US corporate-bond spreads tipped to remain low even as Fed scales back support

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By Peter Brennan
Market Intelligence

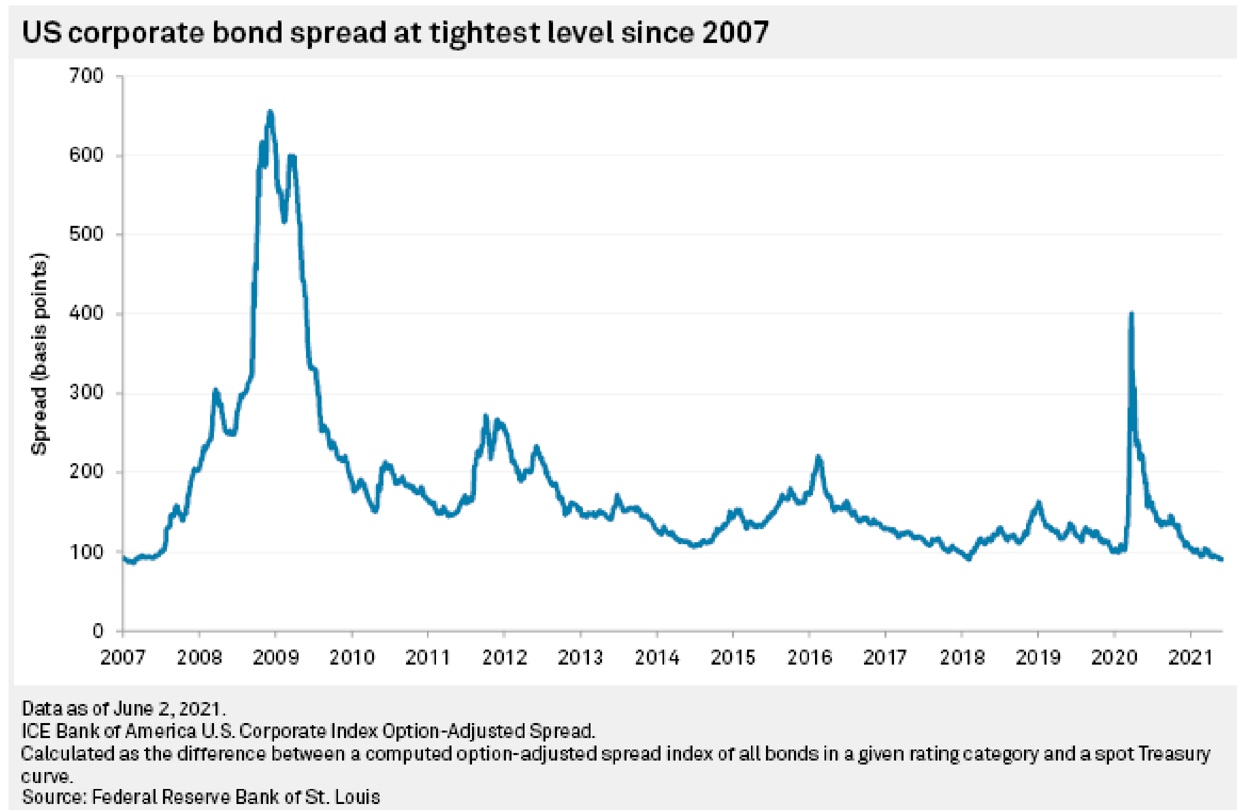
U.S. investment-grade corporate bonds are as expensive as they have been since 2018 as the gap between yields for company credit and government debt has fallen to its lowest point since then.

The difference is tipped to remain near its current low even as the Federal Reserve starts to scale back the policies designed to boost companies' liquidity during the pandemic, experts say.

"Spreads are tight and will remain tight for the foreseeable future. But they're tight for a reason," David Sekera, chief U.S. market strategist at Morningstar, said in an interview. "Default rates should remain low for the next couple of years in our view, and we would expect to see more [credit rating] upgrades than downgrades."

The ICE Bank of America U.S. Corporate Index Option-Adjusted Spread — a closely watched measurement of the premium an investor receives for the added risk of holding corporate bonds rather than Treasurys — narrowed to 90 basis points on June 2, as a recovering economy makes Corporate America an increasingly safe bet.

The recent low in spreads matched a brief drop to the same level in early 2018, which was the lowest point since 2007. Bond yields fall as prices rise, meaning higher-priced corporate bonds push yields for that debt lower.



