**Summary**

**Scoring - Fundamentals, Valuations, Technicals**

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Red/Green: downgrade/upgrade vs. last month

Muzinich Z-score Analysis. Scale runs from -2 to +2 (-2 is the worst score, +2 is the best score). Internal calculations. Results of Muzinich’s investment team’s appreciation of different economic and statistical data such as economic cycle, leverage, interest coverage ratios etc.

**Key takeaways**

- Despite higher yields in April, we see little incentive to move from our short-term duration bias. This is expressed by a shorter US duration exposure than in the euro market, given the probability of monetary policy bifurcation in the near term. We continue to believe curve steepening will materialise, reducing the benefit of long duration exposure.

- There were few changes to our scoring matrix. Spread widening was short lived and did not provide a real opportunity to add significant risk to portfolios. In fact, most portfolios are moderating credit beta after the retracement in spreads. This translates into a high credit quality bias, adding BBs while reducing B risk. This is also reflected in a reduction in high beta sectors, such as real estate. We maintain our overweight in euro subordinated financials.

- Our regional preference for euro-denominated credit remains, but with no significant overweight. Depending on the level of bifurcation between the US Federal Reserve (Fed) and European Central Bank (ECB), FX hedging costs may rise and, at some point, reduce the benefit of US credit for European investors. For now, we are comfortable with our moderate overweight in euro credit.

- We believe yields remain attractive and should continue to encourage inflows into credit although net flows, after new issuance, are less strong at tight spread levels.

**Fundamentals** - Global macro backdrop and first releases of Q1 corporate earnings constructive, with US HY scores upgraded to positive.

**Valuations** - Spreads remain expensive. Portfolios’ beta moderately reduced but are ready to add on any spread weakening.

**Technicals** - Active primary issuance continues to be well absorbed with few concessions. Net flows less strong on HY due to tight valuations.

**Tail Risks** - Geopolitical tensions remain high but are not escalating. A further rise in US inflation or JPY weakness could create more FX volatility globally.

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**Indices used:** J4CS - ICE BofA 0-3 Year Duration-To-Worst BB-B Cash Pay US High Yield Constrained Index. CSLL – Credit Suisse Leverage Loans Index. CSWELLI - Credit Suisse Western European Leveraged Loan Index. C0A4 - ICE BofA BBB US Corporate Index. J0A0 - ICE BofA US Cash Pay High Yield Index. ER00 - ICE BofA Euro Corporate Index. HEC0 - ICE BofA Euro High Yield Constrained Index. EMCL - ICE BofA US Emerging Markets Liquid Corporate Plus Index. ADOL – ICE BofA Asia Dollar Index. Please see Market Index Descriptions in the Appendix.
US stagflation? Really?

- Q1 real US GDP came significantly below expectations at 1.6% in seasonally adjusted annualised rate (SAAR) terms, down from 3.4% in Q4 2023.¹ The core Personal Consumption Expenditures (PCE) Price Index rose 3.7%, above expectations and well above the 2% reported in Q4.¹

- Markets quickly, and wrongly in our view, interpreted the mixed data as “stagflationary”. Net exports, a notoriously volatile contributor to GDP, took more than 0.8% off the total number. Inventories, no less volatile, wiped off 0.35%.¹ This masked solid 2.8% annualised growth of real domestic final sales, supported by 2.5% growth in consumer spending. On the corporate side, business spending on equipment rose a healthy 2.1%.¹ With strong job markets and positive momentum in capex, we do not see stagflation risk for Q2.

- However, the Fed will not ignore the signals from PCE data. Even if we thought up until recently the Fed wanted to cut rates multiple times in the second half, the conditions for it do so are disappearing, especially when the potential complications of the US elections calendar are considered. Barring a quick reversal in price pressures, the possibility of a July rate cut seems off the table.

- The FOMC meeting and press conference on May 1 brought no surprises on where the Fed stands after the last two months of data, but was clearer than many expected on the direction of the next move. By pushing back on the possibility of hikes, Fed Chair Jay Powell left two scenarios open: hold rates for longer if inflation persists in Q2 or progressive cuts if it doesn’t. Only a large negative shock in the labour market, which few expect, would justify quicker action. This supports our bias for short duration for the next couple of months given the likely persistence of an inverted yield curve.

