

# *»Investment Grade Corporate Bonds: Outlook for 2021*

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10 December 2020

# IG Corporates Outlook 2021: The year of repair

## Executive summary

- Policy makers keep stimulus in place for most of 2021 to allow for **a year of fundamental repair**.
- We expect the improved market sentiment to trigger a rotation into higher beta assets. The USD is set to weaken and rates to increase modestly as safe-haven attributes are less in demand.
- **We expect spread tightening across the board**, but segment performance to be a function of beta<sup>1</sup>, supporting compression across credit quality and regions.
- While we expect excess returns<sup>2</sup> in 2021 to be in the low to mid-single-digit area, we expect total returns net of USD hedging costs to be a little more challenged on an index basis. Duration management and picking relative value opportunities across regions is key for active managers.
- **Key upside risks** include a democratic win in the Georgia senate runoff and a faster vaccine rollout / better uptake than currently anticipated, making further rounds of lockdowns a low-probability tail risk.
- **Key downside risks** include a no-deal Brexit and concerns around inflation leading to earlier-than-expected withdrawal of central bank support.

## Review of 2020

2020 started on a very strong foot by adding a total return of 3.7% in USD for the US investment grade corporate bond index by the end of February. Already back then, the driver of this return was a strong rates rally. Credit spreads, on the other hand, flatlined at best as (possibly already forgotten given the events that followed) the geopolitical tension in the Middle East was followed by the correction of the oil market.

In the second half of February, the market started realizing that Covid-19 was escalating into a real threat for the Western world. As lockdowns were announced country by country, the market started to price in a shock, which quickly turned into a downward spiral where a day of losses triggered new selling. The resulting liquidity shortage caused by record-level outflows from mutual funds and significant redemptions of index-tracking funds led investors across markets to adopt a “sell what you can” attitude, selling even safe-haven assets, such as government bonds and gold. During the month of March, US investment grade (IG) corporate bonds lost 7.5%, while their counterpart in Europe lost 6.8% (based on ICE Data indices in local currency). The correction stood out as the heftiest and fastest drawdown in history for both markets, exceeding the loss magnitude of September 2008. Even within IG credit, we witnessed some disproportionate moves, with the highest credit qualities (rated AA and A) correcting to a greater extent than BBB rated bonds, for instance. The liquidity crisis, however, was most obvious in the money market – specifically in commercial paper, where credit spreads for US commercial paper (basis: 3 months) increased from a few basis points at the end of February to more than 200 bps within two weeks. Thus, investment strategies focusing on short duration and high credit quality suffered just as much as the general IG market for a time. While the first couple of rates cuts were barely

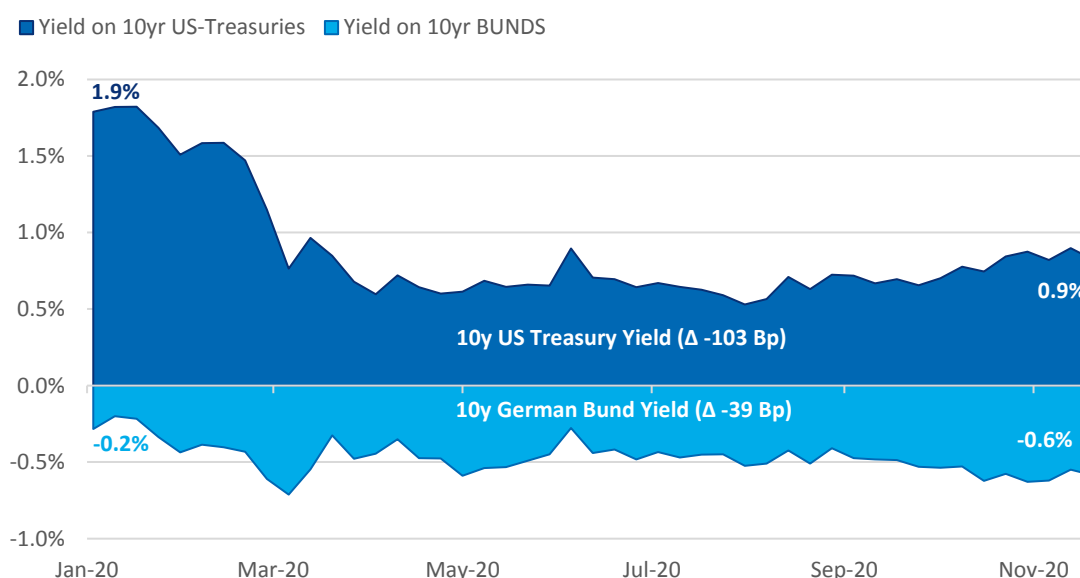
<sup>1</sup> In this document we define „beta“ within the context of corporate bonds as Duration Times Spread (DTS). The DTS methodology has become the industry standard for measuring the credit volatility of a corporate bond. It measures the sensitivity of the price of a bond to relative changes in credit spread, and is a single number that can be used to compare credit volatility across a wide range of bonds. In practice, it is applied in the portfolio management process to assess relative value, manage risk exposure in portfolio construction and conduct performance attribution.

