Investment Grade Corporate Bonds: A Convergence of Yield, Duration and Credit Advantages

Robert Cohen, Director, DoubleLine Global Developed Credit, and **Colin Callahan,** Product Specialist | December 2023

The outlook for investment grade (IG) corporate credit is more favorable than it has been in a decade. The yield, duration and credit quality foundation provide an opportunity to construct a high-quality portfolio with a positively skewed return profile with the potential to generate high single-digit returns while running limited downside risk. In this paper, we explore the key ingredients in this outlook: yield per unit of duration, all-in yields, credit spreads and rating migration. Then we review the widespread use of longer-term financing by IG issuers during the years of historically low borrowing costs and its significance as an offsetting mitigant of refinancing risk around the timing of debt "maturity walls," a colloquial term for when maturities arrive en masse. Finally, we break down select sectors of this investment universe into positive and negative outlooks.

Yield Per Unit of Duration: A Fundamental Reordering of Reward to Risk

Since the Great Financial Crisis, Federal Reserve monetary policy has suppressed yields in the corporate credit market – first indirectly through purchases of government and government-guaranteed fixed-income securities (aka quantitative easing), then directly with brief, limited-scale purchases in the corporate bond market in 2020. Corporate borrowers took advantage of generationally low bond yields to refinance and term out their debt obligations into long-maturity new issuances. This issuance trend, along with overall low yields, increased the duration of the Bloomberg US Corporate Bond Index from a 20-year average of 6.92 years to a peak of 8.84 years in 2020. At the same time, the yield on the index fell to a low of 1.74% in 2020 from an average of 4.12% over the previous 20 years. This resulted in a yield per unit of duration of 0.20. (*Figure 1*) This relationship generated a high degree of risk for the sector since yields and spread were unlikely to fall further, and an increase of 100 basis points (bps) in U.S. Treasury yields would erase five years of income.

Today, the index yields 5.60% with a duration of 6.90 years for a yield per unit of duration of 0.81. Thus, the loss in price of a move of 100 bps in Treasury yields would be almost entirely offset by the yield of the portfolio.

Investment Grade Corporates (Bloomberg US Corporate Bond Index) Yield Per Unit of Duration
As of November 30, 2023

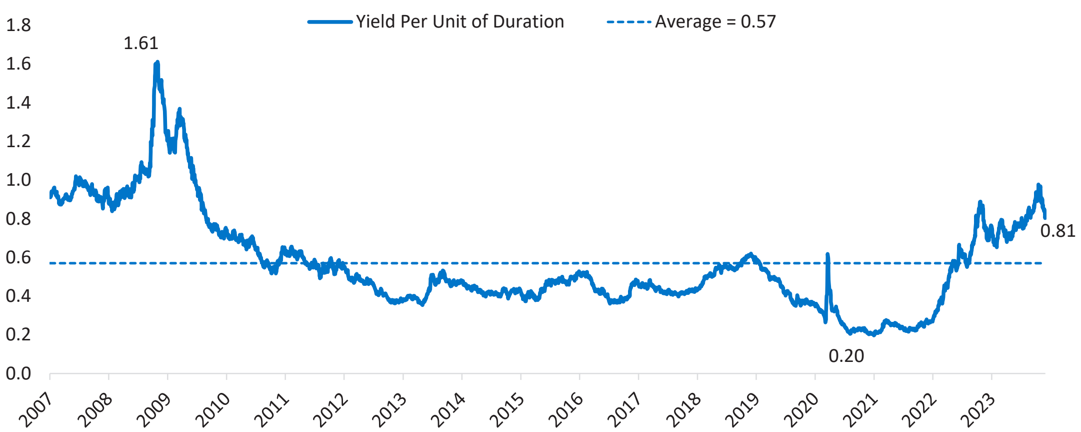

Figure 1
Source: DoubleLine, Bloomberg

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Positive Skew

By virtue of their current yield-to-duration profile, IG corporate bonds as an asset class are set up to generate positive returns under various interest rate and credit spread scenarios. (*Figure 2*) If the economy enters a period of significant economic weakness, it is possible that IG corporate spreads widen at least 100 bps. Under this economic scenario, Treasuries would likely rally. A 25-bp rally is all that would be required to offset such spread widening to generate a positive return. However, it's more likely that rates would rally over 100 bps, which would be likely to offset expected spread widening and generate a mid- to high single-digit return. Under a no-recession scenario with decreasing inflation, credit spreads and Treasury yields could both fall. Such a scenario would have potential for double-digit returns.

