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Going Global in Investment Grade Credit

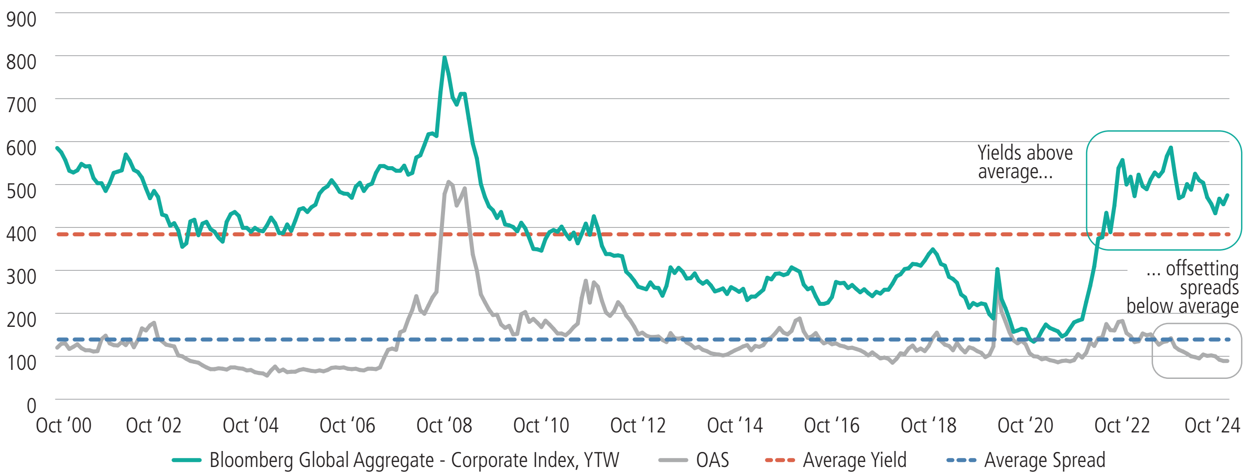
With yields close to multiyear highs and most of the world's central banks lowering policy rates, we think investment grade fixed income is attractive. Moreover, as concerns about government debt sustainability build, we believe the strong balance sheets of investment grade corporate bond issuers look particularly interesting. Taking a global approach to investment grade credit can potentially enhance the opportunity set and diversification potential as the fortunes of different economies diverge.

Credit spreads are as tight as they have been for many years—and for two decades in some markets. However, a great deal of that spread-tightening has been due to the rapid run-up in government bond yields since the pandemic. As a result, yields from global investment grade corporate bonds are above the long-term average, and remain attractive.

While it is true that interest-rate futures have been volatile over recent weeks, rates are still expected to decline. We think that makes current all-in yields attractive.

FIGURE 1. CREDIT SPREADS ARE TIGHT, BUT ALL-IN YIELDS ARE HIGHER THAN AVERAGE

Yield to worst and option-adjusted spread, and their averages over the period shown, 2000 – 2024, basis points



Source: FactSet. Data as of December 31, 2024. "Yield to worst" is the yield of a bond or bond index that assumes all outcomes that could adversely affect its yield, short of a default, occur; provisions that can influence yield to worst include call provisions and prepayments. Option-adjusted spread is the spread of the yield of a bond over the yield of a benchmark government bond of the same maturity, adjusted for the value of embedded options, such as the (call) option of the issuer to call the bond early or the (put) option of the holder of the bond to sell it back to the issuer on certain dates.

Technical and Fundamental Support

Do declining rates suggest widening spreads? We see only moderate risk.

There is technical support: issuance of dollar and euro bonds in 2024 was up around 15 – 20% year-over-year, but elevated yields have attracted substantial inflows to meet that demand. We expect those flows to continue this year.

