360°

Dispersion, disparity, duration

Fixed Income Report
Q1 2024

Federated Hermes Limited

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Commentary

A year to savour the certainty of coupons (over the guesswork of earnings)

2023 was a year plagued by geopolitical uncertainty and stubborn inflation, fuelling a series of rate hikes and rate market volatility. Markets witnessed a dramatic pivot in Q4, however, which renewed optimism and repaired lacklustre total returns for fixed income. This year, investors are yearning for more certainty.

Developed market central banks have indicated they have reached the peak of the hiking cycle and are now carefully taking the steam out of the 'higher for longer' narrative. The global economy has been surprisingly resilient, but cash buffers built up through the pandemic are now winding down, locked-in low rates are rolling off, and – while yields may be lowered by central bank cuts – it remains much more uncertain whether spreads at the lower end of the spectrum will be able to follow. It is hard to see help coming in the form of top-line growth with consumers tightening their belts, facing higher loan payments, greater rewards for saving, and the ill feeling of house prices in Europe and the UK continuing to adjust downwards.

Spreads are fair at best today versus historical averages, but yields are at some of the highest levels since the 2007/08 global financial crisis in parts of the fixed income spectrum – and this, perhaps, provides one area of opportunity. Here, higher yields coupled with historically low cash bond prices will likely be enough to cushion investors from a moderate recession and perhaps even systemic stresses. Indeed, by accessing subordination, complexity and liquidity premia segments of the structured credit market, we believe attractive returns should be available with limited delta to the underlying economy.

> **Higher yields coupled with historically low cash bond prices will likely be enough to cushion investors from a moderate recession and perhaps even systemic stresses.**

To add further complication, structural economic trends, globally, may cause some inflation to be stickier than we would like – the climate transition, an ageing population, and the related greying of the developed market workforce, as well as increased defence spending, all point to lofty fiscal spend. Governments will have their hands full balancing public debt that is rising rapidly, with a higher proportion of spending on interest payments. A false step will see the bond market punish fiscal profligacy. However, cutting public services or raising taxes is a notoriously difficult step, particularly in an election year. And it's not just voter confidence that is required – markets are going to be asked to digest a sea of sovereign new issuance at a time when central banks are also attempting to decompress bloated balance sheets.

The 'trash' rally, reversed

Given all of this, it's no surprise that, in 2024 and beyond, we expect analysis of corporate fundamentals to be a dominant theme. This is in contrast with 2023, where the lower quality component of the market outperformed almost irrespective of underlying fundamentals.

This partly stemmed from investors' relief that the long-feared hard landing had not materialised but other factors were also at play, not least a lack of new issuance which meant capital competed for whatever opportunities were available. But, this year, with earnings set to disappoint, we expect to see a pick-up in leverage, less comfortable levels of interest coverage and a rise in defaults coupled with lower recovery rates. In short, a reversal of last year's 'trash' rally, with a new set of opportunity for investors positioning themselves in the higher quality part of the market.

For fixed income investors, higher interest rates may restore some discipline to markets – a reminder that you *can* pay a dividend, but you *must* pay a coupon. Defaults will rise but not spectacularly so. However, the pain will be compounded by low recovery rates stemming from years of covenant degradation. The new regime of higher rates feels strange and uncomfortable, but really it was the prior time of ultra-low rates and quantitative easing (QE) that was the abnormality.

