— Investing for a world of change

A new dawn for credit markets

Darpan Harar
Portfolio Manager

How have credit markets fared in this bond bear market?

A combination of rising government bond yields and higher credit spreads (reflecting investor risk-aversion) made 2022 a brutal year for credit investors. Counterintuitively, the more defensive, higher-quality areas of the market – areas that would typically outperform in a bear market – really suffered. So a key difference between this bear market and ones that have come before has been the lack of differentiation in terms of credit market performance. Faced with outflows, investors were effectively forced to sell at any price, resulting in a blanket sell-off that left active credit investors with nowhere to hide. But we believe that return dispersion between different credit asset classes will rise meaningfully as investors begin to discriminate between the winners and losers in an increasingly challenging economic environment.

Where does that leave valuations?

This is where we get to the good news. Most credit asset classes have cheapened significantly, with spreads well above their 10-year averages. As a general theme, this has been most pronounced in the higher quality sectors of the market such as investment grade and high-quality structured credit. The picture is even more compelling in a historical context if you focus on yields – in the investment-grade market, yields are significantly higher than levels seen during the COVID crisis. All this means that credit markets have underperformed other risk assets such as equities. Furthermore, it is very rare that we see corporate bond yields exceeding earnings yields that are available in equity markets, but that is currently the case in some key markets like the US. From a variety of angles, valuations are historically very compelling.

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The content of this communication is intended for readers with existing knowledge of financial markets.

Are more companies likely to default on their debt given the challenging economic conditions?

While segments have experienced some stress, the overall market has been quite robust, as reflected by default rates remaining below their long-run averages. As macro conditions get tougher, we expect to see some increase in default rates. But we expect this rise to be less pronounced than in previous recessions for three reasons. First, company balance sheets have started from a position of strength, as firms have been more disciplined and conservative in managing their balance sheets. Second, many companies did a great job of taking advantage of the low yield environment to finance themselves with longer maturities, meaning a relatively low amount of debt will mature in the near term. Third, the overall quality of credit market has improved dramatically; with the weakest companies defaulting and exiting the market during the COVID crisis, the average quality of companies that remain is much higher now.

Looking further ahead, we see increased potential for negative credit surprises as the financial impact of higher rates begins to really test the more vulnerable companies, and as maturities start to stack up. Investors will need to be selective; we think favouring companies from high quality sectors with good balance sheets is a good way to mitigate risk.

What will signal a turning point for the asset class?

While we will be watching very closely for signs that the interest rate hiking cycle is coming to an end, we also see market valuations as an important signal. Historically, we observe credit spreads peaking (and valuations bottoming) well before defaults materialise. We think we are nearing that point – whereby a lot of the coming slowdown and recession is in the price. With credit spreads so wide in many segments of the market, and yields – which historically have been the best predictor of future returns – very attractive in many areas, we think the outlook for the asset class is brightening significantly, but selectively remains key.

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How will you be positioned in 2023 in light of all the uncertainty?

There are three areas we currently like. First, we find some really compelling valuations in quality segments of the market, like investment-grade debt. Second, we like high-quality structured credit which has underperformed this year and offers a significant cushion in the event of further credit stresses. In addition, the fact that coupons are floating rate means structured credit tends to behave better in an environment of high interest rate volatility. Finally, we like high-carry opportunities as we believe that these will be the engine for credit returns, as they provide investors with a high and stable income source. That said, we believe it is important to remain dynamic in order to take advantage of current mispricing opportunities and to navigate the increasing dispersion we expect to see across the asset class as the cycle evolves.

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Australia
Level 28 Suite 3, Chifley Tower
2 Chifley Square
Sydney, NSW 2000
Telephone: +61 2 9160 8400
australia@ninetyone.com

Botswana
Plot 64511, Unit 5
Fairgrounds, Gaborone
Telephone: +267 318 0112
botswanaclientservice@ninetyone.com

Channel Islands
PO Box 250, St Peter Port
Guernsey, GY1 3QH
Telephone: +44 (0)1481 710 404
enquiries@ninetyone.com

Germany
Bockenheimer Landstraße 23
60325 Frankfurt am Main
Telephone: +49 (0)69 7158 5900
deutschland@ninetyone.com

Hong Kong
Suites 1201-1206, 12/F
One Pacific Place
88 Queensway, Admiralty
Telephone: +852 2861 6888
hongkong@ninetyone.com

Luxembourg
2-4, Avenue Marie-Thérèse
L-2132 Luxembourg
Telephone: +352 28 12 77 20
enquiries@ninetyone.com

Namibia
Am Weinberg Estate
Winterhoek Building
1st Floor, West Office
13 Jan Jonker Avenue
Windhoek
Telephone: +264 (61) 389 500
namibia@ninetyone.com

Singapore
138 Market Street
CapitaGreen #27-02
Singapore 048946
Telephone: +65 6653 5550
singapore@ninetyone.com

South Africa
36 Hans Strijdom Avenue
Foreshore, Cape Town 8001
Telephone: +27 (0)21 901 1000
enquiries@ninetyone.com

Sweden
Västra Trädgårdsgatan 15, 111 53
Stockholm
Telephone: +46 8 502 438 20
enquiries@ninetyone.com

Switzerland
Dufourstrasse 49
8008 Zurich
Telephone: +41 44 262 00 44
enquiries@ninetyone.com

United Kingdom
55 Gresham Street
London, EC2V 7EL
Telephone: +44 (0)20 3938 1900
enquiries@ninetyone.com

United States
Park Avenue Tower, 65 East 55th Street
New York, 10022
US Toll Free: +1 800 434 5623
usa@ninetyone.com

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