<sup>2</sup> The excess return is the return of a portfolio over the return of a risk-free investment. In the case of corporate bonds, government bonds with a comparable interest rate duration constitute the risk-free investment.

acknowledged by markets, once central banks coordinated their support measures with broad-based fiscal stimulus, the situation improved significantly and markets rallied from then on.

Looking at year-to-date total returns in both markets today, we can spot a sizeable difference between the US and Europe. While IG corporate bonds in USD returned close to 9% (local), EUR credits appreciated by “only” 2.5%. The key reason for the difference is to be found in the development of underlying interest rates. Since 10-year bund yields were already in negative territory at the start of 2020, they were not able to absorb the Covid-19 shock to the same extent as US Treasuries did.

**Chart 1: US rates rally was a major tailwind, while Bund yields were only marginally lower**



Source Bloomberg, as of 24 November 2020

Once we strip out the factor of interest rate returns and hedge costs we arrive at the excess return, i.e. the pure return from credit risk, earned predominantly through the level and change of credit spreads. While the recovery that started in March 2020 allowed spreads to rally broadly, US IG credit spreads have not fully retraced all the year-to-date widening, and hence the excess return is still in negative territory. EUR IG corporates have just retraced all the widening in November 2020, and hence the resulting excess return reflects the income component of credit spreads.

**Table 1: Decomposition of IG corporate returns reveals unspectacular excess returns in 2020**

YTD returns (EUR hedged)	USD IG corporate bonds	EUR IG corporate bonds
Interest rate return (local)	9.4%	1.2%
FX return (i.e. currency hedge cost)	-1.4%	0%
Excess return (credit return, local)	-0.7%	1.3%
<b>Total return</b>	<b>7.3%</b>	<b>2.5%</b>

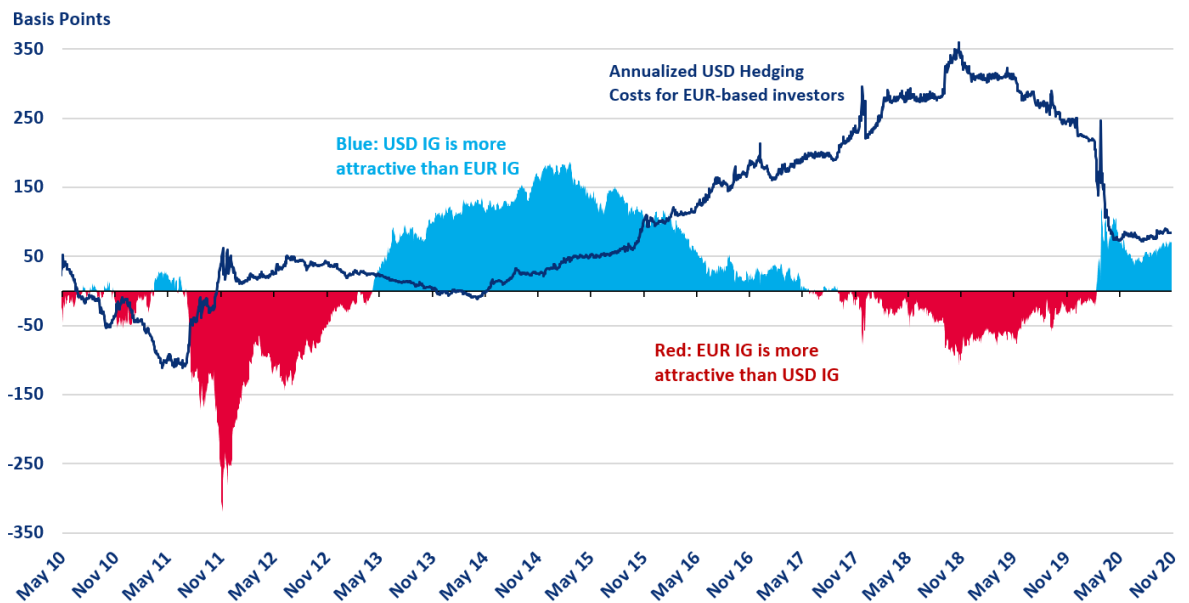
Source ICE Data Indices, returns as of 24 November 2020

