PICTET WEALTH MANAGEMENT

Credit markets update

Challenging environment ahead

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22 MAY 2023, CIO OFFICE & MACRO RESEARCH

FLASH NOTE

SUMMARY

- Because we expect the cost of financing to remain elevated for US and euro corporates throughout the year and foresee an economic slowdown in H2 (but no policy rate cuts), we believe the market environment will remain challenging for corporates. That is likely to translate into higher high-yield (HY) default rates in the twelve months ahead.
- In this challenging context, we believe the risk premiums for HY over investment-grade (IG) bonds could prove too low and we expect credit spreads to widen in H2. We keep our forecasts for much wider US and euro HY spreads by year-end and for some more limited spreads widening for US and euro IG corporates.
- This means that we continue to underweight HY corporate bonds but have a more positive view of their less risky IG peers. Indeed, we have an overweight position in euro IG, in keeping with our view that Europe will skirt recession and inflation will progressively come down, helping to reduce bond volatility.
- Overall, given their attractive yields, we keep our preference for short-term US and euro IG corporate bonds. Finally, in the banking sector our focus remains on senior debt, as the subordinated debt segment could still prove highly volatile in the more challenging market environment that likely lies ahead.

RESILIENCE IN CREDIT MARKETS

After a tumultuous March, waters have calmed in credit markets and following the earnings season, companies (mostly investment-grade (IG) ones), **have again tapped the primary market to issue bonds**. Since the beginning of the year, gross bond issuance stands at USD631 bn (down 10% year-over-year) and at USD402 bn (up 5% year-over-year), respectively for the US and euro IG market (on 22 May). Interestingly, euro companies have offered more generous new issue premiums (NIP) (between 20 to 50 bps), compared to their US counterparts, where the NIP rather hovered around 10-20 bps.

The higher uncertainty around the terminal rate for the European Central Bank's (ECB) policy rate could partly explain lower investors' appetite for euro bonds. Market participants see it peaking at 3.67% in September (on 19 May), but we remain of the view that the ECB will halt at 3.5% with a last hike in June. Moreover, looking at fixed income total returns in local currency since the beginning of the year, **US bonds have performed better than their euro counterparts**.

This is true not only for IG corporates, up 2.2% in the US against only 1.7% in euro (according to ICE indices), but also for 10-year sovereign bonds, with US Treasuries up 2.3%, while the German Bund is down 3.4% year-to-date on 19 May. **What is more surprising, is the resilience of the high-yield (HY) bond market in a context of economic slowdown, elevated cost of financing and rising default rates**. Both US and euro HY ICE indices have outperformed their IG peers year-to-date (at 3.8% and 3.7%, respectively) with the lowest rating category in US HY (CCC & lower rated bonds) posting a whopping 6.4% total return.

Part of the resilience of the HY bond market probably has to do with the low gross supply. The face value of the US and euro HY outstanding bond markets have shrunk by 10% since the beginning of 2022, to USD1374 bn and EUR420 bn, respectively (on 15 May). This means that net supply (gross supply deducted from maturing bonds) has been negative, thereby reducing the investable universe. Part of this shrinkage also comes from the fact that the outstanding face value of rising stars (HY-rated bonds upgraded to IG) has surpassed fallen angels (IG-rated bonds downgraded to HY) since early 2022. It is worth noting however that the trend has moderated since the beginning of the year in part due to more challenging environment for high-yield issuers on the back of elevated cost of financing.

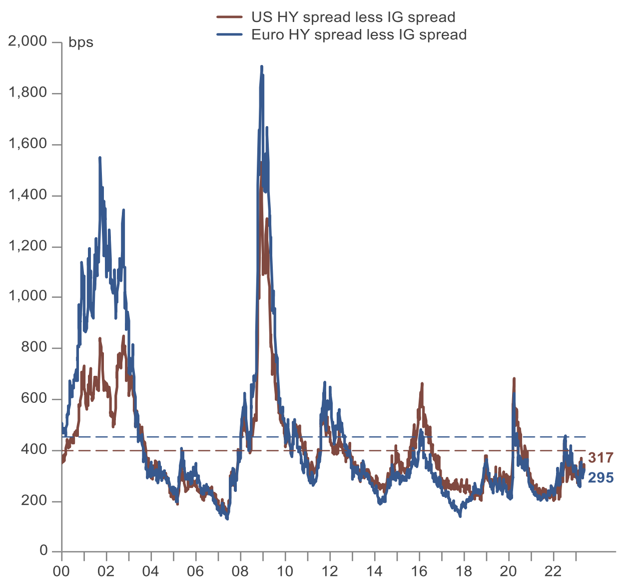
A TALE OF TWO SEGMENTS

Since the beginning of the year**, US and euro IG corporate bonds spreads have experienced a slight widening** to 145 bps and 167 bp, respectively (on 19 May), **while their HY counterparts have experienced a slight tightening** both to 462 bps. Nevertheless, looking beneath the surface one sees differences between industry and rating segments.

