CIO View

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Marketing material

Despite recent volatility, corporate bonds are likely to continue benefiting from solid demand

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IN A NUTSHELL

– For the past one and a half years, the spreads of investment-grade corporate bonds have been narrowing, and even the recent volatility triggered by the political situation in France should calm down in the foreseeable future.
– While the already tight spreads relative to government bonds already make the market segment appear expensive, the high yields contribute to its ongoing attractiveness.
– More favorable financing conditions in euros have led to a resurgence of so-called "Reverse Yankees".

Positive sentiment helps corporate bonds to deliver solid performance

Since the beginning of 2023 the investment-grade corporate bond segment on both sides of the Atlantic has been in very good shape. Spreads are now back at significantly lower levels, even though the nervousness surrounding the French elections recently initiated a small countermove. However, in our view, the downtrend does not appear to be permanently broken. Even the high volume of new issuance does not seem to be affecting the solidity of the market. In terms of yields, corporate bonds are still quite attractive. We expect that investors will refocus on the strong fundamentals once the recent volatility subsides, and the market will return to its solid path.

1 / Mostly stable spread development on both sides of the Atlantic

1.1 The entire investment grade segment looks very solid

Corporate bonds are debt securities issued by companies to raise funds in the capital markets. This distinguishes them from loans from financial institutions. Investment grade bonds, the only bonds considered in this publication, are those with a credit rating of BBB or higher, meaning that they are rated as solid by the rating agencies. For investors, corporate bonds are just one of many classes of bonds, but they have very specific characteristics and a number of influencing factors that affect their price or yield performance. Some of these factors are market specific. Corporate performance or rating agency assessments play an important role.

For investors, the main advantages of corporate bonds are higher yields compared to government bonds due to the increased risk premium – but with (usually) lower volatility and risk compared to equities. However, in general, there is also an increased risk of default compared to government bonds or of delayed or reduced payments of interest and principal. Risk and return in corporate bonds is typically primarily influenced by the creditworthiness of the issuer, usually expressed by a rating which is based on, among other things, financial strength and business prospects. Of course, the general market environment also affects the yield of corporate bonds. Monetary policy decisions, for example, are highly relevant.

Looking at the evolution of corporate bond spreads in recent months, we believe that the trend towards tighter levels reflects the fact that this segment of the market currently looks very solid despite the negative market developments and high volume of new issues since the beginning of the year. Potential disruptive factors are being almost completely ignored, even though the nervousness induced by France recently led to slight spread widening. This, in our view, is because investors seem convinced that no emerging potentially negative factor is capable of disrupting the current picture: The risk of recession is gradually being priced out, while at the same time falling interest rates still seem to be a given, even if the timing of rate cuts is being pushed further and further out.

Although these two fundamental pillars of the market's assessment are being constantly tested, sentiment remains positive and, in our view, there is little sign of any imminent change. However, spreads are already quite tight, and that is grounds for caution on corporate bonds in general.

1.2 Rising risks and high new issue volumes are not yet problematic

The risk tolerance for geopolitical tensions also appears to be rather high. In our view, this probably reflects the fact that commodity prices have shown relatively little volatility recently in response to the conflicts in Ukraine and the Middle East. Again, there is a real risk that developments which are important for corporate bonds will be overlooked, as the recent very positive performance obscures the market's view.

Looking at the rating development, the environment remains quite solid, both for issuers on this side and across the Atlantic. In the investment-grade sector, we continue to see significantly more rating improvements than downgrades, even though this ratio has slightly deteriorated in recent months. The key metric, equally important for investment-grade bonds (IG), is how many issuers slip from the investment-grade category into the speculative bond segment (high yield) due to a rating downgrade. This metric has been at very low levels for several years now, further indicating the solidity of this segment.

