MFS® White Paper

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Minicycles and Liquidity as a Fixed Income Alpha Lever

Authors

Joshua P. Marston
Director of Fixed Income – North America

Robert M. Hall
Institutional Portfolio Manager

Benjamin T. Dyer
Reserach Analyst

In brief

- Shifts in market structure since the global financial crisis (GFC) have resulted in lasting changes in the behavior of credit spreads through a credit cycle with significant implications for active investors.
- Liquidity in the credit markets has contracted dramatically post-GFC, contributing to increasingly frequent episodic periods of notable intracycle spread volatility (*i.e.*, minicycles).
- While increased volatility can be challenging, it also creates opportunities for active managers to add value through tactical asset allocation.
- To capture alpha through these minicycles, valuation discipline is critical, as the risk of short-term give-ups in relative portfolio performance created by reducing credit exposure when spreads are tight is likely to be more than offset by the potential gains realized by being positioned to redeploy back into credit at more attractive valuation levels (*i.e.*, positioned to be a provider of liquidity during periods of distress).

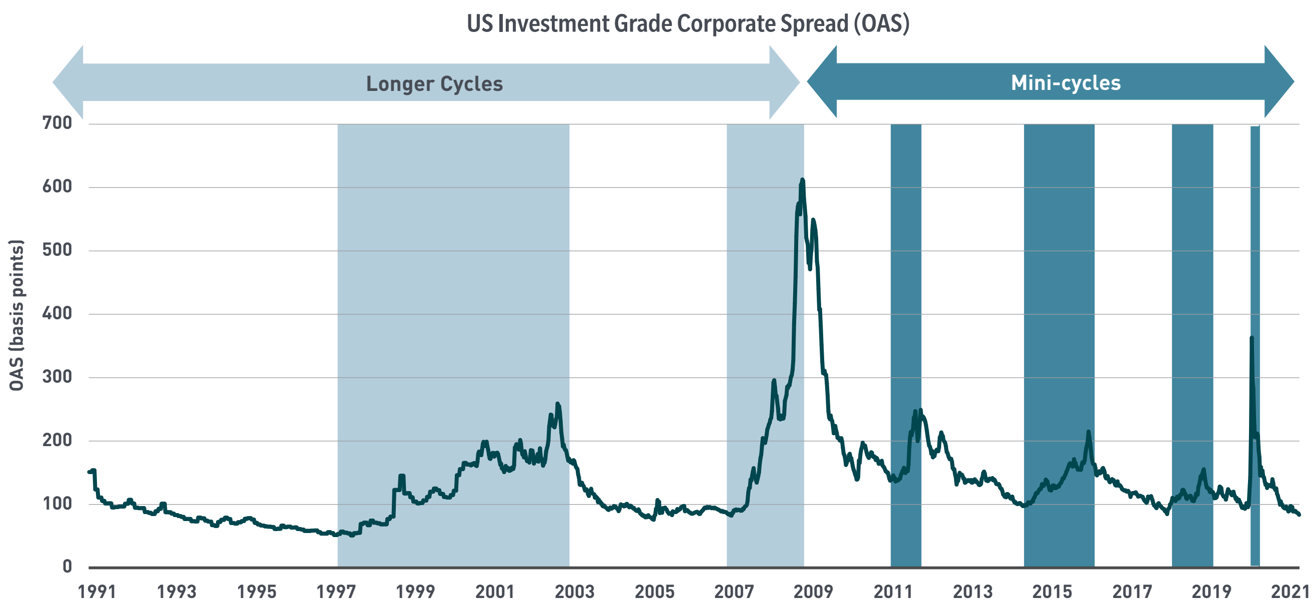
Credit spread volatility intracycle has risen post-GFC

The credit cycle that began following the GFC has distinguished itself from prior cycles in many notable ways. One is that it features the absence of an inflationary threat coupled with a US Federal Reserve willing to do whatever it takes to sustain the credit cycle. While a number of factors that may or may not persist in future credit cycles have contributed to comparatively tepid long-term economic growth despite easy financial conditions, some of the factors that have left the credit markets more vulnerable to periods of intracycle spread destabilization will remain intact absent extensive regulatory liberalization and monetary policy reorientation. As a result, the pattern of spread movement through cycle will be different, suggesting a new approach to generating alpha through cycle that places more emphasis on market technical factors in risk budgeting and relies more on price appreciation to seek excess return, at the expense of carry.

