Sharmin Rahmin: Bond market 're-couponing' will increase dispersion and present opportunities

Bond market yields have risen significantly over the last year as investors have adjusted to rapidly rising interest rates. One obvious implication of higher yields is that companies will have to pay a much higher coupon to attract capital over the coming years. We think these higher costs will create more dispersion in corporate credit, leading to investment opportunities.

As you would expect, corporate borrowers took advantage of the prior several years' exceptionally low interest rates to raise finance cheaply. They often issued long maturity debt in order to lock in these favourable rates for a longer period, meaning that there is no impending 'maturity wall' of bonds that will need refinancing at the same time.

There will, however, be a gradual refinancing of liabilities over the next few years as this old, low-coupon debt matures. This will mean issuers having to 're-coupon' upwards to match the higher yields now on offer in a world of more historically normal interest rates.

Higher coupons may seem like good news for bond investors, but yields had already rebased higher over the last year, offering a much improved returns outlook for the asset class.

From an investor's perspective, re-couponing to a higher rate would simply mean a greater portion of an investor's future return comes in the form of coupon running yield rather than capital appreciation to par. An old, low-coupon bond and a new higher-coupon bond issued by the same company would trade on similar redemption yields – the combination of their coupon running yield and their pull-to-par as they approach maturity.

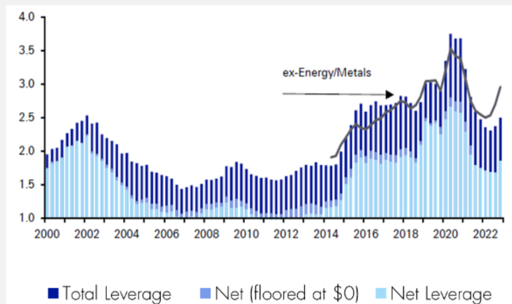
For the issuing company, however, the refinancing process will be the first time it has been exposed to more expensive borrowing rates. Although prices in the secondary market for existing debt dropped as yields rose last year, this hurt the investors who owned them at the time, not the issuer.

The biggest impact from the refinancing process could therefore be the additional strain it places on borrowers and, in turn, the increased importance that investors should place on credit selection.

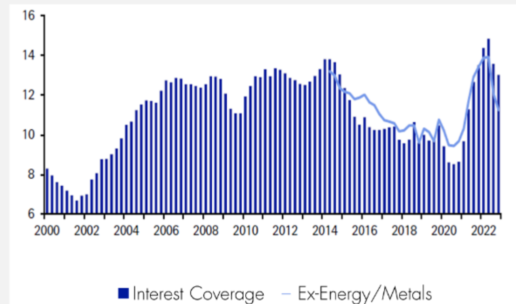
As it stands, corporate borrowers are largely in good shape, having trimmed down leverage levels to pre-pandemic levels, while most companies have been prudent in their cash deployment in the face of a challenging economic environment. Interest coverage – the extent to which debt interest payments are covered by profits – is currently pretty robust.

Spread product: Investment Grade

US IG Total and Net Leverage



US IG Interest Coverage



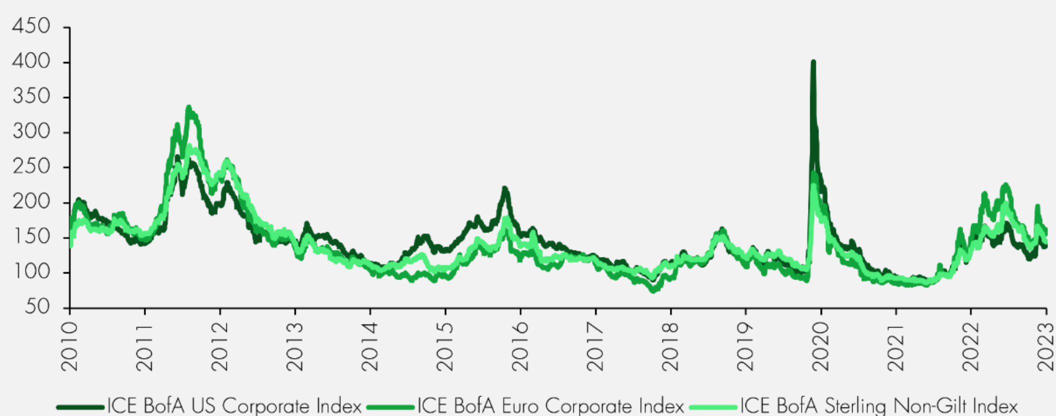
Source: Deutsche Bank, Global Credit Chart Book, March 2023

As higher debt servicing costs bite, free cash flow will be hit and interest coverage ratios will decline. When combined with the mild recessionary period we expect later this year, we should expect default rates to rise slightly too.

While this may sound like bad news for credit investors, it isn't.

Valuations are much improved, meaning that expected returns are higher so long as defaults can be largely avoided. Credit spreads, the additional yield offered by corporate bonds above government bonds, have tightened since their zenith in October 2022, but because government bond yields remain much higher than a year ago, corporate bond 'all-in' yields are still at attractive long-term levels.

Investment Grade Index credit spreads (bps)



Source: ICE BofA, Liontrust, 28.04.23

The process of bond refinancing will create greater dispersion in credit markets between those issuers whose business model and balance sheet can withstand a period of higher interest rates and those that will struggle. An environment of greater dispersion should naturally suit our highly selective style, which emphasises higher-quality companies operating in less cyclical sectors of the economy.

We have recently been participating in high quality BB-rated high yield new issues which are offering very attractive coupons and we expect some increased market volatility later this year which should present further investment opportunities.

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