TD Asset Management

U.S. Corporate Bond Market + ⏱ 10 Minutes
= New Thinking

The Changing Landscape of the **U.S. Corporate Bond Market**

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U.S. bond markets have undergone dramatic changes due to the 2008 Global Financial Crisis (GFC) and the COVID-19 pandemic. In taking a retrospective view, we can see that bond markets, viewed through the lens of major bond indices, have been evolving for quite some time. Within this paper, TD Asset Management Inc. (TDAM) will explore underlying changes that have occurred within the U.S. Corporate Bond Index, a sub-component of the larger U.S. investment grade bond market, over the past decade. We will highlight key structural changes that have occurred within bond markets and why they are noteworthy. Finally, we will provide our viewpoint regarding the future of bond markets and how we are best positioned to capitalize on emerging opportunities.

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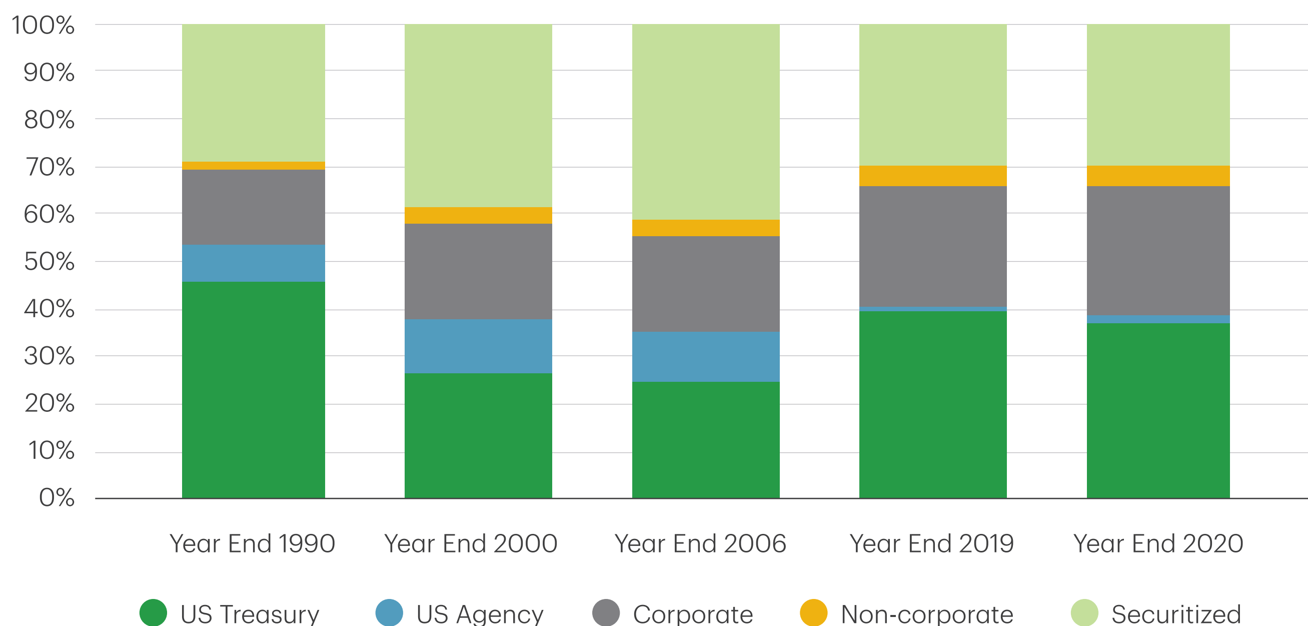
Please see final page for important disclosures.

A view from above

The Bloomberg Barclays U.S. Aggregate Bond Index, a proxy for the U.S Bond Market, has been a fixture within bond markets for decades; serving as a performance benchmark for investors and as a blueprint for passive bond fund index strategies. However, beyond its conventional uses, the index has compositional value and can highlight the structural changes that have occurred within the U.S. bond market, over time. The analytics expertise within our Fixed Income team has enabled us to actively identify when these structural shifts occur and the reason for their occurrence. As illustrated in **Chart 1**, not only has the underlying composition of the U.S. bond market changed over time – but the size of market has increased substantially. There has been significant growth in the Corporate and U.S. Treasury segments of the bond market.