As ever, there is plenty more nuance and interesting market views to follow in this report, tapping into the broad and diverse expertise we are proud to have within our Fixed Income team. We hope you enjoy. To find out more about our wider credit offering, please visit our website**.**

Fundamentals

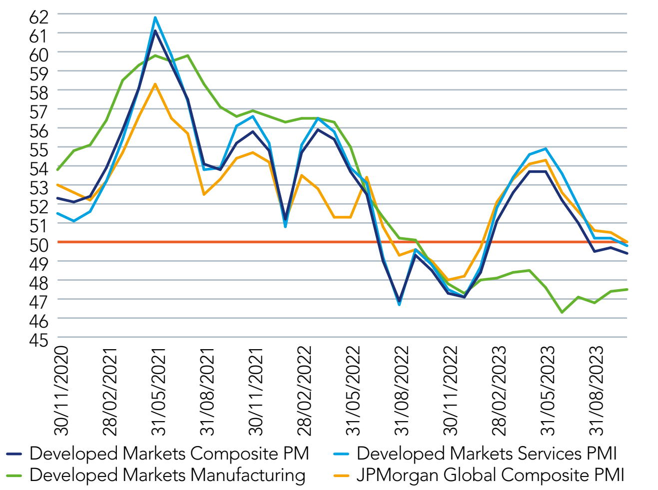
Economic outlook

(Written December 2023)

The picture for global growth was one of resilience in 2023, as tighter policy was offset by a stronger service sector, supportive fiscal policy, and an improving real wage outlook. Looking ahead, we believe these tailwinds may become headwinds, with the pent-up demand for services likely played out, fiscal support ending and, in most cases, the boost from lower inflation unlikely to reoccur to the same degree.

Bloomberg consensus expects **growth** in developed market economies to decline from 1.7% in 2023 to 1.1% in 2024 (with China expected to decline from 5.2% to 4.5%)[1]. **Headline inflation** normalised quickly over the course of 2023 and is expected to continue towards target through 2024 as tight policy constrains activity, momentum in services continues to slow, unemployment slowly picks up and labour markets loosen.

Figure 1: Developed market PMIs – Manufacturing, services, composite and global composite

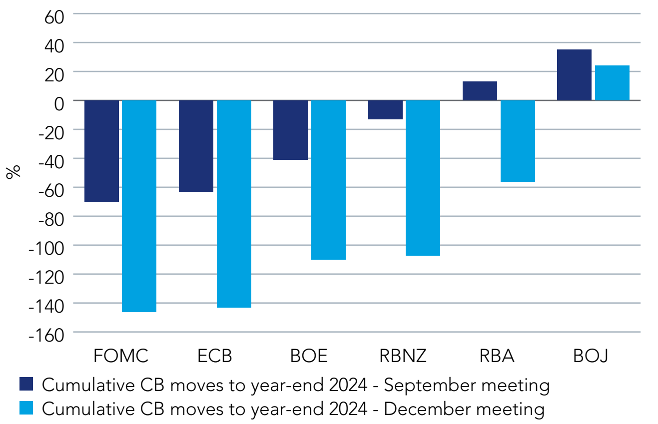


Source: Bloomberg, as at 31 October 2023.

Central banks maintained their 'higher for longer' stance for most of 2023. As we made more progress towards inflation goals at the end of the year, the US Federal Reserve (the Fed) began to moderate its tone and thinking about policy rates in real terms. This, alongside lower oil prices, prompted the large repricing of market expectations of central bank base rates into year end.

Figure 2: Net pricing of central bank (CB) expectations in 2024

FHL September strategy meeting vs. FHL December strategy meeting



Source: Federated Hermes, as at December 2023.

The US was a standout performer in 2023, growing above its pre-Covid trend. The strength of consumer spending was the primary driver, supported by Covid-19 relief measures, lower inflation, a run down in savings balances and a robust labour market in the region. A repeat of these factors is unlikely heading into 2024 and so we believe tighter policy and credit constraints could start to bite. The Fed can now adjust the policy rate lower over the year **and still communicate that their stance is restrictive**. Euro Area growth continues to falter and inflation has been coming off faster than expected, with the Harmonised Index of Consumer Prices (HICP) at 2.4% at the time of writing (notwithstanding December's inflation reads in the eurozone, the UK and the US, which surprised to the upside). The initial weakness stemming from Germany's manufacturing sector is now visible across the region with manufacturing and services PMIs contracting.

[1] Bloomberg, as at December 2023.

