Credit Outlook: Q2 2022

April 2022

Time to read: 6 minutes

The fixed income market in the first quarter was characterised by widening spreads, fund outflows and constrained issuance. What are our expectations for the second quarter? In a nutshell: we remain optimistic on the global investment grade and convertible bonds market, while maintaining a defensive view on emerging-market debt and high yield.

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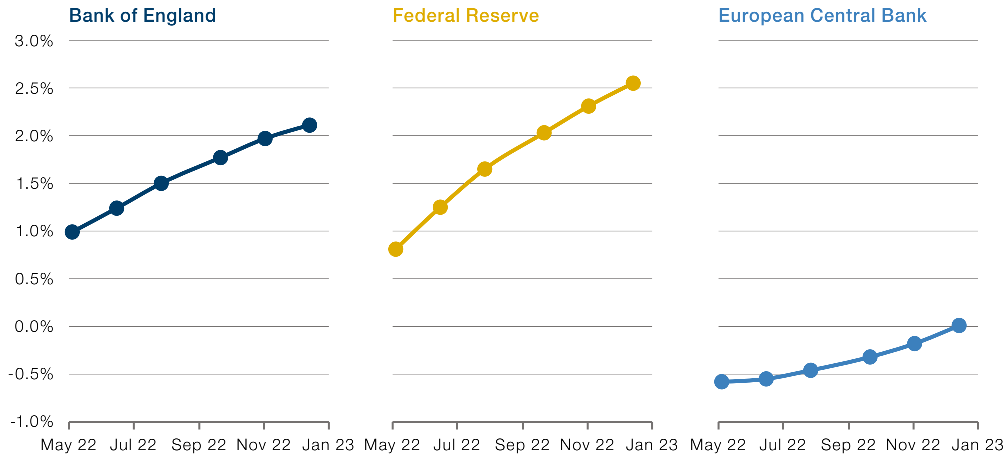
> The first quarter saw a number of rate hikes globally, which led to a very challenging market backdrop for fixed income.

Q1 Recap

Whenever we see outsized moves across markets, we find ourselves constantly searching for historical precedent. And it's no different now. The current situation provides eerie similarities to the 1970s, when an oil shock heaped additional pressure on an already-elevated inflation backdrop. Instead of an oil crisis, the current exogenous shock has been the war in Ukraine, with a broad range of commodities spiking higher and fanning the inflation flame. The short-term implications are certainly going to crimp consumer disposable income and heap pressure on the margins of companies that are large consumers of commodities. Unfortunately, this is likely to have a disproportionally negative impact on lower-income regions, which will be hit harder by the rise in soft commodity prices such as wheat.

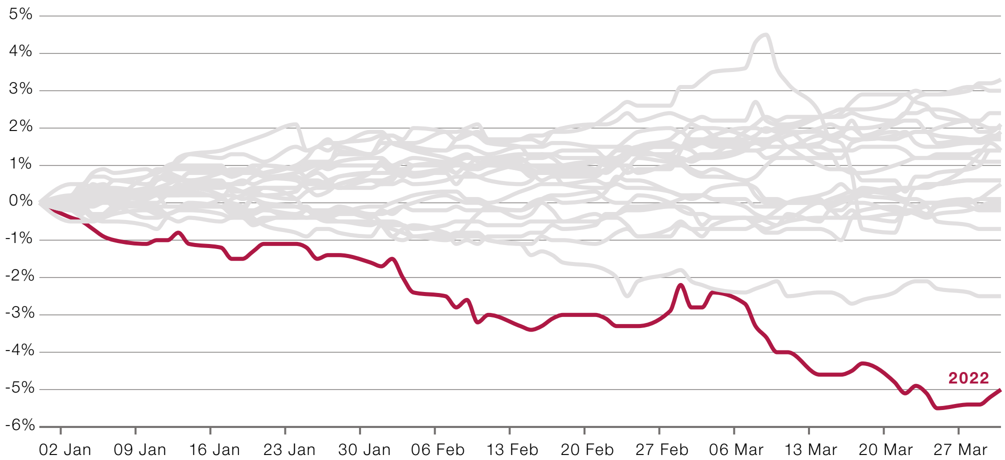
While recent tragic events naturally dominate our thoughts, it is worth remembering that the start of the year was defined by volatility triggered by quantitative tightening signals from a range of central banks. Indeed, rate hikes began well before invasion-related volatility, with the Bank of England first out of the trap in December 2021. We have seen a number of rate hikes globally and the market is now pricing in more than eight hikes in the US, over five hikes in the UK and even a move closer to 0% in Europe (Figure 1). This led to a very challenging market backdrop for fixed income, with the first quarter seeing one of the worst returns for the Bloomberg Global Aggregate Index since inception (Figure 2).

