Credit markets: Too cheap to ignore

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Federated Hermes
Limited

Historically, investing in credit markets offers several significant advantages to investors, such as high total returns and diversification. The market environment this year has proven tricky to navigate, but today credit markets offer a compelling entry point into global credit for investors who focus on long-term, fundamentally driven analysis.

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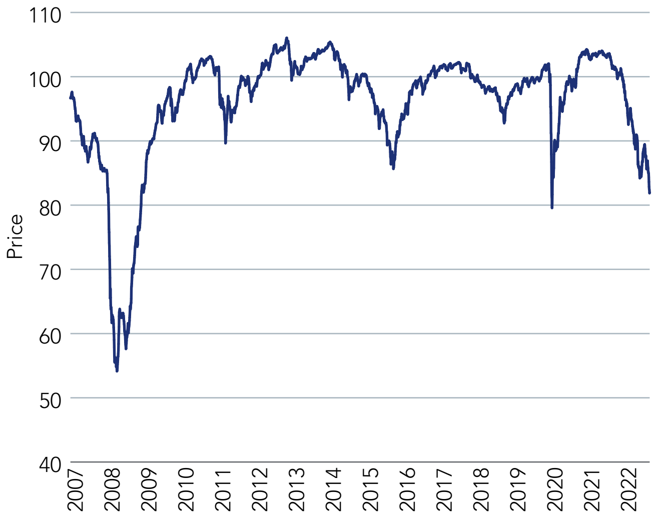
Why invest today?

Prices at most attractive level in years:
The cash price of **investment grade bonds recently fell to 87.1**, making it the most attractive level we have seen in years. For context, this level is only **0.3 points away from the Global Financial Crisis (GFC) low**. Because of this, convexity concerns have all but banished and expectations are high for healthy levels of income going forward. Similarly, within high yield, the bond cash price fell to approximately 80, which is the lowest level we have seen since the GFC and the start of the Covid-19 pandemic.

Figure 1: Global corporate index price level

Figure 2: Global high yield index price level



Source: Bloomberg, Global Corporate Index: ICE BofA Global Corporate Index, ICE BofA Global High Yield Index, as at September 2022.

Yields at decade highs:
Yields, which are at almost 10% for global high yield and 6% for the global investment grade market, are looking very attractive. From a historical point of view, and looking at the past decade, these yields are the highest we have seen for the investment grade market and the second highest for high yield, indicating that a moderate recession and even some systemic stress are already in today's prices.

With an effective duration of six years approximately, and assuming inflation will halve over the next two years, investors are looking at potentially significant and positive returns. As an indication of value, investors in the investment grade market today receive a yield similar to one year ago from a CCC-rated index.

Figure 3: Yield levels at highs over the past decade

Source: Bloomberg, Global High Yield: ICE BofA Global High Yield Index, Global Corporate Index: ICE BofA Global Corporate Index, as at September 2022. **Past performance is not a reliable indicator of future returns.**

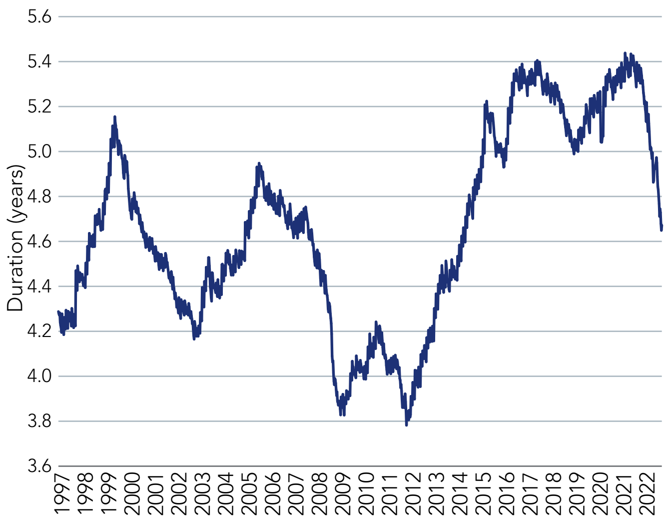
European investment grade corporates are more attractive:

As discussed in our latest **360° quarterly publication** ('Rates, recovery, recession'), within investment grade corporates, Europe is very attractive vs. the US, given that the latter trades at two standard deviations rich from the former over a three-year look-back period. In addition, lower duration in European investment grade can provide a meaningful cushion against further market volatility.