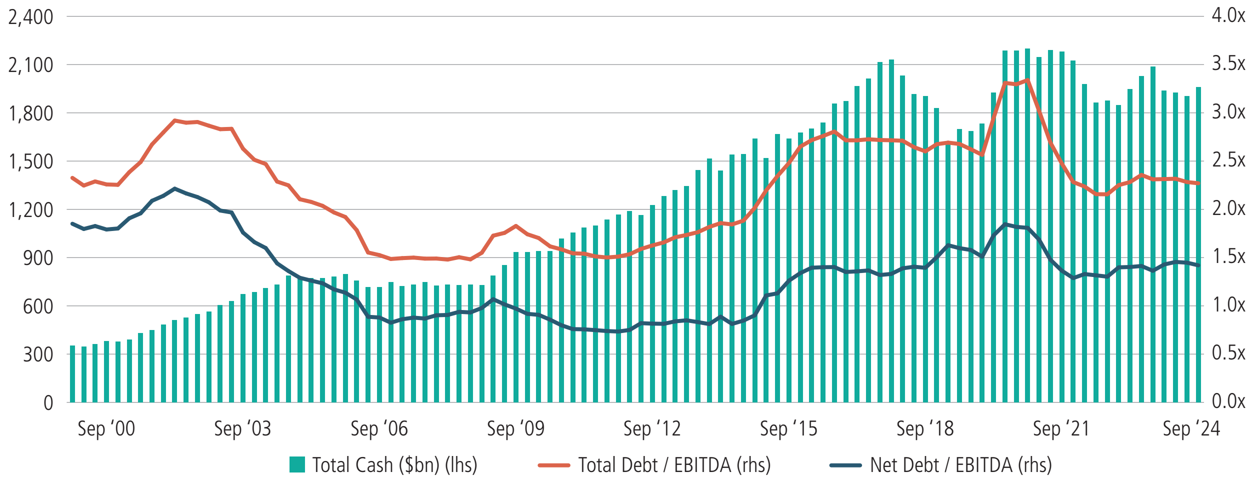
We also anticipate a favorable fundamental backdrop in which resilient U.S. economic growth coincides with manageable inflation and declining rates. Even if the backdrop were to be less favorable, investment grade issuers' balance sheets look robust, in our view.

The constituents of the S&P 500 Index, ex. Financials, are a reasonable proxy for global investment grade credit issuers, around 65% of whose bonds are denominated in U.S. dollars. In figure 2 we can see that these companies issued a lot of debt during the low-rate environment before the pandemic. For the most part, that enabled them to sit out the higher rates we have seen since. This has allowed them to reduce their debt ratios substantially while spending only a little of the cash reserves built up pre-pandemic.

At a time when investors are increasingly concerned about government debt sustainability, these robust corporate balance sheets are an important part of the investment case for the asset class—and today's tight spreads.

FIGURE 2. STRONG LARGE-CAP CORPORATE CREDIT FUNDAMENTALS

Cash and debt metrics for S&P 500 Index ex. Financials



Source: Bloomberg. Data as of September 30, 2024.

