COVID-19 Research Update

Global Fixed Income Themes & Market Conditions

Investment grade credit markets have garnered solid investor interest over the last three consecutive months—even as the coronavirus outbreak spread beyond China's borders. On the back of the Federal Reserve's (Fed) relief package geared toward corporate bond purchases, new issuance activity within U.S. investment grade corporate credit remained robust month over month. See **Figure 1.** While largely untapped, Fed support created enough of backstop for capital markets to renormalize and allow companies to access markets at record levels. Meanwhile, investment grade issuance has also picked up in EMEA (see **Figure 2**), the region's total volume in May was only about 16-20% of activity in the U.S. for the same period.

Figure 1 Rolling Monthly U.S. Investment Grade New Issuance As of 5/28/2020

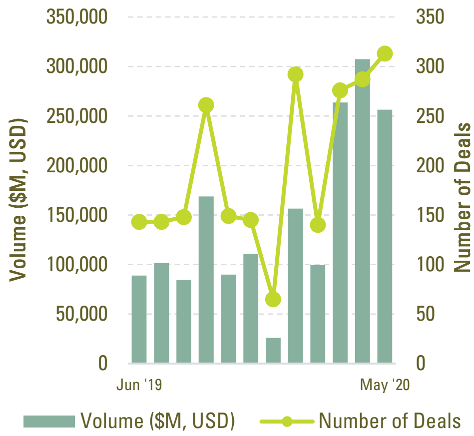
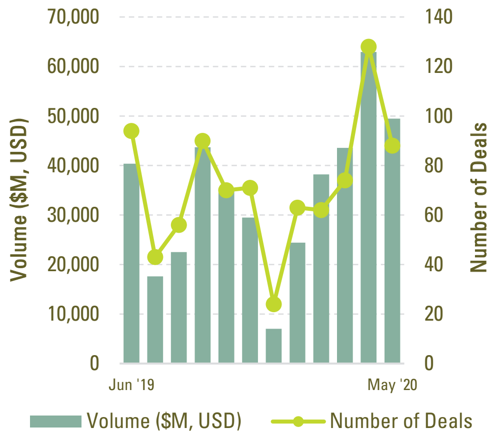


Figure 2 Rolling Monthly EMEA Investment Grade New Issuance As of 5/28/2020



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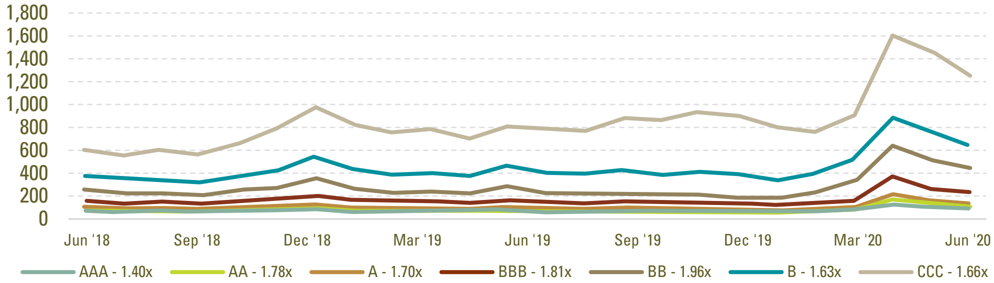
As the U.S. and European economies gradually come back online, the opportunities within credit markets may start to shift. The risk-on rally over the last 10 days in May suggest a shift in investor sentiment, particularly as spreads compress in certain pockets of the credit market. **Figure 3** breaks down U.S. corporate spreads by credit quality. Unsurprisingly, the lowest-rated CCC segment of the market is trading at the widest spreads while the highest rated AAA bonds are virtually flat versus the 10-year Treasury yield.

