# 360°

## Inflation, disinflation, inflection

**Fixed Income Report**
Q1 2023

Federated Hermes
Limited

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# Commentary

## Who is right?

As I write this, the market narrative remains focused on a single topic – inflation – but the overall picture is markedly different to that of late 2022. Equity, credit and rates markets are not synchronised in their pricing or probabilities of the outcomes from here. This conflicting picture of significant rate cuts just around the corner, dovetailing nicely with median levels of credit spreads and a somewhat lofty equity multiple valuation backdrop, leave us asking: **'Who is right?'**

The main issue with having a view on inflation is the ever-present cacophony of short-term noise, much of it backward looking, leaving both investors and central bankers in a difficult position to champion long termism. That said, looking at what has been reflected in forward curves can be informative. Right now, the picture it paints is of a market that has priced in the prospect of inflation moderating, with interest rates cuts and looser conditions to follow in 2024 and 2025. Volatility in front-end rates is being sucked out, providing oxygen to the rally. Whisper it, but we believe there is now a decent chance inflation could be on its way to very low levels again, perhaps inside of 2%.

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## Scouring the spectrum

The wide range of scenarios that might play out depending on the broader inflation picture are crucial to the views across all the asset classes in our fixed income spectrum (read our latest Fiorino blog for more on this), as well as to many of the sectors we analyse for opportunities with a bottom-up approach. Everything from emerging markets to European structured credit are affected. It's therefore a source of both pride and pleasure to me that we can call upon such a breadth of experience and expertise when our fixed income group comes together in the form of our **Multi Asset Credit Strategy Meeting (MACSM)**. While this framework has now been in place for nearly two decades , the depth and quality of resource has never been this strong.

Our views remain highly nuanced, with multiple areas of opportunity which we find exciting, as well as others we avoid, either for fundamental concerns, or because the value is simply not there. **Robin Usson, our Senior Credit Analyst**, for instance, makes a compelling case for corporate hybrids, given how they benefit from complexity premia and relative value when compared to dividend yield and senior yields at a company-specific level. In contrast, it appears that fundamental cracks are appearing in the leveraged loan market (as **Emeric Chenebaux, Portfolio Manager**, details later in this report) where many issuers are experiencing unprecedented changes in their cost of capital as the floating-rate nature of their debt begins to ratchet up interest expense ratios.

## Analysing companies holistically

In the face of all of this, we remain selective in our allocations, maintaining discipline through our credit committee processes to ensure eligibility is earned. We continue to benefit from a process that considers a company from various perspectives, both financial and sustainability-related. This is particularly important in the more 'material' and carbon-intensive sectors, of which there are plenty in the credit space.

> **We remain selective in our allocations, maintaining discipline through our credit committee processes to ensure eligibility is earned.**

Pricing risks to a company's enterprise value (and therefore credit worthiness) stemming from ESG risks is paramount. In this, we work with our companies to encourage good corporate governance and ambitious decarbonisation policies. Our belief is that this ultimately leads them to mitigate risk, become more investible to more investors, and reduce costs of capital – in other words, a genuine win-win.

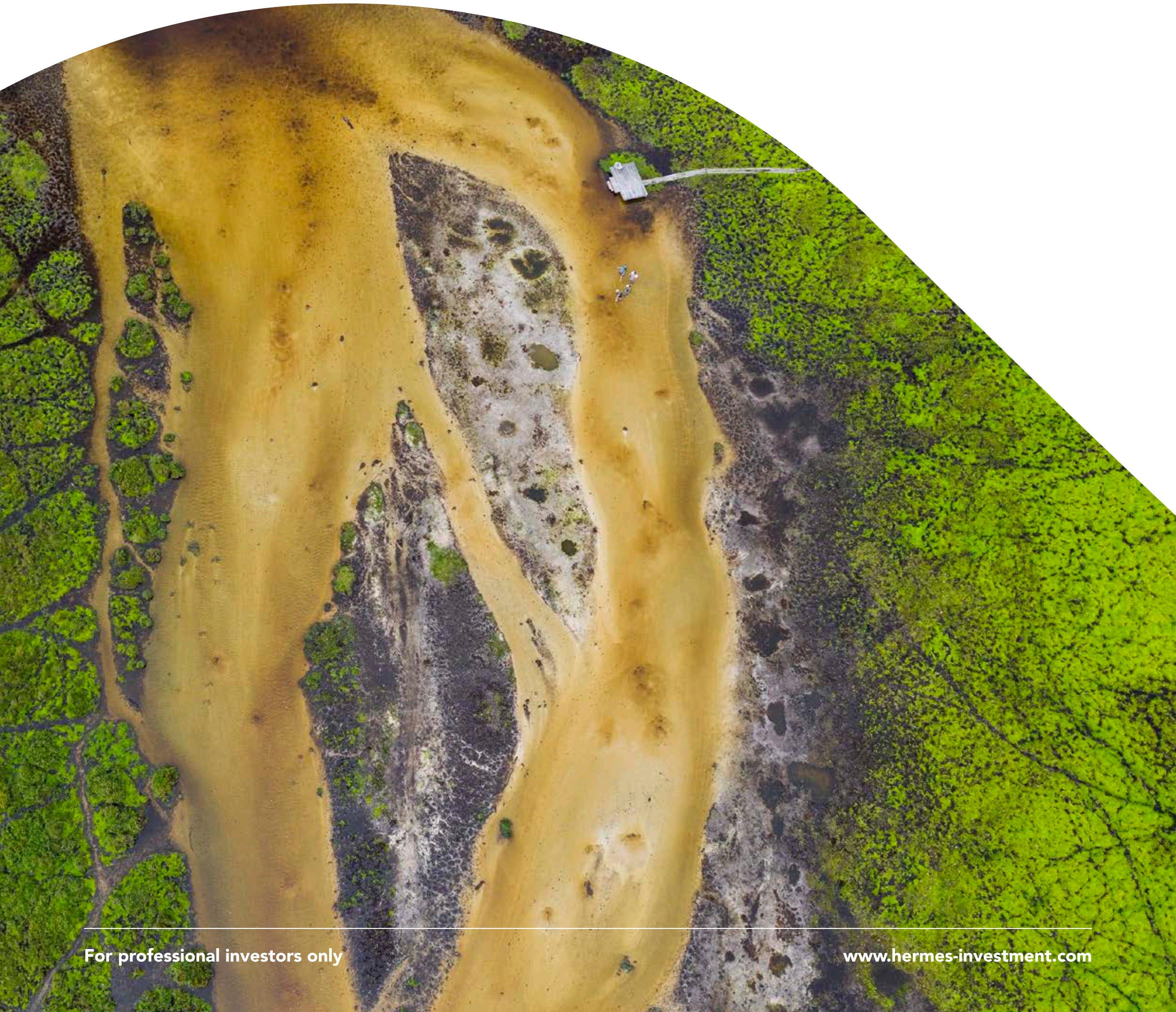
These selections are long term in nature, but the market can, and will, prove to be volatile in the near term, and our ability to be dynamic in our repositioning and hedging will also be important in the months to come.

So, as we look to Q2, the referee in the inflation tussle will be the data. But we keep our eye on the mid- and long-term scenarios too – and, here, the potential for disinflation is very real.

Take the secular stagnation theme, for instance. Has that been written off too soon? Sure, we might be seeing a change from what we've experienced over the past decade or so, but is it wise to entirely discount the effects of ageing and shrinking demographics on aggregate demand? Likewise, the same can be said for advances in technology and the impact on aggregate supply. These mega trends must not be forgotten as we strive to maintain a long-term approach to investing.

Thank you for reading this issue of the 360°, and we hope you enjoy.

