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One for the Record Books: US Investment Grade Credit New Issuance in 2020

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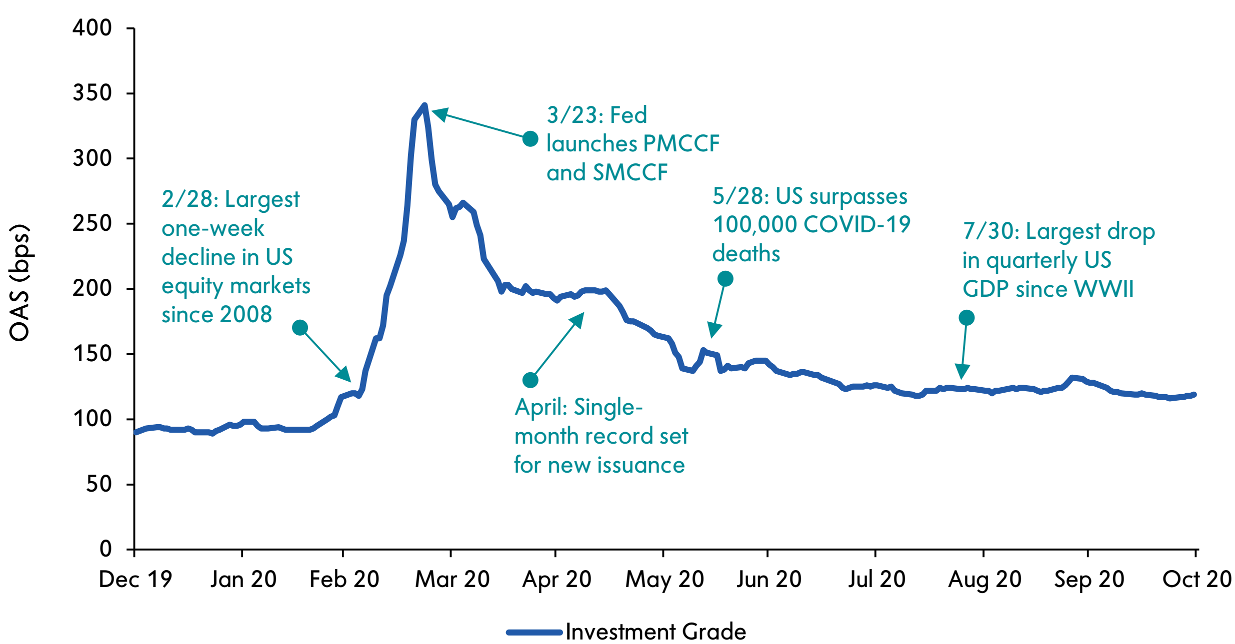
Global turmoil created by the COVID-19 pandemic sparked record-breaking new issuance in US corporate debt. From the intense market disruption in late March that saw companies seeking liquidity at all costs, to the beginnings of a recovery that has seen opportunistic refinancing, we look at the impact of the pandemic through the lens of the US credit markets.

Credit Spreads and the Rise of the Pandemic

In early 2020, sentiment in the US credit markets was remarkably sanguine. Several quarters of robust corporate profitability provided support for relatively strong interest coverage ratios despite a minor uptick in net leverage. Credit spreads over the course of 2019 were range-bound, ending the year slightly tighter at 90 basis points as measured by the option-adjusted spread (OAS) of the Bloomberg Barclays US Credit Index.

Spreads widened only modestly in the first few months of 2020 when it was believed the coronavirus might not spread beyond its first appearance in Asia. However, once the virus spread to Europe, the US, and then on to the rest of the world, investors began to struggle with increasing levels of uncertainty regarding the social, financial and economic impact of the growing pandemic and the accompanying efforts by global authorities to contain the outbreak. On March 11, 2020, the World Health Organization (WHO) declared the coronavirus outbreak a global pandemic. The following day, a US equity selloff triggered a market-wide circuit breaker event, the first of several over the coming days and weeks. On March 13, the United States declared a national emergency regarding the coronavirus outbreak.

Bloomberg Barclays US Credit Index OAS



Source: Bloomberg. As of October 30, 2020.

