

# » *Investment Grade Corporate Bonds: Outlook for 2022*

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10 December 2021

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# Outlook for IG corporate bonds 2022: An uneventful year is not a bad year

## Executive summary

- After a year of strong revenue and profit growth, the fundamental backdrop for investment grade corporates has improved significantly
- Valuations of investment grade corporate bonds may not appear cheap, but in light of solid global demand they are, in our view, fair
- Due to our expectation for monetary tightening, we expect 2022 to be accompanied by volatility
- Nevertheless, we expect positive low single-digit returns for 2022 (for currency-hedged non-USD-based investors)

## Review of 2021

As we wrote in our outlook for 2021, the Senate runoff in the US state of Georgia (at the beginning of the year) had a major effect on the performance of investment grade (IG) corporates. The victory of the Democrats, and the small majority it gave them in Congress, paved the way for a much more extensive economic programme. This led to a sharp rise in yields on 10-year US Treasuries and, as we anticipated, a steeper US yield curve. European sovereign bonds, where yields fell to a much lesser extent at the beginning of the pandemic, were slightly better protected in this environment.

The rise in interest rates resulted in a loss of almost -5% for USD corporates (hedged in EUR) during the first quarter of 2021. In contrast, the trend in credit spreads was positive. Renewed optimism about the economy led to fresh highs in equity markets from February onwards, with credit spreads narrowing at the same time. Commodity markets were more solid and the price of oil continued to rally from its 2020 lows, with spreads on riskier credit market segments also major beneficiaries. At the same time, concerns grew about the possible consequences for inflation – an issue that became more pressing as the year progressed.

In April, however, the emergence of new variants of the virus put a stop to the rise in interest rates. Fears about inflation abated for the time being. The excess return – i.e. that part of the return that is solely attributable to the credit component – remained positive, since credit spreads narrowed further by virtue of good technical conditions in credit markets. While new issuance exceeded our expectations, demand was also surprisingly strong considering the degree of interest rate volatility. This is likely to have been due partly to the relative attractiveness of USD bonds compared with their EUR counterparts. In our outlook for 2021 we pointed out the yield advantage in the USD IG market since the beginning of the pandemic. While the currency hedged income yield in fact turned out to be almost twice as large as in EUR IG, the sell-off in US Treasuries, coupled with the longer duration of the USD IG market, resulted in a lower total return compared to EUR IG corporate bonds.

At a global level, the second half of 2021 was shaped to a greater extent by challenging times in emerging markets: the tightening of regulations in China, the subsequent collapse of the property market, political despotism in Turkey as well as the political uncertainties and key elections in a number of Latin American countries. In addition, topics such as global supply shortages and more recently the problem of herd immunity to coronavirus moved back into the spotlight. We mentioned both aspects in our outlook for 2021, and expected that the system would first have to digest the lasting changes brought about by the

pandemic in terms of technology and supply chains. Also, we anticipated that there would be substantial differences between countries in terms of vaccine acceptance.

All the same, the movement in IG spreads was largely sideways up to the end of October. However, a distinct yield curve flattening set in as markets prepared for the rate hiking cycle to begin earlier than previously anticipated due to the pick-up in inflation. With the Fed beginning tapering in November, market participants subsequently anticipated almost three interest rate hikes in 2022. Four appear likely from the Bank of England. Meanwhile, the ECB is seen as much more cautious. Aside from reducing the bond purchase programme, it is expected to at the maximum make one rate move in 2022.

**Table 1: 2021 breakdown of return components**

YTD return (EUR hedged)	USD IG corporate bonds	EUR IG corporate bonds
Interest rate component (in local currency)	-1.8%	-0.9%
Foreign exchange component (here: cost of currency hedging)	-0.8%	0
Excess return (credit component, in local currency)	1.0%	0
<b>Total return</b>	<b>-1.5%</b>	<b>-0.9%</b>

Source ICE Data Indices, returns as at 30 November 2021

## Fundamental situation is strong

In 2021, supply shortages gave rise to the question of whether tight supplies coupled with sharp price increases could bring about stagflation in the near future. This scenario has not materialised so far; in fact, companies posted record-breaking sales and profits. This led to a significant reduction in leverage, bringing it back to pre-pandemic levels. However, a closer look also reveals that a fair amount of the positive surprises occurred within the energy and financial sectors – i.e. those that are positively correlated with commodity prices and interest rates. In other sectors, such as retail, margins began to react negatively to rising wages and higher purchase prices.

For 2022, we expect excess consumer savings (especially in the US) and government stimulus programmes (Next Generation EU, Build Back Better plan in the US) to make it possible for the positive growth environment to continue. Supply shortages and fears about inflation are likely to remain present for the time being, but with declining relevance. In particular, we believe inflation will cool off in the second-half of next year – partly thanks to base effects. We expect company results to remain strong against this backdrop, even if margin expansion and profits peaks may be behind us.

However, we also expect that, in time, companies will revert to late-cycle behaviour – that is to say that they may increasingly attempt debt-financed acquisitions or share buybacks. In this context, it is worth noting that there is hardly any incentive to defend a strong IG rating from an economic point of view. In 2021 the BBB-A spread differential fell to a record low (currently 39 basis points). This is prompting many companies to adjust their financial policy accordingly. A notable example of this trait in 2021 was Oracle, which raised USD 15 billion in debt in March and incurred a downgrade from single A to BBB. Since we do not think we have seen the last of this, we are cautious when it comes to high qualities in the IG segment, preferring to position ourselves in BBB names that have adopted a transparent and credible financial policy, and where the fundamental risks seem well compensated.