Data as of June 2, 2021.
ICE Bank of America U.S. Corporate Index Option-Adjusted Spread.
Calculated as the difference between a computed option-adjusted spread index of all bonds in a given rating category and a spot Treasury curve.
Source: Federal Reserve Bank of St. Louis

Investors expect an improving economy, stable outlook for interest rates and a reduced supply of bonds to keep spreads low, even if the Fed begins to tighten the loose monetary policy it adopted during the pandemic to support

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liquidity in credit markets.

"A well-telegraphed and highly anticipated tapering by the Fed is unlikely to have a marked impact on corporate credit spreads," Gene Frieda, global strategist at PIMCO, said in an email. "As long as the Fed communicates a belated and gradual process of interest rate hikes well beyond the period of tapering, we expect spreads to remain well contained."

Fed no longer a backstop

The spread exploded when COVID-19 reached the U.S., rising from a pre-pandemic level of 102 bps to a peak of 401 bps on March 23, 2020, as investors anticipated a rise in corporate defaults. The Fed then pumped trillions of dollars into financial markets to restore liquidity in debt markets, lowering borrowing costs for companies.

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The central bank acted as a backstop for the bond markets during the pandemic, primarily through its $120 billion monthly asset purchases. While the program principally targeted Treasurys rather than corporate bonds, each time the Fed hoovers up a government bond, the seller needs to reallocate their cash, diverting capital toward other assets, such as corporate bonds, and allowing companies to borrow.

The question of when the Fed will eventually taper its bond-buying program is dominating financial markets even though Chairman Jerome Powell is adamant that the governing council is not even discussing scaling back purchases.

One of the central bank's smaller economic support programs will soon end. The Federal Reserve Board announced June 2 its plans to begin winding down the Secondary Market Corporate Credit Facility, through which the Fed holds $13.7 billion of outstanding corporate bonds and ETF holdings. The Federal Reserve Bank of New York will handle the sell-off, which is expected to begin June 7.

The gradual unwinding of the program "will hardly be a rounding error on the Fed's balance sheet," Marc Chandler, chief market strategist at Bannockburn Global Forex, wrote in a June 3 market commentary, and investors do not expect corporate bond spreads to change dramatically even when the main bond-buying program slows down.

Improving credit fundamentals

The main threat to the outlook for corporate spreads is if interest rates rise, according to Morningstar's Sekera, though the Fed does not expect to raise rates until 2023.

The prospect of a rate hike was compared to an oncoming "steamroller" by Viktor Hjort, global head of credit strategy at BNP Paribas. "But that steamroller is likely far away leaving plenty of pennies to pick up and coupons to clip," Hjort said in an email.

The accelerating relaxation of social distancing measures and reopening of the economy is removing much of the risk in the corporate sector, which has already done much to improve its financial position. High cash ratios and increasing interest coverage ratios highlight a healthy business environment, even as debt levels rose over the course of the pandemic.

Bolstered by high cash levels, many companies have less need to issue bonds than they had in 2020 — a year of record issuance forced by lost revenues — reducing the supply-side pressure on spreads. Fewer bonds mean fewer assets for investors to buy, pushing up prices and lowering yields.

Bond issuance by investment-grade rated companies is down 32.5% year over year in the first five months of 2021 to $662.14 billion, according to LCD. While this is still a historically high level — 35.3% higher than in 2019 — the volume of issuance should be easily absorbed by the market, according to BNP Paribas' Hjort.