In our outlook for 2020, we acknowledged the increasingly attractive relative value of USD IG corporates vs. EUR IG corporates. We obviously did not foresee the pandemic, but hedge costs had already started to decrease in the second half of 2019, allowing the currency-hedged yields to improve for international investors. In March 2020, the Fed lowered the Fed Funds target rate by a cumulative 150 bps, leading to a sharp drop off in USD currency hedging costs for foreign investors. Therefore, currency-hedged USD yields became much more attractive, not only for European investors, but also to a large Asian

community of strategic USD investors (predominantly life and P&C insurance companies). This, combined with the US yield curve steepening in the second half of the year, provided a significant technical tailwind for USD credit vis-à-vis the EUR IG space.

As the following chart demonstrates, as at the end of November, BBB-rated USD corporates in the 7-10 year maturity component offer close to 70 bps more yield on a currency-hedged basis compared to the respective EUR corporate bond market segment. We believe that this presents an excellent opportunity for investors to pick up yield without significantly altering the risk profile of their portfolios.

**Chart 2: For the first time since 2016 USD IG BBB corporates offer superior FX hedged yields**



The colored area represents the currency-hedged yield pick-up in USD corporate bonds (on the basis of 3-month rolling Forwards) compared to EUR corporate bonds of the same maturity (7-10 years) and credit quality (BBB).

Source: Fisch Asset Management, ICE Data Indices, Bloomberg, 24 November 2020

The last time the market offered this valuable opportunity in USD IG credit was between 2013 and 2015. While the yield pick-up might not be as large as back then, the importance of yield enhancement is amplified by the increasingly painful and global thirst for yield. During 2020, there was USD 17.5 trillion of negative-yielding debt in the market, exceeding previous records from 2019. Hence, we have every reason to believe that the USD IG market should remain well supported into 2021 from a technical point of view.

**Chart 3: Global negative yielding debt reaches new record high of USD 17.5 trillion**



Source: Bloomberg

## Hope and repair

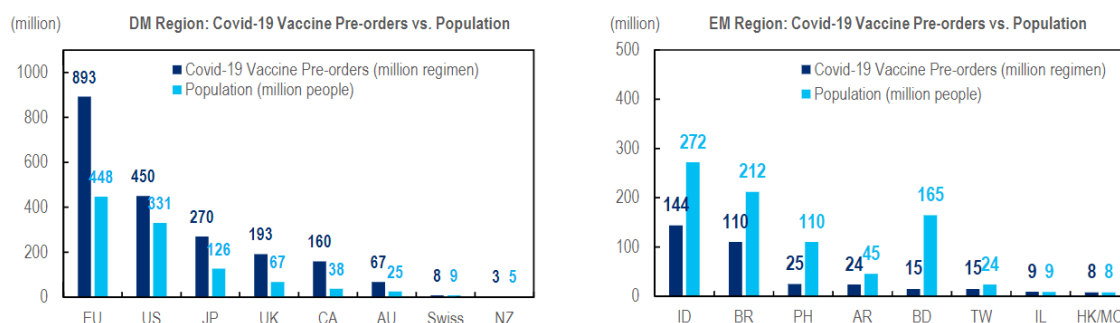
We believe that markets have managed to leave the worst of the pandemic impact behind them, owing to a coordinated fiscal and monetary policy response of unprecedented size globally. However, there is still a considerable amount of healing needed for the real economy to get back to pre-crisis output levels. Meanwhile, the policy response is leaving significant marks in terms of debt and productivity levels, which will inevitably have to be dealt with in the longer run.

