Morningstar Corporate Credit Research Highlights

Corporate Bond Markets Soften in Sympathy With Surging Volatility

Morningstar Credit Ratings, LLC
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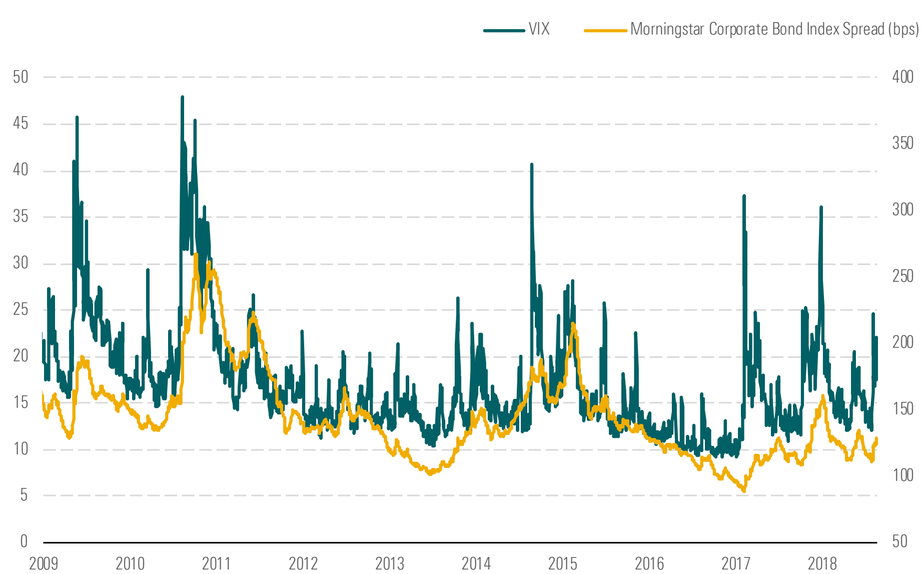
Credit Market Insights

Corporate Bond Markets Soften in Sympathy With Surging Volatility

Volatility refused to subside last week as asset markets were whipped around by a barrage of headlines regarding the U.S.-China trade dispute. In the equity market, in four out of five days last week, the S&P 500 either fell or surged well over 1% per day, with the greatest swing occurring Wednesday, when stocks fell almost 3%. It was a similar story in the bond market as interest rates swung 5-10 basis points per day depending on investor sentiment as to whether the trade war was cooling off or heating up. Even the measurement of volatility was volatile. As measured by the CBOE's Volatility Index, the volatility of the S&P 500 traded between 17.8 and 23, depending on which way the market was headed at any one point. Corporate bond traders were whipsawed as they tried to keep up with the amount that credit spreads were either widening out or gapping in based on the swings across the equity markets and underlying interest rates.

Over the past 20 years, the movement in investment-grade credit spreads has had an 85% correlation with equity volatility as measured by the VIX; however, over the past six months, the correlation has dropped to only 40%. In an environment in which volatility stays elevated and the market reverts toward its historical correlation, the current gap between corporate credit spreads and volatility could condense.

VIX vs. Morningstar Corporate Bond Index Spread



Source: Morningstar, Inc., CBOE Volatility Index.. Data as of 8/16/2019.

The corporate bond market tried to end the week on a more positive tone Friday, but after widening most of the week, credit spreads were unable to recoup much of their losses. On a week-over-week basis, in the investment-grade market, the average spread of the Morningstar Corporate Bond Index widened 5 basis points to +128. In the high-yield market, as measured by the ICE BofAML High Yield Master II Index, credit spreads widened 16 basis points to an average credit spread of +447.

Corporate Bond Credit Spreads

Source: Morningstar, Inc., ICE BofAML Global Indexes. Data as of 8/16/2019.

10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity

In mid-2018, while the yield curve was on a multiyear flattening trend and looked like it was going to invert, we noted that it may not have as high a predictive power to indicate a near-term recession as it had in the past. Although the Federal Reserve made a modest attempt at tightening monetary policy with a few rate hikes in the United States, most global central banks have kept their monetary policy extremely loose for the past decade. For example, the European Central Bank lowered its short-term rate to a negative yield (unheard of before the global financial crisis), and its deposit rate remains at a yield of negative 0.40%. Both the Bank of Japan and Swiss National Bank are managing their monetary policy to bolster their respective economies. The Swiss 10-year bond is trading at a historical low of negative 1.10%, and the Japanese 10-year bond is trading at negative 0.23%, only a few basis points above its all-time most negative yield.

