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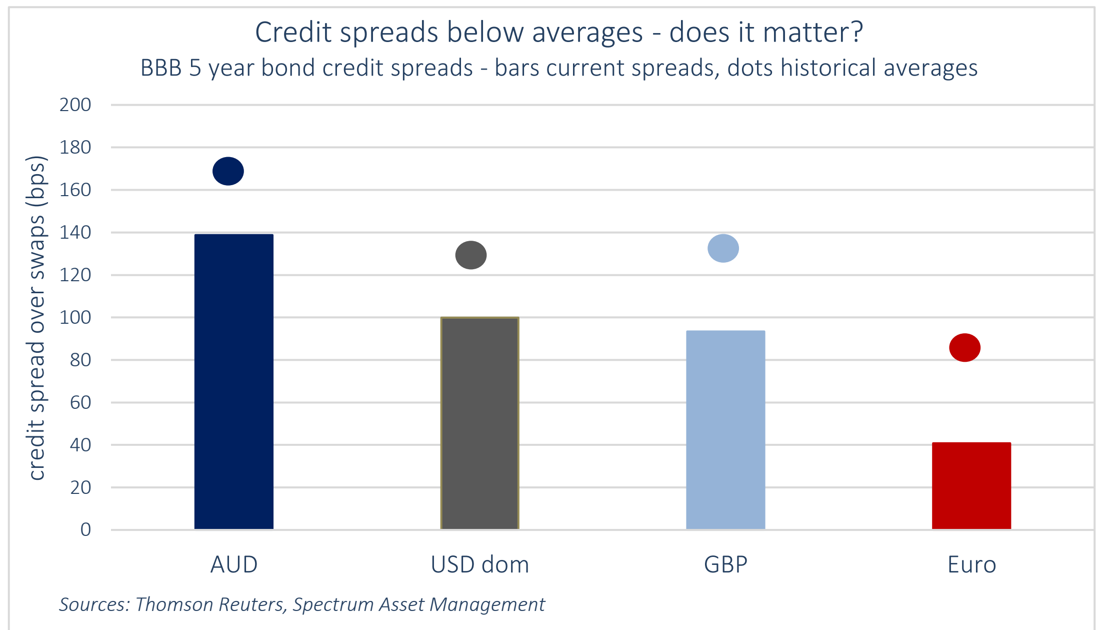
Average focus, below average outcome

Investment prices keep rising. Valuations are now well beyond long term averages for many asset classes. Pundits are increasingly calling for a big correction. Fears of overvaluation is also found in the corporate bond market. Credit spreads – the extra margin for default risk - are now notably lower than averages. But so too are expected default rates. Putting these two factors together makes the A$ corporate bond market, overall, appear around fair value to us. Add in the prevailing quest for yield and corporate bond spreads look like being well supported in the coming six months. In our view, those currently shunning corporate bond risk due to a reference to a one dimensional valuation technique – average credit spreads - look destined to generate below average returns.

Credit spreads below average – does it matter?

At Spectrum we believe averages are a useful analytical tool. They give perspective on valuations. But they do not give guidance on the direction of prices. Nor do they give context on current market conditions nor insight into absolute value.

