

# Soft or hard landing: does it matter for investment grade bonds?

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Portfolio Managers **James Briggs** and **Tim Winstone** look back at previous Eurozone economic downturns for their impact on investment grade corporate bonds and whether parallels exist with today.

## Key takeaways

- There have been four economic contractions in the Eurozone since 2000, with investment grade corporate bonds outperforming sovereign bonds in three of the four episodes.
- Extending the holding period around the downturn (to account for lack of precision when contractions start and end) typically smooths extremes in excess return and turns total return positive in all four periods.
- Looking at starting characteristics of past downturns, today's investment grade corporate bond market has some commonalities with a deep economic downturn despite being priced more for a shallow downturn, in our view, warranting some caution.

Soft or hard? That's the dilemma facing markets and we're not talking about cheese. Can central banks engineer a soft landing for the economy or will they provoke a hard landing with a deep recession? We take a look at previous economic downturns in the Eurozone and whether there might be lessons for today's euro investment grade (IG) corporate bond market.

During the last 25 years the Eurozone has had four contraction/recessionary episodes, as represented by periods of negative quarterly real gross domestic product (GDP) growth. The automatic assumption might be that holding government bonds over corporate bonds would be a good strategy in a period of economic weakness. History suggests that is only true in hard landings.

The four eurozone economic contractions are:

- **2003 Iraq War** (Q1 2003 short contraction)
- **2008/9 Global Financial Crisis** (Q2 2008 to Q1 2009 deep recession)
- **2011/13 Eurozone Debt Crisis** (Q4 2011 to Q1 2013 protracted shallow recession)
- **2020 COVID Pandemic** (Q1 2020 to Q4 2020 V-shaped recession)

The ICE BofA Euro Corporate Index is a basket of Euro investment grade corporate bonds. Returns data is available for both total return (combined income and capital movements) and excess returns. The excess return isolates the portion of performance that is attributed solely to credit and is equal to the corporate bond(s) total return minus the total return on a risk-matched basket of government bonds. It essentially displays the excess return on an index that comes from the additional yield that corporate bonds accrue over government bonds of the same maturity and the effect of any change in credit spreads over the period.

Figure 1 shows that in three out of the four periods, holding investment grade corporate bonds was more rewarding than holding government bonds. Incidentally, investment grade bonds also outperformed equities (as represented by the MSCI Europe ex UK Total Return Index) in three out of the four periods (the exception being the 2011-13 debt crisis).<sup>1</sup>

**Figure 1: Total and excess returns of Euro investment grade corporate bonds during economic contractions (annualised figures)**



Source: Janus Henderson, Bloomberg, ICE BofA Euro Corporate Index, total returns and excess returns in euro. All economic contraction periods are inclusive (Iraq War = Q1 2003, Global Financial Crisis = Q2 2008 to Q1 2009, Eurozone debt crisis = Q4 2011 to Q1 2013, COVID = Q1 2020 to Q4 2020). **Past performance does not predict future returns.**

To correct for the fact that recessions do not just start and finish at the same time for all companies, i.e. some corporates will be affected earlier or later by economic weakness, in Figure 2 we expanded the period around the contractions to cover the preceding six months and the following six months. This turns total return positive in all the longer periods and tends to soften the extremes of excess return, i.e. lowers strong positive excess return and reduces negative excess return.

**Figure 2: Total and excess returns of Euro investment grade corporate bonds during economic contractions plus six months either side (annualised figures)**



Source: Janus Henderson, Bloomberg, ICE BofA Euro Corporate Index, total returns and excess returns in euro. **Periods in bold in brackets** reflect the period shown, which comprises the six months before the contraction, the contraction period itself plus the six months after the contraction, all periods are inclusive. Iraq War = Q1 2003 (**Q3 2002 to Q3 2003**), Global Financial Crisis = Q2 2008 to Q1 2009 (**Q4 2007 to Q3 2009**), Eurozone debt crisis = Q4 2011 to Q1 2013 (**Q2 2011 to Q3 2013**), COVID = Q1 2020 to Q4 2020 (**Q3 2019 to Q2 2021**). **Past performance does not predict future returns.**

Given the uncertainty in the market about whether we will experience a hard or soft landing, the previous episodes are instructive. They reveal that it has historically made more sense to own investment grade corporate bonds over government bonds in all but the most severe economic contractions.

#### Accounting for differences

Of course, each of the four contractionary periods was different. But that can be helpful. We can look for similarities and differences among past contractions compared with today. In the table below we have colour coded green where factors are similar to today.

