Beyond Sovereign Bonds

A higher-yielding, risk-conscious strategy for today's market and economic landscape

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Building on our publication from March 2023, entitled "Higher Yields Are Bringing Investors Back to Fixed Income," this paper examines several asset classes that offer additional yield over sovereign bonds: investment grade (IG) and high yield (HY) corporate bonds, preferred shares, and emerging market (EM) corporate bonds. Importantly, we situate our discussion in the context of the current economic cycle to determine how investors can best orient their exposure to these instruments, recognizing that each person's decision will be based on their own risk tolerance and financial circumstances. In our view, it is prudent for investors to improve credit quality in their portfolios given currently high sovereign yields, fairly tight credit spreads and our belief that slowing economic conditions will further weigh on corporate profitability and hence credit profiles going forward.

Economic backdrop suggests proceeding with caution

As we projected in our March 2023 report, the Canada 10-year yield retraced to its 2022 high of 3.6% during the summer of 2023 and in fact briefly eclipsed 3.8% in late August. Canadian yields were (and still are) buffeted by concerns around sticky domestic inflation, but they were impacted to a greater degree by negative sentiment surrounding renewed inflation pressures in the U.S., as well as the Fed's hawkish policy rate agenda and heavy supply of Treasuries from mounting budget deficits.

Adding to U.S. interest rate and fiscal woes was the ongoing quantitative tightening on both sides of the border, as well as diminishing international demand for U.S. bonds, stemming from the repatriation of funds in countries such as Japan, as their own yields rose to more attractive levels, and from changes in China's balance of trade with the U.S.

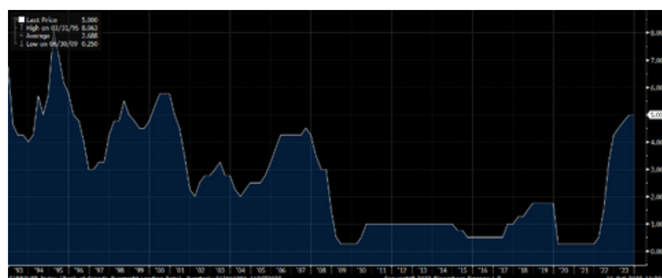
Government of Canada 10-Year Note Yield – 2018 to 2023

Source: Bloomberg

In addition, there was a building narrative during the summer months about the U.S. avoiding an economic slowdown altogether given persistent consumer spending and labour market strength, which extended market expectations for the timeframe of Fed rate cuts into next summer and was subsequently priced into the curve, most notably in higher 10-year real yields. Long story short, from June to the start of September, Canada 10-year yields popped roughly 15 bps to 3.55%, while 10-year Treasuries shot up 50 bps to 4.10%.

Recently, however, emerging signs of underlying economic weakness in Europe and the U.S. are drawing a more sobering picture for investors regarding the increasing likelihood that a profound tightening of monetary conditions in Europe and North America over the past couple of years is triggering a meaningful slowdown on both sides of the Atlantic. Even China, the traditional stalwart of global economic growth, is suffering its own challenges, including percolating problems in its property development sector, the adverse international trade effects of "on-shoring" and "friend-shoring," and muted domestic demand.

Bank of Canada Overnight Lending Rates – 1991 to 2023



Source: Bloomberg

Notwithstanding, we believe monetary policy in both Canada and the U.S. will remain restrictive for the foreseeable future, as central bank officials on both sides of the border have made it clear that taming inflation is still their top priority. We expect that a persistently hawkish rate policy backdrop will inevitably lead to a further slowing of economic conditions in North America, and quite likely the onset of a recessionary environment as soon as the first half of 2024.

Improve credit quality into IG corporate bonds

Given our expectation for a consequential slowdown in North American economic activity, we suggest investors look to improve credit quality within their portfolios. Adding to our conviction, we believe a combination of elevated sovereign yields and corporate spreads that are towards the lower end of their historical ranges creates a constructive environment for investors to improve credit quality and benefit from a pending decline in sovereign yields without relinquishing too much present spread valuation. As such, we believe investors should work towards increasing their exposure to higher-quality IG corporate bonds and reduce their positioning in HY corporates, preferred shares and EM sovereign debt.

