Fixed Income Insights
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The Big Mac[1]

Managing Credit's Pricing of Perfection

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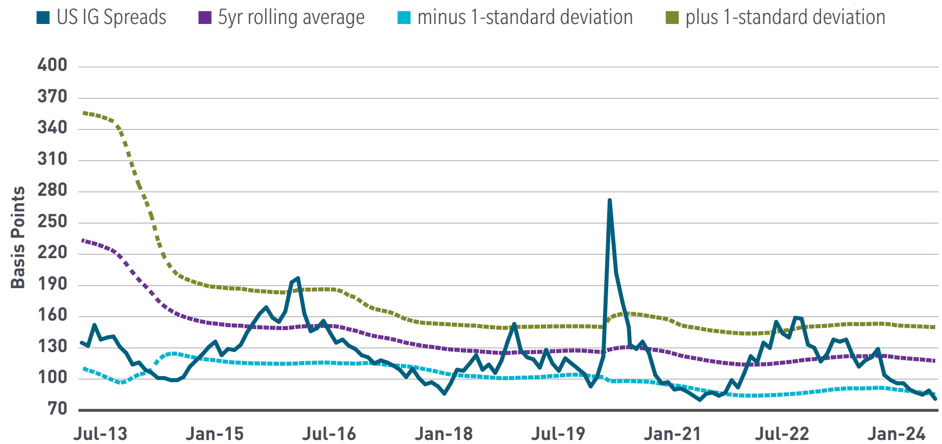
For some investors, credit spread valuation may be perceived as a major headwind for fixed income. But we are of the view that the outlook for fixed income total returns remains robust in the period ahead despite the current level of spreads, which looks stretched by historical standards. This is because the major source of total returns will likely come from somewhere else, namely the impact of rate decline, the elevated carry and, last but not least, the potential contribution from alpha.

There is no denying that credit spreads look stretched in many segments of global fixed income. For instance, US investment-grade credit spreads currently stand at about 80 basis points, well below their 5-year average of 118 bps (Exhibit 1). The current level at 80 bps corresponds to a z-score of -1.16, which points to significant overvaluation.[1] It's not just US IG. Many asset classes are currently displaying spread levels that look rich. Based on the 10-year percentile rank, the percentile is close to zero in the cases of IG, high yield, taxable munis and emerging market corporate debt, suggesting that we are currently observing very tight spread levels by historical standards (Exhibit 2).

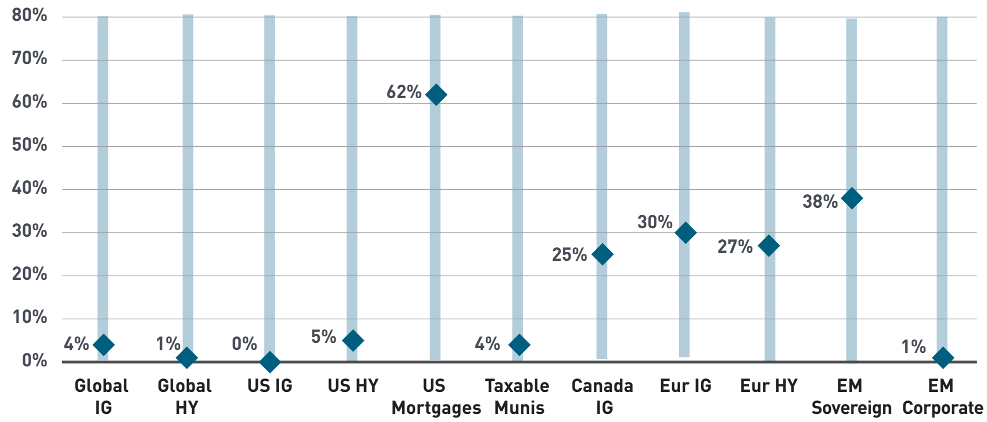
Exhibit 1: US IG Credit Spreads Look Rich



Source: Bloomberg. US IG credit = Bloomberg US IG Corporate Index. Spreads = option-adjusted spreads. Historical average is estimated using a 5-year average rolling window. The 1-sigma deviation from the historical average typically designates a level that would be considered attractive on a historical valuation basis (z-score of 1). Conversely, the minus 1-sigma tends to designate a level that would be considered expensive. Monthly data from Aug. 2013 to Oct. 2024 (data as of 15 Oct).

