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AAM
Insurance Investment Management

Value in Corporate Bonds

Elizabeth Henderson, CFA | Director of Corporate Credit & Principal

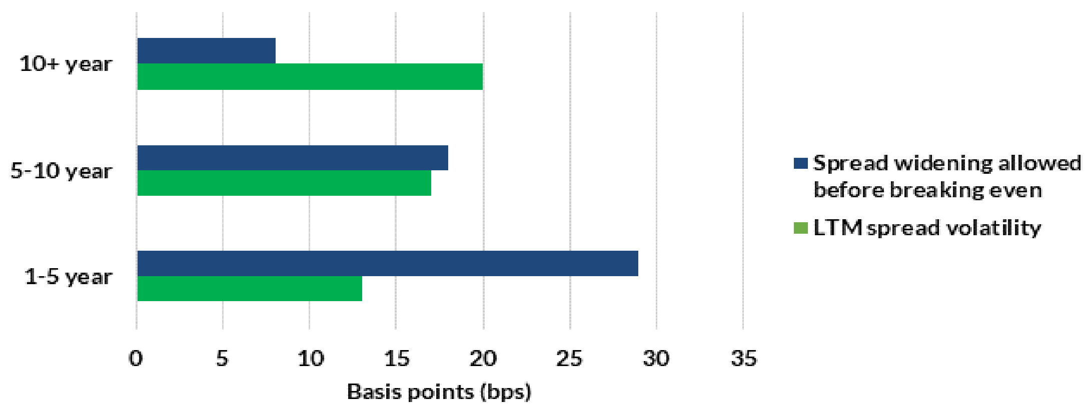
Are Investors Getting Paid for the Risk in the Corporate Bond Sector?

With credit spreads over US Treasuries (UST) for U.S. investment grade (IG) rated corporate bonds declining towards decade lows, we must step back and ask ourselves if we are getting paid to own them. Risk in this sector for investors is largely the volatility in spreads which affects bond prices, as losses on IG rated bonds is virtually nil[1]. When examining potential volatility and credit fundamentals, we generally find value today in short-to-intermediate maturities, Financials and Utilities. We expect that credit and sector selection will be an important driver of performance in 2024.

Working under the assumption that UST risk is hedged, thereby focusing only on the movement in credit spreads, one can measure relative value in multiple ways. One way is performing a breakeven analysis, which includes examining the minimum spread widening allowed to achieve an excess return of zero versus the volatility in spreads. Exhibit 1 shows that if the spread of the average 10+ year corporate bond widened more than 8 bps, that bond would generate a negative excess return vs. the UST. Since the volatility in spreads for long maturities has averaged 20 bps over the last twelve months, the risk appears elevated today. Conversely, the volatility for shorter maturities (1-5 years) has been 13 bps, which is well inside the 29 bps allowed for an investor to breakeven.

1 Moody's; "Annual default study: Corporate default rate will rise in 2023 and peak in early 2024", Exhibit 29; 4/14/2023. The average annual loss for IG rated debt averages 0% with a maximum loss of 0.3% in 2008 since 1983.

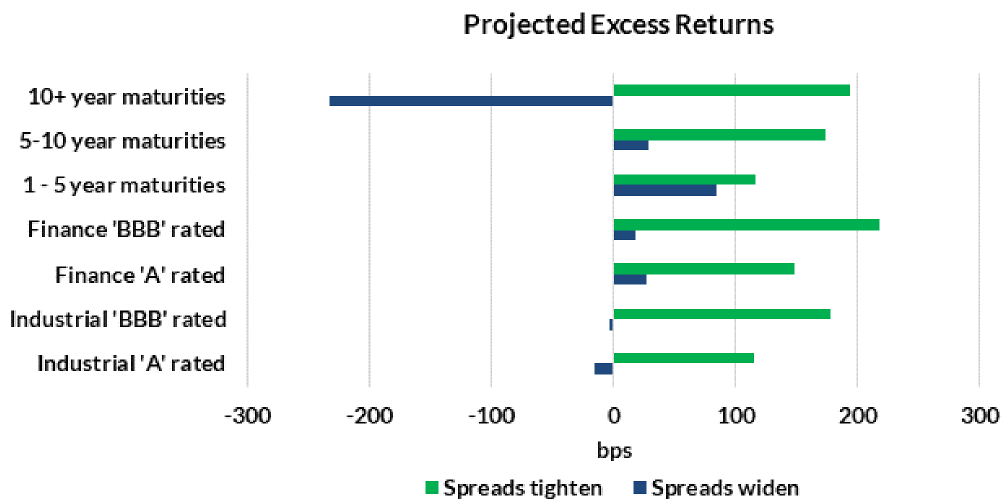
Exhibit 1: Shorter maturities have a higher breakeven point



Source: AAM, Bloomberg Investment Grade Corporate Index (breakeven is calculated using the OAS and duration at 1/30/2024 with volatility representing the standard deviation in the OAS over the last twelve months

While this is an easy analysis to perform, assumptions are important when performing these calculations. Drivers for spreads last year are likely to be different this year. If one forecasts lower volatility in 2024 than what we have experienced in 2023 given the risk of recession was higher last year[2], the output changes. In this scenario, projected excess returns are positive or only modestly negative except for long maturities given the level of spreads today. For instance, for 5-10 year maturities, projected excess returns over UST are 0.28% to 1.74% (i.e., both positive) if the spread today (108 bps) widened to 134 (last twelve month (LTM) mean) or tightened to 106 bps (LTM minimum) respectively.

