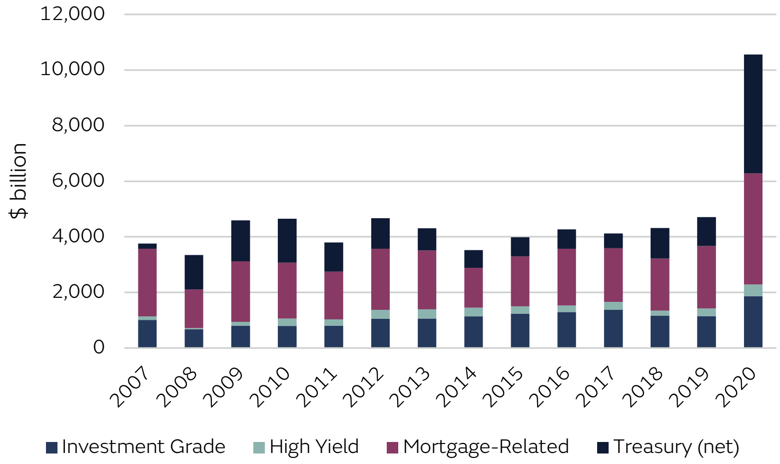
Are bonds junk?

"It's the end of the world economy as we know it" according to the New York Times, April 16, 2020. Tell that to those plying their trade in the debt markets. 2020 saw debt issuance at all-time highs.

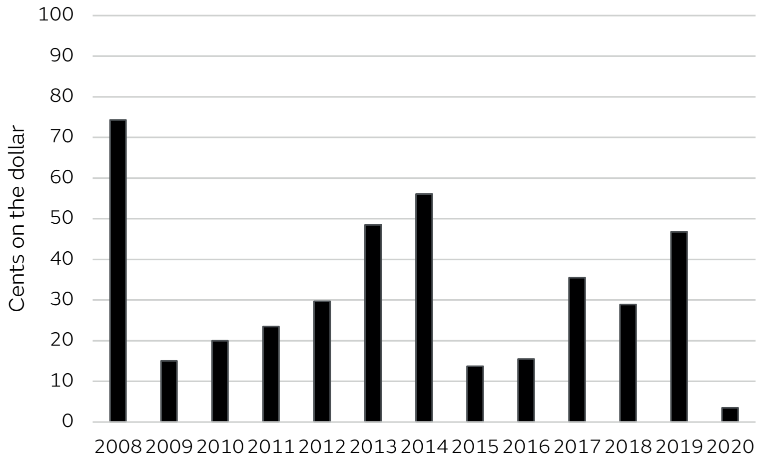
Chart 1 - US Corporate Bond, Mortgage-Backed & Treasury Issuance



Source: Refinitiv, Federal Agencies (FHLMC, FNMA, GNMA, NCUA, and FDIC), Bloomberg, Dealogic, Thomson Reuters, US Treasury

We are yet to learn how much, if any, of the 2020 record-setting debt issuance will default. We do know that market sentiment is not optimistic.

Chart 2- CDS Median Auction Value (US corporates)

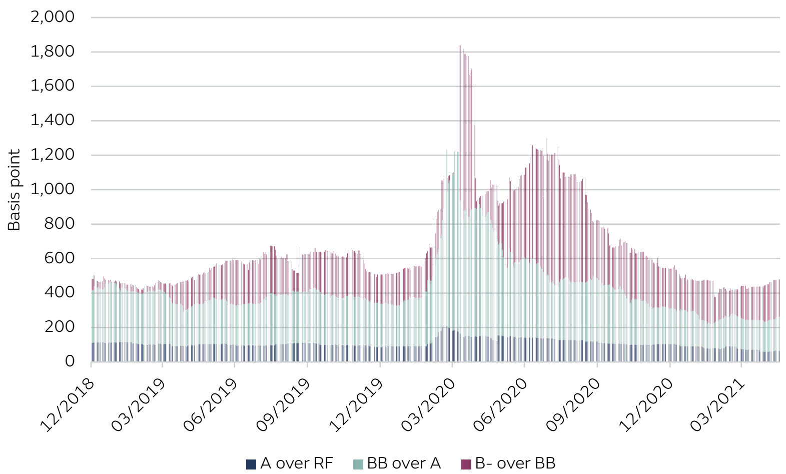


Source: Bloomberg, Creditex and Markit

In 2020 the value of US corporate bonds in auctions for credit derivative payouts reached a record low of 3.5 cents. While this does not necessarily represent actual bondholder recoveries, lower market values do reflect investor concerns.

