Credit Chronicle

Market review from Ninety One's Developed Market Credit team

Market review

At the macro level, the US Treasury market remained volatile over the quarter. During April, a combination of sticky inflation, signs of labour market resilience, and hawkish comments from the Fed caused a sharp rise in US Treasury yields; market participants continued to postpone interest-rate cut expectations. Subsequently, weaker-than-expected US non-farm payrolls data and lower-than-expected US inflation helped US Treasury yields to retreat, despite a hawkish-leaning Fed meeting. The 10-year yield ended the quarter 20bps higher at 4.40%. In Europe, the European Central Bank (ECB) began its rate-cutting cycle as expected in early June, with a 25bps cut (the ECB's first rate reduction in five years). Overall, European bond yields rose over Q2, driven by sticky inflation and better-than-expected economic data released earlier in Q2. The rise in yields was particularly pronounced in France – the snap election there drove a sell-off.

Credit markets had a positive quarter from a total return perspective. In a similar theme to Q1, the top-performing areas of the credit market were assets with floating-rate coupons, such as leveraged loans and collateralised loan obligations (CLOs). Both benefited from the rising risk-free rates early in the quarter, with high carry providing a boost over the rest of the period. The loan market was also boosted by credit spread tightening, helped by continued strong demand for the asset class. In the more traditional corporate bond markets, high-yield bonds in the US and Europe performed well from a total return perspective, driven primarily by carry. Turning to the investment-grade market, while the June rally in government bond markets helped, both the US and European markets only managed to deliver a slightly positive total return over the quarter.

Current snapshot

We believe that credit markets are driven by three Compelling Forces and that a careful assessment of each of these is essential for exploiting evolving market inefficiencies and building a robust credit portfolio. Here's our current view:

Compelling force	**Fundamentals** Fundamental strength	**Valuations** Attractiveness of valuations	**Technicals** Supply/demand dynamics
US high yield	● (grey)	● (red)	● (light teal)
European high yield	● (orange)	● (orange)	● (light teal)
US investment grade	● (light teal)	● (red)	● (light teal)
European investment grade	● (grey)	● (grey)	● (light teal)
US loans	● (orange)	● (orange)	● (light teal)
European loans	● (orange)	● (orange)	● (light teal)
Bank capital	● (grey)	● (grey)	● (grey)
Corporate hybrids	● (grey)	● (grey)	● (grey)
EM corporate credit	● (grey)	● (orange)	● (light teal)
Short-duration high yield	● (grey)	● (orange)	● (light teal)

Key: Worst ← ● (red) ● (orange) ● (grey) ● (light teal) ● (dark teal) → Best

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Where to focus and what to avoid

- Higher carry (higher income) holdings such as structured credit, loans, and selective parts of the short-duration high-yield and bank capital market, offer an attractive income profile and favourable downside characteristics.
- In traditional markets, such as high-yield debt and US investment grade, credit spreads remain near the tightest (most expensive) levels seen over previous cycles; we see limited potential here for further price appreciation or attractive income.
- From a sector standpoint, we continue to see selective value in the banking sector in both senior and subordinated instruments.

Sector by sector

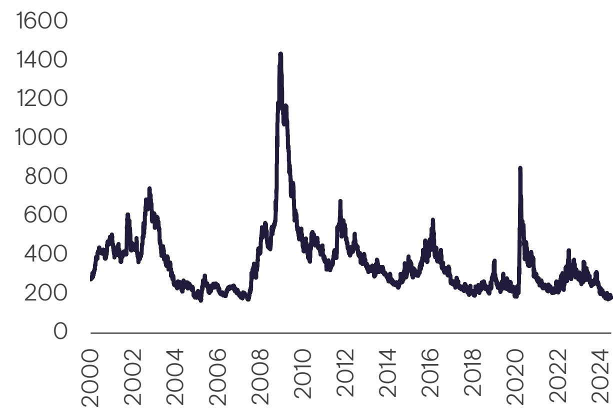
High yield

US	– –	–	0	+	+ +
Fundamentals			●		
Valuations	●				
Technicals				●	

EUR	– –	–	0	+	+ +
Fundamentals		●			
Valuations		●			
Technicals				●	

An empty circle denotes our view in the previous quarter, if it differs.

US BB spreads, basis points



Source: BofA, 30 June 2024. Spreads are option-adjusted (OAS).