New investment grade issuance has been very strong since the beginning of the year. Except for the records set in 2020, volumes are higher than in previous years. While it remains to be seen whether issuance will maintain these strong levels for the remainder of the year, demand is stable and likely to ensure that no significant slowdown occurs, at least for the foreseeable future. As Bloomberg data shows, new issues have been well received so far this year and have subsequently performed well in the secondary market. Moreover, there has been no significant selling pressure in secondary bonds to make room for the new issues. In some cases, market activity even suggests that the high volumes of new issuance are not sufficient to meet demand. Against this backdrop, spreads are likely to remain well supported.[1]

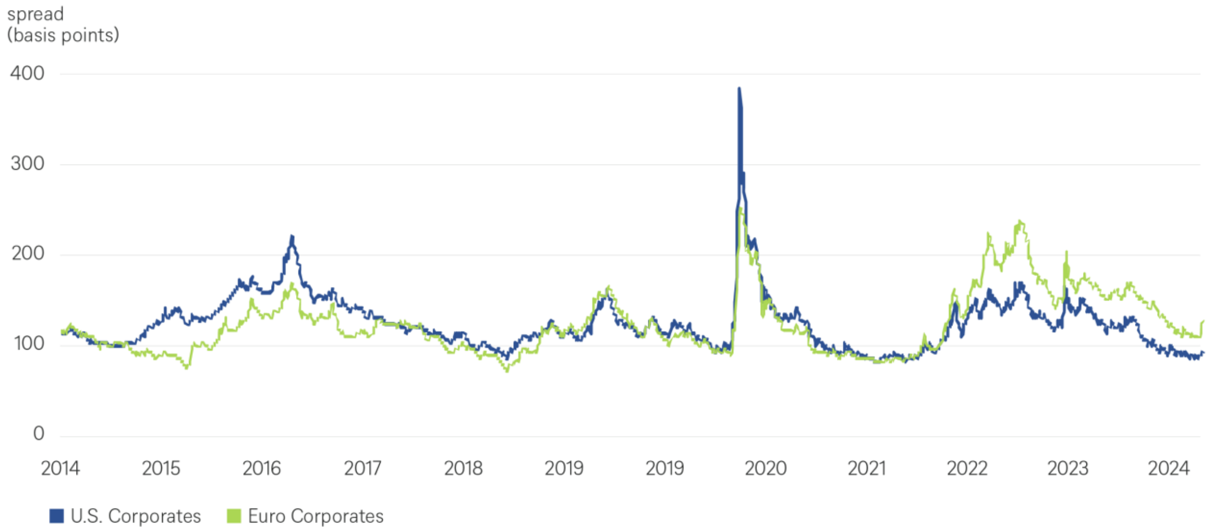
1.3 Spreads appear slightly cheaper after the recent setback, yields remain attractive

Spreads on investment-grade corporate bonds have been impressive in recent months, both in Europe and the U.S. After interim highs in October 2022 and then again in March 2023, the direction is clear and spreads were tightening. The pace of tightening has nevertheless slowed noticeably in recent weeks and due to the situation in France, there has even been a slight setback. However, we still assume that a prolonged trend reversal is not to be feared at this point. Instead, we expect a return of the spreads to their narrowing path once the current market nervousness subsides.

[1] All data – unless otherwise quoted – from Bloomberg L.P. as of 6/17/24

The spread on European corporate bonds is indeed still well above the lows of 2021 and especially 2018, also due to the recent slight widening. Back then, the European Central Bank (ECB) acted as a strong buyer through its corporate bond purchase program, leading to massive spread compression. Against this backdrop, we find the current spread development all the more impressive, as the ECB is no longer a buyer and demand appears to be much broader-based and, above all, sustainable. On the other side of the Atlantic, the spread lows of 2021 and 2018 have already been reached, but this is not yet detracting from the positive sentiment.

Yield differential to government bonds considerably lower now for U.S. corporates ...