**To find out more about our wider credit offering, please visit our website.**



# Fundamentals

## Economic outlook

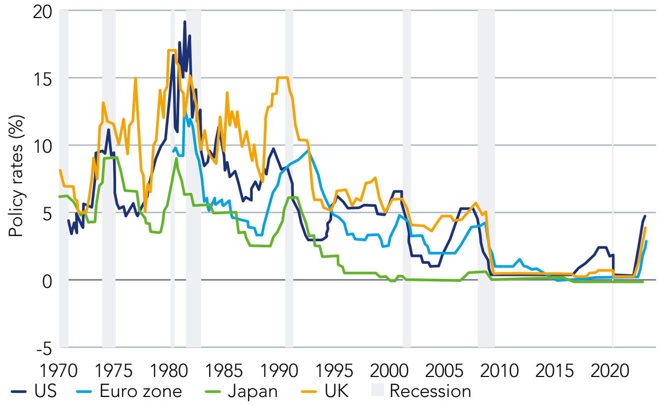
The core view of falling inflation and slowing growth continues to play out, with strong wage gains and hot labour markets presenting a barrier to monetary easing this year.

In our baseline scenario, global growth will continue to slow in 2023, reflecting a continuation of the themes that dominated 2022. Inflation has moderated but is still running at elevated levels, significantly eroding real disposable incomes. More importantly, the sharp tightening of monetary policy that major central banks (the US Federal Reserve, most notably) implemented in 2022 will materialise over 2023.

With this in mind, there is no denying that growth momentum is slowing. Our baseline scenario suggests global growth will slow to about 2.5% in 2023, from just below 3% in 2022 and well below the trend prevailing in the three decades before the Covid-19 recession (~3.5%). That would entail a significant slowdown in major advanced economies including a short and mild recession in the US. Meanwhile, the rebound in China's growth following the decision to rapidly exit its zero-Covid policy in late-2022 is unlikely to significantly lift global growth via indirect effects.

We believe central banks are probably close to their peak rates (as shown by figure 1, below), but, given expectations of inflation remaining above target this year, we expect their monetary policy stance will remain restrictive over the coming months. While there is some divergence in the pace of tightening between the Fed and the European Central Bank (ECB), we believe the Fed, the ECB and the Bank of England (BoE) will converge to a slower hiking pace and, eventually, a pause over the course of the year.

**Figure 1:** The fastest tightening cycle in decades for the Fed, the ECB and the BoE




Source: Refinitiv Datastream, as at February 2023.
**Past performance is not a reliable indicator of future performance.**

### The fixed income view

From a fixed income standpoint, we believe the outlook is fundamentally asymmetric and the view for markets is structurally stronger. We continue to look for a normalisation in volatility given pricing of hiking cycles and moderating inflation pressures – at least until we move closer to recession. This asymmetry also applies to rates curves, with steepening the most likely direction of travel under a range of scenarios.

We see rates curves steeping under a range of scenarios this year, most likely driven by pricing of cuts in 2024/25 but also under the weight of greater supply. Inflation will continue to fall throughout the year, trending down to above central bank targets. However, market inflation expectations in developed markets are trading at or below central bank targets. This tells us that either inflation markets are wrong or central bankers have already tightened policy too much.

**Figure 2:** Yield curve score

| | | UK | US | Bunds |
|---|---|---|---|---|
| **Duration** | 2s | 2 | 1 | 1 |
| | 5s | 1 | 0 | 0 |
| | 10s | 0 | 0 | 0 |
| | 30s | 0 | 0 | 0 |
| **Curve** | 2s5s | -1 | -1 | -1 |
| | 5s10s | -1 | -1 | -1 |
| | 10s30s | -1 | -1 | -1 |

| Duration | Curve | Vol |
|---|---|---|
| **1** | -1 | 0 |
| | (-1 = steeper) | (-1 = higher) |

Source: Bloomberg, Federated Hermes Limited, as at 25 January 2023.

**Figure 3:** Multi-Asset Credit Strategy Meeting (MACSM) marked to market

| | | Nov MACSM | Jan 23 MACSM | Chg Nov MACSM – Today | Nov MACSM | Jan MACSM |
|---|---|---|---|---|---|---|
| US | 2y | 4.517 | 4.128 | -0.389 | 0 | 1 |
| US | 5y | 3.945 | 3.547 | -0.398 | -1 | 0 |
| US | 10y | 3.757 | 3.444 | -0.313 | -1 | 0 |
| US | 30y | 3.826 | 3.595 | -0.231 | 0 | 0 |
| UK | 2y | 3.1011 | 3.3739 | 0.2728 | 0 | 2 |
| UK | 5y | 3.2078 | 3.1261 | -0.0817 | -1 | 0 |
| UK | 10y | 3.1327 | 3.2397 | 0.107 | -1 | 0 |
| UK | 30y | 3.3122 | 3.5916 | 0.2794 | -2 | 0 |
| DE | 2y | 2.088 | 2.519 | 0.431 | 0 | 1 |
| DE | 5y | 1.957 | 2.168 | 0.211 | -1 | 0 |
| DE | 10y | 1.975 | 2.151 | 0.176 | -1 | 0 |
| DE | 30y | 1.884 | 2.122 | 0.238 | -2 | 0 |
| US | MOVE | 133.53 | 107.74 | -25.79 | 0 | 0 |
| US | 5s10s | -0.1885 | -0.1027 | 0.0858 | -1 | -1 |
| UK | 5s10s | -0.0846 | 0.1104 | 0.195 | -1 | -1 |
| DE | 5s10s | 0.0177 | -0.0171 | -0.0348 | -1 | -1 |
| US | 10s30s | 0.0688 | 0.1521 | 0.0833 | 0 | -1 |
| UK | 10s30s | 0.1791 | 0.3499 | 0.1708 | -1 | -1 |
| DE | 10s30s | -0.0914 | -0.0298 | 0.0616 | -1 | -1 |

Source: Prices Bloomberg as at 25th January 2023. Scores our own.

**Figure 3** shows our previous and current scores (ranging from -2 to +2) alongside the change in the indicators since the previous meeting. These represent our forward-looking views on different segments of the rates market.

**Figure 4:** Our 2023 scenarios

| | Upside | Central | Downside |
|---|---|---|---|
| | | **FH Eco Outlook** | |
| **Growth** | Slowing, recession is avoided | Growth slowing - recessions more finely balanced | DM recession - likely prompted by higher for longer rates |
| **Inflation** | Inflation cools in orderly fashion - small rise in unemployment, open vacancies closed etc | Trending down through 2023 to above CB target, but with confidence over the medium term direction | Services inflation remains sticky - adjustment lower required higher rates for longer than expected/Energy prices pick up and dampen the impact of positive base effects causing inflation expectations to rise. Requires sustained tightening - ultimately prompts recession and much lower inflation |
| **Monetary policy** | Rates remain higher for longer, with some potential for further hikes/different distribution of hikes in 2023 - but economy can withstand it | No cuts until 2024 | No cuts in 2023, deeper cuts in 2024 |
| **Fiscal policy** | No fiscal intervention | No more fiscal intervention | Still low probability of timely fiscal intervention |

Source: Federated Hermes Limited, as at January 2023.

## Corporate fundamentals

### The outlook for corporate credit fundamentals could burn brighter over the next six months. Even so, in an ever-evolving macroeconomic environment, vigilance is rewarded.

In our 2022 Q3 update, (360°: Rates, recovery, recession), we were cautious in our outlook for corporate fundamentals for Q4 and beyond. Since then, our stance has shifted and we are now altogether more positive. Partly this is because we have not witnessed material demand deterioration or severe margin compression as previously feared. From a macroeconomic perspective, we see a number of positive drivers:

**1) China's reopening**

**2) The easing of the energy crisis in Europe**

**3) Low US and EU unemployment levels**

As it relates to corporate fundamentals, these developments translate into an improved demand and pricing outlook as well as an easing of inflationary cost pressures. Severe margin erosion has been avoided thus far as corporates have been able to implement at least partial price increases, allowing them to offset higher costs. Balance sheets and credit metrics remain in good shape and while we expect EBITDA[1] growth to slow materially, or even modestly decline, these should remain relatively stable.