Credit spreads in the high yield (HY) market moved slightly wider (+6bps) over the quarter to 321bps in the US, and slightly tighter in Europe (-5bps) to 353bps. While spreads in Europe widened towards the end of the quarter due to the French snap election-induced volatility and associated risks, we would argue that the more important factor for both markets was that lofty valuations going into the quarter created a material headwind. In particular, spreads on BB rated bonds across both sides of the Atlantic touched multi-year tight levels in early May, with the option-adjusted spread on US BB rated bonds falling to a mere 175bps at one point – a level not seen since before the GFC.

While both the US and European HY markets continue to be supported by relatively healthy aggregate fundamentals and favourable flow dynamics, we are cautious as we move into the second half of 2024 – given the combination of high current valuations and uncertainty relating to upcoming elections and earnings results.

Global loans

US	– –	–	0	+	+ +
Fundamentals		●			
Valuations		●	○		
Technicals			●		

EUR	– –	–	0	+	+ +
Fundamentals		●			
Valuations		●	○		
Technicals			●		

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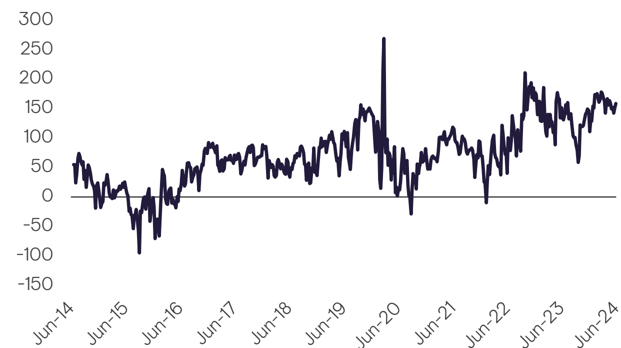
Spread differential: US loans vs US B-rated bonds, bps



Source: JP Morgan, Bloomberg, Ninety One, June 2024. Loan spreads are JPM Leveraged Loan Index Split BB and B- Spreads over SOFR. US B spreads are Bloomberg B US High Yield Average OAS.

Loans posted another strong quarter, with June marking the eighth consecutive month of gains. Over Q2, US and European loans returned 1.9% and 2.4% respectively, outpacing the 1.1% and 1.5% returns seen in the US and European HY markets. Loans rated BB and B outperformed those with a CCC rating in the US, while performance was more broad-based across ratings bands in Europe.

Despite the strong returns seen over the quarter overall, loan market performance moderated somewhat in June (US and European loans returned 0.3% and 0.1%). This was driven by a slight easing of technical tailwinds: US ETF outflows kept the flow picture more balanced, and the historically high amount of loan repricing and refinancing volumes (issuers negotiating a lower floating-rate coupon) continued as companies sought to take advantage of the lower cost of funding. June also saw the lightest monthly level of new CLO issuance of 2024. Still, the loan market remains very firm overall, and issuance in the quarter was robust on both sides of the Atlantic, with June the second strongest month on record for primary activity in the US.

Despite the repricing wave reducing the overall spread levels, loans still look relatively attractive compared with other asset classes. The spread differential between B rated high yield credit and B rated loans in the US is close to the widest level of the last 10 years. US B rated loans also look attractive on a standalone basis, with a current index-level spread of 437bps, which is still wide of the 392bps level reached in 2022, leaving room for spreads to compress further against the strong technical backdrop.

Developed market credit indicator: Credit Chronicle

Investment grade

US	- -	-	0	+	+ +
Fundamentals				●	
Valuations	●				
Technicals				●	
EUR	**- -**	**-**	**0**	**+**	**+ +**
Fundamentals			●		
Valuations			●		
Technicals				●	

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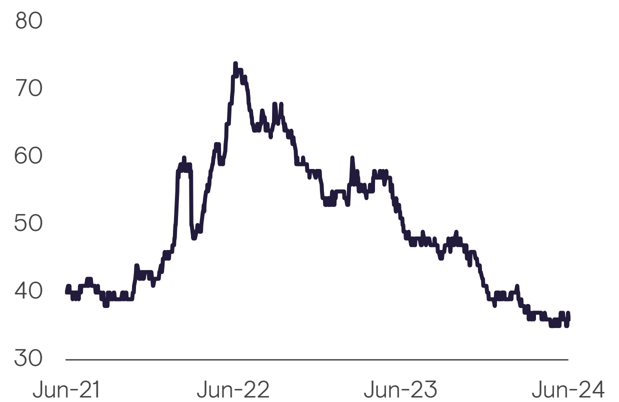

Source: BofA. 30 June 2024. ICE BofA US BBB and A indices.