Figure 3 U.S. Credit Spreads by Quality
As of 5/28/2020



Source: BofA Merrill Lynch

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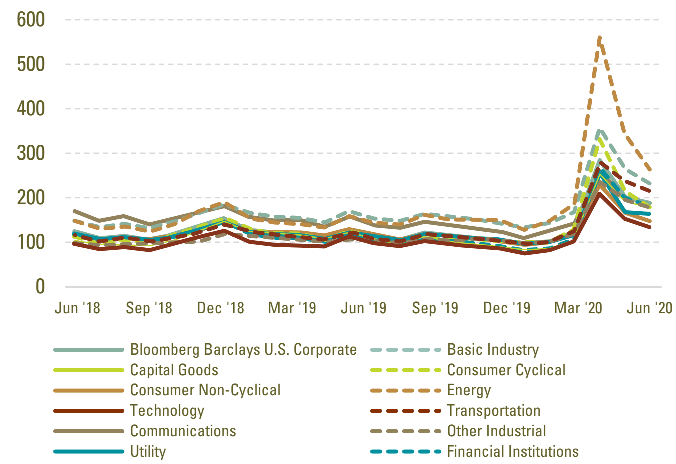
While the highest-quality corporate credit may be trading like U.S. Treasuries, compelling valuations opportunities still exist within U.S. investment grade credit, as shown in **Figure 4**.

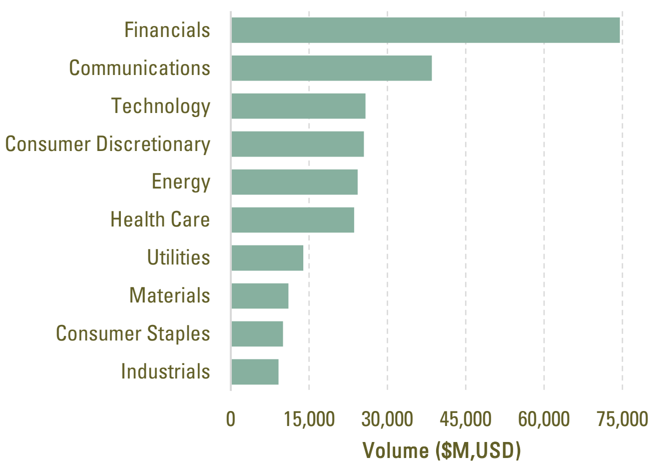
Although spreads within the energy sector have contracted considerably since March, these investment grade corporate bonds have continued to trade at a discount relative to peers. Energy yields have compressed to converge with other growth-oriented sectors such as basic industry, consumer cyclicals, and transportation—which also trade at a discount within the investment grade universe. **Figures 5** and **6** categorize U.S and EMEA investment grade new issuance by sector. The composition of activity varies across the two regions, yet we have generally focused our purchases on the top U.S. sectors by issuance: financials, communications, and technology—with careful company selection within energy and industrials. Large U.S. financial institutions have steadfastly tapped debt markets over the last three months, preferring to raise cash through capital markets than borrowing directly from the Federal Reserve.

Figure 4 U.S. Investment Grade Option-Adjusted Spreads by Sector
As of 5/28/2020



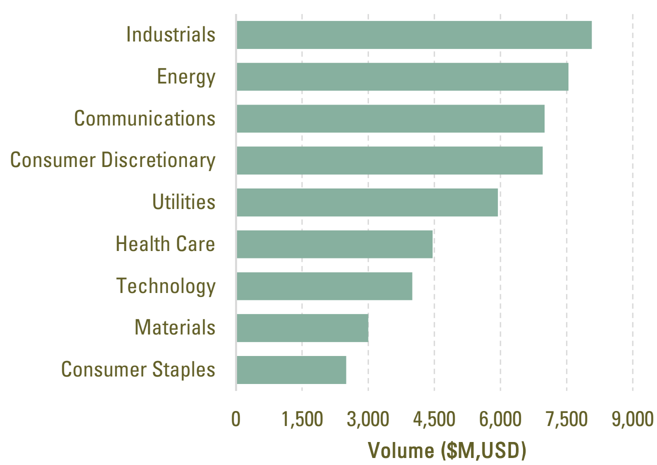
Source: BofA Merrill Lynch

Figure 5 U.S. Investment-Grade New Issuance by Sector
May 2020



Source: Bloomberg (© 2020, Bloomberg Finance LP)

Figure 6 EMEA Investment-Grade New Issuance by Sector
May 2020



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Since European banks are not as well capitalized as U.S. peers, financials have largely abstained from new issuance. We continue to assess opportunities within European credit, and if we decide to initiate an allocation, large international industrial companies would be an area of interest.