10-Year U.S. Treasury Rates (25-bp Intervals)
As of November 30, 2023

Level		3.33	3.58	3.83	4.08	4.33	4.58	4.83	5.08	5.33
Spreads (10-bp intervals)	Change	-100	-75	-50	-25	0	25	50	75	100
65	-40	15.8%	13.8%	12.0%	10.2%	8.4%	6.7%	5.1%	3.5%	2.0%
75	-30	15.0%	13.1%	11.2%	9.4%	7.7%	6.0%	4.3%	2.8%	1.2%
85	-20	14.3%	12.4%	10.5%	8.7%	7.0%	5.3%	3.6%	2.0%	0.5%
95	-10	13.6%	11.7%	9.8%	8.0%	6.2%	4.5%	2.9%	1.3%	-0.2%
105	0	12.9%	11.0%	9.1%	7.3%	5.5%	3.8%	2.2%	0.6%	-0.9%
115	10	12.2%	10.3%	8.4%	6.6%	4.8%	3.1%	1.5%	-0.1%	-1.6%
125	20	11.5%	9.6%	7.7%	5.9%	4.2%	2.5%	0.8%	-0.8%	-2.3%
135	30	10.9%	8.9%	7.1%	5.2%	3.5%	1.8%	0.2%	-1.4%	-2.9%
145	40	10.2%	8.3%	6.4%	4.6%	2.8%	1.1%	-0.5%	-2.1%	-3.6%
155	50	9.5%	7.6%	5.7%	3.9%	2.2%	0.5%	-1.2%	-2.7%	-4.3%
165	60	8.9%	7.0%	5.1%	3.3%	1.5%	-0.2%	-1.8%	-3.4%	-4.9%
175	70	8.3%	6.3%	4.5%	2.6%	0.9%	-0.8%	-2.4%	-4.0%	-5.5%
185	80	7.6%	5.7%	3.8%	2.0%	0.3%	-1.4%	-3.1%	-4.7%	-6.2%
195	90	7.0%	5.1%	3.2%	1.4%	-0.4%	-2.1%	-3.7%	-5.3%	-6.8%
205	100	6.4%	4.5%	2.6%	0.8%	-1.0%	-2.7%	-4.3%	-5.9%	-7.4%

Figure 2
Source: DoubleLine, as of Nov. 30, 2023

Only under a scenario of both widening spreads and rising rates would negative returns be expected for the asset class as tracked by the index. However, a 100-bp increase in spreads and rates generates a negative 7% return compared to 15% positive return if rates fall 100 bps and spreads tumble 30 bps. Thus, there is a significant positive skew to returns.

Improving Credit Quality

During the last decade, borrowers in the IG credit market, as well as other credit markets, increased their balance sheet leverage, and borrowers were not penalized for leveraging their balance sheets and lowering their credit ratings from the nationally recognized statistical rating organizations (NRSROs).

Currently, because of elevated yields and tighter lending standards, borrowers are defending their balance sheets by paying down debt and upgrading their credit ratings. This campaign to improve overall creditworthiness is clearly supportive for credit investors. Evidence of this trend is reflected in the rating upgrade-downgrade ratio of the corporate IG universe. In particular, credit rated BBB is being upgraded to A in record numbers. (*Figure 3*) Likewise, rating upgrades have been outpacing downgrades. (*Figure 4*)

Volume of BBB's Upgraded to Single-A | As of October 31, 2023

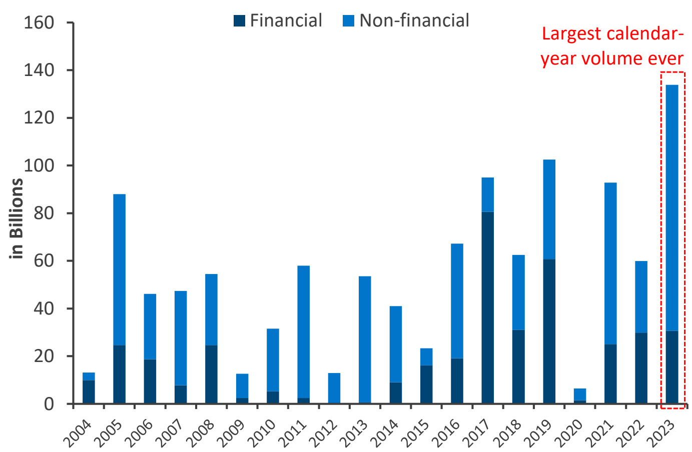

Figure 3
Source: DoubleLine, Barclays, as of Oct. 31, 2023

Investment Grade Corporates: Rising Stars vs. Fallen Angels
As of September 30, 2023