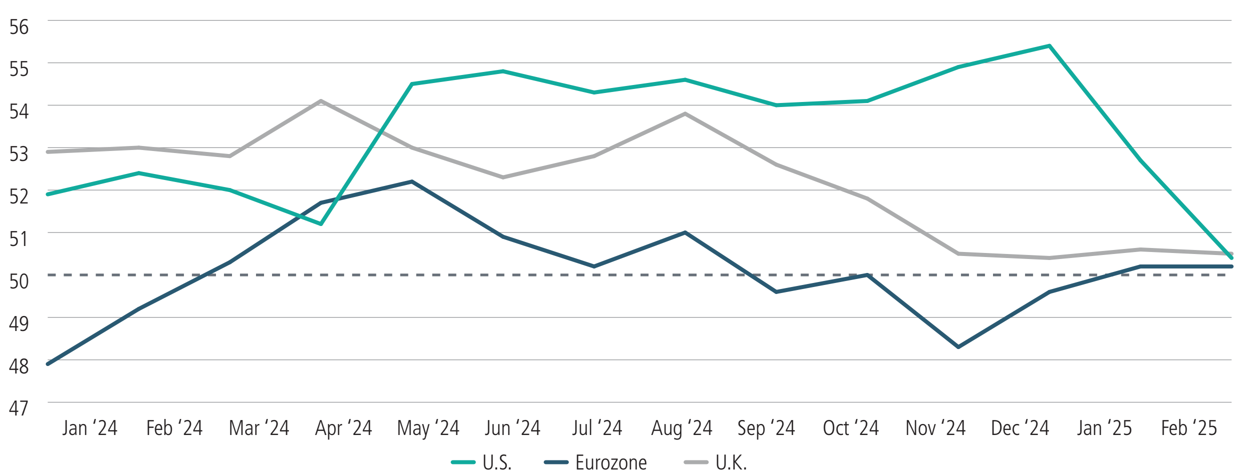
A Global Approach

Loosening the ties to a single country, region or currency can widen the opportunity set, reveal regional relative value and enhance diversification.

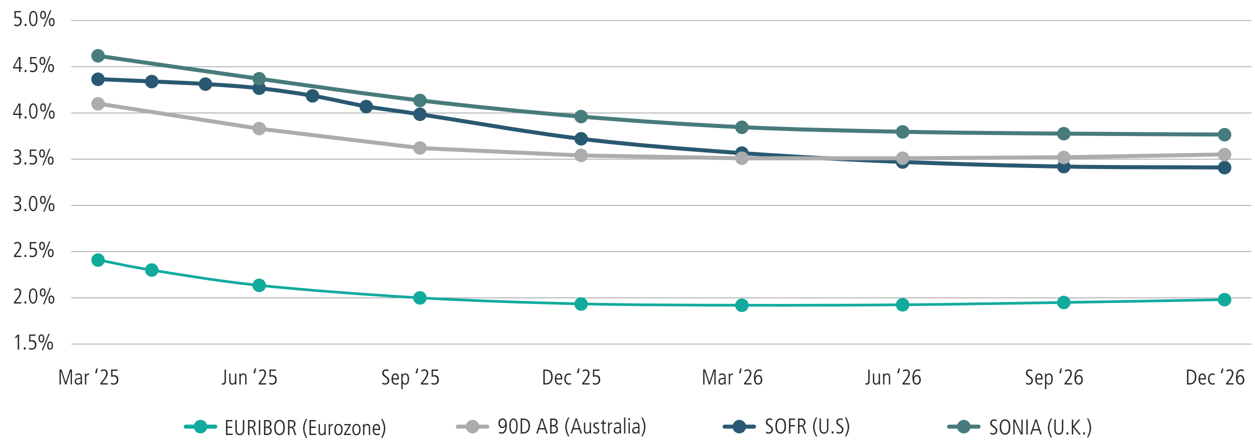
For example, as figure 3 shows, at the end of 2024, the U.S. economy appeared to be outperforming Europe and the U.K. quite signifcantly, but the past two months have revealed a sharp convergence. Interest rates are expected to decline at similar speeds this year, but they are already much lower in the eurozone than elsewhere.

FIGURE 3. FLUCTUATING FORTUNES FOR THE WORLD'S BIG DEVELOPED ECONOMIES

Composite Purchasing Managers' Indices



Futures-market-implied interest rates, by expiry date



Source: S&P Global (top), FactSet (bottom). Data as of March 4, 2025.

