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For BBBs, This Sell-off Looks Like a Rally

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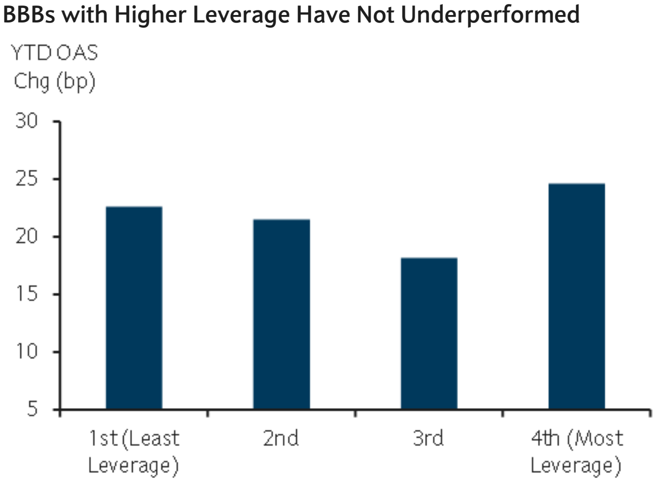
US investment grade credit has experienced persistent weakness through most of 2018, widening 20bp on the year and meaningfully underperforming riskier asset classes – namely, equities and high yield bonds. As we have highlighted before, riskier investment grade debt has outperformed as well; the BBB/A ratio has dropped from 1.67x at the beginning of the year to 1.51x currently, implying beta-adjusted BBB outperformance. The move has been driven primarily by industrials, which have seen their BBB/A ratio compress from 1.78x at the end of December to 1.63x now (the financial BBB/A ratio fell from 1.53x to 1.45x, while in utilities, the ratio has been essentially unchanged year-to-date). The compression in the BBB/A basis has been supported by a stronger fundamental backdrop for BBBs – non-financial leverage for BBBs has improved relative to As, with BBB gross and net leverage falling 0.2x y/y while A leverage was unchanged (see *US Investment Grade Credit Metrics: Q1 18 Update*).

Even though BBBs have outperformed A-rated credit this year, there is growing concern about the significant increase in the notional amount outstanding of BBB debt, which could weigh on the performance of the cohort, particularly highly leveraged credits, should the economic backdrop weaken and downgrade risk increase. That has not shown up in performance yet, however. Figure 1 shows the spread widening in BBB industrial credits versus leverage (we group industrial BBB issuers by quartile of net leverage[1] and calculate the weighted average spread performance of issuers in each quartile). Interestingly, the year-to-date spread move has been relatively uniform across leverage quartiles, with the lowest leverage quartile selling off as much as the highest.

Instead, despite the risk-off environment in investment grade, starting spread has been the more important factor for outperformance. Figure 2 illustrates spread performance by quartile of starting spread instead of leverage. BBBs with the highest starting spread have widened almost 10bp less than their their tighter-trading peers year-to-date. As demonstrated in *US Credit Focus: The Best Wost Sectors*, starting spreads are generally more closely linked to outperformance when the market is rallying; during sell-offs, this relationship normally breaks down.

FIGURE 1

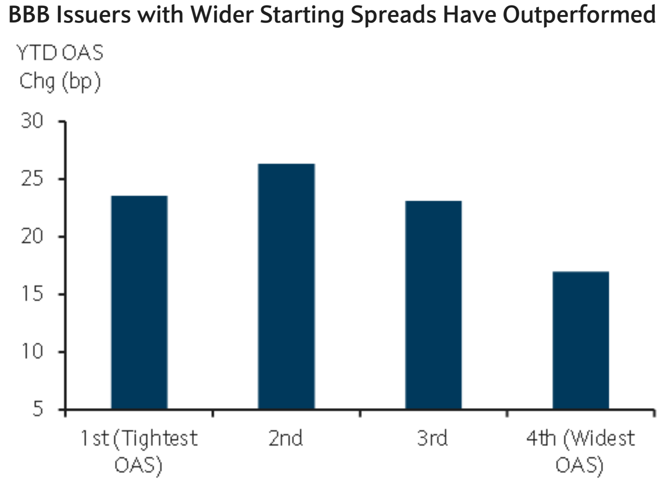
BBBs with Higher Leverage Have Not Underperformed



Source: Factset, Bloomberg Barclays Indices, Barclays Research

FIGURE 2

BBB Issuers with Wider Starting Spreads Have Outperformed



Source: Bloomberg Barclays Indices, Barclays Research

[1] These results are based on uncapped Factset data[our quarterly credit metrics update uses capped data from Compustat.

The significant spread widening in investment grade, both in absolute terms and relative to high yield and equities, has raised concerns that it may be portending a worsening fundamental backdrop. Performance within the BBB cohort suggests otherwise, however, with highly leveraged credits performing in line with their lower-leveraged peers. We would have expected the former to underperform meaningfully if investors were worried about fundamental deterioration. Rather, we continue to believe that weak technicals have been the driver of investment grade spread widening. Given our benign view on the future demand backdrop, particularly for long-dated debt (see *No Trouble with the Treasury Curve* and *International Demand – Taiwanese Edition*), we expect the technical weakness to be only temporary and expect spreads to rally. However, for more bearish investors, the in-line performance of issuers with different leverage profiles offers an opportunity to move into lower-leveraged names that have sold off equally with higher-leveraged ones.

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