

Focus on Credit

Investment grade credit: this is only just the start



Given the buzz surrounding credit since the beginning of the year, investors may be wondering how much more this asset class can offer. In this article, Adam Cordery, Head of UK & European Credit Strategies, outlines why he believes the huge opportunity relative to cash and government bonds still looks very far from over.

Adam Cordery, Fund Manager – UK and European credit

2009 so far ...

Given significant investor interest and strong returns since January, credit has already established itself as one of the 'hot' markets of 2009. Somewhat inevitably, this development has prompted talk as to whether the investment window for credit has already closed, and, indeed, whether we are now witnessing the development of yet another bubble.

As far as we are concerned, the answer to both of these questions is no. In fact, whilst corporate bond yields have already come in to some degree since March, we remain convinced that there is still a significant opportunity for investors relative to cash and government bonds.

The antithesis of a bubble

The thing to remember is that a 'bubble' simply means an overly stretched valuation. This could well be said to be the case within government bonds at the moment, but we believe the complete opposite is true of credit. This is because the spread of credit over government bonds is now higher than for any normal reference points, and the spread of credit over cash is greater than ever before.

We believe the bubble in credit, if ever there was one, was actually two years ago when cash was still yielding 5% and the spread over government bonds was virtually non-existent. This gave investors little incentive to make the switch into corporate bonds, and was very much the reverse of what we see today.

The rotation into credit has started but there is still much further to go

Largely as we anticipated at the beginning of the year, this extreme degree of yield divergence has started to be noticed throughout the rest of the market - prompting credit to outperform by quite some margin over the year to date. We remain very confident that this



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represents only the beginning of the upswing, however, and that there are at least two more years in which credit will prove very attractive.

Demand outstripping record levels of supply

Much of our confidence comes down to the significant levels of demand that we are seeing from all sides. In fact, it is no exaggeration to say that almost everyone we meet at the moment who is invested in cash or government bonds has expressed a desire to switch – firstly into good quality credit and secondly into high yield.

Moreover, there are some very significant trends developing on the supply side, which highlight the sheer extent of investors' current appetite for credit. The first relates to the secondary market, where a lack of willing sellers has reduced the overall supply of investment grade bonds. The second relates to the primary market, where 2009 has already proved to be a record year for corporate bond issuance around the world. The UK has been no exception to that, with figures from analytics firm Dealogic suggesting that non-financial investment grade companies have already raised around \$10 billion more than they did in 2008*.

What is most remarkable about the primary market, however, is that investors are eating up these record levels of credit issuance in their entirety. This trend has been very much borne out by our own experience, having submitted orders for around 52% of the new UK issues and been allocated only half of those orders. We believe this highlights not only the sheer weight of the demand for good quality credit, but also provides quite an interesting contrast to the excess supply currently seen within the gilt market.

Economic improvement and survivor bias should prompt the full upswing

Looking ahead, we believe there are two factors that should help to maintain the outperformance of credit over the next 12 to 24 months. The first is an improvement in economic growth, which we believe should occur as we move into 2010. By that stage, the huge fiscal stimulus and interest rate cuts should be feeding through to the real economy, whilst those consumers that have been able to keep their jobs should stop panic-saving.

The second is greater clarity on which companies will be able to survive this recession – a trend that we feel could see spreads coming in by as much as 50% over the course of the next 12 to 24 months. This comes back to the fact that, whilst defaults remain the biggest risk for credit, investors' expectations about the likely rate of default appear to be excessively high.

The best example of this can perhaps be seen within the investment grade arena, where the worst one-year default rate on record is just under 2%. With spreads at their current levels, however, the market appears to be expecting a default rate that is not only higher than this, but one that persists at this worse-than-ever rate for several consecutive years. Bearing in mind that we now look set to have a difficult recession rather than a full-scale depression, such dire assumptions about the outlook for investment grade credit would appear to be very overblown.

Picking out the winners

With these considerations about default risk and valuation in mind, it should be no surprise that we are focusing much of our attention on investment grade credit. This does not

* www.ft.com, BAE bond highlights revival of credit, 3 June 2009

entirely eliminate the risk of default, however, so an ability to strip out the winners from the losers remains an extremely important tool for generating the greatest value-add. We remain very confident that we can achieve this against what should be an extremely favourable backdrop for credit for some time to come.

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