With spectacular moves in rates impacting global fixed income, growing concerns of a recession, ongoing high inflation and elevated energy prices, 2022 has been a tough year for financial markets including credit. However, after decades of low interest rates and macro-financial crisis management sending real interest rates negative, the investment landscape for savers has profoundly changed. Income from credit is back and we believe will likely remain at the top of the investment agenda for some time.

**A Fast and Furious Rise in Rates**

By the end of September, global corporate bond markets had fallen 18% year to date;1 an unprecedented move in the last two decades. Two-thirds of the negative performance came from rising interest rates, with only one third from spread widening.

The radical change in the post-Covid inflation landscape - Euro area inflation rose from -0.3% to 10% in annual terms2 - has forced the largest central banks to raise interest rates. This trend will likely continue into early 2023. Markets are now anticipating the US Federal Reserve will push policy rates to at least 4.5% by the end of Q1 2023,3 while European Central Bank policy rates are expected to reach 2.75% by mid-2023.4 Both are expected to leave interest rates elevated for some time.

Today, market participants and central banks appear better aligned in terms of the future path of interest rates. While the risk of a negative surprise cannot be underestimated, it is unlikely to be similar to what financial markets endured this year. It is then fair to expect most policy rate tightening is incorporated in the current price of short-term forward rates.

**Credit Market Premiums Have Incorporated a Recession**

The credit market premium over the safest government bonds has materially increased. In investment grade, the average premium has risen from 96bps - 181bps,5 while in high yield the average spread has grown up from 400bps - 622bps.6

This rise in credit premia is a logical reflection of a deteriorating economic climate, compressed corporate margins and lower global liquidity. However, global credit market spreads are now close to 70bps above their 5-year average.7 Over the past two decades when this level was reached it indicated markets believed a recession was imminent. As a result, we believe current spreads are incorporating a “mild recession” premium.

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**Income is Back - Enjoy It**

October 2022

*After a significant sell off in credit markets, yields have reached levels that we believe should protect investors from future volatility while providing an attractive income stream*

With spectacular moves in rates impacting global fixed income, growing concerns of a recession, ongoing high inflation and elevated energy prices, 2022 has been a tough year for financial markets including credit. However, after decades of low interest rates and macro-financial crisis management sending real interest rates negative, the investment landscape for savers has profoundly changed. Income from credit is back and we believe will likely remain at the top of the investment agenda for some time.

**Capital at risk.** The value of investments and the income from them may fall as well as rise and is not guaranteed. Investors may not get back the full amount invested.
Corporate Fundamentals Appear More Resilient

Corporate balance sheets have been challenged by the Covid crisis but have emerged resilient. While we believe default rates will increase from early 2022’s historically low levels, it’s unlikely they will match previous recession cycles. The most vulnerable credits (high yield) contained their leverage ratio during Covid and have since maintained high levels of cash on their balance sheets. With financing needs met in 2021 in anticipation of tougher times, there is no urgent need for these companies to come to market in 2023 if market conditions are not favourable. Meanwhile high energy prices should prevent the energy sector contributing to the default cycle, as in previous economic downturns. Despite this, the market is being excessively pessimistic with European credit spreads pricing in a 44% cumulative default over the next five years, a level we believe is overdone.

Credit Market Valuations Have Improved

In our view, the combination of higher yields and wider spreads has significantly improved valuations and radically changes the performance outlook for credit markets. Put into perspective, average yields in European investment grade have risen from 0.5% to 4.15% year to date while in high yield, yields grew from below 3% to 8.25%. US credit markets have experienced similar moves. For years savers faced very low all-in yields, yet an allocation to global credit market average investment grade solution with limited interest rates sensitivity is now able to offer a gross yield in euros above 5%.

The current new valuations in fixed income markets allows the yields to act as a shield against future volatility in financial markets. The mechanism is simple as the current yield would need to be erased before the investor loses money. As a matter of fact, some simulations made at end of September showed that a similar rise in yields and spreads seen so far this year would not incur losses should an investor allocate into a global crossover mandate.

Rebalancing From Equity to Fixed Income

Early 2022’s low yields meant most global portfolios preferred equities over fixed income. The prospect of resilient dividends and share buy-back programmes offered better value. This has radically changed with today’s prices and yields. With recession a very plausible scenario, earnings growth is uncertain and could be negative for a few quarters. The dividend yield on the S&P500, a benchmark US equity market, is hardly 1.7% as of third quarter 2022, far below the US investment grade yield of 5.74%.

Income is Back

The ‘income’ in fixed income is back, and investors willing to protect their savings portfolio from excessive financial market volatility should no longer ignore the opportunities in global credit markets after a prolonged period of poor returns. In our view current valuations offer an attractive and predictable revenue stream for medium term investors and it is time to enjoy it.

All data to 30th September unless otherwise stated.

This material is not intended to be relied upon as a forecast, research, or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed by Muzinich & Co are as of October 2022.

1. ICE Index Platform, ICE BofA ML Global Corporate & High Yield Index (GI00)
2. Eurostat, 31st December 2020 to 30th September 2022
3. Bloomberg, Fed Fund rates, Federal Reserve as priced by forward markets
4.Deposit Facility Rate, European Central Bank
5. ICE Index Platform, ICE BofA Global Large Cap Corporate Index (G0LC) 31st December 2021 to 30th September 2022
6. ICE Index Platform, ICE BofA Global High Yield (HW0C) from 31st December 2021 to 30th September 2022
7. Bloomberg, ITraxx Crossover Index, with 40% recovery rate assumption
8. ICE Index Platform, ICE BofA Euro Corporate Index (ER00)
9. ICE Index Platform, ICE BofA European currency High Yield Constrained Index (HECO)
10. Bloomberg, Standard & Poor’s, as of 30th September 2022.
11.ICE Index Platform, ICE BofA ML US Corporate Index (C0A0, as of 30th September 2022
Index Descriptions

GI00 – The ICE BofA ML Global Corporate & High Yield Index tracks the performance of investment grade and below investment grade corporate debt publicly issued in the major domestic and eurobond markets. Qualifying securities must be rated by either Moody’s, S&P or Fitch, have at least one-year remaining term to final maturity, at least 18 months to maturity at point of issuance and a fixed coupon schedule.

G0LC - ICE BofA Global Large Cap Corporate Index (G0LC) ICE BofA Global Large Cap Corporate Index tracks the performance of large capitalization investment grade corporate debt publicly issued in the major domestic and eurobond markets. Qualifying securities must have an investment grade rating (based on an average of Moody’s, S&P and Fitch). In addition, qualifying securities must have at least one-year remaining term to final maturity, at least 18 months to final maturity at point of issuance and a fixed coupon schedule.

HW00 – The ICE BofA ML Global High Yield Index contains all securities in The ICE BofA ML Global High Yield Index (HW00) but caps issuer exposure at 2%

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.

HE00 – 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%.

ICE BofAML US Corporate Index (C0A0) ICE BofAML US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

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