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Bonds and credit spreads

Credit quality is a key factor affecting the value of a bond. If a bond has high credit quality, it means investors perceive it as being a secure investment with a high likelihood of payment.

Credit risk is essentially the risk of not being paid. It is the chance that a bond issuer will fail to pay their obligations—known as default—or that negative perceptions of the issuer's ability to make such payments will cause the price of a bond to decline. Credit quality is measured by a bond's credit rating.

Investors expect to be rewarded for taking on credit risk

Bond credit ratings are important because they indicate how much an issuer must pay to borrow money and compensate investors for assuming credit risk. A higher credit rating indicates a lower likelihood of default and lower credit risk. Investment-grade bonds (bonds rated BBB- and higher) have a lower risk of default and higher credit quality than high-yield bonds (bonds rated lower than BBB-).

Credit risk is reflected in corporate bond yields and prices. Investors expect to be rewarded for taking on risk, so they demand a higher yield for bonds with higher credit risk (known as the credit premium). This equates to a lower value for the bond. If a bond's credit quality takes a hit, then its yield will rise, and its price will fall.

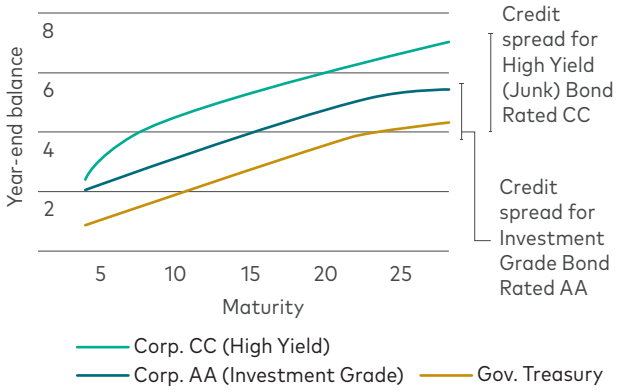
What are credit spreads?

A credit spread is the difference in yield between two bonds of similar maturity but different credit quality. Typically, spreads are measures of the difference between corporate bond yields and government bond yields. These spreads can widen or narrow depending on the credit premium demanded by investors, along with any other economic factors that may be at play.

Are widening credit spreads cause for panic?

Credit spreads move around as investors react to economic and company-specific news. These movements can have an effect on the value of bond portfolios. During periods of uncertainty or market volatility, it's common for credit spreads to widen, reflecting a decrease in perceived credit quality and an increase in the credit premium demanded by investors.

Figure 1. Hypothetical yield curves



Source: Investopedia

Figure 2. High-yield spreads during the pandemic

Source: Federal Reserve Bank of St Louis. ICE BofA US High Yield Index OAS. Data as at 30 June 2021.

All things equal, a rise in the credit premium will lead to a fall in the value of a bond portfolio. However, in a risk-off environment, government bond yields may also fall, which would lead to an increase in the value of government bonds, potentially offsetting the credit effect in a diversified portfolio.

It's important to note that, while there will be periods when credit spreads widen—sometimes significantly—capital losses will only be realised if investors draw down on their portfolio or a company defaults. Once markets return to more normal conditions and credit spreads narrow, corporate bonds will reclaim their value.

Spreads widen

Immediate impact

- Period of economic uncertainty or stress leads to reduction in credit quality.
- Risk premium for corporate bonds increases and credit spreads widen.
- Corporate bonds on issue lose value. Composition of credit quality in the portfolio may counteract the loss.
- Investor will realise capital losses only if they draw down on their portfolio.

If widening persists

- Some companies may default, resulting in non-payment and capital loss. Diversification across many issuers can mitigate the risk of default.
- Income generated from the portfolio is reinvested at a higher yield, increasing the portfolio's yield to maturity.
- Bonds that have suffered a credit rating downgrade may present opportunities for investors.

Spreads stable

- Steady economic growth produces minimal change in credit quality.
- Risk premium for corporate bonds largely unchanged.
- Risk of default largely stable.
- Corporate bonds maintain value. Composition of credit quality largely unchanged.
- Income generated from the portfolio is reinvested at a similar yield.
- Bond credit ratings largely stable

Spreads tighten

Immediate impact

- Period of higher economic growth and certainty leads to increase in credit quality.
- Risk premium for corporate bonds falls and credit spreads tighten.
- Corporate bonds on issue gain value. Composition of credit quality in the portfolio may counteract the gain.
- Investor will realise capital gains only if they draw down on their portfolio.

If tightening persists

- Companies previously at risk of default may become sustainable.
- Income generated from the portfolio is reinvested at a lower yield, decreasing the portfolio's yield to maturity.
- Fewer opportunities to receive relatively high returns from high yield bonds.

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