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Understanding Corporate Credit Spreads

- Corporate bonds can play an important role in a diversified fixed income portfolio, potentially adding yield and increasing returns.
- The credit spread refers to the difference in yield between a corporate bond and a Treasury security with the same maturity.
- Credit spreads can provide insights into perceived credit quality, investors' risk appetite, market sentiment, and the overall health of the economy.

The Basics of Corporate Bonds

Corporate bonds are securities typically issued by companies to raise money for a variety of reasons, such as funding operations, making capital investments, or for acquisitions. The company borrows money from investors, and, in exchange, agrees to pay periodic interest payments (known as coupons) and repay the principal of the bond at maturity.

Corporate bonds can play an important role in a well-diversified fixed income portfolio. Investors choose to invest in these bonds for two key reasons: higher potential yield and income, and increased diversification. Corporate bonds generally have higher yields than similar-maturity government bonds and may provide attractive income and return potential. Additionally, corporate bonds can help improve portfolio diversification, which is desirable as it may help reduce overall risk and improve returns over time.

What is a Credit Spread?

"Credit risk" refers to the possibility that a company defaults or is unable to fulfill its obligation to make interest and principal payments. It also refers to the potential for an investor to lose value on corporate bonds from events such as negative company news, ratings downgrades, or a general weakening of the credit markets. Investors generally demand incremental yield versus government securities to compensate them for taking this credit risk. This incremental yield over a Treasury bond with a similar maturity is referred to as the credit spread. There are several different ways to measure credit spreads, but the two most used are:

- G-spread, which represents the difference in yield between a corporate bond and a government bond of the same maturity; and
- Option-adjusted spread (or OAS), which is used for more complex bonds that have embedded options such as a call features or variable principal payments.

Companies that are lower rated or perceived by the market as being riskier typically have higher (or wider) credit spreads to compensate investors for the additional risk. Companies that are higher rated or perceived by the market as less risky investments have smaller (or narrower) credit spreads.

Credit spreads change regularly. When economic conditions improve or when investors feel more confident in a company's prospects, credit spreads tend to narrow because the investment is seen as less risky and the likelihood of a default is lower. On the other hand, if economic conditions or the company's financial condition deteriorates, credit spreads tend to widen because investors demand more compensation. Credit spreads can also be impacted by industry trends, competition, or changes in financial metrics, such as leverage ratios.

Credit rating agencies such as Fitch Ratings, Inc., Moody's Investors Service, Inc., and S&P Global Ratings provide independent evaluations of the credit risk of individual companies and assign ratings to various categories of company debt or individual bonds. Credit ratings fall into two broad categories – investment-grade and below investment-grade (aka high yield or "junk bonds"). The ratings are based on issuers' ability to repay their debt obligations and the priority position of the debt within a company's balance sheet, and this assessment includes a variety of financial and non-financial factors. Credit ratings are just one of many inputs that investors consider when purchasing or selling a corporate bond. It is part of the evaluation of a corporate's "creditworthiness" or "credit quality."

The below chart reflects the various ratings scales that corporate bonds can be assigned from the three most commonly referenced rating agencies:

Credit Risk	Moody's	S&P	Fitch
Investment-Grade			
Highest Quality	Aaa	AAA	AAA
High Quality	Aa	AA	AA
Upper Medium Grade	A	A	A
Medium Grade	Baa	BBB	BBB
Below Investment-Grade			
Lower Medium Grade	Bb	BB	BB
Low Grade (Speculative)	B	B	B
Poor Quality (May Default)	Caa	CCC	CCC
Most Speculative	Ca	CC	CC
No Interest Being Paid or Bankruptcy Petition Field	C	C	C
In Default	C	D	D

The credit rating agencies can move an issuer's rating into a higher category (referred to as an "upgrade") or a lower category (referred to as a "downgrade"). Upgrades typically occur when a rating agency believes the company's creditworthiness has improved, and as such is typically accompanied by a narrowing of credit spreads. When a company is downgraded, credit spreads tend to widen.

Factors Influencing Credit Spreads

Credit spreads are impacted by a combination of factors that include the following:

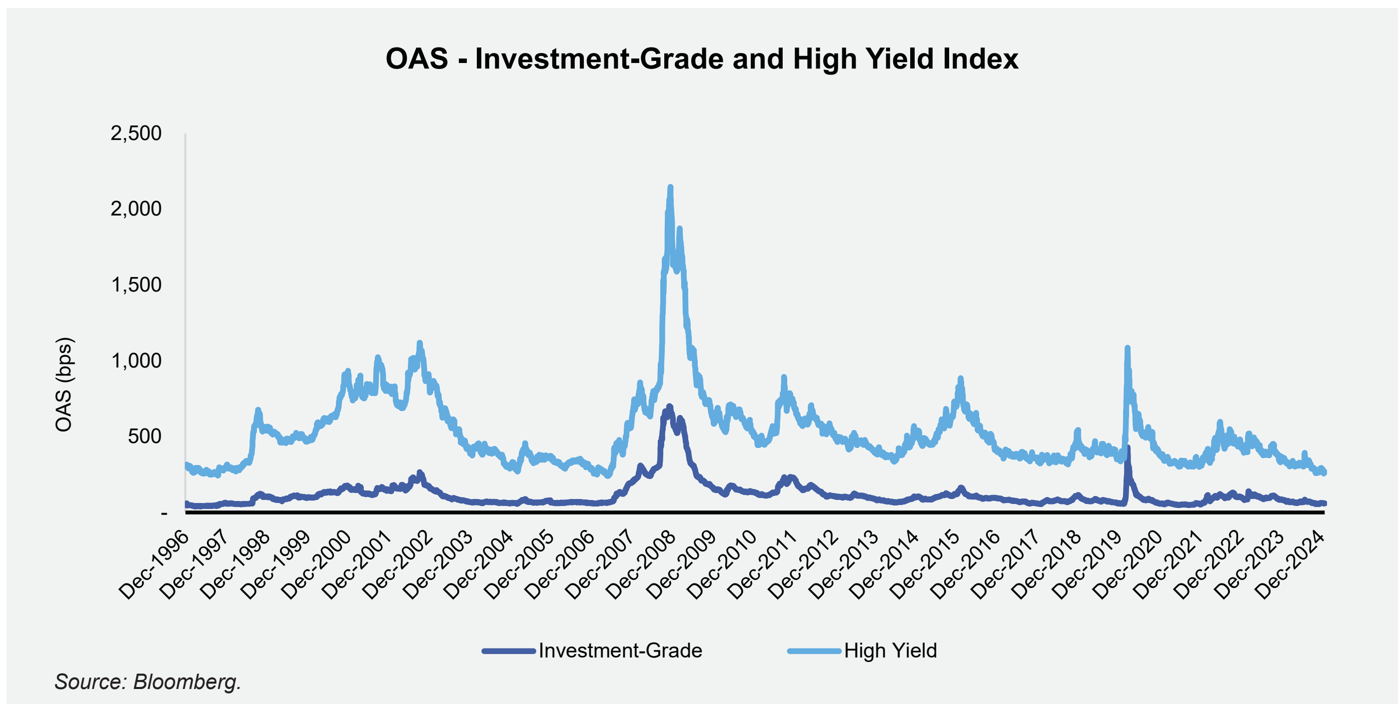
- **Duration and maturity** – credit spreads tend to increase with maturity to reflect the longer period that an investor is exposed to the repayment risk
- **Industry-specific factors** – riskier industries, such as ones whose profitability is heavily dependent upon the strength of the economy, generally have wider credit spreads
- **Issuer-specific factors** – lower-rated issuers, issuers with weaker balance sheets or lower profitability, and issuers that are viewed as having higher default risk tend to have wider spreads
- **Liquidity** – less liquid securities tend to have wider spreads because these securities may be harder to sell. Liquidity is particularly relevant during times of market stress as investors are trying to move out of riskier securities and into less risky ones. The liquidity of a bond or a company depends on several factors including overall market conditions, the number of available bonds from a given company, and how frequently the company is in the market issuing bonds.

Other factors that may influence spreads include general supply and demand dynamics (often referred to as "technicals"), overall risk sentiment, and fiscal, monetary and regulatory policy. Since all the factors above can affect credit spreads, and therefore market values, they represent some of the risks associated with investing in corporate bonds.

Market Behavior and Credit Spreads

Overall, credit spreads can function as market indicator, providing insights into investors' risk appetite, sentiment, and the overall health of the economy. Generally, tightening credit spreads reflect improving investor optimism about the health of the economy. When the economy is improving, corporates tend to be more profitable and therefore less likely to default. On the other hand, widening credit spreads can signal uncertainty or financial stress as investors demand more compensation to take on credit risk.

Currently, spreads are very tight, as shown in the chart below, which charts OAS for investment-grade and non-investment-grade corporate bonds. The difference between the two is also well below the historical average; however, with Treasury yields still at elevated levels, many investors are still finding these securities attractive.



Source: Bloomberg.

Why do Credit Spreads Matter?

Understanding credit spreads is essential for making decisions in a fixed income portfolio. Investors analyze credit spreads to not only assess market sentiment, but also to evaluate the risk and return profiles on the wide range of corporate bonds from various issuers available at any given time. Changes in credit spreads can be telling of emerging economic conditions. And the ability to understand the relationship between credit quality, credit spreads and yields can help an investor diversify a portfolio.

Stay Tuned

In the months ahead we plan to touch on other important credit related topics including credit spreads and portfolio allocation, and recent trends in credit markets.

To learn more about credit spreads, please reach out to your relationship manager.

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