We have turned more constructive on several sectors lately (as shown in Figure 5). This is primarily driven by basic materials, such as metals, mining and steel (where China's reopening has boosted demand and improved the pricing outlook) and chemicals (where lower natural gas prices have eased input cost pressures).

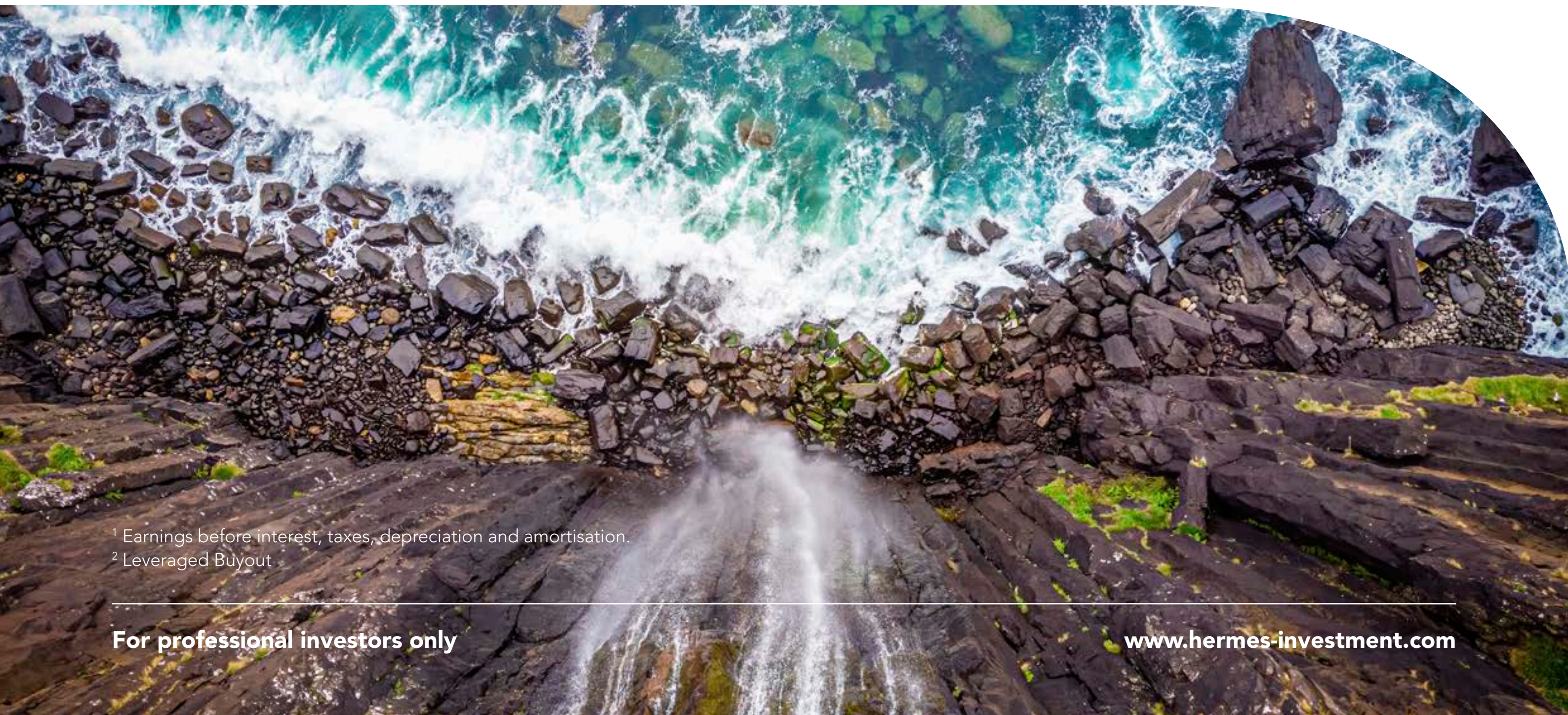
For air travel, demand and pricing remain strong and guides for 2023 have been encouraging. However, we continue to be cautious on retail as consumer confidence remains low, as well as homebuilders and real estate, where fundamentals are being substantially impacted by higher interest rates.

Against this backdrop, high yield leverage remains below pre-pandemic levels (see Figure 6). This year, we do expect leverage and interest coverage to roll over and modestly deteriorate as well as default rates to pick up. Nevertheless, this should be viewed as a normalisation trend coming down from very strong levels post Covid-19, as opposed to a material deterioration. As ever, we note how critical it is to remain vigilant in a rapidly evolving and uncertain macroeconomic environment.

### All eyes on issuer behaviour

2022 was a low supply year but a large proportion of issuance was for LBO[2] and M&A (on the back of an increase of average premium for M&A recently). One trend to watch is a potential frothiness in the M&A space, as companies seek opportunities with lower-equity values and as small caps (which are struggling in the current environment) aim to make acquisitions. Elsewhere, there are rumours of mega mergers in the mining space, as evidenced by two large acquisitions in Australian Mining: BHP Oz minerals and Rio Turquoise Hill.

Meanwhile, covenant quality may well be at an inflection point in North America, as only relatively strong issuers were able to access capital markets at all in H2 of last year, leading to an artificial deterioration of covenant levels in the third quarter. As outlined in our article from **Joe Howes, Senior Credit Analyst** (The time is now: Creditors to negotiate stronger covenants in 2023), we are starting to see some investor pressure to improve covenants for high yield (HY) issuers who need to refinance – a positive development in our view.



[1] Earnings before interest, taxes, depreciation and amortisation.
[2] Leveraged Buyout

**Figure 5:** The outlook on corporate credit fundamentals turns more positive

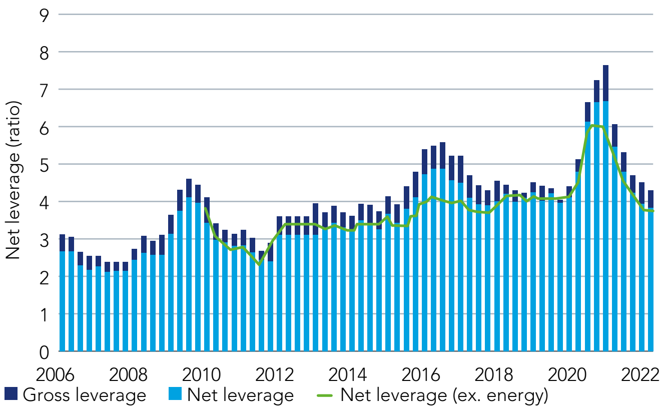
| Corporate credit sub-sectors | Fundamental sector scores | Outlook |
|---|---|---|
| Non-food retail | 4 | Stable |
| UK food retail | 4 | Stable |
| Real estate | 4 | Stable |
| Health care | 3 | Stable |
| Pharmaceutical | 4 | Stable |
| Energy – oil | 2 | Declining |
| Energy – natural gas | 3 | Stable |
| Energy – midstream | 2 | Stable |
| Building materials | 4 | Stable |
| Chemicals – commodity | 4 | Improving |
| Chemicals – specialty | 3 | Improving |
| Homebuilding | 4 | Improving |
| Mining and metals | 1 | Stable |
| Paper and forestry | 3 | Stable |
| Steel | 3 | Improving |
| Utilities | 2 | Stable |
| Autosuppliers | 3 | Stable |
| Airlines | 3 | Stable |
| Auto OEMs | 4 | Stable |
| Packaging – metal | 2 | Stable |
| Packaging – glass | 3 | Stable |
| Packaging – plastic | 4 | Stable |
| Telecoms | 3 | Stable |
| Media | 3 | Stable |
| Technology | 4 | Stable |
| Towers | 2 | Stable |

Green indicates an upgrade
Red indicates a downgrade

Sector scores
1-2: Improving fundamentals
3: Stable fundamentals
4-5: Deteriorating fundamentals

Source: Federated Hermes Limited, as at January 2023.

