Corporate Credit Charting its Own Course

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At the start of the year, equity investors were fretting about possible emerging-market contagion, while bond investors were fretting about fallout from US Federal Reserve tapering. Meanwhile, the corporate credit market seemed to be charting its own course. Eric Takaha, director of the Corporate & High Yield Group and senior vice president, Franklin Templeton Fixed Income Group®, takes a look at the corporate credit/high-yield market and explains why he currently sees supportive fundamentals.

So far in 2014, the corporate credit sectors have generally carried forward the supportive tone that we saw during the back half of 2013, a somewhat different trend line with respect to the broad equity markets and even the interest-rate markets generally.

Although high-yield corporate bonds did see some short-lived pricing pressure during the second quarter of last year, overall, 2013 was a period of spread tightening for high-yield and high-grade corporates, as well as for leveraged loans.

Certainly, the robust performance of the equity markets last year did provide comfort for many credit investors in regard to the fundamental health of corporate issuers. In addition, the floating-rate loan asset class experienced positive inflows every single week during 2013, and that has continued into 2014 and supported loan demand throughout periods of market volatility.[1] The floating-rate debt market consists of below-investment-grade credit-quality loans that are arranged by banks and other financial institutions to help companies finance acquisitions, recapitalizations or other highly leveraged transactions. These are also called “leveraged loans” or “bank loans.” Although leveraged loans are considered below investment grade in credit quality, typically their senior and secured status can provide investors and lenders with a degree of potential credit risk protection.

A Focus on Fundamentals

Even with equity markets moving a bit lower early in 2014 and some risk aversion seeping into financial markets, the corporate credit sectors were still able to post positive returns in January, supported by still-healthy fundamentals.

Focusing on the fundamental backdrop, although we think corporate profit margins may have peaked, overall, both sales top line and earnings did gain this past year. Even with weakness in select emerging markets, the strength in the US economy, combined with the stabilization in the eurozone, helped to support corporate profitability.

As expected, we have continued to see a growing emphasis on shareholder returns in the form of rising dividends, stock buybacks, and some merger and acquisition (M&A) activity. However, given the lingering memories of the financial crisis of 2007–2009, many senior management teams and boards have maintained a greater level of balance sheet conservatism and liquidity than they typically would have this far into an economic recovery.

Moreover, companies have been able to refinance a significant portion of their debt over the past several years with longer-maturity and lower-cost obligations. Consequently, while the quality and covenant protections for new corporate issues have become more aggressive of late, this favorable fundamental backdrop has led to default rates well below historical averages.[2]

Importantly, as we look forward into 2014, we see relatively few large issuers that appear at risk for default, which should help to support both the high-yield and bank loan credit fundamentals as we head through the balance of the year.

Given the focus on US interest rates during 2013, it’s important again to revisit the correlation or relationship between Treasury yields and the corporate credit markets. In general, if Treasury yields are rising as a result of a healthy or at least an improving economic situation, that tends to translate into supportive fundamental credit outlooks.

Consequently, you’ll often see corporate credit spreads (compared to Treasuries and LIBOR, the rate at which banks can borrow funds from other banks in the London interbank market) narrow in a period of rising rates as investors assess a lower underlying credit risk to their corporate investments. In addition, while many loans do have interest-rate floors,

the longer-term floating-rate nature of the asset class can provide better protection from a potential further rise in long rates. In the second quarter of last year there was a short period of high-yield spread widening, but we attribute much of that to temporary high-yield outflows.

We believe macro headlines and technical supply and demand factors may cause periods of volatility in the corporate credit markets this year. However, to the extent the fundamental outlook remains supportive and default rates remain anchored, we maintain a positive stance toward corporate credit, particularly high-yield corporates and leveraged bank loans, albeit with a more tempered total return outlook given current yields.

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1. Source: S&P Capital IQ Leveraged Commentary & Data, January 2014.

2. Source: Moody's, January 2014.

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