Credit spreads: not as tight as they seem

Credit risk measures in an environment of declining bonds prices

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We recently explained in our thought leadership paper "Why convexity matters" how low bond prices impact interest rate risk. Over the past year and a half many fixed income investors have experienced steep price declines in their bond portfolios. We have argued that it is not only duration that explains the interest risk of a portfolio, but that convexity needs to be accounted for as well. In this paper we point out that credit risk measures also have to be adjusted in an environment of declining bond prices.

Credit risk is measured by comparing the yield of a corporate bond with a risk-free investment. The difference is called the "credit spread". In our thought leadership paper "Credit spread explained: The devil is in the details" we highlighted how to accurately calculate the credit spread.

If an investor compares bonds from the same issuer with a similar maturity but with different coupons and therefore different cash prices and credit spreads, the bond with the lower cash price will have a lower coupon and a lower spread. BofA recently published a research paper[1] highlighting an historical as well as theoretical 0.6 basis point (bps) spread impact per bond price of US dollar (USD) 1. The historical impact was measured by observing how the "off the run" spread discount[2] fluctuates with bond prices; the theoretical bond price was established with the help of the CDS market. Bonds with lower cash prices will trade on a lower spread because it will have a higher recovery in case of a default as the recovery is based on the bond's notional price and not its coupon. The latter (the coupon) will be set to zero when a company defaults while the former will benefit from the recovery rate. For example, if a bond gets bought at a cash price of 80 cents and later defaults with a recovery rate of 40%, the investor will lose 40 cents. In contrast, an investor who paid 100 cents will face a loss of 60 cents.

In order to calculate the theoretical spread difference of a sub-par bond, it can be assumed that the recovery of a bond trading at par will be similar to a bond trading at 80 in combination with a long risk position in CDS (selling protection). To derive the nominal amount of the CDS position, an iteration is used to match the pay-out of the par bond in case of a default. The extra cash earned from the CDS position, expressed in basis points, will define the spread difference between a par bond and a discounted bond.

[1] BofA Global Research, Credit Market Strategist, Price Fall, 06.05.2022

[2] "Off the run" spread discount is the spread difference between the latest bond issue by a company and its previously issued bonds.

Nevertheless, over the last 10 years, default losses in the investment grade universe have not been more than 12 bps annualised, according to BofA's research. This implies that the additional spread offered by higher cash price bonds is overcompensating investors and therefore could be viewed as a buy opportunity. However, part of the higher spread could be seen as compensation for the liquidity disadvantage "off the run" high cash price bonds often have.

Regardless of the composition of the spread difference, we believe that it is important for investors to adjust spreads before they consider the richness or cheapness of the investment grade credit market. Spreads currently might look tight but after the adjustment, spreads will likely be wider than the headline figure suggests. At the end of September, US investment grade bonds traded with a spread of 127 bps over US Treasuries and an average price of USD 87.3. Adjusting for the difference between par and USD 87.3, based on the data from BofA, leads to a spread adjustment of approximately 7.6 bps. Therefore, the current spread is closer to 135 bps than 127 bps and more attractive than investors initially might think.

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