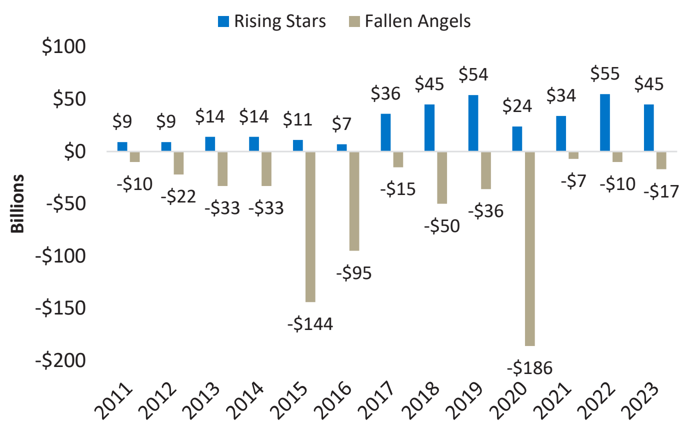

Figure 4
Source: DoubleLine, J.P. Morgan, as of Sept. 30, 2023

Beyond rate risk, another key factor for investors in the corporate credit market is downgrade risk, particularly the phenomenon of fallen angels, the downgrading of investment grade credits to below investment grade. However, the IG corporate sector is in the midst of a multiyear upgrade cycle, mitigating fallen angel risk.

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Maturity Walls

Another consideration for investors in corporate debt is the possibility of maturities arriving en masse, known colloquially as a "maturity wall." Since early 2022, the Fed has raised the federal funds rate by more than 5%, the swiftest and most severe set of hikes in recent history. The not-so-distant memory of a near-0% rate was ripped off like a Band-Aid in an effort to curb inflation running at a 40-year high. Companies looking to issue or refinance debt in today's elevated-rate environment face higher borrowing costs that would reset coupon payments 50% higher on average than current market average. In general, however, IG borrowers do not face an imminent maturity wall. The vast majority of high-grade corporate issuers termed out their debt obligations while rates were low into longer-dated fixed-rate issues, the bulk of which don't come due until 2035 and beyond. (*Figure 5*) The sector's lack of a significant and imminent maturity wall is another reason why DoubleLine has a favorable outlook on IG corporates relative to lower-rated areas of the corporate market.

Investment Grade Corporate Maturities
As of October 31, 2023

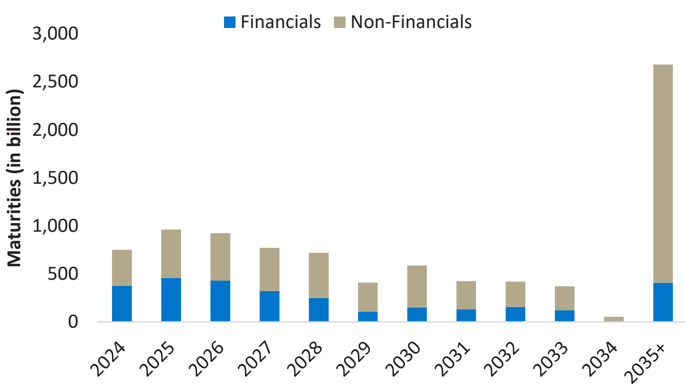

Figure 5
Source: DoubleLine, J.P. Morgan, as of Oct. 31, 2023

Sector Outlooks

Credit selection is paramount in an environment of tight monetary policy and slowing economic growth. With a potential recession on the horizon, we expect pronounced performance dispersion across sectors and among individual issuers of the IG corporate bond market. Outlooks on key sectors of the market are as follows:

Positive

Financials: Global Systemically Important Banks (GSIBs)

Post-GFC reforms have strengthened money center banks by increasing bank capital ratios and transparency, and decreasing risk-taking. GSIBs enjoy solid balance sheets despite provisions for credit losses that are likely to rise from weakening consumer balance sheets largely due to a gradually worsening U.S. economic outlook.

Technology

We favor technology companies that have pursued disciplined capital allocation policies and are scaling AI vertically across their business models. Strategic cost-cutting measures, such as layoffs, have improved balance-sheet health. We expect the sector to maintain its high profitability and increase free cash flow given its resilience and adaptability in the face of market dynamics.

Pharmaceuticals

We favor pharmaceutical companies that generate strong cash flows without significant loss of exclusivity rights in the near term. We prefer companies that are actively delivering and whose management teams are committed to disciplined capital allocation policies.

Negative

Financials: Regional Banks

After the regional banking crisis in March, investors have become cautious about regional banks given their concentrated and localized loan portfolios; smaller and less liquid issue sizes; and poor relative value compared to more-diversified banks, such as the GSIBs. Regional banks are not subject to the same liquidity requirements as GSIBs, which must hold a predetermined amount of high-quality, liquid assets to fund cash outflows in case of various stress scenarios. We expect regional banks to suffer more stress in a higher-for-longer interest-rate environment.

