Divergence, duration, dislocation

Fixed Income Report
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Commentary

Bonds are based on information; equity on ideas

As we pass the halfway mark of 2023, it remains unclear what the US Federal Reserve's next move will be. We await firmer evidence that sticky, core inflation is on the wane. As such, the focus remains on the conflicting narratives of the bond and equity markets, with inverted curves contradicting still-lofty valuations in the mega-tech space. Moreover, the diverging 'fear gauges' in the respective markets continue to paint a differing picture.

The spread between fixed income volatility (monitored by the MOVE Index) and equity volatility (the VIX Index) has been widening further and further. On the fixed income side, this means the interest rate-linked bond market continues to experience turbulence. US short-term bond yields still far exceed long-term bond yields. Investment flows remain very choppy in the short term because market participants do not have a clear view on the end to the hiking cycle. The likelihood of a soft-landing remains uncertain, as too does the probability of an economic recession in 2024. On the equity side, the VIX index implies benign market conditions, with, at the time of writing, the gauge at 15 (anything sub-20 spells 'R-E-L-A-X'). And while the lack of breadth of the equity rally this year has been well documented, rally it has. So, how can this conflict be explained?

> **I attended a conference recently where I was reminded of the old adage, 'bonds are about information; equity about ideas'.**

Two schools of thought

I attended a conference recently where I was reminded of the old adage, 'bonds are about information; equity about ideas'. Inherent to that viewpoint is a difference in timeframes, with bonds reacting to the 'here and now', while equity valuations, especially of those mega-cap techs, being driven by structural changes, such as AI. It seems to me that the reason the picture is so conflicted today is primarily down to the immediate uncertainties around inflation and associated central bank actions. While these have admittedly been in the 'immediate' bucket for some time, it's our belief that this will eventually lead to a revert and recoupling within the VIX in both behaviour and direction.

Positioning for this likely outcome was a key topic of debate in our most recent **Multi Asset Credit Strategy Meeting (MACSM)**, which takes place once every couple of months, and provides a forum for the team to meet and discuss their views across the asset classes within our fixed income spectrum.

Which sub asset classes and sectors stand to benefit, and which are at risk of headwinds from the eventual fear-pendulum swing shifting from the MOVE to VIX? Will the areas that have surfed successfully through the middle of this landscape (such as asset-backed securities and collateralised loan markets) continue to win out? These questions are tackled in detail in the pages that follow but, to generalise, we see opportunity in market segments that have been badly affected by the gyrations in the MOVE Index – everything from financials, to corporate hybrids, to UK gilts. On the contrary, we have an increasing aversion to areas that are likely to have high sensitivity to the underlying economy and therefore do not stand to flourish should the VIX awaken from its slumber – notably emerging market debt, leveraged loans, and the lower end of the high yield market.

A holistic approach

As ever, the devil is in the detail, and such generalisations and optimal return outcomes are only brought to life through nuanced opinions on individual companies and securities. It's here that the heavy lifting can really enhance the end outcomes. This is why we insist on deriving input and views from across the team in the MACSM – with traders, portfolio managers, credit analysts, sustainability specialists and risk professionals all weighing in on the debate.

We hope the content that follows is testament to this collaborative effort, highlighting a level of detail impossible to be covered from a 40,000ft view alone.

We hope you enjoy reading this issue of the 360. To find out more about our wider credit offering, please visit our website**.**

Fundamentals

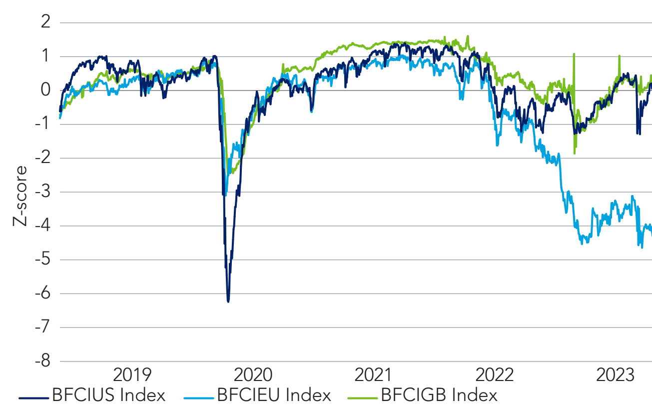
Economic outlook

Despite signs of inflation being more entrenched than initially expected, the outlook for fixed income markets remains positive going into the second half of the year, with yields at attractive levels and total returns likely to be positive.

A series of tailwinds which came to the fore in late 2022 and helped the global economy get off to a strong start this year were overwhelmed in mid-March by the failure of two large US regional banks and the collapse of confidence in Credit Suisse. These events led the International Monetary Fund (IMF) to lower its global GDP growth forecast to 2.8% this year from 3.4% in 2022[1]. The IMF also flagged the potential for growth to decelerate further to 2.5% this year, if stress in the financial sector deepens, representing the third lowest outcome since 2001. Our base case remains that the US will experience a mild recession in either the back half of this year or early 2024, spilling over to other advanced economies soon after.

While March's banking panic raised the odds of a recession down the line, the swift and decisive policy response that followed helped to avert more immediate and significant macroeconomic consequences. That said, recent events have changed the balance of risks to the downside as the banking stress adds to tightening financial conditions already underway due to 14 months of central bank rate hikes, as illustrated by Figure 1 below.

Figure 1: A tightening of financial conditions resulting from March banking stress



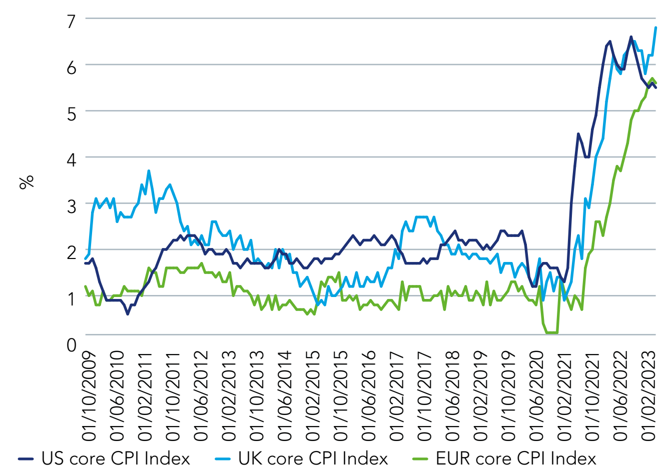
Source: Bloomberg, as at April 2023. The Bloomberg US Financial Conditions (FCIUS) Index is a Z-score tracking the overall level of financial stress in the US money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms. The Bloomberg EU Financial Conditions (FCIEU) and the Bloomberg UK Financial Conditions (FCIUK) indices perform the same role but for the EU and the UK respectively.