[1] The Big Mac, which is a hint at big macro, is a periodic global fixed income note that discusses relevant topics in the global fixed income/global macro environment.

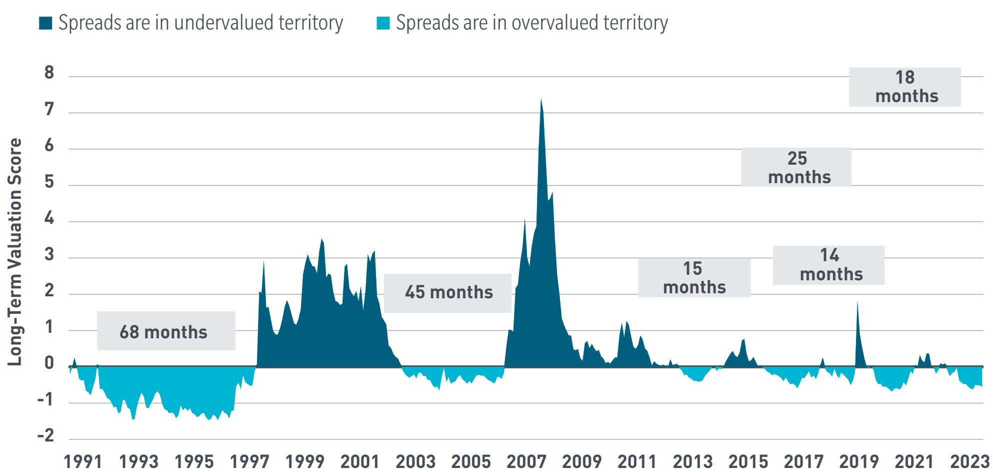
Exhibit 2: Spread Percentile Rank (current versus last 10 years)



Source: Bloomberg. Daily data from 15 October 2014 through 15 October 2024. US IG = Bloomberg US Aggregate Corporate Index. US HY = Bloomberg US Corporate High Yield Index. US Mortgage = Bloomberg US MBS Index. EM Sovereign = J.P. Morgan EMBI Global Diversified Index. EM Corporate = J.P. Morgan CEMBI Broad Diversified Index. Europe IG = Bloomberg Pan-Euro Aggregate Corporate Index. Europe HY = Bloomberg Pan-European High Yield Index. Global IG = Bloomberg Global Aggregate Corporate Index. Global HY = Bloomberg Global Corporate High Yield Index. Canada IG = Bloomberg Canada Aggregate Corporate Index. US Agg-Eligible Taxable Munis = Bloomberg US Taxable Municipal Aggregate Eligible Index.

The good news is that stretched spread valuation is not uncommon. In itself, a stretched level of spreads doesn't necessarily mean that a major spread correction is on the way. In fact, throughout recent history, we have observed many lengthy episodes of rich credit spreads. As long as there are no correction catalysts, spreads can remain in overvalued territory for an extended period of time, especially if market technicals, including inflows into the asset class, are robust and if the global risk appetite remains healthy (Exhibit 3).

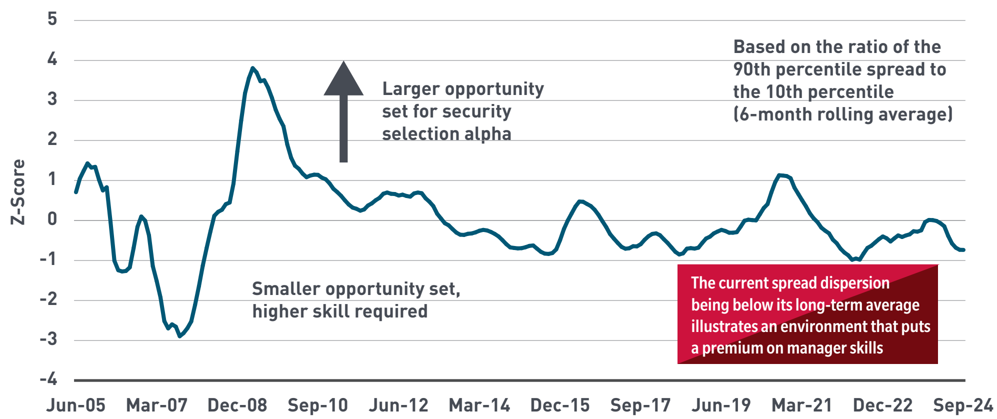
Exhibit 3: The Persistence of Rich US IG Credit spreads