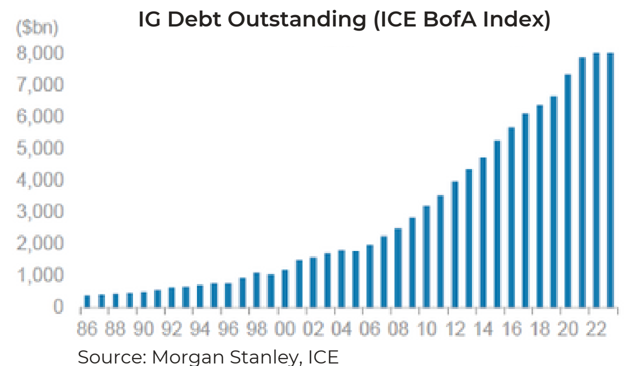
More than just a valuation story, we believe tightening credit conditions associated with restrictive central bank monetary policies will adversely impact corporate profitability and escalate bankruptcies in both the high yield and commercial real estate sectors, particularly in the U.S. And while the coming economic slowdown will eventually prove favourable for sovereign yields in North America, we expect spreads across IG and HY corporates, preferred shares and EM corporate debt to weaken in the coming months, with the extent of that weakening being determined by the severity of the economic slowdown. What's more, we believe softening economic conditions in North America and China will add a layer of foreign exchange and inflationary vulnerability for EM corporate debt.

IG corporate bonds: a bit of background

Credit investors can take comfort in the fact that credit markets are essential to a well-functioning economy and that central banks continuously monitor credit market vital signs, as evidenced by the extraordinary measures taken by the Fed (and other central banks) during the Great Financial Crisis, and more recently at the height of the pandemic with purchases of corporate bonds through both the Primary and Secondary Market Corporate Credit Facilities.

The U.S. credit market is the deepest and most efficient in the world and serves as a bellwether for the health of the credit markets in other developed economies.

According to a recent report from Bank of America, the size of the U.S. IG credit market is estimated at US$9.7 trillion in cash bonds and US$0.48 trillion in credit derivatives. These figures consist of domestic and foreign issuers that are marketed in the U.S. and rated BBB- or better by rating agencies such as Moody's and Standard & Poor's. The graph below shows the growth of the fixed-rate U.S. investment grade market since the mid-1980s:



Source: Morgan Stanley, ICE

The Canadian IG credit market is much smaller. As at Q2 2023, the total size of the Canadian corporate credit market (domestic and foreign issuers in Canadian dollars) was estimated at just over $500 billion. This figure may seem small compared to the U.S., but over the last two decades the Canadian IG market made great strides in its development. There was a rise in the number of issuers (domestic and foreign), and broader industry representation as issuers increasingly termed out bank debt to tap the debt capital markets.

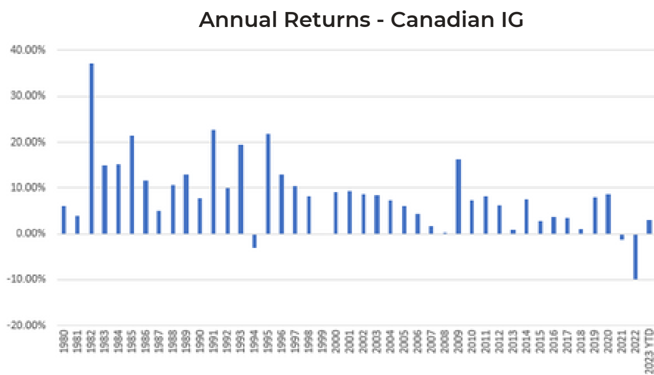
Yields on IG credit have not been this attractive in over a decade (see chart below) due to the combined effect of rising government bond yields and widening credit spreads.

Source: Bloomberg

Following the dismal annual returns in 2022 (see chart below), IG credit built in the potential for stronger returns moving forward as government yields adjusted downward and credit spreads firmed due to anticipated central bank easing. Furthermore, we believe Canadian credit is more attractive than its U.S. counterpart due to higher overall quality and greater relative spreads.

