Credit Chronicle

Investment review from Ninety One's Developed Market Credit team

2023: Quarter 3

Market review

At the macro level, the quarter began on a positive note, with a less hawkish tone from the US Federal Reserve (Fed) stoking hopes of an imminent end to the rate-hiking cycle. However, a more volatile backdrop subsequently ensued. First, a downgrade to the US credit rating by Fitch triggered a sell-off across markets. Then came a reprieve after more dovish Fed comments in August. But this proved short-lived; somewhat more persistent inflation and surprisingly resilient economic data (coupled with an increase in the Fed's 'dot plot' rate forecasts) caused markets to increasingly price in a 'higher for longer' interest-rate outlook. As a result, the yield on 10-year US Treasuries rose to end the quarter 73bps higher at 4.57%, and the bond market sell-off extended beyond the US, with rates in Europe also rising meaningfully. The European Central Bank (ECB) raised interest rates to a record high of 4% and indicated that it expects it to take longer than previously thought for inflation to reach its 2% target, and that economic growth is likely to slow further.

Global credit markets were largely at the mercy of these large moves in sovereign yields, especially higher duration assets such as investment-grade (IG) bonds. Within the IG market, Europe materially outperformed the US given the size of the yield moves in the latter. After the significant move in rates, US IG is now yielding 6.1% - a level only seen a few times over the past 20 years. In contrast, high-yield debt proved resilient in the face of higher rates and weakness in equities, with Europe again outperforming the US as markets priced in a more resilient economic outlook than previously feared. CCC rated bonds were the standout performers in both regions, with US CCC spreads tightening over the quarter. Turning to loan markets, robust performance continued, helped by floating-rate coupons, taking year-to-date returns into double digits across both Europe and the US.

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)	● (orange)	● (light teal)
European high yield	● (orange)	● (grey)	● (grey)
US investment grade	● (light teal)	● (orange)	● (light teal)
European investment grade	● (grey)	● (grey)	● (light teal)
US loans	● (orange)	● (light teal)	● (grey)
European loans	● (orange)	● (light teal)	● (grey)
Bank capital	● (orange)	● (light teal)	● (grey)
Corporate hybrids	● (orange)	● (grey)	● (grey)
EM corporate credit	● (orange)	● (orange)	● (light teal)
Short-duration high yield	● (grey)	● (grey)	● (grey)

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.

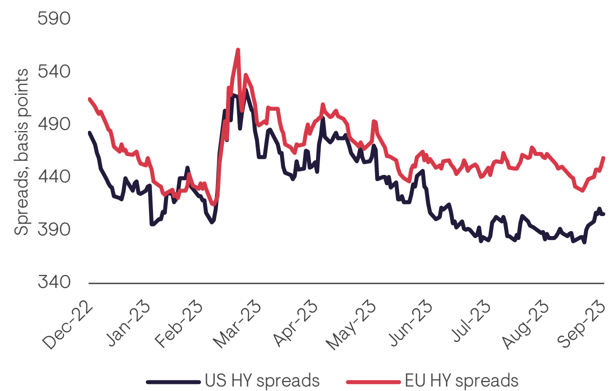
Sector by sector

High yield

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

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

US versus European high yield spreads



Source: ICE BAML, Bloomberg, 30 Sept 2023. US HY = BofA US HY (HUC0), EU HY = BofA EU HY (HPC0).

High-yield (HY) markets proved fairly resilient in the face of the meaningful repricing of long-end rates and weakness in equities. For context, US and European HY markets returned 0.5% and 2.1% in the quarter respectively. Interestingly, spreads in both Europe and the US ended the quarter broadly flat, after a rally in the early part of the quarter took US HY spreads to year-to-date tights, before a late September sell-off gave all of that back. From a performance standpoint, CCC rated bonds in both the US (+2.5%) and Europe (+3.7%) led the charge, with the more rates-sensitive BB segment lagging in both markets (US -0.4% and Europe +1.1%). Following the recent rates sell off, it is notable that US HY has again breached the 9% yield barrier, a level only seen in the last 15 years at times of extreme market stress.

It remains debatable whether this outperformance of lower rated credit is a function of investors pricing a more benign economic outcome, or the result of persistent technical tailwinds, including moderate new issuance, continued net rating upgrades, decent coupon accumulation and fairly benign fund flows. In that vein, new issuance amounted to US$39 billion and €13 billion in the US and Europe respectively. Both markets absorbed the supply well, as most deals consisted of refinancings. Despite the constructive sentiment, some cyclical businesses have had to widen the spreads on offer at primary issuance to attract investor interest.

