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Corporate bonds in the U.S. and Euro area – risks and opportunities

Key takeaways

- Positive rating development for investment grade corporate bonds in the U.S. and Europe.
- Interest rate spreads for bonds from the financial sector have not yet fully recovered from the turbulence in the spring and offer catch-up potential.
- Interesting yields in the IG segment should compensate for the risk of higher volatility due to economic developments in the U.S. and the Eurozone.
- High-yield bonds offer comparatively higher interest rates, but also harbour further increasing default risks.

01 The U.S. macroeconomic environment

Since the turbulence on the financial markets in the first quarter, caused by difficulties at some U.S. regional banks in the wake of higher U.S. interest rates, interest rate spreads on corporate bonds (Bloomberg U.S. Corporate Bond Index) versus benchmark government bonds have narrowed and almost returned to their February lows.

While the U.S. manufacturing sector is currently also caught up in the global recessionary mood, the services sector has displayed stronger momentum since the end of the Covid restrictions. Services are benefiting from strong demand from private consumers. In addition to the reduction in savings, the economy continues to be supported by a strong U.S. labour market: While inflation is trending down, the labour market continues to show a robust picture. Even though new job creation recently lost momentum, wages continued to grow strongly. The resulting resilience of the U.S economy, which posted a surprisingly strong annualised growth rate of 2.4% in Q2 has increased the odds of a soft landing for the U.S. economy in 2023.

One consequence of this development: capital market volatility indices have declined significantly. For example, the VIX index fell from 26 to 15 between spring and August, signalling a decline in price or market volatility. Congruently, spreads on investment grade (IG) U.S. corporate bonds have also narrowed from a year-to-date high of 163 basis points in March to 120 basis points.

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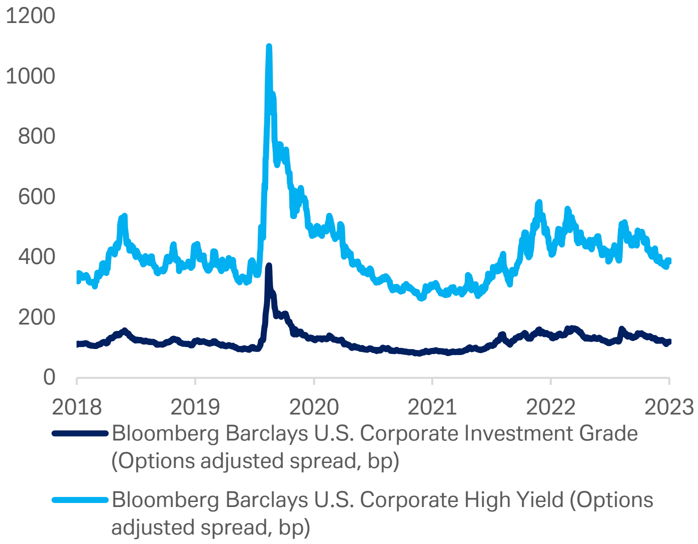
A fundamental improvement with regard to ratings has underpinned this spread tightening. This year, bonds worth around USD82bn were upgraded to investment grade (IG), i.e. to a rating in the top credit quality range. In the bond market, these bonds are often referred to as "rising stars" due to their improved rating. On the other hand, there are the "fallen angels", which have lost their investment grade rating and have fallen into the high yield (HY) range, i.e. those characterised by poorer credit ratings which must therefore offer higher interest rates. In 2023 so far, the bond value of these fallen angels is about USD17bn. This puts the YTD ratio of "rising stars" to "fallen angels" for the current year at 4.8. The only previous full calendar year in which a higher ratio was observed was 2021.

However, there were also strong movements within the investment grade space: In Q2, nearly USD120bn worth of bonds moved up from a BBB rating to an A rating, the highest quarterly upgrade ever recorded. Looking ahead, this trend is expected to continue within the IG sector, as the net value of bonds in the BBB segment with a positive outlook exceeds USD80bn. This represents the opposite of the HY segments below the BB grade, where the overall rating outlook points to the lower-rated segment.

