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Averages, shmaverages... it's outliers that matter.

Jeffrey Hobbs, CFA
Head of Insurance
Portfolio Management

As the range of economic outcomes has widened, insurance investors need to be laser focused on the potential catalysts for tail risk.

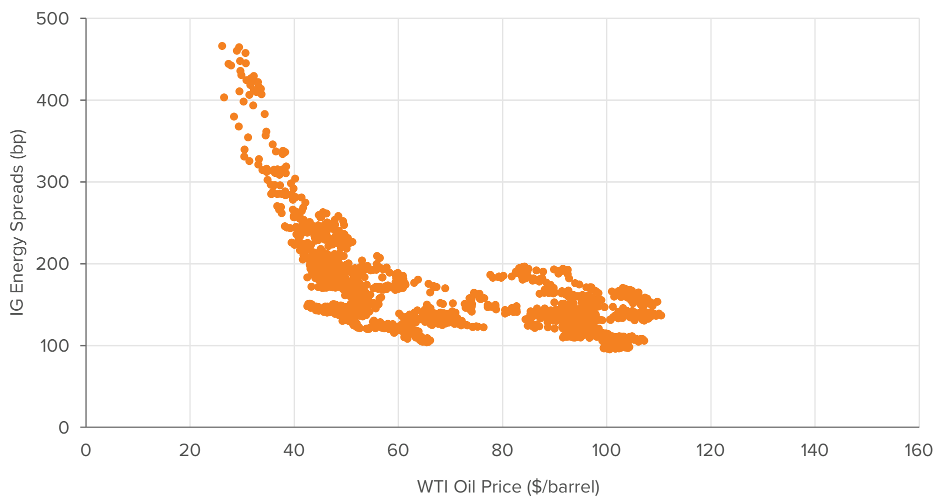
Despite widening meaningfully to start the year, spreads for investment grade (IG) corporate bonds are near their 20-year average. But averages can be misleading. Over the last 20-year period, spreads have been within 10 basis points of their average only about 10% of the time.

If IG spreads rarely trade near their long-term average, does it matter that they're close to it now? The answer: not really. Remember, most insurance portfolios are built to return par. Unfortunately, downside risk can be both meaningful and asymmetric along the way. Roughly 70% of the time, spreads have been tighter than the trailing 20-year average; in recessionary periods of market dislocation, however, spreads have been much wider. As a fixed income manager, downside risk is my number-one concern. In light of this, I believe managing for nonlinear outcomes is more important than focusing on averages, especially in a more fragile environment.

For perspective, consider the chart below, which shows the relationship between oil prices and the spreads of IG-rated exploration and production companies during the commodity stress period of the last decade. When oil prices ranged between $100 and $50 per barrel, spreads were less sensitive to price. But as oil prices moved lower, towards the marginal cost of production, we saw a sharp uptick in financial distress.

Beware of nonlinear outcomes

Oil Prices & Independent E&P Spreads



2014-2016. Source: Bloomberg Indices and Voya Investment Management. IG energy spreads represent the Bloomberg Barclays Investment Grade Corporate Index: Independent Exploration & Production Subsector.

So, what's the point? To be sure, this example is not about the current opportunity set in energy! It is about the importance of homing in on the potential for nonlinear spread moves. As the range of economic outcomes has widened, we must be diligent about the potential for sources of tail risk. Where is my portfolio exposed?

In our view, Europe and China are the most likely catalysts for tail risk. As George R.R. Martin wrote, "Winter is coming." In Europe, the decreased availability of Russian oil and gas could have a marked impact on industrial production. This would have an impact on corporate credit metrics...which would have an impact on corporate default rates...which would have an impact on European bank balance sheets...which would have a recursive impact on lending and European economic growth.

Meanwhile, the possibility of a hard landing in China feels as real as ever. The pandemic-driven lockdown dampened growth figures to anemic levels. The property sector feels like it is unwinding. Key export markets such as Europe have their own headwinds. Geopolitical tensions remain heightened around Taiwan. Slower growth in China would have a ripple effect across Asia and significantly hamstring its key global trading partners, as well as global commodity markets. China is such a force in global markets that this risk is bordering on systemic, and a hard landing remains a possibility that could lead to nonlinear spread outcomes.

If you're looking to stress test your portfolio for tail risk, assessing your exposure to China and Europe (both direct and indirect) is a good place to start.

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