**Figure 6:** US high yield total and net leverage




Source: Deutsche Bank, as at 30 September 2022.

# Sentiment, technicals and relative value

## What factors fed into recent market performance and what is the outlook for 2023? The credit team offer their views.

### i) Sentiment

**A mixed picture on current risks and rewards.**

To better assess market sentiment, the Federated Hermes credit team routinely considers several indicators across rates, equities, and credit. One such indicator is the MOVE Index, a yield-curve-weighted index of the normalised implied volatility on one-month Treasury options.

In a matter of weeks, sentiment has totally turned. If the MOVE Index had appeared elevated (when compared to the past five years), it is now significantly lower than the last quarter of 2022, when the index briefly topped the highs of March 2020 sell-off caused by the lockdown policies introduced as a response to the Covid-19 pandemic. This lower overall trajectory is a clear sign that rates volatility has taken a pause, easing pressure on the credit market.

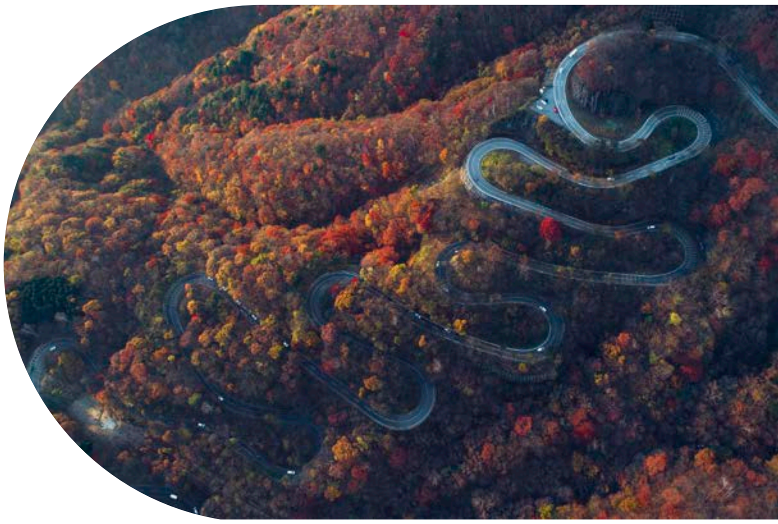


**Figure 7:** The MOVE fixed income volatility index dips slightly from Q4 2022


Source: Bloomberg and ICE BOFA as at 20 January 2023

Outside of rates, the bull versus bear survey is back to neutral territory following a more bearish H2. Meanwhile, the Standardised Global Risk Demand Index (STGRDI) is flirting with five-year highs. This trend is most clearly reflected on the Fear and Greed Index, one of our preferred sentiment indicators, as shown below.

**To better assess market sentiment, the Federated Hermes credit team routinely considers several indicators across rates, equities, and credit.**

In our Q3 edition of 360°, we noted that among the five subsections (implied volatility, skew, momentum, ETF premium and CDS strength) three were trading above their 80th percentile. Currently, all sections have normalised with the implied volatility screening at the top decile for greed.

**Figure 8:** The Fear and Greed Index

| | VTRAC-X | Skew | Momentum | ETF premium | CDS Strength |
|---|---|---|---|---|---|
| EUR IG | 9% | 22% | 22% | | 6% |
| EUR HY | 7% | 24% | 23% | | 15% |
| EUR FIN | 8% | 37% | 24% | 46% | |
| USD IG | 8% | 29% | 20% | 48% | |
| USD HY | 7% | 30% | 18% | 45% | |
| TOTAL | 8% | 28% | 21% | 46% | 8% |

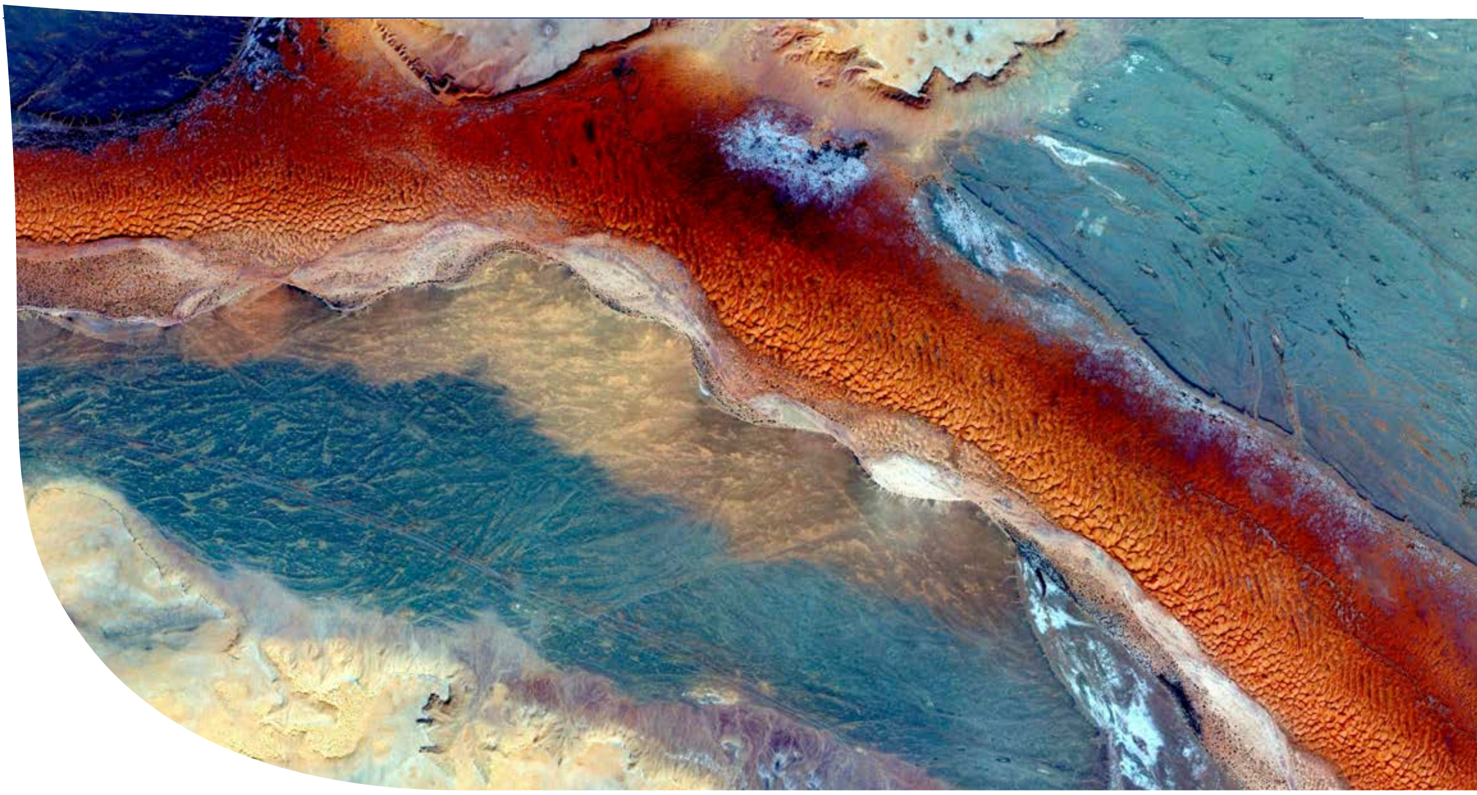
Source: JPM as at 19 January 2023.

