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# Economic Insights

## Credit spreads: at a critical macro juncture?

### Key takeaways

- The share of lower rated companies in the US investment grade corporate bond market has grown dramatically over the last decade, to more than 50% of the total.
- US investment grade spreads have more than halved in the past 10 years despite the decline in quality, leaving investors under-compensated for the risk exposure.
- Less return compensation for more credit risk reflects the low-yield environment and central bank actions such as quantitative easing.
- Looking ahead, less central bank support and/or higher yields due to persistent inflation could cause a re-evaluation of the fundamental credit quality that investors hold

**About Economic Insights**
Analysis of key economic developments and their implications for the global re/insurance industry.

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### In a nutshell

Credit spreads have trended lower over the past decade to levels that do not reflect the underlying deterioration of the credit quality of corporates. Should central bank support to financial markets be withdrawn quickly, or persistent inflation lead to rising sovereign bond yields, the underlying credit quality of fixed income may return to the spotlight.

Inflation is at its highest levels in decades in many parts of the world, and there are few signs of a quick reversal. We expect that US inflation will peak above 7% year-on-year this winter and forecast 5% annual average inflation for 2022. These elevated price dynamics will put central banks under pressure to withdraw existing quantitative easing measures and raise interest rates sooner than initially expected. In turn, such a backdrop can be challenging for investment grade corporate bonds if the fundamental credit quality is re-assessed by investors. This is also an important consideration for the insurance industry, given that the largest re/insurers hold more than 35% of their assets in corporate bonds.[1] The clear majority of such corporate bond holdings (more than 80% in the US)[2] are in investment grade-rated assets.

Credit spreads are the compensation investors get when taking on additional credit risk beyond the yield on a "risk-free" investment. In theory, lower credit spreads suggest lower default risks. But in reality, looking at spreads as an indicator for how elevated credit risk is can be misleading. Not least because developments in the credit market over the last 10 years have given rise to a scenario today in which investors in corporate credit face significantly higher risk, but receive lower compensation for it. Since 2011, the market value of lower rated companies within the investment grade (IG) corporate bond universe has increased dramatically. For example, the share of riskier Baa companies in the USD IG credit index was about 37% in 2011. As Figure 1 shows, this share is now at just above 50%.[3] Looking at it through another lens, the two best rated categories (Aaa and Aa) made up 15% of the index in 2011; today they account for less than half of that (7%). At the same time, US IG spreads have more than halved, even with the credit quality deterioration. The decline in spreads was greater than that of government bond yields. The ratio of the spread from the worst-quality segment of US IG credit (ie, Baa) [2] to the top-Aaa-rated 5-year US government bond fell from more than 250% to now being around 100% over the past decade (see Table 1). In Europe, the deterioration of credit quality has been even more pronounced with the Baa-segment of the IG index having surged from 28% in 2011 to 57% currently.[4]

[1] Based on looking at financial results of the largest 14 re/insurers.
[2] Insurers' exposure to US IG credit is concentrated in the Baa-rated segment. *Insurance Companies and the Growth of Corporate Loans' Securitisation*, New York Fed, August 2021
[3] The rating scale is that of the *Moody's* long-term obligation ratings. The scale reflects both the likelihood of default and any financial loss suffered in the event of default. Within the investment grade universe, the scale ranges from Aaa (highest quality with minimal risk) to Baa (obligations carrying moderate risk), after which we go into the speculative grade universe.
[4] Using Bloomberg Barclays Benchmark Indices with data sourced from Barclays.

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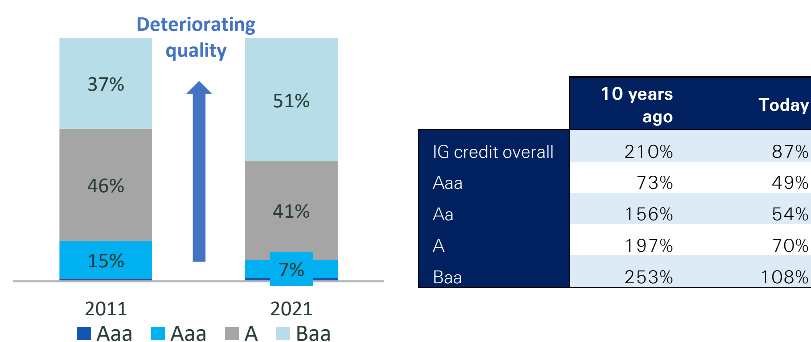
There are two main reasons for the current mismatch between credit spreads and fundamental quality of corporate debt. First, the low yield environment – which we expect to persist for longer-dated government bonds - has forced many investors to look for yield-enhancing strategies. And second, quantitative easing programs from central banks have increasingly targeted the IG credit universe to facilitate the transmission of monetary policy. As a result, very large and price insensitive buyers have entered the credit market, which has further reinforced the search for yield. But besides actual buying flows, sentiment and expectations are often as important as the action itself. The Bank of International Settlements has found that announcements by the Federal Reserve to buy corporate bonds significantly reduced credit spreads.[5] The main transmission mechanism has been yield-reduction: by encouraging demand for corporate credit, the associated price has risen and the yields have fallen. The lower credit spreads, however, are not a reflection of reduced likelihood of default. Rather, the Fed has provided a backstop which reassured investors in accepting the fundamental credit risk without benefitting from the associated compensation that might otherwise have been expected.

We expect the longer-dated government bond yields to remain low, and this should continue to foster narrower credit spreads versus a decade ago. However, if central banks need to raise interest rates and turn to quantitative tightening quickly as a result of higher inflation, the outright and implicit support for corporate bonds would evaporate. In such a case, the structurally worse fundamental quality of IG credit would become more evident again given that spreads do currently not reflect such a quality deterioration.

**Figure 1**
Underlying quality composition of the US investment grade credit market deteriorated over the last decade

**Table 1**
The ratio of credit spreads relative to the "risk-free" 5-year government bond yield fell dramatically over the last decade*




| | 10 years ago | Today |
|---|---|---|
| IG credit overall | 210% | 87% |
| Aaa | 73% | 49% |
| Aa | 156% | 54% |
| A | 197% | 70% |
| Baa | 253% | 108% |

* Rows indicate the numerator used in computing the ratios. The denominator is always the 5-year government bond yield.
Source: Bloomberg, Barclays, Swiss Re Institute

[5] *The Fed takes on corporate credit risk: an analysis of the efficacy of the SMCCF*, BIS, September 2021

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