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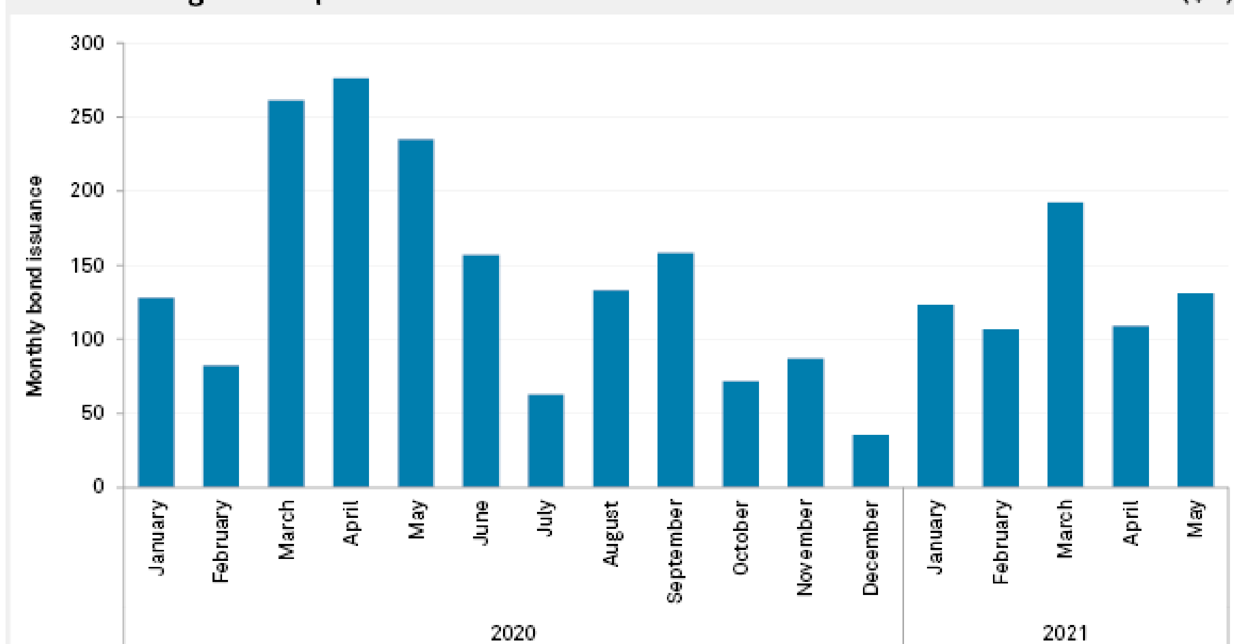

Investors are also backing companies with lower credit ratings. The ICE Bank of America U.S. High Yield Index Option-Adjusted Spread hit a three-year low of 324 basis points in April and has hovered around that level since, ending June 4 at 328 bps. This means bonds are relatively expensive for investors, and the cost of borrowing is relatively low for non-investment-grade-rated companies.

"We believe the [high-yield] asset class should be supported by the continued search for yield amid accommodative global central bank policies, and default risks should abate as social activity normalizes and growth and earnings recover," Mark Haefele, global chief investment officer at UBS Wealth Management, said in a May 26 research note.

The recovery in credit is reflected by the number of rising stars — companies upgraded from non-investment-grade credit ratings to investment grade — outpacing the number of fallen angels by seven to two so far in 2021, with companies such as WPX Energy Inc., Parsley Energy LLC and Advanced Micro Devices Inc. all being upgraded.

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7 rising stars so far in 2021

Issuer	To	From	Sector/subsector	Rated debt affected ($B)
WPX Energy Inc.	BBB-	BB-	Oil and gas	4.8
Parsley Energy LLC	BBB	BB	Oil and gas	4.8
Advanced Micro Devices Inc.	BBB-	BB+	High technology	1.3
QEP Resources Inc.	BBB-	B	Oil and gas	1.6
PulteGroup Inc.	BBB-	BB+	Homebuilders/real estate companies	2.1
MDC Holdings Inc.	BBB-	BB+	Homebuilders/real estate companies	0.9
Qorvo Inc.	BBB-	BB+	High technology	1.6

2 fallen angels so far in 2021

Issuer	To	From	Sector/subsector	Rated debt affected ($B)
Host Hotels & Resorts Inc.	BB+	BBB-	Media and entertainment	4.8
Hexcel Corp.	BB+	BBB-	Aerospace and defense	0.7

Data as of June 2, 2021.
Fallen angels are investment-grade issuers currently with bonds outstanding that have been downgraded to speculative-grade (i.e., from 'BBB-' or above to 'BB+' or below).
Rising stars are speculative-grade issuers currently with bonds outstanding that have been upgraded to investment-grade (i.e., from 'BB+' and below to 'BBB-' and above).
Includes all rated issuers with valid outstanding debt at the time of the ratings action.
Sectors defined by S&P Global Ratings.
Source: S&P Global Ratings

BNP forecasts the amount of rising star debt in 2021 to grow from the current $17.1 billion to $80 billion. And while high-yield issuance is up 68.5% year over year at $246.8 billion, according to LCD, BNP Paribas does not expect BBs — the highest rated tranche rated below investment-grade — to increase the supply of bonds to the same extent as single-Bs and loans.

"Such low level of vulnerability means it will have to take unusually dramatic shocks to move spreads widely in either direction," Hjort said.

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