Divergence between ECB and Fed

- In these circumstances, the fact the ECB is preparing markets for a rate cut in June may surprise. However, keep in mind its most recent hike last September was an insurance policy and should probably be withdrawn. Seventy per cent of European corporate refinancing goes through the banking sector, i.e. with floating rates. This differs from the US and adds pressure on the ECB not to delay cuts. As we questioned last month, what happens beyond June is less clear.

- In our view, we see three phases for what the ECB could do in this cycle, which will take time to complete: 1) Remove the September 2023 insurance hike in June; 2) Converge slowly to a new observation point which would keep a moderately restrictive stance (c.3% Deposit Facility Rate by early 2025); 3) Converge towards long-term terminal rate, with DFR at 2.25-2.5% by the end of 2025 if inflation cools durably towards 2%.

- A prolonged freeze in US rates adds complexity. The macro situation is different in the US and Europe, as is corporate sensitivity to interest rates. Some bifurcation between the ECB and Fed is justified by the poor performance of domestic demand in Europe. Additionally, corporate borrowing in Europe largely happens through the banking system via floating-rate loans. This ratio is closer to a third in the US, with more borrowing via capital markets and in fixed-rate securities.

Source Fig. 1 & Fig. 2: Macrobond at end of April 2024. For illustrative purposes only. ¹ Bureau of Economic Analysis, as of April 24, 2024. ² Bloomberg, as of April 30, 2024.

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• A closer look at the forward curve shows forward policy rates have repriced higher in the US and Europe by a similar proportion. Figure 3 shows 1-year forward SOFR and Euro short-term rates (ESTR), rebased on January 1. Although the absolute levels are different, the repricing shows no fundamental divergence between the two regions.

• In our view, this helps explain the ECB narrative on a June rate cut, even if the Fed must remain patient. The Eurozone cannot wait for the US to be ready to cut with the inflation and domestic demand dynamic bifurcating.

Figure 3. Repricing in Euro and USD rates

• The Fed’s hesitation on rates may slow EM monetary easing but, if history is a guide, we should have seen more EM outflows. This has not happened, reflecting the growing credibility of EM monetary frameworks in the past decade.

• An aggravating factor in late April was the Bank of Japan’s rate stance, with more downward pressure on the JPY. This puts more pressure on Asian economies competing with Japan, in tech export markets for example. The combination of US rates and falling JPY increases EMFX volatility, which could impact international investor appetite for local currency markets.

• While geopolitical risks can add uncertainties to capital flows towards EM, the positive global manufacturing cycle developing is providing strength to the commodities rally. That could uncover new opportunities, such as South Africa or some LatAm countries, extending export momentum beyond agricultural goods.

Figure 4. Outperformers and underperformers EMFX vs. US$, April 2024

• In aggregate, thanks to strong technicals, we see attractive opportunities emerging in hard-currency debt to take advantage of EM diversification and the commodity rally, while staying in US$-denominated assets.

Source Fig. 3: Macrobond as at end of April 2024. Fig. 4: Bloomberg, WCRS function, emerging-market FX, as of April 30, 2024. For illustrative purposes only.

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All about dispersion

- The macro backdrop remains supportive for credit fundamentals. Behind the seemingly negative surprise in US GDP in Q1, final domestic demand progressed at a healthy pace. The positive surprise in European real GDP (up 0.3% from Q4 2023 on a SAAR basis) adds to the strength of macro fundamentals for corporates.
- US corporate earnings for Q1 have also been supportive so far. While turnover is close to expectations, earnings progression appears superior to initial expectations. Only a few companies have reported pressures from labour costs, despite a tight labour market. The strong start to earnings season helped spreads to reverse the widening seen in the first half of April.
- This may be a good omen for corporate fundamentals, ahead of the potential challenge of higher-for-longer rates, at least in the US. The main risk in that scenario would be its “negative time value”, should higher rates finally hurt balance sheets and push up defaults beyond market expectations for just a modest rise.