Inflation remains a top concern, and even though headline consumer price indices have come down across major economies, (largely due to lower energy prices), as seen in Figure 2, various price gauges continue to run well above central bank targets. The composition of inflation is evolving in a manner which continues to cause concern to most major central banks, as it becomes entrenched, with core inflation in particular proving sticky.

Figure 2: Headline inflation (%) for the US, the UK and the eurozone

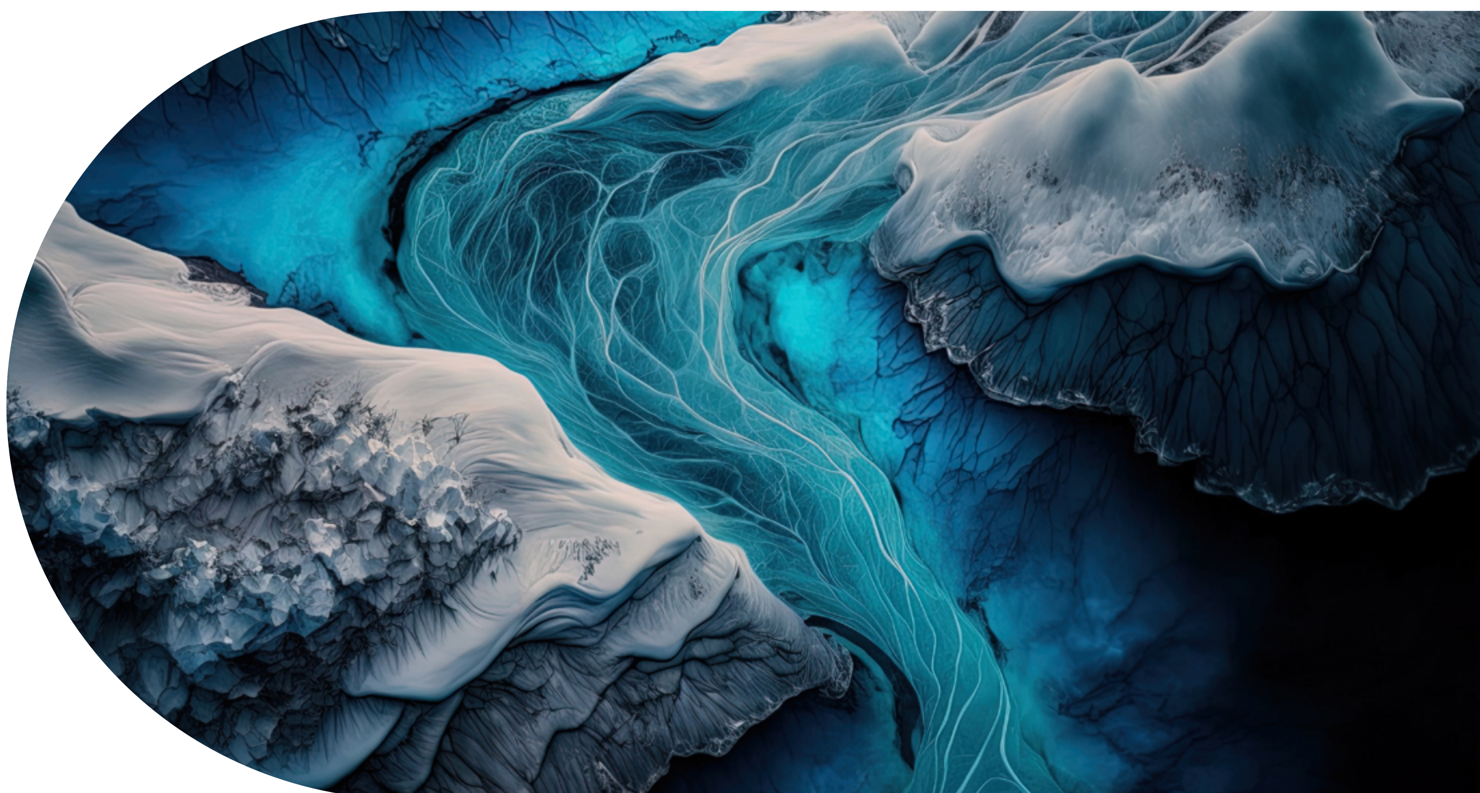
Source: Bloomberg, as at 31 May 2023.

Figure 3: Core inflation (%) for the US, the UK and the eurozone



Source: Bloomberg, as at 31 May 2023.

[1] Deutsche Welle, as at 11 April 2023.



We expect inflation to stay on its downward trend through 2024, abetted by lower commodity prices (and related base effects), further normalisation of global supply chain disruptions and, later, the impact from slower demand. Even so, it is likely to end this year well above targets—at 3-3.5% in the US and the eurozone, and 4.5% in the UK. Whether it converges to target in 2024 depends on developments in economic activity and, crucially, labour markets. Year-to-date, labour markets remain tighter than expected, with buoyant wage inflation fuelling services inflation.

It is likely that central banks are currently at – or close to – peak rates, and we expect rates will remain around these levels for at least the remainder of this year. With headline inflation above target and core inflation stabilising at higher levels, policymakers will remain concerned about second-round effects and therefore policy will remain tight this year through the combination of high rates and quantitative tightening. Absent any unexpected market stresses, we do not expect any developed market central banks to cut policy rates this year.

There is now awareness that something else could break, creating more episodes of stress in financial markets.

More generally, it is now clear that risk of accidents in financial markets has risen as the environment has shifted from extremely easy to somewhat restrictive monetary conditions. There is now awareness that something else could break, creating more episodes of stress in financial markets. This uncertainty is making for generally fragile sentiment and more volatile financial conditions.

However, we believe patience is vital, and while we haven't yet seen a meaningful impact on the economy from higher rates and tighter lending conditions, this will likely materialise as we move towards the end of the year. As such, we continue to believe that the outlook for fixed income is promising, with yields at attractive levels and total returns likely to be positive.

We expect rates markets to remain range bound given how inflation is still too high to price the inevitable cutting cycle in the absence of data confirming a recession is on the cards. Rates offer a valuable hedge and, as such, we retain a moderate overweight duration position. Rates market volatility has remained high so far this year and, with an uncertain economic outlook and the potential for further market dislocations, this is likely to continue. We expect curves to steepen this year likely driven by pricing of cuts in 2024 and 2025, but aided by greater net supply.