Figure 1. Market Implied Policy Rates



Source: Bloomberg; as of 31 March 2022.

Figure 2. Bloomberg Global Aggregate Index Returns



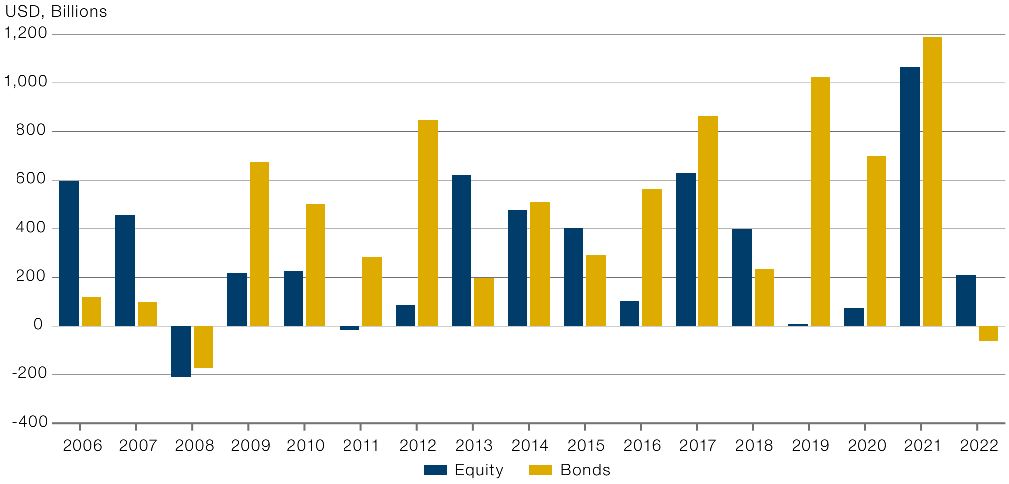
Source: Bloomberg; as of 31 March 2022.

> Fixed income saw more than USD62 billion in outflows globally in the first quarter of 2022, the largest drop since 2008.

Tightening financial conditions are probably here to stay, with a number of pressure points reducing consumer disposable incomes – such as higher mortgage and energy rates. The US 30-year mortgage rate recently hit 4.5%, which while low on a long-term basis, is similar to levels that it peaked at during the past Federal Reserve hiking cycle in 2018. All signs are pointing towards a slowing growth environment over the coming quarters, with economists' expectations being downgraded as we write.

Flows have taken this on the chin, with more than USD62 billion in outflows from fixed income assets globally in the first quarter of 2022 (Figure 3). This represents the largest drop since 2008, when the market experienced more than USD172 billion in outflows. In contrast, equity sentiment remains robust: the 'buy-the-dip' mentality is still evident across markets, with c. USD210 billion of inflows over the first quarter.

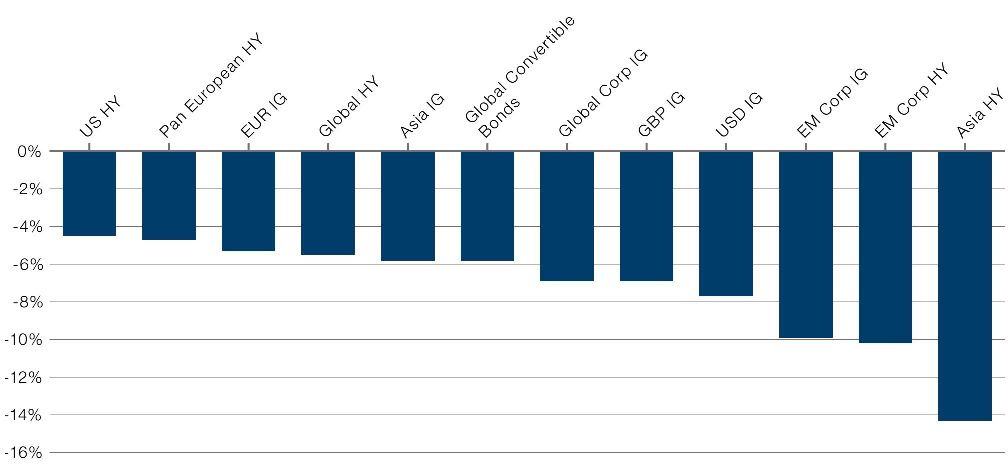
Figure 3. Global Equity and Bond Flows



Source: JP Morgan Flows & Liquidity, ICI, EPFR, EFAMA, Bloomberg; as of March 2022.
Note: Flows are from ICI (worldwide data up to Q4 2021). Data since then are a combination of monthly and weekly data from EPFR and ETF flows from Bloomberg. 2022 data as of end March.