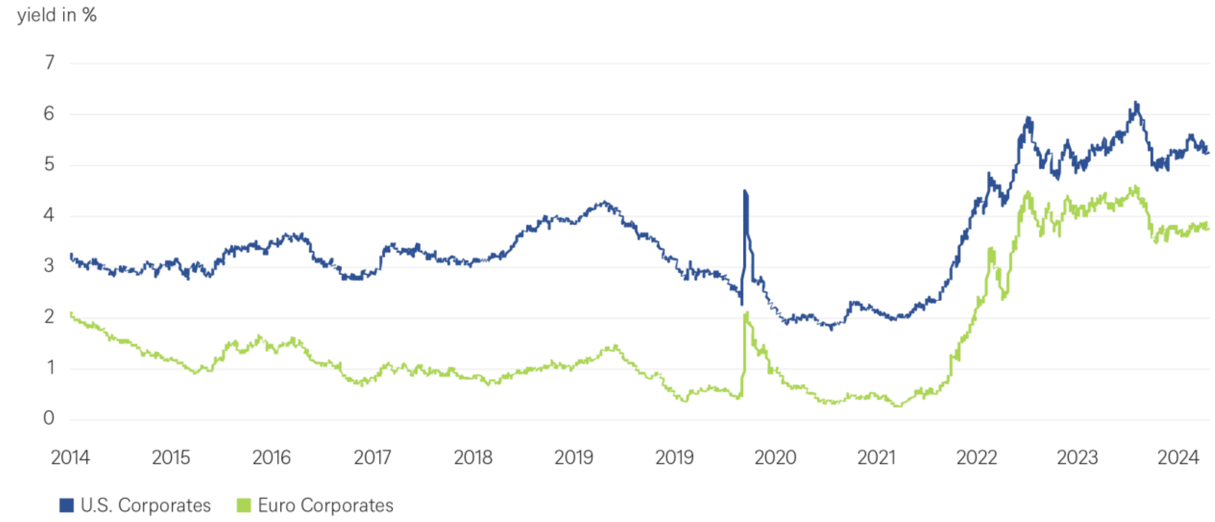


Sources: Bloomberg L.P., DWS Investment GmbH as of 6/17 /24

Particularly worth mentioning is the tightening in spreads since the beginning of the year, with Europe clearly outperforming in the first quarter. The generally good market conditions were mainly driven by falling inflation rates and expectations of a soft economic landing. Volatility seemed to have all but disappeared. European corporate bonds have been in greater demand as it became increasingly clear that the ECB's first rate cut would come before the Federal Reserve's (Fed.) In addition, as mentioned above, there was (and still is) potential for further downside given the historical spread development in Europe.

However, it should also be noted that yields seem to be at still very attractive levels, given that government bond yields have risen significantly since 2022. Particularly in the U.S., yields have tended to rise slightly in recent months on the back of diminishing expectations of Fed rate cuts, while in Germany there has been more of a consolidation. In our view this helps to counteract the rather expensive spreads and means that corporate bonds remain appealing, both in the U.S. and in Europe.

... but yields remain at attractive levels on both sides of the Atlantic



Sources: Bloomberg L.P., DWS Investment GmbH as of 6/17/24

Looking at the individual segments of the corporate bond sector, the spreads of financial companies still show a significant premium, but this has narrowed since the mid of last year. Financials in general, and banks in particular, were hit hard by rising inflation in 2022. Although they began to recover strongly at the end of October 2022, they suffered again in March 2023 after the collapse of Silicon Valley Bank in the U.S. and Credit Suisse. At the moment, we believe that the outlook for financials remains good, especially in light of expected rate cuts and the likely evolution of yields, even though there has naturally been a more pronounced reaction, especially with theses papers in recent days. Continued spread convergence is therefore quite probable in the coming months. We currently prefer financial companies over other corporate bonds, also because banks have been on a positive rating trend for several years now. Nevertheless, further developments in France, especially concerning financial companies, should not be disregarded.

2 / A Renaissance of Reverse Yankees

2.1 A number of U.S. issuers are currently taking advantage of the opportunity to obtain cheaper financing in Euros

Since the beginning of the year one trend in particular stands out: high issuance of so-called Reverse Yankees. These are bonds issued by U.S. companies but are denominated in euros. We believe that the volume of these in 2024 could come close to the record level of 2019. Since the beginning of the year, more Reverse Yankees have been issued than in the entire previous year.

"Yankee Debt" generally refers to dollar-denominated bonds issued by non-U.S. companies. "Reverse Yankees", on the other hand, are bonds issued by U.S. companies denominated in foreign currencies, most often euros. Market conditions are currently favorable for such issues, especially since coupons are much lower in Europe. U.S. companies can borrow euros at very competitive rates and then convert them into dollars using derivatives, rather than borrowing dollars directly. However, this is no longer the primary goal of all issuers of reverse Yankees. Many also have a need for euros, or they exchange them into other currencies, such as the Swiss franc.