Global loans

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

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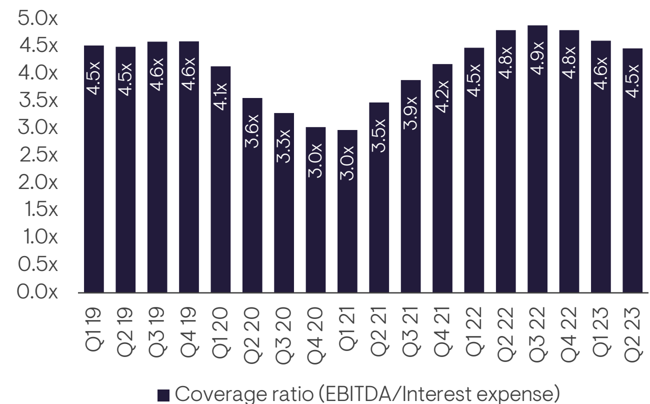
Declining interest coverage ratios



Source: JP Morgan, Capital IQ data, plotted by Ninety One. Sept '23.

The robust relative performance of loans continued in Q3, with US and European loans delivering returns of +3.3% and +4.1% respectively in the period, comfortably outpacing US high-yield (HY) debt. This brings US and European year-to-date loan returns to an impressive +10.0% and +11.5% respectively. September in particular stood out as US and European loans returned +0.9% and +1.1% versus US HY -1.2% in a month when the sell-off in US government rates was a headwind to bond market performance. CCC rated loans remain the star performers, with US CCC loans returning 5.5% in quarter and 14.9% year-to-date. European CCC loans were not far behind (4.3%), followed by US single B loans (3.7%). While fundamentals remain solid, with average US loan issuer leverage of 4.6x declining for the 9th consecutive quarter in Q2, we have started to see some profitability and margin pressure feeding through, and notably interest coverage ratios – while still 0.3x above the 5-year average of 4.2x – continued to deteriorate given the higher risk-free rates.

The technical backdrop, however, remains supportive, with subdued net new loan supply due to a substantial majority of activity being refinancings/repricing orientated, as new money issuance remains at multi-year lows. Conversely, the demand picture continues to improve, with the pace of CLO formation picking up notably in September and retail loan flows improving; the week of 20 September saw inflows of US$539 million – the most since May 2022. That inflow was only the ninth weekly inflow over the last year, however, it was the fifth weekly inflow over the past seven weeks, underscoring the increase in appetite as Q3 progressed.

Developed market credit indicator: Credit Chronicle

Investment grade

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

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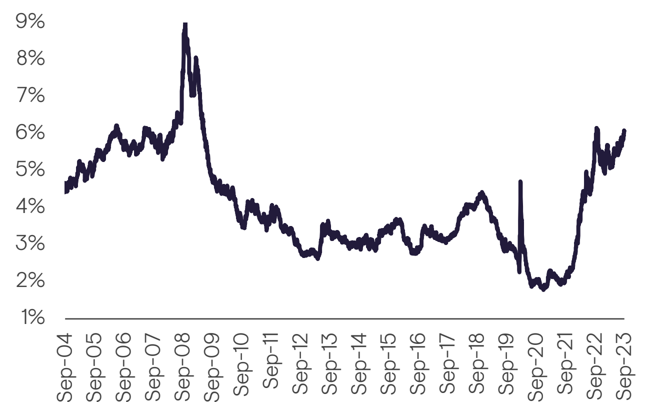
US IG yields are at levels not seen since 2009



Source: Bloomberg, 30 Sept 2023. US IG index = BofA US IG index.

Global investment-grade (IG) performance was driven entirely by risk-free rates in Q3. IG spreads were slightly tighter over the period, but total returns were down a meaningful 1.6% as risk-free rates climbed relentlessly. This was especially pronounced in the US as 5-year Treasury yields rose by 45bps to end the quarter at 4.61%, a level not seen since 2007. By comparison, Bunds were better behaved, with 5-year yields up 22bps to 2.77%. This dynamic drove European IG to significantly outperform US IG, with the former eking out a positive 0.8% return compared to the latter's -2.7% return. Spread moves across ratings were relatively similar, with BBBs tightening slightly more than single-As; however, all rating classes saw negative total returns as rates moves overshadowed any of the spread tightening.

After the significant move in rates, US IG was yielding 6.1% at quarter end, a level only seen a few times over the past twenty years (including through the GFC). As we've highlighted before, this high absolute yield could continue to attract investors into the asset class and keep spreads relatively tight, especially given the healthy credit fundamentals of the underlying constituent issuers. Further support for IG spreads has come from lighter-than-usual new issuance volumes, which some expect to continue through the rest of the year.

Structured credit

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

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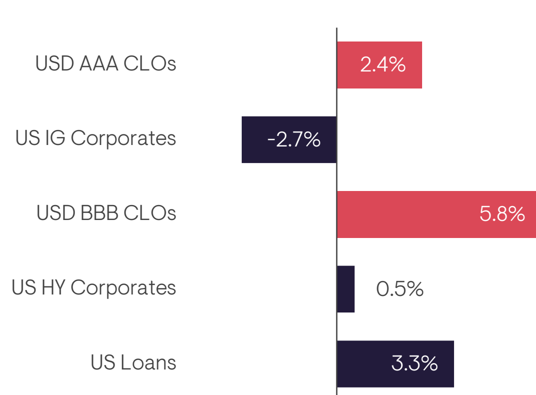
Q3 US CLOs returns vs. comparable markets



Source: Ninety One, ICE Data Indices (for corporate bonds) and JP Morgan (for loans and CLOs). 30 September 2023.