For the IG corporate bond market's fate in 2021, we believe that the following factors are the key determinants:

- **Vaccine rollout and public take-up:** The recent efficacy rates of vaccine frontrunners have raised expectations of targeted vaccination starting by year-end 2020. Mass vaccination is currently expected to start in Q2 2021. We believe that acceptance plays an as important role as availability and logistics. According to Citi Research, herd immunity can be reached if 70% of a population are vaccinated. The average global acceptance rate is estimated to be just slightly above that, with big deviations on a country-by-country level.

Within many populous developed market (DM) regions, vaccine pre-order numbers have surpassed the respective populations significantly, making availability less of a concern. Therefore, the market is expecting major DM countries to reach herd immunity by the second half of 2021. In EM, this development could take about one year longer, given that many populous countries have not been able to pre-order enough doses relative to potential demand.

**Chart 4: Comparing vaccine pre-orders vs. population across major EM and DM regions**



Source: Citi Research, various media, UN World Population Prospects, Eurostat. Number of pre-orders have been adjusted to reflect the regimen to vaccinate one person, hence the number does not reflect the number of doses pre-ordered.

With this timeline in mind, we expect some return to normalcy in 2021, but not to see the lion's share of the economic recovery until 2022. We cannot ignore the need for confidence to be re-built as employment has suffered significantly and companies still fight costs in order to survive and pay down their debt. Also, the pandemic brought about secular changes in technology and supply chains, which will have to be digested. Currently, global passenger flights are down 50% according to FlightAware/Cirium, and the International Air Transport Association (IATA) does not expect volumes to recover to pre-Covid-19 levels until 2024.

- **Georgia Senate runoff is decisive for interest rate direction:** The two senate seats in Georgia, currently Republican, are up for a runoff race on 5 January 2021. If the Democrats manage to flip these two seats, there will be exactly 50 Democratic and 50 Republican senators. In this particular case, Vice President-elect Kamala Harris would have the tie-breaker vote, which in effect realizes the "Blue Sweep" scenario (i.e. Democrats win all three branches of government in the 2020 elections). Winning both senate seats for the Democrats is currently a lower probability than for the

Republicans. However, if it did happen, it would raise the probability of passing a major stimulus and infrastructure spending bill. We expect that the related financing needs would lead to an increase in Treasury yields accompanied by a steepening yield curve.

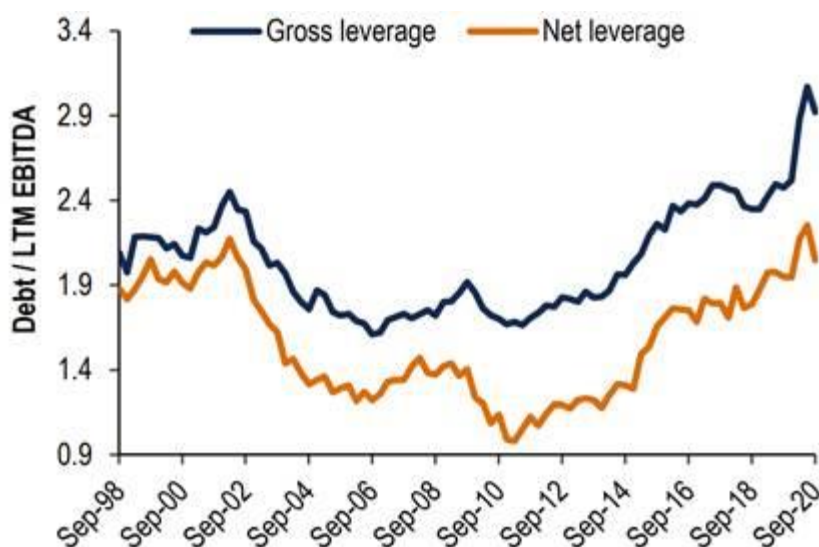
If at least one of the two senate seats in Georgia remains Republican, we still expect rates to increase modestly on lower demand for safe-haven assets. We expect a more modest and gradual increase than in the Democratic scenario, as stimulus would be somewhat limited in size in a split congress. Also, if rate volatility stays low, Treasury yields look very attractive to international investors, which provides an important technical tailwind.

