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OPINION

Markets Insight

Why top-tier bonds are not as safe as they might seem

Fund managers should pay attention to the duration risk in investment-grade bonds

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Individuals and institutions alike have grown very fond of high-quality US corporate bonds, which are prized for their relative safety. But after a long rally, these bonds now pose greater risk than many may realise.

The duration of this class of assets — its interest-rate risk — has increased to near record highs, while spreads over the yield of equivalent Treasuries have fallen to near record lows.

A pick-up in interest rates, depending on its speed and longevity, could significantly push down prices across the market, which totals over $7tn, accounting for just over a quarter of the total US bonds outstanding. That could happen even without a deterioration in credit quality.

Returns from bonds break down into four basic components. The first is the security's yield. The other three are the movement in Treasury rates, the movement in credit spreads, and duration.

The yield is the sum of the equivalent Treasury yield plus the spread over that Treasury yield. The yield on the asset class is near all-time lows, hovering below 3 per cent.

The rate component is simply the nominal government yield. In 2019, Treasury rates fell, lifting the prices of investment-grade bonds. The benchmark ICE Bank of America Merrill Lynch US Corporate Index returned 14 per cent last year, the best performance since 2009.

About half of that return has come from a decrease in Treasury rates, which are now near their lowest levels on record.

The spread component is the additional yield over the Treasury rate received for taking on credit risk — primarily company — or industry-specific risk. Factors like credit metrics and cash flow growth affect this part of the return.

Other dynamics can be at play, notably relative-value investing, where investors buy bonds that carry attractive spreads compared with other bonds, pushing spreads of those securities lower and their prices higher. Indeed, this has happened over the past year, as yields outside the US remain low and in some cases negative, driving non-US investors into US credit.

The last component of return, duration, is near an all-time high. The higher the duration, the higher the sensitivity to changes in interest rates. How did this come about? In part, because of a trend of companies issuing longer-maturity bonds, looking to lock in better long-term borrowing costs. However, a large part of the increase is because of lower interest rates.

As rates have fallen, the periodic coupons have decreased, meaning that a higher portion of the bonds' return comes from the return of principal at maturity. Historically, the duration of the investment-grade universe has hovered around 6 years; it is now over 7.6 years. At this level, a 1 per cent increase in either spreads or Treasury rates would push prices down by 7.6 per cent.

As 2020 gets under way, the market is offering near-record lows in yield and spread and a nearrecord high in duration. This is not a great set-up. Given the advanced age of the business cycle, investors are rightly on the lookout for signs of credit deterioration.

However, many financial professionals may be overlooking this other risk: the increased sensitivity to a change in interest rates given the increase in duration.

Historically, Treasury yields and investment-grade corporate spreads had a negative correlation. As the economy strengthened, spreads would tighten and Treasury yields would increase. As the economy got weaker, spreads would widen and Treasury yields would fall. Movements in spreads and Treasury yields would offset each other.

But this relationship has broken down. Over the past couple of years, Treasury yields and corporate spreads have displayed a positive correlation. In other words, rates and spreads have moved in the same direction: lower and tighter in 2019, and higher and wider in 2018.

It is difficult to confirm why this relationship has changed, but a plausible cause might be found in central bank policy. As the Federal Reserve remains accommodative, Treasury rates remain low, "animal spirits" remain high in the market, and investors look for yield — moving into corporate credit and pushing down spreads. If policy were to change, as it did in 2018, watch out. Yields and spreads could go higher in tandem.

Falling Treasury yields and spread compression formed tailwinds for the investment-grade market in 2019, but we saw the inverse in 2018. Investors should pay attention, and consider reducing the duration of their investment-grade corporate holdings before those tailwinds — whether on rates, spreads or both — turn into headwinds.

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