To summarise, not only has this reversal has been fast, but we believe it has also been overdone. As a result, we choose to take a contrarian approach towards current sentiment.

### ii) Technicals

**Investment grade, high yield and emerging market debt record the strongest inflows since Summer 2020.**

Current record numbers on inflows result from lower rate volatility (as highlighted by the Move Index, in Figure 7, above) as well as lower sovereign bond yields.



Looking at supply, it seems the challenging picture from 2022 is making way for a more favourable outlook, as we see an encouraging boost to availability this year. This has been most notable within investment grade, albeit more muted within high yield.

However, overall, flows remain far superior to supply explaining the very strong performance of primary market. The fact that investors ran ample cash reserves to get into 2023 has also proved positive to the asset class.

With both investment grade and the high yield market on course to deliver their best January performance year-to-date in over a decade, it is clear technicals have played a strong role.

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### iii) Relative Value

**Spreads have generally tightened but there is still value to be found in selected areas.**

Spread value has corrected considerably, and now appears fair if not on the tighter side when compared with economic indicators such as the Purchasing Managers' Index (PMI), growth, or rates volatility.

As a result, spread percentiles now oscillate between 50% and 30%, with the widest subsectors being on the less liquid section of the market such as sterling high yield or emerging market high yield.

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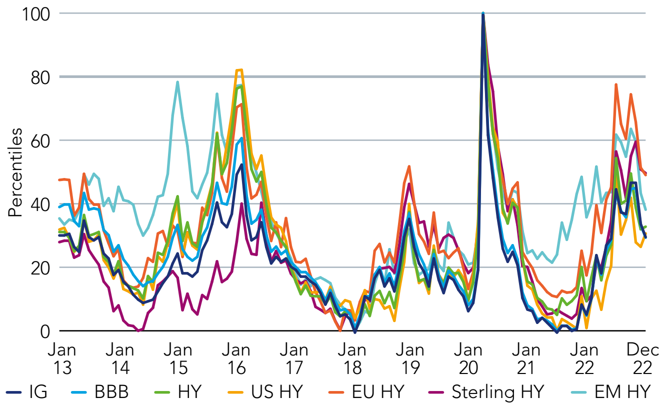
However, the average cash price of the high yield market remains around 88 cents on the dollar while the investment grade market is at 91 cents, which is evidence of good available convexity. All-in yield also remains attractive.

**Figure 9:** Credit spread percentiles




Source: Bloomberg and ICE BOFA as at 30 December 2022.

# Catalysts

## The credit team offer a whistle-stop tour of the key tail risks as we move through the first quarter of 2023, including an assessment of their impact and probability levels.

As we reassess our macro outlook based on falling inflation and a strengthened labour market, we are downgrading our expectations of a severe global recession from an area of high probability/high impact to medium probability/medium impact, as we expect any potential recession to have a shallower shape, though perhaps a longer duration.

However, due to China's unexpected reopening, and the subsequent rally year-to-date, we are upgrading the prospect of a disappointing Chinese macro performance as a high-impact event, given how much of the rally has been attributed to this 'risk on' event.

Elsewhere, the ongoing geopolitical risks relating to US/China relations, as well as the negative developments we are seeing with regards to the Ukraine situation, are major negative catalysts for us, which we consider to be medium impact and medium probability.

> **From a more positive standpoint, we see the main upside catalysts coming from policy, either fiscal support, or a dovish pivot from central banks.**

We have also added two new catalysts which we view as slightly longer-term and do not expect to materialise immediately, but may creep into prominence as the year progresses:

- **Government balance-sheet stress, which may need to be funded by significant tax rises geared toward resolving the European wave of labour unrest in the public sector**
- **US debt-ceiling issues, with noise from the 2024 election cycle ramping up**

From a more positive standpoint, we see the main upside catalysts coming from policy, either fiscal support, or a dovish pivot from central banks. Our base case positive catalysts centre around the view that the market is already pricing in too much dovishness from the US Federal Reserve, and as a result we have assigned the dovish surprise to the market as a low probability event.

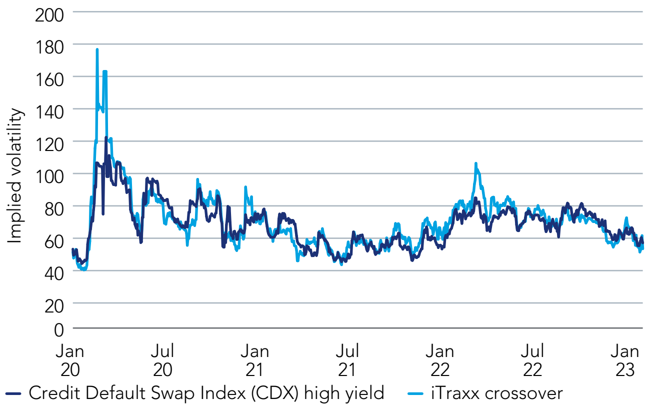
China's gradual recovery is already somewhat consensus but if the data comes back even stronger, this could be another catalyst for markets to go a leg higher.

A new catalyst we have added is that while earnings are expected to remain weak, outlooks could start being revised upwards. This could surprise investors with the speed by which the outlook improves.

Inflation coming under control is now viewed as consensus, and so we consider this to be only a minor positive catalyst, and we view the de-escalation of the Russia-Ukraine conflict as low probability, so this is not factored into our top-three tail risks.

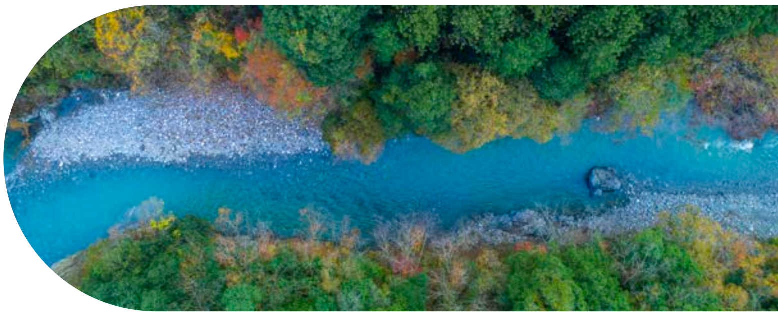
As the risk-on rally has gathered pace, we have seen investor confidence reflected in the market for credit protection. Implied volatility has continued its trend downwards, normalising to trade close to average levels on a five-year look-back period, and at the lows of the past 12 months, signalling a cheaper hedging environment.

**Figure 10:** Implied volatility




Source: Citi Velocity, Federated Hermes, as at 23 January 2023.

Likewise, volatility skew[3] continues to trade at low levels, indicating a limited appetite from investors for tail risk protection. Regionally, recent outperformance of the European iTraxx Crossover vs. US CDX HY, as illustrated in figure 10, has closed some of the gap in terms of the European risk premium priced into synthetic markets, though implied volatility remains slightly cheaper in the US. Given our more neutral view on near term catalysts and the cheaper environment for hedging, we move our overall score to -1.



[3] Defined by the volatility difference between an option trading at the money and another one out of the money.

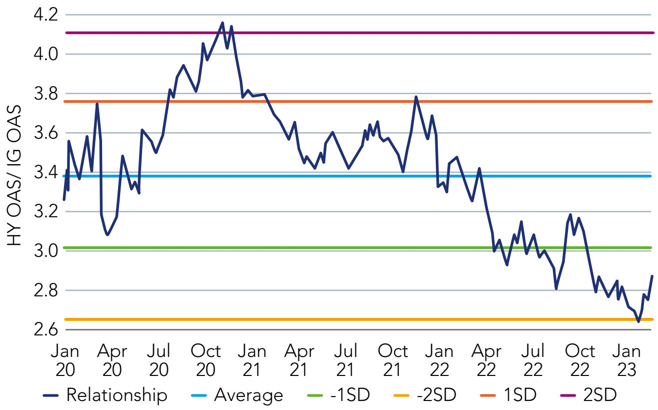
# Credit relative value

## i) Intra-credit opportunities

Compression has been a key theme year-to-date within global credit, as investor optimism from a more constructive macroeconomic tone has led to a risk-on move across the asset class, with both rates and spreads rallying.

