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Global Corporate Bonds: A good time to bolster defensive allocations

Key takeaways

- At the end of June, global investment grade (IG) corporate bonds provided a yield of around 5.2% (USD hedged). Historically, yield has been highly correlated to future 5-year returns. In other words, at current yields, dollar-based investors could reasonably expect annualised results in the mid-to-high single digits over the next five years.
- Today's historically strong fundamentals suggest IG corporates are an attractive option to provide defensive ballast and to fulfil the role of capital preservation in portfolios. Additionally, with inflation gradually stabilising, and central banks cutting rates, duration is once again providing a useful source of diversification.
- Spreads are tight relative to historical levels but beneath the surface there are opportunities for bottom-up investors, focused on security selection. Three areas of opportunity include European banks, US electric utilities and pharmaceuticals.

This year, financial markets have often seemed like a rollercoaster. Prices have whipsawed as investors have attempted to price heightened geopolitical risk and President Donald Trump's America first approach to global trade. In the aftermath of Trump's "Liberation Day", the S&P lost 20% only to regain almost all of this in a matter of weeks. At the same time, US treasury yields were equally volatile, rising and then falling back by nearly 80bps. What can investors do to manage portfolio risk amid such extreme market moves?

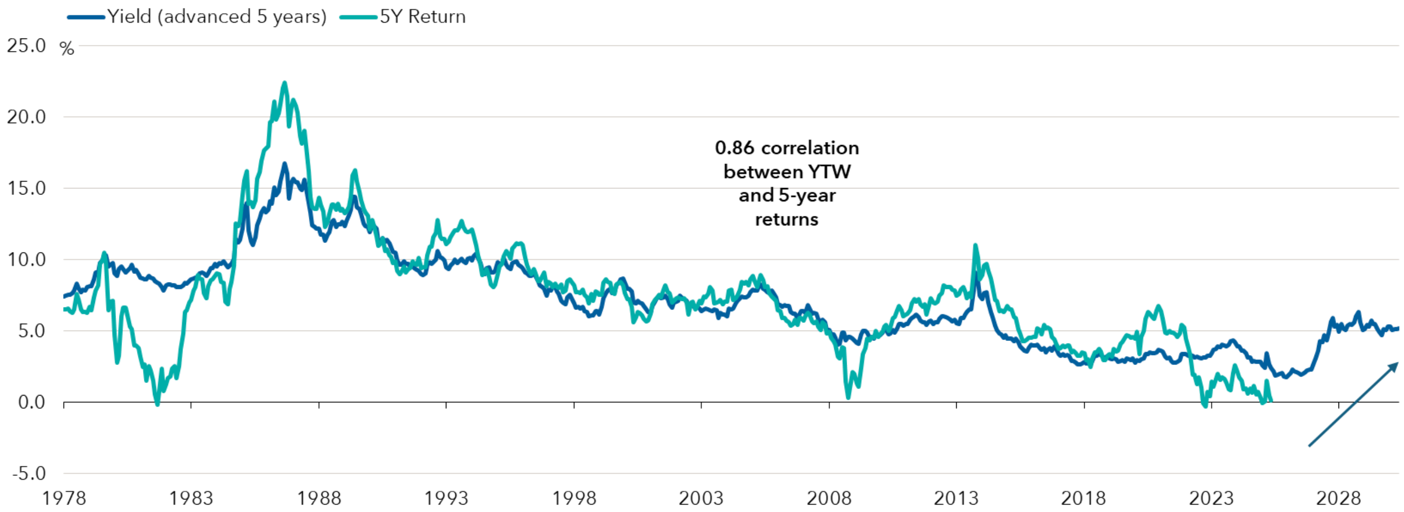
One important lesson we think investors can draw from such volatility is the value of maintaining a solid defensive allocation to help smooth portfolio results. We think global IG corporate bonds are an effective way investors can achieve this with the asset class providing three of the key roles investors typically required of fixed income: Income, capital preservation and diversification from equities.

Income: The power of yield

Yields across IG corporate bonds are high relative to levels over the past decade. As of 30 June 2025, US IG had yield to worst (YTW) of 4.99% and European IG a YTW of 3.07% (5.48% when hedged to US dollars[1]). As the following chart highlights, yields have historically been closely correlated to future returns. This would suggest that at current levels, it is reasonable for dollar-based investors to expect annualised results in the mid-to-high single digits over the next five years.

