Bumps in the road

THE VOLATILITY WITNESSED IN THE POLITICAL DOMAIN AND IN GLOBAL MARKETS HAS FED THROUGH INTO BOND PERFORMANCE. JAMES WEST EXPLORES KEY TRENDS

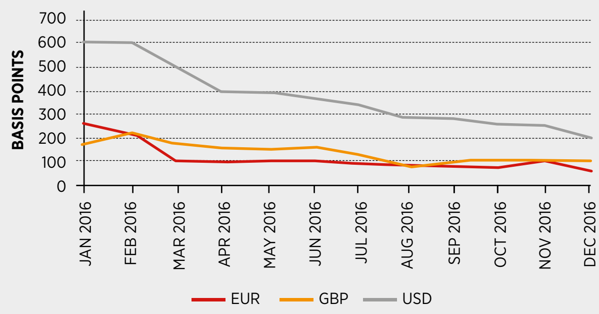
With the vast array of political and economic activity throughout 2016, it certainly was difficult to keep up with the volatility in the corporate bond market. Brexit, presidential elections and monetary policies, to name but a few, contributed to what was a very eventful year. So, when there is such volatility and unrest, how do you keep an eye on the changing spreads and yields in the corporate bond market? Using S&P ratings and our corporate bond curve data, we have taken a look at 10-year BBB-rated corporates throughout 2016.

The main trends we saw were as follows:

- The energy sector saw the largest spread declines: for EUR -72%, USD -65%, GBP -42%.
- Average corporate bond spreads declined by 45.6% for EUR, 38.9% USD, 33.8% GBP.
- The average spread differential between EUR to USD tightened 32% from 155bp to 104bp.
- The average spread differential between GBP and USD tightened 49.5% from 107bp to 54bp.
- Overall, we saw considerable spread tightening across all sectors.

SHUTTERSTOCK

Figure 1: BBB energy sector spreads by currency 2016



Source: S&P Global Market Intelligence Data as of 10 February 2017

Looking at figure 1 above, we can see how the energy sector performed throughout 2016. When we consider that 2015 was extremely negative with regards to this sector, and that energy spreads were at levels last seen during the financial crisis, a correction was always a possibility. The crash in oil prices to its low of $26 a barrel in February caused a sell-off in the energy sector that caused the market to become nervous that perhaps even those companies with excellent credit health might be at risk of defaulting. Spreads for US dollar energy bonds were over 600bp at the beginning of 2016 and, if we look at BB spreads, they were up at 970bp in February 2016. However, the stability provided by the oil-price recovery, helped by a positive

reaction to the Organization of the Petroleum Exporting Countries' production cuts announced in November and an increased investor appetite to look for yield, the sector was the best performing of 2016.

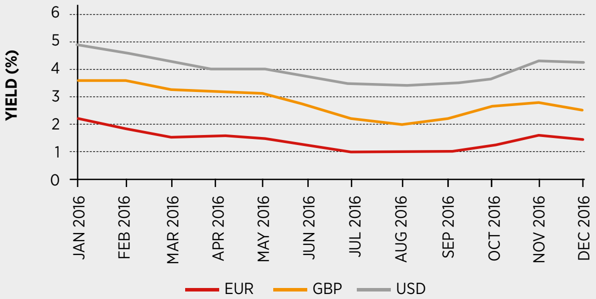
All sectors in USD, GBP and EUR saw dramatic decreases in spreads throughout 2016; however, there are some nuances. As noted, the energy sector saw the largest spread declines: EUR -72%, USD -65%, GBP -42%. The healthcare sector showed the least amount of decline, but still saw significant decreases in spreads of -24.1% in USD, -26.1% in GBP and -18.2% in EUR.

One of the main drivers for spread decreases during 2016 was the decision by the European Central Bank (ECB) in March and the UK government in August to extend their asset-purchase plans to include corporate bonds. Following the unexpected outcome of the Brexit vote and the possibility of a recession as a result, the Bank of England was keen to ensure that the largest corporations continued to borrow. By buying these assets, the interest rates that needed to be offered to attract investors would remain low and therefore make it easier to borrow money.