Figure 5. Higher price dispersion but left tail well flagged (US high-yield sample)

- In our view, such a development would bring more dispersion in high yield without derailing the entire market. Less than 10% of the market is trading at a price of less than 80, a threshold associated with meaningful stress. Only 2.3% of bonds are trading below 50. These situations are well known and priced accordingly.
- High rates may push up defaults marginally later this year and next, but in the absence of exogenous shocks, we see this translating into more dispersion, not a major reassessment of default risk for the broader market.

- Default activity was moderate in the US, with US$350 million of bonds and US$1.5 billion of loans. Distressed transactions amounted to US$1 billion in bonds. The default rate was 2.3% for bonds and 2.9% for loans.
- As European companies publish Q1 results, it is worth remembering Q4 last year created a relatively constructive base from a credit metrics standpoint, despite weak macro data for the Eurozone and a quarterly fall in EBITDA and revenues. After GDP surprised on the upside in Q1, and stronger sentiment reported in business surveys, there is also a possibility of a positive surprise in corporate results as well.
- Net leverage continued to fall in Q1, confirming the trend initiated after the pandemic. While still higher than the long-term average, it does not present systemic concerns, even with high rates. Unsurprisingly, higher-rated companies progressed most, confirming our view more dispersion is coming.
- Interest rate coverage declined and is expected to fall further, with higher rates and large refinancing activity negatively impacting credit metrics. This should affect all ratings, but the BB segment should see the largest decline, given its sensitivity to the yield rise at the longer end of the curve.

Figure 6. Interest coverage ratio by rating, Euro HY

- The European default rate fell in April to under 2%, as certain 2023 defaults moved out of the calculations and because the month saw only one default. The main development to watch will happen when the restructurings of debt from Altice France, Intrum and Ardagh hit the numbers. This may push the default rate beyond current forecasts if these events take place over a short period.

References to specific companies are for illustrative purposes only and does not reflect the holdings of any specific past or current portfolio or account.

Sources: Fig. 5: ICE Index Platform, ICE BofA US High Yield Index, April 29, 2024. Fig. 6: JPMorgan ‘High Yield Talking Point’, 24 April 2024. For illustrative purposes only. ³ European Commission, as of April 30, 2024. ⁴ JP Morgan, as of April 24, 2024.

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Technicals still supportive despite lower inflows

- April saw further strong issuance in US investment grade with US$104 billion printed, following US$141 billion in March. In net terms, c.US$40 billion was issued in April. This confirms the availability of cash to support refinancing activity, a point we consider critical when evaluating fundamentals.

- New deals are coming with few concessions and are performing well in secondary markets. Demand remains robust despite higher yields and the negative total return for IG markets in April.

- May is traditionally active for US IG supply. There seems to be a desire from issuers to frontload issuance this year, perhaps to get ahead of the risk of uncertain demand around US elections in Q4.

- Primary markets for European credit were moderately active in April, due to the blackout period before earnings releases and holidays. Despite this, the month saw €40 billion of issuance in Euro IG.

- Again, issuers could come to the market with few concessions. New deals were largely oversubscribed despite volatility in rates markets.

- Traditionally, May is a busy month for supply. The heavy government bond schedule for the next two months may compete with corporate supply, especially for long maturities.

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Figure 7. Lower primary activity in April with lower inflows

- The US HY primary market also continues to be very active, with US$26 billion printed in April following US$28 billion in March. In net terms, US HY issued close to US$7 billion, a high number in historical. YTD issuance totalled US$114 billion at the end of April, more than double issuance in the same period last year.

- Leverage loan issuance totalled US$72 billion in April, mostly refinancings. YTD, we have seen US$390 billion of US loan issuance, of which less than US$50 billion has been for non-refinancing. On the demand side, CLO activity remains strong, helping to absorb primary loan issuance.

- April was active for European HY non-financial issuers, with over €8 billion printed. Supply was well absorbed, although demand was slightly weaker at the end of the month.

- Euro IG continues to see investor inflows, but euro HY saw some profit taking late in the month.

- Loan markets continue to be supported by CLO activity. In the US, retail demand is adding to institutional demand, which shifted its focus from fixed to floating-rate structures.

- In the US and Europe, money markets funds (MMFs) are seeing outflows, albeit in small numbers compared to the amounts accumulated in 2023. In the US, April tax payments likely contributed to outflows. We will keep a close eye on MMF flows in May. In Europe, with term deposit rates less attractive than they were in 2023, we could see persistent outflows in MMFs in the event of the ECB cutting rates in June. In our view, this should benefit short-duration credit.