Looking at ICE corporate bonds indices, while average spreads in US and euro IG, are comfortably trading above their long-term median, **US and euro HY average spreads are trading very close to their long-term median** (on 19 May). Interestingly, **in high-yield it is quality that seems to be more expensive**, as spreads for the highest-rated part of the HY universe (BBs) are back to levels consistent with their long-term median while spreads for the lowest-rated segment (CCCs and lower) remain much wider and at distressed levels (above 1000 bps).

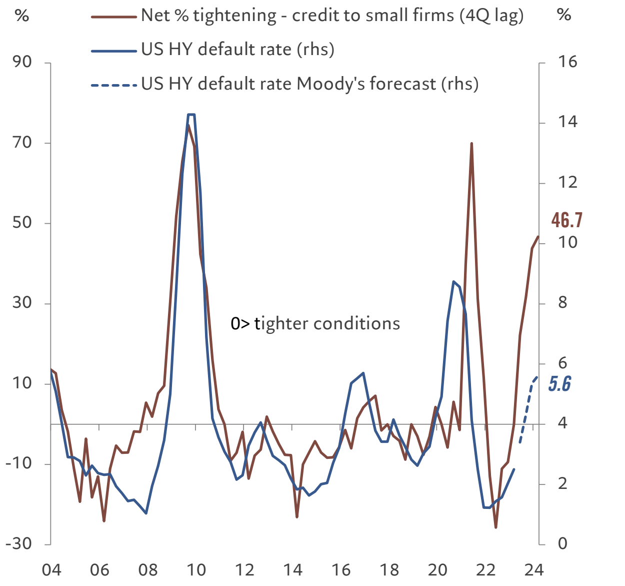
Looking at industries, **the banking sector still bears the scars of March's banking turmoil, with both US and euro IG banking spreads trading wider than the overall index.** The same is true for euro subordinated over senior debt where the spread differential at 117 bps remains wider than before March's turmoil (on 19 May).

Chart 1: US and euro HY credit spread premium over IG



Source: Pictet Wealth Management, FactSet, 19.05.2023

Chart 2: US banks' lending conditions and HY default rate



Source: Pictet Wealth Management, Moody's, FactSet, 19.05.2023

What we observe beneath the surface in credit indices translates into a lack of significant spread premium of US and euro HY bonds over IG ones (their spread differential hover around 300 bps, which is well below their long-term median, *see chart 1*).

Similarly, when we calculate the default-adjusted spreads for US and euro HY indices based on one-year ahead default rate projections of 5.7% and 4.0%, respectively,[1] we find a negative number for US HY and a slightly positive one for euro HY. This means that **although HY spreads are wide enough to compensate investors for the actual default rate** (it stood at 2.8% and 2.7% in US and euro HY, respectively in April according to Moody's), **current spreads levels could not be sufficient to protect investors meaningfully against a risk of higher HY default rates.**

This default rate projection is important to factor in when assessing the relative attractiveness of HY bonds over their IG counterparts in a context where HY default rates have picked up and are likely to continue their ascent over the coming year.

Not only have yields gone up to historically elevated levels for HY issuers on average (to 8.8% for US HY and 7.4% for euro HY according to ICE indices on 19 May) and to levels around 15% for CCC & lower-rated issuers, **but banks also tightened lending conditions further into restrictive territory** for the fourth quarter in a row in Q1 of this year. Historically, **tighter financing conditions have been a good harbinger for an upcoming default cycle** (*see chart 2*), as corroborated by S&P Global Ratings, which observed that **half of the US HY defaults in April have been caused by missed interest payments.** A cohort that is likely to grow over the coming months as we expect financing costs to remain prohibitive for the riskiest issuers and profits to shrink as we forecast an economic recession in the US in H2.

