BENCHMARK RISK AND PORTFOLIO IMMUNIZATION CONSIDERATIONS DURING A GLOBAL PANDEMIC

December 2020

Markets are increasingly ebullient on the reported efficacy of several vaccines and the potential for the COVID pandemic to be brought under control in 2021. Despite on-going histrionics, investor appetites were whetted as markets look past the contentious election to a more hopeful outlook supported by continued monetary policy support and the potential for additional fiscal stimulus. While Americans gathered for a non-traditional Thanksgiving feast, market participants gorged on risk assets over the course of November. The Bloomberg Barclays Credit Index produced over 200bps of excess return during the month with the index Option-Adjusted Spread (OAS) tightening by 19bps to 100bps. Lower quality outperformed, with BBBs besting higher quality investment grade sectors by over 100bps; high yield excess returns approached 400bps.

We share the markets' growing optimism for a normalization of economic conditions next year. However, we have near-term concerns not just with current developments in the course of the pandemic but, more importantly, the continued evolution of risk characteristics in the corporate credit market that heightens risk/return asymmetry. With more scarce sources of alpha, we believe investors will be rewarded by considering more defensive portfolio risk allocations given current market dynamics. While widely covered in the press generally, we feel it is prudent to highlight three notable developments in the corporate market.

Yield to Worst

Global yields have been pulled lower over the course of 2020 due to slowing economic growth and extraordinary central bank support; the Bloomberg Barclays Aggregate Negative Yielding Debt Index is at a record high and approaching $18 trillion in market value. While the Bloomberg Barclays Aggregate yield to worst has risen modestly off all-time lows, the move in credit spreads over the course of November has pushed U.S. credit yields to all-time lows (Chart 1).

Chart 1

Bloomberg Barclays U.S. Credit Index - Yield to Worst

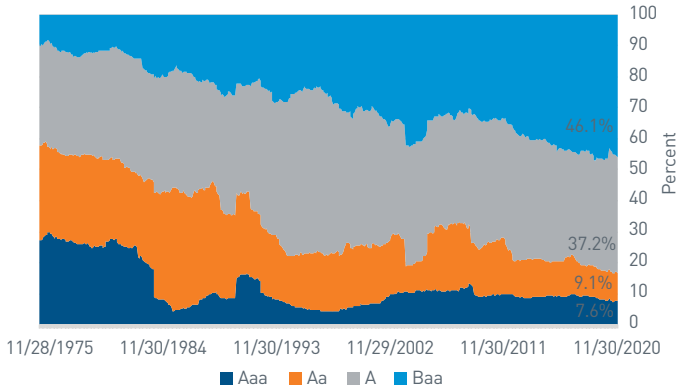
Data from 11/30/2000 to 11/30/2020. Source: Bloomberg L.P., PNC Capital Advisors

Quality

With an increasing concentration of BBB-issuance, trends in benchmark credit quality composition have been deteriorating since the Great Financial Crisis. Disruptions to commercial paper markets with the initial outbreak of the pandemic – combined with enticing overall yields on new issues – boosted higher quality issuance in 2020 as overall gross supply reached a record $1.5 trillion (Chart 2).

Chart 2

Quality Analysis of Bloomberg Barclays U.S. Credit Index



Data from 11/28/1975 to 11/30/2020. Source: Bloomberg L.P., PNC Capital Advisors

Duration

Asymmetry is particularly pronounced when considering the duration of the Bloomberg Barclays U.S. Aggregate Credit Index, which has risen by a remarkable 1.5 years since the end of 2018 (over 20%). Dislocations in short-duration credit, combined with the enticing yield dynamics of longer-term issuance, have incentivized corporations to extend liability maturities. Duration profiles increased due to lower coupons from declining yields and tighter spreads. With a current index

OAS in the mid-90s, the break-even spread-widening event that would overwhelm annual carry barely exceeds 10bps (Chart 3).

Conclusion

As we pivot to the turn of the year and eagerly put 2020 behind us, we continue to focus on managing the risk profiles of our client portfolios. This has served us well over the last several years and enabled us to deliver a consistent excess return profile through a variety of market cycles. Broadly, we believe market risk sectors are expensive and expect subsector and issuer selection decisions will present opportunities for incremental alpha in 2021. We appreciate our clients' on-going commitments to our strategies and wish everyone a healthy and happy holiday season.

Chart 3

Bloomberg Barclays U.S. Credit Index – Modified Adjusted Duration

Data from 11/30/2000 to 11/30/2020. Source: Bloomberg L.P., PNC Capital Advisors

Indices

The **Bloomberg Barclays U.S. Credit Index** measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the U.S. Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is an unmanaged index composed of securities from the Bloomberg Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index and represent the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

The **Bloomberg Barclays Global Aggregate Negative Yielding Debt Index** represents the negative yielding segment of the global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

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