Figure 4: Macro scores

Economic outlook	Duration	Curves	Volatility
-1: weak	+1: positive	-2: steepening	-2: high

Source: Federated Hermes Limited, as at 31 May 2023.

Corporate fundamentals

In our previous edition of the 360°, we observed how the outlook for corporate credit fundamentals could burn brighter over the first half of 2023. In the months since, corporate credit fundamentals continue to hold up as cost pressures ease, but dispersion is rising.

The mid-Q2 reporting season reaffirmed that credit fundamentals remain resilient, despite an uncertain macroeconomic environment. While the demand and pricing picture varies, the easing of cost pressures appears to be a central theme. Lower energy prices are aiding airlines and the cost of building materials, while lower lumber prices are helping homebuilders and easing labour costs in healthcare. Despite the broader uncertainties, our analysts have made more positive than negative revisions to their sector fundamental views this quarter, as highlighted in the table below.

From a macroeconomic perspective, we see several positive drivers:

- Homebuilders in the US have benefited from stabilising rates and demand, which led to a better-than-anticipated spring selling season.
- European airlines continue to see strong demand, pricing power and lower jet fuel costs.
- UK food retailers are focusing on internal efficiency measures, allowing them to maintain profitability despite cost pressures.
- US hospitals have reported better-than-anticipated results as admission volumes appear to be accelerating and labour challenges seemingly abate.

However, we also acknowledge the sectors with a worsening fundamental view:

- The real estate sector continues to struggle as higher rates negatively impact property valuation and debt maturities are front-loaded.
- The paper and forestry sector suffers from weaker demand.
- The metals and mining industry is being affected by lower pricing and demand with a weaker-than-hoped post-Covid recovery in China.

Interestingly, there is encouraging commentary around the sectors with unchanged views.

- In the telecommunication sector, tailwinds such as lower energy costs, pricing power, and a peaking capex cycle should aid operations.
- We see limited downside to demand going forward in the chemicals sector.
- In the automotives space, despite our cautious view, pricing and volumes remain robust. Credit metrics are holding up well, with US high yield gross and net leverage ticking up by 0.1x to 4x and 3.4x[2], according to Bank of America Merrill Lynch.

However, despite fundamentals being resilient in aggregate, we note that dispersion is rising. Therefore, we continue to highlight the need to pay particular attention to idiosyncratic stories or credits heavily dependent on capital markets, especially as the 2025 maturity wall looms and will have to be addressed at significantly higher rates.

US hospitals have reported better-than-anticipated results as admission volumes appear to be accelerating and labour challenges seemingly abate.

[2] Bank of America, Merrill Lynch.

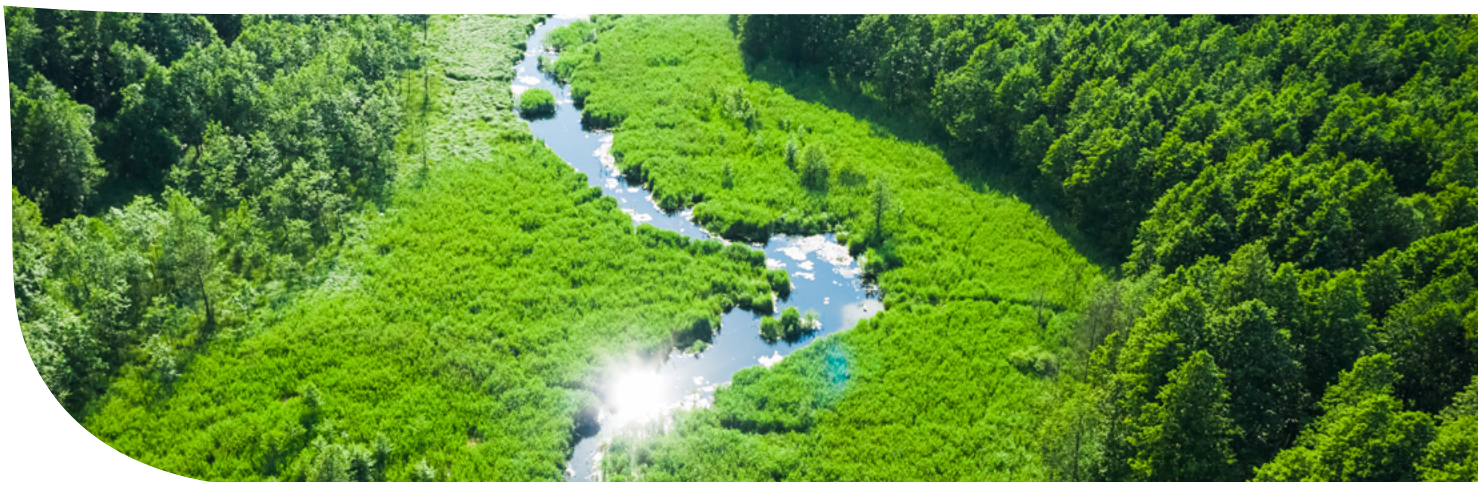
Figure 5: Corporate credit fundamentals are holding up, with more positive changes on fundamentals vs. negatives

Improved fundamental view				
Sector	**Prior Score**	**Prior Outlook**	**Current Score**	**Current Outlook**
Homebuilders	4	Improving	3	Stable
Building Materials	4	Stable	3	Stable
Technology	4	Stable	4	Positive
Airlines	3	Stable	2	Stable
Healthcare	3	Stable	3	Improving
UK Food Retail	4	Stable	3	Stable
Worsening fundamental view				
Sector	**Prior Score**	**Prior Outlook**	**Current Score**	**Current Outlook**
Metals & Mining	1	Stable	2	Stable
Steel	3	Stable	3	Declining
Paper & Forestry	3	Stable	4	Improving
Towers	2	Improving	2	Stable
Real Estate	4	Stable	4	Declining
Sectors with unchanged view on corporate fundamentals by analysts				
Sector	**Prior Score**	**Prior Outlook**	**Current Score**	**Current Outlook**
Telecom	4	Improving	4	Improving
Chemicals	4	Improving	4	Stable
Auto OEMs	4	Improving	4	Improving
Auto parts	3	Improving	3	Improving
Utilities (US IPPs)	3	Stable	3	Stable
Utilities (YieldCos)	2	Stable	2	Stable
Utilities (European Uts)	2	Stable	2	Stable
Packaging (Metal)	2	Stable	2	Stable
Packaging (Glass)	3	Stable	3	Stable
Packaging (Plastic)	4	Declining	4	Declining
Media	3	Stable	3	Stable
Non-food retail	4	Stable	4	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 May 2023.