For fixed-income investors looking to add yield income, Canadian credit is certainly well positioned as we face uncertain economic times ahead.

Annual Returns - Canadian IG



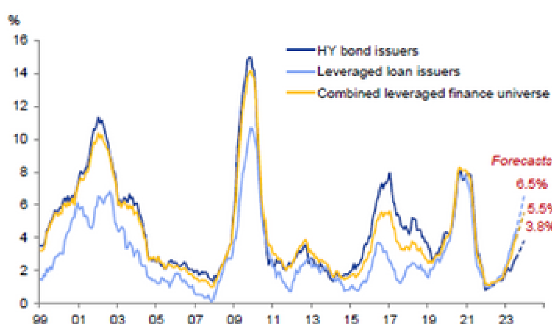
Source: FTSE Russell, iAGAM

The case for IG

Notwithstanding recent events related to U.S. regional banks, IG issuer defaults have been relatively few and far between, even in times of turmoil. For the period from 1920 to 2022, the average annual issuer-weighted high-grade default rate was just 0.14%. Accounting for a 40% historical recovery rate, default losses were even lower. Since 1983, the average annual high-grade default loss was 5 bps. These historical default losses represent just a tiny fraction of the historical median of 133 bps of spread income.

However, as noted earlier, a slowdown in the economy, depending on its severity, will put increasing pressure on issuer balance sheets and deteriorate credit quality. This growing risk is why we make the case for reducing beta by increasing quality in credit portfolios. Highly leveraged issuers in the HY market are showing deteriorating metrics (albeit at their historically healthiest levels). Since speculative-grade issuers' historical default rates are typically much higher than IG, HY investors need to consider if yields are attractive enough to compensate for defaults, net of the potential recoveries on events such as restructurings or bankruptcies. As the chart below shows, the default rate for speculative-grade issuers is expected to rise into year-end. The HY market could be facing a rough ride by then.

Trailing 12-month issuer weighted default rates for USD HY bonds, leveraged loans and the combined leverage finance universe

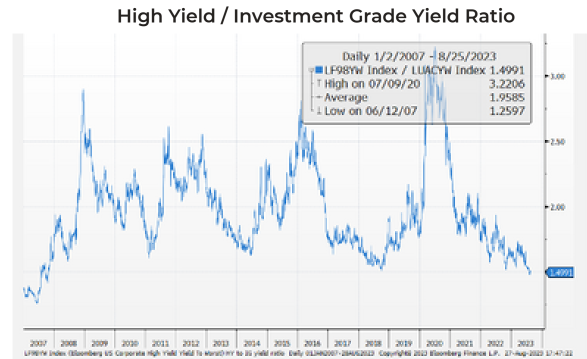


Source: Moody's, Goldman Sachs Global Investment Research

The net level of yields offered in the HY space, considering anticipated default and recovery rates, is simply not enough to rival the yield available in IG.

Also consider the historical yield ratio between HY and IG. This ratio is at historical lows going back to the Great Financial Crisis, confirming that overall yields for highly leveraged issuers do not provide enough cushion relative to higher quality and practically default-free issuers. In our view, IG is a much better proposition versus HY at this point in the cycle, on a risk-adjusted basis.

High Yield / Investment Grade Yield Ratio



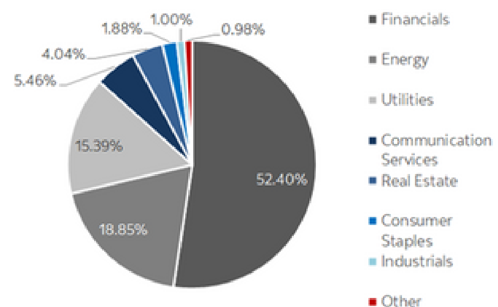
Source: Bloomberg

Preferred shares: key market characteristics

Preferred shares are a type of equity security that exhibits features of both stocks and bonds. They typically pay a fixed dividend, which is usually higher than the dividend paid by common shares. They also have priority over common shares in the payment of dividends and in the distribution of assets in the event of bankruptcy.