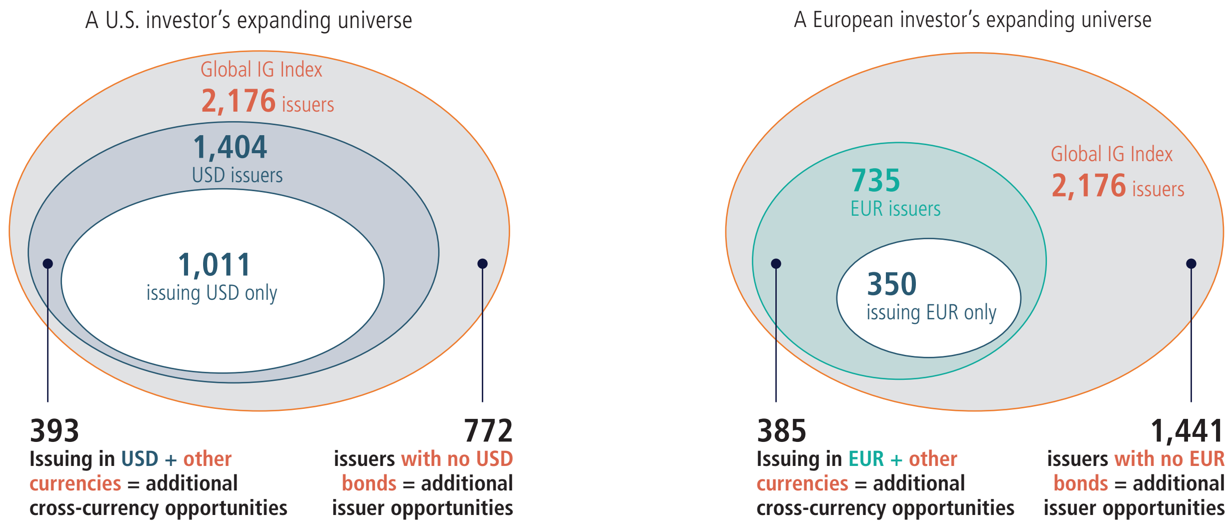
These changes in relative economic outlooks can often be captured by credit strategies that are active in multiple regions. The more strategic case for a global approach lies in its diversification benefits.

The global investment grade market is worth $13 trillion—even the giant U.S. market accounts for little more than half of that. The upper diagram in figure 4 shows the two ways in which augmenting your home market by going global expands the opportunity set.

A U.S. investor's home universe has just over 1,400 issuers; roughly 1,000 of those issue only in U.S. dollars, but almost 400 issue in other currencies, too. If the investor switches to global investment grade, that offers the first expansion of the universe: the ability to take cross-currency views on these ~400 issuers, seeking the most attractively priced bonds across the global market. That still leaves the second expansion: almost 800 issuers in the global opportunity set that do not have outstanding U.S. dollar bonds and are not included in the U.S. universe. For a European investor, the expansion is even greater: almost 400 issuers are included in the euro-denominated home universe, but also issue outstanding bonds in other currencies, and more than 1,400 entirely new issuers without euro bonds. By switching to global investment grade, the U.S. investor increases its issuer universe by 50% and the European investor doubles it, and both add hundreds of cross-currency opportunities in issuers they already know.

The lower chart in figure 4 shows some of the diversification benefit that a bigger, global universe has offered over the past two decades. The calendar-year returns of the seven individual markets we consider show notable dispersion. On average the returns of the top- and bottom-performing markets differed by more than eight percentage points. The biggest difference was 18.4 percentage points, between the AUD and the GBP markets in 2008. U.S. dollar investors might note that the USD market was the most frequent bottom performer, whereas the GBP market was the most frequent top performer and the EUR market was never the bottom performer—even during the eurozone crisis of 2011.

FIGURE 4. GLOBAL INVESTMENT GRADE CREDIT: A SUBSTANTIALLY MORE DIVERSE MARKET



Calendar-year total returns for seven individual credit markets, 2005 – 2024

		2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
CAD	BEST	7.7%	5.0%	6.3%	7.3%	18.6%	8.9%	8.9%	15.3%	2.5%	12.1%
GBP		6.9%	4.8%	4.7%	7.0%	15.6%	8.8%	8.6%	13.9%	1.9%	8.4%
CHF		5.6%	3.9%	3.1%	4.8%	14.9%	6.4%	6.5%	9.6%	1.5%	8.0%
EURO		5.1%	2.8%	2.9%	1.9%	7.4%	4.8%	5.2%	7.2%	1.2%	7.4%
JPY		3.8%	2.7%	1.7%	-4.2%	6.3%	3.9%	4.4%	5.0%	-0.8%	6.7%
AUD		3.4%	2.1%	1.3%	-5.8%	3.5%	3.8%	1.1%	3.0%	-1.8%	5.6%
USD	WORST	0.5%	1.1%	0.0%	-11.1%	2.0%	2.1%	-1.6%	2.4%	-2.3%	3.0%