Figure 4: Investment grade, US vs. EU

Source: BofA Global Research, ICE Data Indices, LLC, as at August 2022. **Past performance is not a reliable indicator of future returns.**

Figure 5 : European investment grade duration



Source: Bloomberg, ICE BofA Euro Corporate Index, as at 21 October 2022.

Fundamentals remain solid:

Even though we expect credit fundamentals to deteriorate somewhat over the next few quarters – making credit selection the most important factor of returns – they will do so from a very healthy starting point. As outlined below:

- **Defaults** are at historically low levels. At the end of September, the HY default rate was 1.57% in the US and 0.4% in Europe. The market expects defaults to increase next year to 3-4% in the US and 2-3% in Europe, as elevated input prices squeeze corporate cashflow and tight credit conditions reduce access to capital. However, even at these levels, they will be below their respective long-term averages. It is worth mentioning that the implied default probabilities today (given spreads and assuming recovery rates at 50%) are north of 5%, indicating that investors are over-compensated for the risk they are taking on.

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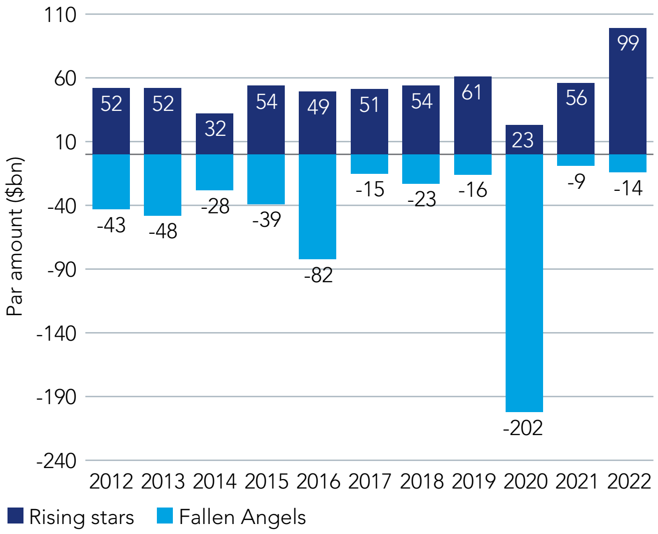
- **Leverage levels** continued their decline to 2.9x and 4.2x respectively for the investment grade and high yield markets. These levels mark a low from the peak of 3.3x in Q3 2020 for the investment grade market, and the fifth consecutively positive quarter to the lowest point since Q4 2019 for high yield.
- **Revenues** and **EBITDA** expanded for both the investment grade and high yield markets.
- **Coverage ratio** increased and is at the strongest level for the investment grade market since Q4 2008. Similarly, the high yield market reached a high of 5.68x.

Technicals are weak for a reason:
We have seen outflows this year driven mainly by rate volatility and geopolitics. Mitigating the effects of these outflows is the sharp slowdown in supply, as issuers are holding off for the same reasons, and the large numbers of rising stars after the wave of fallen angels in 2020.

Figure 6: Historical rising stars and fallen angels



Source: Barclays, as at 7 October 2022.

Why we think investing in credit makes sense

A global opportunity set:
Credit markets continue to grow, with the investment grade index currently representing 36 countries and the high yield index representing 80 countries. For context, two decades ago the IG index represented 16 countries, and the HY index represented 59. This expansion of the investment universe beyond the US and Europe to emerging markets creates more opportunities, diversified sources of return and less exposure to one geography.