[1] We assume a recovery rate of 49% in the US and 27% in Europe.

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SAFE CARRY REMAINS KING

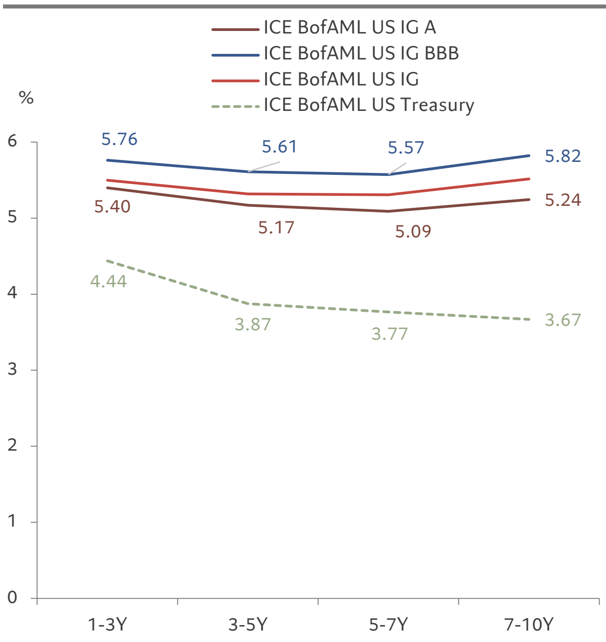
Because we expect the cost of financing to remain elevated for US and euro corporates throughout the year and foresee an economic slowdown in H2 (but no policy rate cuts), **we believe the market environment will remain challenging for corporates. That is likely to translate into higher HY default rates in the twelve months ahead.**

In this challenging context, we believe the risk premiums for HY over IG bonds could prove too low and we expect credit spreads to widen in H2. **We keep our forecasts for much wider US and euro HY spreads by year-end** (to 680 and 670 bps, respectively). **We also foresee some spreads widening for US and euro IG corporates, but less meaningful ones** to 190 bps and 220, respectively, as they are already wider by historical comparison. Moreover, **our more benign view for IG credits is underpinned by more solid fundamentals in the form of lower leverage ratios, easier access to funding** (through capital markets or banks) **and very little risk of defaults.**

This means that **we continue to underweight HY corporate bonds but have a more positive view of their less risky IG peers**. Indeed, **we have an overweight position in euro IG**, in keeping with our view that Europe will skirt recession and inflation will progressively come down, helping to reduce bond volatility.

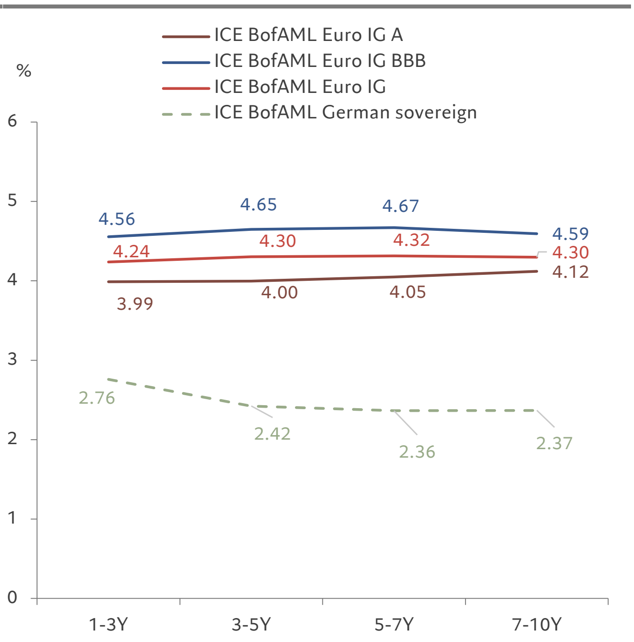
Overall, given their attractive yields, **we keep our preference for short-term US and euro IG corporate bonds** (around 5.5% and 4.2% for one-to-three years maturity, on 19 May, *see chart 3 and 4*). Finally, in the banking sector our focus remains on senior debt, as the subordinated debt segment could still prove highly volatile in the more challenging market environment that likely lies ahead.

Chart 3: US IG corporate yield curves



Source: Pictet Wealth Management, FactSet, 19.05.2023

Chart 4: Euro IG corporate yield curves



Source: Pictet Wealth Management, FactSet, 19.05.2023

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