The second quarter marked a steady but uneventful period for investment-grade (IG) markets, with the Global IG index finishing the period with a 2bps wider spread, while still generating a small positive total return thanks to carry. That said, all of the spread widening occurred in June following volatility driven by France-related headlines, marking IG's worst monthly spread performance since March 2023. This widening was concentrated in the higher quality end of the market, leading to material spread compression between the BBB and single-A rating categories. The differential in spread between the two rating categories is now at multi-year tights – as shown in the chart above – making a case for investors to move up in quality within the IG sector, especially as spreads represent a small portion of the overall yield in this environment. For example, US IG spreads over government bonds of 93bps represent just 17% of IG's 5.5% yield today. Put another way, the yield pick-up to be earned by investing in lower-quality (BBB rated) bonds today is relatively modest.

Zooming out, the theme in IG remains consistent: spreads are near multi-year tights while yields are near multi-year highs, which continues to draw demand from yield-seeking investors. We expect this dynamic to continue to support IG markets, which could cause spreads to grind tighter through the summer lull as new issuance slows down.

Structured credit

Senior CLOs (AAA/AA)	- -	-	0	+	+ +
Fundamentals			●		
Valuations		●	○		
Technicals				●	
Mezzanine CLOs (A-BB)	**- -**	**-**	**0**	**+**	**+ +**
Fundamentals		●			
Valuations				●	
Technicals			●		

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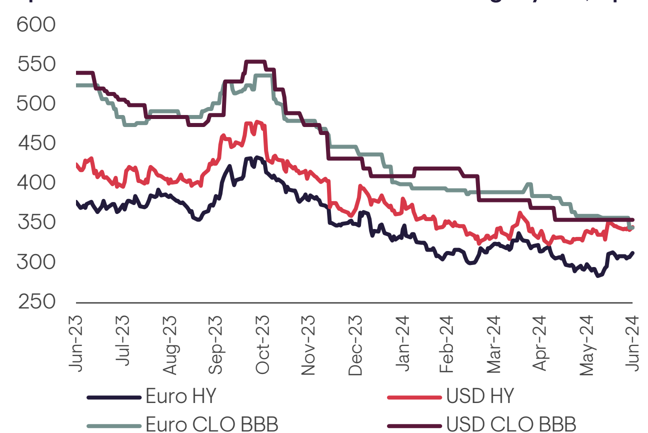

Source: Citi, ICE, 30 June 2024. Euro HY = BofA EUR High Yield; USD HY = BofA US High Yield. CLO spreads are from Citi Velocity.

Tighter credit spreads and higher risk-free rates helped floating-rate collateralised loan obligations (CLOs) deliver another strong quarter of total returns. European and US BBB rated CLOs returned 3.2% and 2.9% respectively in Q2, according to JP Morgan Indices, while European and US high-yield corporate bonds delivered returns of 1.5% and 1.1% respectively. CLO market supply and demand dynamics remain robust, keeping prices well supported even through a pick-up in volatility for many other risk assets towards the end of the quarter (mainly prompted by French political developments).

New-issue CLO supply is at record levels year to date in both the European and US markets, but an accelerating pace of CLO amortisation and liquidations has left net supply at a fraction of gross supply. In Europe for example, gross year-to-date supply totalled €25.5 billion according to BofA, only €0.5 billion short of the full-year supply for 2023, but net supply was only €8 billion. Meanwhile, growing demand from a range of investor types, including global banks, asset managers, and a small but fast-growing CLO ETF community, has helped continue to drive spreads tighter across both geographies and across rating categories.

Developed market credit indicator: Credit Chronicle

Specialist credit

Bank capital	- -	-	0	+	+ +
Fundamentals			●		
Valuations			●		
Technicals			●		

EM corporate debt	- -	-	0	+	+ +
Fundamentals			●		
Valuations		●			
Technicals				●	

Corporate hybrids	- -	-	0	+	+ +
Fundamentals			●		
Valuations			●		
Technicals			●		

Short-duration high yield	- -	-	0	+	+ +
Fundamentals			●		
Valuations		●			
Technicals				●	

