Credit Chronicle

Investment review from Ninety One's Developed Market Credit team

2022: Quarter 1

Market review

The war in Ukraine and a hawkish shift in monetary policy were the key drivers of credit market moves over the quarter.

The wide range of sanctions imposed on Russia (and Russia's retaliation to these) caused significant uncertainty and disruption in financial markets, and the resultant soaring commodity and energy prices have put significant additional upward pressure on inflation. The US Federal Reserve raised interest rates and accompanied the move with decisively hawkish rhetoric, sparking a sell-off in rate markets which caused longer-duration investment-grade debt to be one of the worst performing credit asset classes in the quarter.

Widespread risk-off contagion following Russia's invasion of Ukraine caused a widening of credit spreads, although much of that move was reversed with a solid rally into quarter-end as broader risk sentiment settled. Among high-yield issuers, the backdrop of rising commodity prices benefited bond prices in the energy sector, while higher inflation and rising interest rates weighed on issuers in the consumer products, food and real estate sectors. More broadly, amid the backdrop of credit spread widening, higher quality parts of the credit market have – somewhat unusually – underperformed, due to a combination of duration aversion in a rising rate environment and market technical dynamics, as we explain in this edition's spotlight article. This has resulted in compelling valuations in some higher-quality market segments.

Leveraged loans showed impressive resilience, supported by short effective duration which offered protection from rates volatility, outperforming most asset classes. CLOs also performed relatively well through the market volatility. Similarly to leveraged loans, their floating rate nature also provided insulation from rising interest rates, explaining much of their outperformance compared to fixed rate products like corporate bonds.

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	Grey
European high yield	Orange	Orange	Grey
US investment grade	Grey	Orange	Grey
European investment grade	Orange	Grey	Grey
US loans	Grey	Grey	Light teal
European loans	Orange	Grey	Light teal
Bank capital	Grey	Orange	Grey
Corporate hybrids	Grey	Orange	Grey
EM corporate credit	Grey	Orange	Grey
Short-duration high yield	Grey	Orange	Light teal

Key: Worst ← Red, Orange, Grey, Light teal, Dark teal → Best

For illustrative purposes only. For further information on the investment process, please see the important information section.

Credit spotlight

How recent market moves made quality cheap

During periods characterised by a widening of credit spreads, credit investors typically see higher quality segments of the market outperform lower-rated areas on a risk-adjusted basis. In Q1, the opposite occurred, resulting in attractively valued opportunities in the higher-quality end of the credit rating spectrum. We explain the somewhat unusual recent moves in credit markets and highlight the areas of the market that we currently find most compelling, in light of these shifts.

Quality segment underperformance

Evidence of the recent underperformance by quality credit can be seen in several relative-value relationships across global credit markets:

- In the high-yield market, BB rated has underperformed CCC rated debt.
- There is limited dispersion between sectors or companies, despite differences in cyclicality and margin pressures.
- Even investment-grade debt in aggregate has underperformed high yield on both a total and excess return basis.

Drivers of dispersion

In our view, a large part of the underperformance of the quality factor can be attributed to two key drivers: duration aversion and liquidity/fund flow technicals. Regarding the former, quality segments of credit tend to be longer duration and these markets have naturally seen both lower demand and a bigger price impact of rising government bond yields, given the hawkish backdrop for central bank policy. As for liquidity/fund flow technicals, most credit markets have experienced outflows this year and quality segments of credit markets, particularly BB rated high-yield debt, tend to be used as cash sources for fund raising, given their greater liquidity. This technical dynamic is typically most pronounced for those bonds that are also included in popular high yield ETFs.