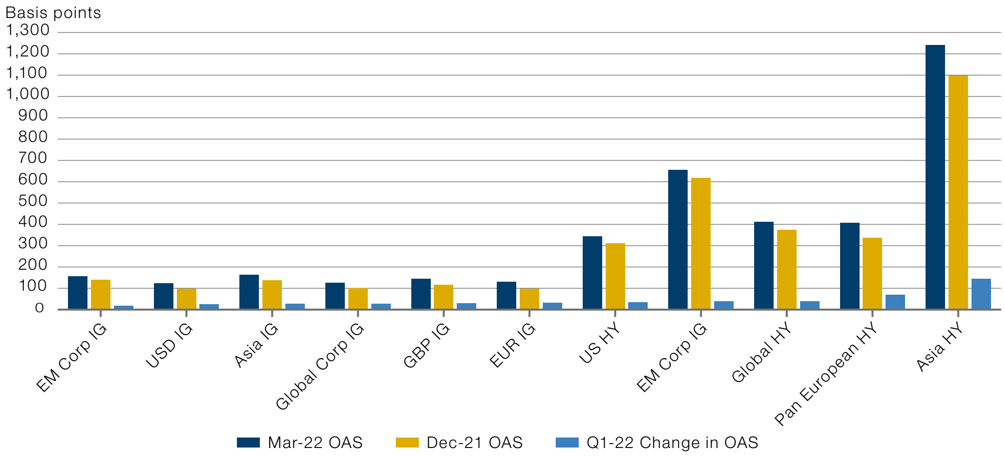
Spreads have reacted to the macro and geopolitical backdrop and moved wider across the board (Figure 4). Europe broadly underperformed global markets with all-in spreads in pan-European investment grade ('IG') above the third quartile, which has historically been a level that provides investors with adequate compensation for recessionary risk (Figure 5). In developed high yield ('HY'), spreads have moved in a similar fashion, but remain below third-quartile levels. In fact, they remain below median levels and are expensive in the US. Emerging markets were the weakest performer on the quarter, with Asian HY and EM HY corporate and sovereign bonds selling off due to Chinese real estate and Russian and Ukrainian exposures.

Figure 4a. Total Returns



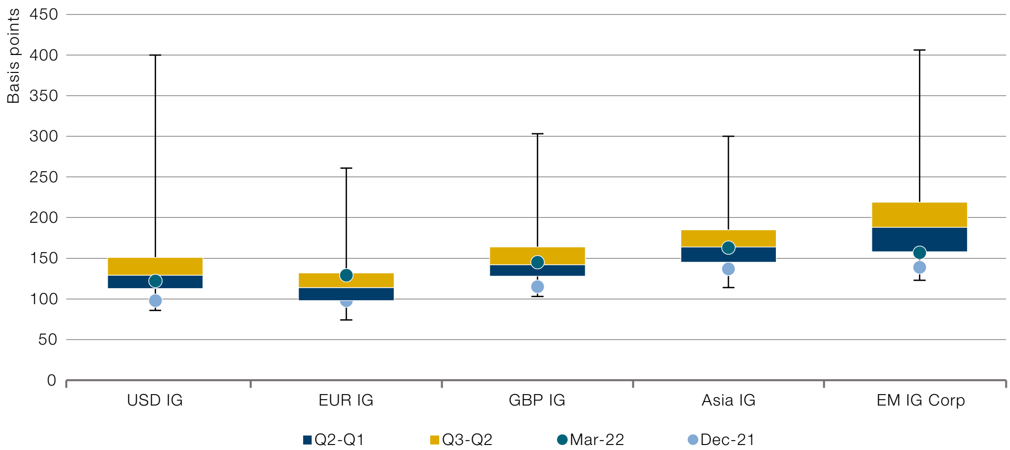
Source: Bloomberg, ICE BofAML; as of 31 March 2022.

