Where Are We in the Credit Cycle?

July 2023

While credit markets have performed relatively well year to date, the macroeconomic backdrop, inflation and the reaction function of central banks remains uncertain. Mike McEachern discusses his thoughts on the key macro themes influencing credit markets and how he is positioning his multi-asset credit strategies to navigate this uncertain environment.

Key Themes

• Focus on high quality credits (US investment grade and US Treasuries) given expectations for a further slowdown in the macro cycle
• Barbell approach on duration
• Expect spreads to widen with dry powder available to take advantage of better valuations in the coming months

What do you think are the main themes in this credit cycle?

This cycle is being dominated by inflation. While inflation has come down, central banks are remaining hawkish as the fall has not been fast enough for a change in rhetoric.

Given this uncertain environment, we are taking more cautious positioning in our multi-asset credit strategies with a large weighting to higher-quality assets in terms of duration and spread. This should enable us to participate in the upside available in credit while avoiding the risks.

What is your view on rates?

It is possible that long-term rates have likely peaked in both the US and globally, although we would caveat that it’s a hard thing to predict. As a result, we are taking a barbell approach to our duration exposure. Overall, we have been increasing duration with an overweight in long maturity high-quality bonds, although lately we have been shifting some of our duration exposure to the 7-10 year maturity areas as the US curve has inverted quite significantly over the last few weeks. Our credit risk is positioned mostly at the front end of the curve.

Given your view on current valuations, how are you positioned across US Treasuries, investment grade and high yield?

Over the last 6-7 months we have held some Treasuries but have reduced the positioning when attractively priced new issues come to market. Longer term, we are waiting for spreads to move wider before adding further to credit. Our strategy’s primary corporate allocation is within US investment grade which we believe appears attractive from a fundamental standpoint. We are focusing on collecting spread and yield and protecting the portfolio from idiosyncratic issues while awaiting more attractive valuations to add good quality credits. We have some high yield exposure, although it’s largely focused on high quality BBs.
How do you differentiate between the US, Europe and emerging markets?

All regions have their own issues, although there are some common denominators like restrictive monetary policy by most central banks (China being the exception). Certainly, this is the case in the US, where we have seen economic challenges because of higher rates. Europe is also experiencing similar concerns although its economy is likely in a different phase relative to the US. Within emerging markets, we are constructive on the fundamentals although question the growth and rebound of the Chinese economy and what it means for other markets within the region.

Given the US market is the largest and most liquid, we believe this segment offers good downside protection and this makes up a large proportion of our portfolio allocation. Within Europe, on a currency adjusted yield we see some attractive relative value opportunities and we also see some potential within emerging markets, although we are avoiding sovereigns with underlying problems and are again focusing on higher quality credits.

What is your view on banks?

Most of our banking exposure is based in Europe. We do not have any exposure to US banking given underlying concerns around commercial real estate. The volatility created earlier in the year by the Credit Suisse crisis was concerning and we have since reduced our banking exposure. Although balance sheets are likely to feel the effects of weakening economies, we believe banks are well positioned for tougher times. Although again we are awaiting a wider spread environment to reinvest back into banks.

Where do you see challenges and opportunities in the primary market?

The markets are open for increased issuance and the investment grade market is reopening notably in the US and Europe. The high yield market is quieter as most issuers have balance sheet liquidity and believe interest rates will be lower later in the year. However, we believe it is risky for companies to time the market and spread uncertainties, so now is the time for them to start tackling the maturity wall that begins in 2025 (when 10% of the US high yield market comes due).¹

Is there a particular level that you believe spreads should reach before valuations look attractive?

The US high yield index spread was around 420bps which is slightly below its 10-year average.¹ This doesn’t really incorporate the uncertainties in the macroeconomic environment or the increasing likelihood of volatility. From an historical perspective, if an investor were to access the US high yield market at 550bps or higher, over a three-year period they would be well rewarded. Spreads are a long way from this level. We also believe US high yield and some of the other asset classes appear in good balance sheet shape as Covid interrupted the natural late cycle leveraging of balance sheets for the benefit of shareholders. So, while we’re in the latter stages of the cycle, companies look pretty healthy. While it’s difficult to time it perfectly, we would start looking to reenter the market when spreads reach c. 500bps if the macro environment hasn’t significantly deteriorated. I think we are currently around 70bps from where we would add in high yield and 30-40bps in investment grade.

Past performance is not a reliable indicator of current or future results Risk: Index performance is for illustrative purposes only. You cannot invest directly in the index.

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 June 2023 and may change without notice.

¹ Source: ICE Data Platform, ICE BofA US High Yield Index (J0A0), as of 30th June 2023
Important Information

Muzinich and/or Muzinich & Co. referenced herein is defined as Muzinich & Co., Inc. and its affiliates. Muzinich views and opinions. This material has been produced for information purposes only and as such the views contained herein are not to be taken as investment advice. Opinions are as of date of publication and are subject to change without reference or notification to you. Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy. The value of investments and the income from them may fall as well as rise and is not guaranteed and investors may not get back the full amount invested. Rates of exchange may cause the value of investments to rise or fall. Emerging Markets may be more risky than more developed markets for a variety of reasons, including but not limited to, increased political, social and economic instability; heightened pricing volatility and reduced market liquidity.

Any research in this document has been obtained and may have been acted on by Muzinich for its own purpose. The results of such research are being made available for information purposes and no assurances are made as to their accuracy. Opinions and statements of financial market trends that are based on market conditions constitute our judgment and this judgment may prove to be wrong. The views and opinions expressed should not be construed as an offer to buy or sell or invitation to engage in any investment activity, they are for information purposes only.

This discussion material contains forward-looking statements, which give current expectations of a fund’s future activities and future performance. Any or all forward-looking statements in this material may turn out to be incorrect. They can be affected by inaccurate assumptions or by known or unknown risks and uncertainties. Although the assumptions underlying the forward-looking statements contained herein are believed to be reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurances that the forward-looking statements included in this discussion material will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation that the objectives and plans discussed herein will be achieved. Further, no person undertakes any obligation to revise such forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

United States: This material is for Institutional Investor use only - not for retail distribution. Muzinich & Co., Inc. is a registered investment adviser with the Securities and Exchange Commission (SEC). Muzinich & Co., Inc.’s being a Registered Investment Adviser with the SEC in no way shall imply a certain level of skill or training or any authorization or approval by the SEC.

Issued in the European Union by Muzinich & Co. (Ireland) Limited, which is authorized and regulated by the Central Bank of Ireland. Registered in Ireland, Company Registration No. 307511. Registered address: 32 Molesworth Street, Dublin 2, D02 Y512, Ireland. Issued in Switzerland by Muzinich & Co. (Switzerland) AG. Registered in Switzerland No. CHE-389.422.108. Registered address: Tödistrasse 5, 8002 Zurich, Switzerland. Issued in Singapore and Hong Kong by Muzinich & Co. (Singapore) Pte. Limited, which is licensed and regulated by the Monetary Authority of Singapore. Registered in Singapore No. 201624477K. Registered address: 6 Battery Road, #26-05, Singapore, 049909. Issued in all other jurisdictions (excluding the U.S.) by Muzinich & Co. Limited, which is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 3852444. Registered address: 8 Hanover Street, London W1S 1YQ, United Kingdom. 2023-07-05-11331