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Credit spreads on AAA corporate bonds at historic low

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Credit spreads on AAA-rated corporate bonds have fallen sharply from their historical levels. Take for example the 3-year and 5-year bonds. They are currently trading at yields of 6.4% and 6.9% respectively, only 8-9 basis points (bps) higher than similar tenure government bonds (g-secs), shows data from *Bloomberg*. Going by the last 10 years' average, these bonds have traded at significantly higher spreads of 82 bps and 74 bps, respectively.

Though an expansion in these spreads (higher yields) from hereon may imply an adverse impact on the market value of debt fund portfolios, the current composition of these funds can help withstand the impact.

Unlike the highest-rated AAA bonds, today, many AA-rated bonds and even more so, most A-rated bonds are trading at close to or slightly higher than their historical credit spreads.

All corporate bonds trade at a premium to g-secs. The spread—the difference in yields between any bond and that on g-secs of the same tenure—compensates for the relatively higher risk of default associated with the former.

What's at work

"Spreads have come down because, on one hand, AAA corporate bond yields have not risen that much, while, on the other, g-secs yields have moved up sharply," says, Joydeep Sen, corporate trainer and author. So, the gap or the spread between the two has narrowed.

"Unlike in the past, where large issuers such as REC, Power Finance Corporation (PFC), and National Bank for Agriculture and Rural Development (NABARD) would raise large sums through bonds, there has been no such AAA bond supply this year," says Devang Shah, co-head, fixed income, Axis MF.

According to Sen, private sector AAA bond issuances also have been tepid, given the deleveraging of corporate balance sheets over the past year. The limited supply of such corporate bonds has, therefore, kept a lid on yields (lower supply keeps bond prices from falling and their yields from rising too much).

Data from the Securities and Exchange Board of India (Sebi) shows that corporate bond issuances through private placement at ₹5.9 trillion in 2021-22 were down 24% from ₹7.7 trillion in 2020-21.

The limited supply, along with good demand from target maturity funds that invest in such AAA bonds, has kept the yields under check, according to Shah.

G-sec yields, however, have been on a tear on the back of the government's large borrowing programme, rising inflation, and most recently, the hawkish monetary policy.

Investor implications

Corporate bond issuances are expected to pick up as the capex cycle recovers and companies amp up their fundraising. "This could see AAA corporate bond yields rising and the spreads slowly widening over time," says Sen.

Many AAA-rated corporate bonds are offering only 8-9 basis points more than government securities today

According to Shah, most mutual funds have re-aligned their portfolios more towards cash, g-secs, and SDLs (state government bonds) and have smaller allocations towards AAA bonds. So, once the spreads start widening and these bonds start trading at higher yields than now, debt fund portfolios won't take a significant hit (mark-to-market loss).

"Most investors have been putting money in shorter duration funds, so the adverse impact of expansion in spreads, as and when it happens, will not impact many," says Ajay Manglunia, managing director & head, Institutional Fixed Income, JM Financial.

For those investing directly in bonds, Manglunia recommends parking money in shorter maturity bonds and shifting to longer-maturity ones, once the current inflation environment stabilizes and the bond markets normalize.