

# RETHINKING THE ROLE OF INVESTMENT GRADE CORPORATES



**FATIMA LUIS**

Senior Portfolio Manager

Q4 2022

## IF GOVERNMENT BONDS AREN'T THE OBVIOUS BUY THEY ONCE WERE, WHAT ELSE SHOULD YOU CONSIDER AS A CORE PORTFOLIO ALLOCATION?

### Is it time for government bonds to step aside in favour of a new core portfolio allocation?

Successful investing is all about getting your risk/reward balance right. The classic approach to constructing a balanced portfolio is the 60/40 ratio – 60% in equities to provide growth and 40% in bonds to deliver stable income and protect against equity volatility.

Government bonds have been a core component of the fixed income 40%, ranking low on the risk spectrum and typically considered a 'safe bet' for long-term returns.

But today's macro environment is delivering a unique combination of geopolitical uncertainty, high inflation, a shift from quantitative easing to tightening and the threat of recession.

On top of this, we're facing political disarray in the UK, with a revolving government rehashing policy and ramping up volatility across developed markets.

The result is the debt of many developed economies is a much less appealing portfolio stalwart than it has been historically. Yields on 10-year US Treasuries have increased from 1.5% at the start of the year to 3.6% today. In the UK, 10-year Gilt yields have gone from 0.9% to 3.4% (data to 28 October 2022).

If government bonds aren't the obvious buy they once were, what else should you consider as a core portfolio allocation? Right now, we're looking at high-quality, developed market corporate debt as an alternative.



Investment grade (IG) corporate bonds currently offer higher income and higher returns compared to developed market sovereign bonds. Combined, the yield and spread offer a buffer against rates volatility and recession risk. In a recessionary environment, government bond yields typically fall, providing an uplift to long-dated investment grade.

## WHAT IG CORPORATES OFFER

### 1. Spread

The Bloomberg US Aggregate Corporate Index's average spread has nearly doubled from the low in June 2021 when it was at 80bps.

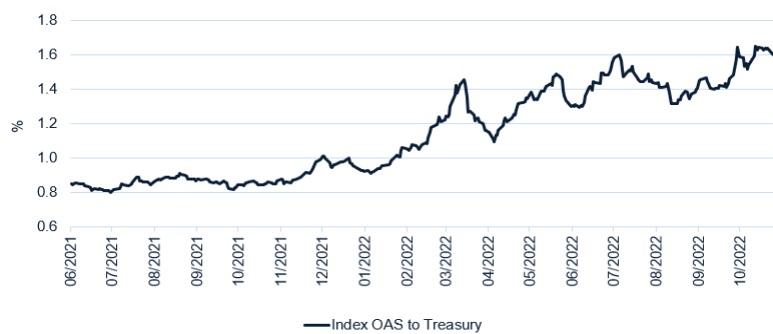
At the end of October 2022, it was 158bps (Chart 1). If we discount the Covid-19 induced spike, this is a five-year high. This spread cushion should protect corporate credit from the volatile yield environment.

### 2. Yield

Yields are at multi-year highs, approaching levels last seen during the global financial crisis (Chart 2), yet the default probability on IG corporates is negligible, so you can sensibly assume that the rate is locked in. While inflation remains a concern, our view is that an economic slowdown will prove disinflationary.

## CHART 1: BLOOMBERG US AGGREGATE CORPORATE INDEX SPREAD

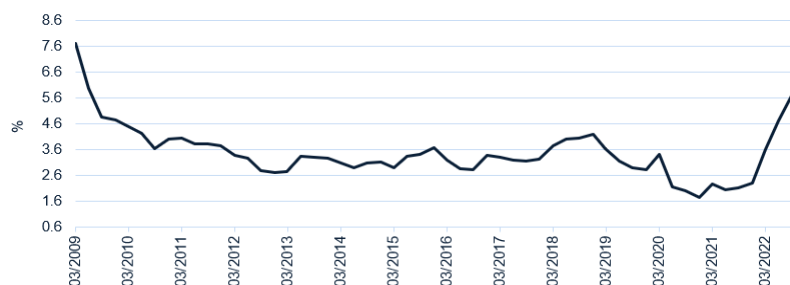
Spreads have nearly doubled from June 21 lows



