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Investment Grade Corporate Spreads – Impact of Credit Quality Migration

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This article is written as a supplement to the three part series on Long Duration Strategies Using Corporate Bonds. In this article, we look at corporate spreads from a historical perspective to gauge their current value. We also analyze the impact of the downward migration in credit quality on the attractiveness of corporate bonds. The analysis is based on option adjusted spread (OAS) data for the Barclays Capital U.S. Corporate Investment Grade Index.

Graph 1 shows that corporate spreads are still at historically high levels, despite the significant narrowing of spreads that has occurred during the past six months.

Table 1 shows the historical ratings distribution of the index. Note that in early 1991, over 35% of the index was comprised of securities rated AA to AAA compared to slightly less than 16% in June 2009. To better gauge the attractiveness of current spreads, we have computed an adjusted OAS for the index. The adjusted OAS was calculated by holding the ratings distribution of the index constant at January 31, 1991 levels and then applying that ratings distribution mix to the monthly spread levels for each rating bucket. The data was then aggregated to arrive at an adjusted OAS for each month from June 1989 to June 2009 (see Graph 2 and Graph 3). We chose to use the ratings distribution mix as of January 31, 1991 since that month corresponded with the peak in OAS for the 1990's recession. We plotted the adjusted OAS from June 1989 since that was the earliest date that OAS data was available and we wanted to provide a perspective on spreads levels heading into the 1990's recession.

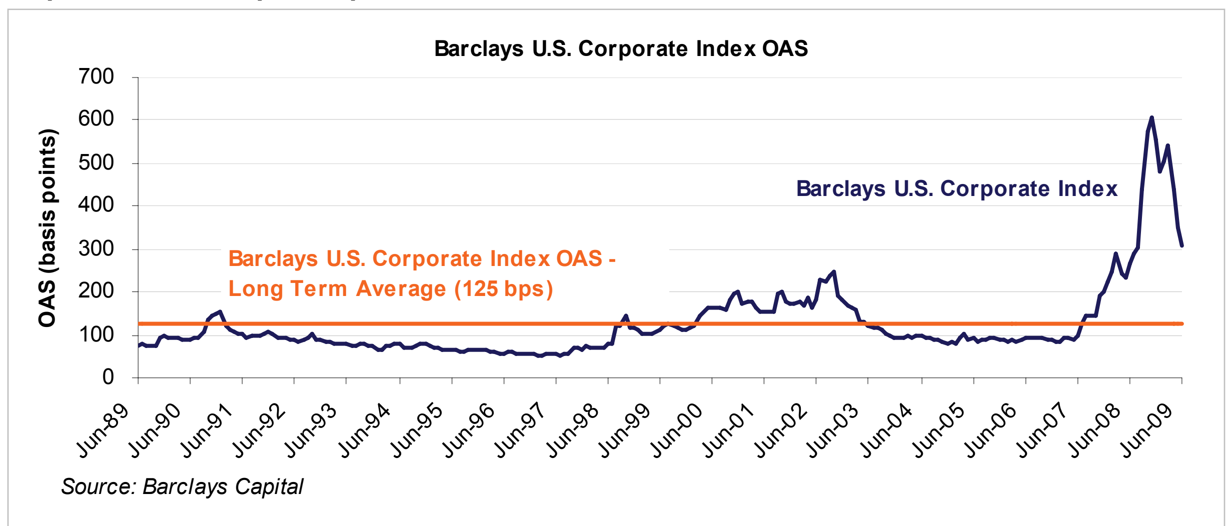
Table 1: Historical Ratings Distribution

	Ratings Distribution (%)				
Date	**Total**	**AAA**	**AA**	**A**	**BBB**
1/31/1991	100	11.6	25.5	37.6	25.3
10/31/2002	100	3.4	19.1	40.7	36.8
11/28/2008	100	4.9	18.4	43.5	33.2
6/30/2009	100	0.6	15.2	47.8	36.4