Sentiment, technicals and relative value

i) Sentiment

In a matter of weeks, the market's mood music has changed key.

To better assess market sentiment, the Federated Hermes credit team routinely considers several indicators across rates, equities, and credit. One such indicator is the Morgan Stanley Global Risk Demand Index, which gauges the change in risk demand from the price performance of risky assets relative to safe ones.

With this in mind, it's fair to say that over the space of just a few weeks, market sentiment has turned. In this, we point to a seemingly strong sense of complacency as illustrated by the Global Risk Demand Index (see Figure 6 below) – despite historically elevated fear levels as recently as March at the height of Q1's banking turmoil.

Figure 6: Morgan Stanley Global Risk Demand Index

Source: Morgan Stanley, Bloomberg, as at 31 May 2023.

The MOVE Index paints the same picture. With a level of 136 at the end of May, versus a peak of 198 in mid-March, it would appear that normalisation is already here (despite interest rate volatility having been the biggest driver of performance impacting markets in 2022.)

Finally, we would also consider the Fear and Greed Index, which looks at several sub-sectors of the credit derivatives market. In our Q1 edition of 360°, we noted that the Standardised Global Risk Demand Index (STGRDI) was close to five-year highs. At present, and apart from the skew section, we see numbers trading at multi-month lows once more, especially on the implied volatility side, the fear indicator.

Figure 7: The Fear and Greed Index

	VTRAC-X	Skew	Momentum	ETF premium	CDS strength
EUR IG	13%	63%	19%		22%
EUR HY	29%	81%	19%		12%
EUR FIN	11%	63%	17%	55%	
USD IG	13%	11%	50%	55%	
USD HY	9%	9%	54%	52%	
TOTAL	14%	42%	30%	54%	20%

Source: JPM as at 27 May 2023.

Overall, we assess a score of -1 to reflect this increased confidence within markets. We do not assign a score of -2 because absolute levels of spread and volatility remain in line with the historical average.

ii) Technicals

Relatively high investor cash balances continue to support fixed income allocations.

Flows across fixed income are moderately positive on a year-to-date basis. Investment grade flows – which reached +2.6% of AuM as at 25th of May 2023[3] – correlate highly with rates market uncertainty and, as such, the lower the volatility, the greater the flows. The picture is more varied on the high yield side, with a net flow of -0.5% on a year-to-date basis, signalling a considerable improvement over 12 months[4].

[3] EPFR, as at 25 May 2023.
[4] EFPR, as at May 2023.

The supply side mirrors what we see in flows, as a significant pick up in high grade issuance has created positive net supply. Here, it is worth noting that, with capital buffers readily available, this increased issuance has been well absorbed by investors.

In high yield, by way of contrast, we have seen supply contract – as companies that have the ability to wait do so rather than lock into the current higher funding rates.

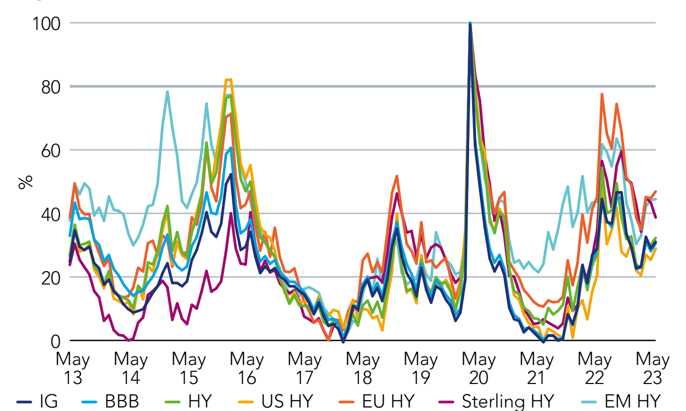
Finally, investor positioning is constructive, with a decent cash buffer, an average fund beta across the board, and a moderate index positioning. Therefore, we maintain our score of +1 for this section.

iii) Relative Value

When looking at credit spreads in Figure 8 below, they appear fair at best and on the tighter side on certain sub asset classes, versus the historical standard. In the meantime, spreads also appear fairly priced to slightly tight when compared to economic indicators such as the Purchasing Managers' Index (PMI), growth, or inflation. For this reason, we are downgrading our score to -1.

In high yield, by way of contrast, we have seen supply contract – as companies that have the ability to wait do so rather than lock into the current higher funding rates.

Figure 8: Credit spread percentiles, per sub asset class



Source: Factset, ICE BAML, as at 31 May 2023.

A note on scoring: Throughout this report we assign scores of between -2 to +2 to the various asset classes mentioned. These scores - whether for valuations, technicals or sentiment - are a measure of our view on how supportive each area is for credit markets on a forward-looking basis.

Catalysts

As the second half of the year inches into view, the credit team provide a rundown of their key tail risks in a unique environment where structurally low volatility is subject to periodic episodes of market stresses.

From a fundamental point of view, as US debt ceiling concerns abate and we move into the summer season of trading, we feel fundamental catalysts are balanced. As such, the team have assigned a neutral score for our fundamental catalysts.

From a positive standpoint, we see the main upside in the form of additional stimulus from the Chinese government, as government and regulatory interventions look to stamp out small crises as they occur before any contagion sets in. Faster-than-expected dovishness from central banks is also a positive on this front.

The key downside catalysts we have identified include higher-for-longer inflation and the knock-on impact this would have on rates, signs of a more significant recession than anticipated with broad-based weakness across developed markets and China, and an escalation of geopolitical tensions. We also remain vigilant to accounting standards, as we think this poses a key governance risk.

We have entered a very different phase when compared with previous years, as the market continues to experience episodic bursts of volatility . These episodes typically move the market wider over a short period of time and normalise quickly. The current environment is no different.

