360°

Debt, deficit, dispelling doubts

Fixed Income Report
Q4 2023

Federated Hermes Limited

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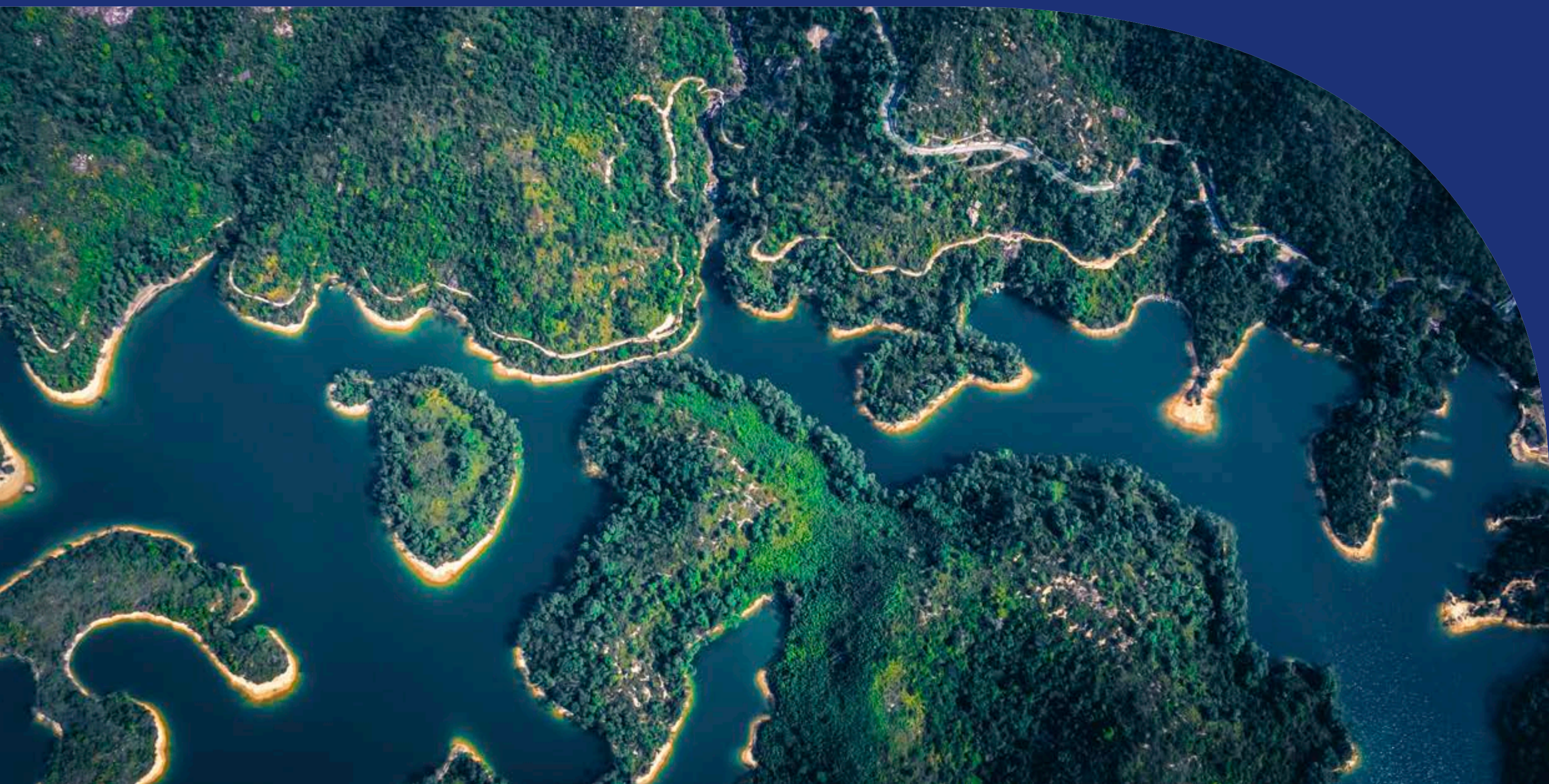

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Commentary

Identifying 'rising stars' amid a darkening fundamental outlook

Our recent team discussions have focused on the effects of the likely regime change from inflation concerns to growth concerns. This may result in more tailwinds for fixed income with lower inflation and central bank tightening, but we expect the corporate landscape to witness increased headwinds as fundamentals weaken. Against this backdrop, investors will have their work cut out to identify areas of the fixed income universe that will benefit from the former but remain insulated from the latter.

With a darkening of the macro firmament, we believe there is one area within the fixed income universe that offers a bright spot for those who know where to look: the so-called 'rising stars'[1], where credit quality and ratings are transitioning from high yield to investment grade. At this stage of the cycle, we believe this is an area of the fixed income spectrum which could provide an important source of alpha for investors.

Indeed, at the most recent count, this cohort outnumbered their counterparts going in the other direction – 'fallen angels'[2]. This is surprising given the broader economic outlook. Tighter policy has raised the cost of borrowing, and lending standards have become more restrictive – and both factors have curtailed the supply of credit and constrained economic activity.

Indeed, the International Monetary Fund (IMF) has projected that the global growth slowdown overall this year will be significant, falling from 2.7% in 2022 to 1.5% in 2023[3]. Second-quarter earnings have indicated a notable slowdown in cyclical and consumer-sensitive sectors, with chemicals, paper, and consumer electronics particularly weak.

Balance sheets remain robust, but credit metrics are starting to deteriorate. With weaker earnings and 2025 maturities approaching, issuers will need to begin addressing this – and, as ever, access to capital is key.

> **With a darkening of the macro firmament, we believe there is one area within the fixed income universe that offers a bright spot.**

Strong, and only getting stronger

Exploiting the opportunity set among potential rising stars requires an in-depth knowledge of the market and a bottom-up approach. Credit analysis offers insights into the many triggers that can cause a bond's rating to change, and aids our ability to distinguish investment candidates from those that could begin to deteriorate, both in terms of rating and performance. We also interrogate management's policy when it comes to rewarding shareholders at the expense of prudent financial discipline – a common late-cycle red flag.

[1] **Rising stars** are bonds that were considered speculation grade when issued but have since improved their financials, reducing the risk of default.
[2] **Fallen angels** are bonds that at one time in the past were considered to be investment grade and are now categorized as 'junk' bonds due to a reduction in the issuer's credit rating.
[3] IMF, 'World Economic Outlook: A Rocky Recovery', as at April 2023.

At a time where growth concerns are building, and margin pressure through cost inflation persists, identifying credits that remain on a positive trajectory should be a rewarding offset to a challenging macroeconomic backdrop. In recent quarters, technology giant Netflix, US retailer Macy's and integrated energy company EQT have all graduated to rising stars status. We have seen their strength fully recognised by rating agencies; they have made significant improvements to their free cash flow generation while reducing leverage. They have also been proactive in refinancing upcoming debt, terming out the liability term structure and lowering their cost of capital.

We expect there could be further examples to come into 2024, with several candidates currently sitting on a 'positive outlook' at the rating agencies – a precursor for some to a rating upgrade. Additionally, rating agencies tend to want to see sustained credit metric improvement before acting, and so the passage of time will naturally aid further rising star activity among those already deemed to be on a positive trajectory.

More buyers than sellers

The potential reward is further bolstered by another less tangible, technical tailwind. The rising star transition brings with it benchmark eligibility and inclusion dynamics. The resultant passive demand that meets this change typically sees such securities well sponsored, with deep bids in the market in the subsequent months.