Looking at the level of new issuance on a year-over-year basis, some investors may question how long this pace can last. Based on **Figures 7** and **8**, U.S. investment grade new issuance has far surpassed its post-GFC peak while EMEA hovers around its previous high water marks.

Figure 7 Year-Over-Year U.S. Investment Grade New Issuance
As of 5/28/2020

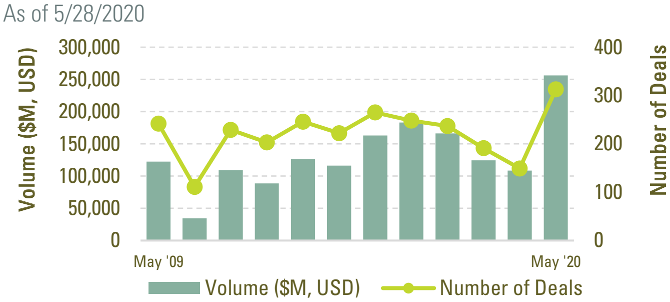

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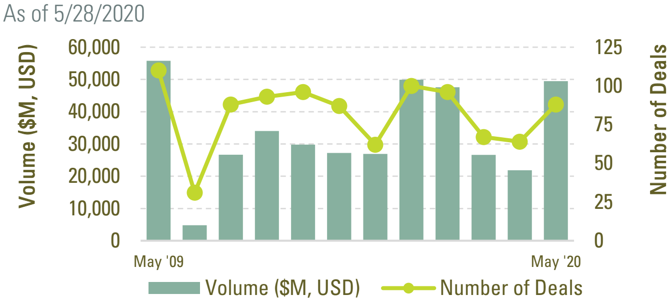
Figure 8 Year-Over-Year EMEA Investment Grade New Issuance
As of 5/28/2020



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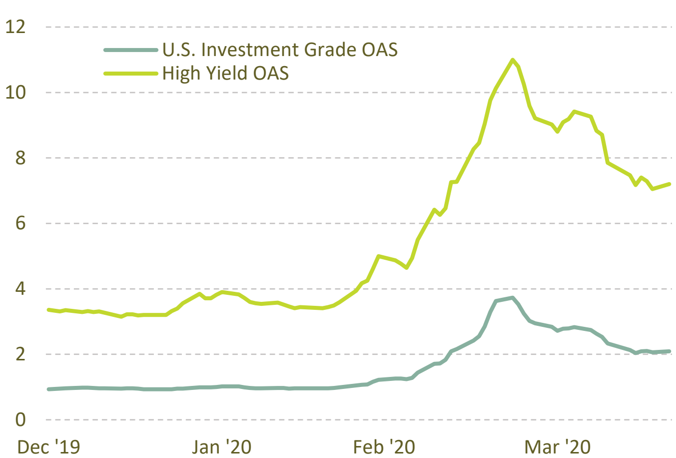
Opportunities to enter European investment grade credit may be on the horizon given constructive factors, such as the nascent economic reopening within the eurozone and signals of unprecedented fiscal cooperation amongst European Union members.

Additionally, the U.S. high yield credit market may be positioned for a snapback as the domestic economy begins to recover. Based on valuations, U.S. high yield credit trades at a substantial discount to investment grade corporates on an option-adjusted spread basis (see **Figure 9**).

The risk of rising defaults and weak cash positions against a dismal economic backdrop have likely dampened investor interest in high yield credit. According to **Figure 10**, high yield issuance is currently nowhere near post-crisis peaks, underscoring the noticeable absence of a risk-on environment. Furthermore, the U.S. high yield market did not participate in the significant new issuance rebound that occurred within the investment grade universe in March. See **Figure 11**. Nevertheless, new issuance substantially recovered in April, and strongly improved in May, as shown in **Figure 12**.

