While we remain cautious about the fundamental outlook for growth (i.e., how fast will global economic growth slow as interest rates rise), it seems to us that credit markets appear to be stabilizing and are absorbing bad news rather well (e.g., higher US consumer price and producer price index data, more aggressive Fed rate hikes, disappointing JP Morgan earnings etc.). This may be because most investors have by now conservatively positioned their portfolios.

In aggregate, while we believe credit spreads could be wider given macro uncertainties, we recognize that yields are attractive, prices are at nice discounts and spreads are above their long-term averages. It is important to be keenly aware of the fact that when credit markets approach a bottom, trading volumes fall to low levels rendering good market timing decisions ineffective because offerings become scarce; there are few sellers.

To fully take advantage of a depressed credit market and really achieve good investment results, an investor must be prepared to invest before a market bottom is confirmed, even if this may imply some short-term mark-to-market loss. This will allow a well-positioned portfolio to fully profit from a potentially significant upward market move. We believe now, while uncertainties still abound, may offer a good entry point.

Credit spreads and yields are pretty attractive using a number of metrics. As long as our credit research group continues to select solid companies, capital will be preserved through the macro uncertainties while poised for upside capture when the market rebounds. We may be early with this reallocation to better-quality high yield credit, but we believe we shall be well rewarded over a 12-to-24-month horizon with exceptional returns.

1. Source: ICE Index Platform, ICE BofA ML US Cash Pay High Yield Index (J0A0), as of 18th July 2022
Credit spreads could widen further for the following reasons:

1. There are still too many uncertainties around inflation, central bank rate hikes and terminal rates, and the repercussions of a drawn-out Russia/Ukraine conflict.
2. Huge event risk for Europe and global repercussions if Russia decides to shut off all natural gas deliveries. We’ll know later in July how real this risk is.
3. US dollar strength could create an emerging markets financial crisis, led by the weakest frontier sovereigns.
4. A bursting of China’s all-important property sector bubble that can’t be controlled by the government.
5. Stubbornly high energy prices to keep inflation high.
6. European sovereign bond curve fragmentation risks with Italy front and center.
7. Finally, but not least, the US Treasury yield curve is firmly inverting which has been a reliable early indicator of a recession, although it is not that predictive of the severity of a recession.

US high yield credit spreads appear to be stabilizing and trading technicals are improving for the following reasons:

1. Generally, credit metrics today are at a stronger level than credit metrics of past tightening cycles (e.g., US high yield (USHY) not overleveraged and maturity wall not until 2025-2026). ¹
2. Minimal bubbles in credit sectors which typically involve rapid growth in issuance like past cycles (e.g., telecoms, energy).
3. In USHY, as an example, defaults are expected to increase from current low levels but stay below 4% for the next year (our own forecast) which means spreads are too wide (current USHY spreads imply a default rate of about 5%). ¹
4. Price discounts are at attractive levels, levels that generally suggest a more difficult outlook but really are because, in all probability, rates are higher and average market coupons are lower.
5. Given low maturities over the next two years, issuance has been low which has not pressured spreads further.
6. Anecdotally it seems most investors are underweight duration and credit risk and essentially the need to sell has dropped.
7. Our traders indicate that offerings of bonds we would deem as attractive are very low and any amount of real money buying will push prices higher.

Conclusion. It is extremely difficult to pick the market bottom. It is important to start putting a portfolio together as prices fall and before quality bonds become too scarce to buy at compelling prices. Now is a good time to start a re-allocation to credit. We believe investors will be well rewarded for increasing their exposure to credit in the coming weeks.

¹ Source: ICE Index Platform, ICE BofA ML US Cash Pay High Yield Index (J0A0), as of 18th July 2022
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Index Descriptions

HE00 - The ICE BofA ML Euro High Yield Index tracks the performance of EUR dominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. 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, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

JOA0 - The ICE BofA ML US Cash Pay High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt, currently in a coupon paying period that is 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.

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.

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