Across the fixed income spectrum we see other notable areas of opportunity as we balance the competing forces.

This effect is even more pronounced as the investment grade asset class is today standing on its own two feet in terms of relative value. Where once it was hampered by a decade of low interest rates (making it difficult to compete against the growth of equities and strong dividend yields), it has now returned to form. Bonds can revert to their traditional role: balancing a portfolio but also providing a competitive yield. For issuers, becoming a member of this club is therefore even more attractive.

Focusing on other areas of insulation

Across the fixed income spectrum we see other notable areas of opportunity as we balance the competing forces. This paper goes into detail on where they reside – notably in the European structured credit market, particularly in CLOs[4]. Corporate hybrids, subordinated financials and synthetic credit remain areas we believe will outperform in the coming months.

Active management at the core

What is consistent to all these sub-asset class areas and themes is that effective identification of rising star candidates should always be based on an active approach. Modelling out forward-looking projections of a company's credit metrics is necessary to understand their financial robustness, while qualitative analysis is vital to understand the capital allocation policy, ESG and sustainability profile, and to bring together a holistic, long-term view.

We hope you enjoy this edition of 360° and welcome feedback on our views. To find out more about our wider credit offering, please visit our website**.**

[4] Collateralised loan obligations.

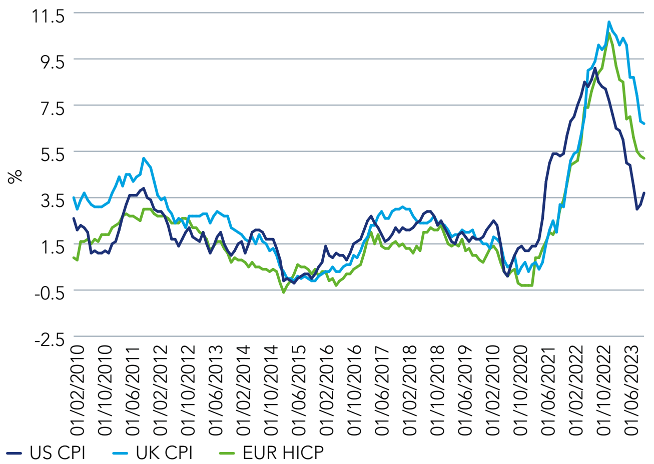
Fundamentals

Economic outlook

The economic picture remains one of slowing growth and inflation, with recession expectations largely pushed into 2024. Consensus now expects two years of sub-trend global growth with GDP in 2023 at 2.7% and 2024 at 2.4%. Developed market (DM) countries are expected to grow at 1.2% in 2023 and 0.9% 2024, within that H1 2024 is looking particularly weak with the US, UK, eurozone and Japan showing negative growth[5].

Inflation at a headline level continues to normalise; core is also off the highs but tracking lower more slowly. Consensus expectations see developed market consumer price indices (CPI) close to target in 2024 as tight policy constrains activity, unemployment slowly picks up and labour market pressures cool - with persistently higher oil prices an obvious risk.

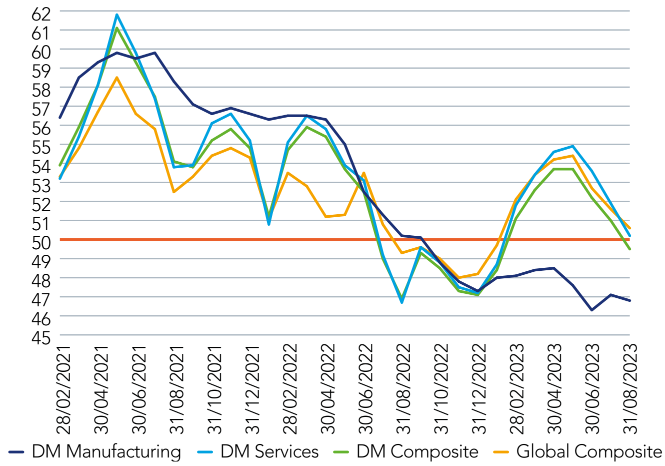
Figure 1: US, UK and eurozone CPI



Source: Bloomberg, as at September 2023.

While manufacturing Purchasing Managers' Indices (PMIs) have been sub-50 for most of the year, service sector demand, in contrast, remained robust until recently and is now hovering above contractionary territory.

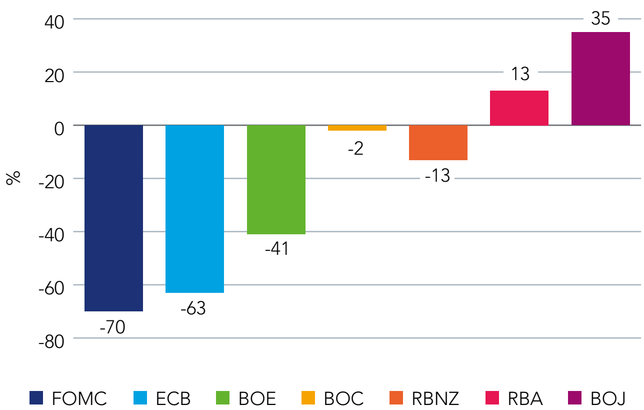
Figure 2: Developed market PMIs – Manufacturing, services, composite and global composite



Source: Bloomberg, as at 31 August 2023.

Developed market central banks have indicated they see themselves at the peak of the cycle, where they will stay for the foreseeable future. While the next move from most could be a hike or a cut depending on data, all else being equal we believe it's fair to conclude that this hiking cycle is largely 'done'. Certainly this is the message central banks are sending with their recent 'higher for longer' stance.

Figure 3: Cumulative implied central bank expectations to year end (2024)

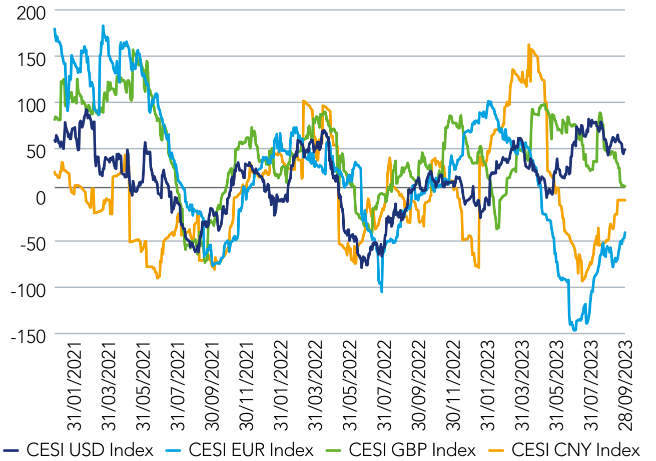


Source: Bloomberg, as at September 2023.

[5] All forecast data, Bloomberg consensus estimates as at 10 October 2023.

A central theme this year has been desynchronised growth in the US, the eurozone and China. Here, US growth has remained surprisingly strong in the face of tighter policy, while Europe and China have disappointed.

Figure 4: Citigroup Surprise Indices - US, Europe, UK and China



Source: Bloomberg, as at 28 September 2023.

Looking forward, risks abound and uncertainty around growth and inflation remains high. The irrepressible US consumer, after a period of robust performance, may be facing some headwinds, with student loan payments restarting after a long period of forbearance, excess savings balances declining, loan delinquencies rising and higher gas prices (+20% year-to-date) also acting as a drag.

