Why Negative Correlation in Credit is Positive

June 2023

*The return of differentiated behaviour between investment grade and high yield could prove beneficial for investors in crossover strategies.*

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2022 was a difficult year for credit investors. Interest rates and credit spreads were positively correlated, and both moved higher/wider to the detriment of bond prices.

As the rate cycle matures, we see a re-emergence of negative correlation in which gains in some parts of credit can offset losses in others. Combining interest rate risk and credit risk had limited benefit in 2022, but this appears to be changing.

In credit, there are two price drivers - credit spreads and interest rates. Each drives different parts of the credit market to varying degrees.

Returns from interest rates and credit spreads often work in opposition, introducing a natural balance in credit portfolios. Intuitively in an improving economic environment, rates would move higher whilst spreads tighten. A credit portfolio would therefore be negatively impacted by rates, but positively impacted by spreads.

Similarly in a weakening economic environment, rates could be expected to move lower, to the portfolio’s benefit, and spreads to widen, to its detriment. In a market in which rates and spreads are negatively correlated, credit portfolios can benefit from an element of natural stability which can help contain volatility.

Periods of negative correlation present a strong argument for combining interest rate risk and credit risk within a portfolio. This can be done through allocations to both investment grade - where performance tends to be primarily driven by interest rates - and high yield - where credit risk tends to be the key driver.

Unfortunately, market conditions in 2022 were quite the opposite. Interest rates rose in response to monetary policy tightening, and credit spreads widened as investors demanded a higher risk premium to reflect the uncertainty of future rate hikes.

Credit investors lost money due to rates and spreads, with only limited offsetting benefit between the two. Many investors therefore tried to dampen the resulting portfolio volatility, either by buying protection on CDS indices to offset widening credit spreads, or by selling Treasury and Bund futures to offset rising rates.

In European credit there wasn’t a single month in 2022 in which investment grade and high yield returns were not positively correlated¹. In the US there was only one such month². Perhaps this is not surprising given the significant moves in interest rates which impacted returns in both investment grade and high yield.

If we look solely at interest rates and high yield credit spreads, we see a similar dynamic. There were only two months in 2022 when interest rates and credit spreads were not positively correlated in Europe, and only one month in the US (Figs. 1 and 2).

¹ ICE Index Platform. European Investment Grade - ICE BofA Euro Corporate Index (ER00); European High Yield - ICE BofA Euro High Yield Index (HE00)
² ICE Index Platform. US Investment Grade - ICE BofA US Corporate Index (C0A0); US High Yield - ICE BofA US Cash Pay High Yield Index (J0A0)
In March 2023, with the failure of Silicon Valley Bank and Credit Suisse, negative correlation returned (Fig. 3). Interest rates had risen far enough that they had room to rally in reaction to market concerns, helping to offset the spread widening triggered by fears of a banking crisis. The symmetry of the two market forces appeared to have been restored; rates were again rallying to provide support as spreads widened. This relationship has since continued, as we see in Figure 3.

Source: Bloomberg, as of 31st December 2022. For illustrative purposes only.
In the 10 years prior to 2022, we saw this negative correlation in Europe in each of the 5 years when the ECB kept policy rates unchanged. In the US, we saw the same in 4 of the 6 years when the Fed was not raising or cutting interest rates (including 2015 and 2016 when the Fed hiked once in December in both years).

As we approach the end of the current hiking cycle in the US and Europe, and greater stability in policy rates, we believe this shift to negative correlation could persist. If so, this would support a portfolio that combines interest rate risk and credit risk - particularly through investment grade and high yield - to benefit from the return of their naturally offsetting dynamics.

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3 Based on calendar year change of ITRAXX XOVER 5Y spread and German 5-year Bund yield
4 Based on calendar year change of CDX HY 5Y spread and US 5-year Treasury yield
**Index Descriptions**

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.

HE00 - The ICE BofA ML Euro High Yield Index tracks the performance of EUR dominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. Qualifying securities must have a below 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.

CO00 - The ICE BofA ML 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.

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