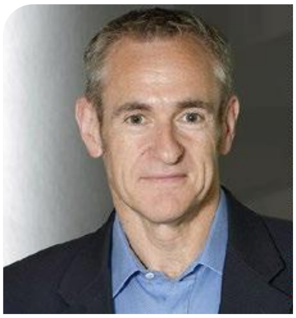

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Whatever the long-term effects of the pandemic, one thing stays the same: IG looks attractive

The longest cyclical upswing since 1854 is over. And although few foresaw that its nemesis would take the form of the worst pandemic in a century, maybe it shouldn't have been such a surprise. Aids, sars, mers, ebola and swine flu were all a heads-up to the growing threat of zoonotic contagion (surely an important ESG consideration?), and 2008 should have taught us a few things about tail risk.

Be that as it may, the public health response to the crisis has necessitated inducing an economic coma that will not merely precipitate a new default cycle, but will inflict severe distress quite arbitrarily, including on companies hitherto deemed blue chip. The longer the recovery from the coma, the more likely it is that permanent changes in behaviour (such as working from home) will reshape the economic landscape.

Investment grade is a good starting point

The default risk premium offered by IG credit still compensates investors for five-year cumulative default rates of about eight times the historical average, over three times the worst experience since 1970 and well over the levels prevailing at the depths of the great depression. The high yield default risk premium is nowhere near as generous, despite decompression between IG and HY spreads from about four times pre-crisis to roughly six times currently.

Moreover, it is IG credit that central banks have sought to backstop. The Fed's $750 billion primary and secondary market corporate credit facilities and corporate purchases under the ECB's pandemic emergency purchase programme are tasked primarily with buying IG bonds and loans. The Fed extended its mandate in April to include fallen angels — credits rated BB-/Ba3 or better that were IG prior to March 22 — and the ECB also relaxed collateral requirements to include fallen angels, although it is not yet buying them. This should give investors comfort that the bulk of the $280 billion (US) and €100 billion (EU) of triple Bs potentially circling the HY drain over the next 12 months may still enjoy central bank liquidity support if they succumb.

Central bank actions with regard to IG liquidity have created a positive feedback loop by encouraging traditional IG investors and tourists to commit to IG primary, leading US IG credits to benefit from $547 billion of new issuance over March and April, while flat curves allowed issuers to extend maturities. In addition, while March issuance was dominated by high-quality IG (single-A and better), by April triple Bs had assumed their historical dominance of the new issue profile, attesting to investors' willingness to commit to IG even with fallen angel potential. Bank of America estimates that US IG has raised sufficient money to cover coronavirus-related cash shortfalls.

Europe tells a similar tale. ECB purchases of IG corporate paper of €20bn-€28bn per month, are fostering sufficient confidence to force new issue premia to a point where some new issues priced inside secondary levels. While the German constitutional court played party-pooper by finding that the ECB/ECJ may have acted ultra vires in constituting the original asset purchase programme, it seems probable they will be able to prove it was a proportionate policy measure.

High yield has also seen an uptick in new issuance after a month of lockdown and the ability of the Fed's secondary market corporate credit facility to purchase HY ETFs should help fix the plumbing in HY secondary, preventing the kind of rout we experienced at the outset of the crisis. However, the rising distress ratio in HY (30.2% in US HY in April and almost 70% in the oil and gas sector) points to a new wave of defaults, while zombie credits are finally being decapitated. As pressure mounts, there will surely be jewels in the HY dung heap, but it's early days yet. The risk-reward trade-off is more compelling in IG.

> There will surely be jewels in the high yield dung heap, but the risk-reward is more compelling in IG

Investors should be better off leveraging IG than punting junk. Efficient use of leverage implies access to IG through credit derivatives, which can be levered on margin and at zero cost; liquidity in single-name CDS has come under pressure during the crisis, but not as much as that of cash bonds — hence, in part, the explosion in the negative basis between the two. It is to be hoped that it improves as markets stabilise.

A longer-term consideration might also steer credit investors in the direction of CDS.