The ECB, for the moment, are sticking to their 'higher for longer' mantra but we expect them to call time on this as we continue into 2024. Similarly, growth has stagnated in the UK throughout 2023. Fiscal policy will likely turn from a marginal support to a drag, and the consumer will be under more pressure as debt servicing costs bite and unemployment continues to rise. Looking ahead, we expect faster progress on headline inflation through spring and summer as Ofgem price caps reset and the loosening within the labour market picks up pace. This will allow the Bank of England's Monetary Policy Committee (MPC) to step away from their current stance and begin to lower rates somewhere around the middle of 2024.

As has been the case for all of 2023, the outlook for this year remains murky and risks abound. While recent rates market moves aligned with our views, we acknowledge the speed of the move and the supporting role played by weaker oil prices. **In the short term, a renewed move higher in oil would challenge current market pricing.** This year we have a host of **national elections in countries that represent 60%+ of global GDP**, and this will undoubtedly set the tone for geopolitics and fiscal expectations going forward, potentially impacting central banks' ability to ease policy at the appropriate time. **There remains significant uncertainty around where r*[2] is or how tight monetary policy is, but we are not ruling out the possibility that banks have now overtightened. We believe this presents a particular risk for the European Central Bank (ECB) and the Bank of England (BoE)**.

Market outlook

The market has worked hard recently to reprice the central bank outlook, and total returns are now positive across the fixed income spectrum. The growth outlook has darkened and we have made significant progress on inflation. If, as we expect, other central banks continue to follow the Fed in adopting a dovish tone, this will be broadly supportive for fixed income as an asset class. However, recession risk remains – and this could challenge some segments of the credit market.

We continue to take profits on some of our long-duration positions but retain a moderate, well-diversified long position overall. Curve steepening remains high conviction. It is asymmetric in our favour and would expect to see the steepening continue under a range of scenarios. Our view is that the real bull case is a weaker-than-expected economy, prompting a more protracted aggressive easing cycle.

Figure 3: Macro scores

Duration	Curves	Volatility
+1	+2	+1

Source: Federated Hermes Limited, as at December 2023.

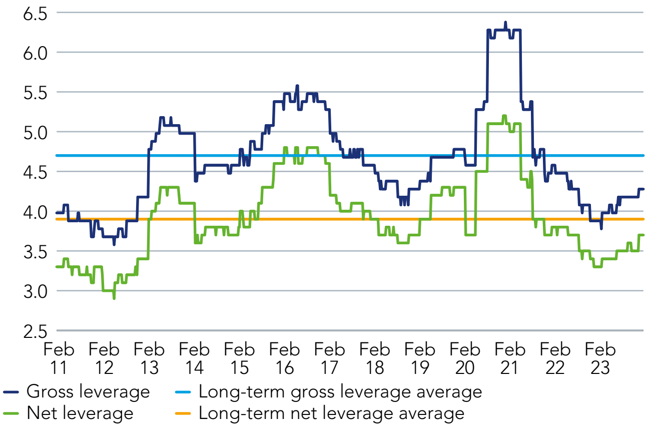
[2] R* is the natural rate of interest that signals neither restrictive nor expansionary monetary policy.

Corporate fundamentals: Opportunities and challenges within credit dispersion

The upcoming reporting season will be crucial in our assessment of corporate credit fundamentals.

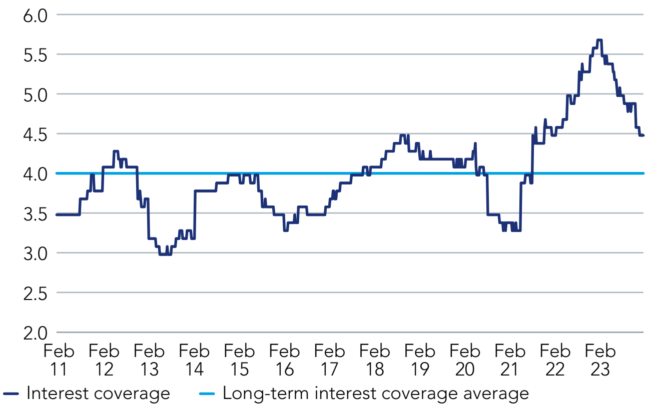
Credit fundamentals continued to modestly weaken towards the end of 2023, with both leverage and interest coverage metrics trending towards long-term averages from the lows and highs respectively witnessed a year ago, as shown in Figures 4 and 5 below.