Chart 1: The growing and changing composition of the U.S. Bond Market



Year	U.S. Aggregate Index US$	U.S. Corporate Index US$	U.S. Corporate % of Aggregate
1990	2.996 Trillion	0.471 Trillion	15.7%
2000	6.002 Trillion	1.235 Trillion	20.6%
2006	8.863 Trillion	1.720 Trillion	19.4%
2020	25.126 Trillion	6.877 Trillion	27.4%

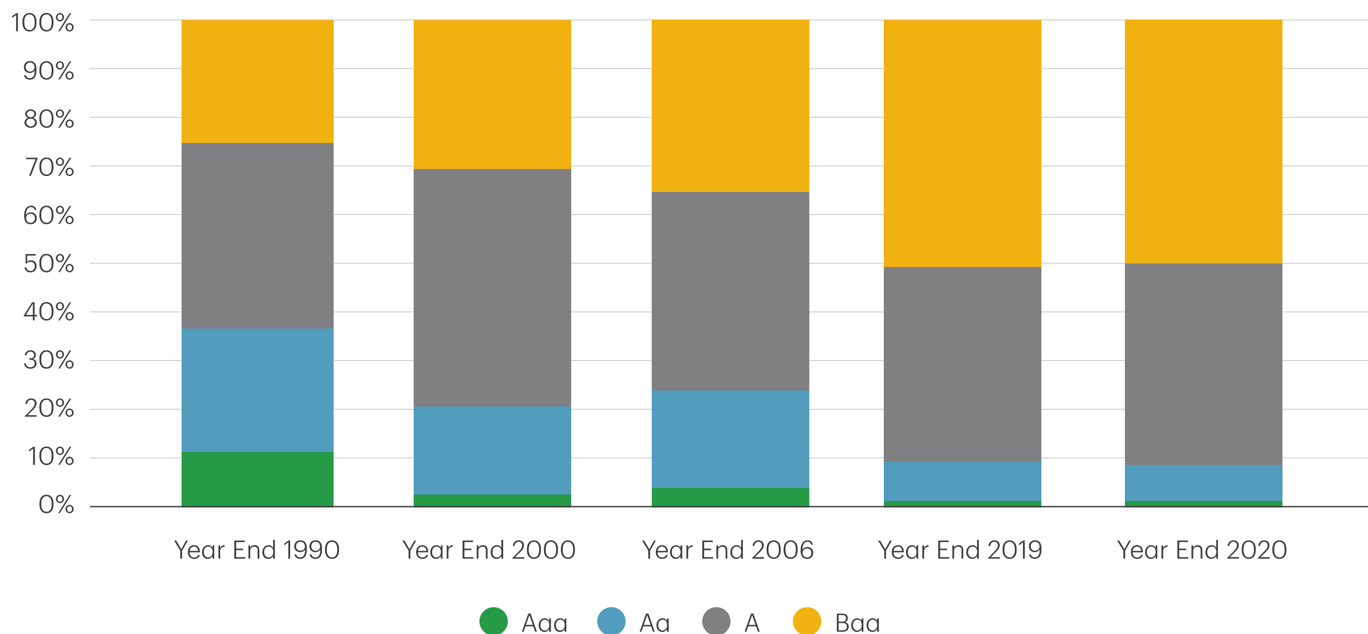
Source: Bloomberg Finance L.P., As of December 31, 2020

The increase in the size of the bond market during the last decade can be primarily attributed to increasing U.S. Treasuries and Corporate issuance; due to Quantitative Easing and a prevailing low interest rate environment, respectively.

A shift in quality

The growth and structural change observed in the U.S. bond market has also been accompanied by a shift in investment grade quality, or risk exposure, within the investment grade bond market. As detailed in our paper **Looking Beyond the Ratings**[1], the BBB bond segment now represents over 50% of the market value of the corporate bond index; mostly at the expense of AA and A bonds within the index (**Chart 2**). The size of the BBB rated segment has been gradually increasing over time, with a sizable shift occurring throughout the last decade.