In addition to the attractive level of income, the relatively high yields available also give portfolios an income cushion that can help offset price volatility and thereby protect total returns.

Yield has historically been a strong indicator of future returns from US corporate bonds

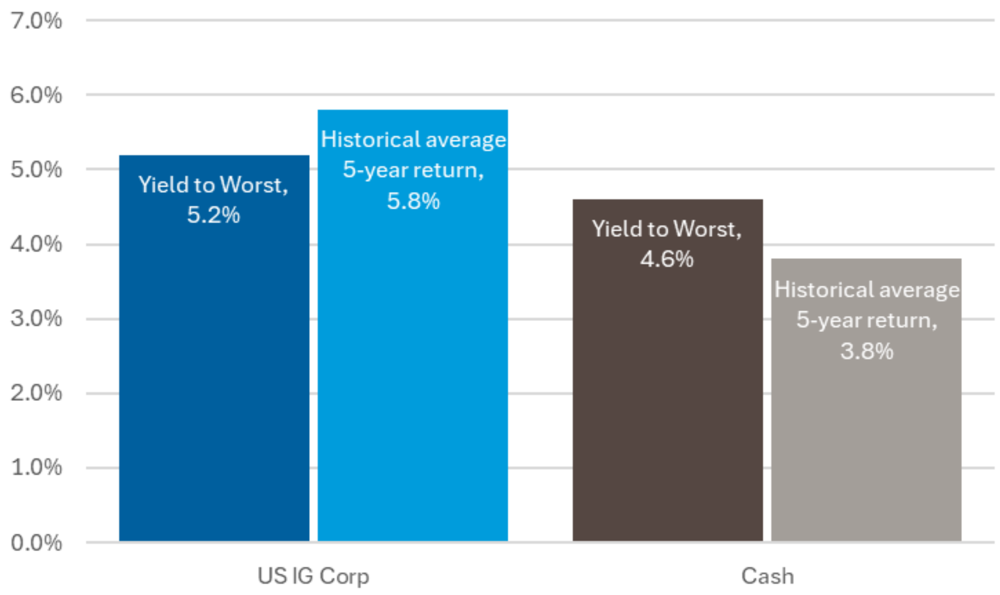


Past results are not a guarantee of future results.
Data from 31 January 1973 to 31 May 2025 and in US dollar terms. Index used: Bloomberg US Corporate Total Return Index.
Source: Bloomberg. Yield is yield to worst.

[1]Source capital Group. Hedging proxied by 3-month forward FX contracts annualised.

The current high level of yield compares particularly favourably with cash, which is likely to see declining returns as central banks around the world continue to cut rates. On the other hand, the longer maturity profile of bond markets means today's higher bond yields are locked in for longer.

Bond yields outperform cash when central banks cut rates



Past results are not a guarantee of future results.