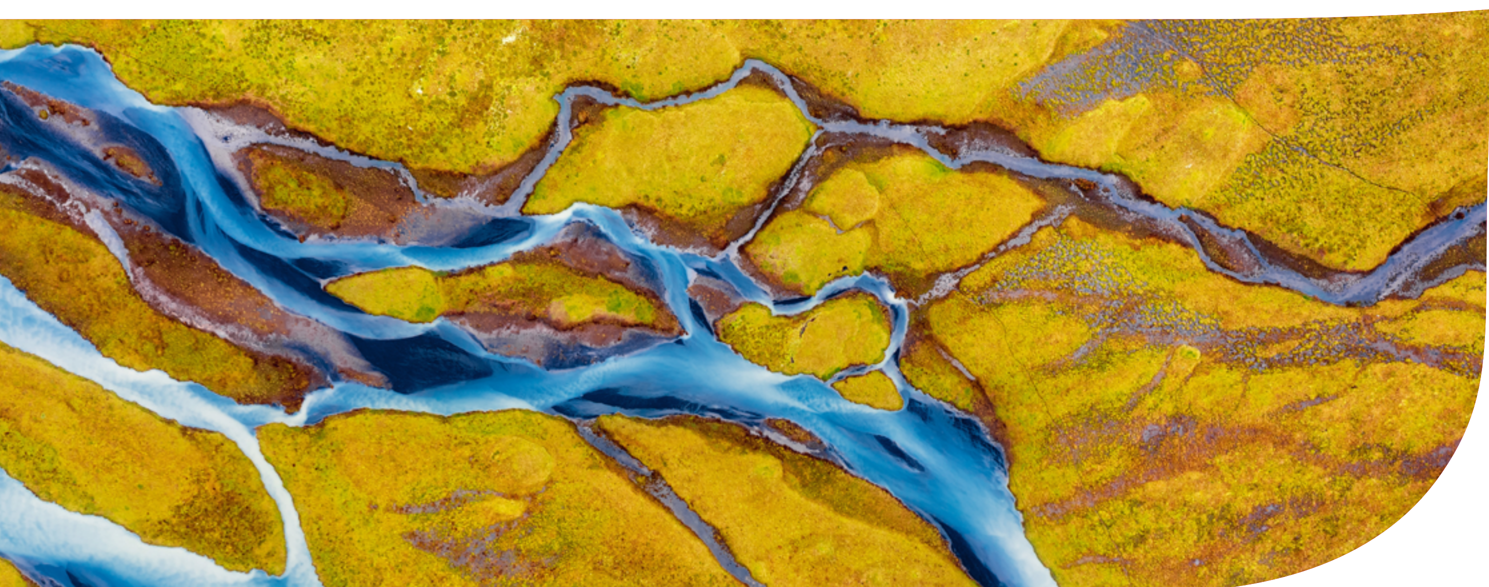
With spreads trading in a tight range (financials proving to be the only exception), implied volatility at a 12-month low (as demonstrated by Figure 9), and with skew hovering at around the 95th percentile over a year, it appears the sell-off induced by the collapse of several US regional banks and culminating with the downfall of Credit Suisse is already a thing of the past.

However, there are additional potential headwinds in the weeks ahead. Therefore we consider the current situation as a strategic entry point to reset or add hedges on the credit side.

Figure 9: Implied volatility (three months)

Index	Spot		1-year min	1-year max	1-year percentile	3-year percentile	5-year percentile	1-month change
iTraxx Europe Series OTR 5y	51.2		50.6	76.6	1	27	42	-2.5
iTraxx Europe Xover Series OTR 5y	46.9		46.3	69.7	2	23	45	-2.3
CDX.NA.IG Series OTR 5y	45.8		44.6	73.4	1	19	33	-5.2
CDX.NA.HY Series OTR 5y	44.7		43.8	71.0	2	23	48	-5.1

Source: Goldman Sachs, as at May 2023.



Credit relative value

i) Intra-credit opportunities

The calm before the storm? Investment grade and high yield spreads are at historically average levels but, with risks likely to increase during 2023, we remain vigilant.

Global investment grade: With developed-market inflation proving difficult to tame, bouts of interest rate volatility and a pick-up in primary market supply have contributed to recent investment grade underperformance vs. high yield, especially in Europe. In spread terms, global indices are the place to go for an illustration of this narrative, as investment grade continues to trade at decent levels compared to high yield based on a three-year look-back period. We maintain a preference for European investment grade from a valuation perspective, and continue to focus on the belly of the curve (five-to-ten years) where we see the best balance of convexity and spread available.

In absolute terms, investment grade spreads are just above average over a five- or even 10-year history. We are mindful of long-end exposures which look rich in relative terms, and may be more susceptible to a continuation in interest-rate-related volatility. From an asset allocation perspective we favour defensive exposures in sectors such as utilities, telecommunication and packaging, while reducing exposures in areas such as homebuilders which have experienced strong performance and now trade at unattractive levels relative to their inherent risk. Having sold off materially in the wake of the March banking crisis, financials, particularly subordinated layers, also continue to trade wide to corporates. We remain constructive on national champion European financials: we view them as being fundamentally sound and less exposed to the regional banking issues seen in the US.

Figure 10: EU credit: High yield vs. investment grade

Source: ICE Bond Indices, Federated Hermes as at 25 May 2023.
Past performance is not a reliable indicator of future returns.

Global high yield: In high yield, with issues concerning the debt ceiling now resolved, the US market has been able to catch up with the strong performance of Europe from a valuation perspective to trade around fair value on a three-year look-back period. Corporate fundamentals remain robust for the time being, however, we expect some deterioration going forward and therefore see dispersion as a likely theme over the coming months, especially in the higher-levered section of the market. From a rating perspective, BB-rated bonds have outperformed both BBB and Bs recently, leaving them trading at expensive levels based on a three- year look-back period.

Figure 11: US BB vs. BBB corporates

Source: ICE Bond Indices, Federated Hermes as at 25 May 2023.
Past performance is not a reliable indicator of future returns.

ii) Stressed, distressed and special situations

Spreads remain within historic bounds but caution looking ahead is warranted.

The percentage of the high yield benchmark trading below 80 continues to hover around the 10% mark. Here, the broader High Yield Index and single-Bs are tracking with an average cash/price in the 85-90s region, while CCCs remain with a cash/price in the 70s region. In spread terms, CCCs are around one standard deviation cheap to the historical relationship with the High Yield Index, as shown in Figure 12 below.

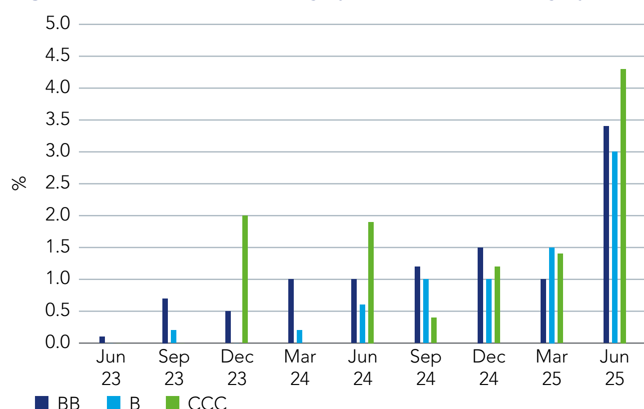
Figure 12: CCC vs. US high yield

Source: Federated Hermes Limited, FactSet, as at May 2023.
Past performance is not a reliable indicator of future returns.