Consumer Discretionary: Food and Beverage

Food and beverage companies face eroding fundamentals, such as declining sales and margins. These companies are also exposed to high merger and acquisition risk, and secular risks from shifting consumer appetites due to GLP-1 diet drug uptake.

Conclusion

Years of low interest rates might have tempted many investors into lower-rated parts of fixed income in pursuit of yield, but with interest rates having risen materially, DoubleLine believes IG corporate bonds are more attractive today than they have been in over a decade. Moreover, the sector's higher yields combined with a lower relative duration relative to history offer investors a cushion against future interest-rate volatility, with outsized potential returns if rates fall. We also believe the sector's diversification benefits can help lower a portfolio's correlation to other risk assets and provide downside protection. The favorable outlook for IG corporate bonds can potentially offer a compelling reward-to-risk proposition with a lock-in of roughly 6% yields. ■

About the Authors

Robert Cohen, CFA
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Mr. Cohen joined DoubleLine in 2012. He is a Portfolio Manager and Director of the Global Developed Credit team. Mr. Cohen oversees the team's investment activities in investment grade, high yield (HY) and bank loan corporate credit markets. He also leads the collateralized loan obligation (CLO) issuance effort at the firm. Mr. Cohen is a Portfolio Manager for the Opportunistic Income, Income Solutions, Low Duration, CLO and Floating Rate strategies. He is a permanent member of the Fixed Income Asset Allocation Committee. Prior to DoubleLine, Mr. Cohen was a Senior Credit Analyst at West Gate Horizons Advisors (and its predecessor, ING Capital Advisors), where he worked as an Analyst covering bank loans and HY bonds. Prior to ING, he was an Assistant Vice President in the Asset Management Group of Union Bank, where he managed CLO and bank loan portfolios. Prior to Union Bank, Mr. Cohen was an Associate Director of Corporate and Investment Banking at the Bank of Montreal in its Natural Resources Group. He holds a B.A. in Economics from the University of Arizona and an MBA from the University of Southern California. Mr. Cohen is a CFA® charterholder.

Colin Callahan
Product Specialist

Mr. Callahan joined DoubleLine in 2018. He is a member of the Product Specialist Team. In this capacity, he is responsible for various aspects of DoubleLine product marketing, investment strategy updates, portfolio communications and competitive analysis, with a focus on DoubleLine's Global Developed Credit strategies. Mr. Callahan is also responsible for producing market commentary and dedicated strategy content. As part of the Product Specialist team he attends the Fixed Income Asset Allocation, Macro Asset Allocation, Global Developed Credit, and Structured Product meetings. Prior to DoubleLine, Mr. Callahan was an Assistant Vice President at Gabelli Funds. He holds a BS in Finance from Fairfield University cum laude and an MBA in Finance from the UCLA Anderson School of Management. Mr. Callahan also holds the Series 7 and 63 Licenses.

Definitions of Terms and Index Descriptions

Basis Points (bps) – Basis points (or basis point (bp)) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument. The relationship between percentage changes and basis points can be summarized as: 1% change = 100 basis points; 0.01% = 1 basis point.

Bloomberg US Aggregate Bond Index – This index (the "Agg") represents securities that are SEC registered, taxable and dollar denominated. It covers the U.S. investment grade, fixed-rate bond market, with components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indexes that are calculated and reported on a regular basis.

Bloomberg US Credit Index – This index tracks the U.S. credit component of the Bloomberg US Government/Credit Index on a total return basis. It consists of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity and quality requirements. To qualify, bonds must be SEC registered. The US Credit Index is the same as the former US Corporate Index.

Bloomberg US Corporate Bond Index – This index measures the investment grade, fixed-rate taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

Bloomberg US Treasury Index – This index measures on a total return basis U.S. dollar-denominated, fixed-rate nominal debt issued by the U.S. Treasury with a remaining maturity of one year or more. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index.

Duration – Measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates.

High Yield (HY) – Bonds that pay higher interest rates because they have lower credit ratings than investment grade (IG) bonds. HY bonds are more likely to default, so they must pay a higher yield than IG bonds to compensate investors.

Investment Grade (IG) – Rating that signifies a municipal or corporate bond presents a relatively low risk of default. Bonds below this designation are considered to have a high risk of default and are commonly referred to as high yield (HY) or "junk bonds." The higher the bond rating the more likely the bond will return 100 cents on the U.S. dollar.

It is not possible to invest directly in an index.

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