Market Insight

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Impact of the Credit Cycle on Security Selection

Executive Summary

Recognizing the nature of environments that favor a portion of the corporate credit curve can have a beneficial impact on security selection. This Insight focuses on how the credit default cycle affects credit curves, how credit curve changes and economic momentum impact the relative performance of longer and shorter maturity corporate securities and how maturity-bucket positioning influences security selection. The discussion dispels several myths about the relationships between credit spreads and credit curves, and the varying impact of market swings on maturity buckets.

Introduction

For corporate bonds of any given maturity, investors get paid a spread (or additional yield) over U.S. Treasuries for assuming the risk that the credit quality of a corporate bond issuer might deteriorate. This spread is commonly referred to as the credit risk premium. Many issuers have multiple bonds outstanding, some with longer maturities and some with shorter maturities. Generally speaking, the spread between long maturity bonds and short maturity bonds of a given issuer is called the credit curve. Credit curves for individual issuers are influenced by many factors, including some which are idiosyncratic or unique to a particular issuer and some which are systematic or common across issuers.

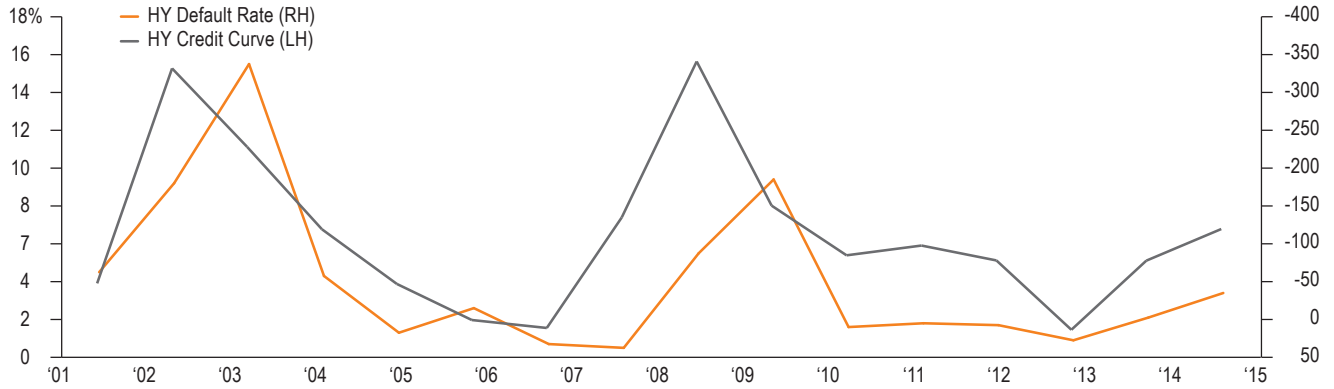
Lower Credit Risk Does Not Equal Flatter Credit Curves

Many credit strategists have expressed frustration at the persistent steepness of investment grade credit curves in this cycle, but steep credit curves are a reflection of a constructive credit risk-taking environment. Having a constructive view on the market and a view that credit curves should flatten is a somewhat inconsistent stance as illustrated by the historical market performance pattern.

A bullish or pro-risk environment is characterized by spread tightening where the credit risk premium over Treasuries declines, i.e., compresses. The opposite is true for bearish or risk-off environments. In a bullish market, it is common for investors to expect spread compression within the corporate bond market to translate into flatter credit curves and vice versa. This rationale is logical considering that one might expect credit risk premiums to compress along the credit curve or term structure as the economic environment improves and as credit default risk declines.

In practice, credit curves tend to steepen during declining default risk environments as risk premiums decline more in shorter maturity bonds than in longer maturity bonds. During periods of credit stress, credit curves tend to flatten and ultimately invert. Figure 1 utilizes historical default rate and spread data from the U.S. high yield market to illustrate the general steepening of credit curves during periods of declining credit stress and the inversion of credit curves during periods of rising stress. Credit spreads are anticipatory or leading while default rates are lagging, so it is not unusual for credit spreads to peak and credit curves to reach their maximum level of inversion prior to the peak in default rates.

Figure 1. Credit Curves Generally Steepen When Default Stress Declines and Invert When Stress Rises



Sources: Credit Suisse, Barclays Capital, Voya Investment Management

The reason for the inversion of credit curves during times of severe credit stress relates to the equal nature of bonds with similar contractual and structural seniority in the event of default. When an issuer defaults, investors in bonds of the same seniority theoretically receive the same recovery as a percentage of par, regardless of the maturity date of the bonds held.

For any given issuer, application of the same dollar price (recovery estimate) to bonds that have the same coupon and seniority but different maturities results in the shorter maturity bond trading with a higher yield than the longer maturity bond. The higher yield of the shorter maturity bond relative to the longer one causes an inversion of the credit curve.

