



Q&A



Greg Nordquist

The practical implications of tight credit spreads

With: Greg Nordquist, CFA, Director, Overlay Strategies and Travis Bagley, CFA, Director, Transition Management

Q: GLOBAL CORPORATE CREDIT CONDITIONS HAVE BEEN ON A POSITIVE TREND. CAN THIS TREND CONTINUE?

A (Nordquist): Corporate credit spreads are unquestionably tight compared to history (see Exhibit 1). This is not an easy measure to forecast, but it's difficult to envision many scenarios where spreads tighten significantly from here.

There are several known risks that could have a significant impact on the economy and, specifically, on credit markets. These include things like U.S. Federal Reserve activity around its inflation and employment goals as well as actions by other central banks across the globe. Then we have the civic and geopolitical environment, which is in some ways unlike anything we've seen before. There's no way to foresee with certainty how that might eventually impact global capital markets.

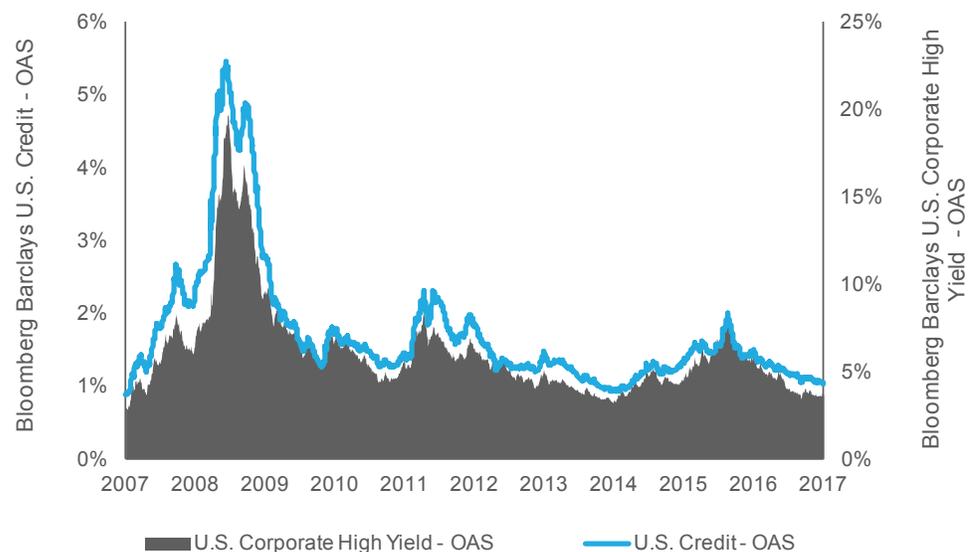
In theory, this uncertainty is priced into today's credit market. But with spreads as low as they are, it becomes less and less clear how to make a convincing case that credit markets will continue to strengthen.



Travis Bagley

In theory, this uncertainty is priced into today's credit market.

Exhibit 1: Bloomberg Barclays Indices Option Adjusted Spread (OAS)



Source: Bloomberg Barclays June 2007 – June 2017

Q: WHAT CHALLENGES CAN TIGHT CREDIT SPREADS CREATE FOR INVESTORS?

A (Bagley): Meeting long term return goals is more difficult, given the lower return expectations from all markets right now. For bond investors, this tight credit spread market also creates implementation challenges when trying to transact in credit securities. Finding reasonably priced credit securities is tougher in this environment, so building a credit portfolio is more challenging and takes longer.

These liquidity challenges can feed on themselves, as investors have less incentive to sell desirable credits. Many would rather hold the securities and continue to receive healthy yields. The larger the portfolio, the bigger the challenge can be. And liquidity is especially tight for longer duration securities.

Q: WILL NATURAL SUPPLY AND DEMAND FORCES HAVE AN EFFECT AND ALLEVIATE SOME OF THESE CHALLENGES?

A (Nordquist): That would be the hope, but that's a long-term impact. Meanwhile, in the near term we see the imbalance in supply and demand growing rather than shrinking. Although corporate issuance has been strong over the past several years, demand has been even stronger. Many defined benefit plans are de-risking, typically selling equities and shorter term fixed income to buy long-dated credits, which better hedge their liabilities. This de-risking demand will most likely weigh on credit spreads at the long end of the yield curve for the foreseeable future, unless credit conditions and/or supply change considerably. There is also speculation that bond issuance will be further reduced if a change in corporate taxes eliminates the tax deductibility of bond interest. That has the potential to drive spreads even lower.

Q: WHAT CAN CREDIT INVESTORS DO TO MITIGATE THESE IMPLEMENTATION ISSUES?

A (Bagley): Some liability-driven investing (LDI) strategies lend themselves to more effective implementation than others. For example, many plans have adopted de-risking glide paths¹, which tie asset allocation to funded status and therefore re-allocates into a portfolio of long credit and government securities over time. This breaks the de-risking transition into multiple stages, rather than requiring a single transition for the entire plan all at once. Reducing the size of credit trade makes the event less costly and easier to implement.

Another noteworthy de-risking approach is a hedge long first² strategy, which hedges the longest duration liabilities first. This approach relies mainly on treasury strips to hedge these very long duration liabilities, thus is unaffected by the state of liquidity in credit markets.

Even if you're not following a hedge long first approach, it's worth addressing the question of whether current credit spreads offer enough return over government bonds to be worthwhile. In an extreme environment, some plans may choose to hedge only the interest rate exposure – the largest risk exposure versus the liability value – and not, for the time being, the credit exposure. For plans with a meaningful allocation to return seeking assets, the interaction between the credit premium and the equity risk premium can be a factor in that decision, too.

For shorter maturity portfolios, there is an array of ETFs and derivatives that allow investors to obtain credit exposure at very reasonable costs with good liquidity. These instruments are blunt; however, in many cases, they provide the needed exposure for a short period of time or for an extended investment horizon.

Some liability-driven investing (LDI) strategies lend themselves to more effective implementation than others.

¹ See Gannon, J. and Collie, R. (2017). "Liability-responsive asset allocation: Defining the de-risking glide path for defined benefit pension plans". *Russell Investments Viewpoint*.

² See Phillips, D., Gannon, J., Sylvanus, M., and Collie, R. (2015). "Hedge long first: An alternative approach to LDI". *Russell Investments Viewpoint*.

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