Figure 1: Development of U.S. corporate bond spreads



Source: Bloomberg, Deutsche Bank. Data as of August 2023.

02 Sectoral differences between U.S. bonds

Comparing the current sectoral spreads with the levels before the turmoil at U.S. regional banks in March, we see that spreads for financials have still not recovered. In particular, spreads for U.S. regional banks are still around 70 basis points higher than before the market turmoil. The other subsectors of the financial sector, such as life insurers, large U.S. banks, and Yankee banks (foreign banks with a significant share of their business in the United States), are also trading at wider spreads than before the financial turmoil, although not to the same extent as U.S. regional banks.

However, there are early signs of improvement at U.S. regional banks. The latest earnings season suggests that regional banks were able to stem the outflow of deposits in Q2 after deposits fell nearly 3.2% in Q1 due to nervousness in the sector. These developments could further lower the spreads of regional banks and narrow those for the financial sector as a whole.

03 The outlook for U.S. corporate bonds

Given the significant spread tightening that has already occurred, any further tightening is likely to be more moderate. The current Goldilocks environment, which the market is pricing in, is susceptible to corrective moves in this regard. For example, renewed U.S. growth – this time well above expectations – could force the market to reprice expected Fed rate hikes upward, which would immediately lead to rate swings in the market. On the other hand, much lower growth could in turn bring a hard landing scenario for the U.S. economy to the fore, and also lead to strong price reactions on the capital market. With a current yield of around 5.6% for U.S. corporate IG bonds, the risk-reward ratio nevertheless appears attractive to us. Setbacks in the market may therefore be seen as an entry opportunity.

For the HY market, the recent increase in the number of bankruptcy filings in the U.S. represents a further risk. According to S&P Global Market Intelligence, 340 bankruptcy filings were made in H1 2023, the highest since 2010 and about 93% higher than in H1 2022. These developments are more of a concern for the high-yield corporate bond segment than for the IG segment. The concerns are also reflected in the trailing 12M HY default rate, which has risen from last year's favourable levels to 2.6% this year. And given the rating outlook mentioned above, it seems likely that this rate will continue to rise. A widening of HY spreads therefore appears likely.

04 The state of the Eurozone economy

The Eurozone economy performed somewhat more strongly than previously expected in Q2, posting growth of 0.3% compared with the previous quarter. Overall, however, momentum in the Eurozone is currently stagnating, with the manufacturing sector a drag as industry has been contracting for more than a year. Outside of an economic crisis, the state of Eurozone manufacturing has never been viewed with such scepticism since the introduction of the euro as the current level of confidence indices indicates. Fortunately, services sector confidence has remained positive given the upswing in services sector activity at the turn of the year. In the last two months, however, there have been signs that the recovery of the service sector has also stalled. Despite this moderation, the corporate bond market proved robust. Interest rate differentials (spreads) for European investment grade (IG) bonds (Bloomberg Euro Corporate Bond Index) versus German bunds of comparable maturity fell by 17 basis points year-to-date.

To understand this development, one has to look at the situation one year ago. The gas price shock in the wake of the Russia-Ukraine war weighed heavily on euro area growth expectations last year, and it was widely expected by analysts at the time that the Eurozone economy would fall into a deep recession. Now the likelihood of a (severe) recession is much lower, justifying the lower spreads. The ECB's fastest rate hike cycle in its brief history is also already at an advanced stage. Some market observers expect a pause in interest rates at the ECB's upcoming September monetary policy meeting due to the tepid economic situation.

However, a further significant narrowing of spreads is unlikely in the near term. Forecasts point to stagnating growth in the coming quarters. Demand for corporate loans is weaker than ever before. Lending standards have also tightened, although this trend has eased somewhat recently.