**Global investment grade:** Investment grade continues to look attractive compared to lower-quality credit. This is evident in global indices, where high yield now trades rich to investment grade based on a three-year look-back period, with the trend especially strong in Europe given the perceived dissipation in credit risk. Relative to the US, European high grade credit spreads continue to trade at wider levels than their historic relationship. We maintain a preference for European investment grade from a valuation perspective and continue to focus on the belly of the curve (five to 10 years) where we see the best balance of convexity and spread available, since curves remain flat to inverted in many capital structures.

**Figure 11:** EU credit, high yield vs. investment grade




Source: Factset, Federated Hermes as at 20 January 2023.
**Past performance is not a reliable indicator of future returns.**

**Global high yield:** Despite the fourth quarter outperformance of European high yield in both cash and synthetic markets, the US still trades rich to Europe based on a three-year look-back period. Within this segment we maintain a preference for exposure to quality European high yield issuers with a strong fundamental and sustainability profile, especially in sectors less exposed to a cyclical downturn, such as utilities, telecommunications and packaging.

Looking at ratings, CCC-rated bonds underperformed the fourth quarter rally, leaving them looking attractive from a relative value perspective versus the broader high yield market. We are cautious, however, of adding significant exposure in this area given the possible range of outcomes that could materialise for more highly levered issuers in the near term. That said, we have found attractive opportunities to step down in seniority within the capital structures of certain issuers to take advantage of this valuation differential.

From a curve perspective, high yield credit curves are more normalised compared to investment grade, meaning we have been able to take advantage of opportunities across the portfolios to earn attractive spread pick-ups from limited maturity extensions.

**Figure 12:** US HY, CCC vs. US high yield


Source: Factset, Federated Hermes Limited, as at 20 January 2023.
**Past performance is not a reliable indicator of future returns.**

## ii) Stressed, distressed and special situations

**CCCs are screening cheap on a spread basis – by nearly two standard deviations – despite some outperformance year-to-date.**

On a cash price basis, CCCs have also recovered less than the HW0C Index[4] so are looking better value. High yield distressed ratios remain elevated (see Figure 13), and CCC dispersion levels are rising. Moody's are projecting default levels to rise to 5.1%[5], which means bottom-up analysis and selectivity will be very important.

Another factor that supports the idea of getting slightly longer CCCs is that the benchmark has become much less cyclical in the last two years, as this had been driven by high turnover and more exposure to pharmaceuticals, telecommunications and media, while exposure to healthcare, mining & metals and energy has declined.

[4] BofA Merrill Lynch Global High Yield Constrained Index, as at January 2023.
[5] Moody's Analytics, as at 17 January 2023.

CCCs have performed well year-to-date but still look cheap when considering 52-week tights/wides. Here, the contrast is with single-Bs which are close to BBs on a cash price basis and just over 100bps from the tights, and over 200bps inside the wides.

**Figure 13:** High yield distressed ratio, spreads > 1000 bps


Source: Baml, as at January 2023.

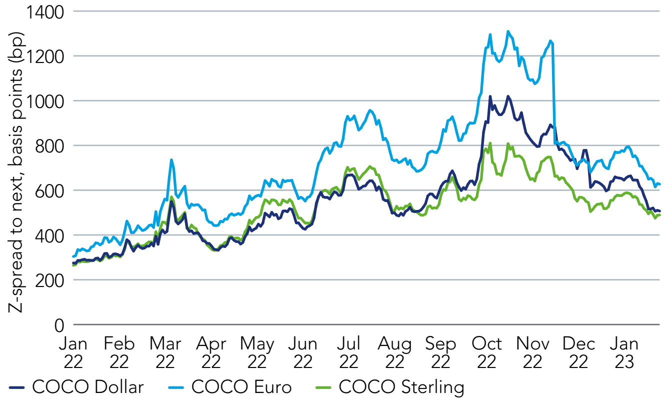
## iii) Financials

**After a year to forget for financials, how will 2023 fare?**

All things considered, 2022 was an average-to-good year for holders of shares in global financials, but less for holders of those same companies' bonds. After a rollercoaster 12 months, shares in European financials ended up outperforming the broader market by +12% points[6]. US banks fared worse, starting 2022 strong but underperforming by -4%[7] as concerns about recession and peak Net Interest Income (NIMs), (despite a very hawkish Fed) took front seat.

Mostly owing to rates selling off, subordinated financials bonds had a torrid year up until the second half of October. From this stage in Q4, brighter macro projections – combined with very fine numbers in terms of both capitalisation, P&L and asset quality (AQ) outlook – drove a rally which continued throughout January of this year (see Figure 14).

**Figure 14:** ATI 1 year-to-date Z-spread evolution, by currency




Source: CS Index Plus, Federated Hermes Limited, as at January 2023.

In our view, 2023 will be another very challenging year for the sector, defined most likely by high volatility. Given the wide range of possible macroeconomic outcomes (a topic we cover in our most recent Fiorino blog), we believe there is little point in trying to make bold macro calls.

After a rollercoaster 12 months, shares in European financials ended up outperforming the broader market by

**+12%** points.

That being said, we would try to add more value by trying to call intra-sector, intra-geography dispersion around key themes. We start the year relatively bullish on all the most important themes – recessionary risks, asset quality (AQ) trends, net interest income (NII), and regulatory safeguards against excessive capital return and regulation, especially in Europe with the finalisation of Basel IV.[8]

There will, of course, be land mines along the way. The usual areas of concern include commercial real estate (CRE), where we think risk lies mostly with private equity (PE) and listed REITs. Another area of concern is residential mortgages in countries with a high percentage of standard variable rate, high yield and collateralised loan obligations (CLOs) – although our analysis of these areas is reassuring as far as bank/insurance risk goes.

Quantitative tightening in the US and repayment of Europe's Target Longer-Term Refinancing Operations (TLTROs), meanwhile, could cause indigestion in government bonds, albeit both the Fed and the European Central Bank (ECB) have backstop tools ready.

One thing is certain: 2023 will keep us busy.

6 Eurostoxx Banks Index, as at January 2023.
7 KBW Bank Index, US S&P 500, as at January 2023.
8 The proposed banking reform (building on previous international banking accords, Basel I, II AND III) which aims to strengthen the international banking system by standardising rules from country to country, including those related to risk. Basel IV was implemented on Jan 1 2023.

## iv) Corporate hybrids

**Valuation of corporate hybrids remain compelling as they have continued their period of underperformance compared to other fixed income sub-asset classes on a beta-adjusted spread basis.**

Relative to senior instruments, under our *Investment Grade vs. Hybrids Relative Value Framework*, Sub-Senior Spreads (SSS) peaked at ~520bps in early July 2022, but have since rallied and are now back to six-month tights of ~360bps.The Hybrid-Senior Spread Ratio (HSSR) peaked at ~3.75x and is now around 3.65x vs. 2.5-2.75x in 2021. This suggests to us that there is compelling value to be found in the hybrid sub-asset class versus senior debt.

