Global High Income

Mine the gap: Exploring crossover credit

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Global High Income
Executive summary

Introduction

In the current environment, with government bond yields at historic lows and negative interest rates in Europe and Japan, investors looking for yield have to move down the credit spectrum. However, recent market events such as the UK Brexit vote and cuts in economic growth forecasts have caused many investors to turn to safe haven assets.

We believe that investors seeking yield without venturing into a pure high yield allocation should consider the BBB-BB crossover space which can offer attractive risk-adjusted return potential.

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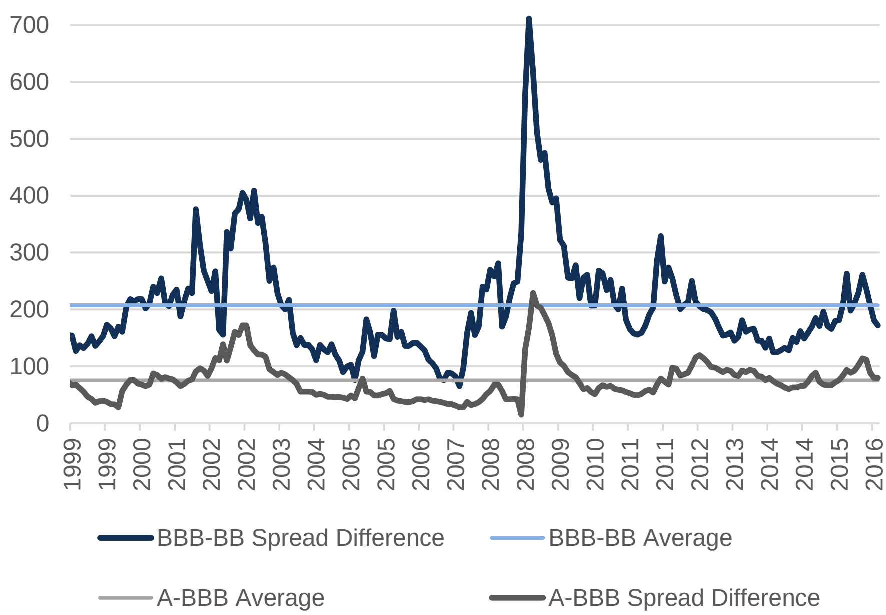
What are crossover bonds?

Crossover credit: the intersection of high yield and investment grade bonds

The corporate credit sector is divided into two broad rating categories: Investment Grade (IG) bonds rated BBB- and above, and High Yield (HY) bonds rated BB+ and below. Corporate bonds that span the BBB to BB rated space are referred to as crossover bonds. As these bonds “crossover” from the high yield to the investment grade space, or vice versa, asset managers can find opportunities due to mispriced risk or forced selling in the market.

As shown in Figure 1, the historical average spread differential between BBB and BB corporates is 208 bps compared to 75 bps between A and BBB corporates. The excess133 bps represents an opportunity for active managers to take advantage of market inefficiencies.

Figure 1: Asset class risk/return comparison (over 15 years)



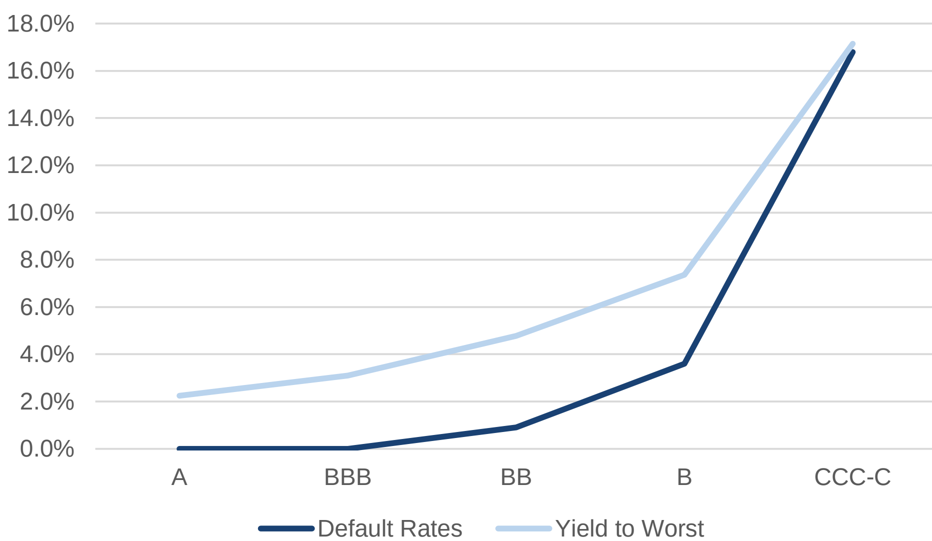
Source: HSBC and BofA ML Bloomberg. Data as of May 31, 2016.

