Searching for value: a closer look at spreads

Portfolio manager Ian Horn discusses the latest developments, themes and opportunities in the investment-grade market.

Key Takeaways

- Despite a market trend to tighter spreads, there remain interesting sector wide opportunities in investment grade, particularly in Europe.
- Spread premia continues to be attractively priced in European investment-grade financials, despite spread compression, while value in the real estate sector is fading.
- Current spread curves suggest more value in front-end EUR and GBP investment grade markets, whilst long-dated USD and GBP markets look most compressed.
- Coupons are set to rise faster in Europe than the US due to the latter’s shorter duration profile in a higher-for-longer rates environment.

Spread compression has been a consistent theme across credit markets this year as corporate fundamentals remain positive, fears of an economic hard landing recede and inflows to the asset class persist. Nevertheless, tighter credit spreads mean investors are being paid less for the risk they take.

Breaking down the market by sector and duration can, however, highlight areas of differentiation and help investors identify value.

Financials show healthy spread premia

Financials are a significant allocation in several of our portfolios, which we believe is warranted by the spread offered over the broader US and European corporate bond market (Figure 1). This continues to be an opportunity that has been particularly visible for the last couple of years.

In late 2022, financial spreads widened notably on the back of concerns around extension risk in subordinated instruments. This was compounded by issues at Credit Suisse and US regional banks in 2023, and concerns regarding commercial real estate exposure. Despite the extension risk not materialising and the Credit Suisse situation being contained, this spread premia is still evident in the sector (Figure 1). As a result, we continue to see value in financials, with a bias to Tier 2 instruments and European names.

Figure 1: IG spread premia in financials vs. corporates

Source: ICE Data Platform, as of 21st March 2024. ICE BofA US Non-Financial Index (CF0X), ICE BofA US Financial Index (CF00), ICE BofA Euro Non-Financial Index (EN00), ICE BofA Euro Financial Index (EB00). For illustrative purposes only.
Real estate valuations less compelling

Real estate bonds have performed strongly since the end of 2022 (Figure 2), and we expect this to continue. We increased our exposure to this sector at a time when spreads had widened on the back of valuation and debt sustainability concerns. However, this premium has compressed and valuations now look less compelling given the continued uncertainty.

Figure 2: Spread premia in European real estate over broader European corporates

![Spread to Worst (bps)](chart)

Source: ICE Data Platform, as of 21st March 2024. ICE BofA Euro Real Estate Index (EJRE), ICE BofA Euro Corporate Index (ER00). For illustrative purposes only.

Relative value: UK and Europe outshine US

Investment grade spread curves suggest there is better value in the UK and EUR markets at the front-end, whilst longer-dated USD and GBP credit looks most compressed (Figures 3 & 4).

We currently prefer EUR and GBP credit over USD across our strategies. This is most visible in our short-duration strategies, where credit spreads are a key driver in our asset allocation.

Global strategies can take advantage of spread divergence between markets, particularly when a company issues bonds across various currencies. The banking sector tends to offer such opportunities given the large and diverse capital structures. In particular we have found opportunities in USD denominated bonds from European banks, with the US market more concerned about extension risk and European banks in general. We have also found opportunities to switch from EUR bonds to GBP bonds for an attractive yield pick-up in similar instruments from the same issuer.

Fig. 3: Investment Grade spread curves in EUR, USD and GBP

![Spread to Worst (bps)](chart)

Source: ICE index platform, ER01, ER02, ER03, ER04, ER09, C1A0, C2A0, C3A0, C7A0, UR01, UR02, UR03, UR04, UR09, as of 22nd March 2024. See index descriptions at the back for full index names. For illustrative purposes only.
A final thought: Average coupons to rise fastest in Europe

The shorter maturity profile of the European investment grade market, and the lack of rate hikes in 2017 and 2018 (unlike in the US), has allowed European issuers to take full advantage of low rates in Europe.

This shorter duration will also likely result in coupons rising faster in Europe than in the US in a “higher-for-longer” rates environment.

Interest coverage tends to be healthy in IG companies. However, smaller companies with fewer bonds outstanding could see significant changes in their interest coverage metrics, particularly in Europe.

Figure 5: Rise in European vs. US coupons

Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy and should not be construed as investment advice or investment recommendation of those companies.

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Index Descriptions

C0A0 - The ICE BofA US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody’s, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

ER00 – The ICE BofA ML Euro Corporate Index tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets. Qualifying securities must have an investment grade rating (based on an average of Moody’s, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

ICE BofA 10+ Year Sterling Corporate Index (UR09) ICE BofA 10+ Year Sterling Corporate Index is a subset of ICE BofA Sterling Corporate Index including all securities with a remaining term to final maturity greater than or equal to 10 years. Inception date: December 31, 1996

ICE BofA 5-7 Year Euro Corporate Index (ER03) ICE BofA 5-7 Year Euro Corporate Index is a subset of ICE BofA Euro Corporate Index including all securities with a remaining term to final maturity greater than or equal to 5 years and less than 7 years. Inception date: December 31, 1995

ICE BofA 10+ Year Euro Corporate Index (ER09) ICE BofA 10+ Year Euro Corporate Index is a subset of ICE BofA Euro Corporate Index including all securities with a remaining term to final maturity greater than or equal to 10 years.

ICE BofA 1-3 Year US Corporate Index (C1A0) ICE BofA 1-3 Year US Corporate Index is a subset of ICE BofA US Corporate Index including all securities with a remaining term to final maturity less than 3 years.

ICE BofA 3-5 Year US Corporate Index (C2A0) ICE BofA 3-5 Year US Corporate Index is a subset of ICE BofA US Corporate Index including all securities with a remaining term to final maturity greater than or equal to 3 years and less than 5 years.

ICE BofA 5-7 Year US Corporate Index (C3A0) ICE BofA 5-7 Year US Corporate Index is a subset of ICE BofA US Corporate Index including all securities with a remaining term to final maturity greater than or equal to 5 years and less than 7 years.

ICE BofA 7-10 Year US Corporate Index (C4A0) ICE BofA 7-10 Year US Corporate Index is a subset of ICE BofA US Corporate Index including all securities with a remaining term to final maturity greater than or equal to 7 years and less than 10 years.

ICE BofA 10+ Year US Corporate Index (C7A0) ICE BofA 7+ Year US Corporate Index is a subset of ICE BofA US Corporate Index including all securities with a remaining term to final maturity greater than or equal to 7 years.

ICE BofA 1-3 Year Sterling Corporate Index (UR01) ICE BofA 1-3 Year Sterling Corporate Index is a subset of ICE BofA Sterling Corporate Index including all securities with a remaining term to final maturity less than 3 years.

ICE BofA 3-5 Year Sterling Corporate Index (UR02) ICE BofA 3-5 Year Sterling Corporate Index is a subset of ICE BofA Sterling Corporate Index including all securities with a remaining term to final maturity greater than or equal to 3 years and less than 5 years.

ICE BofA 5-7 Year Sterling Corporate Index (UR03) ICE BofA 5-7 Year Sterling Corporate Index is a subset of ICE BofA Sterling Corporate Index including all securities with a remaining term to final maturity greater than or equal to 5 years and less than 7 years.

ICE BofA 7-10 Year Sterling Corporate Index (UR04) ICE BofA 7-10 Year Sterling Corporate Index is a subset of ICE BofA Sterling Corporate Index including all securities with a remaining term to final maturity greater than or equal to 7 years and less than 10 years.
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