In dispersion terms, CCCs are at 53% (ranking at the 62nd percentile) as of end of April. For high yield, the dispersion level of 74% is also quite close to median dispersion levels at around the 54th percentile. Therefore, we are not seeing an outsized dispersion level that might be expected in a more recessionary environment. Distress levels are fairly benign within the High Yield Index, with EM USD HY ticking up slightly to 14%, which is modestly higher than the DM USD HY levels of 9%[5].

We expect a key driver of potential distress over the next year to be the growing concern around corporates' ability to address maturity walls. Here, we note that CCCs have 11% of bonds due by June 2025, and 24% of loans. Across high yield ratings, the most exposed names to maturity walls through to June 2025 are the gaming, auto, and transportation sectors[6].

Figure 13: Face amount of high yield bonds, maturing by quarter



Source: BAML, as at 5 June 2023.

Dispersion definitions:

- The proportion of face value in the DM USD HY Index is marked outside +/-100bps of the overall index level.
- In CCCs, the proportion of face value is marked outside +/-400bps of that rating's subindex level.

[5] Federated Hermes Limited, BofA Global Research, as at 30 April 2023.
[6] Federated Hermes Limited, BofA Global Research, as at 30 April 2023.
[7] The Financial Times, as at 18 May 2023.

iii) Financials

Last year was considered an average-to-good year for holders of shares in global financials, but less so for holders of those same companies' bonds. This year, following a spate of banking collapses, Filippo Maria Alloatti, Head of Financials (Credit), outlines the key reasons why it is crucial to restore investor trust and engagement in the (AT1) sector of the market.

Fundamentals have been strong in the first quarter of 2023, illustrating the benefits of normalised rates (higher net interest income), higher capital, stable funding and, most importantly, given recession fears, a more reassuring asset-quality outlook.

The asset class will benefit from markedly-enhanced disclosure requirements, a more stable deposit base and more realistic valuations on commercial real estate (CRE) exposure, even as the US Federal Reserve looks likely to continue with its hiking cycle. We discuss the overblown fears of system-wide deposit redemptions in our latest Fiorino blog.

This fundamental backdrop is important for the Financials sector, given the macro set up.

On the fixed income side, the sector is trying to move on from the banking turmoil of the first quarter. The European Banking Authority (EBA) held talks last month to discuss ways to boost investor interest in the additional tier 1 (AT1) market following the collapse of Swiss giant Credit Suisse, which resulted in Swiss authorities wiping out US$17bn in AT1 bonds[7].

Ideas highlighted include cancelling dividend payments before AT1 coupons can be approved [currently prohibited by Article 53 of the Capital Requirement Regulation (CRR 1)] or the more revolutionary possibility of deferring coupons, rather than cancelling them. These would require legislative change at the EU level.

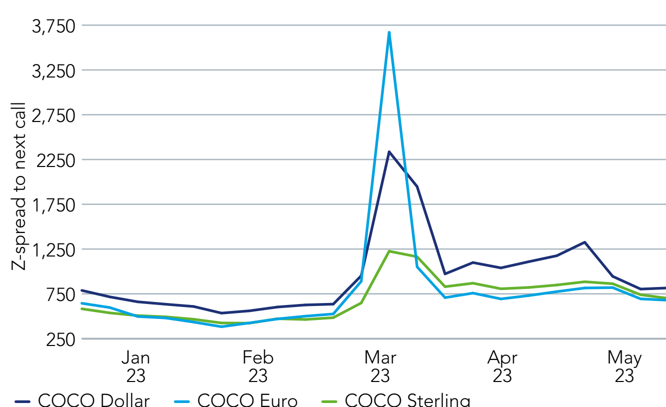
More broadly, the AT1 asset class plays a significant role for the following key reasons:

- **Size:** The AT1 is an important market for banks' capital with more than US$245bn in the sector. On average it represents more than 250bps of a bank's risk-weighted assets (RWA). A functioning AT1 market is important for the pricing of other bank liabilities, such as senior bonds.
- **Unintended consequences:** Without AT1s, banks would have to hold more common equity (CET1), restricting their lending capacity, which would be particularly detrimental for bank-centric Europe by lowering their prospective return-on-equity (ROE).
- **Regulatory support:** Regulators have stood behind the asset class in difficult periods before, such as the oil price slump of Jan 2015, the Covid-19 pandemic in March 2020, and during Q1 of 2023 after the Credit Suisse event. If the regulators want to revive confidence in the asset class, then it might look at ensuring AT1 bonds provide more security and other fixed income-like attributes, hence the dividend stopper and the idea of making coupons cumulative.

- **Rates:** We are at, or close to, peak rates. This should support depressed cash prices.
- **Supply:** Supply has been non-existent since the Credit Suisse demise. Banks are therefore running excess CET1 ratios, and the majority of 2023 calls have been pre-financed.
- **Fundamentals:** As mentioned above, fundamentals were strong in the first quarter, highlighting the benefits of normalised rates (higher net interest income), high capital levels, stable funding, and a solid asset-quality outlook. They have also seen markedly enhanced disclosures, such as deposits, commercial real estate (CRE), and so on.
- **Pricing:** Only about 10% of the market is trading to first call. From a historical standpoint, we believe this is too harsh as the market will eventually differentiate between issuers.

As evidenced in the chart below, AT1s are recovering some of the mark-to-market losses but are still wider year-to-date (YTD). We see value in the asset class and catalysts on the horizon.

Figure 14: AT1 year-to-date Z-spread evolution, by currency



Source: Credit Suisse Index Plus, as at 31 May 2023.

[8] Credit Suisse European Corporate Hybrid Index, as at 31st May 2023.

iv) Corporate hybrids

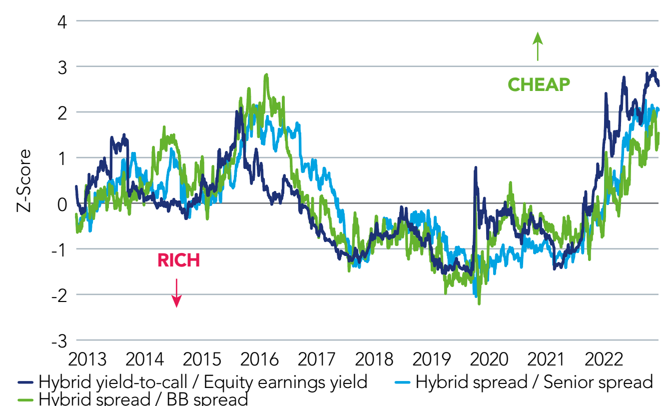
Given the subordinated nature of corporate hybrids, credit selection is vital. However, with valuations where they are, we believe the asset class offers an attractive return proposition for credit investors.

