The case for investment grade corporate bonds

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Key takeaways

- Investment grade corporate bonds could play a vital role in terms of adding balance and resilience as part of a core fixed income allocation within a balanced portfolio.
- The asset class has provided an attractive alternative to developed market sovereign bonds, potentially offering both higher income and higher returns as well as diversification from equities and capital preservation.
- Credit markets have sold-off significantly since the beginning of the year, arguably presenting an attractive entry point for investors. However, recession risk is on the rise and careful selection in companies and sectors remains key.

Why investment grade corporate bonds?

We believe bonds can serve four central roles in a balanced portfolio, namely:

Four roles of fixed income

As part of a core fixed income allocation within a portfolio, investment grade corporate bonds could play a vital role in terms of adding balance and resilience.

These roles can aid in pursuing retirement goals or help stabilise a portfolio to be more resilient when economic shocks hit markets. Due to the characteristics of investment grade corporate bonds, they could be an ideal asset class to fulfil most of these roles simultaneously in a balanced portfolio. As such, they could readily serve as the core fixed income element of a portfolio. Global investment-grade corporate bonds have provided an attractive alternative to developed market sovereign bonds, potentially offering both higher income and higher returns as well as diversification from equities and capital preservation.

Income

Fixed income fundamentally differs from equity in its explicit income component. Although some common and preferred stocks pay dividends, these income streams can fluctuate or disappear at a company's discretion. Bonds typically carry more explicit and predictable income streams in the form of coupons, so long as the issuer remains solvent. Investment grade corporate bonds therefore have the potential to provide a reliable stream of income for investors with income return having served as a large component of total returns. This could help provide a cushion to total return should price movements remain volatile.

Capital preservation

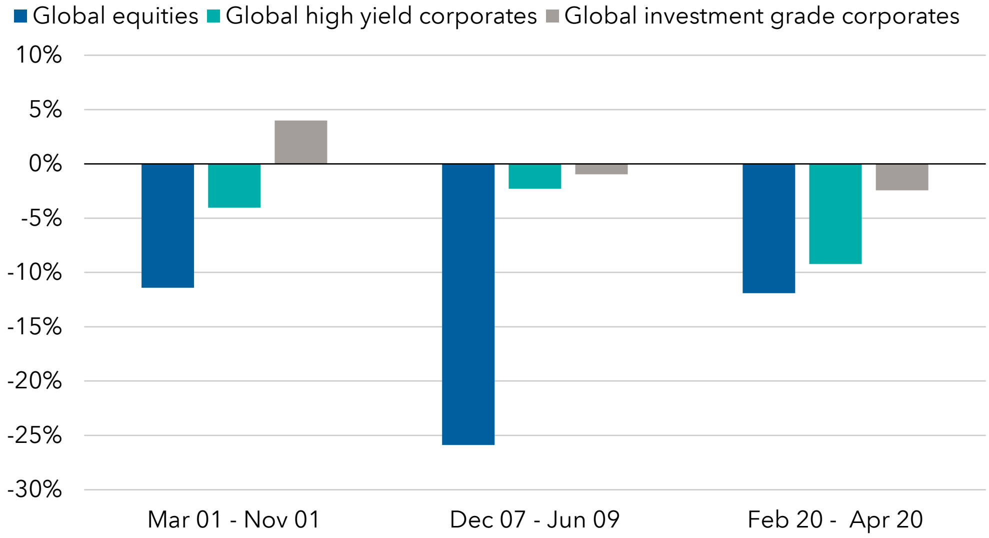
The market's focus is shifting towards the prospect of slower growth and the rising risk of recession. However, corporate fundamentals remain in good shape, which should help investment grade companies to navigate a slow-growth environment. Default risk for investment grade corporates is relatively low compared to high yield bonds, and even if the global economy enters a recession, this would likely lead to an increase in downgrades and fallen angels[1]

1. Fallen angel: a bond downgraded from investment grade to high yield status.

rather than defaults. It should be noted though that this would also likely result in an uptick in volatility and a widening in spreads.