Source: JPMorgan Daily Credit Strategy, Dealogic, May 6, 2024. JPMorgan, European Credit Weekly May 3, 2024. JPMorgan, as of April 24, 2024. Muzinich views, opinions are for illustrative purposes only, not to be construed as investment advice or an invitation to engage in any investment activity, subject to change. See Important information at the end of this presentation regarding forward-looking statements.
Better value in spreads, but not enough to jump

- All developed-market government bonds saw negative total returns in April. Changes in rate expectations pushed yields higher and steepened curves in all regions. Only ultra-short maturities avoided negative performance.
- As a result, IG saw negative performance, particularly in the long end, putting YTD total returns in negative territory, regardless of currency or region. The picture is different for excess returns, where the carry and spread tightening supported positive returns.
- HY markets outperformed IG on aggregate, with less duration and even more carry protection. Excess returns were all positive, with European HY outperforming US HY. Meanwhile EM outperformed again in terms of excess returns on the back of further spread tightening.

As mentioned last month, HY could see further dispersion, with weakest credits weakening further, but the market still looks attractive at an aggregate level in our view. In the widening phase last month, spread decompression within HY was limited.

When spreads retraced at the end of the month, compression came back quickly, apart from in the CCC segment. This is symptomatic of what we may increasingly see in the coming months. In the absence of bullish views on rates, weaker credits in HY will suffer and look unlikely to participate in upside moves. We will retain our quality bias as long as the rates scenario is unchanged.

- Valuations scores were mostly left unchanged, except for US HY, where the yield argument was upgraded after the move in absolute yields. Domestic demand for yield is apparent; lower stock markets by the end of the month did not deter demand for HY bonds or loans.
- Many discussions with our clients focus on their fears of being too late in the credit rally and tension around the entry point. We reiterate our view 2024 is a year for carry. The higher-for-longer narrative only reinforces this. With the potential for capital appreciation being limited, we believe the opportunity cost not to capture the carry is the most important factor to focus on with a medium-term outlook.

Figure 9. April positive for excess returns in credit

Figure 10. Spread percentiles suggest more value for Euro HY vs. US HY

However, our investment team is not ignoring tight spreads levels in the short-term, and overall risk appetite has moderated, reflecting the asymmetric return potential if volatility rises further. This is translating into more prudent positioning in HY portfolios, by maintaining the exposure but reducing higher beta sectors, such as real estate, or shifting to higher-quality BB names, taking advantage of the recent negative duration impact. Our overweight in HY to take advantage of the carry remains stable, while duration positions are kept underweight versus reference indices in most portfolios.

- Our regional bias remains focused on short-dated US and EM credit, while allowing more duration in European credit, and keeping the overweight in subordinated banks. Exposure to real estate is being reduced, as mentioned above.

Past performance is not a reliable indicator of current or future results.

Fig. 9: Macrobond, Bloomberg as of April 30, 2024. Excess Returns per market and rating segments. ICE BofA Index US Corporate Index (C0A0), US High Yield Index (H0A0), Euro Corporate Index (ER00), Euro High Yield (HEC0), Emerging Corporate Liquid Plus Index (EMIB), Emerging High Yield (EMHB). Fig. 10: Macrobond, ICE BofA index US High Yield Index (H0A0) European High Yield Constrained index (HEC0). For illustrative purposes only.

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Index descriptions

ER00 – The ICE BofA ML Euro Corporate Index tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets. Qualifying securities must have an investment grade rating (based on an average of Moody’s, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

COAO - The ICE BofA ML US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody’s, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

EMIB - ICE BofA High Grade Emerging Markets Corporate Plus Index is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated AAA through BBB3, inclusive.

EMHB - ICE BofA High Yield Emerging Markets Corporate Plus Index is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated BB1 or lower.

H0AO – The ICE BofA ML US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody’s, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

HECO – The ICE BofA ML Euro High Yield Constrained Index contains all securities in the ICE BofA ML Euro High Yield Index (HE00) but caps issuance exposure at 3%.

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