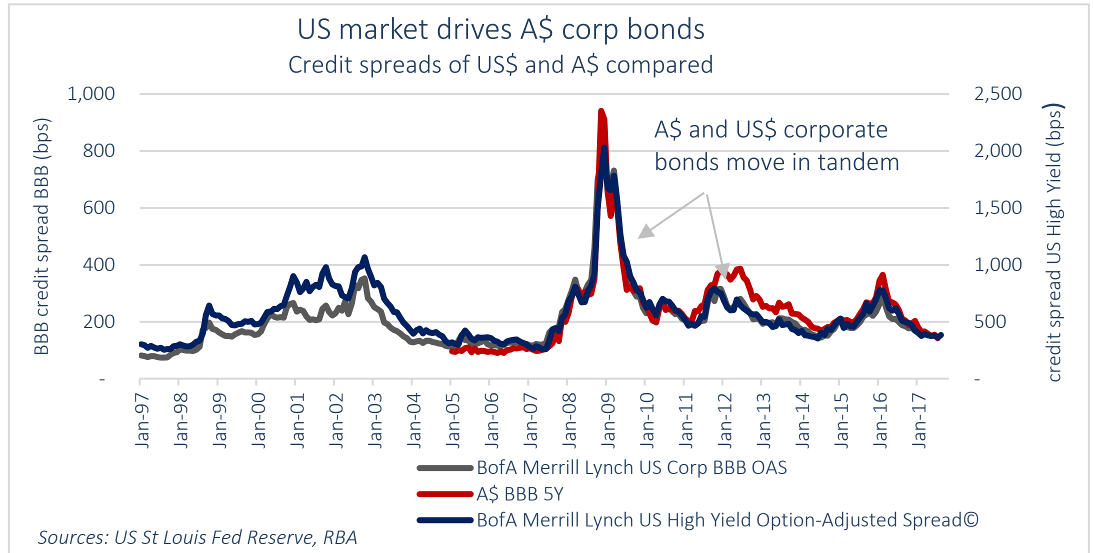


To default or not default - the ultimate question

In corporate bond investing the ultimate validation of an investment is determined by whether the issuer defaults or not. And if it defaults and this risk is not reflected in the price when you buy the bond you will probably lose money.

Global relevance to the Australian market

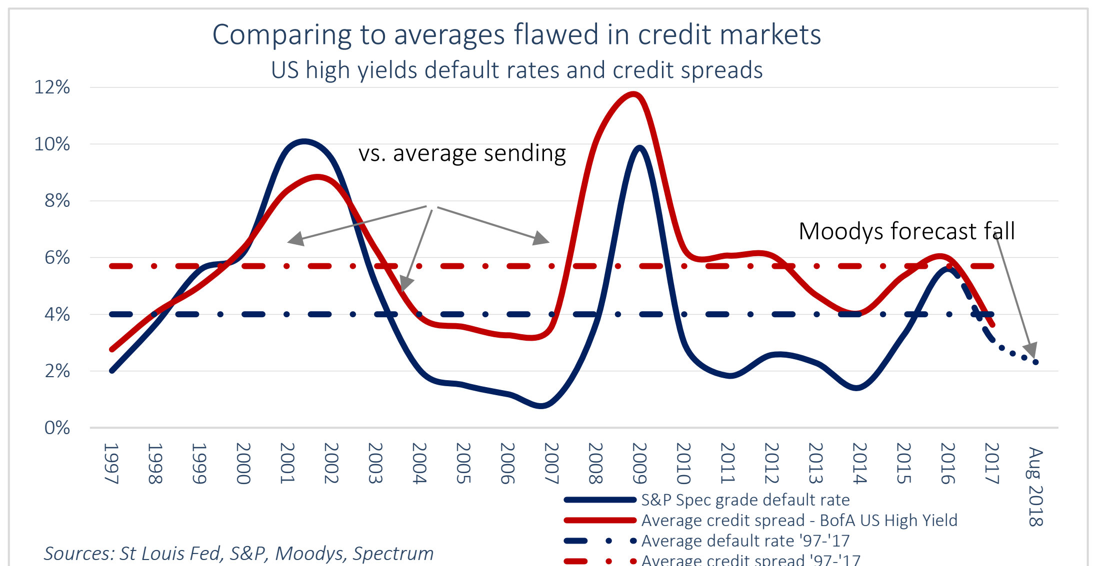
Defaults are most prevalent in the non-investment grade bond market otherwise known as junk. Australia does not have an evolved junk bond market. Our market generally looks abroad for default trends. These drive junk bond credit spreads which in turn drive investment grade bond performance in US$ and in turn A$ corporate bond credit spreads. This relationship is depicted in the graph below.



Where the above analysis falls on its face is when A$ corporate bond issuers experience a surge in financial distress while offshore default rates are low. Low default rates abroad will not prevent pain onshore. We see this as unlikely in the coming six months.

Where we are we going is more important than where we are

The assertion that credit spreads are below historical average and hence a bad investment is poor investment analysis. Comparing credit spreads to averages tells us little about the merit of investing in the corporate bond sector. Assessing whether current credit spreads adequately capture future losses is more important. The folly of average observations only, as a value indicator, can be seen in the graph below.



Default rates falling, so are spreads

The long term average default rates for sub investment grade default rates are a little over 4%. Moody's notes that global speculative grade annualized defaults have fallen from 4.8% in August 2016 to 2.9% in August 2017. More importantly the rating agency forecasts they will fall to 2.3% by August 2018.

Hence, if defaults are lower than average and expected to fall further, it makes sense to Spectrum that the margins for default risk are lower than the average as well.