Source/ Bloomberg, 28 October 2022

## CHART 2: BLOOMBERG US AGGREGATE CORPORATE INDEX YIELD

Approaching levels last seen during the Global Financial Crisis



Source/ Bloomberg, 28 October 2022



## UNIQUE ALLOCATION REBUILD OPPORTUNITY

The correlation between fixed income and equities should begin to normalise as central bank support is withdrawn, allowing interest rates to revert to levels that are market-driven. As correlations revert, so too should the efficacy of the 60/40 portfolio structure.

 Right now, we have an opportunity to rebuild bond positions, with IG corporates looking like the more attractive allocation choice over government bonds.

We're seeing price action in the IG market that is more akin to what we'd typically see for high yield corporates that are experiencing serious issues.

For example, you can currently buy quality, A-rated names for around 60 cents on the dollar – representing a 40% discount to par. This is the type of price point you'd expect to see in a default scenario, not for quality, stable debt. This price discrepancy is being driven by the move in rates rather than fundamental issues with the credit because yields were abnormally low for so long and many corporates were able to issue with extremely low coupons.

**WE'RE SEEING PRICE ACTION IN THE IG MARKET THAT'S MORE AKIN TO WHAT WE'D TYPICALLY SEE FOR HIGH YIELD CORPORATES THAT ARE EXPERIENCING SERIOUS ISSUES.**

## BALANCING RISK & REWARD

While corporate bonds aren't a risk-free investment, the default rate of IG companies has historically been close to 0%, according to Moody's data. Even if we were to see a global recession, it's more likely we'd see ratings downgrades, with IG names becoming fallen angels, rather than defaults.

Compare this to government bonds, particularly in the UK where the government is flailing around, taking wild guesses at policy and making decisions that are ultimately bad for its own credit.

In the corporate market, you typically don't get this kind of management disarray as the companies have fiduciary responsibilities to their investor base. Thorough credit research also helps to identify quality companies with robust management and strong fundamentals, further reducing investment risk.

## CLOSING THOUGHTS

The fixed income landscape is unique – yields are at multi-year highs and rates continue to rise. While corporate debt won't be immune from the impacts of recession, we believe quality IG credits should prove resilient and present a more attractive proposition compared to government bonds. As interest rates peak and we see inflation begin to fall and the economic slowdown take hold, owning longer-duration IG assets should prove fruitful. For the more conservative investor, shorter-date bonds now offer very attractive yields.



---

## IMPORTANT INFORMATION

This marketing material is for your exclusive use only and it is not intended for any person who is a citizen or resident of any jurisdiction where the publication, distribution or use of the information contained herein would be subject to any restrictions. It may not be copied or transferred.

**This material is provided for information purposes only and shall not be construed as an offer or a recommendation to subscribe, retain or dispose of fund units or shares, investment products or strategies.** Potential investors are recommended to seek prior professional financial, legal and tax advice. The sources of the information contained within are deemed reliable. However, the accuracy or completeness of the information cannot be guaranteed and some figures may only be estimates. In addition, any opinions expressed are subject to change without notice.

**All investment involves risks, returns may decrease or increase because of currency fluctuations and investors may lose the amount of their original investment. Past performance is not indicative or a guarantee of future returns.**

Issued by: in the UK: Mirabaud Asset Management Limited which is authorised and regulated by the Financial Conduct Authority. D14 In Switzerland: Mirabaud Asset Management (Suisse) SA, 29, boulevard Georges-Favon, 1204 Geneva. In France: Mirabaud Asset Management (France) SAS., 13, avenue Hoche, 75008 Paris. In Luxembourg, Italy and Spain: Mirabaud Asset Management (Europe) SA, 25 avenue de la Liberté, L-1931 Luxembourg.

FOR PROFESSIONAL INVESTORS ONLY