Somewhat linked to this is the potential for financial stability risks to re-emerge. While the hiking cycle may be largely finished, central banks are continuing to press ahead with balance-sheet reduction. In this context, rising deficits and higher-for-longer rates highlight the need for increased term premia in debt markets. A disorderly transition here could destabilise markets and feedback into consumer confidence and labour markets. In Japan we have already seen changes to the yield-curve control policy. The market is pricing something of a hiking cycle from here but, even so, any hawkish surprises could be impactful.

We expect the outlook for the eurozone and UK to remain lacklustre. Weakness in Germany's manufacturing sector has not filtered across the region, but service sector PMIs are faltering. In the UK, headwinds linked to tight monetary policy are gaining momentum: PMIs are contracting, the housing market is cooling and the boost from fiscal support packages and positive terms of trade are fading. Unemployment has risen 0.8% from earlier lows and are expected to continue climbing. The post Covid-19 reopening bounce in China petered out quickly, giving way to growth and inflation disappointment. Going forward, growth will likely remain weak, though supported by ongoing stimulus from the People's Bank of China (PBOC).

Market outlook

After recession hopes were dashed, rates have repriced higher led initially by a re-rating of central bank easing expectations and then compounded by growing concern around sovereign debt burdens. While total returns in the rates space have largely been negative this year, we continue to believe that Fixed Income is attractive as an asset class. In the rates space, yields have broken out of established ranges with some risk of further moves higher under certain scenarios. However, with central banks largely on hold for an extended period and data continuing to come off slowly we believe it still makes sense to retain a moderately positive view on duration. **Duration +1 (long)**

Rates volatility has re-traced from the highs of the year but is elevated versus more recent history. We believe there remains potential for more volatility linked to the uncertain economic outlook and financial stability issues. **MOVE -1 (higher volatility)**

Curve steepening remains high conviction. It is asymmetric in our favour and would expect to see the steepening continue under a range of scenarios. The real bull case for being long steepeners is a weaker-than-expected economy, which would prompt an easing cycle; however, in the interim a need for increased term premia and inflation risk premia will remain supportive. **Curves -2 (steepening).**

Figure 5: Macro scores

Duration	Curves	Volatility
+1 duration	-2 steeper curves	-1 moderately higher volatility

Source: Federated Hermes Limited, as at 27 September 2023.

Corporate fundamentals

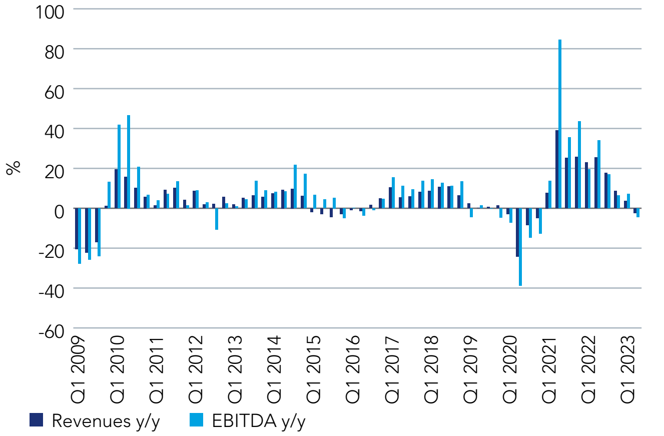
Corporate credit fundamentals have had a good run, but it's time to be more cautious.

After being relatively constructive on corporate credit fundamentals throughout the year, we are turning slightly more cautious from here. Through the second quarter we have seen a slowdown in cyclicals and consumer discretionary sectors, such as chemicals and consumer electronics. Although retail and overall consumer earnings have remained resilient thus far, we note that companies have become more tempered on their outlook for the second half of the year on expectations of weakening consumer spending. Also, while margins have remained steady, aided by easing cost pressures (labour, energy), the recent run-up in oil prices poses a risk that cost inputs will rise. It's also worth noting that for the first time in two-and-a-half years we have witnessed a decline in US HY EBITDA of -4.4%, primarily driven by cyclical sectors such as Metals & Mining, Chemicals and Energy[6].

Leverage also increased in 2Q to 4.17x, but remains below the long-term average of 4.37x (since 2008). Taken together, the decline in earnings and the tick-up in leverage are a sign that fundamentals appear to be slowing. Also, while the present interest coverage of 5.25x is still above the long-term average of 4.48x, we expect this to decline over the next two to three years. This is largely a function of companies refinancing elevated maturities within that timeframe (currently 9% and 22% of bonds in US HY Index respectively). The result will be a continued erosion of interest coverage and higher interest rates will mean a greater allocation of companies' free cash flows to service interest payments.

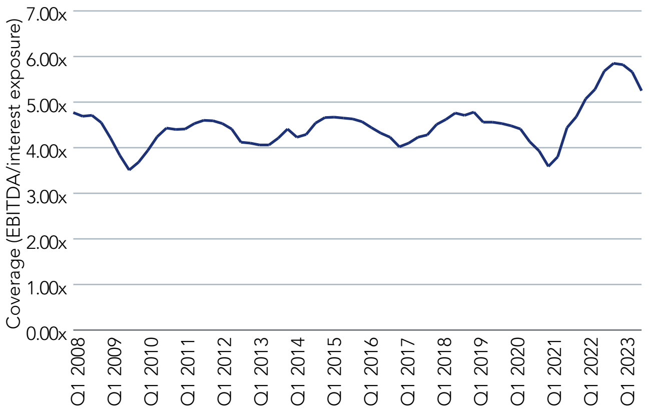
Despite our overall more cautious stance, the Telecoms sector is one area we have turned more constructive on lately, with price increases helping the top line while easing energy headwinds have supported profitability.