Figure 4: Leverage increasing towards long-term averages



Source: BofA, as at 31 December 2023.

Figure 5: Interest coverage deteriorating towards long-term average



Source: BofA, as at 31 December 2023.

With the backdrop of US economic data remaining resilient (though weaker in Europe), materially lower commodity prices and somewhat improved financing conditions in the capital markets since the US Federal Reserve's pivot in December, the current reporting season is important in reassessing our more cautious stance towards corporate credit fundamentals.

Specifically, we are looking for any signs of either improvement or deterioration in fundamentally challenged sectors and any sectors adopting a more cautious outlook, as communicated previously by a number of industries. For example, the **chemical industry** suffered last year from destocking and weakening European demand and has provided little visibility for the timing of recovery, **non-food retail companies** noted consumer spending pressures, while defensive **healthcare companies** delay spending decisions, despite continuous EBITDA growth.

Despite yields and cost of capital remaining historically high, the material rally of treasuries and spreads since October (100bps tighter on both) are benefitting issuers in the form of lower debt costs in the capital markets. This is potentially putting less pressure than previously anticipated on issuers' cash flows as companies refinance upcoming maturities.

However, the situation remains fluid. The ongoing conflict in the Middle East and the threat to the shipping industry will likely result in rising costs and margin pressure in industries such as retail. Historically tight valuations on a spread basis are likely to lead to greater dispersion and severe spread underperformance in credits with disappointing earnings, especially within levered capital structures with upcoming maturities or other credit-negative idiosyncratic developments.

This uncertain environment requires vigilance from credit investors and an in-depth understanding of underlying operating and financial fundamentals as well as ESG dynamics of credits. At the same time, this of course will present investment opportunities for savvy credit investors in some of the oversold credits.

Issuer behaviour remains broadly neutral

We continue to see issue behaviour as broadly neutral with limited evidence of a shift to more creditor-friendly capital-allocation policies in the most recent 3Q23 earnings cycle, with the exception of specific idiosyncratic sectors.

Issuers in the chemicals space have cut dividends and/or explored asset sales to shore up balance sheets in the face of gloomy demands from ongoing destocking and lacklustre end markets. However, this is not a wider theme seen across the universe and we have seen buybacks and dividends continue (albeit often from a position of strength) in many sectors including retail, healthcare and energy.

M&A volumes are still depressed but premiums are very high, which may indicate opportunistic transactions at companies where equity values are depressed.

The use of proceeds of new issuance in the high yield market has been skewed towards refinancing.

On documentation, issuer-friendly qualitative changes cleared the market in 3Q23 on terms such as contribution debt, financial calculation flexibility and EBITDA add-backs.

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 J.P. Morgan Fear and Greed Index, which helps gauge stock market movements and whether stocks are fairly priced.

The relentless rally that started in early November has, unsurprisingly, had an impact on sentiment. The indicators we track to assess a fair view of the world have sharply moved into extreme territories. For instance, at the time of writing, the JPM Fear & Greed Index (the price of hedging using credit options) shows signs of overheating especially on the implied volatility side (trading around the 5th percentile over one year).

Figure 6: The Fear and Greed Index

	VTRAC-X	Skew	Momentum	ETF premium	CDS strength
Investment Grade	7%	22%	16%		14%
Financials	6%	36%	15%		0%
High Yield	6%	20%	14%	29%	
US Investment Grade	10%	10%	16%	50%	
US High Yield	6%	5%	16%	34%	
Total	7%	16%	15%	37%	11%

Source: Federated Hermes Limited, Bloomberg, FactSet, as at 10 December 2023.