Figure 4b. Option Adjusted Spreads



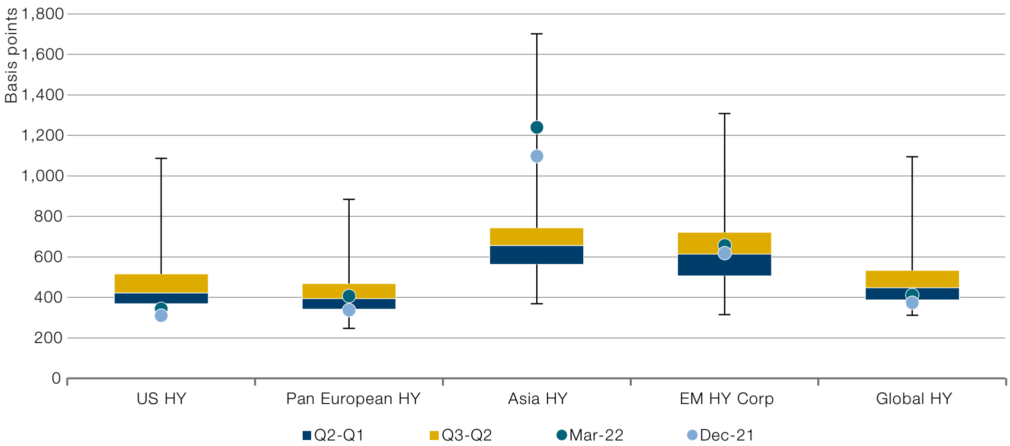
Source: Bloomberg, ICE BofAML; as of 31 March 2022.

Figure 5a. Investment Grade – Historical Spreads



Source: Bloomberg, ICE BofAML; as of 31 March 2022 over the past 10 years.

Figure 5b. High Yield – Historical Spreads



Source: Bloomberg, ICE BofAML; as of 31 March 2022 over the past 10 years.

Credit issuance remains constrained across markets.

Issuance in the US high yield bond market totalled c. USD47 billion and c. EUR10.9 billion in Europe in the first quarter of 2022.[1] This compares with USD162.6 billion and EUR41 billion, respectively, in the first quarter of 2021. Convertible bond new issuance came in at USD8 billion in the quarter, the-second weakest first-quarter on record, below only the first quarter of 2009.[2] Supply in the emerging-market corporate market was similarly depressed, coming in at USD99.4 billion, with a significant weight in investment grade issues. Indeed, the IG market is the outlier, which continues to remain open (although new issue premiums have remained healthy to encourage buyers).

Q2 Outlook

> "We remain more optimistic on the global investment grade market as the sharp move higher in yields and spreads offers investors better income."

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:

- **Investment grade**: We remain more optimistic on the global IG market as the sharp move higher in yields and spreads offers investors better income. This, in turn, could act as protection in case Growth rolls over or if central banks fail to match the level of rate hikes priced by the market. In terms of sectors, we remain positive on energy, European insurers, real estate and alternative financials, while being cautious towards cyclical industrials and consumer cyclicals.
- **High yield**: In HY, we have a defensive attitude relative to the overall market, as we believe spreads have yet to price in a potential growth slowdown. We retain a preference for pan-European opportunities and a cautious view on the US (and, in particular, the CCC portion of this market). Our overall outlook favours the health care, TMT and energy credits, while retaining a healthy scepticism of basic materials and commodity consumers, autos and consumer cyclicals.
- **Convertible bonds**: Convertible bonds delivered negative total returns in the first quarter as the sentiment shift from Growth to Value and the underperformance of a number of expensively priced new issues from 2021 contributed to a shift in valuations to more balanced levels. The broader moves in the convertible bond universe mean that investors are now compensated with a more attractive yields within a low-duration asset class that offers upside participation should we see a continued recovery in equity markets.
- **Emerging-market debt**: In EMD, we maintain a defensive view. The Russia-Ukraine war added new upside risks to the inflation outlook from higher commodity prices and downside risk for growth. Rising global yields, normalisation of international liquidity, slowing growth and de-leveraging of crowded positions in an environment of potential outflows is likely to lead to another leg down on EMD valuations, in our view. In hard currency, rising inflation and lower growth is likely to lead to wider EM spreads, particularly in more vulnerable commodity importing countries. Many frontier countries, some of which were already in a vulnerable position prior to the Russian invasion of Ukraine, are experiencing widening current account and fiscal deficits (given the sharp increase in global food and energy prices) that will be more challenging to finance or refinance given a risk-off environment and continuation of global tightening. In local currency, EM inflation has risen faster than policy rates in most countries, leading to more negative real interest rates now than a year ago. Thus, local EM yields are likely to increase, in our view. Similarly, deteriorating external balances and higher developed-market yields may cause EM currency weakness, despite their already-depressed level by historical standards.

1. Source: Bloomberg; as of 31 March 2022. **2.** Source: Bank of America.

Author

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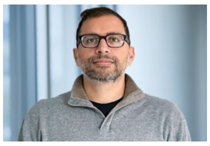

Sriram Reddy is a Managing Director for credit at Man GLG. He is responsible for coordinating business development, product development, marketing and client service efforts across both long only and alternative credit strategies. Sriram joined Man Group in 2022. He was previously a Credit Investment 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.