Q3 2023 Credit Outlook:
Opportunity Knocks in Europe

Please note that the opinions discussed below are those of the individual authors and do not reflect a Man Group house view. All market data referenced below sourced from Bloomberg unless otherwise specified.

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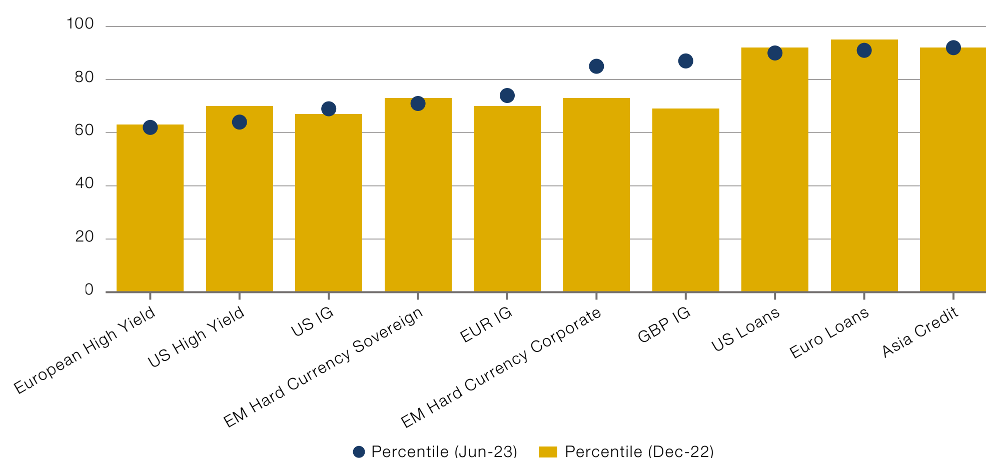
Time to read: 10 minutes

As we enter the third quarter of 2023 and the northern hemisphere summer season, investors may be asking what comes next for credit sectors after a first half of elevated inflation and sharp hikes in rates by most central banks. Despite the rate rises, and at this stage of the economic cycle, the credit markets remain much calmer than might be expected. There is a reasonably positive tone to the markets: yes, inflation remains sticky, but attractive all-in yields and low default rates are maintaining the attractiveness of credit, as shown in Figure 1.

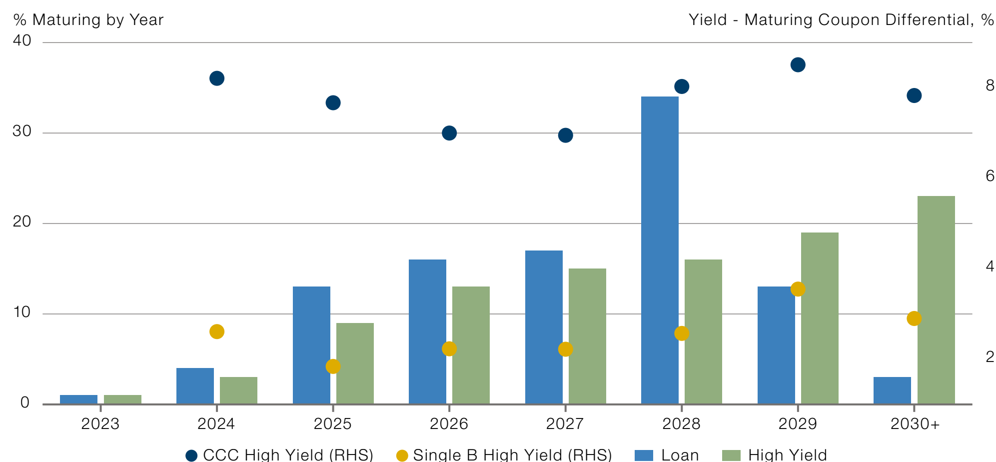
Figure 1. Yield Percentiles: Still Attractive Compared to Last Year



Source: Bloomberg, ICE BofA, JP Morgan, Credit Suisse indices in local currency, as at 30 June 2023.

Having duration in one's portfolio may help to provide ballast as central banks reach the end of their rate hiking cycle and growth eventually slows. We have spoken for some time about the turn of the credit cycle and have been surprised by the resilience in the lower-quality portions of the credit markets. However, we do feel the consequences of both tightening policy and reduced bank lending should lead to pressure on lower-quality portions of the loan and high yield bond market. With all-in yields above 10% the higher interest costs for companies already remain prohibitive and in the high yield bond market, CCC issuers face a refinancing reckoning in terms of higher interest costs if, indeed, they are able to refinance in current market conditions at all, as is indicated in US markets in Figure 2. Of course, many will be locked out of the market and we do expect more distressed opportunities to present themselves over the coming quarters.