The preferred share market in Canada is relatively small compared to other equity markets, such as the common share market. However, it is still an important market for investors seeking income and stability. Preferred shares are often issued by financial institutions, utilities and other companies that have a stable cash flow and want to raise capital without issuing debt. In Canada, the preferred share market has a capitalization of $50 billion as of August 2023. Like common shares, preferreds are traded on an exchange but they are significantly less liquid, which can be a problem if an investor needs to trade larger volumes.

Preferred Share Market Sectors



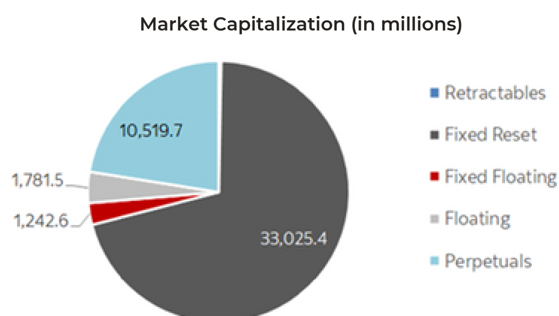
Source: Scotiabank

In recent years, the preferred share market in Canada has undergone changes as a result of tax law and regulatory changes. The federal government changed the tax treatment of preferred shares, which made them less attractive to some investors, such as life insurance companies. Additionally, there was a major change for the market in 2020 when the Office of the Superintendent of Financial Institutions (OSFI) concluded that Limited Recourse Capital Note (LRCN) structures met the criteria to be recognized as Additional Tier 1 regulatory capital issued by the banks, life insurers, property and casualty insurers and mortgage insurers. Due to the favourable tax treatment given to issuers of LRCNs compared to preferred shares, financial institutions decided to issue this new type of security and redeem some of their outstanding preferred shares. In total, there was approximately $10 billion in redemptions during 2021 and 2022. Considering the size of the market, the impact was major. However, given ongoing macroeconomic uncertainty, OSFI announced recently that it would require banks to increase minimum regulatory capital, making further redemptions by Canadian banks unlikely.

Preferred share structures

Preferred shares can be structured in many ways, but the most common in the Canadian market are fixed-rate perpetuals, rate-reset preferreds and floating-rate preferreds. One of the most important risks to understand with preferred shares relates to changes in interest rates. The value of preferred shares may be positively or negatively impacted by an increase in interest rates, depending on the type of preferred share and its potential dividend variability.

Market Capitalization (in millions)



Source: Scotiabank

Perpetuals
Perpetuals are a straightforward preferred security. As the name suggests, these issues pay a fixed dividend for as long as the shares are outstanding. The dividend on perpetual preferred shares is typically fixed at a specific rate stated in the prospectus at the time of issuance.

Rate-reset preferred shares
This type of preferred share has a dividend rate that is reset at predetermined intervals, usually every five years. The dividend rate is usually based on a benchmark rate plus a fixed spread or percentage above that rate. Most fixed-reset preferred shares have the Canada 5-year government bond as their benchmark.

When the reset date arrives, the dividend rate is reset to a new rate, with the spread remaining constant. The new rate is determined by the applicable benchmark rate at the reset date. The reset feature provides protection to investors against rising interest rates and ensures the issuer can adjust the dividend rate to remain competitive in changing market conditions. Some rate-reset preferred shares have been issued with minimum dividend “floors.” This feature guarantees the security’s fixed-dividend reset value cannot be below a specified level, typically the initial fixed rate.

Floaters
Floating preferred shares, also known as floaters, are a type of preferred share with a dividend rate that varies or "floats" based on a certain benchmark rate, typically the 3-month Government of Canada T-bill rate. The dividend on a floating preferred share is calculated by adding a spread or percentage to the benchmark rate, creating a floating or variable dividend that changes periodically as the benchmark rate changes.

Preferred share risks

Investors should be aware of four key risks when considering preferreds:

1. Interest rate risk: Depending on the type of preferred share, an increase in interest rates could negatively or positively impact the value of preferred shares. For example, as interest rates rise, the value of perpetual preferred shares can decrease, which can result in reduced liquidity and a decline in market price.