Why consider the crossover space?

The high yield premium vs. credit risk

Corporate bond investors demand compensation in the form of yield in order to take on additional credit risk, which is the risk that an issuer will not be able to meet its loan obligations which, in turn, results in a loss of principal and/or interest. As seen in Figure 2, both yields and average default rates increase as average credit quality decreases.

Figure 2



Rating	Default rates	Yield to Worst	Differential	Change in Differential
A	0.0%	2.24%	2.24%	----
BBB	0.0%	3.10%	3.10%	0.86%
BB	0.9%	4.78%	3.88%	0.78%
B	3.6%	7.37%	3.77%	-0.11%
CCC-C	16.8%	17.14%	0.34%	-3.43%

Source: Moody's Investor Services, BofA ML Bloomberg. Yields as of May 31, 2016. Dollar-Weighted Bond Default Rates as of May 31, 2016

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Why consider the crossover space?

For global corporate bonds rated BBB, the 12-month trailing default rate is close to 0% with a yield-to-worst of 3.1%. Moving to BB rated bonds adds 1.7% in yield, while the average default rate moves by a smaller 0.9%. This relatively larger yield increase versus the default rate can be attributed to the premium investors require to hold high yield bonds over investment grade. By focusing on this BBB-BB space, investors can maintain a higher quality rating while adding relatively higher yield for the level of credit risk.

This additional yield can also be explained in part by the market segmentation that exists between the IG and HY universe. Certain investors in IG are unable to invest in HY due to investment guidelines and restrictions. Therefore, as a credit moves from IG to HY, these investors become forced sellers, which puts technical pressure on the bonds. Many managers are organized the same way with an IG team and a separate HY team. As a result, as credits move between IG and HY, coverage is dropped by one team and must be taken up by the other team. This crossover coverage anomaly is a market inefficiency that can provide an opportunity for a manager that continuously covers the credit regardless of rating.

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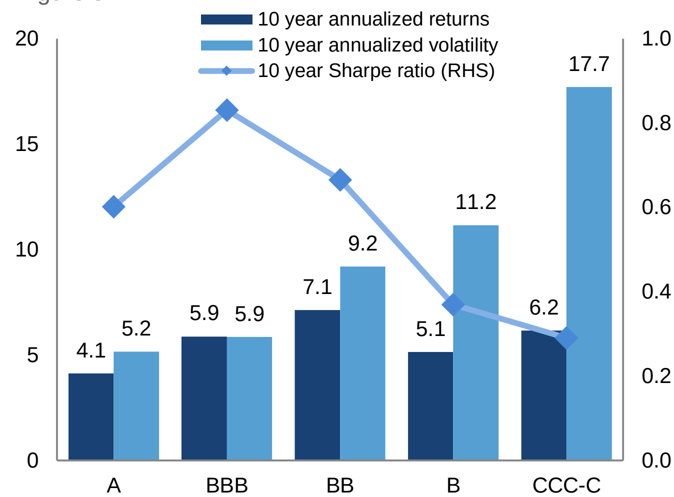
Why consider the crossover space?

Higher Sharpe ratios for BBB and BB

Figure 3 highlights the 10-year annualized return, volatility, and Sharpe ratios for corporate bonds across rating categories. Over this period, BBB and BB rated bonds delivered the strongest risk-adjusted returns in the A to CCC credit spectrum as indicated by their corresponding Sharpe ratios. Additionally BB's delivered the highest absolute returns and displayed less volatility than the B and CCC rated bonds.