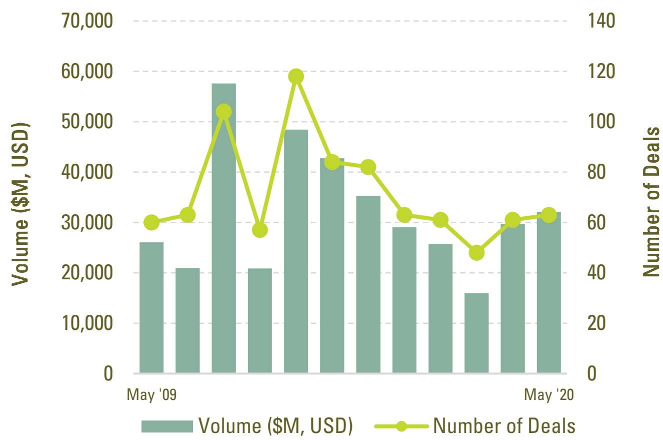
The profile of companies accessing high yield debt markets looks quite different than the investment grade universe. In May, smaller consumer discretionary companies have been issuing debt in order to raise cash and eventually participate in the anticipated economic recovery. Conversely, the capital-intensive energy and industrials sectors barely registered in activity.

Figure 9 U.S. Investment Grade and High Yield OAS
As of 4/20/2020



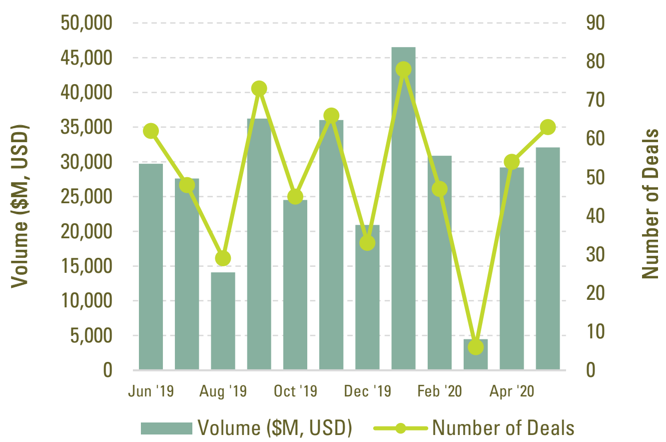
Source: Bloomberg (© 2020, Bloomberg Finance LP)

Figure 10 Year-Over-Year U.S. High Yield New Issuance
As of 5/28/2020



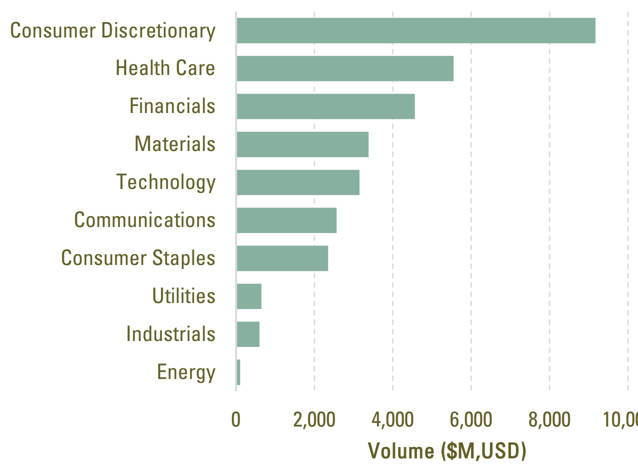
Source: Bloomberg (© 2020, Bloomberg Finance LP)

Figure 11 Rolling Monthly U.S. High Yield New Issuance
As of 5/28/2020



Source: Bloomberg (© 2020, Bloomberg Finance LP)

Figure 12 U.S. High Yield New Issuance by Sector
May 2020



Source: Bloomberg (© 2020, Bloomberg Finance LP)

As the rate of fallen angels crossing over from the investment grade to high yield threshold slows, we believe that fewer companies will be competing for capital within debt markets. Since smaller, regional U.S. banks are also well capitalized following stringent post-GFC regulations, financials could continue to lead high yield new issuance. However, energy and industrial companies could begin to issue debt as U.S. manufacturing recovers and high yield spreads compress. Regardless of which sectors and companies lead new issuance during 2Q and 2H20, it will likely only matter how prudently they are redeploying debt proceeds and conserving cash.