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
BEST	3.3%	12.8%	5.9%	3.7%	12.8%	10.2%	-0.1%	-7.3%	12.2%	9.8%
	2.7%	6.3%	4.8%	3.4%	11.2%	8.7%	-0.5%	-8.3%	10.8%	7.3%
	1.3%	4.4%	4.4%	1.9%	9.4%	8.3%	-1.0%	-10.1%	10.6%	6.4%
	0.7%	3.3%	4.3%	1.7%	8.5%	6.6%	-1.7%	-11.1%	9.9%	5.0%
	0.0%	2.7%	3.0%	1.5%	7.7%	6.5%	-2.0%	-11.6%	7.9%	5.0%
	-0.2%	2.6%	2.7%	-0.6%	7.3%	4.2%	-2.6%	-17.8%	7.4%	2.0%
WORST	-0.9%	1.6%	2.5%	-5.3%	6.5%	2.6%	-3.1%	-18.1%	5.8%	0.3%

Source: Aladdin, Bloomberg. Data as of November 29, 2024. Indices used: Bloomberg Sterling Corporate Total Return Index (LC61TRGU); Bloomberg Euro Aggregate Corporate Total Return Index (LECPTREU); Bloomberg U.S. Corporate Total Return Index (LUACTRUU); Bloomberg Global Aggregate Corporate Index (LGCPTRUU).

More Layers of Opportunity

The global opportunity set is simply bigger and more diverse than that of any single domestic or regional market. It allows investors to mix and rotate among different markets as they go through their often asynchronous cycles: they can take different duration positions in different markets and currencies; seek relative value between the same issuer's bonds in different currencies; or take advantage of sectoral opportunities that are tied to idiosyncratic local dynamics.

Recent examples of these sector-specific local dynamics might include the European Real Estate sector between mid-2022 and the end of 2023. The rapid rise in inflation and commensurate tightening in the policy rate by the European Central Bank led to widespread uncertainty about fundamentals, valuations and liquidity, creating a number of opportunities to allocate to issuers at elevated spreads. Spreads tightened again in 2024 as inflation moderated, banks supported issuers with secured funding, and unsecured debt markets reopened to the sector.

In the U.S., we could point to the "mini banking crisis" of early 2023, when Treasury market volatility and funding stress among a handful of regional banks spilled over into materially wider spreads for the entire sector, creating opportunities to allocate across investment grade Financials. And since early 2024, the U.K. Water Utility sector has come under stress as investors have recognized the large amount of capital needed to upgrade the country's water infrastructure, and face the uncertainty of a less stable regulatory regime.

As economic performance and outlooks diverge, and dispersion of credit performance rises in the new environment of higher rates and asynchronous global cycles, we believe it is important for fixed income investors to explore a range of regional exposures for their portfolios. We believe this can contribute meaningful diversification and expand the opportunity to take advantage of relative value and tilt to countries with more favorable outlooks.

At a time of uncertainty around inflation, rates and governments' fiscal strength, investment grade credit looks increasingly attractive to us. We believe a global approach, combined with active management to take advantage of the bigger and more diverse universe, adds another layer of opportunity.

Index Definitions

The **S&P 500 Index** consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The **Bloomberg Sterling Corporate Total Return Index** is a broad-based benchmark that measures the investment grade, sterling-denominated, fixed-rate corporate bond market.

The **Bloomberg Euro Aggregate Corporate Total Return Index** is a broad-based benchmark that measures the investment grade, euro-denominated, fixed-rate corporate bond market.

The **Bloomberg U.S. Corporate Total Return Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate corporate bond market.

The **Bloomberg Global Agg Corporate Index** measures the performance of corporate bonds from the Bloomberg Global Aggregate Bond Index, a broad-base, market capitalization-weighted bond market index representing intermediate-term investment grade bonds traded worldwide.

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