Figure 7: Geographical composition of the global HY market

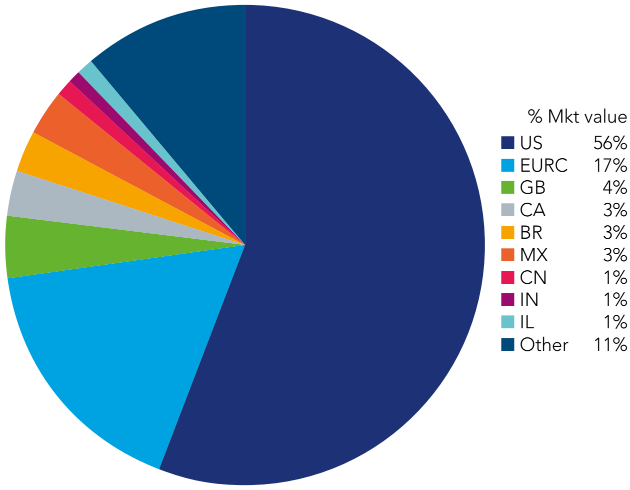
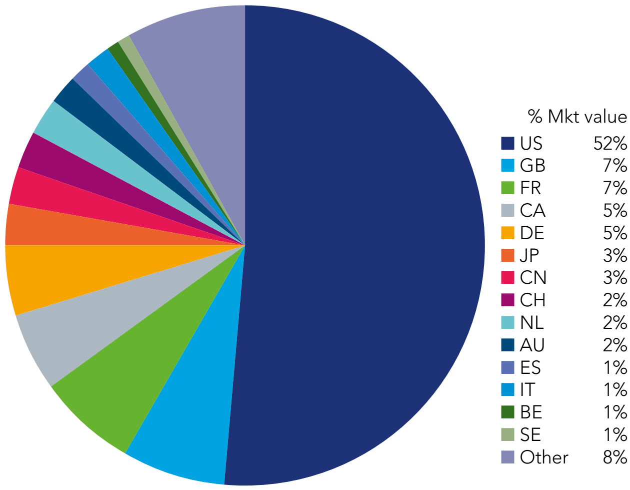


Figure 8: Geographical composition of the IG market



Source: Bloomberg, left: ICE BofA Global High Yield, right: ICE BofA Global Corporate Index, as at September 2022.

Today's yield is a good predictor of future returns:
Yields for the high yield and investment grade market have reached one of the highest levels we have seen historically, with the drivers of this not related to credit fundamentals. But what does this mean for future returns? When looking at the yield offered at different points in history and the return after five years, we notice that the yield level was a good predictor of future returns.

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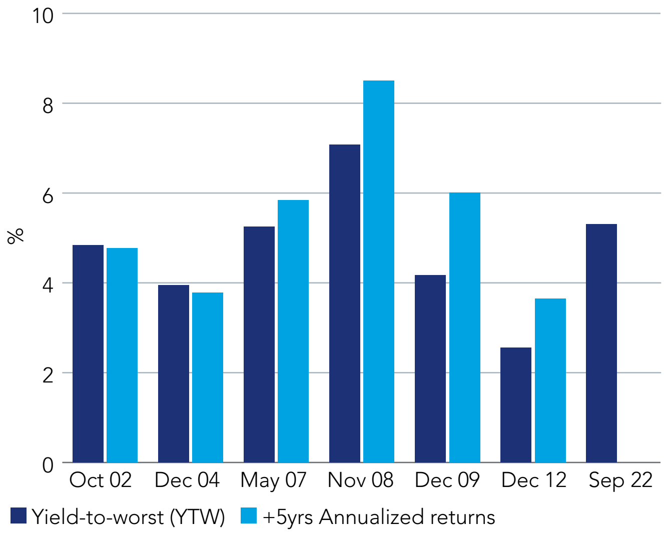
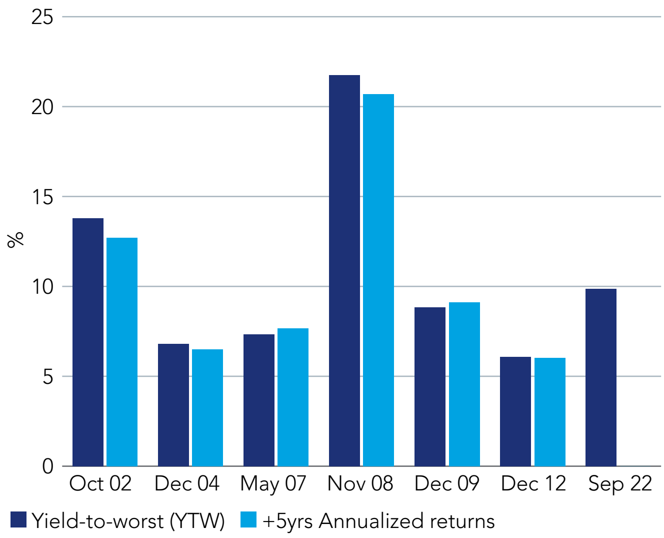
Figure 9: Investment grade yields and returns after five years



Source: Bloomberg, ICE BofA Global High Yield, ICE BofA Global Corporate Index as at September 2022. **Past performance is not a reliable indicator of future returns.**

Over the past **25** years, credit markets have produced comparable returns to the equity market but with much lower volatility.