- **Regardless of the outcome of the Georgia runoff, we expect the USD to weaken** for three reasons:
  - We expect a continuation of ultra-loose monetary policy in the US
  - We believe that the USD is currently overvalued versus fundamentals
  - Once the economic recovery gains traction there will be less demand for safe-haven currencies, such as the USD
- **Corporate credit fundamentals have reached a weak level but the case for improvement is becoming even stronger.** As Chart 5 shows, corporate leverage has reached new record highs as companies issued debt to shore up liquidity, while profits were down significantly. The latter side of the equation (annual EBITDA) reflects a relatively short period of time, and hence naturally improves in a strong economic rebound. This improvement could be accelerated even more when combining the expected revenue growth with the profit margin expansion that results from tight cost control by companies.

As we pointed out in our 2020 outlook, US tax reform has made corporate leverage less desirable. Shareholders have increasingly taken the view that deleveraging is preferred over M&A or shareholder rewards. This year, shareholders have been given another reason to bring down debt: Being IG-rated going into a crisis has become much more valuable in 2020 as central banks offered market support only for companies with IG ratings at the start of the crisis.

For all of these reasons, we believe that 2021 will be the year of corporate balance sheet repair.

**Chart 5: US IG non-financial corporates have reached record levels of leverage**

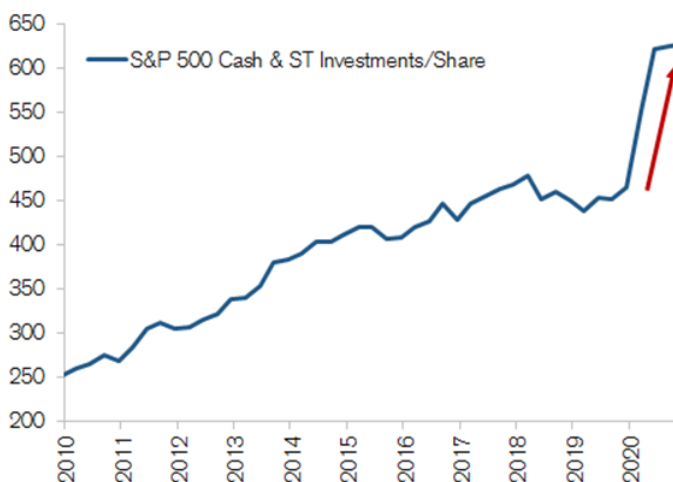


Note: Quarterly median leverage for US public industrial companies (non-financial, non-utility) with IG ratings in the ICE BofA US Corporate Index. Net debt is gross debt minus cash and marketable securities.

Source: BofA Global Research, 2020

- **Improving cash flow combined with deleveraging implies significantly lower supply and potentially even higher demand for corporate bonds.** Due to the extreme uncertainty in Q1 2020, corporates have built an impressive pile of emergency cash (Chart 6). Once revenue growth sets in earnest, cash flow will recover as well and drive down corporate funding needs. This will reduce new issue supply in IG corporates significantly. Market consensus for 2021 USD IG gross issuance gravitates around USD 1.0-1.1 trillion. This would be close to one-third lower compared to 2020, and cuts net supply to the market by more than 50%. In EUR, we believe that the drop off in supply will be less pronounced, but we also believe that the ECB will remain one of the key investors in the EUR corporate bond market throughout 2021.