While credit spreads widened during 2020, during 2021 we have seen all spreads come into historically low ranges.

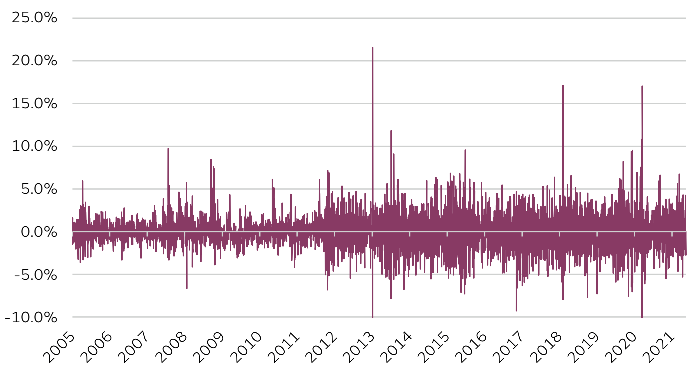
Chart 3 - Spread differentials (A, BB and B-)

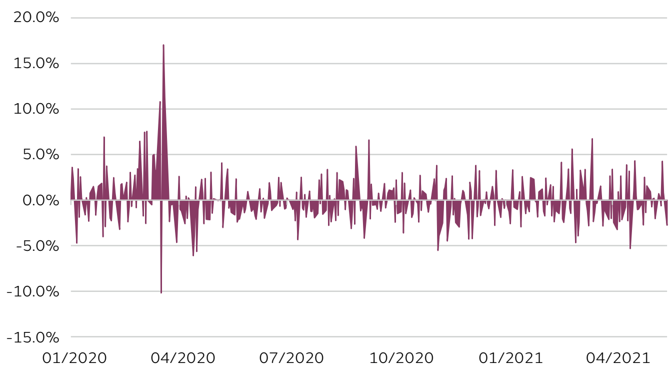


Source: Bloomberg, GIBUK analysis

Consistent with spread tightening the volatility of credit spreads has also come back into more predictable ranges.

Chart 4 - Daily change in US Corporate Baa 10 Year spread





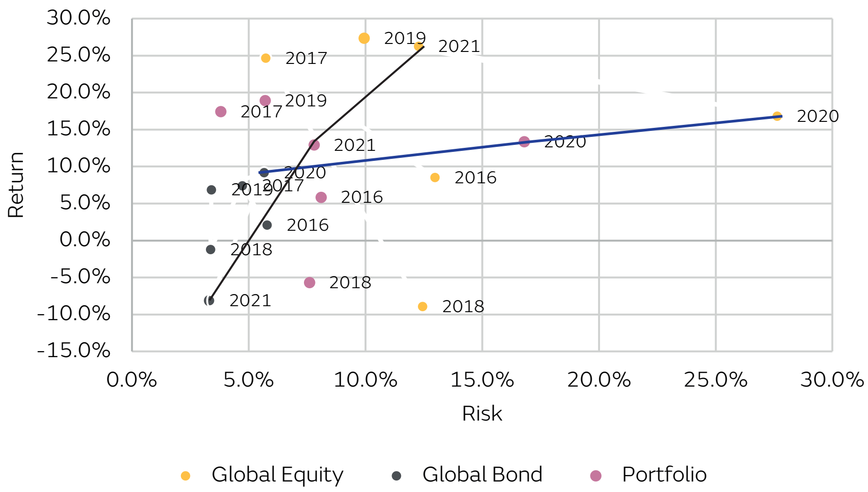
Source: Bloomberg, GIBUK analysis

Of course, lowering risk, or more precisely improving risk-adjusted returns, is the whole point of bond allocation in traditional 60:40 balanced portfolios.

And this is where it's all starting to breakdown in 2021. The traditional broad-based top down 40% allocation to bonds in balanced portfolios has served passive institutional investors well over the years, including in 2020 (blue line in chart 5).

Chart 5 shows five years of return against risk for a traditional balanced portfolio and its components (60% global equity, 35% global fixed income and 5% T-Bills). Every year the bond allocation served to moderate risk for the price of return. This stopped working in 2021 (YTD, black line in Chart 5) when bond total return losses reduced returns much more than risk.