When comparing corporate hybrids to equity, BB-rated corporates and investment grade, the asset class continues to screen as being attractively valued notwithstanding outperformance over recent weeks, particularly when compared to equity and BBs.

The average yield on the Credit Suisse European Corporate Hybrid Index was 8.1% at the end of May, compared to an average earnings yield of 7.6% on the Stoxx 600 Equity Index[8]. Similarly, credit spreads on the Credit Suisse European Corporate Hybrid Index were at 565 bps, compared to 371 bps for BB-rated European high-yield issuers and 148 bps for European non-financial investment grade issuers.

Interest-rate volatility and sector-specific issues have provided headwinds for the asset class recently, however we feel fundamentals remain solid and an allocation to hybrids continues to offer an attractive risk/reward profile for credit investors at this stage of the cycle.

Figure 15: 10 years of European corporate hybrid relative values



Source: Bloomberg, Credit Suisse Indices, Federated Hermes as at 31 May 2023.
Past performance is not a reliable indicator of future performance.

From a technical perspective, primary activity is likely to remain subdued in the near term, leaving hybrids insulated to some degree from the issuance pressures being placed on corporate seniors. That said, investors remain cautious following news of calls being skipped in the Real Estate sector, which remains under pressure, and general concerns around hybrid securities following the Credit Suisse additional-tier one (AT1) write-down. (For more on our AT1 outlook, please visit our website).

With the fundamental outlook for corporates expected to weaken going forward, investors within hybrids need to continue to emphasise issuer selection, as a solid credit profile is key to minimising extension risk and avoiding more material losses should the issuer become distressed. We

maintain our view that owning subordination risk in high-quality issuers is likely to offer an attractive risk/reward profile compared to taking additional credit risk in BB-rated corporates as we move into the second half of the year.

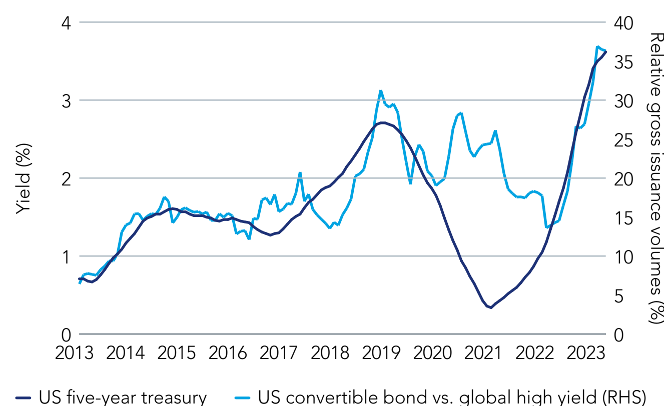
v) Convertible bonds

After a lethargic 2022 for new issues, the convertible bond market is showing its usefulness as a source of capital for corporates.

Attractive funding levels as compared to those available in the straight bond market continue to provide a tailwind for convertible bond issuance.

Global volumes amounted to just over US$33bn year-to-date[9], well above last year's pace and more closely in-line with pre-Covid run-rate averages, in the wake of soaring and volatile interest rates.

Figure 16: Convertible bond vs. high-yield primary volumes against interest rates



Source: BofA Global Research, ICE Data Indices, LLC, Bloomberg, May 2023. Please note that US five-year treasury yield and US convertible bond vs. global high yield relative gross issuance volumes series are on a one-year rolling average basis.
Past performance is not a reliable indicator of future returns.

Primary market trends in 2023 so far have helped to spur on diversification within the convertible universe, with a greater proportion of sales driven by investment-grade issuers, outside the norm of younger, lower-quality companies that have dominated the space since the pandemic-era financing wave. This is a theme we welcome, as it has helped to improve the overall credit strength of the market.

Looming refinancing needs, concerns around funding cost upswings, as well as concerns around the impact on interest coverage ratios will continue to drive this dynamic – and it is no surprise, therefore, that an increasing number of large, high-quality issuers are seizing the opportunity to shave points from their annual coupon expense (relative to levels realised via straight debt, for instance). Here, the focus is on managing upcoming liabilities earlier and on diversifying funding away from traditional sources.

Given this backdrop, we continue to view the higher, and still rising, rate environment as a tailwind for convertible bond new issuance in the near-term, as a function of the instrument's attractive cost and financial flexibility. We expect that the participation of repeat issuers will support this momentum – as will the first-time involvement of larger-cap issuers seeking to alleviate impending credit fundamental problems.

vi) Emerging markets

Despite a turbulent year for emerging market corporates and sovereigns in 2022, the asset class is now looking healthier compared to developed markets. However, caution is advised as headwinds remain in place given the likelihood of higher terminal rates threatening to weigh on EM growth.

Emerging market (EM) corporates look rich versus their developed market (DM) counterparts following the compression we saw between the two segments starting in early Q4 of 2022. This is true in both the high yield and investment grade space, as shown in Figures 17 and 18, which indicate EM currently trades at least one standard deviation rich to DM. As such, we continue to adopt a relatively cautious stance towards our EM corporate allocations and positioning given the uncertainties in recession timing, depth, and how 'global' it will be. Over recent months, our positioning has also become more concentrated as we focus our attention on bellwether EM companies with good liquidity and fundamentals.

Figure 17: High yield – EM vs. DM

Source: Federated Hermes Limited, FactSet, as at May 2023.
Past performance is not a reliable indicator of future returns.

[9] As at the end of May 2023.

Figure 18: Investment grade – EM vs. DM (US$)

Source: Federated Hermes Limited, FactSet, as at May 2023.
Past performance is not a reliable indicator of future returns.

Against this backdrop, we remain cognisant that emerging market growth and assets will face headwinds from a higher terminal rate in the US amid limited policy support in China in the upcoming months. Also, we note that large headline disinflation in EMs is underway, even as core prices remain sticky. Emerging market tightening cycles are nearing their end, but we do anticipate the start of rates cuts will be pushed further into the second half of the year, with the potential risk of shallower cycles.

The loss of economic momentum in China in Q2 suggests that authorities will cut reserve requirement ratios (RRR) and policy rates in the near-term. We do not think we will see pro-growth announcements in upcoming months, and instead expect to see slowing growth in Q3, a deepening property contraction, rising disinflation risks, and slowing credit growth with both corporate and household confidence remaining subdued.