Rating improvement has also been a positive catalyst for the EUR IG segment in Europe. On a net notional basis, bonds worth more than EUR60bn have been upgraded from BBB to A since last year, while the rating for bonds worth around EUR30bn has been improved from A to AA. A similar trend was observed in the high-yield (HY) segment, where there were more upgrades than downgrades overall. Bonds worth almost EUR5bn in this segment were upgraded from B to BB, while EUR4bn were upgraded from CCC to B. However, the aggregate outlook of the rating agencies for the individual bonds indicates that the rating upgrades may already have peaked.

05 Sectoral differences between Eurozone corporate bonds

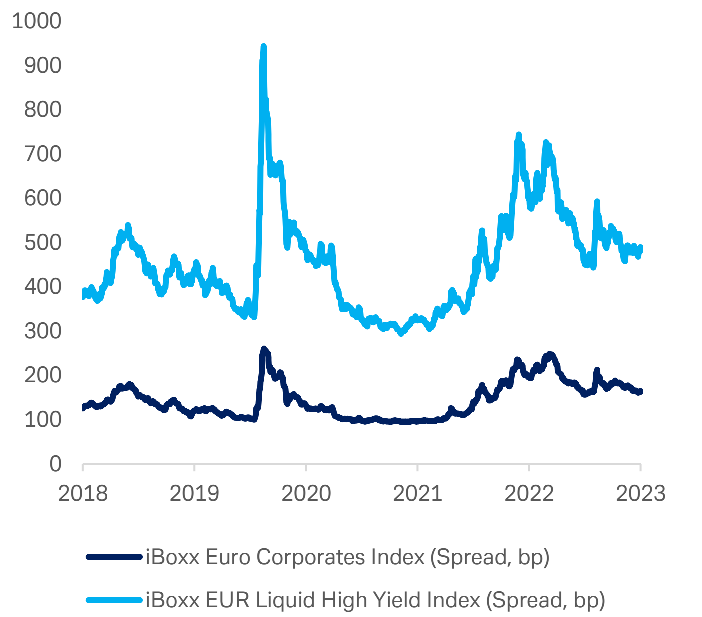
Energy and basic materials, the two sectors whose earnings have most recently declined the most of all sectors in line with the reporting season in the second quarter, account for only around 8% of the EUR IG index and 11% of the HY index. On the other hand,

financials and consumer cyclicals, which are expected to deliver strong earnings growth this year, account for around 50% in both indices. In addition, the solid fundamentals of the banking sector should help to lower the current spreads for financials, which trade at a high premium to non-financials in a 10-year historical comparison and even remain above the levels recorded before the financial turmoil in the U.S. and Switzerland. Although this could partly be attributed to the weakness of the Eurozone real estate sector, it cannot explain the full extent, because real estate does not have the corresponding weighting that would be required among financial stocks. As financials account for around 45% of the EUR IG index, the impact of a catch-up of spreads towards levels before the turmoil in March in this segment should not be underestimated in terms of spread tightening.

06 Outlook for Eurozone corporate bonds

Therefore, despite the unconvincing macroeconomic environment, we see a further slight narrowing of spreads on EUR corporate bonds, which makes such investments an interesting proposition. To be sure, there is some risk of weakening demand from Japanese investors given the recent rise in yields in their home market. But this trend is unlikely to be abrupt. The current yield of 4.2% remains close to the previous 10-year high and will continue to attract inflows into the IG segment, driving prices. However, rising default rates in the HY market prompt us to remain cautious despite higher yields in this segment. The 12-month issuer-weighted default rate has already risen above 2% and could exceed 3% by year-end.

Figure 2: Development of EUR Credit spreads



Source: Bloomberg, Deutsche Bank. Data as of August 2023.

Glossary

Bunds are longer-term bonds issued by the German government.

The European Central Bank (ECB) is the central bank for the Eurozone.

EUR is the currency code for the euro, the currency of the Eurozone.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

High yield (HY) bonds are higher-yielding bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds.

An investment grade (IG) rating by a rating agency such as Standard & Poor's indicates that a bond is seen as having a relatively low risk of default.

Quarter-to-date (QTD).

A spread is the difference in the quoted return on two investments, most commonly used in comparing bond yields.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

U.S. is the United States.

USD is the currency code for the U.S. Dollar.

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