Fed Buying Corporates Is No Panacea

But global investment-grade corporate segments offer value.

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KEY INSIGHTS

- We are more skeptical than some observers about the long-term impact of the Federal Reserve buying corporate bonds.
- It is important to keep in mind that the Fed established its corporate purchase facilities to improve liquidity, not to prop up bankrupt companies.
- While we see opportunities in various segments of the global investment-grade corporate bond market, rigorous fundamental credit analysis remains essential.

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While we are more skeptical than some observers about the long-term impact of the Federal Reserve buying corporate bonds, we see opportunities in various segments of the global investment-grade corporate bond market. The Fed's late-March announcement that it would include corporate bonds in its quantitative easing purchases triggered a strong rally in the asset class as investors welcomed the central bank's support. However, the Fed's support will not reduce the elevated uncertainty about the public health situation and reopening global economies, so rigorous fundamental credit analysis and security selection remain essential.

Rapid Deterioration in Economic Outlook

In March, as investors realized the extent of the coronavirus pandemic and its economic damage, credit spreads[1] rapidly widened and credit rating agencies began to downgrade debt issued by a range of companies. More than USD 100 billion[2] of bonds were downgraded from investment grade to high yield in March alone, including debt from Ford and Occidental Petroleum. Compounding the sudden deterioration in the economic outlook and corporate fundamentals, fixed income illiquidity caused spreads to move even wider.

On March 23, the Fed announced that it would establish primary and secondary corporate credit facilities to acquire investment-grade corporate bonds with five years or less to maturity

> "The central bank's corporate buying will not improve solvency...

[1] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.
[2] Source: J.P. Morgan (see Additional Disclosures).

as well as exchange-traded funds (ETFs) that hold investment-grade corporates. Credit spreads peaked on March 23 at 373 basis points[3] (bp) on U.S. investment-grade corporates[4] and 326 bp on global investment-grade bonds.[5] Spreads retraced about half of their widening by mid-April and have held roughly steady through mid-May.

Our quantitative analysis team determined that much of the spread compression—which happened well before the central bank actually started buying corporates—stemmed from the Fed's backstop removing most of the liquidity premium from the market as well as from lower volatility. Spreads capture the total premia that market participants demand for volatility, liquidity, and credit risk. In order for spreads to continue to narrow, the outlook for defaults needs to improve, which depends on the trajectory of the economic recovery.

Fed Support Designed to Boost Liquidity, Not Solvency

However, some of the spread movement may have come from market participants anticipating that the Fed would provide essentially unlimited support, erasing some of the premium for credit risk—which is undoubtedly higher now than at the beginning of the year. It is important to keep in mind that the Fed established its corporate purchase facilities to improve liquidity, not to prop up bankrupt companies. Fed Chair Jerome Powell has reinforced this distinction in public comments after the initial program announcement. The central bank's corporate buying will not improve solvency, and a company's CEO must attest to the issuer's solvency before the Fed will purchase its debt in the secondary market.

Value in Diversification Outside the U.S.

Although the number of opportunities in investment-grade corporates with dislocated prices have decreased as spreads have narrowed since late March, we believe that some segments of the global investment-grade corporate market offer value. Investing in corporates outside the U.S. can provide valuable diversification benefits.

For example, bonds issued by select banks in the UK and Ireland tend to be less correlated with the U.S. corporate bond market, and we view them as providing attractive value. In contrast with the global financial crisis, when banks were at the root of the problems that radiated out into the economy and financial markets, banks are likely to play an important role in helping the global economy recover from the pandemic. In general, many global banks are fundamentally solid with ample capital levels.

Contrarian Opportunities in Energy

We have not written off the entire energy industry despite the precipitous decline in oil prices that began with Saudi Arabia's decision to boost production in March. In what may seem like a contrarian idea, we are finding opportunities in bonds issued by a few companies in the U.S. shale oil industry. To the U.S. government, this is a key strategic industry, so it is more likely than other sectors to benefit from fiscal policy. We rely on our credit analysts to find the best-run companies in the shale oil business and gauge the value of their bonds. We also favor bonds from some midstream energy companies, which process and transport petroleum products, because of their use of long-term contracts and relatively low exposure to energy price declines.

[3] A basis point is 0.01 percentage point.
[4] As measured by the Bloomberg Barclays US Corporate Bond Index (see Additional Disclosures).
[5] As measured by the Bloomberg Barclays Global Aggregate Corporate Index (see Additional Disclosures).

Ongoing Volatility Likely

Like all risk markets, global investment-grade corporates would likely experience renewed selling pressure if the public health situation deteriorates as global economies start to reopen. We anticipate ongoing volatility amid the elevated uncertainty, and spreads could potentially move wider.

The Fed backstop would probably prevent a repeat of the extreme liquidity problems experienced in March, although the eventual removal of central bank support could also trigger volatility in the longer term. In this unusual environment, strong credit selection is vital, allowing us to build exposure to companies that we believe can sustainably meet their debt obligations through the recession and emerge in a strong position.

WHAT WE'RE WATCHING NEXT

Corporations have become much more conservative in managing their balance sheets since March, prioritizing cash by cutting or eliminating dividends and stock buybacks. This is undoubtedly positive for bondholders, but we will be monitoring the trend to see if corporations return to their pre-crisis patterns of using balance sheets to benefit shareholders.

The specific securities identified and described are for informational purposes only and do not represent recommendations.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material:

Debt securities could suffer an adverse change in financial condition due to a ratings downgrade or default, which may affect the value of an investment. Fixed income securities are subject to credit risk, liquidity risk, call risk, and interest rate risk. As interest rates rise, bond prices generally fall.

Additional Disclosure

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Important Information

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