In the two credit cycles prior to the GFC, spreads compressed coming out of recession and subsequently stabilized at low levels for long periods of time. During the expansion in the 1990s, after a period of rapid compression, corporate spreads stayed low and stable for almost six years. This was followed by an interval of spread widening and increased volatility going into the recession of the late 1990s, the 9/11 terrorism event in the US and the TMT (technology, media and telecommunications) implosion in equity valuation. This cycle was again followed by a period of spread compression and low and stable rates that lasted for years until the GFC.

Since the GFC, the pattern of credit spreads through cycle has changed. Rather than initial compression followed by long periods of low and stable spreads, there have been within a single credit cycle more frequent episodic periods of sharp spread widening followed by compression than were typically observed through past full market cycles. These have occurred every couple of years — and are what we refer to as mini-cycles. While the catalyst in each case has been different, the underlying conditions that allow for this type of volatility have been the same. The changing frequency of periods of spread volatility is evident in Exhibit 1 below:

Exhibit 1: Credit spread volatility intracycle has risen post-GFC



GFC = Global Financial Crisis. Shaded areas represent periods of significant spread widening. Source: Bloomberg. Weekly data from 1 March 1991 through 28 May 2021. US Investment Grade Corporate = Bloomberg Barclays US Aggregate Corporate Index.

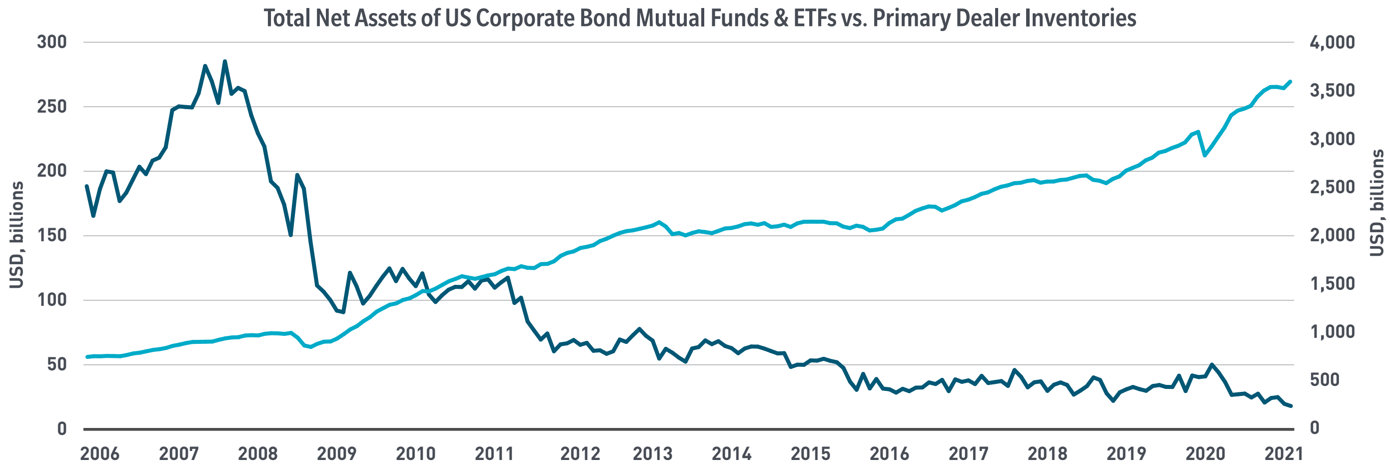
Market structure is challenged

While several forces have contributed to these minicycles in the credit markets, liquidity (or the lack thereof) is the biggest factor. Exhibit 2 charts primary dealer inventories of US corporate bonds, a measure of market liquidity, and total corporate bond mutual fund and ETF assets, which represent investor demand. Dealer inventories dropped from about $100 billion in the wake of the GFC to about $25 billion today, a quarter of the prior level. This is largely tied to regulatory changes related to the Dodd-Frank legislation, including the Volcker rule, that constrained the type of risks financial institutions could take and all but ended broker/dealer proprietary trading, an important source of liquidity.

As Exhibit 2 indicates, while liquidity was dropping, the market was rapidly growing — quadrupling, in fact. This growth was in many ways a byproduct of low interest rates and monetary accommodation that encouraged companies to borrow and forced investors to compete with the Fed for yield as quantitative easing pushed interest rates lower. The result is a liquidity "pipe" that today is one-sixteenth in size what it was relative to the size of the market before the GFC.

Exhibit 2: Market structure is challenged

■ Primary Dealer Inventories of Corporate Bonds (LHS) ■ Total Corporate Mutual Funds + ETF Assets (RHS)



Source: ICI & Haver Analytics. Monthly data from 31 January 2006 through 30 April 2021.