Figure 6: EBITDA trajectory indicates a slowdown

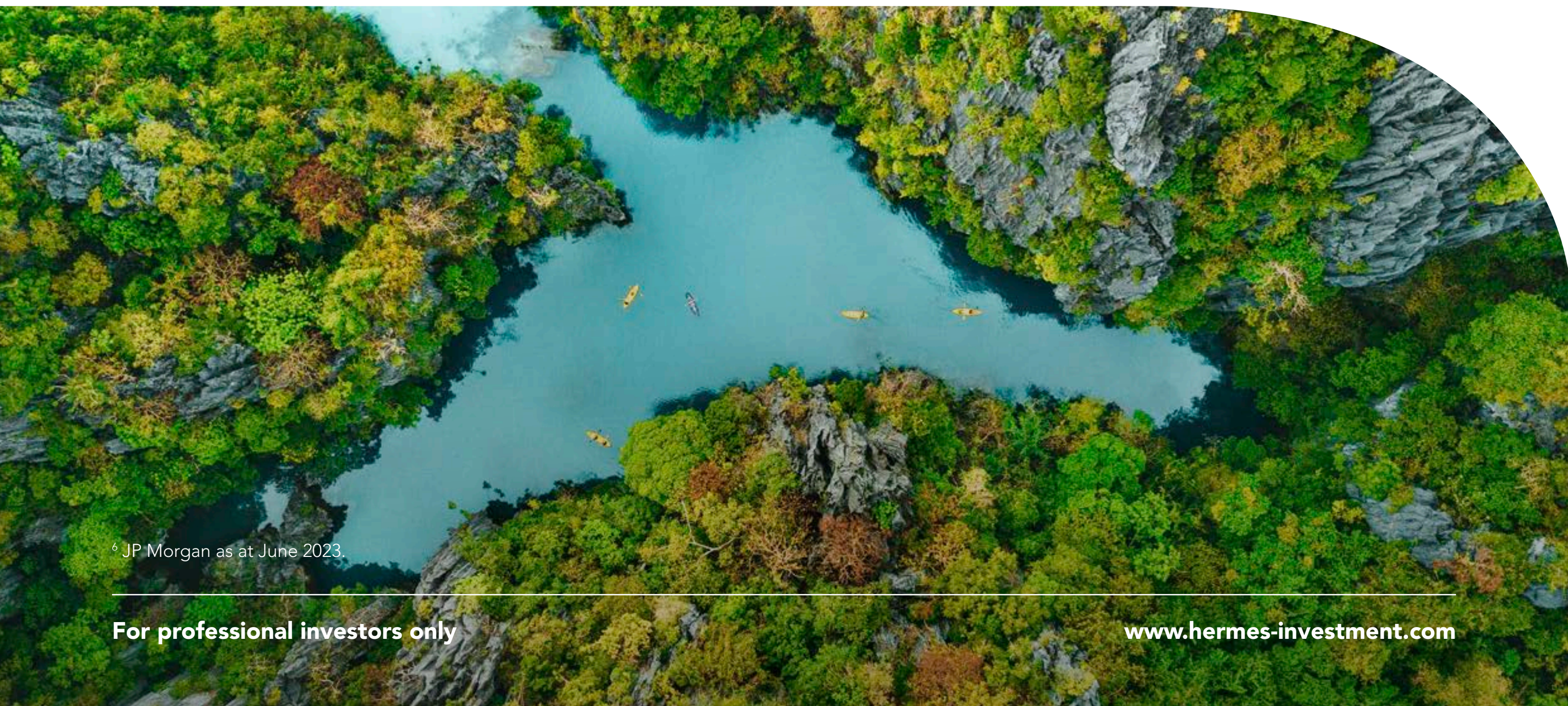


Source: JP Morgan, as of June 2023.

Figure 7: Interest coverage to be pressured as companies refinance with higher rates



Source: JP Morgan, as of January 2023.



[6] JP Morgan as at June 2023.

Corporate Issuer Behaviour:

According to JPMorgan, more than 60% of S&P500 companies increased their capital expenditure in the last 12 months to June 2023. In line with that, we've seen balanced issuer behaviours through the 2Q23 earnings season with regards to capital allocation.

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of S&P500 companies increased their capital expenditure in the last 12 months to June 2023.

Here, refinancing has been a major theme. This has had a positive effect on covenant quality particularly in EMEA, where refinancings are sometimes taking historical terms. Average covenant quality has risen in response – which is as you would expect given the general trend for covenant quality to leak over time. In contrast, covenant quality in North America remains in the Moody's category of 'weakest', despite companies taking advantage of secured capacity to issue new debt. Moody's note that where use of proceeds is for dividends, investors are pushing for better covenants.

One nascent theme given overall leverage in TMT is that of companies allocating more cash to pay down existing debt.

In certain sectors, such as Technology, Media & Telecommunications (TMT), companies have continued to pay dividends and capex programmes have generally continued, but there has been little in the way of new buybacks or dividends. One nascent theme given overall leverage in TMT is that of companies allocating more cash to pay down existing debt.

M&A remains depressed, with deal value down 32.1% YTD year-on-year[7]. Actual US dollar volumes remain light, and the only sectors showing M&A growth for YTD 2023 are Basics Materials, Utilities and Government Debt. M&A premiums are currently running high at over 50%[8] – and this may indicate a couple of possible trends: either acquirers targeting companies with depressed equity valuations or strategic buyers seeking deals with scope for synergies.

M&A remains depressed, with deal value down

32.1%

YTD year-on-year[7].

[7] Bloomberg to 26 Sep 2023.
[8] Ibid.

Sentiment, technicals and relative value

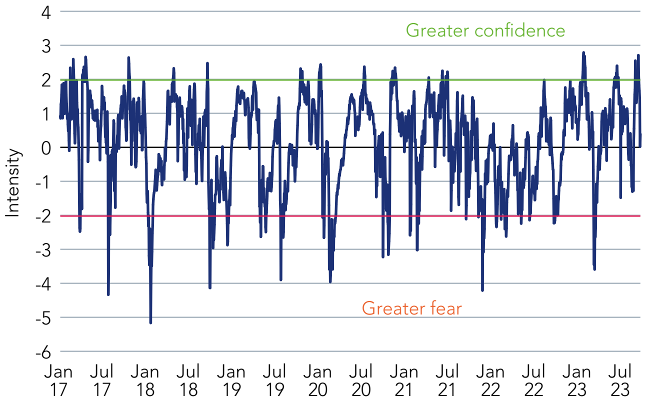
i) Sentiment

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.

Sentiment over the summer reverted to a more benign level and our indicators remain either neutral or moderately negative. This is true whether we look at things through the spectrum of equities, credit or volatility.

As an example, the MS global risk demand index shifted from high level of greater confidence to neutral.

Figure 8: Morgan Stanley Global Risk Demand Index



Source: Morgan Stanley, Bloomberg, as at September 2023.

In the same vein, the Fear and Greed index from JP Morgan has been in neutral territory especially when we look at the implied volatility and momentum components. Broadly, this remains the case despite recent news around the conflict in Israel.

Based on these observations we downgrade our score to 0, reflecting a more cautious sentiment in the market.

On the technical side it's Groundhog Day. Fundamentals are deteriorating slower than anticipated and in the meantime it's the tightness of technicals that's driving the market and keeping things in positive territory. While companies wait for an opportunity to refinance their debt, the flow of primary deals has been virtually non-existent, and we believe this

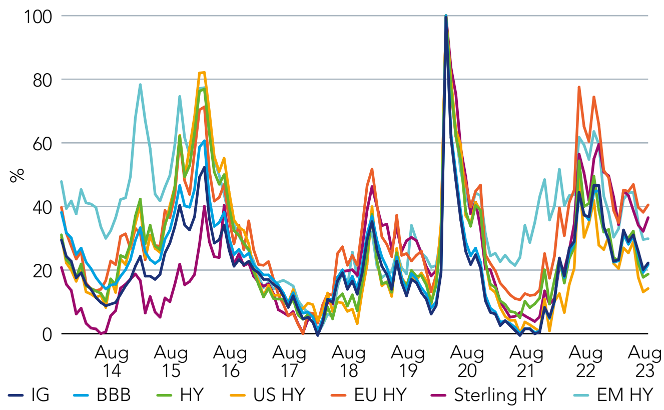
situation will probably continue for another 12 to 18 months. As a consequence, the High Yield market keeps on shrinking and credit spreads are repricing tighter.

On that basis we keep our score to +1

Looking at relative value there are two ways to tackle the matter: If we consider value on an all-yield basis, the recent further widening of rates makes the proposal fair to attractive. However, if we focus on credit spreads on a standalone basis, all sub segments of the credit market appear tight.

With Europe and Sterling HY closer to fair value while US HY appears the more stretched here. We maintain our previous score of -1.

Figure 9: Global credit - Credit Spread percentiles



Source: IceBaml and Bloomberg as at September 2023.

Catalysts

The known/unknown risk equation

Catalysts: events that could change our view from the base-case laid out in the fundamentals section of this report.

Positive catalysts: Our top-three positive catalysts start with a Q3 earnings surprise. Sell-side reports are still pretty pessimistic around the prospect for a meaningful earnings recovery in the quarter particularly in cyclicals, Any positive upside on Q4 2023 and 2024 outlooks would be a meaningful deviation from these expectations and this is our lead risk. Our other key upside risks include more meaningful Chinese stimulus and inflation being brought under control faster than expected.

