Insights

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clearwater® ADVISORS

Diversifying Exposure Away From Corporate Credit on Relative Value

The aggregate U.S. corporate index had a historic year in 2019 achieving 14.3% in total return which was only bested by a 19.7% return in 2009. These two periods of outperformance followed negative returns in the previous year: -5.8% in 2008 and -2.1% in 2018. Buy low, sell high right? But the primary catalyst for both of these rallies was support provided by the central bank to soothe investor sentiment with the Fed cutting interest rates to zero by the end of 2008 and the Fed reversing course on its tightening cycle starting in the summer of 2019. The tables below provide a breakdown of total and excess returns for U.S. corporate credit for 1) the one to five year index and 2) the aggregate index as provided by Bloomberg Barclays.

2019 Total and Excess Returns by Industry and Composite Ratings

U.S. Corp 1-5 Year Index

	Avg % Wgt	Total	Excess
Financial	41.9%	7.1%	2.9%
Industrial	53.8%	6.9%	2.6%
Utility	4.2%	6.2%	2.0%

	Avg % Wgt	Total	Excess
AAA	1.1%	5.2%	0.8%
AA	11.1%	5.6%	1.5%
A	41.8%	6.5%	2.2%
BBB	44.0%	7.8%	3.5%

U.S. Corp Aggregate Index

	Avg % Wgt	Total	Excess
Financial	31.9%	7.1%	6.3%
Industrial	60.9%	6.9%	7.3%
Utility	7.2%	6.2%	4.8%

	Avg % Wgt	Total	Excess
AAA	1.8%	14.4%	4.7%
AA	8.1%	10.5%	3.7%
A	39.1%	12.9%	5.5%
BBB	48.6%	16.0%	8.3%

Historical Total and Excess Returns

	U.S. Corp 1-5 Year Index		U.S. Corp Aggregate Index	
Year	Total	Excess	Total	Excess
2019	7.0%	2.7%	14.3%	6.8%
2018	1.0%	(0.6%)	(2.1%)	(3.1%)
2017	2.6%	1.9%	6.4%	3.5%
2016	2.8%	1.8%	6.0%	4.9%
2015	1.2%	0.3%	(1.0%)	(1.6%)
2014	2.0%	0.7%	7.2%	(0.5%)
2013	1.5%	1.9%	(1.3%)	2.9%
2012	6.2%	5.2%	10.2%	7.3%
2011	3.1%	(0.4%)	8.2%	(3.7%)
2010	5.7%	2.2%	8.8%	2.3%
2009	16.5%	15.8%	19.7%	22.8%
2008	(3.5%)	(12.6%)	(5.8%)	(19.9%)
2007	5.7%	(3.1%)	4.4%	(5.2%)
2006	4.6%	1.0%	4.2%	1.3%
2005	1.3%	(0.2%)	1.6%	(1.2%)
2004	2.8%	1.2%	6.0%	1.6%
2003	5.6%	3.7%	9.3%	5.8%
2002	8.1%	(0.2%)	10.6%	(2.4%)
2001	7.7%	0.7%	9.2%	2.7%
2000	8.3%	(1.6%)	9.7%	(5.0%)
1999	1.7%	1.3%	(1.8%)	1.7%

Source: Bloomberg, Clearwater Advisors

Today's low rates will be supportive of risk asset valuations and any hawkish impulse from the Fed will be quelled by its desire to boost inflation. However, at this point in the credit cycle we question where is the upside? Or in other words, is there adequate compensation for downside risk? 5-year CDS, for example, is a scant 44bps. One could argue this fairly reflects low levels of future default due to Fed accommodation, but this goldilocks level seems to ignore that leverage metrics have climbed as profit growth has slowed leaving little room for error should the cycle turn. In addition, the last time CDS reached sub-40bps at the start of 2018, spreads were 15bps wider within one month.

This brings us back to the buy low, sell high mantra. While we expect credit risk for corporates to remain low, relative spreads on MBS, CMBS, and ABS are sufficiently wide to justify diversification away from corporates. These structured product sectors typically exhibit less volatility compared to corporates. Further, CMBS and ABS sectors incorporate structural features that will limit losses for higher rated tranches should economic prospects sour. At this point, we would generally avoid higher quality corporates (A or better) on a relative value basis given tight spreads and the potential for event risk to pursue inorganic growth. We continue to look for opportunities in corporate credit, but would favor new issuance from infrequent issuers with sustainable cash flows and reasonable valuations. We are also looking out for opportunities in the low-BBB and rising stars space for names we think have a tangible path to deleveraging and improving credit profiles.