Bond returns and investor flows are positively correlated

A combination of a smaller liquidity pipe and an investor base that often moves in the same direction at the same time further exacerbates the liquidity environment. Retail fixed income investors tend to act based on trailing total returns, which is adversely impacted by rising yields, while increased rate volatility also tends to reduce foreign flows as hedging costs reset. In addition, dealers now move in the same direction as the market at the same time — reducing balance sheet risk with the herd.

The result is a recipe for dislocation and volatility, with the market struggling to find a new clearing level whenever there are significant capital flows and shifts in investor preferences. At present, we consider the Fed an investor in the marketplace — perhaps the biggest one. This is a challenging position for the Fed to be in as it makes plans to taper monetary stimulus and reduce its market activity.

We don't expect these market dynamics to change in the near term. Until we have a liquidity solution, we will have an unstable risk pricing mechanism. Significant shifts in investor demand coupled with poor liquidity will create periods of dislocation, *i.e.*, minicycles.

Investment implications of minicycles

We now consider the portfolio management implications of the spread volatility that seems to accompany these minicycles and assess how an active manager can add alpha by taking advantage of them.

Periods of spread widening and tightening in U.S. investment-grade corporates

While this type of volatility can create challenges, it can also create opportunities. Exhibit 3 provides a sense of this by isolating periods of directional spread moves both higher and lower, suggesting the magnitude of positive returns that might have been possible with perfect foresight of directional changes in spread movement.

Exhibit 3: Periods of spread widening and tightening in US IG corporates

	Start Date	End Date	# of months	Cumulative Spread Change (bps)	Cumulative Excess Return for Period (%)	Annualized Excess Return for Period (%)
Pre-GFC	Jan-91	Jul-97	79	-103	13.3	1.9
	Jul-97	2-Oct	64	204	-12.5	-2.5
	2-Oct	7-Feb	53	-173	13.1	2.9
GFC	7-Feb	8-Dec	22	531	-29.8	-18
	8-Dec	11-Apr	29	-477	29.2	11.4
Post-GFC	11-Apr	11-Nov	8	113	-6.6	-10.2
	11-Nov	14-Jun	31	-79	13.4	4.9
	14-Jun	16-Feb	20	118	-7.5	-4.6
	16-Feb	18-Feb	24	-130	13	6.4
	18-Feb	19-Jan	11	70	-4.2	-4.6
	19-Jan	20-Jan	13	-62	7	6.8
	20-Jan	20-Mar	3	270	-18	-68.3
	20-Mar	21-Apr	14	-284	15	13.8

Longer cycles (65 months on average)

Mini-cycles (16 months on average)

Source: Barclays Live. US IG Corporates = Bloomberg Barclays US Aggregate Corporate Index. Blue indicates periods where spread tightened. Gray indicates periods where spreads widened. Past performance is no guarantee of future results.

If we compare the pre-GFC episodes to the post-GFC ones we can see that the frequency increased over time — on average, it was 65 months pre-GFC versus 16 months post-GFC. Gone are the days of putting a risk overweight position in place in the early stages of expansion and keeping it on for half a decade.

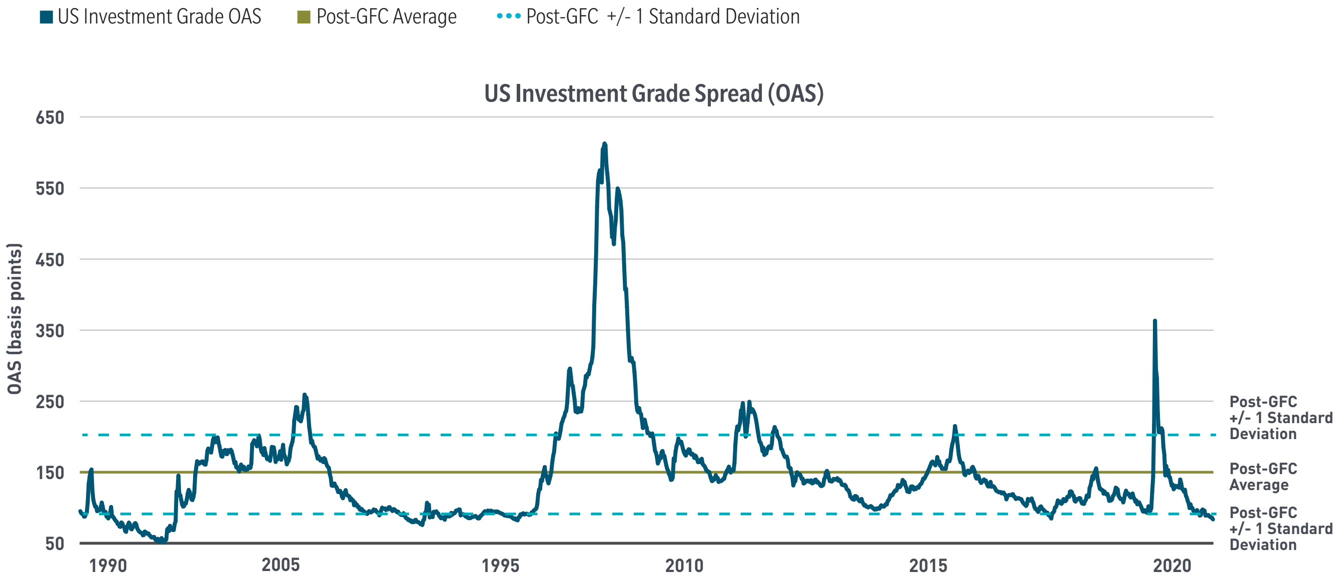
For those better able to recognize critical points in these minicycles and willing to act tactically, there is an opportunity to add value through sector allocation. In our view, the opportunity to generate alpha in the future by reducing expensive credit risk and waiting to reallocate at wider spreads may potentially earn multiples of foregone current yield.