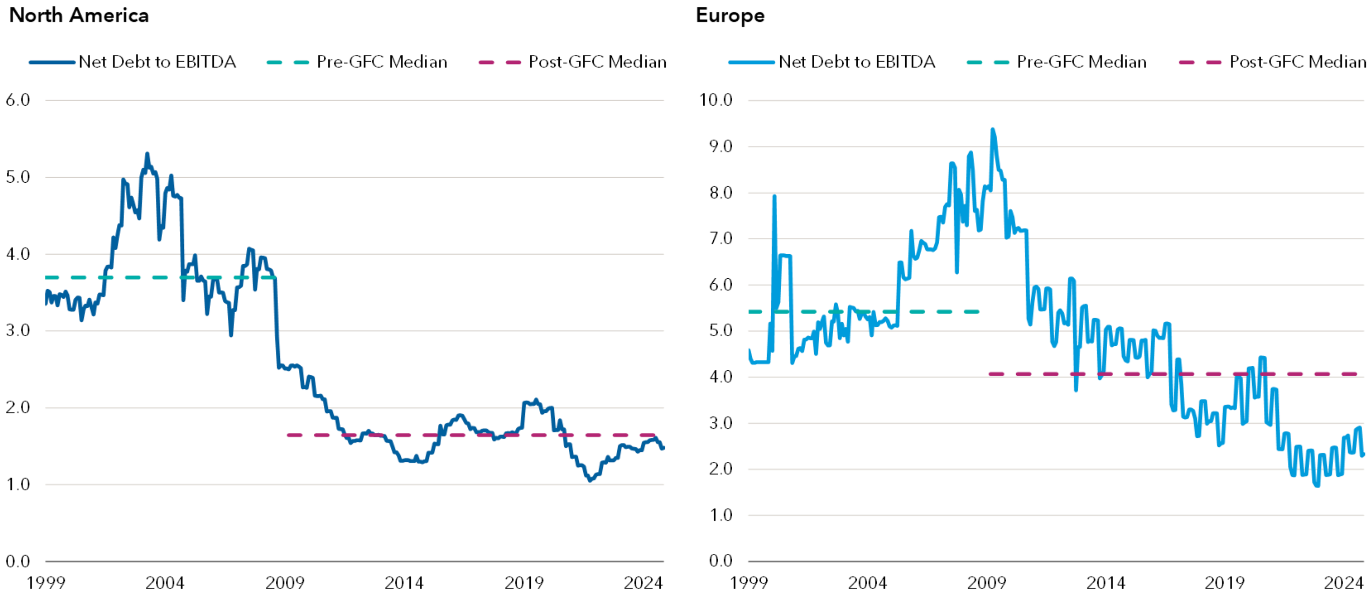
Yields and returns as at 31 May 2025 in USD terms. Sources: Capital Group, Bloomberg, JPMorgan Historical average returns are based on average 5-year forward return data and goes back to December 1987 for all sectors. Based on monthly returns for each sector when in a +/- 0.3% range of yield-to-worst. US Investment Grade (IG) Corporates represented by the Bloomberg US Corporate Index. Cash represented by the JPMorgan Cash Index USD 3-Month.

1. Historical average 5-year returns at the specified yield level

Capital preservation: Defensive ballast in an uncertain environment

The inherent creditworthiness of the sector helps IG corporates provide defensive ballast to portfolios and to fulfil their role of capital preservation. It is encouraging in this respect that, despite the current uncertainty over trade, fundamentals show companies remain in good health. Current credit metrics are particularly strong relative to historical levels. A good indication of this can be seen in the following chart of corporate leverage.