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Corporate hybrids posted a total return of 1.3% in Q2 despite some volatility at quarter end related to the French elections. Year to date, the asset class has performed strongly with a return of 3.5%, driven by lower rates volatility, credit spread compression and fewer issuer-specific stories. Real estate hybrids continued to be the best performing sector. The most notable development was the cash incentivised exchanges[1] led by Grand City and Aroundtown, which have provided a playbook and potential template for other real estate hybrid issuers currently priced out of the primary hybrid market with upcoming call dates. These exchanges are net positive for issuers as they allow them to keep the equity credit with limited additional cash interest cost, while also preserving the issuing companies' liquidity. The high participation rates in these exchanges is also evident of investors' buy-in to this short-term solution, which will give over-levered issuers time to reduce leverage through asset disposals and equity raises. With most of the 2024 refinancing supply having already been managed through tenders and new issuance, the focus has moved to 2025 where there is c.€18.5 billion of hybrids that potentially need to be refinanced. The outlook for corporate hybrids in the second half of the year is well balanced, with fundamentals and technicals remaining supportive, but valuations are stubbornly tight outside of the more stressed credits.

The **bank capital** market, or AT1s, continued its sound year-to-date performance, posting a US dollar hedged return of 1.3% in Q2 (BofA Contingent Capital Index) and bringing the year-to-date total return for the asset class to 4.2%. Returns in Q2 were driven mainly by income rather than price appreciation. Fundamentals continue to provide a positive backdrop for the sector and AT1 investors. We have seen a continuation of issuers calling their bonds at first call as spreads have continued to provide a positive backdrop for new issuance, which has continued at a strong pace (c.US$13 billion of new AT1 issues in Q2). Interestingly, we have seen a number of banks refinancing increasingly further ahead of call dates (10-15 months) and coupling issuance with tenders on existing AT1s, which has been positive for the market as a whole. In our previous Credit Chronicle and our Picture This piece on the topic, we highlighted the increasing importance of selectivity within this asset class, and we still believe this to be the case.

The **EM corporate debt** market had a positive quarter, helped by improved investor sentiment around the health of the global economy, with the JP Morgan CEMBI BD returning 1.5%. Credit spreads tightened the most in the high-yield segment, which outperformed the investment-grade market. However, in both cases, the positive impact of falling credit spreads (given stronger investor sentiment) and healthy levels of income (carry) counteracted the negative impact on bond prices from the rise in US Treasury yields. Within the index, all sectors delivered positive returns, led by real estate, while Argentina's corporate bond market was the top performer at the country level as it continued to benefit from optimism surrounding the new administration and its ambitious reform agenda. Turning to supply/demand dynamics, although primary market activity picked up compared to 2023, new issuance remained subdued, with net financing turning negative again during May; this continued to be supportive for the market.

[1] In a cash-incentivised exchange, a corporate hybrid issuer offers existing hybrid bond holders the option to exchange their bonds for new hybrid bonds. Typically, the new bonds have a non-call, five-year structure with coupons slightly higher than the reset coupons of the existing hybrid bonds. To incentivise investors and encourage the take-up of the exchange offer, the issuer may include a cash component. By executing these exchanges, issuers can keep the equity content of their hybrid capital while only paying slightly higher coupons, with limited impact on their liquidity position.

Developed market credit indicator: Credit Chronicle

Credit market performance	Q2 2024 return (US$ hedged) %	Yield-to-worst %	Spread*	Duration
US high yield	1.1	7.9	321	3.3
European high yield	1.5	6.4	353	2.9
US investment grade	0.1	5.5	96	6.7
European investment grade	0.1	3.8	118	4.6
US loans	1.9	9.1	479	0.3
European loans	2.4	8.3	528	0.3
Short duration high yield	1.5	8.3	394	1.6
CoCo's	1.3	7.5	327	3.1
Emerging market corporate debt	1.5	6.7	217	4.3

Past performance is not a reliable indicator of future results, losses may be made. Please see important information section for information on indices.

*OAS spread. Sources: US high yield = BofA US High Yield (HUC0); European high yield = BofA EUR High Yield (HE00); US investment grade = BofA US Investment Grade (C0A0); European investment grade = BofA EUR Investment Grade (ER00); US Loans = S&P/LSTA Leverage Loan Index; European EUR Loans = S&P/LSTA European Leverage Loan Index; Short Duration High Yield = BofA 1-3yr Global High Yield (H1WN); CoCo's = BofA Contingent Capital Index (COCO); EMCD = JPM CEMBI BD. All as of 30 June 2024.

General risks

The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth.

Past performance is not a reliable indicator of future results. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations.

Specific Risk(s)

Default: There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss. **Derivatives:** The use of derivatives may increase overall risk by magnifying the effect of both gains and losses leading to large changes in value and potentially large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. **Interest rate:** The value of fixed income investments (e.g. bonds) tends to decrease when interest rates rise. **Liquidity:** There may be insufficient buyers or sellers of particular investments giving rise to delays in trading and being able to make settlements, and/or large fluctuations in value. This may lead to larger financial losses than might be anticipated.