While no investor is prescient, and every spread cycle is different, investors should closely examine their credit allocation when credit spreads are at the tighter end of their historical range. This is particularly true given shorter periods of stable carry post-GFC and the instability of spreads at historically tight levels that typifies the current environment.

Windows of opportunity are narrow

The current environment of higher spread volatility and increased instability of spreads upon reaching extremes suggests the windows of opportunity to capitalize on minicycle turning points are short-lived. Exhibit 4 places historical US investment-grade corporate spreads in the context of their post-GFC average, as well as relative to levels that represent +/-1 standard deviation moves relative to that post-GFC average. Given that spreads no longer seem to linger long at levels that look expensive versus history, the relative richness of spreads can provide the investor with tactical signals on when to "reload" portfolio liquidity for the next bout of spread widening.

Exhibit 4: Windows of opportunity are narrow



GFC = Global Financial Crisis. Source: Bloomberg. Weekly data from 1 March 1991 through 28 May 2021. US Investment Grade = Bloomberg Barclays US Aggregate Corporate Index.

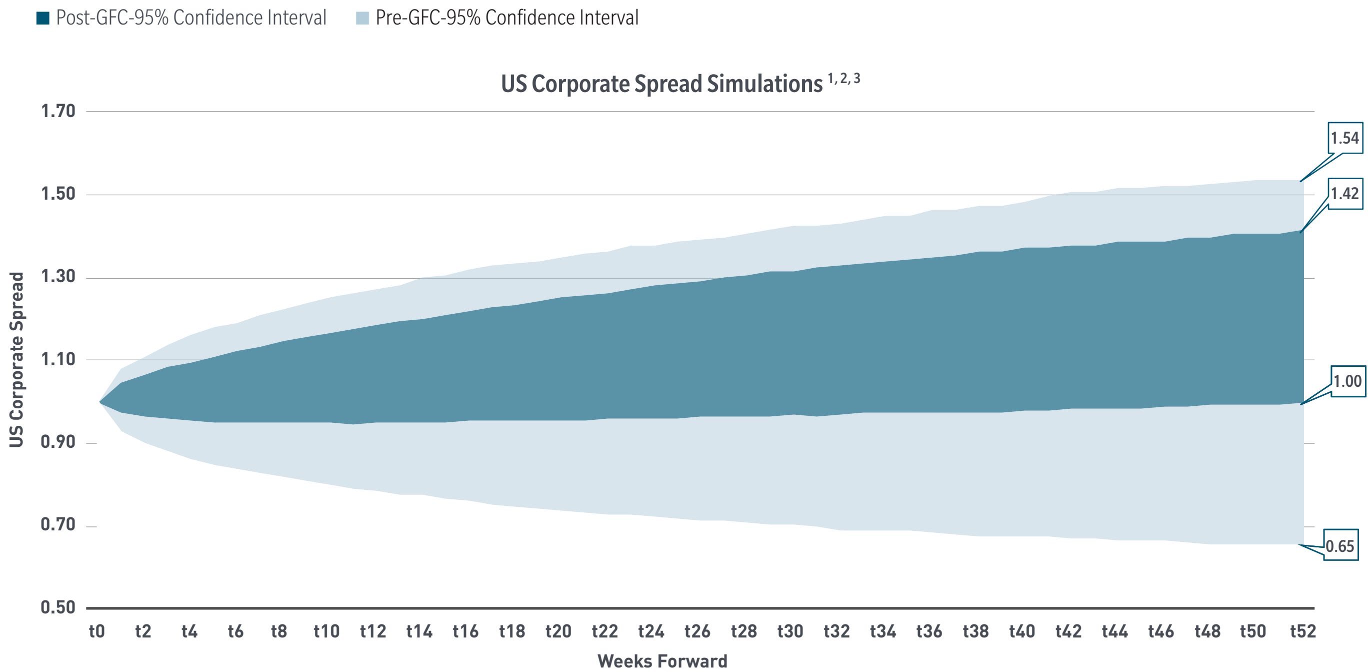
This highlights the importance of maintaining a strong sell discipline. Portfolio managers don’t have the luxury of sitting on a carry trade for several years as they did in the past — the time that spreads stay at low levels is relatively short. This requires willingness to give up some short-term relative outperformance from out-yielding an index when spreads are too expensive to be able to potentially add more alpha over the course of a mini-cycle by stepping back and waiting to buy credit at more attractive levels.