Chart 2: The shifting quality of the investment-grade bond market



Source: Bloomberg Finance L.P., As of December 31, 2020

Observe

[1] The white paper **Looking Beyond the Ratings** can be found **here**

Why has the BBB segment been increasing?

An increasing number of corporate borrowers have been willing to accept a lower credit rating if it meant funding corporate development activities at attractive levels. The increased level of Merger & Acquisition (M&A) and Share Repurchase activity, is shown in **chart 3A and 3B** below. This resulted in an increased BBB-rated bonds representation within the U.S. corporate bonds universe. Note, a lower quality rating means these corporations are becoming more susceptible to interest rate risk.

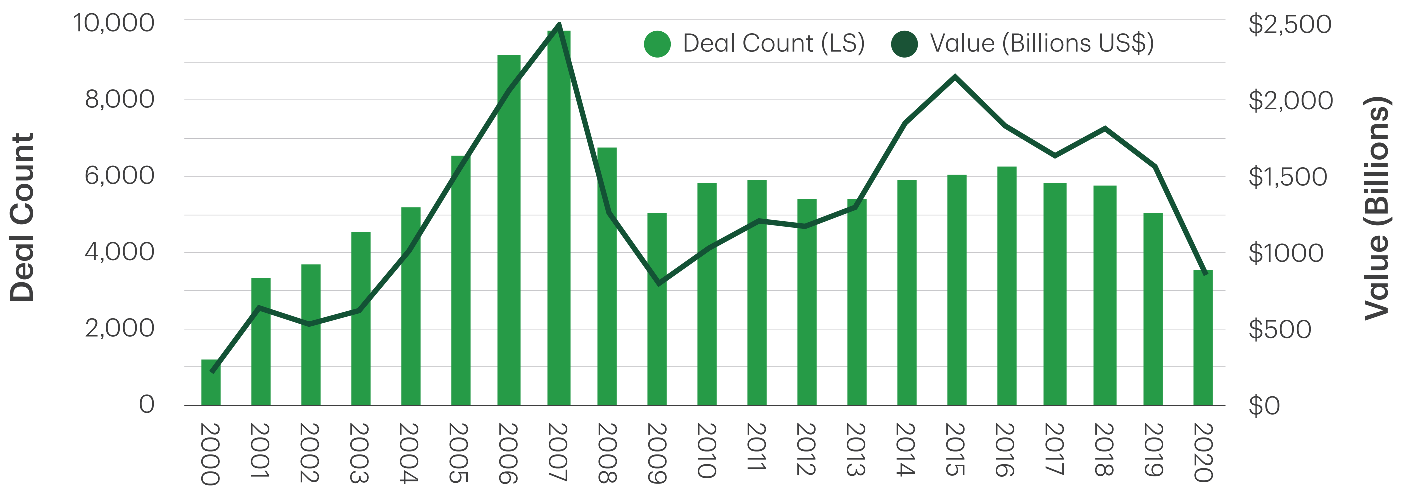
Though the current interest rate environment may be favourable, changes in borrowing conditions could lead to large increases in interest expense for corporations as existing debt rolls over. At the same time, bond holders could suffer a negative price impact in the event of widening corporate spreads should the degradation in credit quality of the issuer become central to market participants.

Chart 3A & 3B

Annual Share Repurchases
(Billions US$)

Source: Bloomberg Financial L.P. Data as of December 2019.