Net debt to EBITDA remains below post-GFC medians

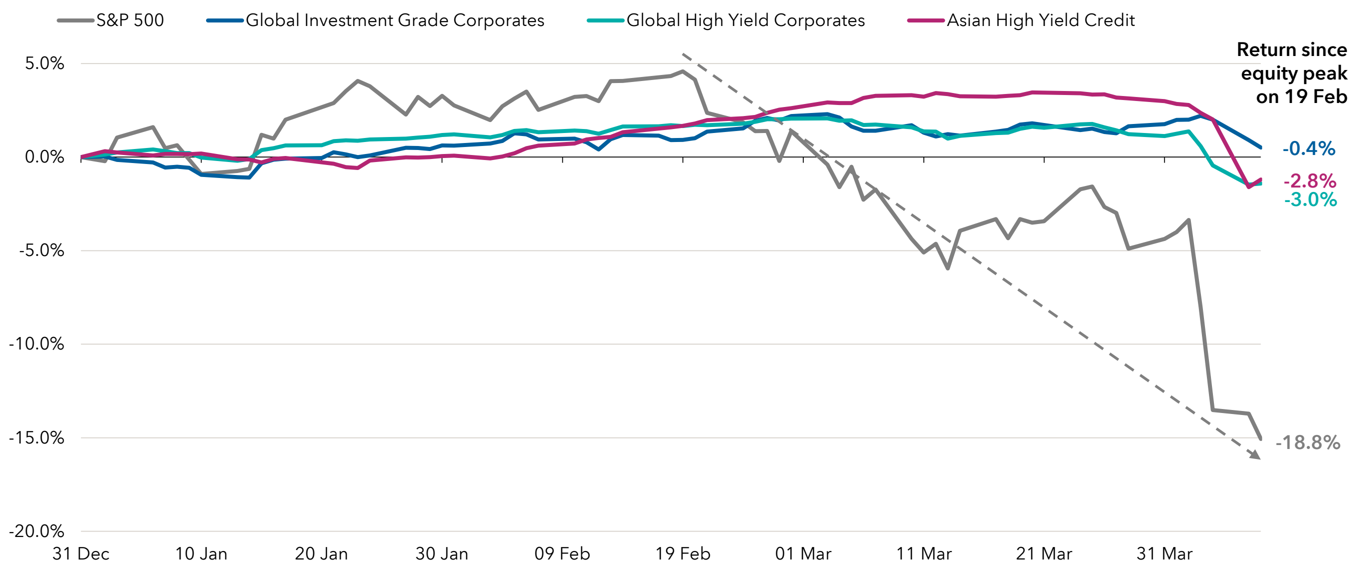


Past results are not a guarantee of future results

Data as at 31 March 2025. Source: Bloomberg. Indices: MSCI North America, MSCI Europe. EBITDA: Earnings before interest tax, depreciation and amortisation

Furthermore, as inflation gradually continues to trend down toward central bank target levels, duration, a core component of IG corporate bonds, provides a useful source of diversification. This was seen in April, when risk markets came under extreme pressure following the implementation of reciprocal tariffs. Equities were hardest hit, with spread products such as high yield also coming under pressure. However, IG corporate bonds held up well. As the following chart shows, from the peak in equity markets on 19 February to 8 April, IG corporate bond results were broadly flat. This was in large part due to the impact of duration.

High quality fixed income has provided much needed equity diversification



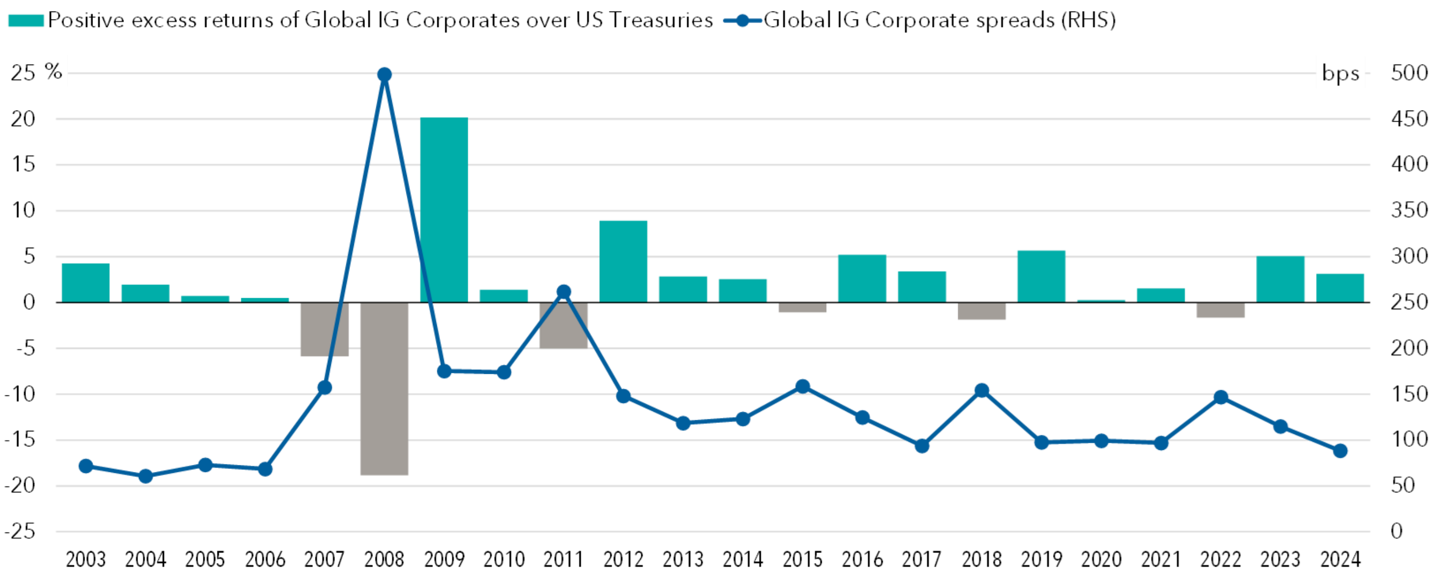
Past results are not a guarantee of future results.