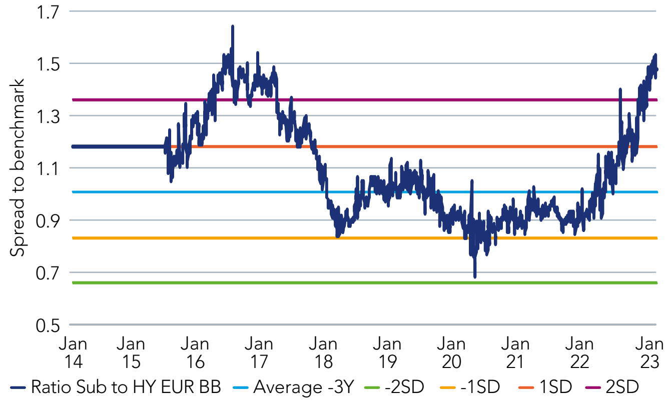
**Figure 15:** Ratio of corporate hybrids spreads to EUR senior debt spreads


Source: Bloomberg, Federated Hermes, Credit Suisse Indices, as at 23 January 2023.

Relative to European High Yield BB-risk, under our *High Yield versus Hybrids Relative Value Framework*, corporate hybrids now yield around 1.6% more or ~1.48x the CS Liq European HY EUR BB Index.

Even when excluding stressed hybrids from European REITs, this ratio remains convincingly attractive at ~1.3x. As explained in our recent paper, Finding opportunity in mispriced corporate hybrids, corporate hybrids possess a similar risk profile to BBs, but a different risk composition, thereby making corporate hybrids valuations attractive.

**Figure 16:** Ratio of corporate hybrids spreads to EUR high yield BBs spreads




Source: Bloomberg, Federated Hermes, Credit Suisse Indices, as at 23 January 2023.

The main reason behind this disconnection versus BB-risk, as we argued in our Q3 2022 report, lies in the investor base for corporate hybrids, which mainly consists of investment grade investors. Recent primary activity of new corporate hybrids suggests pricing that is significantly inside the curve for existing hybrids, highlighting strong demand. Clearly, investment grade investors have begun to revisit their underweight positioning in this sub-asset class.

Nevertheless, the risk of a more prolonged hiking cycle and active quantitative tightening (QT) remain technical overhangs to our constructive view on the sub-asset class.

While we see long-term value in owning corporate hybrids, the lower immediate need for investors to 'reach for yield' could cap near-term sub-senior spread compression.

As raised in our January Multi-Asset Credit Strategy Meeting (MACSM), we saw an excess of supportive liability management exercises, with corporate hybrid issuers taking advantage of the S&P 10% hybrid stock reduction rule. This rule allows a corporate hybrid issuer to redeem, and not replace, 10% of its hybrid capital each year without impacting its equity content, as well as corporate hybrid issuers already looking to refinance their hybrids with call dates in 2024. This supports our view that, at current credit worthiness, extension risk remains low for committed corporate hybrid issuers.

We also saw selected hybrid issuers in the real estate sector arbitraging their cost of equity and cost of hybrids by raising equity and conducting liability management exercises of their hybrid capital to improve their credit metrics. This was discussed in our commentary from mid-August 2022: Goodbye share buybacks, hello bond buybacks.

[8] The Corporate Sector Purchase Programme (CSPP) is a component of the European Central Bank's bond-buying programme, launched in response to the Global Financial Crisis.

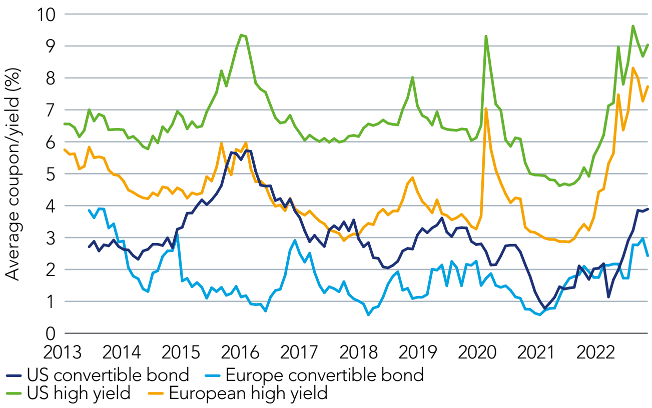
## v) Convertible bonds

**The repricing of risk assets over 2022 catalysed dramatic shifts lower in the average delta of the global convertible bond market.**

As equity valuations plummeted – driven by interest rate-induced volatility – so too did the price of the embedded options within convert structures that drifted progressively more Out of the Money (OTM). As a result, a larger share of the space now trades in a more bond-like fashion, accruing greater interest from the traditional fixed income investor base who are seeking convex opportunities with defensive characteristics similar to corporate bonds.

Given our outlook on the macroeconomic environment, we expect the new higher-for-longer interest rate regime to provide a near-term upside tail for convert issuance. Among other factors, a resurgence in supply is likely to be driven by refinancing from repeat convert issuers managing upcoming maturity hurdles, but we also envisage new players entering the market after reassessing their capital structures.

**Figure 17:** Slutsky's Substitution Effect, average newly-issued convertible bond coupon vs. HY bond yield to maturity




Source: BofA Global Research, ICE Data Indices, LLC, December 2022. Please note that the average newly issued convertible bond coupon is based on a trailing six-month count average and the average high yield bond yield to maturity is based on a market-weighted average of all constituents in the index.
**Past performance is not a reliable indicator of future returns.**

Owing to the instrument's ability to reduce cost of capital through selling forward equity, substituting to convertibles as a source of funding can allow for sizable interest expense savings when compared with tapping other markets (witness high yield data in Figure 17, for instance). The relative attractiveness of the product goes further via financial flexibility benefits – including fast execution, various capital structure options, demand from diverse investor bases – all of which may allow firms to access the market with greater ease.

With higher spot funding levels as a pull factor, we believe there is scope for the asset class to benefit from credit improvements from a pipeline of new, higher quality corporates (compared to the younger, small-cap companies that flooded the market in 2020/21), seeking to shift their funding away from more traditional sources.

## vi) Emerging markets

**Emerging market corporates and sovereigns have experienced a tumultuous 2022 – far underperforming their respective developed market counterparts.**

Despite the overall negative performance, the asset class did manage to recover slightly in Q4 to return -14.10% for EM corporates and -17.41% for EM sovereigns for the year[9].

The reasons for this underperformance were manifold. There was the ongoing crisis in Ukraine, the follow-through in energy prices (which is relevant given that half of emerging markets are oil importers) and China's zero-Covid policy. These factors, combined with inflationary pressures and concerns about global growth, created significant headwinds for EM assets last year.

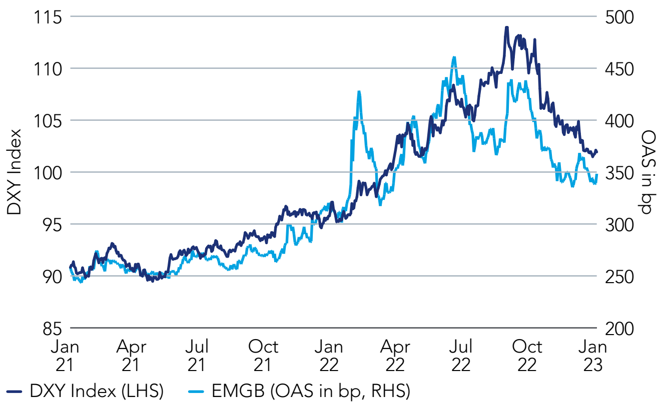
In currencies, the strong US dollar had a significant impact on EM debt trading levels through Q2 and Q3 2022, but this eased in Q4 as investors started to price in a more dovish outlook for the US Federal Reserve (the Fed). This turned out to be supportive for EM valuations, given their heavy reliance on US dollar funding (see Figure 18) and, in the event, EM assets outperformed most of the developed market fixed income space through the Q4 rally.