Glossary

Alpha: outperformance of a reference index or market through an investment manager's active investment decisions.

Bank capital: additional capital held by banks to absorb losses under duress. Cheaper and quicker for banks to issue than equity. Helps banks to improve their capital ratios.

Bank preference securities: issued by banks to meet their required capital ratios. These have characteristics of both equities and bonds. The securities are perpetual (with call features), pay dividends, and are subordinated relative to other forms of debt.

Callable bonds: bonds that can be redeemed by the issuer prior to the maturity date of the bonds. The issuer may look to issue new bonds at a lower coupon.

Carry: the net-of-cost return earned by owning a security – a 'carry trade' might involve borrowing at a low interest rate to invest in a security offering a higher interest rate to earn the additional 'carry'.

CLO: collateralised loan obligations are bonds that are backed by pools of (typically sub-investment grade) corporate loans. Several bonds of varying risk and return characteristics are usually issued against each pool of loans. Lower-risk, 'senior' tranches have higher priority claims on the cash flows from the loans but offer a lower yield than the lower-rated 'junior' tranches, which are the first to suffer losses if the underlying loans underperform.

Corporate hybrids: subordinated debt of Investment-grade issuers. They combine characteristics of bonds (payment of coupon) and of equities (no maturity date or very long maturities) and are typically rated a few notches lower than the same issuers' senior debt. Usually callable by the issuer five or 10 years after issue

Coupon: the regular interest payments a bondholder receives from the issuer of the bond.

Credit rating: a score awarded by an independent rating agency to indicate the financial strength of the issuer of a bond, and the potential for it to default on interest and principal payments. The top credit rating is 'AAA'. The lowest rating to be considered 'investment grade' is 'BBB'. Below 'BBB', bonds are termed 'sub-investment grade' or 'high yield'. The higher the credit rating of the issuer of the bond, the higher the 'quality' of the bond.

Credit spread: the difference between the yield offered by a corporate bond and the yield offered by a sovereign (government) bond of an equivalent maturity. This is the reward the investor gets in return for taking on a greater level risk than they would if they just invested in the sovereign bond.

Credit risk: see *Default risk*.

Currency swap: a swap is an agreement between investors to exchange future cashflows, such as interest payments. In a currency swap, the parties to the agreement exchange future cash flows of different currencies

Default risk: the risk that the issuer of a bond may not be able to meet interest payments or repay the money it has borrowed. The lower the credit rating of the issuer, the greater the risk of it defaulting on its debt and the greater the risk of the investor suffering an investment loss.

Duration: a measure of how much a change in interest rate will impact a security's market value. There is an inverse relationship between interest rates and bond prices.

Emerging market credit: bonds issued by companies from emerging markets (e.g. China, Brazil). Can be rated high yield or investment grade. Largely US dollar-denominated, although a small local currency corporate bond market exists.

Excess return: the total return of the bond minus the return attributable to changes in underlying treasury yields of an equivalent maturity.

Extension risk: the risk that the bond issuer will seek to delay when it pays back the amount it has borrowed from bondholders.

Fallen angel: an investment-grade bond issuer that has subsequently had its debt downgraded to a high-yield credit rating.

Floating-rate notes: the floating nature of coupon provides protection in a rising interest rate environment. Issued by both investment-grade and high-yield borrowers. These are typically shorter duration (up to five 5 years).

Interest rate risk: see *Duration* above.

Leveraged loans: loans that are structured, arranged and administered by at least one commercial or investment bank. Typically issued to support a merger or acquisition or to finance company growth. Sub-investment-grade rated. Typically, the coupon is a floating rate rather than fixed.

Maturity: The date the issuer will repay the bondholder.

Subordinated debt: debt that is repaid only after other debt has been repaid (i.e. comes further down in the order of priority for repayments) in the event of the issuer of the debt falling into financial difficulties.

Synthetics: highly liquid financial instruments that artificially simulate other credit market investments. Instruments can be related to a single corporate, or to a whole credit index. Allows for efficient implementation and hedging.

Total return: the investment return on a bond which takes into account a change in credit spread and a change in the yield of the underlying treasury of an equivalent maturity.

Yield: the return investors earn for owning a bond to maturity. This is a function of the price paid for the bond, the coupon, and the time to maturity.

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