In this environment of extreme uncertainty, US credit market spreads dramatically widened to a high of 341 basis points in late March due to intense selling pressure. Activity in the primary markets ground to a halt while secondary market liquidity dropped precipitously, and bond bid-ask spreads nearly tripled. Faced with rapidly worsening market sentiment, corporate issuers adopted a "survival at any cost" mentality and swiftly tapped any and all available revolving bank credit facilities in an effort to shore up their balance sheet liquidity.

Central Banks to the Rescue

In response to rapidly deteriorating conditions in the fixed income markets, central banks around the globe, led by the US Federal Reserve (the Fed), moved quickly in their efforts to restore normal market functioning. In the US, the Fed slashed benchmark interest rates twice for a total of 150 basis points in early March, and restarted purchases of US Treasuries and mortgage backed securities in those amounts deemed necessary to improve market functioning. The Fed also addressed the short-term borrowing needs of corporations by restarting two Global Financial Crisis-era programs focused on supporting money market funds and direct issuers of commercial paper. Other major developed economies such as the European Union, the UK and Japan also restarted or increased existing quantitative easing programs focusing on government debt.

However, the crucial cornerstone of the Fed's efforts came on March 23, when the Fed launched two new programs aimed squarely at the US corporate markets. Eventually totaling $750 billion in authorized capacity, these programs allowed the Fed to lend directly to corporations via the Primary Market Corporate Credit Facility ("PMCCF" for newly issued bonds or loans); or to make purchases of existing bonds or ETFs focused on corporate bonds through the Secondary Market Corporate Credit Facility ("SMCCF"). In response to these swift actions, spreads declined rapidly after March 23 as the market digested news that the Fed and other central banks around the world were taking aggressive actions to stabilize the markets.

Post-Fed Intervention Change in Spreads

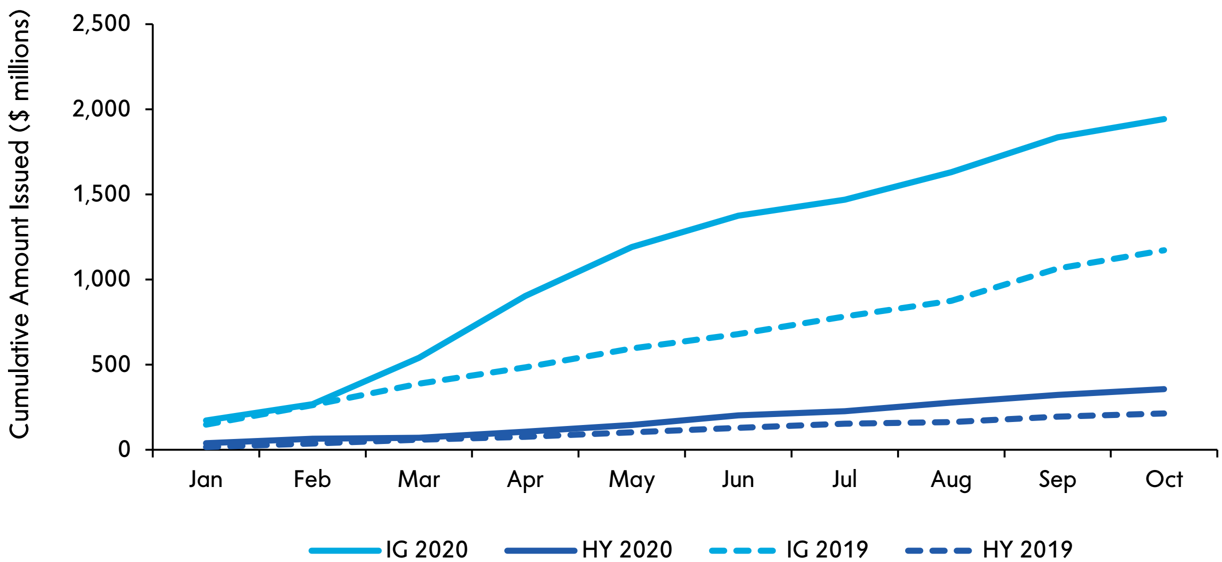
	Level (bps)	Change From 3/23/20 Peak (bps)
Pre-COVID-19 Average (11/30/19 to 2/28/20)	95	--
COVID-19 Peak (3/23/20)	**341**	**--**
1 Week Later (3/30/20)	265	-76
1 Month Later (4/23/20)	197	-144
3 Months Later (6/23/20)	139	-202
As of 10/30/20	119	-222

Source: Bloomberg. As of October 30, 2020.