Sensitivity to Interest Rates

Perpetuals	Rate-reset	Floaters
Tend to outperform when interest rates are falling.	The sensitivity to interest rate expectations is the highest for rate-reset preferred shares that have lower reset spreads. Consequently, these issues tend to benefit greatly from rising interest rates.	Very sensitive to interest rate movements. Floaters have more exposure to interest rate risk than other types of preferred shares.

2. Credit risk: This is the risk that a preferred share issuer defaults on its obligations, which can lead to a loss for shareholders. It is the risk that the issuer will fail to pay its dividend as promised. Companies with low credit ratings are considered riskier and may be more likely to default on their obligations than companies with higher credit ratings.

3. Call risk: Some issuers of preferred shares may have the option to call the shares at certain times, which can result in the preferred shares being redeemed before their maturity date. This can result in lower returns for investors, as they may be forced to reinvest their capital at less favourable rates.

4. Liquidity risk: Preferred shares may be less liquid than other types of securities because they are not as frequently traded.

Not the time for preferreds

Preferred shares can be used to enhance the returns of a bond portfolio. Due to the higher yields and distributions they offer, preferreds may potentially provide higher returns than bonds. However, it is important to remember that preferred shares may also carry additional risks associated with equity investments. Given our expectation that we are entering a period of slowing economic conditions, we recommend investors upgrade the quality of their portfolio away from preferred shares towards IG corporate bonds.

What is an EM?

In general, an EM is a country that is still developing its internal infrastructure (e.g., communications systems, capital markets, economy, political institutions). Although there is considerable variation in stages of development, EMs exhibit poorer liquidity in their capital markets, greater volatility in foreign exchange, lower levels of per capita GDP and personal income, and in some cases higher levels of political instability. In the initial phases, EMs are typically reliant on natural resource extraction and exportation, eventually developing more features of internal infrastructure and an increasingly diversified economy as foreign direct investment flows in. This foreign influx is bolstered by domestic (and in some cases international) political policies designed to foster the development of national infrastructure, along with assistance from non-governmental organizations.

Source: Bloomberg

Importantly, EMs tend to boast higher degrees of GDP growth as they are often undergoing a rapid pace of economic expansion from foreign investment, and therefore present opportunities for outsized investment returns. Those inherent returns are augmented by investor demands for greater levels of compensation due to risks endemic to EMs themselves, such as high inflation, political instability, excessive sovereign debt, commodity price risk and foreign exchange fluctuations, all of which necessitate greater returns than both IG and HY bonds from developed regions.

There is no hard line between what constitutes a developed versus an EM economy. It is more of a grey area once we move beyond institutions like the G7 (plus a number of countries in Europe) that are comprised of clearly developed economies. In recent years, some of the larger EMs banded together to create associations like BRICS (Brazil, Russia, India, China and South Africa) in order to exert a greater influence on global politics and international trade. Casting a pall over the global economy are long, dark histories of colonialism and exploitation that propelled most developed nations to the economic status they enjoy today at the expense of many EMs (see our report from May 2023, entitled “The Future is Greener” for a discussion of some of the consequences of that exploitation). Even Canada not so long ago saw its origins as a “hewer of wood and drawer of water” within the British and French empires, but was fortunate through a massive influx of immigration and foreign investment to rapidly become a member of the G7, not dissimilar to the ascendancy of the U.S.

IG and HY multinationals and EM investments

It is important to distinguish between companies that are headquartered in EMs and those that are headquartered in developed economic regions but own assets in emerging markets. One key difference is IG or HY multinationals headquartered in developed countries internally bear the risks of any EM assets they own (foreign exchange, geopolitical, environmental, etc.).

By comparison, investors who directly own bonds from IG or HY issuers headquartered in EMs (including via mutual funds) assume those risks.

Multinationals diversify their EM risk exposures by owning assets in multiple regions and mix them with assets in developed economies. In this context, we often think of large global corporations in the resource sectors, like mining or oil and gas, or transnational manufacturers in industries such as autos, apparel, electronics or semiconductors.