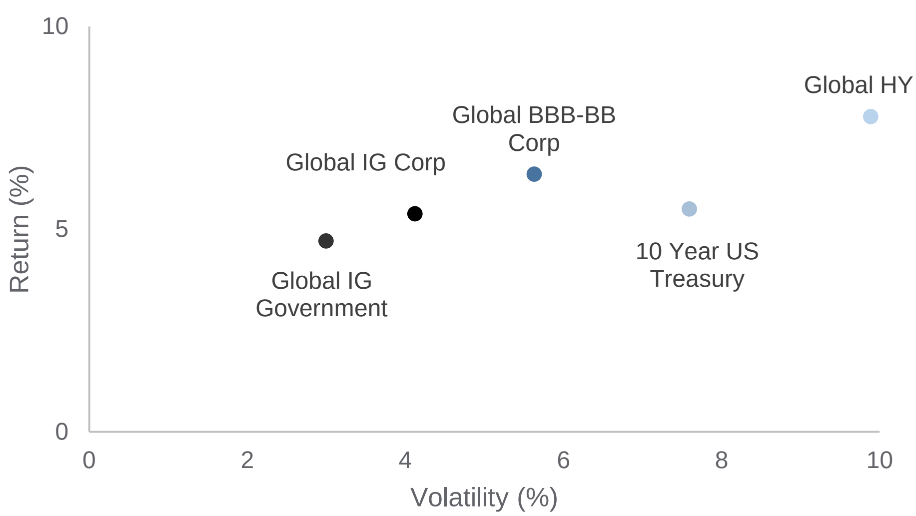
Figure 4 shows that the global crossover space has delivered higher absolute returns than investment grade with significantly less volatility than high yield-only strategies.

Figure 3



Source: HSBC and Bloomberg. Data as of May 31, 2016. Based on monthly observations.

Figure 4: 15-year annualized risk-adjusted returns



Source: HSBC and Bloomberg. Data as of May 31, 2016. Based on monthly observations.

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Adding value to a core fixed income allocation

How crossover bonds can add value to a core fixed income allocation

From an asset allocation perspective within a fixed income portfolio, crossover corporate bonds offer additional yield compensation while maintaining a quality bias within the portfolio. In addition to this benefit, crossover bonds also add value to a portfolio as a fixed income diversifier. Over the last 15 years, crossover bonds have displayed a low correlation to government bonds. As we enter into a lower-for-longer interest rate environment across the globe, this low correlation could make a portfolio less susceptible to surprise rate increases. The higher risk-adjusted returns combined with the low correlation to government bonds can make crossover bonds a valuable part of an investor's asset allocation.

Figure 5: 15-year correlations to global crossover credit

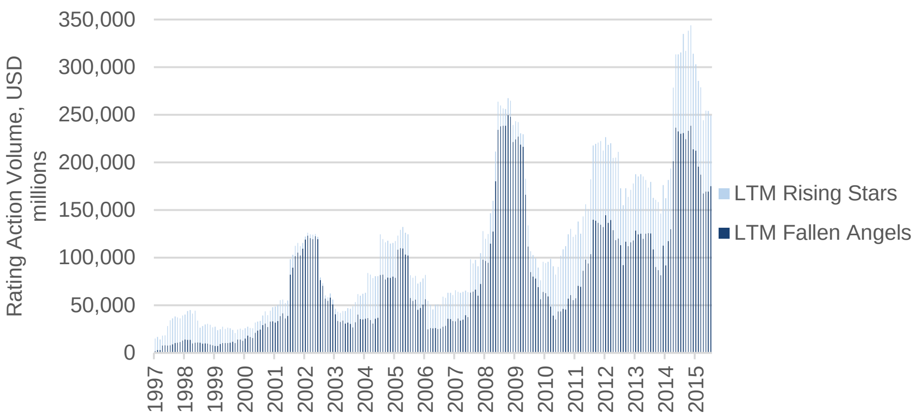
	Global HY	Global BBB-BB Corp	Global IG Corp	Global IG Gov't	US Treasury 10-Year
Global HY	1.00	0.84	0.55	-0.18	-0.21
Global BBB-BB	0.84	1.00	0.85	0.26	0.24
Global IG Corp	0.55	0.85	1.00	0.58	0.53
Global IG Gov't	-0.18	0.26	0.58	1.00	0.91
US Treasury 10-Year	-0.21	0.24	0.53	0.91	1.00

Source: BofA ML Bloomberg. Data as of May 31, 2016. Based on monthly observations.

Fallen angels and rising stars

Fallen angels refer to bonds that have been downgraded from IG to HY, while rising stars refer to bonds that have been upgraded from HY to IG. Rising stars may be fallen angels or HY issuers with improving credit metrics and fundamentals. Figure 6 shows that there has been an increase in ratings action volumes for both rising stars and fallen angels over the period 1997 to 2016, representing an increase in opportunities in the crossover space.