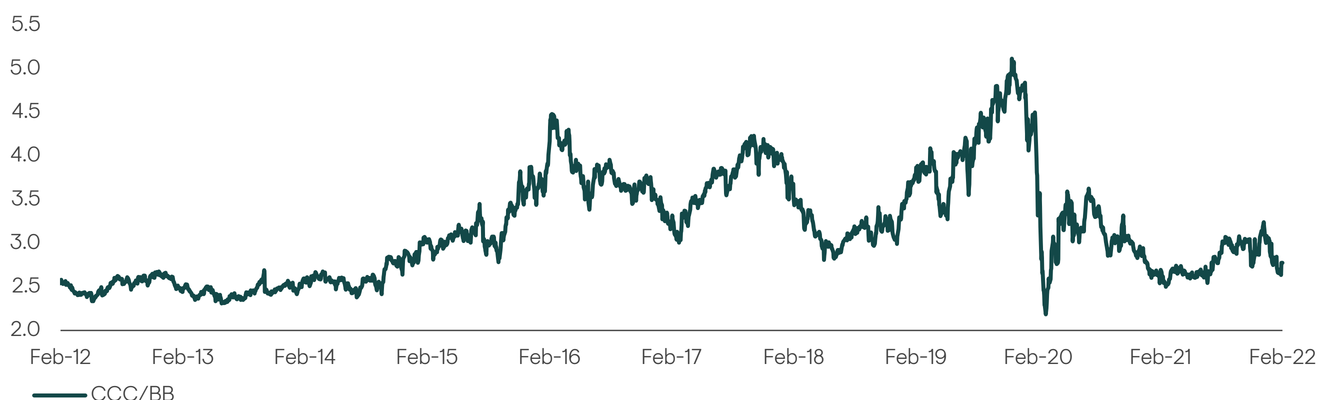
Opportunities for credit investors

As a result of these recent market dynamics, we believe that moving up the quality spectrum looks particularly compelling for credit investors, particularly given the range of possible outcomes at this juncture. If credit spreads continue to move wider, higher-quality assets should be more defensive owing to their stronger fundamentals. Equally, if spreads move tighter, these quality assets – which appear oversold – are most likely to bounce, in our view. Below we look at two particular areas of interest for us.

BBs vs CCCs

BB rated debt is the highest quality segment of the high-yield market and appears particularly cheap relative to the riskiest credit segment, CCC rated debt. The extra risk premium investors can earn from owning CCC rated debt relative to BB rated debt - as measured by the spread ratio – remains very compressed, sitting well below the average level seen over the past 10 years. Given the uncertainty regarding the path of inflation, central bank tightening and the corresponding impact on growth, we believe that BB rated companies are better positioned to deal with these headwinds as they tend to have cleaner balance sheets and greater scale compared to CCC rated companies. All of this points to a picture of attractive risk-adjusted valuations for BB rated debt, with CCC rated debt presenting a poor level of compensation for the apparent risks to the economy and markets.

Fig. 1 CCC/BB credit spread ratio: CCC spreads remain historically compressed relative to BB

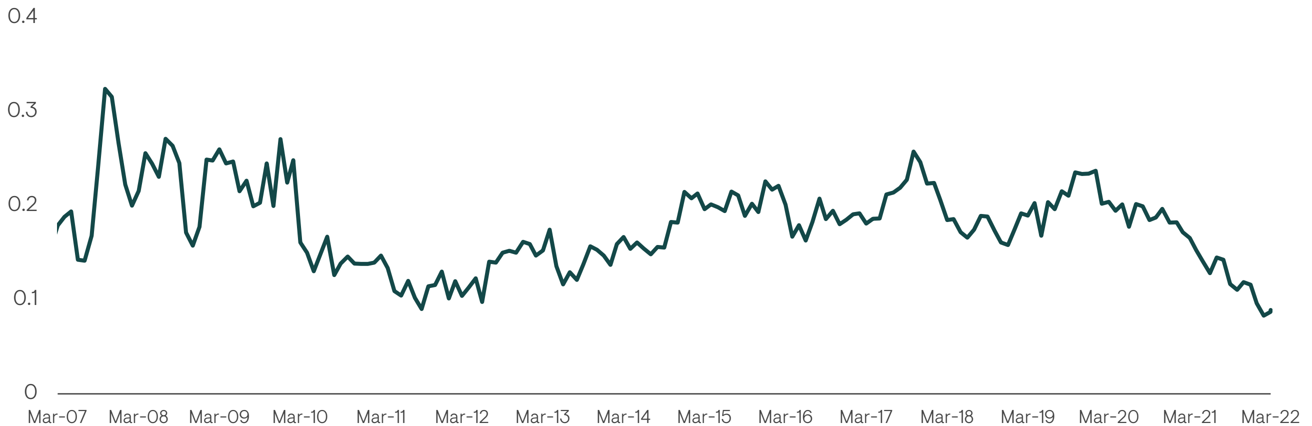


Source: Bloomberg, BofA ML Indices. Based on US HY BB and US HY CCC index. As at 28 February 2022.

