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Time for credit – why we like investment grade

To better understand the impact of potential macroeconomic scenarios on the asset class, we have undertaken a sensitivity analysis of the global investment grade corporate bond market. This sensitivity analysis points to one clear implication: the importance of investing in fixed income despite ongoing uncertainty. We believe fixed income, in particular credit markets, have become a much more attractive proposition for investors.

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Despite interest rates being hiked to their highest level since the mid-2000s and a mini crisis in the US banking sector, the US and other developed market economies remain in relatively robust health, supported by a resilient consumer. A recession has so far been avoided, but the risk of one occurring has not gone away. For the US, the most likely scenarios are now either a soft landing in which recession is avoided but inflation remains above the 2% target, or the economy enters a recession and disinflation accelerates, providing the US Federal Reserve (Fed) with space to pivot.

Fixed income is well placed for this environment, with bonds poised to provide solid returns in most of the expected scenarios. We believe that the combination of high quality income and duration available within IG credit makes it the best area of the market to capture the opportunities now available. Although credit spreads for IG credit have tightened in recent months, dispersion has also increased. For active managers, this is a welcome development that increases the potential investment opportunities available.

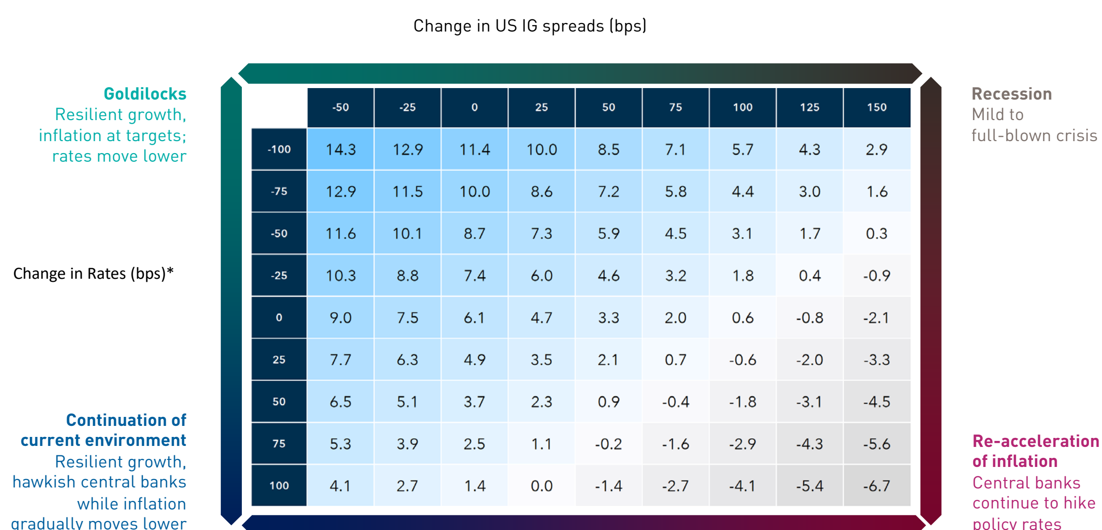
To better understand the impact of the potential macroeconomic scenarios on the asset class, we have undertaken a sensitivity analysis of the global investment grade corporate bond market.

Four scenarios have been built that we think best capture the most realistic paths of the underlying variables:

1. **Goldilocks.** This is the scenario central banks are trying to engineer where growth remains resilient while inflation eases and reaches the 2% target enabling central banks to cut interest rates.
2. **Recession.** We look at a range of recession scenarios from a mild to full blown crisis.
3. **Continuation of current environment.** In this scenario, growth remains resilient, but inflation remains stickier and central banks continue to hold rates higher for longer to reduce inflation and continued pressure on yields.
4. **Reacceleration of inflation.** We consider the impact of an increase in inflation that leads to central banks continuing to hike rates, bring yields higher and a significant widening of credit spreads.

How Global IG could fare under various scenarios

Hypothetical global IG credit returns (%) across rate and spread scenarios including 1-year carry



Rates \ Spreads	-50	-25	0	25	50	75	100	125	150
-100	14.3	12.9	11.4	10.0	8.5	7.1	5.7	4.3	2.9
-75	12.9	11.5	10.0	8.6	7.2	5.8	4.4	3.0	1.6
-50	11.6	10.1	8.7	7.3	5.9	4.5	3.1	1.7	0.3
-25	10.3	8.8	7.4	6.0	4.6	3.2	1.8	0.4	-0.9
0	9.0	7.5	6.1	4.7	3.3	2.0	0.6	-0.8	-2.1
25	7.7	6.3	4.9	3.5	2.1	0.7	-0.6	-2.0	-3.3
50	6.5	5.1	3.7	2.3	0.9	-0.4	-1.8	-3.1	-4.5
75	5.3	3.9	2.5	1.1	-0.2	-1.6	-2.9	-4.3	-5.6
100	4.1	2.7	1.4	0.0	-1.4	-2.7	-4.1	-5.4	-6.7

Hypothetical returns shown for illustrative purposes only and are not a guarantee of future returns. Data shown is based on Bloomberg Global Aggregate – Corporates (USD hedged) Index. Proxied by US 10-year treasuries. Period of analysis: Past 5 years from 6th October 2023. Source: BlackRock Aladdin

There are some important takeaways we can learn from this simulation.

Investment grade (IG) credit is well placed to provide positive returns over one year given the most likely macroeconomic scenarios. In a mild recession scenario, returns are positive. Even under a severe recession, results could still be positive if rates were to fall. This reflects two important characteristics of the asset class. First, the positive duration impact of falling interest rates and second, the higher level of starting yield that IG credit now offers which helps cushion against periods of price volatility.

A continuation of the current environment in which central banks keep rates higher for longer also generally leads to positive returns. This is again a result of the high level of carry, which is able to absorb both the spread and rate volatility.

Under a Goldilocks scenario, the asset class benefits from both the high carry and the duration tailwind from falling rates.

High starting level of yields help reduce losses even under the most bearish of outcomes. The only scenario where results are expected to be negative is in an environment where both rates and credit spreads increase significantly, which could happen if inflation accelerates. Even in the most extreme of scenarios tested, where rates rise 100bps and spreads widen by 150bps, the negative outcomes are anticipated to be less severe than those incurred during 2022. This is because of the healthy buffer offered by higher starting yields today.

Overall, this sensitivity analysis points to one clear implication: the importance of investing in fixed income despite ongoing uncertainty. We believe fixed income markets have become a much more attractive proposition for investors. Credit markets in particular now offer sufficient carry to offset periods of potential volatility.

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