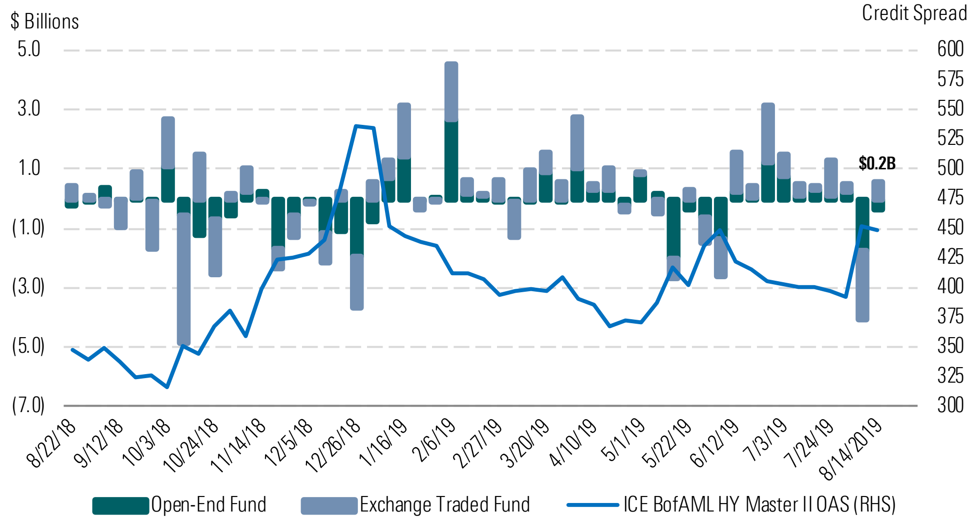
Although interest rates in the U.S. may appear low to U.S. investors, yields remain positive, which is attractive to global investors suffering with negative yields. Investors continued to bid up sovereign bond prices, which in many cases sent their bond yields further into negative territory. According to Bloomberg, over $15 trillion worth of bonds are currently trading at a negative yield. For example, in the middle of last week, the yields on German 5- and 10-year bonds dropped to negative 0.90% and negative 0.70%, their historically most negative yields. These bonds do not pay any interest (they are zero-coupon bonds), and at their current yields, they are priced at 104¾ and 107¼, respectively. Investors in these bonds have to pay an up-front premium, will receive no interest over the life of the bonds, and will only get par back when the bonds mature. The premiums paid today will evaporate to zero over time. What this means is that if investors buy these bonds today and hold them until maturity, they will lock in a 4.75% and 7.25% lifetime loss until the bonds mature. The only way for an investor to generate a positive return would be to sell the bonds to another investor who is willing to pay an even higher price and lock in an even greater loss. Between weakening economic growth in the European Union and the heightened potential for a no-deal Brexit, investors expect that the ECB will pursue even more extreme monetary policies later this year in an attempt to bolster EU economies.

High-Yield Fund Flows Turn Positive After Prior Week's Rout

Retail investors continued to pull money out of the high-yield asset class last week, but institutional investors dipped their toes back into the water after the prior week's rout. In total, there were $0.2 billion of net inflows into the high-yield asset class, consisting of $0.4 billion of withdrawals from open-end mutual funds, which were more than offset by $0.6 billion of net new unit creation across high-yield exchange-traded funds. Historically, open-end funds have been considered a proxy for retail investor demand, whereas ETFs have been considered more of an indicator of institutional fund flows.

Year-to-date inflows into the high-yield asset class total a solid $14.7 billion, consisting of $10.7 billion worth of net unit creation among high-yield ETFs and $4.0 billion of inflows across high-yield open-end mutual funds.

Estimated Weekly High-Yield Bond Fund Flows and High-Yield Credit Spreads



Source: Morningstar, Inc. and ICE BofAML Global Indexes.