Mergers & Acquistions: Completed Deals



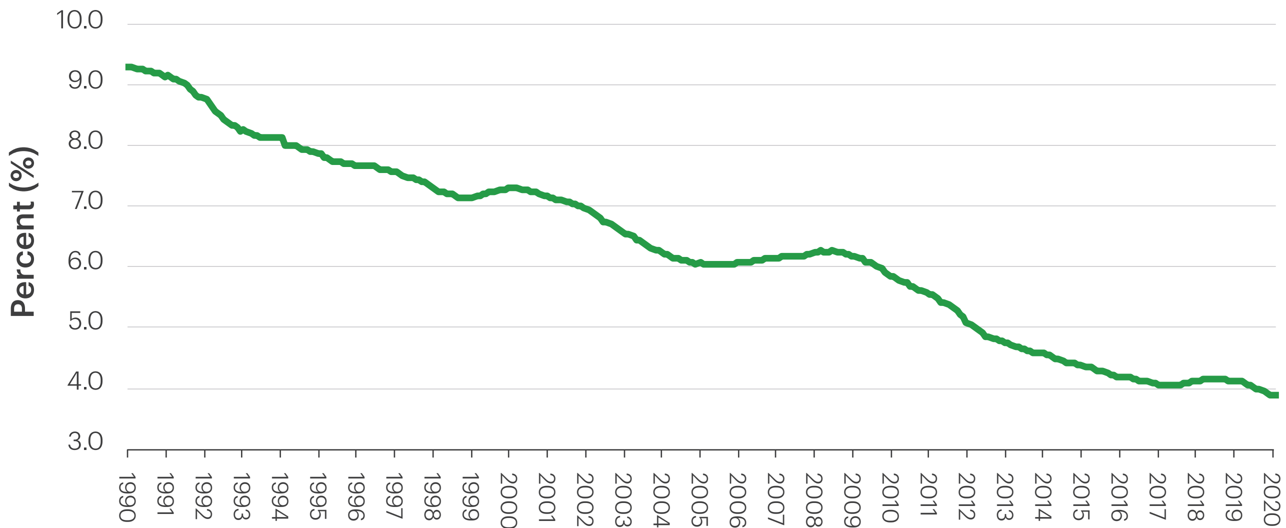
Source: Bloomberg Financial L.P. Data as of December 2020.

The impact of an increasing BBB segment

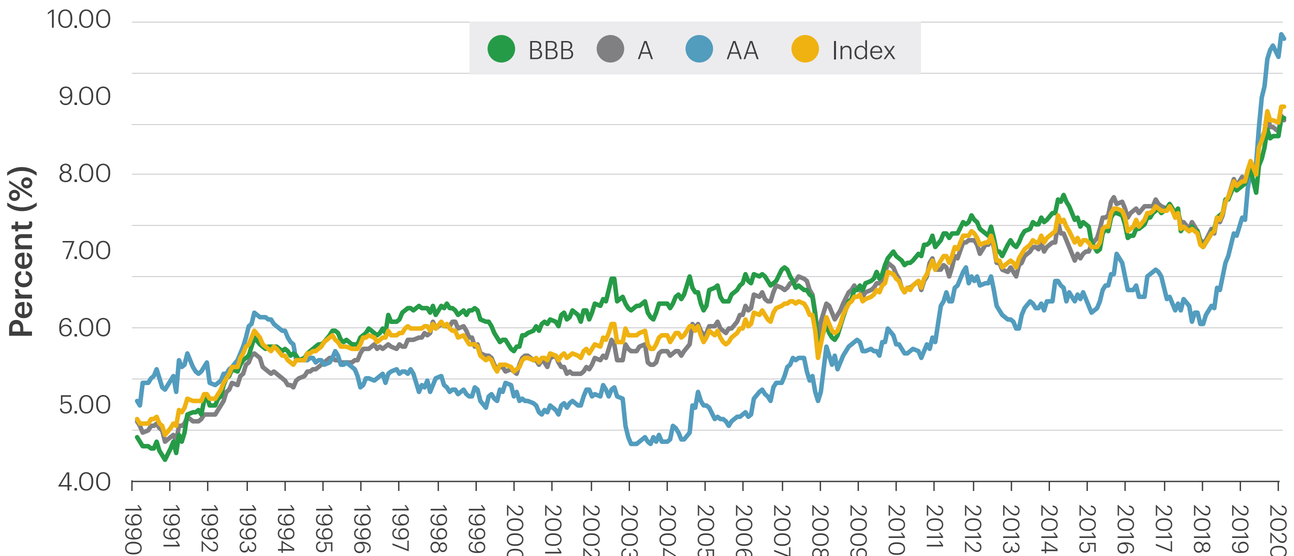
The 'lower for longer' interest rate environment that has existed since the GFC has had far-reaching implications for the U.S Bond market. The yield or coupon rate on the U.S. Corporate Bond Index is currently below the 2006 levels, indicating declining expected returns investors may receive from investing in the corporate bond market (**Chart 4A**). Additionally, the duration or price sensitivity of the index has been increasing over time, a product of falling interest rates and longer maturities especially during the past couple of years, for new issuance; allowing corporations to prolong the benefits of cheap financing (i.e. lower interest payments for longer, extending principal payments into the future). The resulting impact on the index is higher interest rate risk. As the size of the BBB segment continues to grow, the corporate bond segment will increase in sensitivity (**Chart 4B**).