**Chart 6: Corporate America has built up significant cash levels**



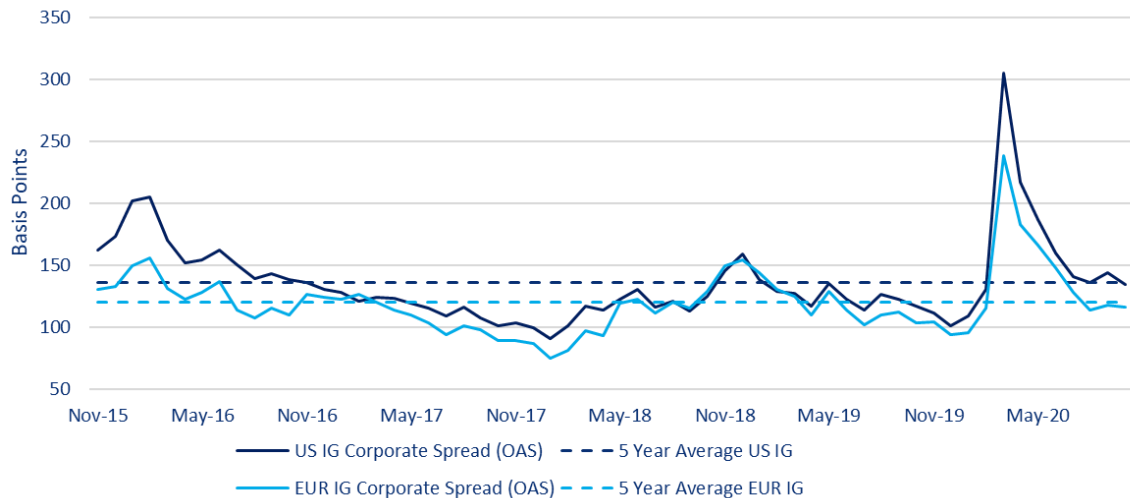
Source Credit Suisse, Bloomberg, 2020

We believe that there will not just be a slower pace of new issuance, but that repurchasing activity will pick up. Additionally, if corporates decide to keep inefficient debt outstanding, they might at least consider investing their cash holdings. Corporate treasuries typically buy IG-rated corporate bonds with a maturity of five years or less. Hence, stepping up the investment activity would add another source of demand to the front end corporate bond market.

## How to position for 2021?

Looking at valuations in the corporate bond market, we believe that the moments of extraordinarily cheap entry levels are probably behind us. Looking at the strong rate rally year-to-date, we also recognize that we are reaching record low levels. However, both IG markets are still trading at spread levels that are in line with their respective five-year average (Chart 7). Given our optimistic view with regards to fundamental developments laid out in the previous chapter, we believe that 2021 offers decent potential for spread tightening, leading to good excess returns. However, we remain wary with regards to potentially increasing interest rates, which would challenge total returns.



**Chart 7: US IG and EUR IG spreads are close to their historical averages**

Source: Fisch Asset Management, ICE Data Indices, 2020

We believe that there will be two important ingredients to a successful IG corporate bond portfolio in 2021: Vigilance with regards to duration management and active tactical exploitation of relative value opportunities across regions, currencies and credit qualities.