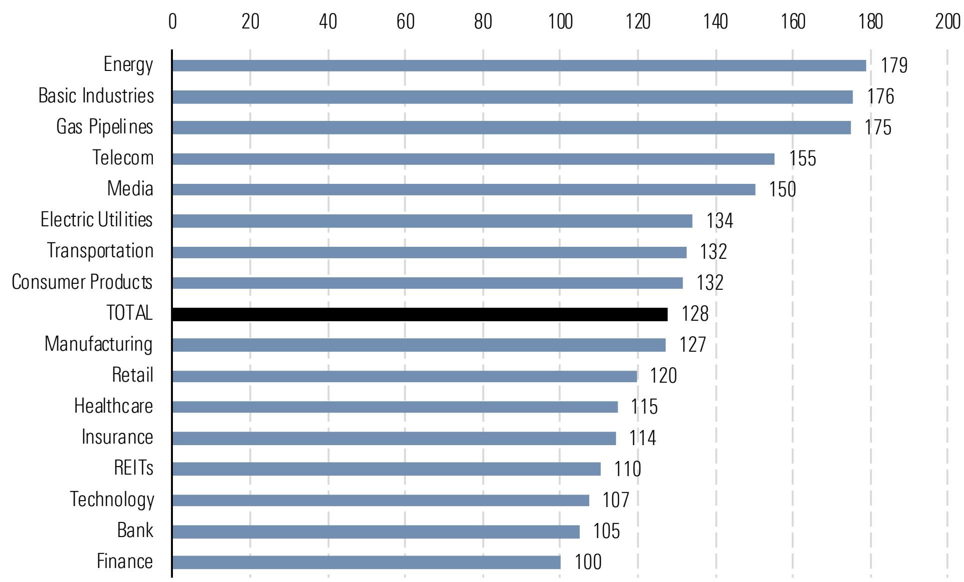
Exhibit 1 Morningstar Corporate Bond Index Sector Summary

Sector	Average Rating	Number of Issues	Modified Duration	Spread (bps)	MTD Spread Chg (bps)	YTD Spread Chg (bps)	MTD Total Return (%)	YTD Total Return (%)
TOTAL	**A-**	**5,303**	**7.4**	**128**	**16**	**(29)**	**2.36**	**12.85**
FINANCIAL	**A-**	**1,463**	**5.5**	**105**	**12**	**(36)**	**1.91**	**10.65**
Bank	A-	869	4.9	105	12	(38)	1.64	9.95
Finance	A-	252	5.3	100	11	(35)	1.81	10.21
Insurance	A	233	8.9	114	13	(24)	3.12	14.48
REITs	BBB+	100	6.2	110	11	(38)	2.32	11.78
INDUSTRIAL	**A-**	**3,116**	**8.0**	**136**	**18**	**(26)**	**2.54**	**13.76**
Basic Industries	BBB	271	7.8	176	21	(23)	2.18	13.72
Consumer Products	BBB+	340	8.3	132	16	(28)	2.70	15.21
Energy	A-	389	7.7	179	21	(17)	1.94	12.82
Healthcare	A-	446	8.3	115	15	(21)	2.94	13.28
Manufacturing	A-	488	6.4	127	20	(34)	1.77	11.76
Media	BBB+	177	9.3	150	18	(28)	3.09	16.23
Retail	A-	209	8.4	120	15	(24)	2.87	13.30
Technology	A	371	7.6	107	14	(20)	2.57	12.56
Telecom	BBB+	157	10.0	155	19	(36)	3.28	18.31
Transportation	BBB+	195	9.2	132	18	(24)	2.91	14.67
UTILITY	**BBB+**	**665**	**9.1**	**152**	**20**	**(33)**	**2.74**	**14.97**
Electric Utilities	A-	370	9.9	134	17	(36)	3.41	15.75
Gas Pipelines	BBB	275	8.0	175	25	(33)	1.84	14.05
Rating Bucket								
AAA Bucket		127	7.8	50	6	(9)	3.15	11.04
AA Bucket		493	6.4	68	9	(18)	2.30	9.85
A Bucket		1,954	7.4	98	13	(26)	2.58	12.10
BBB Bucket		2,729	7.5	166	20	(37)	2.15	14.10
Term Bucket								
1-4	A-	1,737	2.2	75	10	(26)	0.74	5.05
4-7	A-	1,212	4.7	113	15	(41)	1.44	10.13
7-10	BBB+	852	7.0	141	17	(39)	2.17	14.03
10PLUS	A-	1,502	14.3	182	20	(27)	4.72	23.02