Opening the Floodgates

Although the Fed has, in reality, purchased very few corporate bonds or ETFs ($12.9 billion via the SMCCF as of September 30, 2020), their aggressive actions have had an enormously calming influence on the US corporate bond markets. With the implied backstop from the Fed, issuers rushed to tap the public debt markets in an effort to further bolster their liquidity, as demonstrated below.

US Credit Gross New Issuance
2019 vs 2020



Source: Barclays Live. As of October 30, 2020.

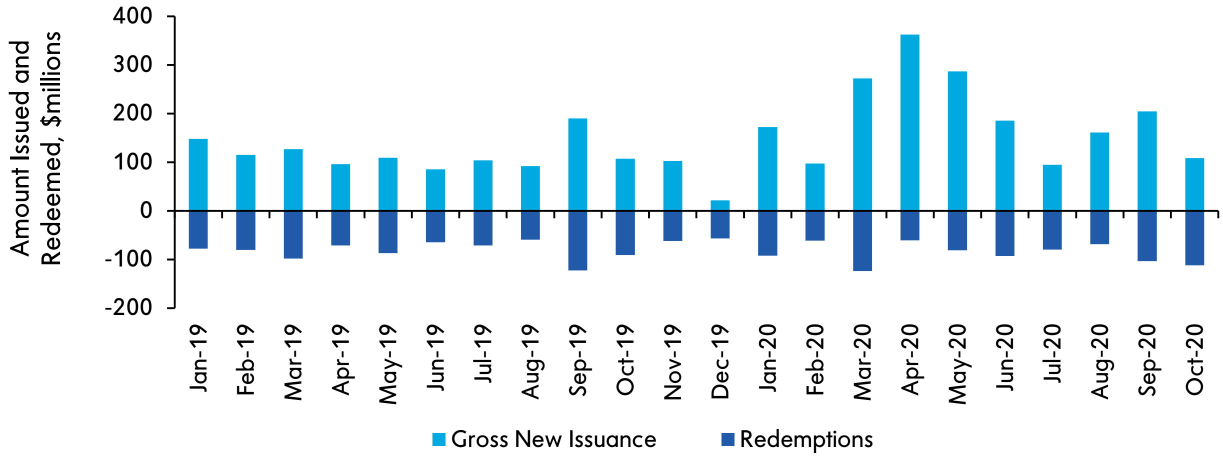
During the height of the early stage COVID-19 lockdowns in the US (late March through June), gross new issuance exploded by over $900 billion, with April 2020 easily setting a new all-time, single-month record of $362 billion. Net new issuance (e.g., gross new issuance less retirement of existing debt), which measures the direct impact to corporate balance sheets and credit metrics, skyrocketed to over twice that during the same timeframe in 2019. Normally, this would be viewed as an adverse dynamic for corporate credit quality, especially when coupled with the expected heavy decline in profitability. However, issuers focused on "survival at any cost" took advantage of the Fed's implied backstop and historically low rates to continue to add to balance sheet liquidity, while emboldened investors continued to snap up the new issues.

"I always thought that record would stand until it was broken."

Yogi Berra

With less than two months remaining in 2020, gross new issuance in the investment grade (IG) credit markets of $1.84 trillion is 66% ahead of the pace of 2019 and handily surpassed the previous annual record of $1.47 trillion set in 2017. Industrial issuers have driven this wave of issuance and have comprised 50% of new issuance so far this year (vs. the trailing 5-year average of 42% of new issuance). Airlines, retail, lodging and restaurant issuers (industries significantly impacted by the pandemic) have accounted for almost $74 billion in new issuance. By credit quality, BBB-rated issuers have accounted for 42% of new issuance. This is in line with the 5-year trend of increased borrowing from issuers at the lower end of the investment-grade credit spectrum.