In addition, investment grade corporate bonds can limit the downside in periods of market volatility, particularly in the contraction phase of the business cycle. As duration of the asset class has extended, interest rates have become a larger component of total returns. Should a mild recession transpire, and interest rates begin to fall, investment grade bonds could offer a degree of resilience through their longer duration profile. As illustrated by the graph below investment grade bonds have outperformed riskier asset classes such as equities and high yield corporate bonds during periods of business cycle contractions since 2001, which is when our available data set began.

Asset class returns during US business cycle contractions



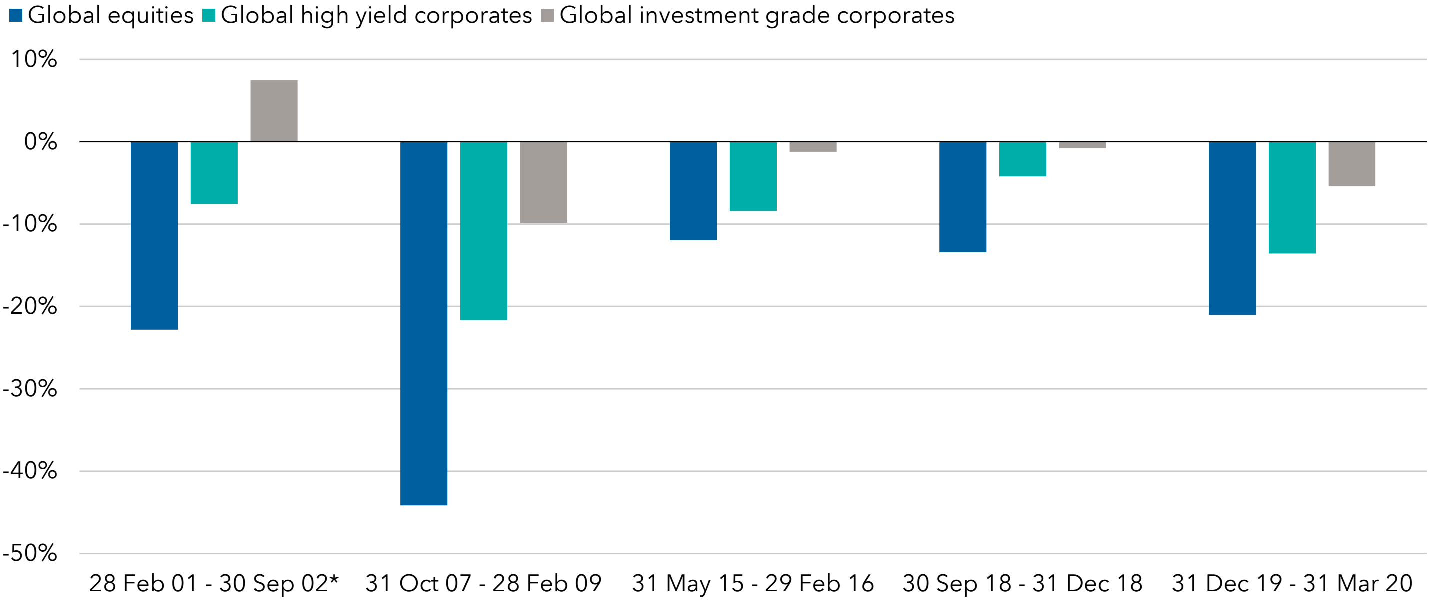
Return (%)	Mar 01 – Nov 01	Dec 07 – Jun 09	Feb 20 – Apr 20
Global equities	-11.40%	-37.76%	-11.89%
Global high yield corporates	-4.04%	-3.61%	-9.22%
Global investment grade corporates	4.00%	-1.52%	-2.43%

Past results are not a guarantee of future results.

As at 31 July 2022. Data in US dollar terms based on monthly data, returns for more than one year are annualised. Indices used are MSCI World Index with net dividends reinvested for global equities, Bloomberg Global High Yield Corporate Index for global high yield corporates and Bloomberg Global Aggregate Corporate Index for global investment grade corporates. US business cycles contraction dates are sourced from the National Bureau of Economic Research (NBER). Sources: Bloomberg, Barclays, MSCI, NBER, Capital Group

Similarly in periods of large equity drawdowns since 2001 investment grade corporate bonds have fared better than other risky assets such as equities and high yield bonds as shown by the following graph.