**From here, with EM duration continuing to perform well against the broader global narrative of slowing inflation and a softer dollar, we expect investor attention to turn to the question of which regions will cut rates first as growth slows.**

From here, with EM duration continuing to perform well against the broader global narrative of slowing inflation and a softer dollar, we expect investor attention to turn to the question of which regions will cut rates first as growth slows. This could be a positive for the asset class given how EM central banks are generally ahead of their DM counterparts in their hiking cycles.

[9] Bloomberg, as at January 2023, based on US-dollar-hedged performance.

**Figure 18:** US$ strength and the impact on EM sovereign credit spreads




Source: Bloomberg, as at January 2023.

**Figure 19:** Emerging markets hard currency corporates – Mexico vs EM Index


Source: ICE Bond Indices, Federated Hermes, as at January 2023.
**Past performance is not a reliable indicator of future returns.**

Year-to-date, news of China's faster-than-expected reopening (following easing of stringent Covid-19 restrictions) has been a further boon to EM assets, boosting investor optimism of a faster recovery and stronger growth for the region, with expectations this will spill over into many other parts of the global economy.

Initial data out of China is supportive, with both manufacturing and non-manufacturing PMIs returning to above 50 in January[10]. Despite the clear upside potential, we believe it remains to be seen if the reopening will have the broad-based effect investors are hoping for, at least in the immediate future. That said, the news should be positive for investment grade credit spreads in the region and support the valuations of certain solvent issuers in the property sector, which have lagged through 2022.

> **In terms of credit quality, EM high yield now trades in line with historical averages compared to investment grade, and BB outperformance vs BBB also leaves the relationship around fair value.**

From a valuation point of view, hard currency EM corporates trade at fair value compared to EM sovereigns, having recently underperformed on a relative basis. We continue to maintain a preference for corporates however, with macro headwinds likely to keep sovereign debt volatile in 2023.

In terms of credit quality, EM high yield now trades in line with historical averages compared to investment grade, and BB outperformance vs BBB also leaves the relationship around fair value. We see the potential for attractive opportunities in certain regions where corporate valuations are trading wide to the broader index, such as India and Mexico, as our focus turns to investing in national champions and exporters. Attractive valuations and a dependency on the US from a trade perspective give us more comfort to like Mexico from this point.

## vii) Leveraged loans

**Renewed optimism of the structured credit space and the return of European CLO issuance has supported the ELLI.**

The European leveraged loan market has had an encouraging start to 2023, with the S&P European Leveraged Loan Index (ELLI) returning +3.02% in January, albeit slightly underperforming the bond market (the ICE BofA Euro High Yield Index returned +3.22% over the same period[11]).

The new year rally was mainly driven by technical factors. The renewed optimism of the structured credit space and the return of European CLO[12] issuance supported the loan index. Additionally, and despite the challenging macroeconomic environment, ratings remain higher than during the Covid-19 pandemic:

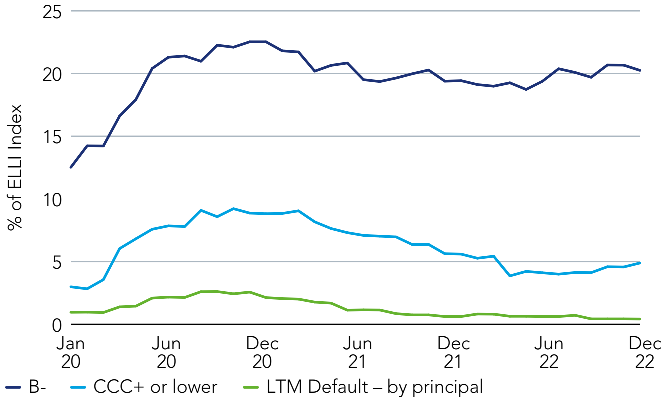
- **B- represent 20.4% of the index (as at December 2022) versus 22.7% in December 2020**
- **CCC+ and lower currently represent 4.9% of the index versus 9.2% in November 2020**
- **Defaults remain low at 0.4% versus 2.6% in October 2020**

The loan market experienced an increasing number of downgrades throughout 2022, and we believe this could mark the beginning of a trend. Loan borrowers will soon publish their annual reports and we will gain a sense of how they navigated the increasing cost of debt and commodities. CLOs are limited in their ability to invest in CCCs (typically 7.5% of the vehicle) and, consequently, we could see a wider dispersion in price based on ratings.

We think defaults could be limited in 2023 as, firstly, there are no imminent refinancing risks, as only 0.6% of the index will mature in 2023 and 4.6% in 2024, and, secondly, CLOs might use 'amend-to-extend' facilities to avoid default.

[10] The National Bureau of Statistics, as at January 2023.
[11] S&P, as at January 2023.
[12] Collateralised Loan Obligation.

**Figure 20:** S&P European Leveraged Loan Index (ELLI) composition




Source: Leveraged Commentary & Data (LCD), as at December 2022.
**Past performance is not a reliable indicator of future returns.**

## viii) Structured credit

**Despite a difficult 2022, the asset-backed securities (ABS) market has had a strong start to the year, with five deals priced so far and one more in the pipeline.**

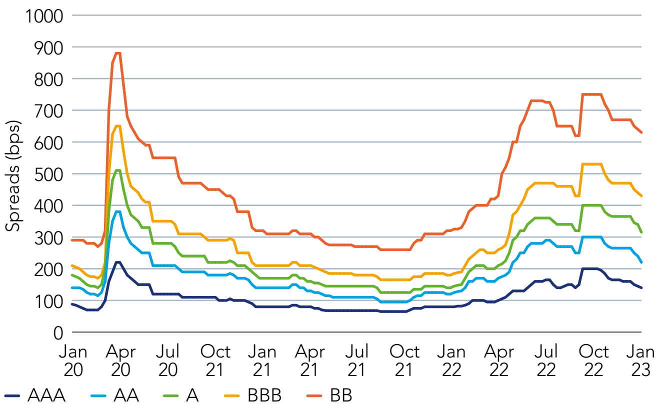
UK BTL RMBS spreads have tightened by around

**40-50bps**

at the mezzanine paper

Primary prints in January 2023 saw very strong book build across the stacks, with the tranches multiple times subscribed and notes printing inside the guidance. Secondary markets also witnessed decent activity and with demand surpassing the supply, spreads tightened. UK BTL RMBS[13] spreads have tightened by around 40-50bps at the mezzanine paper and around 20bps tighter at senior level.

**Figure 21:** RMBS spreads




Source: Citi and Bloomberg, as at January 2023.

According to the Central Bureau of Statistics (CBS), annual house price growth slowed to

**4.9%** in November 22 from **7.8%** in October 2022 and **9.4%** September 2022.

Macro headwinds – including high inflation, rising rates and the cost-of-living crisis – created a weak outlook for the ABS market. This has impacted housing market activity, and house prices have been falling since Q3 2022. Annual house price growth in the UK continued to slow sharply, with January 2023 reporting an annual growth rate of 1.1%, from 2.8% in December 22 and 9.5% in September 22, according to Nationwide.

Similarly, the resilient Dutch housing market is experiencing a slowdown. According to the Central Bureau of Statistics (CBS), annual house price growth slowed to 4.9% in November 22 from 7.8% in October 2022 and 9.4% September 2022.[14]

Despite these headwinds, the credit performance on the ABS pool remains strong, owing in part to the tight labour market and robust underwriting standards.

Here, we sound a note of caution, however: while unemployment rates across Europe remain low, the market is widely projected to weaken as the economy shrinks. In line with this, select geographies are already showing early signs of rising unemployment rates.

Nonetheless, unemployment levels are starting from a low base, being well below the pre–pandemic average. Hence, while we expect some credit deterioration in the non-confirming pools we do expect losses to be limited given overall healthy structures and adequate credit support.

[13] Buy-To-Let Residential Mortgage-Backed Security
[14] Central Bureau of Statistics, as at November 2022.

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