Sector selection

The economic momentum that carried credit markets for most of last year is clearly moderating in the face of rising inflationary pressures. While we expect near-term credit stresses to remain subdued given the current strength of corporate balance sheets, we believe that dispersion between sectors should increase meaningfully in this environment. While signs of increased dispersion are emerging, we believe that today's pricing does not adequately reflect the divergences in cyclicality or margin pressure that different industries and companies face. For example, we have seen some historically defensive sectors, such as telecoms, counterintuitively underperform in the recent sell-off owing to the liquidity/flow technical dynamics mentioned earlier rather than any fundamental reasons, in our opinion

Fig. 2 Sector spread dispersion remains historically low, standard deviations



Based on monthly cross-sectional standard deviation of average spreads across industry sectors, and normalised. Source: Bloomberg, BofA ML Indices. 31 March 2022.

Investment-grade opportunities

Investment grade has also underperformed high yield on a risk-adjusted basis over the sell-off. This has been driven in large part by the factors outlined above – namely duration aversion – but supply technicals have been notably weaker in investment grade relative to high yield. Supply in investment grade has been relatively strong, despite the volatility we have seen this year. Meanwhile supply in high yield in the US, for example, is down over 70%. We believe that there is potential for this relationship to revert to the mean, particularly as supply tapers in the investment-grade market but also as the market better prices the relative defensiveness and quality of investment-grade corporates relative to their high-yield peers in the face of heightened economic uncertainty.

Fig. 3 High yield to investment grade spread ratio

Source: Bloomberg, BofA ML Indices. 28 February 2022.

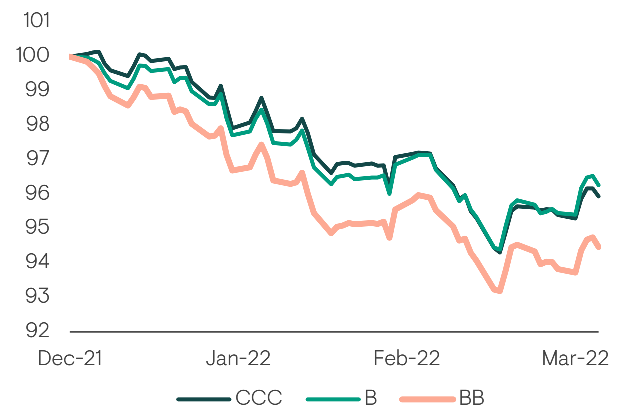
Sector by sector

High yield

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

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

Higher quality high yield underperforms



Source: ICE BofA Index, US High Yield BB, B and CCC. 31 March 2022

The global high-yield market lost 5.6% in the quarter, with returns driven by a 44bps move higher in credit spread and the balance of negative performance derived from higher interest rates. With interest rate forecasts rising meaningfully and the Fed turning more hawkish as it embarked on its rate hiking cycle, 5- and 7-year US Treasury rates rose 120 and 100bps, respectively, to the highest level since late-2018. US high-yield spreads rallied 80bps over the last two weeks of March, absorbing the large sell off in risk-free rates and ultimately closing the quarter 40bps higher than the beginning of the year (resulting in a -4.5% total return). By far the best performing sector in the US high yield index was energy, driven by oil and gas prices rising 50% and 150%, respectively. Laggard sectors were consumer products, food and real estate, given the headwinds from rising inflation and interest rates. Higher rates also had an outsized impact on high-quality credit, especially the BB rating category, given its longer-duration composition. As a result, CCC and B rated credit outperformed BB rated by over 1.5%. Support for the high-yield market this year has come from a beneficial supply backdrop offsetting outflows from the asset class: gross issuance was down 70% versus Q1 2021, and when combined with maturities, coupons and rising stars leaving the index, this amounted to a sustaining technical support for the asset class.

Global loans

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

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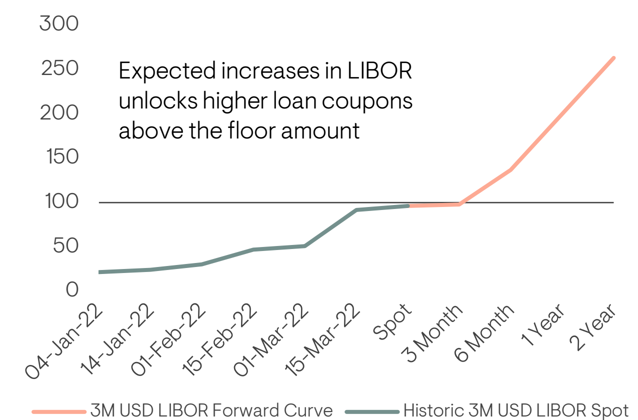
The expected continued rise in LIBOR rates, bps



Source: Bloomberg, 15 March 2022.

