



# Does the corporate bond trade still have legs?

## **Les J. Young**

### **Director, Fixed Income Product Management**

In mid-2008, risk aversion amid a flight to quality led to one of the best years in history for government bonds in almost all jurisdictions. Spreads on corporate issues ballooned to record heights, with credit spreads reaching over three times their long-term averages for investment grade and high yield issues. In an environment where fear had overcome objective fundamental analysis, fixed income investors were presented with a “near once in a lifetime” opportunity in corporate bonds.

That said, we believe spreads remain at attractive levels and there are still opportunities which can be played out.

## **The Background**

Let’s start at the beginning – the global financial system was off-track long before the turmoil of Bear Stearns, AIG, Lehman, et al. However, since these events and over the last 18 months, we’ve witnessed positive and proactive steps, led by the U.S. Government and followed by global governments, to fix the ailing system. This in turn fueled one of the best equity and credit market runs in history.

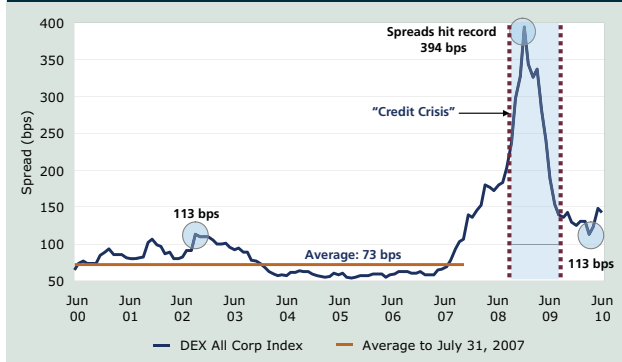
From 2004-2007, there was massive growth of banking outside the formal, country-specific regulated banking system. This is to say, banking transitioned from the conventional deposit/lender relationship to levered financial intermediaries whose liabilities were broadly perceived as having the same characteristics both monetarily and in liquidity as bank deposits. These liabilities were diverse, ranging from money market mutual funds to complex conduits and collateralized debt obligations (CDO). Bottom line: banks were using various instruments that were not equal to conventional bank deposits.

Now, after monumental returns from both equities and corporate credit in 2009, markets year to date have traded sideways. Investors seem to have painful memories of the recent recession fresh in their minds and in the second quarter of 2010, fear once again gripped the financial markets as the developing European sovereign debt crisis dominated. Sovereign rating downgrades, spread widening in peripheral European markets and the specter of a renewed recession served as the catalysts for broad based selling of risk assets. Though seemingly overwhelmed by the risk-averse environment, the direction of monetary policy outside of Europe reflected the encouraging economic conditions in other regions. A number of central banks, including those of Australia, Canada, and New Zealand, have hiked interest rates.

## **A Second Chance**

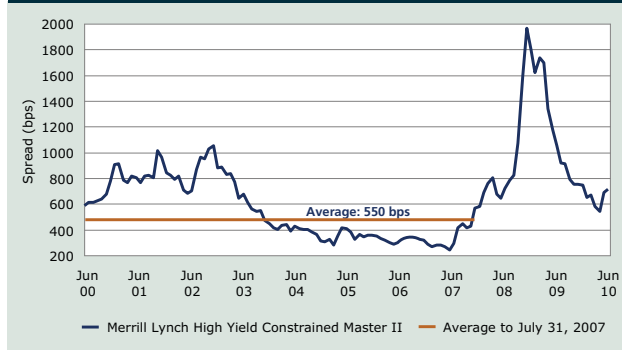
Coming off the stellar returns in 2009 for credit based products, many investors felt they missed their chance in corporate bonds. However, a second chance appears to be in the making, albeit with muted potential. Investment grade spreads in Canada and the U.S. remain above their long-term averages. As at June 30, Canadian investment grade spreads were at 142 bps, while their U.S. counterparts were at 201 bps; levels not seen since October 2009<sup>1</sup>. High yield spreads were at 714 bps, a level last seen in December, 2009. Ten-year averages are 106, 178 and 662 bps for the DEX All Corp, Merrill Lynch U.S. Corporate Master and Merrill Lynch High Yield Master, respectively. All have significantly lower pre-crisis averages of 73 bps, 123 bps and approximately 550 bps. Investment grade spreads should continue to grind lower, while U.S. high yield spreads could reasonably see 550 bps again as they touched this level in April 2010.