Investors often expect flatter credit curves in bullish markets, but this expectation is misplaced. Spread duration or maturity bucket positioning tends to drive the performance of longer maturity bonds in bullish markets, rather than credit curve flattening.

Economic Momentum Drives Maturity Bucket Performance

As discussed, steeper credit curves tend to be associated with declining credit risk and vice versa. While credit curves often steepen during periods of declining defaults, this does not necessarily mean that shorter maturity bonds deliver better excess return performance than longer maturity bonds in these environments. Despite potentially less spread tightening, longer maturity bonds tend to outperform during declining default rate environments due to the power of the spread duration component.

Fundamental bond math tells us that for any given amount of yield change (think of this as spread change), the percentage change in bond price will be greater for a longer maturity bond than for a shorter maturity bond. Consequently, it is possible and often the case that spreads for longer maturity bonds tighten less than for shorter maturity bonds during declining default rate environments but still generate better excess return performance versus Treasuries.

Figure 2 illustrates the historical performance differential between longer maturity and shorter maturity U.S. investment grade corporate bonds in different market environments. Note that in the "up market" environments, or years in which the corporate market generated positive excess returns, longer maturity bonds outperformed shorter maturity bonds by an average of 163 basis points (bp).

Figure 2. Average Annual Performance Differences between Long and Shorter Maturity Corporate Bonds, 1989–2015

	LM vs. SM	Difference (bp)	Accuracy Rate
All Environments	LM underperforms	-71	100%
Market Direction			**81%**
Up	LM outperforms	163	
Down	LM underperforms	-383	
ISM Manufacturing Momentum			**77%**
Strengthening	LM outperforms	218	
Weakening	LM underperforms	-247	
Credit Default Rate Direction			**69%**
Falling	LM outperforms	41	
Rising	LM underperforms	-373	
5-30 Years Treasury Curve Direction			**38%**
Steeper	LM underperforms	-59	
Flatter	LM underperforms	-85	
2-5 Years Treasury Curve Direction			**73%**
Steeper	LM outperforms	104	
Flatter	LM underperforms	-203	

Sources: Bloomberg, Barclays Capital, Voya Investment Management

In contrast, during "down market" years longer maturity bonds underperformed shorter maturity bonds by an average of 383 bp. This outperformance of longer maturity bonds relative to shorter maturity bonds during bullish markets helps to create the perception that credit curves flatten during bullish market environments, when the opposite is generally true. In fact, during the "up market" years, the credit curve steepened on average by 15 bp with a median steepening of 10 bp. In "down market" years the credit curve flattened on average by 15 bp with a median flattening of 2 bp.

From a portfolio positioning standpoint, it might be easier for investors to approach their positioning along the credit curve based upon their view of economic momentum and credit risk trends instead of their view on credit curve direction (steepening vs. flattening). Figure 2 illustrates that stronger economic environments and lower default rate environments tend to translate into excess return outperformance of longer maturity corporate bonds relative to shorter maturity corporate bonds.

Investors often think of Treasury curve movements as being inversely related to credit curve movements and the excess return performance of longer maturity corporate bonds relative to shorter maturity corporate bonds. However, using the expected Treasury curve direction as a guide can lead to confusing results. From a duration perspective, the 5s–30s Treasury curve best matches the long versus short corporate credit curve; but longer maturity corporate bonds tend to underperform regardless of the direction of this portion of the Treasury yield curve. By contrast, if the 2s–5s Treasury curve is used as a performance gauge the results are much cleaner, with longer maturity corporate bonds showing a strong tendency to outperform shorter maturity corporate bonds during Treasury curve steepening environments. This makes intuitive sense given the linkage between this portion of the Treasury curve and the strength of the economic environment.