Leveraged loans showed impressive resilience in Q1 and materially outperformed other asset classes, with support coming from short effective duration offering protection from rates volatility, continuing minimal levels of credit stress, and strong demand technicals. While widespread risk-off contagion post-Russia's invasion impacted loans, much of that move was reversed with a solid rally into quarter-end as risk sentiment settled. US loans (-0.1%) outperformed European loans (-0.6%) perhaps reflecting concerns of bigger impact of war in Ukraine on European issuers. A clear bias towards better quality developed as BB (-0.04%) and single-B rated loans (+0.1%) outperformed CCC rated (-1.6%), which gave up some of 2021's outperformance. US loans also look set to benefit from improving carry as LIBOR/SOFR reference rates rise above contracted floor levels, resulting in higher all-in yields. LIBOR loans, which still represent 93% of the US loan universe, look particularly well-placed as LIBOR rates are rising faster than SOFR, with forward curves implying continued rate rises. Fund flows remained robust as floating-rate assets continue to be in favour. Despite a one-week outflow early in the month, US loan funds saw their 16th consecutive month of inflows in March (total Q1 inflows: US$15.7 billion). New issuance volumes of US$94 billion through February (US$67 billion, net of refinancing and re-pricing) were significantly below the record-setting US$367 billion in Q1 2021 (US$ 182 billion). While global collateralised loan obligation (CLO) formation was subdued, notably in Europe, the combination of robust loan fund flows and muted new issuance volumes proved to be a supportive technical backdrop for loans in Q1.

Investment grade

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

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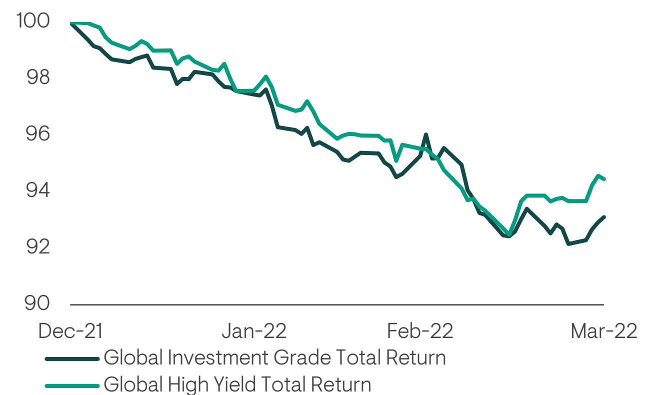
Global Investment grade vs high yield total returns



Source: Bloomberg, BofA ML Indices. 31 March 2022.

Investment-grade debt was one of the worst performing credit asset classes in Q1, with the Global IG Index returning -6.9% in the quarter. This was driven primarily by the long duration nature of the asset class as both credit spreads and risk-free rates rose. As the longest duration ratings bucket, the AAA segment was the worst performer with a -8.3% total return despite being highest quality, highlighting the importance of managing duration in this environment. However, despite the underperformance on a total return basis, IG outflows have been the most muted across credit asset classes as investors shifted up in quality and all-in yields for IG remained attractive as risk-free rates rose. As a result – unlike high-yield primary issuance, which virtually froze in the quarter – IG new issues have remained active, with the market readily digesting even large deals such as AT&T-Discovery's US$30 billion issuance, which was significantly oversubscribed. As the IG market remains wide open, we may continue to see companies issue opportunistic deals to lock in yields ahead of further potential volatility in rates.

Structured credit

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

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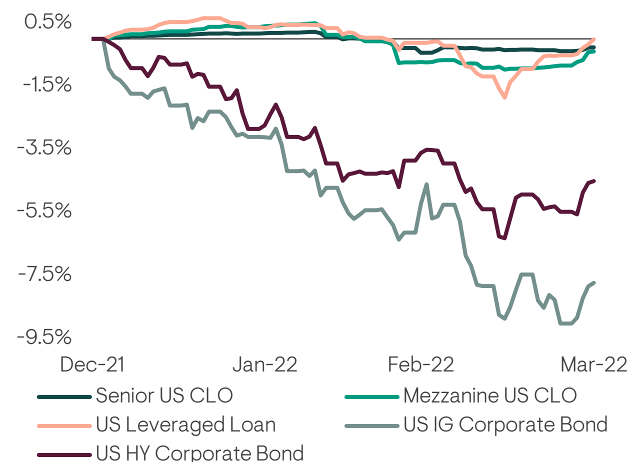
CLO returns versus other credit assets



Source: Bloomberg, Palmer Square, BofA ML Indices. 31 March 2022.