Negative catalysts: Our top-three catalysts of concern include financial instability caused by curve steepening. This has the potential to cause 'known unknown' stress (consider previous issues around Liability Driven Investment and US regional banks, for instance). Elsewhere, global recession is a potential negative catalyst, as is higher-for-longer inflation. On the latter, we view this as becoming more of the base case for markets, though a tail of the tail risk is the potential for a central bank 'hard' pivot to quantitative tightening since this would be a significant change.

In term of valuations, we notice the market's relative lack of interest in general hedging. This situation is driving implied volatility lower while spreads remain rangebound. As a consequence, implied volatility is now trading at around its 5% percentile over a year while the underlying spread is closer to its 50% percentile and the delta between both is as big as ever recorded.

We believe this is not sustainable and the gap will narrow, allowing a window for topping-up the options book.

Overall, balancing the potential for upside events with the scope for negative developments, we maintain our known/unknown future catalyst score at -1.

Figure 10: 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	43.3	40.5	76.6	8	22	20	-9.2
iTraxx Europe Xover Series OTR 5y	38.3	36.1	69.0	7	3	13	-8.1
CDX.NA.IG Series OTR 5y	42.2	36.5	65.4	24	14	14	-3.3
CDX.NA.HY Series OTR 5y	39.4	34.0	69.7	25	15	31	-1.6

Source: Goldman Sachs, as at September 2023.

Credit relative value

i) Intra-credit opportunities

Uncertainty around the future course of central bank policy remains the defining driver of valuations across high yield and investment grade opportunities

Global investment grade: Global government bonds continued to sell off through Q3 2023. This was partly in response to the mood of uncertainty around longer-term rates as higher oil prices and robust economic data continued to put pressure on expectations for inflation and the resulting rate trajectory.

In credit markets, this mood of uncertainty weighed on higher quality credit. Conversely, the US 'soft-landing' narrative coupled with summer liquidity provided support to high yield. As a result, investment grade has continued to trade at attractive levels versus high yield in both the US and Europe.

Within the investment grade market, Europe has outperformed the US and still trades at around a one standard deviation discount in spread terms based on a three-year look-back.

While US growth is stronger than in Europe and investors are more optimistic in the US currently, we believe US consumption-led growth may start to come off the boil as factors such as the resumption of student loan payments take effect – and this may be a catalyst for some compression between the two markets going forward.

Figure 11: IG – US vs. EUR

Source: ICE Bond Indices, Federated Hermes as at September 2023.

> **Within the investment grade market, Europe has outperformed the US and still trades at around a one standard deviation discount in spread terms based on a three-year look-back.**

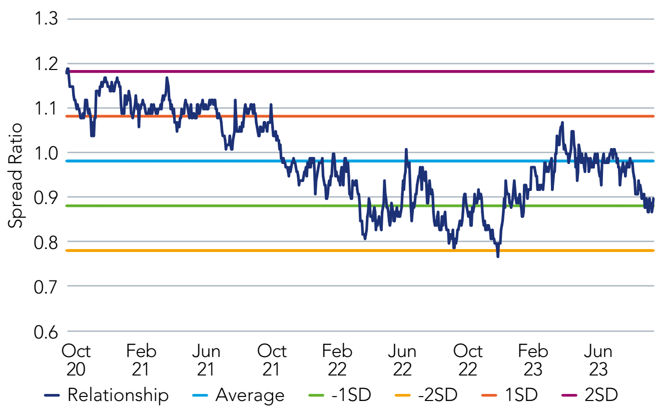
We maintain a preference for the European market from a valuation perspective and continue to focus on the belly of the curve (5-10 years) where we see the best balance of convexity and spread available.

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 a sector perspective, we have turned more cautious on the US homebuilding sector where valuations are trading at unattractive levels and may be at risk in a slowdown scenario. Instead, we focus on more defensive sectors such as utilities and telecoms as well as national champion European financials where fundamentals remain robust and valuations offer investors an attractive risk reward. At 5.82%, investment grade yields are at their highest since 2009[9], offering investors an attractive entry point in our view, while spreads close to longer term averages mean there is some credit risk already priced into the market.

Global high yield: US high yield has outperformed Europe in recent months, led by a compression in lower-rated credit, leaving the US market trading at around one standard deviation rich to Europe. Our preference remains for positioning within European high yield from both a valuation and sustainability perspective, especially in the belly of the curve which remains the sweet spot for relative value.

Figure 12: HY – US vs. EUR



Source: ICE Bond Indices, Federated Hermes as at September 2023.

[9] ICE BofA Global Corporate Index, as at 3 October 2023.

Decompression continues to be a theme we expect to play out in the medium term, especially given the significant outperformance year to date of highly levered CCC-rated debt. Central banks have continued to raise expectations around a 'higher for longer' scenario for interest rates, suggesting rate cuts are not likely to be forthcoming in the near term.

Against this backdrop, the 2025 high yield maturity wall is fast approaching, and issuers will need to start thinking about refinancing options in 2024. Corporate fundamentals generally remain robust, however some combination of economic slowdown and higher refinancing costs could make for a challenging operating environment for highly levered issuers going forward.

With the high yield market paying over 9% yield in absolute terms[10], we feel this remains an attractive investment proposition. Nevertheless, dispersion is rising, and credit selection will be key from here.

From a sector perspective, the energy sector is a space where we believe investors need to be especially selective. It makes up a large portion of the global high yield index and has outperformed recently on the back of the rise in oil prices, leaving it trading at expensive levels. Within the energy sector, picking winners requires both a deep understanding of fundamental characteristics as well as environmental concerns, with long-term financial credit worthiness being inherently linked to the issuers' decarbonisation ambitions and progress.

To find out more about our sustainable fixed income offering, please visit our SFI landing page.

Figure 13: US HY – Energy vs. global HY

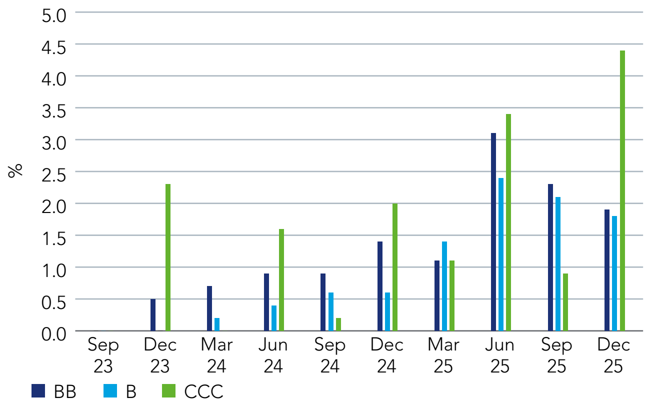
Source: ICE Bond Indices, Federated Hermes as at September 2023.

ii) Stressed, distressed and special situations

Defaults forecast to peak by Q1 2024.

Debt maturing in the next two years continues to flash as a warning signal, with triple-Cs in 2025 facing a particular maturity wall[11].

Figure 14: High yield bonds maturing by quarter (%)



Source: Federated Hermes Limited, BofA Global Research, Bloomberg, as at September 2023.

Dispersion remains around median levels in triple-Cs and is below median levels in high yield[12]. Moody's have revised down their default rate scenarios and now expect defaults (a function of higher rates and lower corporate earnings) to peak at 4.7% in Q1 2024 before easing to 4.2% by August 2024. This is under the assumption that economic activity will continue to slow this year and into 2024 in most countries, including the US, as the full effects of tight monetary policy on aggregate demand come to bear. It also assumes central banks will maintain their current restrictive policy stance through 2024.