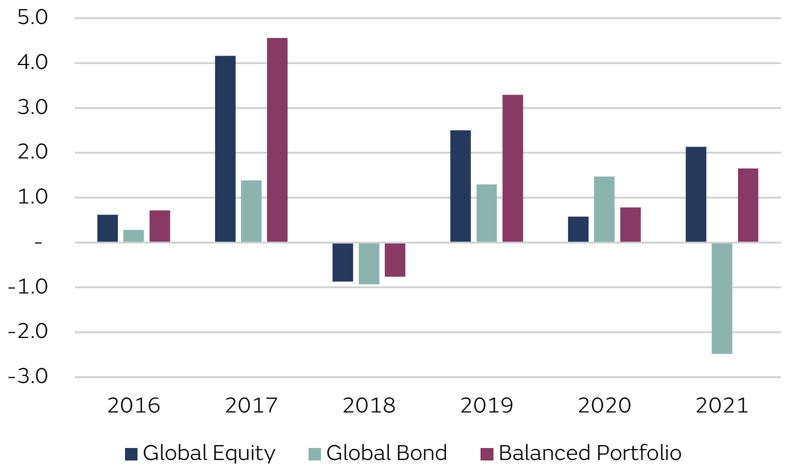
Chart 5 - Risk vs Return



Source: Bloomberg,

This can be seen in Chart 6 where bond allocations led to lower Sharpe ratios for balanced portfolios for the first time in recent history.

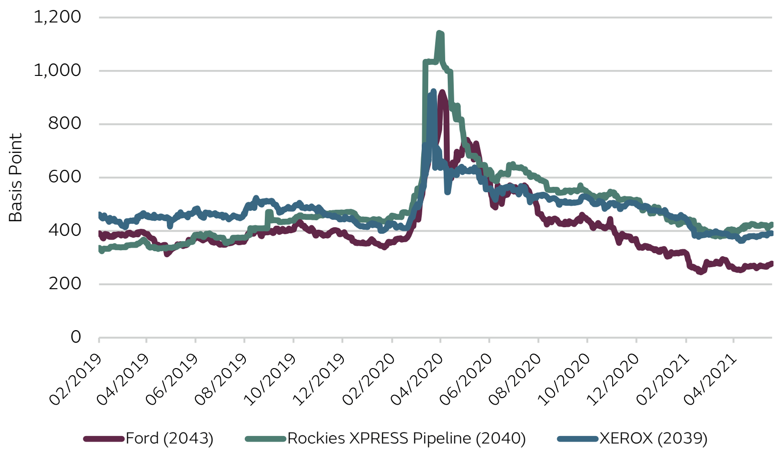
Chart 6 - Sharpe Ratios



Source: Bloomberg, GIBUK analysis

This data suggests 2021 may be time to think differently about how to execute allocations to fixed income at least in the short term. One way is to incorporate active bottom-up approaches to incorporate security specific characteristics to pick up spread differentials between similar bond issues (Chart 7).

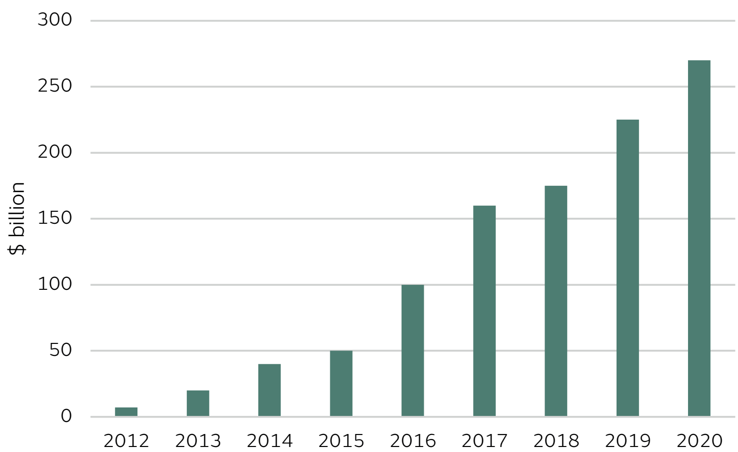
Chart 7 - Selected BB Spreads



Source: Bloomberg, GIBUK analysis

Another way is to introduce thematic elements into bond portfolios to capture rising trends, particularly around sustainability. Green bond issuance remains a very small amount of global new issuance but the growth in issuance is plain to see (Chart 8). Increasingly we expect to see blue bonds and rainbow bonds adding to the investible universe and, with the recent publication of principles by the International Capital Markets Association, sustainability-linked bonds.

Chart 8 - Green bond issuance



Source: Bloomberg, GIBUK analysis

It's not time to junk our bond portfolios just yet.