Asset class returns in periods of large equity drawdowns



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Data in US dollar terms based on monthly data, returns for more than one year are annualised. Indices used are MSCI World Index with net dividends reinvested for global equities, Bloomberg Global High Yield Corporate Index for global high yield corporates and Bloomberg Global Aggregate Corporate Index for global investment grade corporates. * Equity drawdown began on 31 March 2000, but due to availability of data, start date is shown as 28 February 2001. Sources: Bloomberg, Barclays, MSCI, Capital Group.

On a risk-adjusted basis investment grade corporate bonds have also displayed a strong risk/reward profile over the long term.

Mar 01-Jul 22 (% p.a.)	Return	Volatility	Return/risk
Global equities	6.17%	15.51%	0.40
Global high yield corporates	6.40%	10.02%	0.64
Global investment grade corporates	4.30%	6.65%	0.65

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As at 31 July 2022. Data in US dollar terms based on monthly data. Indices used are MSCI World Index with net dividends reinvested for global equities, Bloomberg Global High Yield Corporate Index for global high yield corporates and Bloomberg Global Aggregate Corporate Index for global investment grade corporates. Sources: Bloomberg, Barclays, MSCI, Capital Group

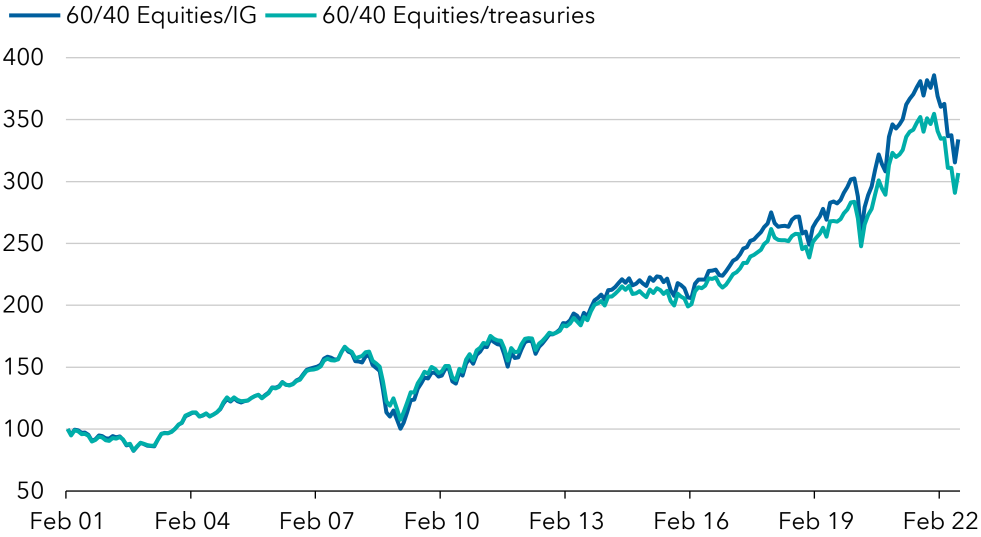
However, investment grade bonds are not without risks and should be considered as part of an overall balanced portfolio. As will be considered in the following section, they can also provide diversification benefits.

Diversification from equities

Investment grade corporate bonds can provide diversification away from equities. Historically, correlations between global investment grade corporate bonds and global equities based on 5-year rolling returns has been very low.

Moreover, over the last 20 years, a portfolio comprised of 60% global equities and 40% global investment grade corporate bonds will have slightly outperformed a more traditional mix of 60% equities and 40% government bonds as illustrated by the following chart.

60/40 balanced portfolio cumulative returns



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As at 31 July 2022. Data in US dollar terms based on monthly data. Indices used are MSCI World Index with net dividends reinvested for global equities, Bloomberg Global High Yield Corporate Index for global high yield corporates, Bloomberg Global Aggregate Corporate Index for global investment grade corporates and Bloomberg Global Aggregate Treasury Index for global treasuries. Sources: Bloomberg, Barclays, MSCI, Capital Group.

Current valuations present a compelling entry point for investors, but caution is warranted.