### Canadian Investment Grade Spreads Can Narrow



Source: PC Analytics, June 30, 2010

### High Yield Spreads Near December 2009 Levels



Source: Merrill Lynch June 30, 2010

### Positive Outlook for Credit

Default rates increased in 2009, but not to the levels some analysts were projecting. Rates should continue the downward trend to their long-term averages in 2010.

In view of the economic recovery still underway and wider spreads, we remain very positive regarding credit. The argument regarding large government bond issuance to finance deficits relative to smaller corporate issuance is still valid. We are expecting a narrowing of spreads and a flattening yield curve to bolster returns from credit based products. Tame inflation readings and subdued GDP reports have led us to temper our interest rate forecast for the remainder of the year.

All this bodes well for credit for the remainder of 2010 and into the first half of 2011. Below we highlight some return expectations:

June 30, 2010 Cdn Inv. Grade Spreads*	Spread Movement	12-Month Total Return Potential
148 bps	25 bps decrease	5%
148 bps	50 bps decrease	7%
148 bps	75 bps decrease	8%
June 30, 2010 High Yield Spreads*	Spread Movement	12-Month Total Return Potential
714 bps	100 bps decrease	13%
714 bps	150 bps decrease	15%
714 bps	200 bps decrease	17%

\*In the above examples, all things were kept equal except for spread compression.

<sup>1</sup>In this article, all Canadian corporate bond information based on the DEX All Corporate Index. All U.S. investment grade bond information based on Merrill Lynch U.S. Corporate Master Index. All U.S. high yield bond information based on the Merrill Lynch High Yield Constrained Master II Index at June 30, 2010.

## About MFC Global Investment Management®

MFC Global Investment Management® is the asset management division of Manulife Financial Corporation. MFC Global Investment Management's diversified group of companies provides comprehensive asset management solutions for institutional investors, investment funds and individuals in key markets around the world. This investment expertise extends across a full range of asset classes including equity, fixed income and alternative investments such as oil and gas, real estate, timber, farmland, as well as asset allocation strategies.

MFC Global Investment Management has investment offices in Canada, China, Hong Kong, Indonesia, Japan, Malaysia, Philippines, Singapore, Taiwan, Thailand, United Kingdom, United States and Vietnam. With more than 300 investment professionals, including 80 in Asia alone, MFC Global Investment Management offers worldwide expertise combined with local, on-the-ground knowledge and backed by a strong risk management framework. Additional information about MFC Global Investment Management may be found at [www.mfcglobal.com](http://www.mfcglobal.com).

All dates relate to 2010 unless otherwise stated. MFC Global Investment Management®, Manulife and the block design are trademarks of The Manufacturers Life Insurance Company and are used by it and its affiliates including Manulife Financial Corporation. The opinions expressed are those of MFC Global Investment Management® as of July 27, 2010, and are subject to change based on market and other conditions. The information in this document including statements concerning financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. The information in this document may contain projections or other forward-looking statements regarding future events, targets management discipline or other expectations, and is only as current as the date indicated. There is no assurance that such events will occur, and may be significantly different than that shown here. MFC Global Investment Management disclaims any responsibility to update such information. All overviews and commentary are intended to be general in nature and for current interest. While helpful, these overviews are no substitute for professional tax, investment or legal advice. Clients should seek professional advice for their particular situation. Neither Manulife Financial, MFC Global Investment Management®, nor any of their affiliates or representatives is providing tax, investment or legal advice. Past performance does not guarantee future results. This material was prepared solely for informational purposes, does not constitute an offer or an invitation by or on behalf of MFC Global Investment Management to any person to buy or sell any security and is no indication of trading intent in any fund or account managed by MFC Global Investment Management.