Some other indicators are already retracing, however, such the Bull vs Bear Indicator and 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 both trading in the middle of the pack. We maintain a score of -1 as we acknowledge the overall greed from investors.

ii) Technicals

From a technicals standpoint, the market remains robust and this is especially evident in high yield. The combination of attractive coupons and positive flows in a shrinking market is a powerful force, which can explain, in part, the vigour of this rally. For 2023, the dollar investment-grade supply is set as the third busiest on record while if high yield remains below historic norms, we have noticed a recent pick up in primary. We maintain our score of +2 as conditions are encouraging, especially on the high yield side.

iii) Relative value

Credit spreads have tightened and some of them are at one-year lows, but the all-in yield proposal remains attractive for the asset class. Looking at convexity, the global high yield cash price moved from 86.2 at the beginning of November to 90 in mid-December. This remains significantly below the five-year average cash price of 95.1, as illustrated in Figure 7 below. Our score remains at 0.

Figure 7: Global HY market – historical vs. average cash price

Source: ICE BAML Global High Yield Index, as at 12 December 2023.

Catalysts

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

Negative catalysts: We remain aware of a number of downside risks for 2024. Though our probability for these has reduced, the relative impact of these events would be greater given the year-end rally, which implied markets may have discounted these events and that they are not priced in. Our top catalysts of concern for 2024 include a global recession – no longer a base case given recent central bank rhetoric, but still a tail risk with the effects of monetary policy tightening unlikely to have fully come to bear.

Our second downside risk is that markets have got ahead of themselves on rates cuts and will be disappointed by either the speed or quantum of rates cuts. We are also cognisant of the refinancing risk for stressed corporates.

Finally, geopolitical risks have the potential to be the 2024 wildcard, with several regions continuing to experience heightened tensions, namely Russia/Ukraine and the conflict in Gaza, as well as a number of countries facing elections over the months ahead, which will likely give rise to bouts of volatility.

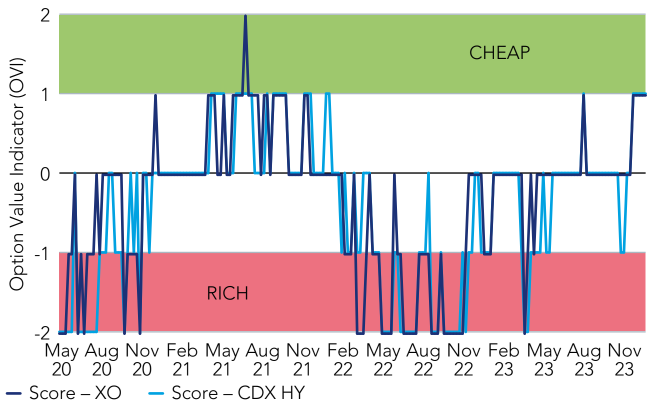
Positive catalysts: On the positive side, improved guidance for 2024 in FY23 earnings calls (ongoing) would be a positive, off the back of 3Q23 earnings which came with limited visibility from corporates for 2024 recovery. Other key upside risks include additional stimulus improving the growth story in China, while further dovish commentary from central banks would also support a 'risk on' move.

In terms of valuations, we acknowledge that the November rally repriced risky assets and the volatility market has also been impacted. Although realised volatility has outperformed implied volatility, the move has also affected options costs which now trade quite cheap on a year-to-date basis.