In EM corporates we expect to see decompression in spreads, with investment grade outperforming high yield. The investment grade credits in which we invest continue to exhibit good fundamentals and resilience, while high yield segments are more vulnerable to market volatility and sovereign 'noise'. The Chinese property sector remains deeply distressed – despite government efforts late last year to 'prop-up' the sector and ease pandemic restrictions.

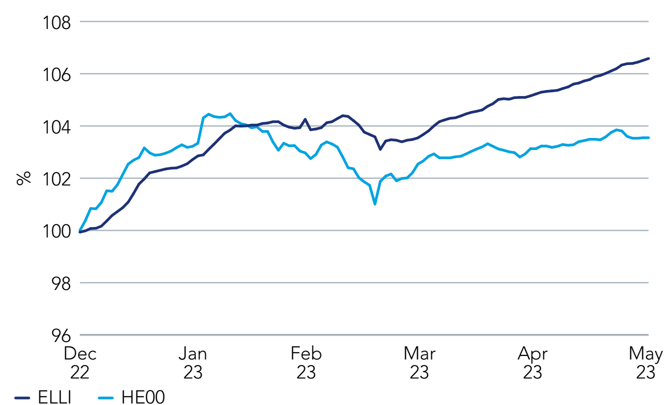
vii) Leveraged loans

Against a backdrop of volatility, European leveraged loans performed well and proved resilient to the March banking collapse.

The total return of the Morningstar European Leveraged Loan Index (ELLI) posted +6.77% year-to-date vs. +3.82% for the ICE BofA Euro High Yield Index (HE00)[10], as shown in Figure 19 below. This outperformance was supported by a strong secondary market, as the European loan Index ended May 23rd at 94.62, compared to 91.34 at the end of last year.

Even so, the dispersion between performing loans and discounted obligations is clear: the percentage of names trading above 95 went from 53% in March to 69% at the end of May, while the share of names trading below 80 only decreased by 0.76% (to 3.00%)[11].

Figure 19: European Leveraged Loan Index (ELLI) vs. ICE BofA Euro High Yield (HE00)



Source: Bloomberg, as at 31 May 2023.
Past performance is not a reliable indicator of future returns.

Looking at fundamentals, it seems that European leveraged loans are still holding up – driven by a default-rate-by-principal amount of 0.60% vs. a 2.61% peak during the Covid-19 pandemic, a CCC+-or-lower bucket of 5.13% vs. 9.22% in November 2020, and limited refinancing risk as 94% of the names are due in 2025 or after[12].

Finally, one of the main topics expressed by the market is the inability of collateralised loan obligations (CLOs) to refinance or reset. Consequently, the share of CLOs out of their reinvestment period (in other words, using the loans repayments to amortise the CLO structure rather than reinvest cash) will reach roughly 37% at the end of the year. This is a significant share which could have an impact on leveraged loan issuances and spreads, as CLOs represent approximately two thirds of loan buyers.

In this event, we view the main outcomes being:

1) As leveraged loans' spreads increase, there is an increase in competition from direct lending funds, or:

2) Borrowers favour bonds (though this is unlikely if rates come down from current levels).

viii) Structured credit

Robust employment numbers continue to support the asset class.

Having undergone a significant repricing of risk in the structured credit markets following the liability-driven investment (LDI) crisis in Q3 of 2022, it does feel somewhat

[10] Bloomberg, as at 31 May 2023.
[11] Loan credit default swap index, as at 31 May 2023.
[12] Loan credit default swap index, as at 31 May 2023.

like the ‘calm before the storm’ on the credit fundamentals side. In our view, this provides an attractive buying opportunity for investors.

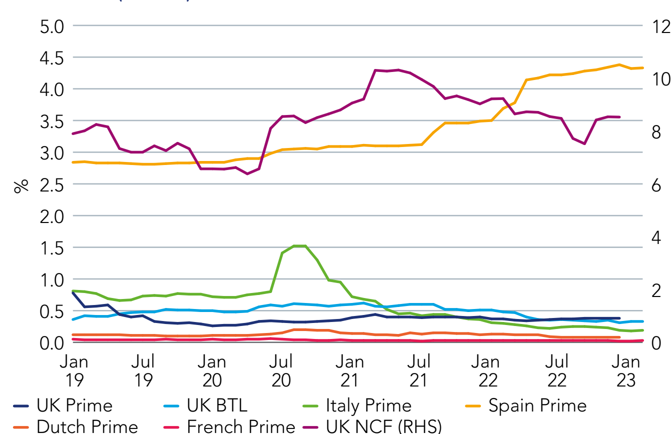
Year-to-date, spreads for most asset-backed securities (ABS) tranches have tightened. Looking at UK non-conforming as an example, AAAs have tightened 30-40bps from mid-100bps to low-100bps. Across investment-grade mezzanine tranches, the re-pricing has been more in the order of 50-70bps.

From an issuer’s point of view, as pricing has improved, so has the motivation to come to the market when compared with the beginning of the year. The result has been an increase in the volume of new issues – and at the current run rate, the European ABS market is on course for approximately €60-65bn of issuance this year.

As we have discussed previously, the outlook for credit fundamentals appears challenging, with rates and inflation causing strain on consumers’ finances. The one saving grace underpinning the relative stability in credit fundamentals right now is the encouraging labour market data we are seeing across the countries in which we are invested. Post-Covid unemployment numbers remain low – and this provides support for the types of consumer products – mortgages, car loans, credit cards – that make up much of the European securitisation market.

Looking at 90+ days arrears in residential mortgage-backed securities (RMBS) across multiple countries, we can see there has not been a deterioration across most markets (see Figure 20 below).

Figure 20: 90+ days arrears in residential mortgage-backed securities (RMBS)



Source: Moody’s, as at 28 February 2023.

In this, however, we note that it is not unusual for performance in ABS structures to hold up while the economic cycle turns. This is due to a number of factors. First, there is the conservative nature of the origination of the underlying assets; then there is the diversification of the collateral pools, which make up a vast number of underlying loans to consumers. Finally, on top of this, structures are designed to withstand significant stresses – far exceeding what we are seeing currently.

The robustness of structures and the continuing performance of collateral is corroborated by recent actions by rating agencies, with more tranches being upgraded than downgraded so far in 2023. Nevertheless, the risks have been well flagged and while investors may be attracted by higher spreads and higher returns, they would still do well, in our view, to exercise caution.

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- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

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