In the coming 12 to 18 months, we also expect significantly more upgrades from the high yield segment to the IG universe than in 2021. Due to the increasing popularity of the “rising star” theme and the

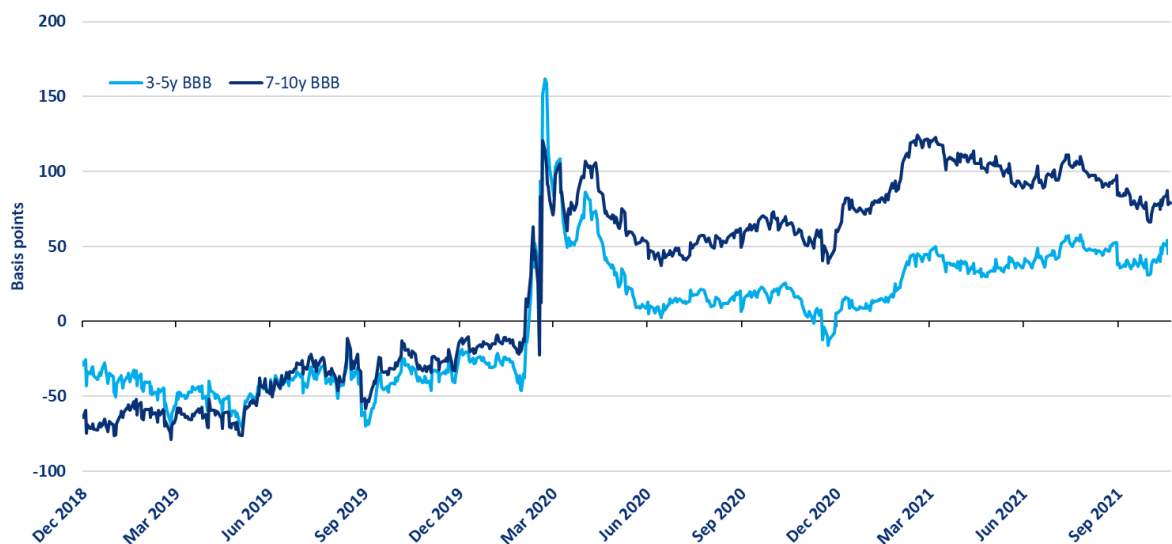
prominence of the issuers (many of them were already IG issuers prior to the pandemic), however, many of these rising stars are now valued as if they had already been upgraded. Therefore, whether or not they are a worthwhile investment is something that must be analysed on an individual basis.

## How should we position ourselves for 2022?

In light of the monetary tightening we expect next year, it seems inevitable that real interest rates rise and markets continue to experience high volatility. Nevertheless, contrary to the very human tendency to place too much emphasis on extreme scenarios, our focus is on a middle-of-the-road and rather uneventful market scenario in terms of the end result. In our opinion, central banks will only tighten financing conditions very gradually and proceed with great care based on the experiences of 2013 and 2018. Considering that bond market volatility has been high for months, we feel it is unlikely that investors have taken excessive positions. Looking back long-term, IG spreads seem somewhat expensive; however, this isolated view misses the full picture. Most of the central bank liquidity should stay in the system for a long time and drive solid demand for high-quality bonds. Investment grade bonds also benefit from the direct reduction of tail risks due to various central banks' corporate QE, which logically also reduces the required return to compensate that risk (i.e. spreads). Furthermore, because equities have outperformed bonds, some large international pension funds need to switch from equities to bonds to a certain extent in order to protect the improvement in the long-term funding ratio. Considering this, we regard IG spreads as fair at the moment. An increase in spreads cannot be ruled out, of course, but as mentioned we do not expect any extreme developments and anticipate a total return in the low single digits.

Therefore, we are heading into the new year with a neutral risk strategy overall. We continue to prefer BBB bonds with the addition of a handful of carefully selected rising stars. As mentioned, USD still has the yield advantage but the characteristics have changed slightly; at the beginning of the year, the longer USD maturities in particular were more attractive due to the steep yield curve, while the shorter maturities held no advantage over the EUR market. The flattening of the USD yield curve from the 5-year point, combined with flatter spread curves, has now created new opportunities at the short end, which are attractive and offer defensive characteristics.

**Chart 1: BBB-rated USD IG corporate bonds continue to deliver better currency-hedged yields, now in shorter maturities as well**



The line 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 ICE Data Indices, LLC, BofA Global Research, Bloomberg, Fisch Asset Management

While the USD market offers better yields overall, we also feel comfortable investing in the EUR segment, as the spreads here are much higher and, in our opinion, the ECB will stick with its loose monetary policy for some time. The eurozone is strongly export-oriented, and thus affected by the slowdown in growth in China to a greater extent than the US, for example. Also, inflation seems to be overshooting to a lesser extent than in other markets. We are cautious about IG bonds in GBP and CAD, as these markets outperformed strongly in 2021 and are facing rather restrictive monetary policies in 2022.

In terms of sectors, we see the greatest potential in financials; meanwhile, we are underweight in real estate and capital goods as well as in the telecoms/media sector.

## Conclusion

At this point in time, we perceive opportunities and risks in the IG market as more or less balanced. We regard valuations as fair in general and are heading into the new year with a neutral risk strategy overall. Since we believe that a good deal of the increase of rates at the long end of the US yield curve has already taken place, we expect a total return in the low single digits for 2022. Throughout the year, we would not be surprised to see bouts of volatility leading to temporary spread widening and potentially some decoupling of market segments, which represent important alpha opportunities for relative value strategies.

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