Insights
November 18, 2020

clearwater® ADVISORS

Looking Beyond the Current Surge in Infections

1-5 year corporate credit is on track to achieve a consecutive year of strong total return. Based on the Bloomberg Barclays Investment Grade 1-5 Year U.S. Corporate Bond Index as of October 31, 2020, total return year-to-date was 4.40% compared to 6.50% for the same time horizon last year. In 2016, 2017 and 2018 year-to-date returns were 3.59%, 2.76% and 0.18%, respectively.

Spreads across the 1-5 curve have recovered tremendously since the peak of coronavirus uncertainty with credits rated A- or better now trading tighter than levels seen at the end of January (see chart). As such, we recommend that risk averse investors consider increasing their exposure to longer duration credits in the 'BBB+' ratings tier.

We think the following factors should decrease credit risk in the investment grade sector through recovery in earnings and reduction in leverage contributing to positive excess returns in 2021:

- The prospects of at least one highly effective vaccine being distributed in coming months and minimal economic scarring from less restrictive lockdowns.
- The Fed's ability to remain accommodative given its new average inflation targeting framework. Even when economic uncertainty eventually subsides, the Fed has demonstrated hesitation in raising rates. This means financial conditions for corporates will likely remain easy for some time.
- New issuance is expected to contract substantially in 2021 given this year's deluge of primary issuance. Strong demand for risk given low yields combined with lower supply will cause spreads to tighten from their current levels.
- If the Fed discontinues its corporate bond buying program, spread levels going forward should nonetheless presume that the Fed would push to intervene again if credit market conditions were to drastically deteriorate.
- Lawmakers desire fiscal stimulus even if Congress remains divided. On the other hand, a divided government should enable the corporate tax cuts passed in 2017 to remain in place. Excess cash from lower tax rates should support deleveraging and stronger credit quality.

Given our favorable credit risk outlook going into 2021, we view select 'BBB+' credits as currently offering better risk-adjusted return for risk averse investors relative to single-A credits.

Further, in regards to historical credit performance, the average three-year cumulative default rate for a credit rated 'A-' is 0.37% compared to a 'BBB+' average cumulative default rate of 0.56%. Over a five-year period this rate is 0.83% for 'A-' compared to 1.04% for 'BBB+'. [1]

At an average spread differential of 14 to 19 bps across the 3-5 year part of the 'BBB+' curve, we believe investors are being adequately compensated for a small degree of incremental credit risk.

[1] Default rates by alphanumeric rating, 1983-2019. Moody's Annual Default Study, January 30, 2020.

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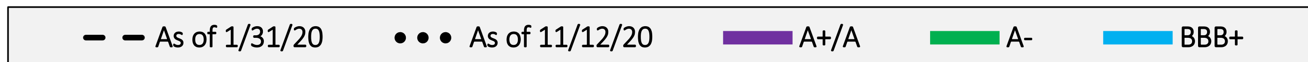
Credit Spread Curves

Investment Grade U.S. Corporate Bonds: 1-5 Year

Credits rated A- or better are now trading tighter than levels seen at the end of January. BBB+ credits in the 3-5 year part of the curve continue to offer value with Banks, Communications, Energy, and REITs on average still wide to January levels.



Source: Bloomberg, Clearwater Advisors