CLOs performed relatively well through the market volatility of Q1. Their floating-rate nature provided insulation from rising interest rates, explaining much of their outperformance compared to fixed rate products like corporate bonds. Russia's invasion of Ukraine prompted some losses in late February and early March, though these were partially reversed in the last few days of the quarter.

Using Palmer Square's US CLO indices, senior and mezzanine CLOs returned -0.3% and -0.4% respectively in Q1, slightly underperforming US loans, which returned -0.01%. Both products outperformed US IG and HY corporate bonds, which returned -7.7% and -4.5% respectively. Much of the corporate bond losses were driven by moves in interest rates. Excluding the rates impact, excess returns over swaps finished the quarter at -1.9% and -0.6% respectively.

Widening spreads have caused the CLO primary market to slow, with refinance and reset transactions in particular dropping significantly over the quarter. Including refinancing, new issuance is down 56% in the US and 43% in Europe, according to Barclays. Excluding refinancing, issuance is down 21% in the US and up 25% in Europe. CLO issuance economics currently look challenging, as the outperformance of loans mentioned above has meant that CLO funding costs (the CLO liability spreads) have become more expensive relative to underlying asset (leveraged loan) spreads. This may keep new issuance suppressed in the near term, providing some technical support to CLO valuations.

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			○	●	

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

Corporate hybrids underperformed high-yield credit markets, with a total return of approximately -6.0% in Q1 due to spread widening and interest rate moves. Supply picked up from the previous quarter, with €7.3 billion in gross issuance, but was far short of the €16.5 billion run-rate equivalent of Q1'21. Valuations are beginning to look slightly more attractive given the spread widening. However, much of this value is focused in sectors that have severely underperformed, such as real estate, where we continue to find compelling investment opportunities.

Bank capital lagged most other credit asset classes over Q1, with a USD-hedged total return of -5.9%. This was driven by a combination of spread widening and negative price impacts, related to both the strong interest rate moves and the initial reaction to the Russian invasion. Fears around the impact of sanctions and possible contagion of Russian bank defaults to the European banking sector were relatively short-lived, as the 'worst-case' scenarios for even the most Russian exposed European banking names seemed manageable. Overall, spreads widened sharply by 160bps from the early-January tights to mid-March, before tightening again by 110bps into quarter end, with spreads ending Q1 at pre-invasion levels as markets recovered a significant part of the earlier losses. This was apparent in the last two weeks of the quarter, with bank capital returning 2.6%, significantly outperforming broader credit markets. There was no supply in the market until the tail end of the quarter, when three banks came to market. This issuance was generally very well received by the market, due to a combination of valuations, a large number of redemptions and a few tenders creating significant pent-up demand. With a relatively large number of bonds callable in Q2 and limited new issue requirements, the net negative supply technical is expected to continue, which should be a supportive for bank capital over the next few months.

The primary drivers of **EM corporate debt** markets over the quarter are largely consistent with the global themes that have impacted developed market asset classes, although the effects were more pronounced given emerging markets' relatively large exposure. For example, exposure to Ukraine and Russia contributed to over half of the fall in value of the EM index, despite accounting for less than 5% of the index NAV. In addition, continued liquidity pressure in Chinese real estate, together with renewed COVID lockdowns, impacted the sector and weighed on overall market returns. This was despite a meaningful positive shift in policy support from China's authorities, which will take more time to be reflected in asset pricing. Away from idiosyncratic country effects, the move in rates was a negative drag on overall index returns, albeit less pronounced than in developed market indices given the overall shorter duration profile. Given the strong rally in commodity prices, issuers exposed to commodities such as oil & gas and metals & mining, benefitted. Overall issuance volume was light over the quarter, but this has started to increase, particularly from issuers in the renewables space.

Developed Market Credit Indicator: Credit Chronicle

Credit market performance	Q1 2022 return (USD hedged) %	Yield-to-worst %	Spread*	Duration
US high yield	-4.5	6.0	344	4.2
European high yield	-4.6	4.3	400	3.6
US investment grade	-7.7	3.6	122	7.8
European investment grade	-5.0	1.5	129	5.2
US loans	-0.1	7.0	446	0.3
European loans	-0.3	5.6	476	0.3
Short duration high yield	-6.0	8.0	656	1.8
CoCo's	-5.9	5.3	341	3.2
Emerging market corporate debt	-9.4	5.3	303	5.4

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 = BofA Emerging Corporate (EMCB). All as at 31 March 2022.

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.

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.

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