Sources: Bloomberg. US IG = Bloomberg US IG Credit Index. Spreads = option-adjusted spreads. Long-term valuation score = spread z-score calculated over the period October 1991 to August 2024, using an expanding window. A z-score is a measure of deviation from long-term average expressed in units of standard deviation. Bars represent periods when the z-score is < 0, *i.e.*, spreads are in rich territory relative to their long-term fair value.

For credit risk, it is currently more about alpha than beta. Given where spreads are, it is unlikely that spread compression will act as a major contributor to credit total returns. Against this backdrop, the role of alpha, *i.e.*, the excess return generated by the active asset manager, takes predominance. Not only are spreads tight, but spread dispersion is also well below its historical average (Exhibit 4). Under tight spread dispersion, the opportunity set for security selection alpha tends to shrink, which means there is a premium on the quality and skill of the asset manager. In other words, a tight spread dispersion environment is an opportunity for the highly-skilled asset manager to shine. A thorough security selection investment process and a developed global research platform are likely to be paramount to adding value in the face of the current valuation landscape, in our view.

Exhibit 4: US IG Spread Dispersion Below Long-Term Average



Sources: Bloomberg. US IG Credit = Bloomberg US IG Corporate index. US IG Spread Dispersion = spread z-score using monthly data from Dec. 2004 to September 2024 on a 6-month rolling basis, using an expanding window. A z-score is a measure of deviation from long-term average in terms of units of standard deviation.

Despite the spread valuation backdrop, credit total return expectations continue to be robust. The impact of rate cuts, the attractive carry, combined with the potential contribution from alpha are likely to play out as the key drivers of the asset class's performance over the next year. The initial conditions appear favorable to us, given where total yields currently are. For instance, the yield on US IG credit currently stands at 5.12%.[2] This means that the potential income return is likely to be elevated by historical standards. To that income return, one must add the contribution from both the spread and rate moves, as summarized in Exhibit 5. Under a scenario characterized by lower rates — following the impact of rate cuts — and stable credit spreads, expected returns over a one-year horizon could potentially hover around the high single-digit territory.

Exhibit 5: One-Year Hypothetical Return Projections for US IG Credit Under Various Rate and Spread Move Scenarios (%)

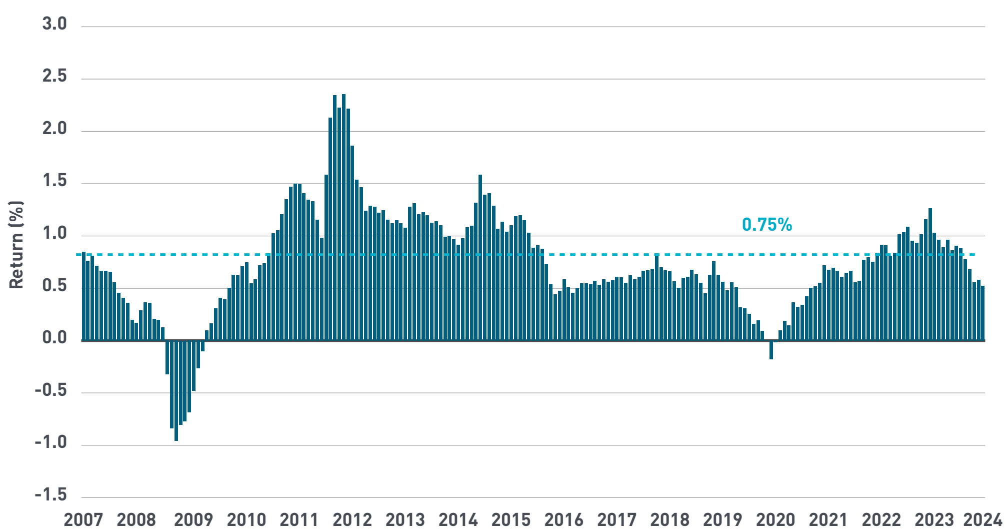
US IG — Spread Moves over the Next Year (basis points)