From a valuation point of view, the percentage of the global high yield benchmark trading below 80 continues to hover at c.10%[13]. Average cash prices of the high yield and single-B index are tracking each other around the 85-90% area, while CCC is between 70-75. On a spread basis, triple-Cs have been trading around face value.

US triple-C spreads look around one standard deviation cheap vs both single-Bs and the wider high yield index on a three-year basis. In Europe, triple-Cs are cheap versus single-B credits but slightly rich versus the historical relationship with the wider EU high yield space. This indicates that the triple-C versus single-B EUR relationship may be driven by current richness in single-Bs rather than EUR triple-C spreads being cheap.

[10] ICE BofA Global High Yield Index, as at 3 October 2023.
[11] BofA Global Research, September 2023.
[12] BofA Global Research, 31 August 2023.
[13] ICE BofA Global High Yield Constrained Index, 10 October 2023.

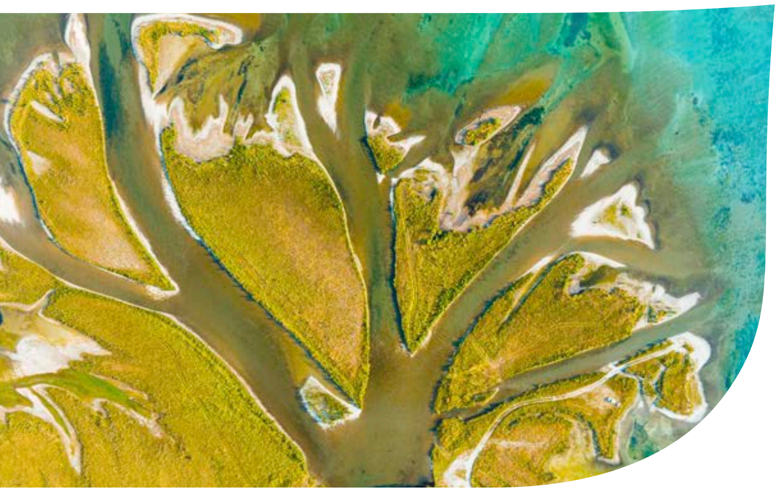
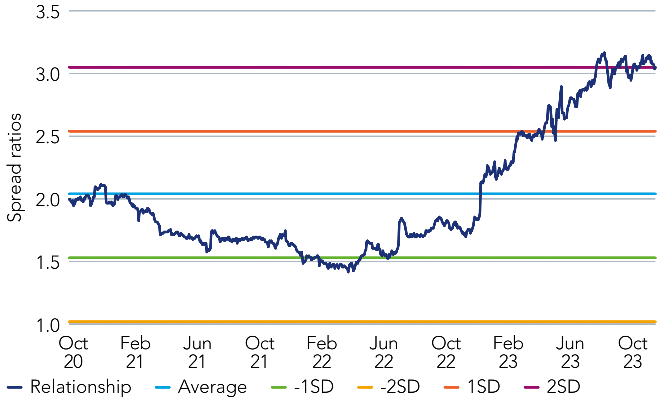


Figure 17: EU - CCC vs. B



Source: BofA Global Research, ICE Data Indices, LLC, as at September 2023.

Figure 15: US – CCC vs. B

Source: BofA Global Research, ICE Data Indices, LLC, as at September 2023.

Figure 18: CCC vs. EU high yield valuations

Source: BofA Global Research, ICE Data Indices, LLC, as at September 2023.

Figure 16: CCC. vs. US high yield valuations

Source: BofA Global Research, ICE Data Indices, LLC, as at September 2023.

iii) Financials

The picture for global financials remains a sound one.

When looking at balance sheet figures such as capitalisation levels (the CET1[14] ratio) for banks and the solvency metrics for insurers, the outlook appears rosy.

The P&L side tells a slightly different story, however, with the benefit of higher rates coming to an end. Here we think of the Net Interest Margin (NIM) peaking at US regional banks due to the higher cost of funding (deposits, mostly). Clearly, cost pressures are becoming more evident in this inflationary environment.

We believe this could affect the credit spreads of financials indirectly by way of pressure on shares, whose upwards consensus revisions are slowing down. Geographically this has not yet happened in Europe ahead of Q3 releases. Similarly, some recent disclosures from UK insurers paint a still favourable environment.

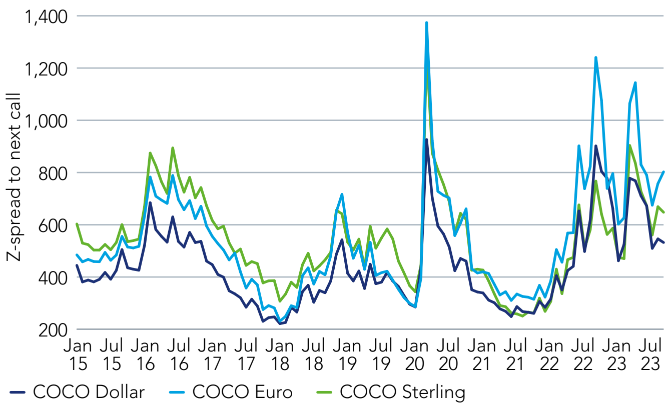
[14] **Common Equity Tier 1:** A component of Tier 1 capital that is primarily common stock held by a bank or other financial institution.

Notwithstanding the grim headlines, the world's major economies remain resilient, with the US in particular having rediscovered the benefits of old-style Keynesian deficit spending with the budget deficit expected just shy of 6% of GDP by the end of 2023[15]. Again, this helps asset quality trends, as (inevitably) they rise from their depressed levels post Covid.

Rates have been and continue to be a key driver of the market – and are also key for cash price products, such as global financial bonds. In terms of rates (and noting the positive convexity of the subordinated part of the capital structure), we would expect the following:

1) If central banks have completed their hiking cycle: Short- to mid-duration callable subordinated instruments (AT1/RT1s) will either reprice to call (assuming spreads rally) or reprice up towards their future implied higher coupons (assuming there are no calls).

Figure 19: AT1 2015 – 2023 Z-spread evolution, by currency



Source: Credit Suisse Index Plus, as at 25 September 2023.

2) If central banks continue to hike rates: Where this occurs via rate curve steepening (my base scenario), we would expect future implied subordinated debt coupons to continue to rise. This, we believe, should offset the impact of higher rates on short- to mid-duration call paper. After all, a yield is simply a discount rate and all things being equal, it makes sense that higher rates push up the Yield to Perpetuity (YTP), leaving the cash price unchanged.

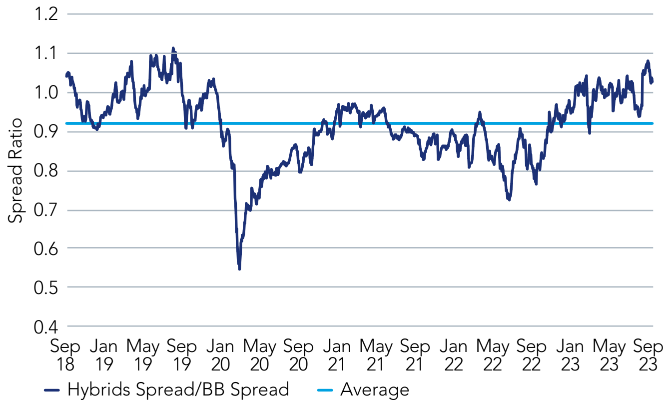
There is a general theme of financials: both banks and insurance being willing to pay up to call their subordinated bonds stack.

iv) Corporate hybrids

Issuance picks up against rising extension risk

The corporate hybrids sub-asset class has performed well year to date, with investment grade and high yield hybrids returning 5.37% and 6.53% respectively as at end of September in US dollar hedged terms[16]. Relative value tells a story of compressing spreads versus matched senior bonds – and this is in contrast with the wides we witnessed in late 2022. Nonetheless we believe this offers investors an attractive entry point at 231bps versus a historic average of around 200bps[17]. Hybrids also continue to screen attractive versus double-B-rated high yield, especially in the context of a 'higher for longer' scenario where bonds from higher levered issuers underperform.

