Aegon Asset Management

LOWER-QUALITY BONDS OUTPERFORM EQUITIES AMIDST INCREASING VOLATILITY

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Key takeaways

- Recent equity volatility has spilled over into lower-quality fixed income markets, but the pullback in Caa-rated bonds has been more muted and primarily driven by a few sectors.
- We view the recent decline in lower-quality bonds as a healthy market correction. Moreover, we believe investors should stay focused on idiosyncratic opportunities rather than using the pullback as an opportunity to add risk broadly.
- We remain constructive on lower-quality credit given low default expectations and generally healthy fundamentals, and expect Caa-rated bonds to provide attractive risk-adjusted returns relative to other fixed income asset classes over the next 12 months.

How has the recent equity volatility impacted the lower-quality bond market?

October has been a volatile month. After finishing September with a healthy year-to-date total return of 10.6%, the S&P 500 Index nearly erased those gains with a -7.1% month-to-date as of October 26. Weakening investor sentiment underlies the equity decline amid fears of slowing global growth, pressure on corporate earnings from rising costs, monetary policy normalization and escalating trade wars between the United States, China and elsewhere.

The equity weakness has spilled over into the lower-quality bond markets, albeit to a lesser extent. The Caa-rated portion of the Bloomberg Barclays US Corporate High Yield index declined 1.97% month-to-date as of October 26, the second largest drawdown in the lower-quality markets in 2018 and only slightly better than the decline in the first quarter. We believe the price deterioration in lower-quality bonds was more idiosyncratic in nature, as evidenced by the fact that a third of the month-to-date decline in Caa-rated came from just five issuers in the energy, wireline and chemicals sectors. Despite the monthly declines, on a year-to-date basis Caa-rated bonds have outperformed many other fixed income assets with a 3.90% total return through October 26.

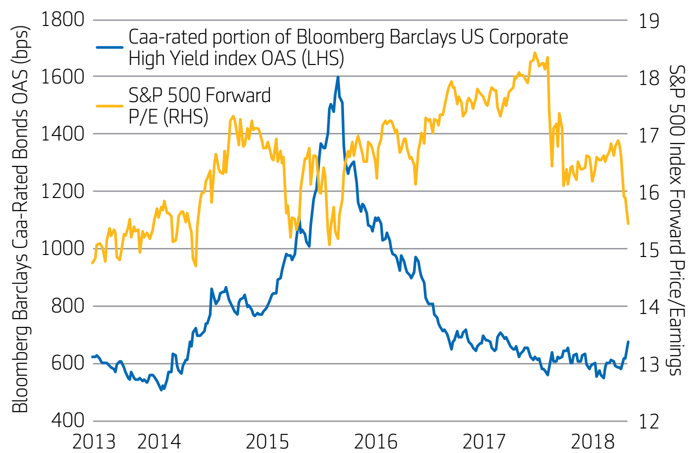
More broadly, investors appear less bullish about future earnings growth, which is likely to affect equities more meaningfully than lower-quality credit. However, fixed income investors remain generally confident about issuers' ability to service their debts and avoid defaults amid a healthy fundamental backdrop.

Do you believe the recent market decline is indicative of near-term sustained weakness?

We believe the recent market weakness witnessed in equities and lower-quality bonds is a healthy market pullback. At the end of September, the S&P 500 was trading at about 17x forward P/E; the October pullback brought the index more in line with its 10-year historical average of 15x. By that measure alone, equities now appear neither an obvious buy or sell.

While lower-quality bonds were not immune to the broader market volatility, the price implications have been more muted. Caa-rated bond spreads, as measured by the option-adjusted spread (OAS) of the Caa-rated portion of the Bloomberg Barclays US Corporate High Yield index, have risen 91 basis points since the end of September and now hover around 675 basis points. In our view, the recent spread widening is rather insignificant, particularly when compared to spread movements seen between mid-2014 and early 2016, when Caa-rated bond spreads increased by approximately 1,000 basis points. While Caa-rated bond spreads are at the widest levels this year and 60 basis points wider than on December 31, 2017, we believe most of the buying opportunities are idiosyncratic in nature rather than being indicative of a major repricing of the entire lower-quality bond market.

Exhibit 1 –Caa-rated bond spreads and equity P/E ratios
As of October 26, 2018



Bloomberg. Data from November 1, 2013 - October 26, 2018.

Have the recent events changed your expectations for corporate defaults and lower quality credit performance?

No. We expect defaults will remain below historical averages for the next 12 months, possibly longer. In our opinion, a material increase in corporate defaults will not occur until we see either a substantial dislocation in the credit markets, such as the one witnessed in 2014-2016 following declining oil prices, or a substantial slowdown in global or US economic growth. As a result, we remain constructive on lower-quality credit given generally healthy fundamentals, and expect Caa-rated bonds to provide attractive risk-adjusted returns relative to other fixed income asset classes over the next 12 months.

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