Seeking the Holy Grail

Paul Brain
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Credit strategy: overweight investment-grade bonds; underweight high-yield bonds

Newton's investment approach is driven by the use of long-term themes. Among the most influential of these themes (for the bond market) have been *debt & credit* and *becalmed*, both of which covered the evolution of leverage in recent years. There has been a shift from a high-leverage environment to an environment of deleveraging (as captured by our 'All Change' theme); this evolution has severely distorted the credit market over the last five years.

Bond investors often use 'regression' analysis models to determine value. Such models help to identify the majority of the value inherent in the market, but they rely heavily on historical data and on historical relationships remaining in place; when a significant change occurs, the models struggle. We like to use these models as an overlay on our theme-based approach but, if there is a significant breakdown in a model, it is the use of themes that helps us to understand what is going on.

Before the onset of the credit crunch in June 2007, the credit markets were distorted by factors identified in our *debt & credit* and *becalmed* themes. These factors resulted in an increased demand for anything that had a spread. As a result, credit markets were driven to unjustifiably low yields over underlying government markets.

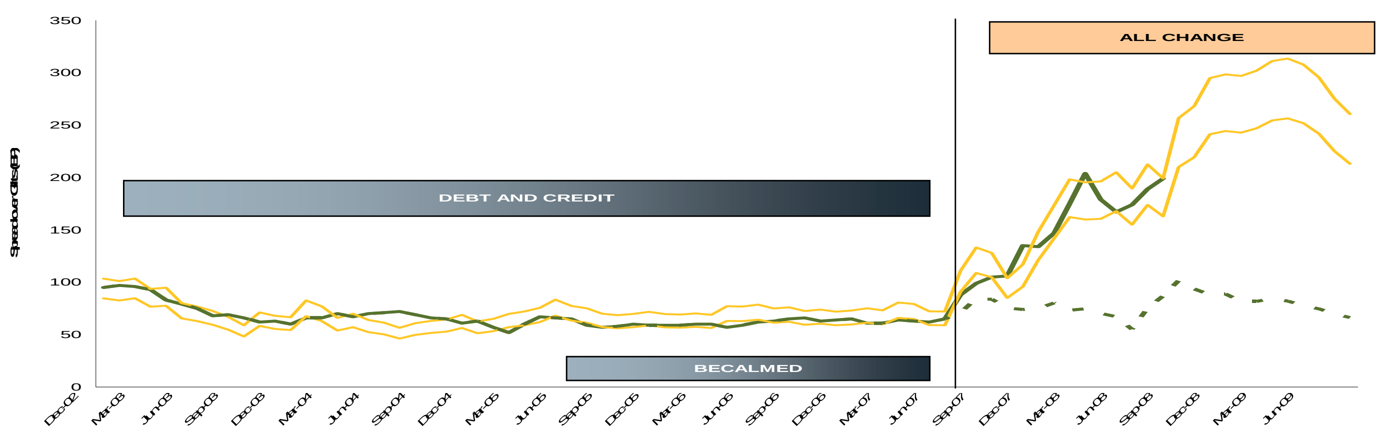
This distortion can be seen in the graph below, which shows the spread on investment-grade bonds trading at or below the value suggested by a regression-based model in the period from December 2002 to June 2007. Traditional buyers of credit were crowded out by hedge funds, investors in collateralised debt obligations and other structured credit buyers.

All Change

When the abundance of liquidity began to dry up in the summer of last year, it devastated the credit markets. The reality was arguably more severe than the destruction of regression-based credit valuation models. If one makes no adjustments to these models, the investment-grade corporate bond market appears to be under-valued. The graph below illustrates the theoretical 'fair' value as a dotted line; it uses the full regression calculation and therefore assumes liquidity is abundant.

However, if we adjust for the factors which have prevailed since July 2007, the model has a much better fit with recent spread movements. The rationale for making such an adjustment is that the background has changed, and we have moved from a loose liquidity environment to a tight one.

The factors being applied remain the same – weak



economic growth, rising default rates, cuts in short rates and slightly lower volatility. Also, by using the most recent period for the regression, we have assumed that the relatively poor level of liquidity evident in markets at the moment will continue. If the market were to revert to 'normal' liquidity conditions, this analysis would not apply, spreads would fall dramatically, and credit would outperform very materially.

Liquidity has been one of the most significant drivers of credit spreads over the last five years (both downwards and upwards). Identifying an effective measure of liquidity is akin to seeking the Holy Grail, but we will continue to look. Understanding that themes will continue to affect liquidity, and using theme-based analysis to interpret markets, are the next best things.

With the economic decline broadening across the globe, the negative effects on the credit market are starting to be felt. Within credit there are number of allocation decisions that need to be made. First, should you be invested in high-quality, **investment-grade** securities or in low-quality, **high-yield** bonds? A global economic slowdown is more detrimental to high-yield than it is to investment-grade. With defaults among high-yield issuers expected to rise, high-yield bonds should be treated with caution for the time being at least.

Within investment-grade, we favour those sectors that have already started restructuring, for example the banks. Such sectors are less vulnerable to a downturn than other sectors. The financial sector already yields more than the industrial sector, a situation that cannot continue for ever.

The dramatic widening in spreads was triggered initially by both the turnaround in the liquidity environment, and subsequently by the significant degree of economic weakness which has been priced into investment-grade bonds. With a deteriorating economic outlook, investment-grade corporate bonds could yet underperform government bonds. However, the higher yield available on investment-grade issues provides quite a lot of 'break-even' protection without exposing investors to the significantly higher default risk prevalent in sub-investment grade bonds.

Difficult outlook for corporate profits requires careful credit selection. There will be winners and losers from these trends.