Figure 20: Corporate hybrids vs. pan-European HY BB (excluding financials)



Source: ICE Bond Indices, Federated Hermes as at September 2023.

From a technical perspective, lower liquidity and interest rate volatility remain headwinds for the asset class. That said, new issuance has picked up after the summer lull and we have seen several performing issuers come to market to address near-term calls and reissue hybrids. New deals have been well supported by the market, with significant investor demand relieving potential pressure on valuations. Given the higher-cost funding environment, we do not expect a significant increase in net supply in the near term and some issuers may look to make use of rating agency flexibility to reduce the size of their hybrid layer and optimise capital structures. We expect issuers to be proactive around managing upcoming call dates, and may see more liability management exercises relating to 2024 calls as a result.

Extension risk remains at the forefront of many investors' minds – however, we continue to view this risk as low in the majority of cases where issuers remain performing investment grade. The bondholder friendly management of the majority of 2023 calls demonstrates ongoing issuer commitment to the asset class and investor base.

[15] Congressional Budget Office, as at September 2023.
[16] ICE BofA Global Hybrid Non-Financial Corporate Index and ICE BofA Global Hybrid Non-Financial High Yield Index as at end of September 2023.
[17] Barclays Research, as at September 2023.

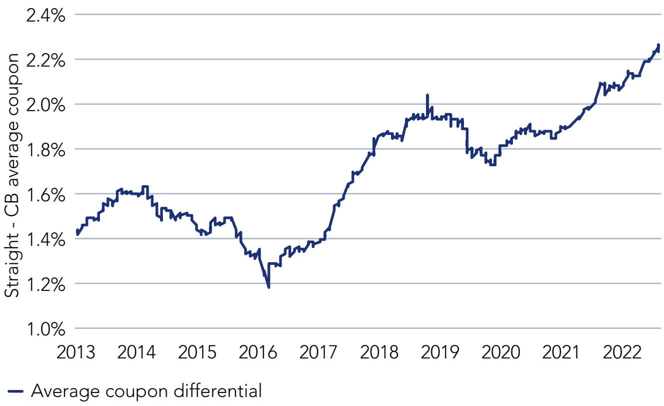
For many companies, the economic rationale for hybrids continues to make sense despite higher nominal yields, with hybrids offering a more cost-effective funding source than the equivalent mix of equity and senior issuance. As a result, we expect issuers to continue to make use of the hybrid market to fund capex programmes, especially in sectors such as Utilities and TMT where net-zero commitments and fibre network roll outs require heavy investment.

v) Convertible bonds

Primary activity in the convertible bond space has neared pace with pre-Covid averages, while continuing to lag across other debt capital market segments. Up to August 2023, around US$52bn priced globally, in-line with average volumes between 2012 to 2019[18].

Underlying this dynamic is the instrument's ability to offer borrowers lower coupon rates (in exchange for selling an embedded call option), a key benefit relative to other products when funding costs are elevated. As an example, the average coupon differential between US investment grade corporate bonds and convertible bonds in the secondary market stands at historical highs of around 2.2%[19].

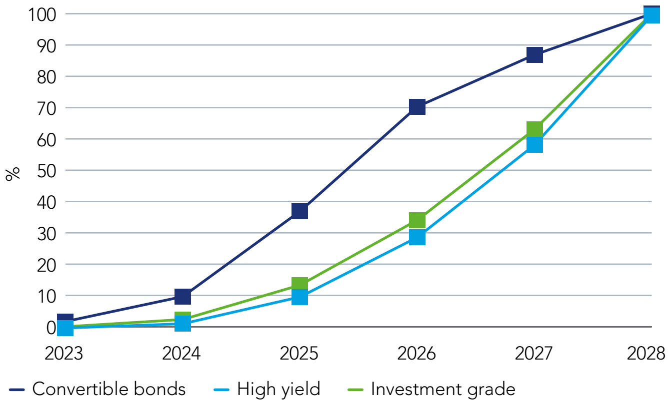
Figure 21: US IG vs. convertible bonds – Historical coupon differential



Source: Bloomberg, as of August 2023.
Past performance is not a reliable indicator of future performance.

At the turn of the decade, many companies took advantage of the low rate environment to term out their debt. The beginning of the hiking cycle across developed market (DM) central banks marked a cessation in that trend as interest rate volatility surged and treasurers stood on the sidelines. However, it has become increasingly difficult to wait things out with 2024/25 maturity hurdles on the horizon. Borrowers will either need to deal with their debt burden soon or accept the implications that stem from agencies reclassifying upcoming liabilities as current.

Figure 22: Convertibles, HY and IG - Cumulative maturity profile over the next five years



Source: Bloomberg, as at August 2023.

Around 40% of proceeds from converts this year have been for refinancing (almost double pre-Covid averages). Alongside regular participants, a portion of that issuance has come from traditional high yield and investment grade issuers entering the market in an effort to manage their interest expenses. We continue to expect this theme to persist.

vi) Emerging markets

Broadly speaking, EM growth rates remain robust but China remains a concern.

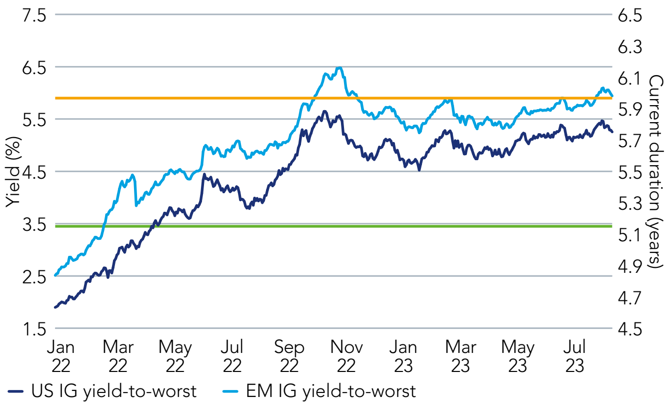
We believe that emerging market (EM) fixed income assets will be largely range-bound in the near term. EM ex-China growth is holding up decently and inflation in the developing world continues to fall, although recent moves in food and energy prices may interrupt the headline disinflation we were expecting to see. If developed market (DM) central banks keep rates higher for longer, that could complicate the task of some EM central banks and put pressure on those countries with high external debt burdens and rigid foreign exchange market (FX) regimes. We tend to focus on issuers with low external financing needs and commodity exporters – and we expect these to experience much less impact.

Chinese growth remains front and centre, with market expectations now downgraded to c.5% this year. Here, many issues remain. Weak private sector investment and housing market activity as well as the sustainability of the consumption recovery are among the key concerns. We have recently seen a flurry of policy action from the Chinese authorities – including cuts to the rate and reserve requirement ratio (RRR) by the People's Bank of China (PBOC), but also increased issuance of special local government bonds and some demand-side measures to ease the stress in the housing sector. However, these measures have been slow to impact the real economy so far and this is a concern for us.

[18] BofA Global Research, ICE Data Indices, LLC, Bloomberg, as at August 2023.
[19] Bloomberg, as at August 2023.