It should be noted, though our immediate analysis has focused on the U.S. investment grade market, the expansion of the BBB segment and its implications has been observed across developed bond markets globally.

Chart 4A & 4B



Source: Bloomberg Financial L.P. Data as of December 2020.



Source: Bloomberg Financial L.P. Data as of December 2020.

Maintaining Risk Awareness

Bond indices, like their index cousins, are typically market-weighted. In the case of capitalization-weighted equity indices, investors are investing in companies that are increasing in valuation. For the bond market, the more debt a company issues, the greater their weight within the index due to an increasing amount of debt outstanding. As a result, investors in passively managed index strategies end up lending more to the firms that borrow the most.

With interest rates expected to remain at historical lows for longer, alongside the continued expansion of the BBB segment, passively managed investment strategies tend to leave investors exposed to increasing credit risk and more sensitivity to interest rate risk.

Though passive bond investors may not be aware that they are lending to companies that borrow the most, active fixed income investors mitigate this exposure risk by ensuring that the market does not dictate the allocation of their fixed-income investments. Some investors may be willing to accept the resulting passive outcomes, others may want to avoid the changing composition (i.e. Drift Risk) of the index.

Capitalizing on Change

The changing risk profile of the corporate bond market provides investors with the opportunity to actively manage the risk profile of their portfolios. Through active management, rather than passively accepting the changing risk profile of the index or benchmark; investors may capitalize on the changing landscape of the corporate bond market.

The TDAM Active Fixed Income philosophy combines our expertise in macroeconomic analysis and credit research, with an in-depth understanding of yield and credit curves.

Our Active Fixed Income strategy focuses on the most definitive sources of long-term return outperformance, namely:

- **Ongoing assessment of risk factors;**
- **Maximizing income when the time is appropriate; and**
- **Focusing on the best compensation for risk**

In ensuring that each source of long-term performance is maximized, TDAM follows three guiding principles to help ensure our strategy is truly effective in its objective.

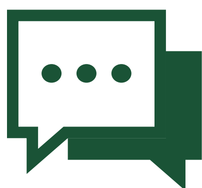
The table below states each lever and details their functional importance

Guiding Principles:	Functional Importance:
Extensive independent credit research	✓ Internal rating and volatility risk scoring
	✓ Security Selection
Sound yield and credit curve analysis	✓ Duration management
	✓ Yield curve positioning
Strategic portfolio construction	✓ Sector allocation and term structure
	✓ Quality of portfolio
	✓ Credit quality allocation

Conclusion

As the corporate bond market continues to undergo changes, TDAM's Active Fixed Income philosophy and strategy allows us to better manage the market risks stemming from the growth of the BBB bond segment. Our investment processes are built on our institutional capabilities in macroeconomic analysis, credit research and an in-depth yield and credit curve analysis. As detailed in this paper, we anticipate that interest rates will remain below their historical averages going forward, as such, managing our client portfolio's for potential vulnerabilities, such as interest rate risk and credit risk scenarios, is truly important.

Through our collective effort, we strive to smoothly navigate multiple market cycles, while continually adding long-term value for our clients. ■



Let's talk

Our **relationship management team** would be happy to discuss our Fixed Income Capabilities, and how they can be of benefit for your plan.

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