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Credit spreads vs bond yields in the current cycle

The move in rates is just one factor of the macro backdrop that can drive spread trends, but one that worked quite well in past cycles and therefore worth focusing on in the current recovery phase. Actually, this credit cycle was cut much shorter by unprecedented intervention from central banks and from huge fiscal support, ultimately leading to relevant differences with past experiences, outlined in this piece. Our conclusions are that these differences are probably going to soften the traditional historical relationship.

The historical link between rising bond yields and credit spreads in the recovery following a recession

Empirical evidence shows that **credit spreads tend to peak at the end of recessionary periods**. Credit then recovers along with rising government bond yields, as bond markets usually start to price in higher real growth rates, increasing inflationary risk, and a change in monetary policy. The table below, which covers the cycles of the past forty years in the United States, confirms that credit rallies following recessionary phases have always been associated with a substantial rise in bond yields. Furthermore, post-recession credit rallies are more vigorous and run out of steam sooner when bond yields rise sharply, as occurred in the 1980s and 1994.

Recession		BBB spread					US 10yr T-note yield		
Starts	Ends	Peak	Spreads at peak	Trough	Spreads at trough	Change in spreads (b.p.)	At spreads peak	At spreads trough	Change in yield (b.p.)
Dec-69	Nov-70	Dec-70	284	Aug-73	92	-192	6.39	7.40	101
Nov-73	Mar-75	Feb-75	294	Mar-78	101	-193	7.39	8.04	65
Jan-80	Jul-80	Jun-80	282	Sep-81	185	-97	9.78	15.32	554
Jul-81	Nov-82	Oct-82	376	May-84	131	-245	10.91	13.41	250
Jul-90	Mar-91	Jan-91	227	Jul-91	163	-64	8.09	8.47	38
Mar-01	Nov-02	Oct-02	273	Apr-04	130	-143	4.29	4.35	6
Dec-07	Jun-09	Dec-08	525	Apr-10	172	-353	2.20	3.66	146

Apart from empirical evidence, a negative correlation between spreads and yields in post-recessionary phases **does make sense**: a macro and micro recovery means improving credit metrics through increasing cash flow generation, though the best of debt reduction is usually already past at that time. Rising inflation expectations, which push yields higher, also mean better pricing power prospects for companies, and initial rate hikes by central banks usually tend not to harm equities and corporate bonds. Furthermore, spreads offer a cushion to the negative duration effects arising from an increase in bond yields. Therefore, investors still perceive corporate bonds as attractive compared to government bonds in these phases.

Contrary to previous experiences the peak in corporate spread occurred much earlier than usual, roughly just one month into this short recession

What about the present cycle?

Chart 1) shows the link between 10-yr Treasury yields and US BBB-rated corporate bond spreads in the very latest cycle from before the Covid-19 crisis up to the present day (ultimately a one-year span). Divergences vs previous cycles are significant not only in macro dynamics but also in market behaviour, which appears quite clearly in the chart. Hereby we summarise three main differences with the past:

Firstly, while much more severe than past GDP contractions, the 2020 recession was also quite short, actually lasting just four months from the end of February to June.

Secondly, contrary to previous experiences the peak in corporate spread occurred much earlier than usual, roughly just one month into this short recession.

Finally, rates started to normalise later than usual, as between February and November the US 10-yr yield moved sideways, within a limited range, and really started to trend higher in December following positive news on vaccines and fiscal packages. In January and so far in February, the trend has accelerated on the back of new expectations of stronger fiscal stimulus and more rapid recovery, following tthe democratic success at the US Senate run off elections.

Getting more deeply into the numbers, BBB spreads compressed by a remarkable 325bp move from the 465bp recessionary peak touched on March 20th to the 140bp area

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by end of November, while over the same period, the 10yr Treasury yield decreased slightly, from 96bps to 84bps, remaining in a trading range. The subsequent move was quite different, as spreads tightened further but to a much lower extent than in the previous phase, namely decreasing from 140bp to 122bp at this writing, actually even below pre-Covid crisis levels. Over this latest period, the corresponding move by the US Treasury was a meaningful increase, as 10yr yield rose by more than 40 bps.

In a nutshell, a period of spread normalisation took place before the yield could start to rise. Monetary and fiscal policies were successful in cutting this credit cycle quite short, both limiting the extent of the spike in spreads and triggering a very rapid compression in risk which started after just one month from the crisis. In simple terms, the best of the credit cycle seems to be behind us (in terms of spread tightening and excess return delivered on government bonds), as the normalisation of credit risk premiums has already taken place, especially relative to bond yields.