Credit spreads may not be high enough for some segments

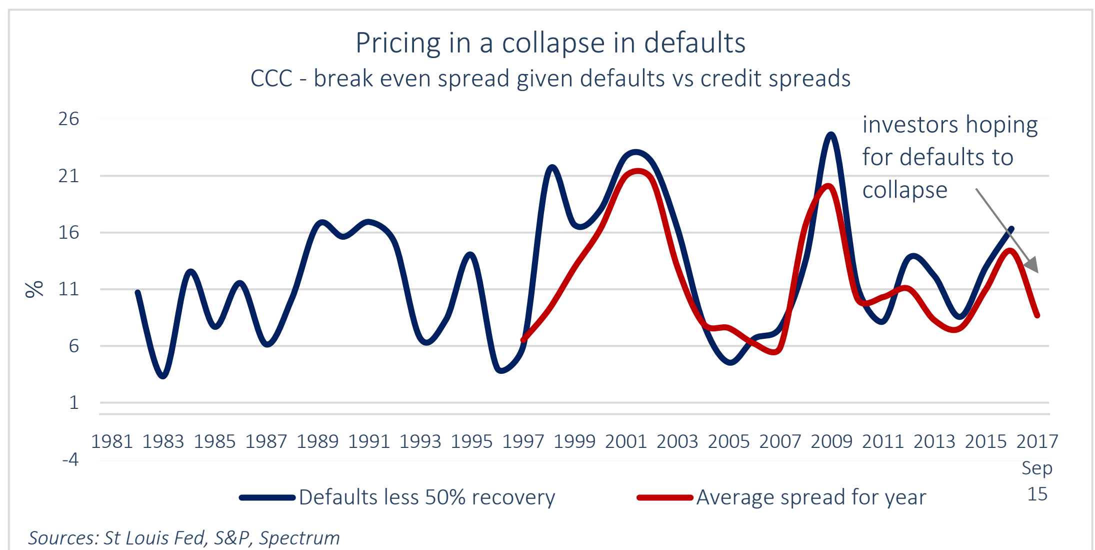
Most segments of credit markets can withstand risk-return analysis to justify current valuations. The riskiest part of international debt markets – peripheral emerging sovereigns and CCC rated bonds – look fully valued, at best.

The recent rise of emerging market sovereign bond issues from countries that are usually shut out of international markets suggests parts of the global credit markets could be losing their perspective on risk versus return.

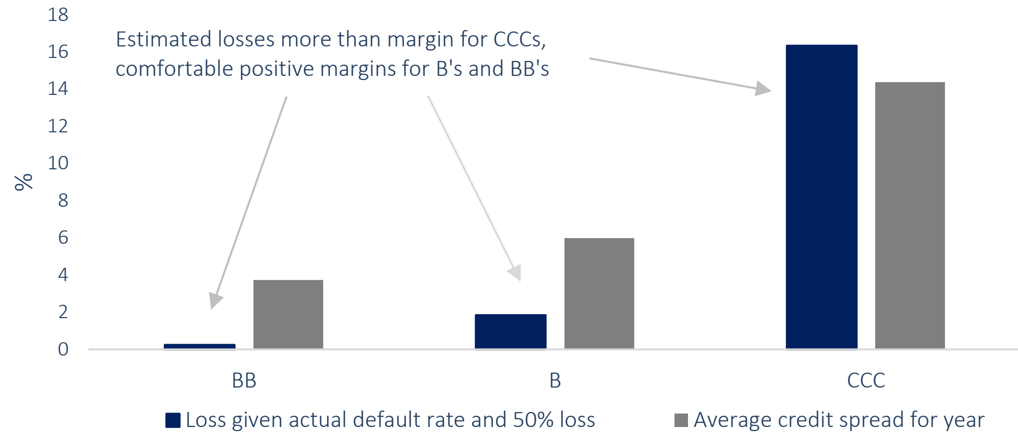
For example buying Argentina's century bond is either:-

- a clear triumph of hope over the investor experience of its frequent defaults or
- relies on a strategy of finding a bigger fool to sell to in the future.

Likewise the lowest rating segment for non-defaulted bonds, CCCs, are looking fully valued as long as default rates for CCC's collapse in the coming year. Below we graph out credit spreads for this sector versus an estimate of the sector's losses assuming a recovery rate of 50% on actual defaults.



Like the overall market CCC investors are expecting a sharp fall in defaults. Unlike the rest of the market there is little, if any, margin of safety for error to us. In aggregate current CCC rated bonds' credit spreads may not be enough to cover future losses. Whereas bonds with higher B or BB ratings provide a large buffer over estimated realized losses.



Sources: St Louis Fed, S&P, Spectrum

Acknowledged but not hampered

We acknowledge we are in the later stages of a credit cycle. As investment managers, though, we attempt to forecast shifts in market trends. Until expected default rates look like moving notably higher or credit spreads fall much further we remain invested acknowledging, but not hampered by, valuations which are beyond averages. Anchoring an investment strategy just on averages, in our view, endangers investment returns to be persistently below average.

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