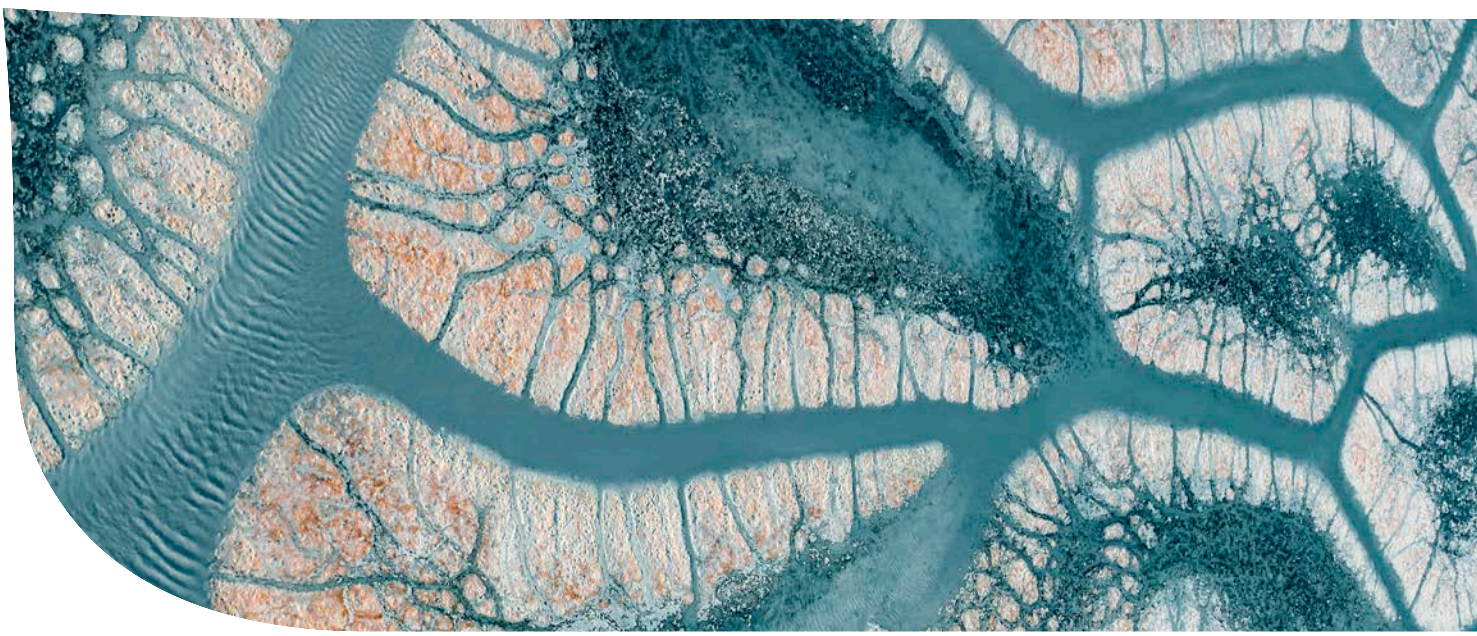
As a result, our Option Value Indicator (OVI)[3] has surged to cheap territory although to move further we would need to see a squeeze tighter.

This, combined with a steep calendar curve and an increasing payer skew, helps confirm our view that a score of -1 is appropriate.

Figure 8: The FHL Options Value Indicator (OVI)



Source: Federated Hermes, as at December 2023.



[3] The Option Value Indicator (OVI) is an in-house tool tracking option pricing.

Credit relative value

i) Intra-credit opportunities

Global investment grade: Yields moved sharply lower in investment grade at the end of December. This followed the dovish change in tone from the US Federal Reserve and revised dot-plot projections all of which suggested the market can expect some easing of rates in 2024. The market now has more confidence in a softer landing scenario and this positivity has fed through into credit valuations, especially on the investment grade side.

From a relative-value perspective, we have seen some decompression in spreads as investment grade has outperformed, notably in the US, leaving investment grade now trading around fair value compared to high yield on a three-year lookback.

Figure 9: Global investment grade yields remain attractive

Source: ICE Bond Indices, Federated Hermes Limited, as at 20 December 2023.

In absolute terms, global investment grade spreads are now at the 32nd percentile of the last 10-year range[4], down from 78th percentile at the start of the year. This indicates that aggregate spreads have limited room to tighten materially from here – though they still provide investors some cushion relative to their fundamental risk.