Helping the eurozone economy

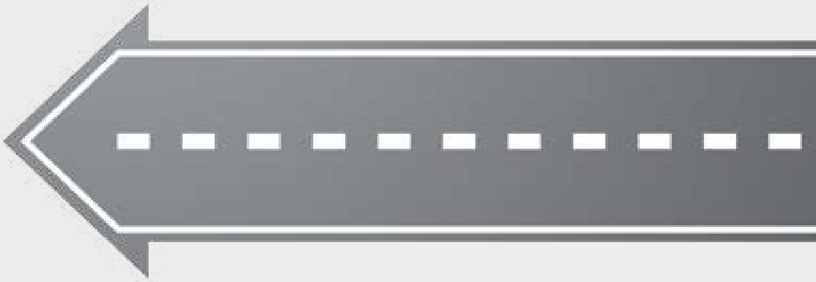
The ECB's reason for doing this was more to look at increasing inflation and to assist the flagging eurozone economy. However, by purchasing these assets, a floor has in effect been put under corporate bond prices, which has driven spreads lower. It is interesting to note that it was spreads in corporate bonds denominated in euros that declined the most on average during 2016, down 43% compared with GBP and USD, which both experienced similar declines of 33.7% and 32.6% respectively. In the hunt for yield, investors have moved down the capital structure, looking at speculative-grade securities. They have also moved towards USD-denominated debt, which offered much more attractive yields compared with EUR and GBP, as we can see in figure 2, below.

Figure 2: Average BBB corporate bond spreads by currency 2016



Source: S&P Global Market Intelligence Data as of 10 February 2017

Other sectors that have benefited from the asset-purchasing plan are utilities and consumer staples. According to the Bank of England corporate bond sector shares, these two sectors made up 35% of the total number of corporate bonds that were repurchased. Our data shows us that the spreads on 10-year BBB-rated GBP utilities tightened 43.9% from 141.5bp in January 2016 to 79.4bp by the end of the year. Interestingly, spreads in 10-year GBP BBB utilities finished the year lower than EUR and USD currencies, despite an increase in the



SHUTTERSTOCK

lead-up to the Brexit vote. Spreads in euro-denominated BBB 10-year debt was also down 43% (151bp to 86bp), while US-denominated spreads tightened 47% (378bp to 157bp).

Spreads in BBB-rated 10-year consumer staples debt, a sector that is typically sought after during times of volatility and uncertainty, tightened 47% (EUR), 35% (GBP) and 22% (USD), meanwhile. With improving economic growth, it is feasible that interest in this sector may decline. However, given the continued uncertainty surrounding Brexit and the pace at which the US may raise interest rates, this sector is likely to continue to interest investors, which could cause spreads to tighten further.

What does the future hold?

With all the volatility caused by the macroeconomic environment and the dramatic changes in the political environment, 2016 is sure to be a year that won't be forgotten in a while. However, despite many investors worrying that spreads and defaults would continue to rise and that the situation would worsen, particularly in the energy sector, quite the opposite has occurred. The initiatives on the part of the ECB and the Bank of England are providing strong technical support for credit spreads at the moment and there is potential for spreads to continue to decline as these asset-repurchasing plans continue into 2017.

It could be argued that there will continue to be good opportunities around for 2017. However, investors will possibly need to take a few more risks. With default rates for the energy sector declining in 2016 and the forecasts suggesting that this trend will continue, this area could provide an opportunity in 2017. The search for yield will continue, which may mean further issuance and investment into speculative-grade corporate debt. It now seems prudent to expect the unexpected; Brexit, the Trump administration, the eurozone elections and questions about economic growth will all have an effect on the direction of credit spreads. In addition, the uncertainty around all of these elements will ensure that volatility remains during 2017, so there may yet be a few more bumps in the road.

James West is EMEA head of market development for public sector & professional services, S&P Global Market Intelligence

S&P Global
Market Intelligence