Data as of 08/16/2019

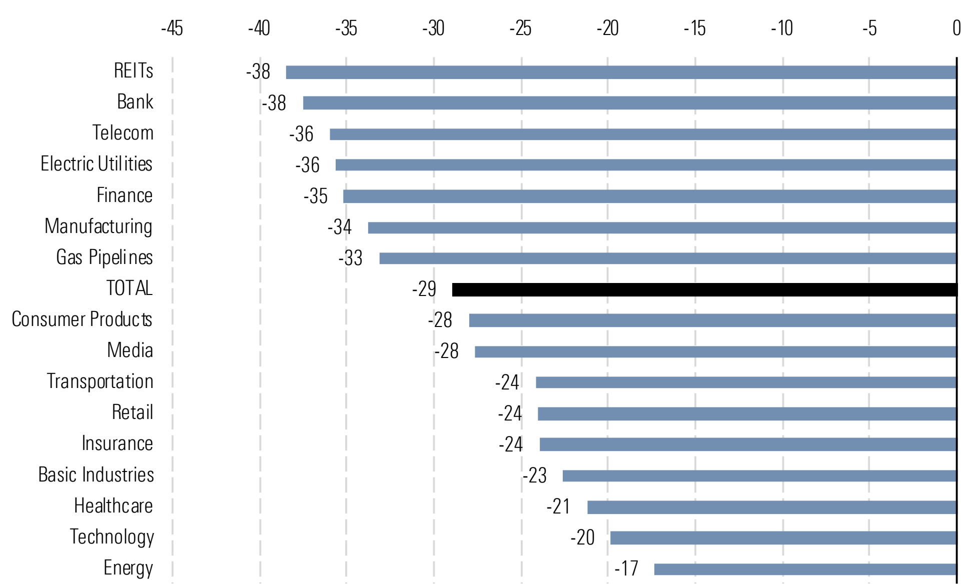
Source: Morningstar, Inc.

Exhibit 2 Morningstar Corporate Bond Index Spread by Sector



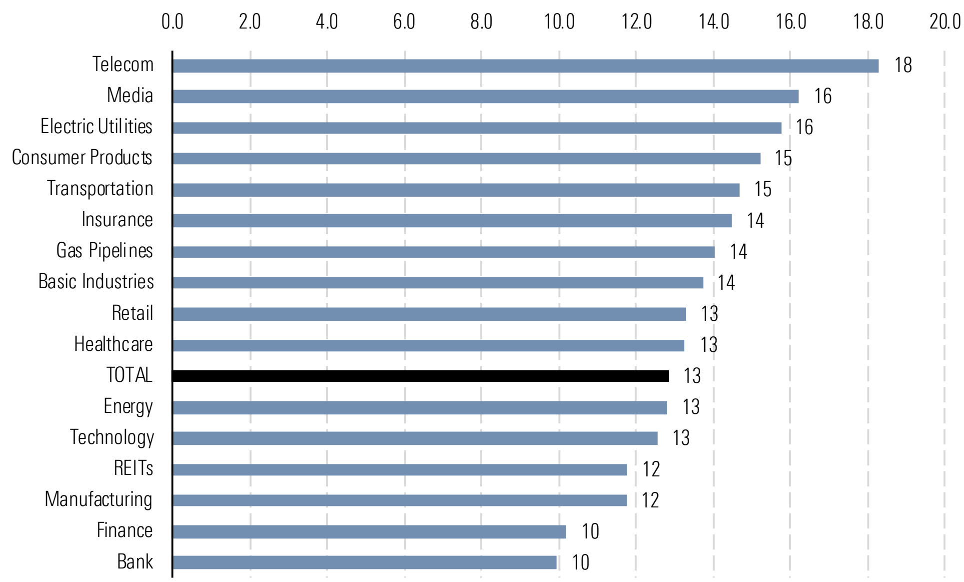
Source: Morningstar, Inc.

Exhibit 3 Morningstar Corporate Bond Index YTD Spread Change



Source: Morningstar, Inc.

Exhibit 4 Morningstar Corporate Bond Index YTD Return



Source: Morningstar, Inc.

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