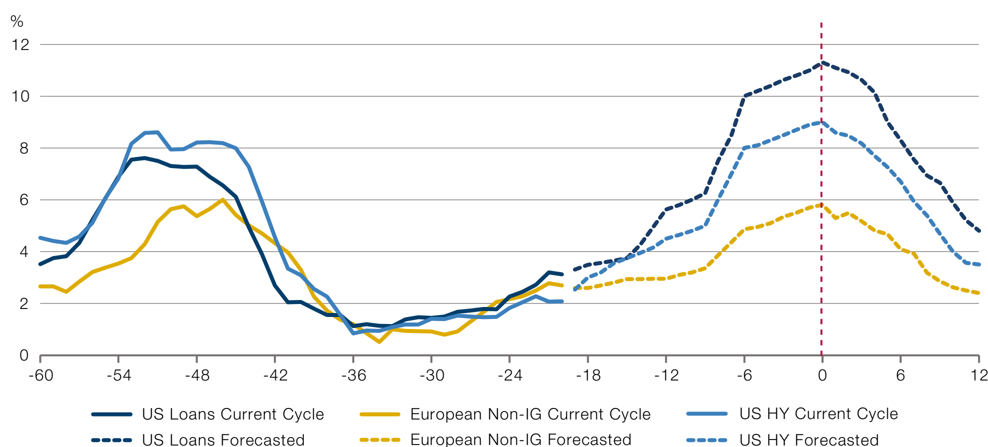
Figure 2. Maturity Walls vs Refinancing Economics



Source: ICE, Morgan Stanley Research. Note: YTW-coupon differentials for 2023 are removed due to limited sample size.

How should investors position within the fixed income market segments? In our view, there is now a clear preference for choosing European credit over its US counterparts. In the US, the downturn in commercial real estate, combined with the persistent deposit flows out of banks, means that US banks face a number of headwinds. In Europe, banks remain in a stronger position and can manage despite the headwinds of a slowing economy. As shown in Figure 3, we also expect the default experience in Europe to remain lower than the US given that it is an overall better-quality market than the US, and less cyclical. This combination of drivers leads us to believe that European credit, and especially financials, are far better placed than US names.

Figure 3. European defaults lower than the US



Source: Deutsche Bank, S&P, as at 30 June 2023.

Q3 2023 Outlook

At Man GLG, we have one overriding principle: we have no house view. As such, portfolio managers are free to execute their strategies as they see fit within pre-agreed risk limits. Keeping that in mind, the outlooks below are from the different credit teams at Man GLG.

Global Investment Grade: Our views remain consistent with the prior quarter, as with all-in yields remaining high we think that investors can continue to benefit from an allocation to investment grade credit. European and Sterling continued to be our favoured regions for investment. We continue to be wary on the US as the recent bank

fragilities are likely to increase the chances of a hard landing over the coming quarter. At the same time, valuations remain more expensive than in Europe, so we maintain a low outright exposure to the US market, representing a meaningful underweight relative to the benchmark.

For us, value remains in Europe with a focus on financials, which remain in a robust position compared with their US counterparts. We find little to no value in industrial cyclical portions of the credit market where spreads continue to price in little prospect of a slowdown in growth. All in all, we see dispersion increasing as growth slows, and we believe that the backdrop creates an attractive opportunity set for high-conviction and active fund managers.

Global High Yield: We continue to remain confounded by the robustness in risk asset performance as we are witnessing signs of economic slowdown, particularly in the manufacturing sector. Our expectation is that the lagged effect of higher interest rates will start to bite in the coming quarters and should lead to a marked deterioration in growth. As we suggested in the previous commentary the pressure on the banking space is likely to reduce the desire of banks to lend to consumers and corporates, which should again create growth problems further down the road.

Speaking of banks, the banking crisis that was unfolding in Q1 has fast faded from people's memories. We believe this is probably the correct approach to take for Europe, but we remained much more concerned about the situation in the US. Regional banks are stuck in the unenviable position of needing to justify their relevance versus the 'too big to fail' banks. This will likely mean that regional banks will have to pay more to retain deposits and given the uncertainty on the stickiness of deposits, they will not be in a position to lend and their profitability could therefore struggle. The other shoe that is likely to drop is commercial mortgages, which make up a large part of the overall lending book. Given the significant growth in lending to this market over the past decade, a small decrease in prices can lead to a significant impact on overall capital.

Emerging Market Debt: With the debt ceiling event risk behind us, attention is shifting to the impact of the liquidity drain caused by the additional debt issuance needed to rebuild the US Treasury's General Account, alongside ongoing quantitative tightening in the US and Eurozone. Another left-tail risk could result from a disappointing timeline for the Fed's anticipated pause and pivot, compared to what is currently priced in. The details of the debt-ceiling deal suggest the US will continue expanding fiscally, which may continue to feed core inflation. Coupled with the US economy's resilient growth, this may support the narrative of higher policy rates for longer.