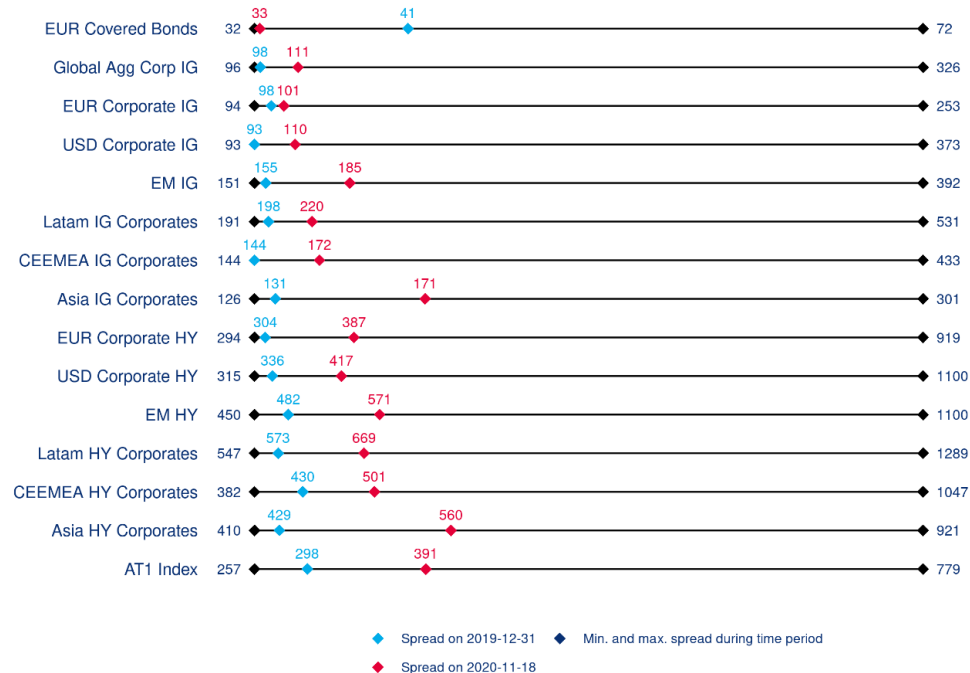
Within our corporate bond strategies, we are able to manage duration exposure separately from credit exposure. This allows us to benefit from spread tightening even in longer duration bonds without necessarily incurring the underlying duration exposure. Given our favourable view of risk markets into 2021, we currently hold a modest overweight in credit exposure (spread duration) but hold a relatively neutral to slightly lower interest rate duration compared to the benchmark (ICE BofAML Global Corporate & High Yield 20% Country Constrained Index). In case we have reason to believe that interest rate increases will accelerate, we are prepared to lower the duration accordingly.

With regards to cross-market relative value we compare the year-to-date spread range to where spreads had arrived in mid-November (Chart 8). Most credit markets have managed to retrace the bulk of the widening, with EUR covered bonds even at the tight end of this year's range and within reach of the post-eurozone crisis tight of 28 bps. Within the 2020 recovery, there has been a clear underperformance of beta, however, which we expect to correct in 2021. We expect positive excess returns on a broad basis, but the magnitude to be a function of beta. Hence we believe that IG investors can benefit by adding select positions in higher-beta market segments in order to benefit from the typical compression that is ignited by an economic recovery.

We believe that reaching for some emerging market exposure can be a valuable addition to an IG corporate strategy in 2021. We also see valuable opportunities in bank capital, given our favourable view on the sector and one of the most appealing relative value propositions versus the sector's own history and versus high yield.

With regards to currencies, we prefer USD IG over EUR IG at the longer end of the curve due to the relative steepness of the USD yield curve. However, at the front end of the curve, we prefer EUR IG due to the same reason. We are cautious in the lower tiers of the rating scale, particularly in emerging markets, as we already witness that the recovery is coming too late for some of these issuers, and we are not sure the current spreads are pricing these risks appropriately.



**Chart 8: Corporate bond market segment spread range YTD (basis points)**

Source: Fisch Asset Management, Bloomberg, ICE Data Indices, LLC, J.P. Morgan, 2020

In terms of sector positioning, we are moving from more defensive sectors (TMT, healthcare) to more cyclical sectors (capital goods, automotive) in order to benefit from the expected improvement in capex and a more friendly global trade environment. We are shifting financials to overweight on a tactical basis, given that the sector benefits strongly from the economic recovery and our expectation of higher interest rates. We do not think that the sector is out of the woods yet in terms of credit losses. However, the significant capital build-up that resulted from widespread dividend bans should absorb most – if not all – of the charge-offs to be taken in 2021. We remain neutral in the energy sector overall. An increasing focus on ESG topics, especially climate change, is also likely to influence the spread development of the sector more strongly than before. Fundamental analysis of issuers, including ESG risks, therefore remains essential for us. We are underweight on real estate and utilities, as we expect these sectors to face headwinds from increasing interest rates.

## Conclusion

In light of our expectation of a powerful economic recovery, while fiscal and monetary stimulus remain in place, we expect a fundamental improvement in the corporate bond market and spread tightening across the board in 2021, leading to low to mid-single-digit excess returns in IG corporates. We believe that the strong market sentiment will trigger a rotation into higher-beta assets, which have lagged in 2020. As demand for safe-haven assets decreases, we expect modestly higher Treasury yields, thus challenging total returns. A weaker USD may support commodity markets and emerging markets, benefiting investors who actively position for relative value opportunities across regions globally.

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