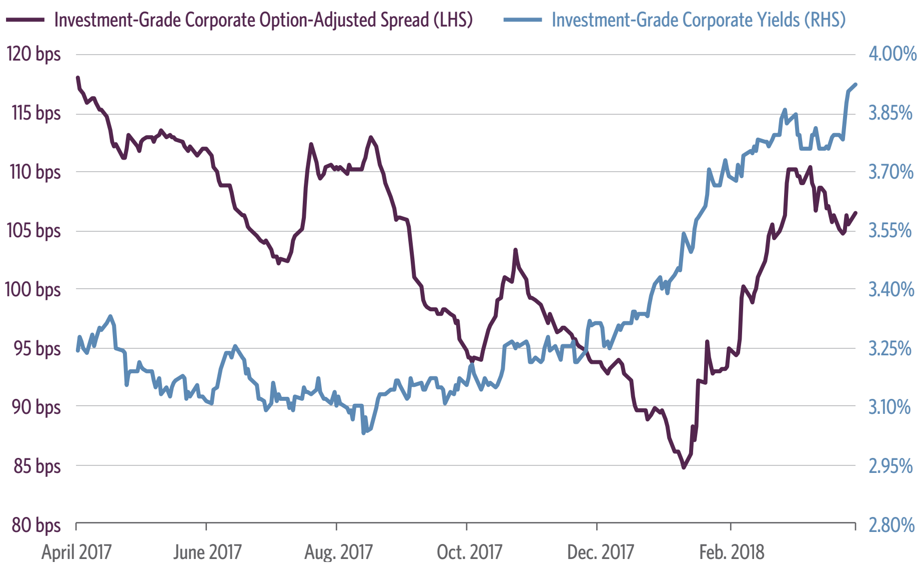
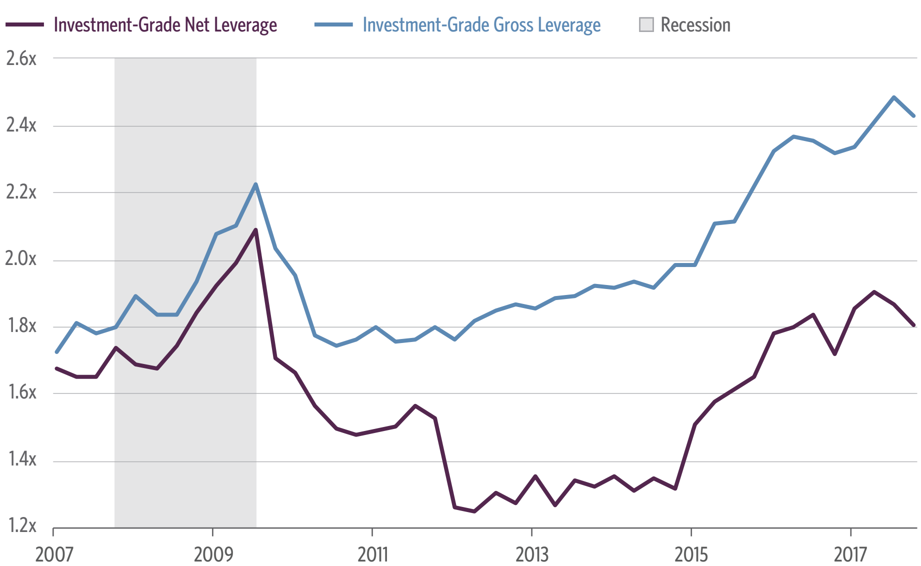
Spread Tightening May Be Reaching Its Natural Conclusion



Source: Bloomberg Barclays, Guggenheim Investments. Data as of 4.23.2018. LHS = left hand side, RHS = right hand side.

Foreign holdings of corporate debt remain high, but rising foreign exchange hedging costs could stymie the technical support bid for U.S. dollar-denominated corporate bonds. With longstanding technicals weakening, spreads will likely experience bouts of fatigue over the next quarter, and tightening may be nearing its natural conclusion.

Rising Leverage May Be a Problem Later as Tax Windfall Dissipates



Source: Morgan Stanley Research, Guggenheim Investments. Data as of 12.31.2017. Gray area represents recession.

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