Yields, however, remain at attractive levels at almost 2 standard deviations above their 10-year average. This, combined with historically low cash prices, offers us comfort in the potential upside from here. Against this backdrop, we would expect investment grade to do well should interest-rate volatility continue to stabilise from here.

Indeed, we expect the asset class to be relatively well insulated from the stress likely to be seen in highly levered credit, with many investment grade companies having multiple avenues to manage their credit quality should they come under pressure.

From a sector perspective, we continue to 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. Regionally, we maintain a preference for Europe at current valuations and continue to focus on the belly of the curve (5-10 years) where we see the best balance of convexity and spread available.

Global high yield: High yield has enjoyed a strong year with year-to-date total returns from global high yield now 12.4% in US$-hedged terms[5] led by the US market which has returned 12.8% since the start of the year. From a relative-value perspective Europe now trades closer to fair value versus the US based on a three-year look-back period. Going into next year, investors will need to be more selective in finding opportunities to exploit cross-currency inefficiencies within the capital structures of issuers.

In terms of credit quality, we have seen a compression in spreads of single-B rated bonds both in the US and Europe over recent months, leaving them trading tight compared to BB bonds. Interestingly we have seen CCC's lagging the recent rally despite having performed well earlier in the year, with dispersion in the segment on the rise. All told, 2023 came in as among the worst years for leveraged loan defaults since 2010, but this has not been matched in high yield bonds with defaults closer to long term average levels of 4.1%[6]. We would expect to see defaults pick up into next year and dispersion to rise as 2024 and 2025 refinancing comes into focus, and so we remain cautious on lower-rated segments of the market.

Figure 10: US CCC vs. US HY

Source: ICE Bond Indices, Federated Hermes Limited, as at 20 December 2023.

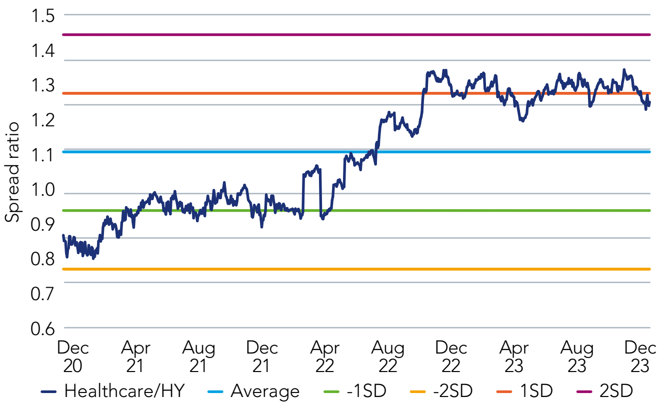
From a sector perspective, Energy continues to trade at rich levels, as does Leisure, with companies having benefitted from strong services demand over the summer months. Despite overall strength, we still find opportunities in certain sectors

[4] ICE bond indices, as at 20 December 2023.
[5] ICE bond indices, as at 21 December 2023.
[6] Moody's Analytics and Moody's Investors Service.

such as healthcare which continues to screen as cheap. We maintain a preference for less cyclically exposed parts of the high yield market, especially in the belly of the curve (5-7 years) which offers the best balance of spread and risk.

Another trend on our radar is 'Fallen Angels' (companies that are being downgraded from investment grade), which often trade at attractive levels for their risk given technicals around their transition between indices. We expect there to be more of these opportunities if we see credit metrics weaken in 2024.