CLOs delivered strong total returns in Q3. Floating-rate coupons helped shield the asset class from the surge in risk-free rates, while tightening credit spreads further helped drive outperformance relative to other fixed income asset classes. At the top of the capital structure, USD AAA CLOs returned 2.4% in Q3, compared to -2.7% for US IG corporates. USD BBB CLOs returned 5.8%, compared to 0.5% for US HY and 3.3% for US loans. Euro CLOs also performed well relative to comparable corporate credit markets, though after several months of outperforming the US market, spread moves mostly lagged US CLOs in Q3.

In Q3, we saw an increase in CLO call activity, with CLO equity holders in a number of deals opting to sell the underlying loans, repay the CLO debt and recoup the residual portfolio value. Bank of America estimates that over US$4 billion of CLOs were called in Q3 in the US. A strong run in loan prices over the last few months has likely contributed to this trend by creating higher residual portfolio values for CLO equity investors to extract via the calls. In addition, many older CLOs have exited their 4-5 year reinvestment periods and have started to wind down, with cash inflows from the loan portfolios now increasingly being used to repay CLO debt instead of buying more loans. As the structures wind down, starting with the repayment of the AAA tranches, the economics of remaining invested in CLO equity diminishes, further incentivising CLO equity investors to call deals. We expect to see this trend continue over the next few months, which should be supportive of valuations of short-maturity CLO bonds, something we wrote about recently in our Picture this series.

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 (perps) had a strong Q3, driven largely by stable spreads and relatively high starting all-in yields. The asset class posted a +0.9% total return for Q3, which compared favourably to global IG at -1.6% and global HY of +0.9%. The real estate investment trust (REIT) sector remained in focus, with Unibail-Rodamco-Westfield's creative exchange solution for its October 2023 call perp. Rather than calling (repaying) the bond at the call date, Unibail offered bond investors the alternative of choosing a 10% cash repayment and then rolling the remaining 90% into a new 7.25% coupon perp that is callable in 5.25 years (which would be higher than the coupon of the existing perp if it remains outstanding). Although not a true call, this type of exchange is potentially a template for REIT issuers that are currently locked out of the primary market and wish to maintain a constructive relationship with debt capital markets. Outside of the REIT space, issuers of perps continued to call and replace existing front call hybrids, compressing extension risk premia in that part of the corporate hybrid market. Gross supply year to date is already higher than FY22 and has been dominated by utilities and telecom issuers.

Bank capital, or contingent convertibles, posted a solid Q3, comfortably outperforming comparable asset classes such as high yield over the quarter. Encouragingly, we have seen a continuation of most issuers calling their bonds in 2023. Furthermore, stronger issuers continue to benefit from access to the market, with several new deals pricing and being relatively well received. Even so, we continue to see elevated risk premia in the sector, even relative to lower-rated asset classes such as high yield. While we expect the sector to continue to recover, we continue to focus positions on higher quality banks and in instruments where we think extension risk is still mispriced.

EM corporate debt demonstrated a continuation of the year-to-date theme, holding up well over Q3 despite further interest rate rises, with the JP Morgan CEMBI BD returning a small negative return of -0.26%. In a similar vein to other fixed income markets, the investment-grade component of the index (-1.3%) materially underperformed the high-yield segment (+1.2%), with the former's longer duration coming under pressure from the rise in global sovereign yields. Away from the rates moves, spreads tightened across both IG and high-yield over the quarter, especially among the lower rated high-yield bonds. Within the asset class, corporate issuers in the more distressed sovereign markets, including Ukraine and Turkey, led the CEMBI index. In the former, poultry producer MHP announced a bond buyback, signalling that Ukrainian corporates are managing liquidity and aiming to stay current on their debt. At the other end of the spectrum, issuers in China struggled the most over Q3, notably in the real estate sector. Weak economic data in China together with ongoing negative headlines and liquidity issues in the real estate sector dragged returns down, although significant policy easing was evident over the quarter in a bid to redress the negative growth picture.

Developed market credit indicator: Credit Chronicle

Credit market performance	Q3 2023 return (USD hedged) %	Yield-to-worst %	Spread*	Duration
US high yield	0.5	9.0	406	3.6
European high yield	2.1	7.5	445	3.0
US investment grade	-2.7	6.1	125	6.5
European investment grade	0.8	4.4	151	4.5
US loans	3.3	10.0	540	0.3
European loans	4.1	9.1	548	0.3
Short duration high yield	1.5	9.5	493	1.7
CoCo's	2.2	8.9	441	2.6
Emerging market corporate debt	-0.3	7.9	305	4.0

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 at 30 September 2023.

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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