Figure 10: High yield and returns after five years



Source: Bloomberg, ICE BofA Global High Yield, ICE BofA Global Corporate Index as at September 2022. **Past performance is not a reliable indicator of future returns.**

Oct-02: High spreads during the .com bubble

Dec-04: Spreads were tight

May-07: 2008 market sell off

Nov-08: Spreads were at widest level

Dec-09: Spreads after the GFC rally

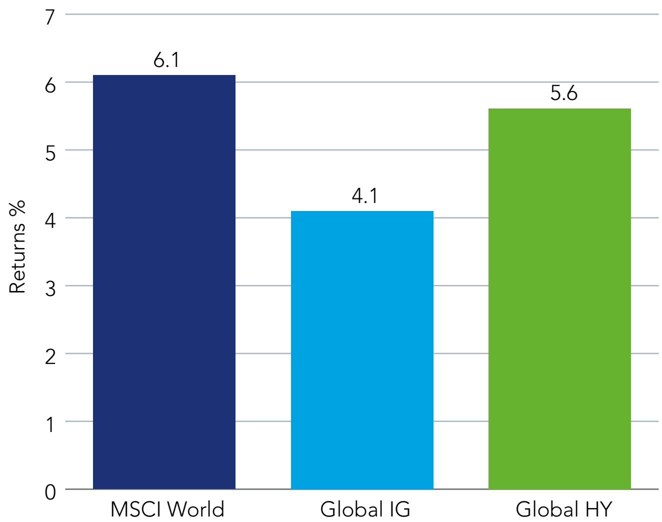
Dec-12: Prior to taper tantrum

Do you want equity-like returns, with half the volatility?

Over the past 25 years, credit markets have produced comparable returns to the equity market but with much lower volatility.

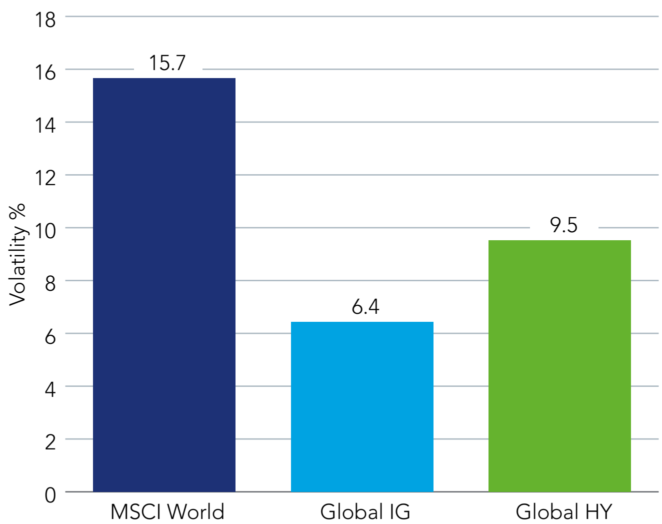
Since September 1997, the global investment grade and global high yield markets have returned 4.1% and 5.6% on an annualized basis, which is very attractive – especially when considering the stock market returned 6.1% over the same period. Of course, these returns vary over time and with changing market conditions, but in the long run, investment grade and high yield produced equity-like returns with almost half the volatility.