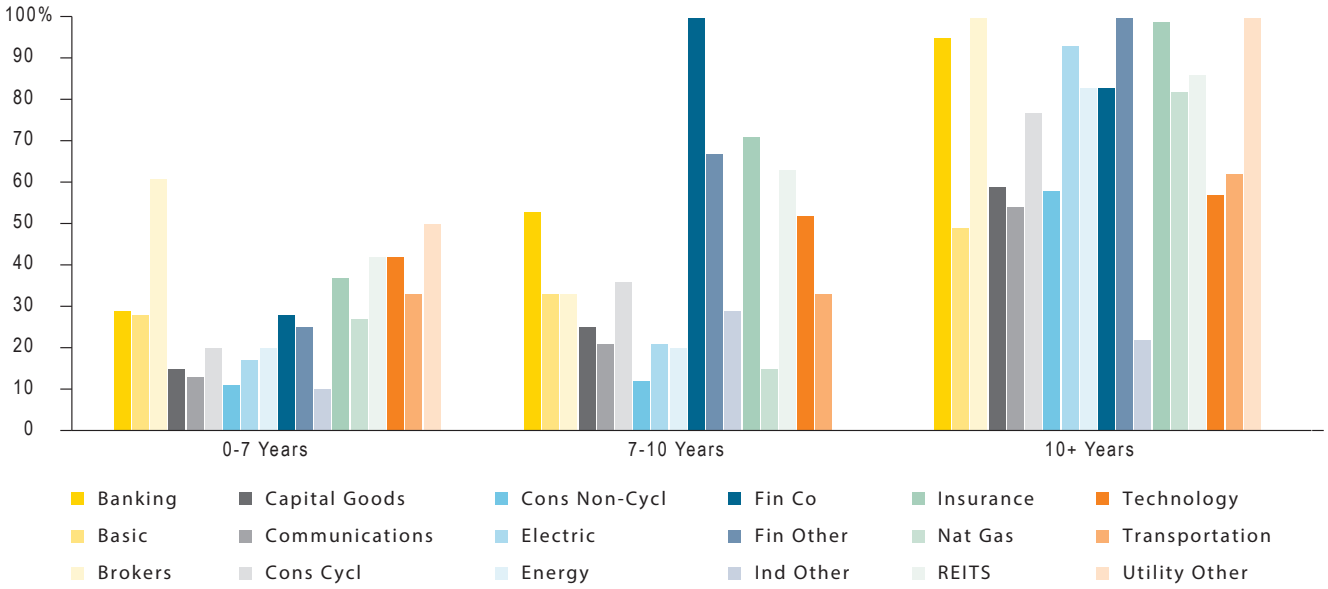
The annual accuracy of the direction of economic momentum and default rate trends are similar in terms of their linkage to the relative excess performance of longer versus shorter maturity corporate bonds, with annual accuracy hit rates of around 70%. The accuracy of the Treasury yield curve direction, however, depends upon use of the appropriate portion of the curve. The 5s–30s Treasury curve direction only has an accuracy hit rate of 38% but the 2s–5s curve direction has a hit rate of 70% due to its strong linkage to the direction of economic momentum. The most straightforward approach for credit investors is to set credit curve positioning based upon the expected trend in default rates or economic momentum. Our analysis uses ISM manufacturing new orders as a proxy for economic momentum. Assuming an accurate read on the likely direction of economic momentum or credit default rates, a tactical overweight or underweight in longer maturity securities may enhance portfolio performance potential.

Maturity Composition Heavily Impacts Issuer and Industry Results

Changes in economic momentum often contribute to meaningful swings in the relative performance of longer maturity versus shorter maturity bonds, but monetary policy and fundamental industry dynamics can also play a role. The market environment in 2013 had more of a macro flavor and was largely driven by Federal Reserve actions rather than by fundamental changes in a specific industry.

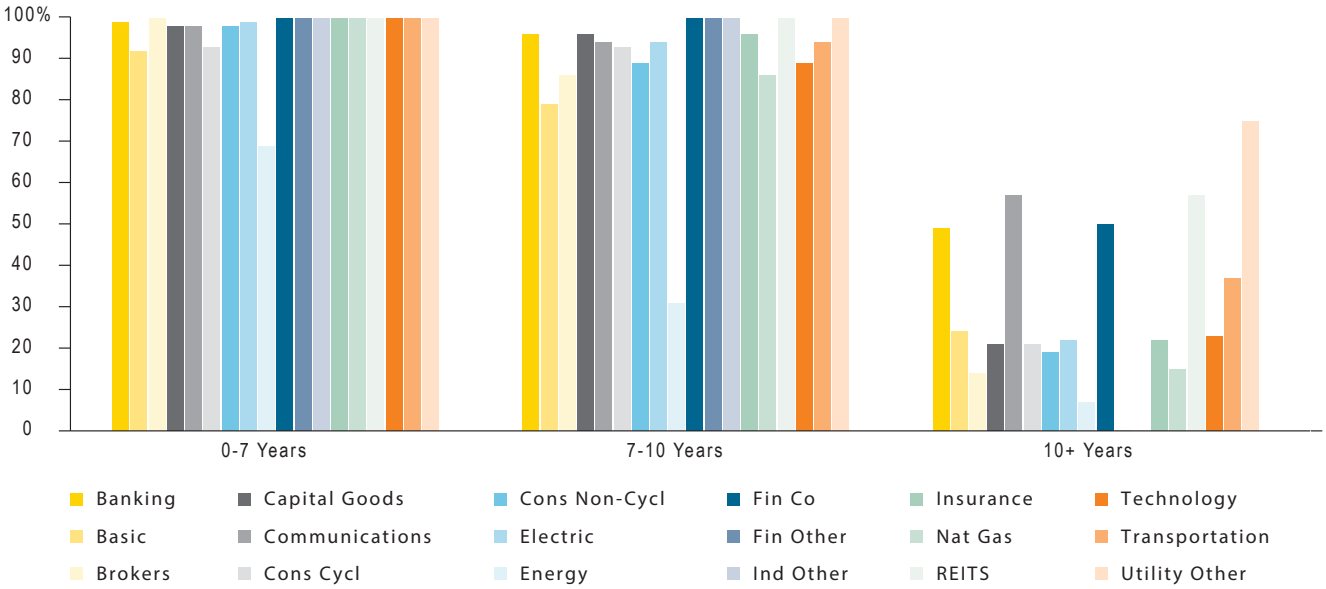
The Fed surprised the market in 2013 by announcing that it would begin tapering its quantitative easing, bond buying program given the improvement in economic conditions. Investors fled the Treasury

Figure 3. Longer Maturity Bonds Most Often Outperformed the Index in 2013



Sources: Bloomberg, Voya Investment Management. Index = Bloomberg Barclays U.S. Credit Index.

Figure 4. Longer Maturity Bonds Most Often Underperformed the Index in 2014



Sources: Bloomberg, Voya Investment Management. Index = Bloomberg Barclays U.S. Credit Index.

market based upon expectations of less government support, which led to a sharp increase in Treasury yields. The market environment in 2012 was characterized by a strong rally in the financial industry. The market environment in 2014 was the opposite in the sense that the market sold-off sharply driven by fundamental weakness and a higher risk of defaults within the commodity industries.

In all three of these years, the outperformance or underperformance of longer maturity bonds was significant and matched the overall direction of market performance. It is important for investors to recognize that market direction has a meaningful impact on the relative performance of longer versus shorter maturity bonds regardless of whether market direction is driven by macro-oriented or bottom-up factors. In general, the top-down is just the aggregate of the bottom-up. Either perspective can help identify potential market catalysts. Identifying the potential catalysts for these environments is a perpetual challenge for investors but is important to investment success. Our investment process is structured to source inputs from both the top-down and bottom-up, which we believe enhances our ability to identify and respond dynamically to changing market environments.

From a security selection standpoint, the implication and challenge for portfolio positioning remains the same regardless of whether the catalyst for a market change has more of a top-down or bottom-up sentiment. Sharp swings in market direction have a meaningful impact on the relative performance of longer versus shorter maturity bonds. In this cycle, and perhaps in other cycles, the performance impact across the maturity spectrum has extended beyond the particular industry that was most directly tied to the change in market environment. Figures 3 and 4 illustrate this point.

Figure 5. Maturity Bucket Composition Can Heavily Influence Issuer and Industry Performance

Year	Market Direction	Performance by Maturity (%)		
		0-7 Years	7-10 Years	10+ Years
2010	Up	45	48	36
2011	Down	91	69	38
2012	Up	27	35	42
2013	Up	24	34	75
2014	Down	95	86	25
2015	Down	92	79	29
YTD 08/31/16	Up	15	37	59

Sources: Bloomberg, Voya Investment Management. Index = Bloomberg Barclays U.S. Credit Index.

In 2013, when longer maturity bonds outperformed, a high percentage of them outperformed the market across every industry group. The same was true in 2014. When longer maturity bonds underperformed, a high percentage of longer maturity bonds underperformed the market across every industry group. This pattern has held true across this entire credit cycle.

Figure 5 relates recent maturity bucket outperformance to market direction by showing the percentage of bonds in each maturity bucket that outperformed the benchmark in each year. The implication for security selection is clear, at least within this credit cycle: environments that favor longer maturity bonds tend to result in a significantly higher percentage of them outperforming the market across almost every industry. The same is true for shorter maturity bonds. From an issuer and industry selection standpoint, this implies that maturity bucket composition can heavily influence the performance of issuers and industries relative to the overall market.

Conclusion

Investors often expect flatter credit curves in bullish markets, but this expectation is misplaced. Spread duration or maturity bucket positioning tends to drive the performance of longer maturity bonds in bullish markets, rather than credit curve flattening. While credit curves often steepen as defaults decline, this does not necessarily mean that shorter maturity bonds perform better than longer maturity bonds during these periods.

It is important to recognize that market direction, whether driven by macro-oriented or bottom-up factors, has a meaningful impact on the relative performance of longer and shorter maturity bonds. Identifying the potential catalysts for these environments is a perpetual challenge but is important to investment success.

Deeper understanding of the credit cycle helps managers make better security selections, and is part of what sets Voya's fixed income investment style apart. While security selection is our primary return driver our team differs in the nature of its structure and the structure of our investment process. We have dedicated resources to top-down and bottom-up considerations, which enhances our ability to identify and respond dynamically to market trends that can influence our security selection and impact performance.