Source: Barclays Capital

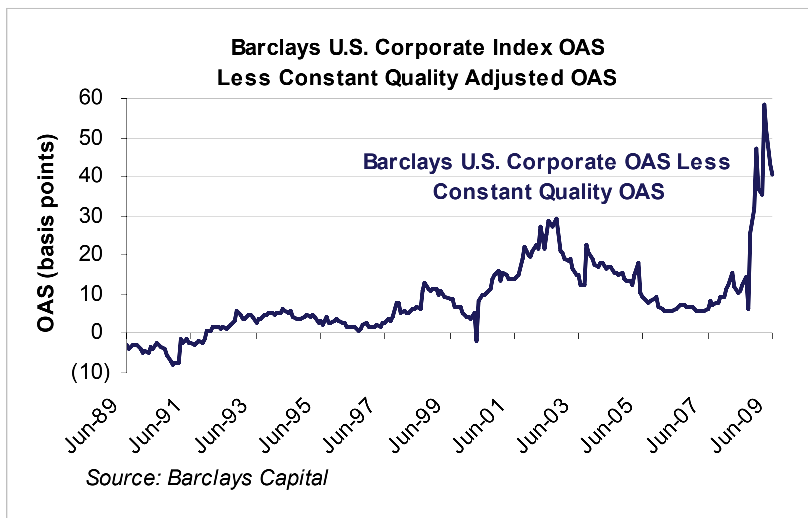
Note: Weights were computed based on the reported aggregate market values for each rating category

Graph 1: Historical Corporate Spreads

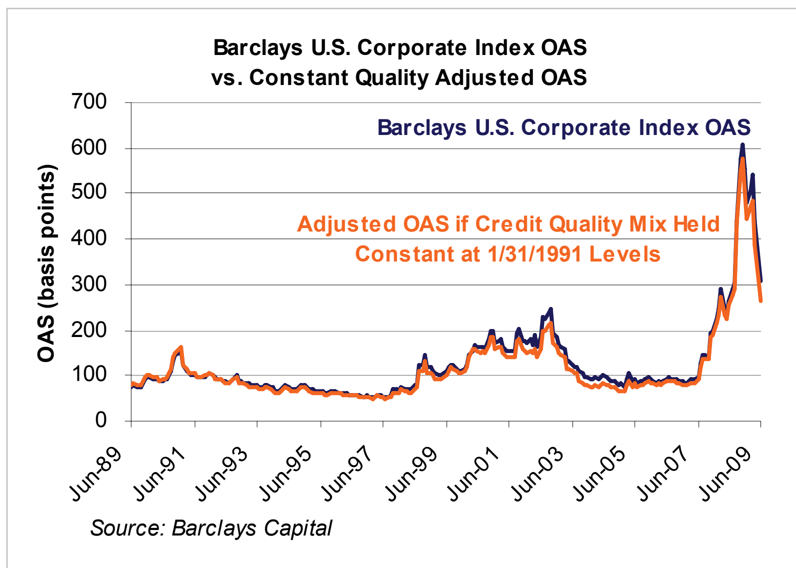


Source: Barclays Capital

Graph 2: Spread Impact from Downward Migration in Credit Quality



Graph 3: Actual vs. Adjusted Spreads



A comparison of the adjusted OAS with the actual OAS provides a measure of the impact on changes in credit quality mix on the spread of the index. In Graph 2, we plot the difference between the constant quality adjusted OAS and the historical OAS of the index to highlight the impact on the spread from the changes in credit quality mix. The graph shows that at the spread peak in late 2008, the index OAS would have been almost 60 bps lower if the credit quality of the index would have remained constant at January 31, 1991 levels.

Given the downward migration in credit quality of the index, the non-adjusted index spread should conceptually be higher now than it was in 1991, assuming that the market was fairly priced at that time. If we assume that spreads were fairly priced in 1991, the next question is whether the corporate market is still attractively valued after adjusting for the impact of the downward credit quality migration. Graph 3 plots the historical OAS of the index versus the constant quality adjusted spread. As can be seen from the graph, even after taking the credit quality changes into account, the OAS of the corporate market is still above the peak level of the prior two recessions. Consequently, if one believes that the U.S. economy is on a path to recovery then the corporate market should provide an attractive excess return versus Treasuries given the higher yield of the corporate market and the potential for incremental return if spreads tighten back towards the historic average (125 basis points) or at least back to levels consistent with prior recessionary spread peaks.

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