Exhibit 2: A lower volatility assumption produces a more favorable view

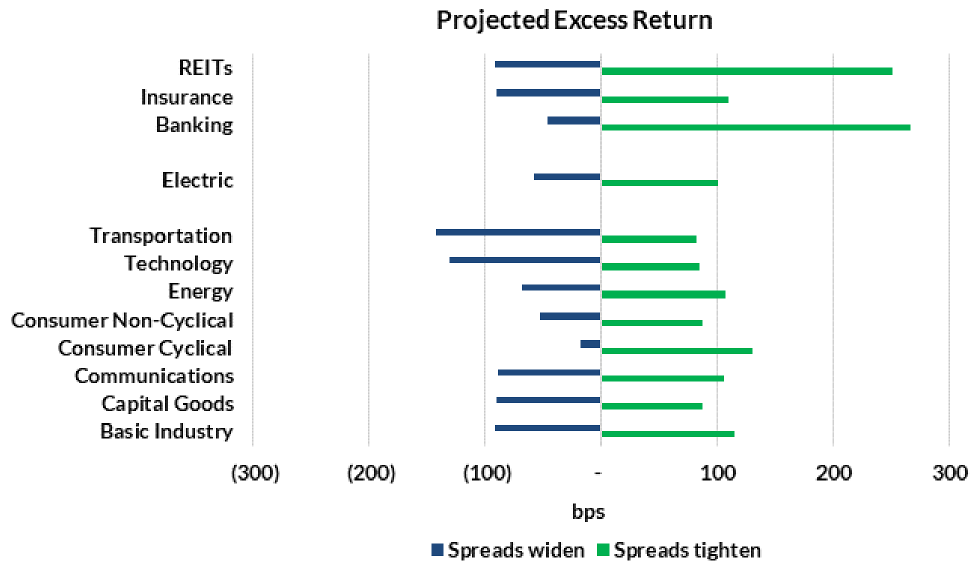


Source: AAM, Bloomberg Investment Grade Corporate Index (Spreads tighten is calculated using the minimum spread over the last twelve months vs. the spread and duration at 1/30/2024. Spreads widen is calculated using the 12 months mean instead of the minimum)

2 Risk of recession for the next 12 months is 45% today vs. 68% in January 2023 per Bloomberg's United States Recession Probability Forecast. These forecasts are derived from the latest monthly & quarterly surveys conducted by Bloomberg and from forecasts submitted by various banks.

Finally, when analyzing various Corporate sectors using the framework in Exhibit 2, we see that financial and commodity-based sectors as well as utilities have more upside than downside projected (Exhibit 3). The spread ranges used in this analysis reflect technicals and fundamentals over the last twelve months. Therefore, to assign probabilities to these bear/bull cases or change the spread range, one must project differences in technical and/or fundamental drivers.

Exhibit 3: Return forecasts differ greatly at a sector level



Source: AAM, Bloomberg Investment Grade Corporate Index using Class 3 sector spreads for maturities 5-10 years (Spreads tighten is calculated using the minimum spread over the last twelve months vs. the spread at 1/30/2024. Spreads widen is calculated using the 12 months mean instead of the minimum)

At AAM, we have a team of experienced, sector-focused analysts and traders who measure risk, do their own analysis and assign credit ratings to companies instead of relying on credit rating agency ratings. Traders look for mis-priced opportunities where the market may be viewing a company more or less favorably than AAM's analysts. After netting positive and negative differences, we view fundamental-driven spread widening risk as fairly balanced. However, there are a handful of sectors where AAM's analysts have a more negative fundamental view than the credit rating agencies. Therefore, we expect that credit and sector selection will be an important driver of performance in 2024.

So, the question remains, are investors getting paid for the risk in the Corporate Bond sector? At AAM we believe the answer is yes, but with a qualified "it depends." It depends on the maturity and it depends on the sector. Specifically, we're focused on shorter maturities and we believe that banks have an attractive risk profile with the understanding that it's critical to be selective. Alternatively, we find technology less attractive given both pricing and rating.

To learn more about AAM's views on sectors and our outlook for Corporate Bonds in 2024, please refer to the Corporate Credit Outlook.

Elizabeth Henderson, CFA, *is a Principal and the Director of Corporate Credit at AAM with 26 years of investment experience. She is responsible for the Corporate sector, in addition to the analysis of investment grade Telecommunications, and Media credits. Additionally, Elizabeth is a member of AAM's "Outsourced CIO" Committee. Prior to joining AAM, Elizabeth was a Director at Fitch Ratings with responsibility for following public and private telecommunications and media companies. She is a CFA Charterholder as well. Elizabeth graduated with honors from Indiana University with a BS in Finance and earned an MBA in Finance, Analytical Consulting, and Marketing from Northwestern University's Kellogg School of Management.*

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