Figure 11: Returns



Source: Bloomberg, MSCI World, ICE BofA Global High Yield, ICE BofA Global Corporate Index as at September 2022. **Past performance is not a reliable indicator of future returns.**

Figure 12: Volatility



Source: Bloomberg, MSCI World, ICE BofA Global High Yield, ICE BofA Global Corporate Index as at September 2022. **Past performance is not a reliable indicator of future returns.**

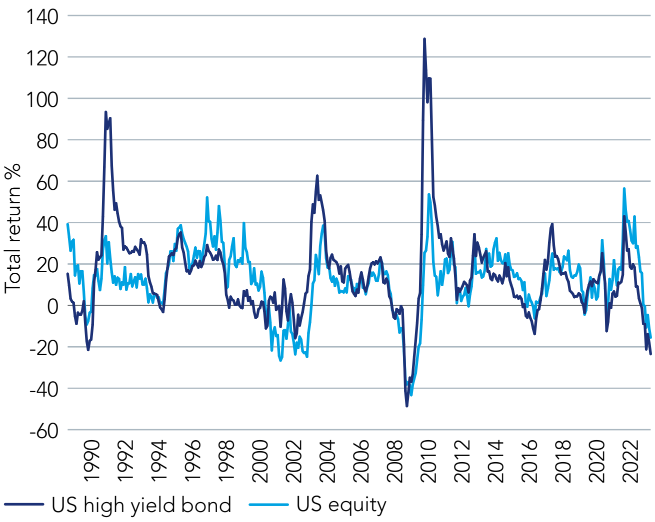
High yield credit not only provides a greater degree of protection to investors due to its position in the capital structures of companies, but also regains lost ground more quickly than equities.

High yield recovers more quickly from shock:

High yield credit not only provides a greater degree of protection to investors due to its position in the capital structures of companies, but also regains lost ground more quickly than equities.

This resilience is partly due to the fact that the coupons of high-yield bonds tend to deliver income much sooner in the cycle than equities do. In other words, high yield has the potential to deliver more upside during the recovery periods following market drawdowns.

Figure 13: High yield market recovery after shocks

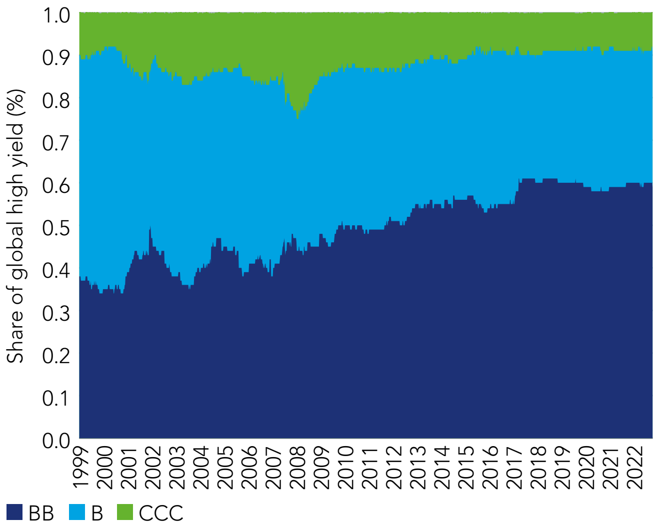


Source: Bloomberg, as at September 2022. US High Yield = Bloomberg US Corporate High yield. US Equity= S&P 500. **Past performance is not a reliable indicator of future returns.**

Credit quality has improved:

The credit quality of the global high yield market has been improving for several years and is currently a predominantly BB market, with over 50% of companies falling within this bucket. This characteristic indicates that the risk level of the overall market is reduced over time.

Figure 14: Credit quality of the global high yield market



Source: ICE Bond Indices, as at 30 June 2022.

Why Federated Hermes Limited?

Investing worldwide
We benefit from the globalisation of the high-yield market by investing in the US, Europe and emerging markets.

Across the capital structure
By searching the capital structures of issuers for securities offering the best returns, we seek bonds and derivatives with superior relative value.

Selecting securities, not just issuers
Identifying outperforming securities is more important than picking issuers that simply pay you back.

An experienced team
We have a skilled, integrated team, whose principal members have together implemented relative-value credit strategies since 2004.

High quality investments
By investing in quality, we are less susceptible to distress than the market as a whole.

ESG and engagement advantage
Best-practice integration of ESG analysis and engagement insights.

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Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes Investment Management are now undertaken by Federated Hermes Limited (or one of its subsidiaries). We still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important strategies from the entire group.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

For more information, visit **www.hermes-investment.com** or connect with us on social media: