Payden&Rygel

Global Corporate Bonds New Opportunities

A discussion on global corporate bond opportunities in this roundtable featuring the Payden and Rygel fixed income team. Participants included Natalie Trevithick, Payden's Head of Investment Grade Credit Strategy; Timothy Crawmer, Director and Global Credit Strategist; and Frasat Shah, a Senior Vice President in Global Fixed Income. Here are highlights from their conversation.

Doubt lingers around the global corporate fixed income sector, but Payden's Natalie Trevithick, urges that investors believe. Why?

Yields are high—around 4% in Euro-denominated bonds and over 5% in U.S. and Sterling issues. Central bank cuts have so far failed to materialize, keeping rates attractive for now, especially at the long end.

- Says Trevithick, "Duration is your friend. So, while global central bank cuts may have been pushed back further in 2024, we still expect them to come, and in the meantime, you're clipping a nice coupon. Even if we only get two to three rate cuts in the year ahead, we're looking at total returns in the high single-digits. If we're pushing out the rate-cutting cycle further, that sets us up nicely for 2025, 2026 with nice solid returns, you want to have that longer duration component within your portfolio."

Three key factors driving performance

Three key factors drive global corporate bond returns fundamentals, technical factors, and valuations.

Fundamentals

- Fundamentals are strong as corporate issuers are benefiting from the stronger than expected global economy.
- Corporate issuers locked in lower borrowing costs prior to 2022 by issuing longer dated bonds with the proceeds going towards paying down shorter maturity bonds.
- As a result, interest costs remain historically low for corporate borrowers, even after the run-up in rates. The average coupon on the Global Investment Grade Corporate index is now just under 3.75%.
- Margins are strong, given still higher-than-normal inflation in the U.S. and Europe.
- Leverage is relatively low, declining in Europe and stable in the U.S., as investors have been exercising prudence with their capital structures.

Technical factors

- Technical factors look even better as investors are pouring money into fixed income assets to capture the currently attractive level of yields. On the supply side of the equation, issuers would prefer not to issue debt at these high levels of yield. “So, there's very much a stronger demand than there is supply,” says Tim Crawmer.
- Supply has been slightly increasing in the U.S. lately, as issuers refinance at lower spreads and merger and acquisition activity generates more new issues. However, demand is strong enough to offset this increase. Says Frasat Shah, “In 2024, inflows have been robust across the spectrum,
  and we've seen investors attracted back into fixed income due to the higher yields against the backdrop of falling inflation. The inflows into investment grade corporates have been enough to soak up the supply and some. We expect this trend to continue this year and technicals to continue to be a strong positive force for returns in the global IG corporate markets.”

Valuations

Meanwhile valuations are fair, even given the decline in spreads amid heightened demand. “When we look back over time, there have been periods where valuations have been even tighter from a spread perspective when fixed-income demand was elevated like it is today,” Crawmer adds.

Risks

Despite an overall positive environment, Payden’s team identified some risks that it is tracking closely.

- As borrowing costs increase, default risk increases, so Payden has been focusing on liquid, higher-quality corporates globally.
- Idiosyncratic credit risk—that is factors that affect only one issuer—becomes more crucial in a tight spread environment. For example, Altice France traded down significantly after the owner proposed a tender offer that was not favorable for the existing bondholders. Payden protects against this type of issue specific risk through broad diversification across securities.
- External risks, including the COVID crisis, Ukraine war and the UK pension crisis have roiled corporate bonds markets in recent years, and these events are by their nature hard to predict. Payden works with its risk department to run scenario and stress test analysis to understand how our global corporate portfolio would perform in unexpected risk environments.
- Liquidity squeezes are another risk, as in the run set off by the UK pension crisis. Payden protects against this risk by maintaining liquid portfolios and working closely with trading counterparties to ensure effective execution.

Investment grade versus high yield

The case for investment grade corporates is somewhat stronger than for high yield bonds for two reasons.

First the high yield market has become fragmented, with higher quality issues (BB and B) trading near historically tight spreads, while lower rated (CCC) issues are less richly valued. The opportunities for price appreciation, then, are in the riskier end of the market.

Second, high yield has an average duration of 3 to 4 years, much shorter than the investment grade asset class. As a result, these bonds don't benefit as much from interest rate cuts and a move lower in government bond yields as investment grade bonds do.

The case for diversifying into global corporate bonds

Natalie Trevithick says the argument for diversifying a portion of the global fixed income portfolio from sovereigns into corporates is simple: excess return potential.

"Last year and year-to-date, 1- to 30-year US corporates provide 80 basis points in incremental yields. Global corporates offer around 50 basis points. So, there's still good excess return to be had just with that incremental carry, especially when we view it to be relatively low risk. Even if we get a little bit of volatility and we'll see spreads widen out, as long as you have the conviction to carry your portfolio throughout these periods of volatility, we think you'll get that nice excess return in the end," she concluded.