One reason for the emergence of Reverse Yankees is the divergence in monetary policy between the U.S. and the Eurozone, although this was also evident in previous years. When the ECB's interest rates were negative it was possible for U.S. companies to issue euro-denominated bonds with very low coupons. Currently, the divergence in monetary policy is resulting in yields on euro-denominated corporate bonds with maturities of 7 to 10 years that are about 1.5% to 2% lower than yields on comparable U.S. dollar-denominated bonds. In addition, yields on U.S. investment-grade corporate bonds have trended higher in recent months as traders have further reduced their expectations for Fed rate cuts. By contrast, euro-denominated corporate bond yields have tended to move sideways as the ECB has cut rates in June, ahead of the Fed. An additional positive are the maturities offered in the Euro area, which provide more flexibility than USD bonds. While in dollar bonds tranches of five, ten, or 30 years are common, in euros maturities of eight, twelve, or 20 years can also be issued.

Euro financing is as favorable for U.S. companies as it has been in a long time (EUR/USD Basis Swap 2Year)

Sources: Bloomberg L.P., DWS Investment GmbH as of 6/17/24

The need for refinancing is also currently driving issuance of Reverse Yankees. As mentioned above, there was a lot of issuance in the years leading up to the coronavirus pandemic. Many of these bonds have already matured or will mature in the coming weeks or months. Many U.S. issuers also want to maintain their Euro financing because it provides them with the opportunity to access an additional and thus even more diverse investor universe. Reverse Yankee debuts have not been as prominent this year, but several U.S. issuers appear to be in the pipeline.

Longer-term considerations are also playing a role. Opening new markets and diversifying the investor base can help sell bonds to investors who do not normally buy dollar-denominated securities. Ultimately, the question is how long the very favorable financing conditions for U.S. companies will last. Fear of missing out on the current opportunity should certainly not be ignored when looking at some issuers.

3 / Summary and outlook

Investment grade corporate bonds already seem to be expensive given the relatively tight spreads. – even if the slight countermovement of the past few days has changed the picture a little. Nevertheless, the current environment seems to indicate that despite the short-term volatility triggered by France, a forthcoming prolonged trend reversal is not likely to be on the agenda. The sector is showing resilience against almost all the negative factors that might have led spreads to widen in the recent past, such as geopolitical tensions or the very high volume of new issuance. In addition, yields are still at very attractive levels, so we expect demand to remain buoyant, when the current volatility has calmed down.

In the coming months, however, we expect the narrowing of corporate bond spreads in the U.S. and Europe to slow or consolidate. Declining interest rates volatilities on both sides of the Atlantic also suggest that at least in the foreseeable future, no significant countermove needs to be feared. Instead, spreads are likely to remain at the achieved low levels for even longer.

Until the outbreak of the war in Ukraine, euro corporate bond spreads had mostly traded below those of their U.S. counterparts for several years. Since then, the energy crisis, the war, high inflation and low economic growth have all had a noticeable impact on the euro markets and led to a deterioration in spreads. However, the outperformance of U.S. corporate bonds relative to European corporate bonds may be set to slow; the fundamentals of U.S. corporate bonds no longer appear necessarily better than those of Europe. In our view, the combination of these factors should lead euro bonds to outperform their U.S. counterparts in the coming weeks and months, after the recent nervousness has calmed down, generating a further narrowing of the spread differential. Against this backdrop, the environment for Reverse Yankee issues remains attractive.

Glossary

One basis point equals 1/100 of a percentage point.

Basis swap is an agreement between two parties to swap variable interest rates based on different money market reference rates.

Coupons are interest rate payments made on a bond.

The European Central Bank (ECB) is the central bank for the Eurozone.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Federal Reserve Bank is a regional bank of the Federal Reserve System, the central banking system of the United States. There are twelve in total.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

A rating is a standardized assessment of the creditworthiness of the issuer and its debt instruments by specialized agencies. The main three rating agencies are the Moody's (Aaa over Baa1 to C, best to worst) , S&P (AAA over BBB+ to D, best to worst) and Fitch (AAA over BBB+ to D, best to worst).

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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