In the EM corporate space, one trend of note is the higher yield but shorter duration offered by EM investment grade corporates versus their US investment grade counterparts. The spread differential between these two segments is also towards the wider end of the range. Our favoured issuers in the space are stable, high-quality corporates (often with an export angle given the strength of the US dollar), which offer a decent pick-up to US investment grade and are supported by good technicals. Currently, we find value in the likes of Mexico and India, for example.

Figure 23: US vs. EM



Source: Bloomberg, as at 31 August 2023.

vii) Leveraged loans

In Q3-23, European Leveraged Loans continued to rally with Morningstar European Leveraged Loans Index posting +4.1% over the quarter[20]. This brings the year-to-date performance to +11.7% vs. +6.1% for the high yield index[21]. Looking at credit quality and ratings, single-B outperformed the rest of the index returning +4.4% over Q3 2023 versus +3.5% for triple-Cs and +3.1% for double-Bs.

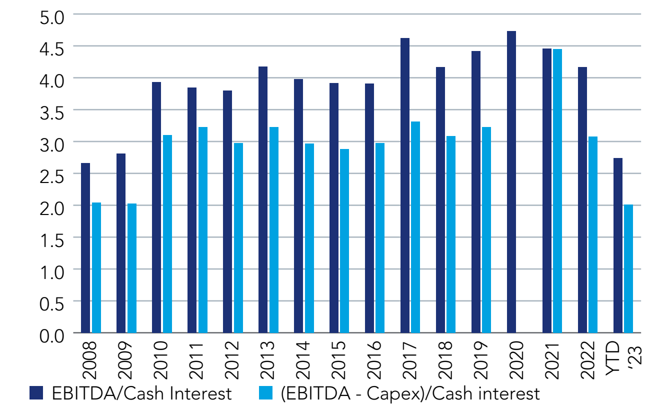
Finally, all sectors posted positive returns during the quarter with top-three performers being Households Durables (+7.1%), Aerospace and Defence (+5.3%) and IT Services (+5.3%). The bottom-three sectors were Life Sciences Tools & Services (+2.6%), Media (+2.8%) and Entertainment (+3.1%).

Regarding fundamentals, we still remain cautious. Although it seems that most of the borrowers put in place hedging mechanisms, we believe there could still be pressure on the top-line leading to concerns around companies' ability to pass-through inflation and building backlog. This is especially the case the Industrials and Building Materials sectors in our view.

In particular, we are seeing Interest Coverage Ratios reaching 2008 levels at 2.7x for standard ICR and 2.0x when adjusted to capex. Nevertheless, the 12-month default remains low at 1.3% by principal amount (versus 2.6% in December 2020) and triple-Cs at 3.2% (versus 8.5% in November 2020).

[20] All performance data, Bloomberg as at 30 September 2023.
[21] BofA Euro High Yield Index, also as at 2023.
[22] J.P. Morgan International ABS & CB Research, as at September 2023.

Figure 24: European interest coverage ratio



Source: Leveraged Commentary & Data (LCD) as at 30 September 2023.

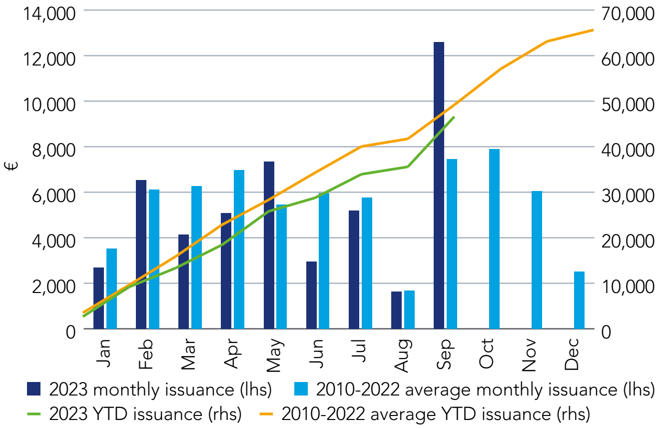
On the technical front, European leveraged loans were highly supported by the return of CLO prints (see Structured Finance section below). The European Leveraged Loan Index (ELLI) price ended the quarter at 96.42 (vs. 94.46 at the end of June) and we can also notice a continuous decline in the distress ratio (share of the index trading below 80), which declined to 2.2% at the end of Q3 2023 versus 7.0% at the end of October 2022. Given the strong CLO pipeline, we believe there is still residual value in European Leveraged Loans subject to picking the right credits.

viii) Structured credit

After a summer of low issuance volumes and subdued activity in the secondary market, the European structured credit market burst into life at the beginning of September.

More than €12bn of new issues priced during September in European Asset Backed Securities (ABS)[22]. That this amount of supply has been absorbed by the market in such a short space of time is remarkable, pointing as it does to high demand for this asset class right now.

Figure 25: Year-to-date new issuance volumes – 2023 vs. 2010-2022 average



Source: J.P. Morgan International ABS & CB Research, as at 25 September 2023.

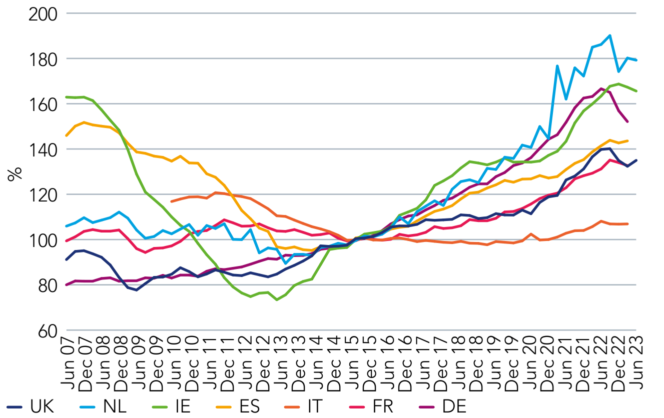
Equally, in the Collateralised Loan Obligation (CLO) space, the recent rally in spreads on the liability side has helped the economics work better and we have seen a pick-up in new issuance as a result. However, the strong technical bid from CLO managers for loans has meant loan pricing has recovered significantly from levels seen a year ago and the arbitrage (the differential between the cost of liabilities against what the assets are paying) for CLO managers remains challenging for equity returns, in turn tempering issuance.

We remain cautious on credit fundamentals for both the assets backing ABS and CLOs, although we still remain constructive on structures withstanding increased stresses from high delinquencies and defaults.

Despite the higher-rate environment, performance in UK ABS is holding up well. While there has been a tick-up in delinquencies, particularly for UK non-conforming residential mortgage-backed securities (RMBS) and buy-to-let (BTL), the increases are from a low base following more than a decade of low rates.

Figure 26: House Price Index – UK and Europe

(Base 2015 = 100)



Source: Nationwide, CBS, CSO, INE, ISTAT, Deutsche Bundesbank, Bloomberg, as at 30 June 2023.

House price declines are in focus once more and have been a theme for much of 2023. Even so, the data suggests that declines are not uniform across the board or being experienced to the same extent.

In particular, those countries with the strongest Covid-related house price increases are also those that have witnessed the largest declines to date. In the UK, for instance, retail bank Nationwide has reported house price declines of 5.8% from a peak in August 2022. With the expectation that rates will remain higher for longer and the amount of mortgages still to reset from the rates lows, we predict further reductions in valuations. However, for RMBS deals, the loan-to-values of the mortgages coupled with the structural protections that are a feature of the asset class mean investors have significant protection from losses, even if house prices decline further from here.

The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Past performance is not a reliable indicator of future results.

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