Rate Moves over the Next Year (bp)	-45	-30	0	+30	+60	+90	+120	+150	+180	+210
+150	-2.18	-3.22	-5.31	-7.39	-9.48	-11.56	-13.65	-15.73	-17.82	-19.90
+120	-0.10	-1.14	-3.22	-5.31	-7.39	-9.48	-11.56	-13.65	-15.73	-17.82
+90	1.99	0.95	-1.14	-3.22	-5.31	-7.39	-9.48	-11.56	-13.65	-15.73
+60	4.07	3.03	0.95	-1.14	-3.22	-5.31	-7.39	-9.48	-11.56	-13.65
+30	6.16	5.12	3.03	0.95	-1.14	-3.22	-5.31	-7.39	-9.48	-11.56
0	8.24	7.20	**5.12**	3.03	0.95	-1.14	-3.22	-5.31	-7.39	-9.48
-30	10.33	9.29	7.20	5.12	3.03	0.95	-1.14	-3.22	-5.31	-7.39
-60	12.41	11.37	9.29	7.20	5.12	3.03	0.95	-1.14	-3.22	-5.31
-90	14.50	13.46	11.37	9.29	7.20	5.12	3.03	0.95	-1.14	-3.22
-120	16.58	15.54	13.46	11.37	9.29	7.20	5.12	3.03	0.95	-1.14
-150	18.67	17.63	15.54	13.46	11.37	9.29	7.20	5.12	3.03	0.95

Bloomberg: US IG = Bloomberg US IG Corporate Index. Starting yield and duration as of 29 Oct. 2024. Hypothetical returns represent a range of outcomes and are for illustrative purposes only and should not be considered an indication of future performance The bold number in the middle is the yield-to-worst for the Bloomberg US Corporate Index. The table illustrates a range of return using the yield to worst and applying incremental changes in interest rates and/or credit spreads. This analysis assumes that if interest rates and credit spreads are unchanged, the index's published yield-to-worst becomes the dominant factor for determining realized return over the next year, which allows for the full capture/earning of the starting yield-to-worst. This analysis assumes that no bonds default, come in or out of the index, and that all bonds are held until maturity. Changes in interest rates represent a parallel shift in the yield curve occurring at the end of the period and measures for duration and spread duration are option-adjusted.

Away from beta, excess returns have historically been significant, thereby reinforcing the case for active management in fixed income. Looking at the history of the community of asset managers that use the Bloomberg US Credit Index as their benchmark, the alpha generated over the past 20 years has reached 75 bps per year on average, which is substantial. The alpha levers at the disposal of the asset manager are diverse, ranging from security selection to sector allocation, relative value or curve positioning. Given that the 20-year beta return for US IG Credit currently stands at 4.03%, a 75 bp alpha represents a major uptick.

Exhibit 6: Average Rolling 3-Year Excess Returns – Average US Corporate Strategy versus Bloomberg US IG Credit



Source: eVestment Alliance, LLC. The eVestment All Global Fixed Income universe was screened for active managers using an unhedged approach and benchmarked to the Bloomberg US Credit Index. The returns are gross of fee and in USD. Quarterly data from April 2004 to March 2024. **Past performance is no guarantee of future results.**

Overall, the outlook for total returns in fixed income remains robust, mainly reflecting the contribution from expected rate declines and the elevated carry. Spreads, however, are unlikely to play out as a major contribution to performance. Ultimately we believe, in credit, this is an environment that is a lot more supportive of alpha as a source of return than beta.

End Notes

[1] A z-score is a measure of deviation from long-term average in units of standard deviation. A z-score of 1 (1-sigma deviation from the historical average) typically designates a level that would be considered attractive on a historical valuation basis. Conversely, a z-score of minus 1 tends to designate a level that would be considered expensive.

[2] Source: Bloomberg. US IG = Bloomberg US IG Corporate Index. Data as of 29 Oct. 2024.

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