Since the 1970s, globalization has fostered the rise of direct foreign investment and partnerships with local governments in EM jurisdictions, versus the gunboat diplomacy and exploitation that dominated previously. Oftentimes, these arrangements are geared towards promoting spillover benefits into the local economies, encouraging entrepreneurship and the development of infrastructure that would stimulate the advancement of domestic firms as well, hence resulting in EM issuers of corporate credit. Owning corporate bonds or bond mutual funds consisting of these multinationals is one way of gaining exposure to the higher growth prospects of EMs with less direct exposure to the risks associated with holding securities headquartered in those regions.

EM corporate bonds

Although the world today is more integrated due to communication and technology improvements, administrative issues persist in buying and holding EM corporate bonds, such as custodial, legal and execution risks for those not cross-listed on multiple exchanges. Yet, even for EM corporate bonds that are cross-listed, the individual buyer assumes foreign exchange risk, which can be quite considerable for smaller economies, as well as information flow risks related to time zone differences or even the flow of communication itself. For more on the issues that can arise with direct ownership of corporate bonds, see our report from March 2023, entitled "Higher Yields are Bringing Investors Back to Fixed Income."

EM corporate bond mutual funds

One way to circumvent the obstacles of directly owning EM corporate bonds is to purchase a mutual fund containing these assets. The management expense ratio that investors pay affords access to professional fixed-income portfolio managers who possess expertise in assessing and managing the risks of holding EM corporate bonds. One needs to be cognizant of the idiosyncratic political risks in each country, including corruption, militarism, populism, regional conflicts, international trade conventions, and so forth.

Having an asset nationalized, depleted via corruption, or destroyed through violence is a material risk in many EM countries. Awareness of local economic conditions, trade flows, infrastructure capabilities and the like, is similarly essential. Moreover, many EMs are exposed to commodity price risk, while high-growth regions are often vulnerable to excessive inflation and imperiling sovereign debt, as evidenced by the Latin American crisis of the 1980s, the Russian crisis of 1987, the Asian crisis of the 1990s and the sovereign crises following the Global Financial Crisis. The smaller the national economy, the more susceptible an EM is to such erosions of confidence. Many mutual funds boast portfolio managers and analysts directly located in the EM countries or regions in which they invest, which is a significant advantage over individual investor ownership of EM corporate bonds. Such expertise is oriented around regions such as Eastern Europe, Latin America, Central and East Asia and Africa.

There are also idiosyncratic company risks exhibited by individual issuers of corporate bonds. Endeavouring to manage those complexities oneself, especially since they are buffeted by the aforementioned country risks, is a full-time job and made more difficult by inherent problems of communication flows (e.g., technology, state-controlled media, questionable reporting standards). Especially at the retail investor level, where individual security ownership is comparatively modest, the ability to manage the notional costs of fully understanding each credit is intrinsically cost prohibitive when assessing adequate risk-reward compensation.

Particularly when it comes to EM jurisdictions, one needs to develop a comprehensive understanding of regional political and economic dynamics, and then diversify associated risks and costs across numerous holdings to make the risk-reward proposition worthwhile. Having an asset in a broad portfolio nationalized or destroyed is obviously not desirable, but having it happen to a less diversified retail portfolio can be devastating.

To be sure, asset impairment of a developed market IG or HY bond is also a risk, but to a much lesser extent, as noted above. Regardless, diversification is key, so EM mutual fund ownership should be considered in the context of the broader portfolio, depending on the investor's financial circumstances and risk tolerance. What's more, investors can obtain EM exposure through IG and HY corporate bond mutual funds that are more global in orientation, such as those discussed above, without having to hold an EM corporate bond fund directly. These funds can also layer in EM sovereign bond exposure to seek outsized returns without engaging in idiosyncratic corporate bond risks.

Too risky in today's environment

Since we believe we are heading towards a further slowing of economic conditions in both North America and Europe, we take the view that EM corporate bonds, whether owned directly or through mutual funds, carry elevated levels of risk and should therefore be avoided. We think investors should focus instead on improving the credit quality of their fixed-income holdings by gravitating towards IG bonds from developed market issuers.

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