Data as at 8 April 2025. Source: Bloomberg, JPMorgan. Global Investment Grade Corporates represented by the Bloomberg Global Aggregate Corporate Index Hedged to USD; Global High Yield Corporates represented by the Bloomberg Global High Yield Corporate Index Hedged to USD; Asian High Yield Credit represented by the JPMorgan Asian Credit Non-Investment Grade Index.

While sovereign bonds are often the default choice when building a defensive portfolio allocation, we believe in the current environment, it is worth investors considering high quality corporate bonds as a better alternative for the following reasons:

1. Historical analysis shows that the higher yield provided by IG corporates has helped the sector to deliver stronger results than sovereigns.
2. IG corporates have provided similar defensive characteristics to sovereigns in all but the most severe market sell-offs. Importantly, in the year after such periods of extreme volatility, corporate bonds results have historically been superior to US Treasuries.
3. In the current environment of strong corporate fundamentals and a solid economy supported by a resilient consumer, we have greater comfort IG corporates can provide portfolios with the required defensive ballast.

Annual global corporate bond versus US Treasury index results



Past results are not a guarantee of future results

Data as at 31 December 2024 in USD terms. Global IG Corporates are represented by Bloomberg Global Aggregate Corporate Index. US Treasuries are represented by Bloomberg US Treasury Index. Spread statistics are as at the end of each calendar year. Source: Bloomberg. BPS: basis points. YTD: year-to-date. IG: investment grade. RHS: right hand side

Historically, when spreads have been tight, dispersion has also narrowed. This relationship has continued to hold in today's market. However, through a deep fundamentals research approach our analysts continue to find attractive total return opportunities. Some good examples of these can be found in banks, utilities and pharmaceutical companies.

Banks

Banks are a core part of the investment grade universe and have been an important overweight position in Capital Group's global investment grade corporate bond portfolios. Positioning has been supported by the sector's strong fundamentals and attractive valuations.

Some of the value that was available in the US money centre banks has now been realised with spreads tightening both relative to the broader corporate index and on an absolute basis. As a result, we have sought to reduce some exposure to US money centre banks. Today, we believe, the opportunity in banks is more skewed to Europe, in particular, banks within Europe's periphery (Spain, Italy and Greece). Many banks in these countries have strong and improving fundamentals. At the same time, the underlying sovereign's economic strength also continues to improve. This combination of improving fundamentals in the banks and the sovereign provides a strong impulse for both to receive further ratings upgrades.

Focusing on the banks, a good illustration of their underlying strength was provided by first quarter results. This was the 19th consecutive quarter in which Europe's banks beat earnings expectations. A feat that was achieved against a backdrop of the ECB lowering rates. While it should be noted that lower rates do pose a risk to the sectors profitability, it is our view that as long as rates do not return to zero, this risk is likely to remain more of an equity than credit story. Indeed, data show that for many of Europe's banks, asset quality continues to improve while regulatory capital and liquidity remain a strength.

Although there has been some tightening of European bank spreads in recent years, valuations for the peripheral European banks continue to price wide of the broader corporate bond market offering selective opportunity.

Utilities

Electric utilities is a defensive, regulated sector that has in recent years traded at wider spreads than the broader investment grade corporate index and other defensive sectors.

This is a complex sector that includes secured and unsecured bonds and issuance by both holding and operating companies. The complexity rewards deep fundamental research and a selective bottom-up investment approach.

Utilities are currently experiencing a resurgence in growth with the emergence of AI and data centres, which are increasing demand for electric generation and transmission. We believe one of the best ways to capture this opportunity is currently through Californian electric utilities, where valuations are attractive while the sector benefits from the state's wildfire fund and a cap on liabilities. This helps mitigate against wildfires, which is a key risk for the sector that we believe can frequently be mispriced by the market.

Pharmaceutical

The pharmaceutical sector is another defensive area of the market, which tends to be less sensitive to the economic cycle due to them providing essential services. Today, valuations in the sector have become more attractive with spreads less tight relative to the broader corporate bond market than has historically been the case. Some of this valuation weakness reflects headline risk on tariffs as well as potential reforms on drug pricing and healthcare in the US. However, our view is that despite these headline risks, the long-term investment thesis for the sector remains strong.

By remaining highly selective, mindful of pipelines and competition from new drugs as well as M&A we have been able to capitalise on this opportunity in global corporate portfolios. As an indication of our selectivity, two companies make up over 40% of exposure to the sector in our global corporate bond strategy.

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