Figure 6



Source: BofA ML. Data as of May 31, 2016.

Generally speaking, a fallen angel is a bond issued by a good quality IG company that has experienced some form of short-term stress. During the period between an initial ratings agency downgrade and when the bond actually enters the HY universe, the fallen angel will experience the majority of its price depreciation—largely due to forced selling by investors with IG investment restrictions. Therefore, once the bond actually trades in the HY universe, the downgrade is already fully priced in. On entrance to the HY universe, many fallen angels undertake actions to deleverage their balance sheets in an attempt to regain IG status. These actions are generally reflected in some price improvement as the bond trades in HY.

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Global crossover in action

HSBC's approach to global crossover credit

The market impact of a potential upgrade or downgrade for crossover bonds is potentially larger than for bonds in other ratings categories due to the practical divide separating IG from HY. For this reason, crossover bonds require in-depth credit research and active management. We believe that the market for BBB-BB rated bonds is inefficient in itself, as technical factors and market overreactions often lead to the mispricing of these bonds as they migrate from one rating category to another.

HSBC Global Asset Management's global credit team manages more than $7 billion in global credit strategies using a local sleeve approach: here, local credit managers each specialize regionally in US, Europe or EM, and cover BBB and BB rated corporate bonds and structured credit. The use of local market expertise is critical for properly evaluating and monitoring credits in the crossover universe. A key characteristic of this universe pertains to the credit rating changes that can have a proportionally larger impact on a bond than in other parts of the credit spectrum. HSBC's extensive global credit research platform with 40+ analysts is not organized by credit rating but by industries across developed and emerging markets. Within their industries, our research analysts follow companies across the ratings spectrum from investment grade to high yield. This approach bolsters our wider industry perspective and provides for continuity of research coverage as companies move between ratings categories.

This enables our managers to avoid the issuers with deteriorating credit profiles and identify credits with stable or improving fundamentals that are undervalued in the market. We believe this risk-aware approach is integral to a successful crossover strategy.

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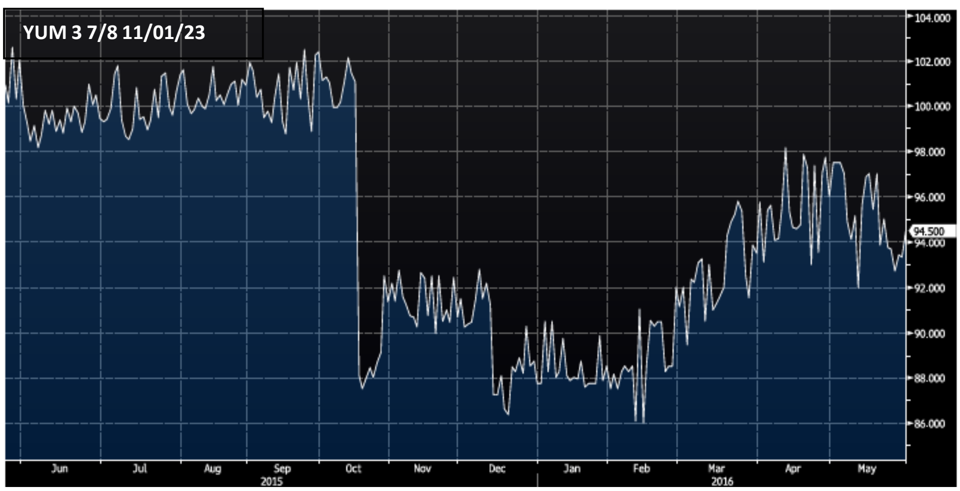
Appendix 1
Example – Opportunities in crossover credit

Figure 7 below shows the sharp decline in a bond's price resulting from a rating agency downgrade from investment grade to high yield. Prior to the downgrade, the bond was trading close par value, but on October 20, when Moody's downgraded the bond from Baa3 to Ba1, the price declined 12.8% as many IG only portfolios were forced to sell the bond. We see a pick-up in price in the following weeks as the bond entered high yield benchmarks. Despite subsequent rating downgrades, the bond price has risen 7.2% from October 20 to May 31. The 12.8% decline exceeds the subsequent 7.2% increase, pointing to the higher importance of avoiding fallen angel candidates over finding the rising stars. The best opportunities in crossover credit lie in strategies that target stable to improving credits within the BB space while avoiding deteriorating credits in the BBB space.

Figure 7



Source: Bloomberg. Data as of May 31, 2016.