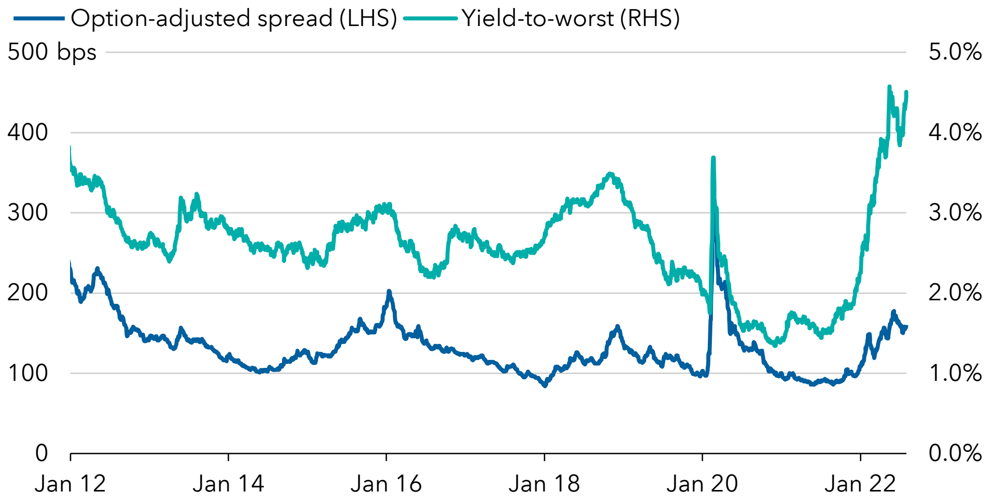
As part of a core fixed income allocation within a portfolio, investment-grade corporate bonds could play a vital role in terms of adding balance and resilience. This is particularly relevant amid high market volatility.

Why now?

It has been a difficult start to the year for investment grade corporate bonds which returned -16.4 year-to-date[2]. Credit markets have repriced significantly, mostly on the back of rising interest rates rather than driven by credit spread widening. As inflation jumped to the highest levels seen in decades in developed markets, major central banks have turned increasingly aggressive in their attempts to control it, gradually removing stimulus measures and raising interest rates. The Russia-Ukraine conflict has also contributed to an overall very volatile macroeconomic environment. As a result, however, valuations have improved significantly and arguably present an attractive entry point for investors.

2. As at 31 August 2022. Index: Bloomberg Global Aggregate Corporate Index. Source: Bloomberg, Barclays

Global investment grade spreads and yields



Past results are not a guarantee of future results.

Data as at 31 August 2022 based on daily data. Index used is the Bloomberg Global Aggregate Corporate Index. bps: basis points. Source: Bloomberg, Capital Group

A fundamentally driven bottom-up investment process that is distinctive in its higher quality approach to credit.

Caution is warranted, however, as there is still a lot of macro uncertainty and spreads could widen further. The risk of recession, or at least a material slowdown in growth, is rising. Spreads are likely to start reflecting this elevated recessionary risk, which could materialise earlier in Europe, especially given the additional uncertainty over the war in Ukraine and its potential impact on gas supplies. Additionally, central banks globally are set to continue prioritising the fight against inflation over a slowing economy, and therefore keep monetary policy tight. This level of co-ordinated tightening could put further pressure on spreads. Credit spreads tend to widen against spikes in real rates and a slowdown in growth.

Although credit fundamentals and consumer spending are currently in good shape, both are likely to deteriorate. Slowing growth and inflation pose risks, and inflation in particular calls into question the sustainability of corporate profit margins. That said, a deep recession is not currently our base case given still strong balance sheets for both financial and non-financial issuers. Investor sentiment has turned negative though, and appetite for credit could continue to wane, especially if the asset class posts negative total returns for a prolonged period. Consumer spending is also expected to fall, which could also drag down economic growth. Further COVID-19 lockdowns in China and their potential impact on global supply chains and growth could act as a further headwind to credit markets.

With the current macroeconomic environment highly volatile and expected to remain so, careful selection in companies and sectors remains key to successful credit investing.

At Capital Group, we believe our higher quality, bottom-up approach to global investment grade credit, which is fundamentally driven, has the potential to fulfil the four roles of fixed income as a core fixed income allocation within a balanced portfolio.

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