Also, *one needs to be early to be right.* Liquidity will not be there when the market moves; that's a big part of why it’s moving in the first place. Portfolio managers should consider selling into a liquid and tight spread market when given the opportunity as the ability to readily reposition will not be there during a period of dislocation. This is how managing portfolio liquidity can serve as an alpha lever.

Asymmetry of spread outcomes pre- and post-GFC

Our analysis shows that since the end of the GFC, the potential alpha through spread compression and price appreciation at a lower starting level of spread has notably decreased.[1] In Exhibit 5, we track the distribution of potential outcomes for future spreads based on a starting spread of 100 basis points during the pre- and post-GFC periods (but excluding the GFC). The light gray probability cone represents the range of outcomes within a 95% confidence interval over a 52-week period pre-GFC while the dark gray represents outcomes within the same confidence interval based on the distribution of spread moves post-GFC. Since the GFC, the range of outcomes given a starting spread of 100 has become much more one-sided (and skewed toward widening) as opposed to a more symmetric range of outcomes pre-GFC. If the post-GFC pattern of spreads persists, investors are unlikely to generate alpha by staying the course when spreads are tight versus history by waiting for spread compression and the resulting price appreciation.

Exhibit 5: Potential upside when spreads are tight has diminished



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[1] A regression-based approach was used to create a future spread distribution based on a starting spread of 100 basis points for the Bloomberg Barclays US Aggregate Corporate Index with OAS as the dependent variable and mean, volatility, skew and kurtosis as the independent variables based on three months of observations.

[2] Post-GFC data: April 2011 to February 2020.

[3] Pre-GFC data: March 1989 to February 2007.

Source: MFS research and Bloomberg Barclays.

The idea is to sell bonds when the liquidity premium investors are demanding is lower than it should be because liquidity is not in demand and to buy bonds when the liquidity premium is higher than it should be because liquidity is scarce and in high demand.

Conclusion

We believe the minicycle phenomenon that has developed since the GFC is likely to continue because the credit markets are not sufficiently liquid to be able to handle significant changes in investor preferences without causing a disorderly repricing of bonds. When these selloffs happen, they create opportunities to add alpha through tactical allocation.

To capture alpha through these cycles, it is necessary to stay disciplined on valuation and to be early, especially in selling. Using liquidity as an alpha generator requires that the investor be willing to temporarily give up some carry as spreads get expensive in order to be able to step into the markets as a provider of liquidity when spreads become cheap. The idea is to sell bonds when the liquidity premium investors are demanding is lower than it should be because liquidity is not in demand and to buy bonds when the liquidity premium is higher than it should be because liquidity is scarce and in high demand.

This requires confidence and courage on both sides of the trade. It means risking some near-term underperformance by reducing risk so as to be able to increase it later when the markets are in turmoil, believing that spreads will again normalize and deliver alpha via spread compression and price appreciation to the patient and disciplined investor.

Endnote

[1] A regression-based approach was used to create a future spread distribution using a Monte Carlo simulation based on a starting spread of 100 basis points for the Bloomberg Barclays US. Aggregate Corporate Index with OAS as the dependent variable and mean, volatility, skew, and kurtosis each as independent variables based on three months of observations. Post-GFC data included April 2011 to February 2020, while pre-GFC data included March 1989 to February 2007.