**Figure 3: Eurozone economic and Euro Investment Grade (IG) factors at start of contraction**

Factor at start of contraction	2003 Iraq War	2008 Global Financial Crisis (GFC)	2011 Debt Crisis	2020 COVID	28 Feb 2023
Extent of GDP contraction during downturn	-0.3%	-5.7%	-1.8%	-4.1%	?
Inflation rate	2.3%	3.6%	3.0%	1.3%	8.5% (Jan 2023)
Inflation falling or rising	Flat	Rising	Rising	Rising	Falling
ECB policy rate (refinance)	2.75%	4.0%	1.5%	0.0%	3.0%
ECB policy rate falling or rising trend	Falling	Rising	Rising	Flat	Rising
Effective duration	4.24	4.47	3.91	5.22	4.64
Yield to worst on Euro IG	4.41%	5.63%	4.06%	0.51%	4.32%
Yields falling or rising	Falling	Rising	Rising	Rising	Rising
Credit spread on Euro IG (basis points)	96	179	299	94	147
Unemployment rate	9.0%	7.4%	10.5%	7.5%	6.6% (Dec '22)
PMI manufacturing	48.4	52	48.5	46.3	48.5
Price (par weight)	104	95	100	106	89

Source: Janus Henderson, Bloomberg: Eurozone real GDP at 2010 prices, inflation = Eurozone Harmonised Index of Consumer Prices, year on year % change, European Central Bank (ECB) policy refinancing rate, Eurostat Eurozone unemployment rate, Eurozone Manufacturing Purchasing Manager Index (a figure below 50 indicates contraction); ICE BofA Euro Corporate Index: yield to worst, credit spread = Govt option-adjusted spread (OAS), basis point (bp) equals 1/100 of a percentage point. 1 bp = 0.01%, 100 bps = 1%, effective duration, par weight price (price of a bond as a % of its face value, showing weighted average for the index). Figures in columns consecutively dated as at 31/12/2002, 31/03/2008, 30/09/2011, 31/12/2019 and 28/02/2023 (or latest figure available). **Past performance does not predict future returns.**

At first glance it looks disparate, but we should expect that as today's environment is not a perfect match with any of the past contractions. If it were, investing might be a lot easier. The clearest distinction is inflation. In all previous episodes it was either flat or rising. Today it has rolled over and is coming down from a peak but the recent peak was much higher than at the start of previous economic downturns. How quickly it subsides will affect central bank policymaking so it remains a key variable for interest rate risk.

The colour coding in the table ominously has the most commonalities with the 2008 Global Financial Crisis (GFC) recession. Recall this was the downturn that resulted in negative excess return. Today's yield and spread are below the levels at the start of 2008, which marries with our view that today's market warrants some caution as it is not pricing in a severe recession. Despite the geopolitical risks emanating from Russia/Ukraine, however, we do not see the same systemic risk within the financial system that existed within the banking sector pre-GFC. Today, the banking sector is better capitalised and the coming downturn in our view is a more traditional economic downturn focused on consumer/corporate retrenchment, which ought to be less severe than a financial crisis.

Today's yields and spreads are similar or higher than shallow recessions, potentially justifying current market pricing if the economy achieves a soft landing or shallow contraction. Another notable difference is that prices today are well below par values, creating a helpful pull to par. Judging against these parameters, Euro investment grade corporate bonds may be fairly priced for a shallow downturn and potentially offer value if the economy could avoid a recession altogether. Much will rest on how quickly inflation can recede and the response of central banks.

<sup>1</sup>Source: Janus Henderson, Bloomberg, MSCI Europe ex UK, ICE BofA Euro Corporate Index, total returns in USD. Periods as per Figure 1.

## The authors

### James Briggs, ACA, CAFA – Portfolio Manager



James Briggs is a Corporate Credit Portfolio Manager at Janus Henderson Investors responsible for the Global Investment Grade, Sterling Investment Grade, Buy and Maintain and UK Cautious Managed strategies. James joined Henderson in 2005 as a credit analyst and was named a portfolio manager in 2010. Prior to this, he was a credit analyst with BlueBay Asset Management and a high-yield analyst with Invesco Asset Management.

James graduated with a BA degree (Hons) in philosophy from University College London. He is a member of the Institute of Chartered Accountants in England and Wales and holds the Chartered Financial Analyst designation. He has 25 years of financial industry experience.

### Tim Winstone, CFA – Portfolio Manager



Tim Winstone is a Corporate Credit Portfolio Manager at Janus Henderson Investors, a position he has held since joining Henderson in 2015. Tim co-manages the European Investment Grade, Global Investment Grade, European High Yield, Global High Yield and Global Responsible Managed strategies. Prior to Henderson, he was an executive director, senior fixed income portfolio manager and part of the global credit team at UBS Global Asset Management. He began his career as a portfolio assistant at Thesis Asset Management and has worked in global credit since 2004.

Tim earned a BSc degree (Hons) in mathematics from the University of Bristol. He holds the Chartered Financial Analyst designation and the Investment Management Certificate and passed the Regulation and Compliance unit of the CISI Diploma. He has 20 years of financial industry experience.

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