US Credit Gross vs. Net Issuance
2019 to 2020



Source: Barclays Live. As of October 30, 2020.

From Surviving to Thriving?

Following a slower tempo in July, new issuance unexpectedly resumed its historic pace in August and September. However unlike the March-to-June period, a different set of factors drove recent new issuance, leading issuers to take a more opportunistic and credit quality-friendly approach in the primary markets.

By the end of July, credit spreads tightened by almost 220 basis points, with the yield on the Bloomberg Barclays US Credit Index reaching an all-time low of 1.73% on August 6. Coupled with the Fed's "lower for longer" stance on interest rates, issuers have been able to redeem older, higher-coupon debt and replace it with lower-coupon, longer maturity debt. Borrowers seized the opportunity to refinance their debt. Notable issues include:

- In early August, a BBB-rated telecommunications company offered to tender over $16 billion in existing debt, to be replaced with $11 billion of new debt bearing an average coupon of 2.70% and an average tenor of 21 years. The company then announced a second tender in September for 42 existing securities, to be replaced with $21.5 billion in debt maturing between 2053 and 2059.

- Also in early August, an AA-rated technology company issued $10 billion of debt in six parts, setting records for the lowest coupons ever for 10-year (1.10%) and 30-year (2.05%) corporate debt. This issue is especially noteworthy as the company had $120 billion in cash on its balance sheet at the end of June 2020, comprising 43.5% of total assets.

- Just days later, an A-rated chemical company and an AA-rated consumer cyclical issuer set new record low coupons of 2.00% for 30-year corporate debt.

- In mid-September, an A-rated beverage company priced $4.1 billion of new debt in three parts with an average coupon of 1.65% and average tenor of almost 17 years; with proceeds to be used to retire several securities maturing in the next two years, as well as two bonds maturing in 20- and 30-years carrying coupons over 4%.

Impact on the Bloomberg Barclays US Credit Index

Despite the substantial changes in the credit markets brought about by the events of 2020, we have successfully weathered this tidal wave of new issuance. With the advantages afforded by our time-tested approach to fixed income index management that incorporates a proprietary credit risk model, our experienced portfolio management team has confidently managed our clients' portfolios through this period of rapid change.

Using the Bloomberg Barclays US Credit Index as a proxy for the broader US credit markets, we highlight some of the substantial changes to the benchmark below (as of October 30):

- Year to date, 1,658 securities have entered the index while 1,024 have been removed; a net total increase of over 600 new securities.
- The average maturity of the index at the start of 2020 was 11.2 years and by the end of October stood at 11.8 years; likewise, the duration of the index has extended from 7.65 to 8.35.
- Spreads (index OAS) began the year at 90 basis points, reached a pandemic high of 341 basis points on March 23, and have since rallied to close October at 119 basis points.
- The yield to worst for the index began the year at 2.79%, touched an all-time low of 1.73% on August 6 and ended October at 1.94%.
- Turnover in the US Credit Index, which averaged around 3% in 2019, increased substantially during the March-to-June peak in new issuance, reaching over 7% in April.

Bloomberg Barclays US Credit Index Turnover

	Securities Entering the Index			Securities Exiting the Index			Quantity Change %	Total Turnover %
	#	MV (000s)	%	#	MV (000s)	%		
1Q 2019 (Avg)	114	118,903,758	1.873	94	86,202,465	1.358	-0.065	3.296
2Q 2019 (Avg)	94	97,445,190	1.471	73	73,031,219	1.102	-0.011	2.584
3Q 2019 (Avg)	125	118,515,910	1.725	73	68,337,911	0.995	-0.099	2.819
4Q 2019 (Avg)	97	85,557,662	1.247	97	83,539,172	1.217	-0.053	2.517
1/31/2020	124	137,619,727	1.948	79	74,383,168	1.053	0.039	3.040
2/28/2020	92	87,127,621	1.221	100	90,803,999	1.273	-0.044	2.538
3/31/2020	233	267,289,719	3.918	121	79,305,540	1.162	-0.084	5.164
4/30/2020	244	290,187,074	4.034	175	214,623,385	2.983	-0.013	7.030
5/29/2020	273	304,733,854	4.071	112	108,404,523	1.448	0.021	5.540
6/30/2020	167	160,912,545	2.095	89	78,743,554	1.025	-0.139	3.259
7/31/2020	127	152,725,794	1.925	95	116,339,288	1.466	0.039	3.430
8/31/2020	165	161,923,336	2.052	62	66,975,921	0.849	-0.241	3.142
9/30/2020	132	142,753,358	1.817	131	106,924,456	1.361	-0.299	3.477
10/30/2020	101	88,165,432	1.124	60	51,024,455	0.651	-0.193	1.968