Differences with past experiences are probably going to soften the traditional historical link between spreads and yields

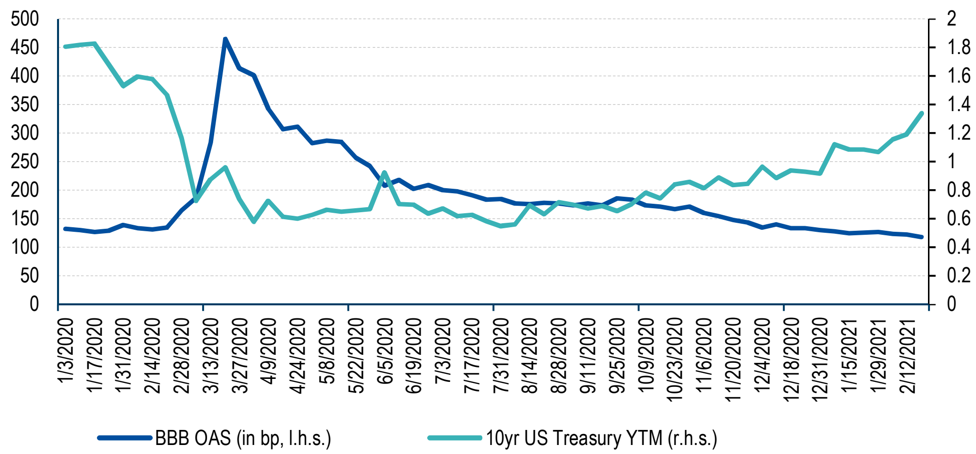
At the same time, a milder upward trend in bond yields may take place looking forward if central banks continue to target preserving favourable financial conditions and in light of the move already delivered by fixed-income markets. Therefore, although credit valuations look like headwinds to spread compression and to the renewal of the usual link with rates, we may also expect central banks to keep an accommodative stance in order to avoid extreme moves in curve steepening, which could ultimately endanger the recovery through tighter funding conditions and higher volatility in financial markets. The legacy of the Covid-19 crisis, as we have underlined many times, is a much higher volume of both public and private debt.

Another peculiarity of this very rapid cycle is the lagged start in the deleveraging process by companies. The latter has also to do with the success of monetary and fiscal policies in avoiding a credit crunch and ensuring easy financing conditions for corporates, in the US mainly through the corporate bond markets, in Eurozone mainly through the bank loan channel. The economic recovery will support the return to lower leverage levels, sustained as well by the likely gradual use of the huge liquidity buffers built to withstand the economic and financial effects of the crisis, but this process will take some time, as companies entered the crisis with already relatively high debt ratios by historical standards.

Bond yields and investment flows into credit markets

Historically, the link between retail flows and returns of credit products is a positive one, as returns and flows tend to go hand in hand: sudden and sharp upward trends in rates, affecting credit returns, tended to trigger subsequent outflows. Not only the level but also the volatility of bond yields has to be considered as a potential driver of investment flows from investors, especially in high-beta credit products. Considering this link and the strong growth of retail funds over the last quarters, the risk of an impact from higher rates into flows is present, as this time the capacity of spreads tightening to balance the increase in bond yields looks lower, as we pointed out. At the same time, in our baseline scenario we expect bond yields to move higher but to a limited extent for the reasons already underlined, and at the same time more attractive absolute valuations may finally drive a higher demand from institutional investors. Further, we expect a steepening in the yield curve, but short-term rates to remain anchored by ZIRP for quite some time, reducing the impact and working

1/ The link between corporate spreads and bond yields in the current cycle



Source: Bloomberg, Amundi Research, Data as of 19 February 2021 as a sort of absorber of higher rates on low duration credit segments, like the speculative grade one.

Conclusion

The move in rates is just one factor of the macro backdrop that can drive spread moves, but one that worked quite well in past cycles and therefore worth focusing on in current recovery phase. Actually, this credit cycle was to some extent cut much shorter by unprecedented intervention from central banks and from huge fiscal support, ultimately leading to relevant differences with past experiences, outlined in this piece. These differences are probably going to soften the traditional historical relationship. But if valuations do not seem to offer the usual scope to compress and therefore to partially absorb the effect of further rising rates, at the same time, support from monetary stimulus and the recent changes in the reaction function of Fed policy to macro factors are expected to contain unwanted excessive volatility in fixed income markets, in order to keep financial conditions easy.

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