In emerging markets (EM), these headwinds add to ongoing capital outflows and restrictive access to more expensive primary debt markets, in addition to the ongoing idiosyncratic risks present in several countries. However, in our opinion these risks are not yet being adequately priced. We remain cautious on hard-currency sovereign credits, as investment grade looks rich both by historical standards and when compared with US investment grade, while EM high yield spreads have improved; however, we believe that credit differentiation will be the key to alpha generation. In EM FX, softer European and Chinese activity data leaves commodity-dependent EM currencies more vulnerable. In local rates, services inflation, which is still high in some parts of EM, and a more hawkish expectation of the Fed's policy path, may prompt central banks to adopt a more cautious stance over the next few quarters.

Emerging Market Corporates: Valuations in EM high yield corporates have started to become more attractive as the market begins to worry that there will be a hard landing. However, once you strip out China from this analysis, the valuation argument becomes more ambiguous. The flight to quality has meant that investment grade markets, particularly in China, broader Asia and across wider emerging markets look less attractive on an outright basis. Supply technicals continue to remain positive as issuance continues to run below long-term thresholds, but this is offset by continued outflows from daily-liquidity products. On a regional basis we see opportunities emerging in Latin America and in particular across Brazil, Chile, Colombia and Mexico, where we are positioned within quasi-sovereign bonds, telecommunications, infrastructure, energy and banks.

Convertible bonds: Convertible bonds are well positioned to outperform broader equity markets from here in a sustained rally. Strength in equity indices in the year to date has been driven by a narrow group of mega-cap tech/growth companies with the rest of the market lagging meaningfully. As a result, underlying equities of convertible bonds remain heavily oversold versus the S&P 500 Index, with many declining by three times the broader market last year, for example. This provides attractive upside opportunities for convertible bond investors if the rest of the equity market catches up with the narrow group of market leaders. In such a scenario, convertibles will see their equity sensitivities increase from current levels, which can be a powerful driver of performance.

For investors who are required to be invested in equity markets but are concerned about downside risks, we believe that convertibles again provide an attractive opportunity. Convexity of the asset class is high with a premium to the bond floor that is below the historical average, credit quality is generally good and valuations are inexpensive versus historical levels. Some 60% of yield-alternative convertibles have only convertible bond debt on their balance sheet. There is no immediate maturity wall to worry about, with only around a third of the market maturing in the next 2-3 years, which gives time for firms to fix any issues. Increasing amounts of investment grade-rated issuance provides strong downside protection. Based on historical data we believe convertibles will exhibit a downside correlation to equities of around 30%.

With their low duration, convertibles potentially offer a compelling and non-crowded contrarian opportunity for fixed income investors. Market consensus remains that central banks are close to peak rates and will soon enter a period of easing. But history suggests central bank pauses often last longer than the market expects. Indeed, in some cases central banks have raised rates further to combat stubbornly high inflation. This is shown by the most recent UK inflation data, which again surprised to the upside, putting pressure on the central bank to continue hiking rates. A further increase in rates could lead to a large drawdown in traditional fixed income assets, given crowded positioning and an investment grade duration of 6.1, high yield at 3.6 and government bonds at 7.5. Convertible bonds meanwhile have a duration of just 2.1. Finally, the latest BAML Fund Manager Survey confirms that investors are still betting heavily on rate cuts, thus setting the stage for a technical correction.

Loans / CLOs: Performance in the year to date continues to remain robust, exceeding over 5% and in line with high yield markets. The market largely shrugged off the regional banking stress in Q1, with the relatively resilient macroeconomic conditions, particularly in the services space, offering a respite for leveraged finance. However, with central banks continuing to remain vigilant, the reduced availability of bank lending and signs of slowing in the manufacturing sector, we believe that investors should retain a cautious approach to the asset class. Historically loans have performed well going into pauses in monetary policy tightening although investors will now need to contend with end-of-cycle dynamics, leading to downgrades and pressure on lower-quality parts of the market. While overall leverage of US loan issuers continues to decline, coming in at 4.61x or a four-year low, coverage metrics have also declined to a one-year low of 4.58x which suggests defaults will continue to pick up over the coming 12-18 months. Maturity walls continue to remain manageable over the next two years but 22% of leveraged credit is coming due over the next three years, which is a decade high. Technicals remain supportive of the asset class, with limited supply compared to prior years leading to a continued reduction in the overall universe.

Primary markets in CLOs have also slowed with $52billion in the US and €12billion in Europe. The technicals in the loan market described above have been supportive of loan pricing, which creates some challenges for CLO arbitrage approaches, although we continue to see opportunity.

Author

Sriram Reddy
Managing Director – Credit, Man GLG

Sriram Reddy is a Managing Director for credit at Man GLG. He is responsible for coordinating business development, product development, marketing and client service efforts across both long only and alternative credit strategies. Sriram joined Man Group in 2022. He was previously a Credit Investment Director at Schroders. Prior to that, Sriram worked at BlackRock for more than 12 years in multiple roles, most recently as an Investment Strategist within the BlackRock Investment Institute. Sriram holds a BA in Economics from Johns Hopkins University.

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