Source: Bloomberg. As of October 30, 2020.

Where Do We Go From Here?

As we enter the final stretch of 2020, we believe there are several key themes relevant to the direction of US credit markets in the months to come:

- How will the recent election of Joe Biden to the US presidency impact issuance in the months ahead? Arguably some of the issuance that occurred in September, coupled with a relatively brisk October calendar, reflected issuer's desires to lock in funding or take advantage of historically low coupon rates ahead of a contentious and volatile election.

- With control of the US Senate still undecided, both issuers and investors alike face uncertainty regarding the eventual ability of President-elect Biden to enact his stated policy goals. A divided US Congress would most likely result in a continuation of the status quo.

- In a world where there are virtually no remaining safe harbors offering a measurable yield, will investors continue to turn to credit as a means to satisfy their hunt for yield? According to recent research from JP Morgan, 70% of the stock of global sovereign debt carries a negative real yield. With central bankers adopting a "lower for longer" mantra, investor appetite for US credit is likely to remain strong in the near-term.

- US corporations have issued record-breaking levels of new debt this year–what will they do with this cash? While certain sectors will rely on their cash buffers to survive the pandemic (airlines, hotels, retailers, restaurants, etc.), other issuers (technology, pharmaceuticals, financials) seem likely to emerge from the pandemic relatively unscathed. Will this set of survivors pay back debt, reinvest in their businesses or go on buying sprees?

As with almost every other aspect of life during the capital markets in 2020, the COVID-19 pandemic has caused sweeping changes in the US credit markets, characterized by record-breaking levels of new issuance and bouts of extreme spread volatility. We have taken these challenges in stride and are prepared to meet the challenges that lie ahead.

Stephanie Hill
Managing Director, Head of Index

Stephanie is Head of Index. She is responsible for managing all aspects of the index business including portfolio management, asset retention and growth, business strategy, profitability and the development of index investment staff into roles of increasing responsibility. Stephanie works closely with the heads of equity and fixed income index.

Previously at the firm, she was responsible for co-heading the index division as well as articulating Mellon's index strategies to clients and prospects. Prior to joining the firm, she was a strategic product innovator within the iShares division at BlackRock, focused on designing and developing new ETF products and business solutions. Prior to joining iShares, she was an institutional investment strategist for BlackRock in San Francisco and New York. Previously, she was an investment strategist with Merrill Lynch Investment Managers. Stephanie has been in the investment industry since 1999.

Stephanie earned an MFA from New York University and a BA from the University of California at Berkeley.

Theodore Bair Jr., CFA
Vice President, Senior Investment Strategist

Ted is a senior investment strategist, responsible for articulating the firm's index strategies to clients, prospective clients and consultants to help grow and retain Mellon's index business. He works closely with sales and client service staff worldwide to guide the messaging and positioning of index strategies and to develop product solutions for client portfolios.

Previously, Ted oversaw attribution and risk analytics for Mellon's Active Fixed Income division. Prior to that, Ted held roles of increasing responsibility in fixed income trading and portfolio management for Mellon Bond Associates, followed by roles as a senior portfolio manager and investment strategist for Standish Asset Management and Cash Investment Strategies. Ted has been in the investment industry since 1995.

Ted earned a BA in finance from Westminster College and an MBA in finance from the University of Pittsburgh. He holds the CFA® designation and is a member of the CFA Institute and CFA Society Pittsburgh.

Disclosure

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