Figure 11: US HY healthcare vs US HY



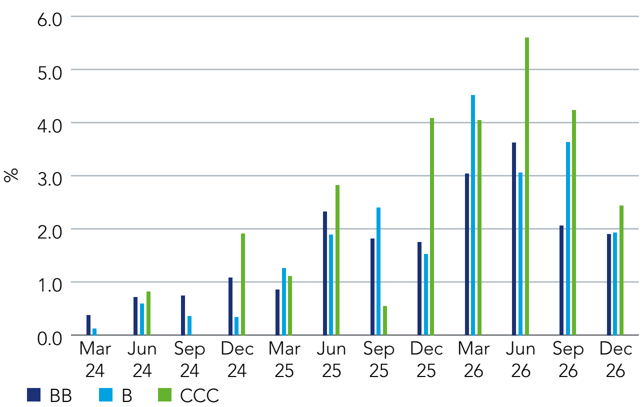
Source: ICE Bond Indices, Federated Hermes Limited, as at 20 December 2023.

ii) Stressed, distressed and special situations

The new year promises to be a challenging one for highly levered corporates with looming maturities. Who will be hardest hit?

The combination of poor growth coupled with high rates is especially problematic for the highly levered corporates which typically make up the CCC part of the market. Corporates with material maturities before 2026 will need to start addressing these over 2024 to avoid this debt becoming 'current'.

Figure 12: 28% of CCC bonds are due by 2026



Source: BAML, as at December 2023.

The higher cost of refinancing expected to persist into 2024 leaves little tolerance for missteps and exposes these corporates to potentially falling into the 'distressed' bucket of issuers with spreads in excess of 1,000bps.

As of end of November 2023, dispersion of CCCs was at the 68th percentile[7]. With central banks not incentivised to ramp up the pace of cuts unless there is significant macroeconomic weakness (a situation which would also not be favourable to typical CCC corporates), this implies the tough funding environment for CCCs is likely to persist into 2024.

Given the uncertainty around access to affordable borrowing rates, we remain cautious on those CCC credits which have high refinancing needs without material catalysts to help raise liquidity. These HY issuers may have to fall back on distressed exchanges or asset sales to start to address the maturity wall, with significant execution risk.

Looking at relative value, dispersion is above median levels for CCCs, while CCC spreads are at average levels vs their historical relationship with the HY market in both vs both EUR and USD HY markets. This implies that there is growing separation between performing CCCs and the distressed bucket of CCC corporates. CCCs are cheap vs single-Bs in Europe, which says more about the relative richness of single-B EUR corporates, but also indicates that EUR single-Bs might be a place where further stress is yet to be priced into spreads.

Figure 13: EU – CCC vs. B

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

[7] BAML, as at 30 November 2023.

Figure 14: EU – CCC vs. HY

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

For more insight on corporate credit, please read this article.

iii) Financials

One word to describe the story for global financials last year would be 'eventful', beginning in March 2023 with the collapse of several Californian lenders.

Liquidity was a defining concept for the whole sector. The contrast between now and the same period last year is stark – at least in terms of the market's rates expectations. At the time of writing, markets are pricing five to six rate cuts by the US Federal Reserve. If – and that's a big 'if' – realized, the positives from the priced-in rate cuts are:

- Abating deposit pricing/gathering pressure,
- Less pressure on the 'usual culprits' (CRE, consumer, esp. sub-prime), and;
- Positive securities month-to-month (10-year treasuries tighter by 70bps in Q4) reducing the (big) unrealized losses.

There are some market participants who think these interest rates are abnormally high. In our view, they are quite normal. In a declining rates scenario anyway, the much-talked-about deposit beta, a measure of the pass-through from US Federal funds to the deposit returns, should come down too. The question then becomes which bank will be able to cut returns when the repurchasing rate starts coming down.

The Federal Reserve Board data for all banks in the last quarter of 2023 paints a picture of higher deposit balances and a slowdown in loans growth (having halved from 4%+ to 2%+ year-on-year). This is remarkable for an economy which, based on recent data, grew at 2.5% annualized over Q4. This trend, we believe, should persist as the economy cools down.

Figure 15: Deposits, all US commercial banks, seasonally adjusted

Source: The U.S. Federal Reserve, Assets and Liabilities of Commercial Banks in the United States, as at 12 January 2024.

That deposits have stabilised and started rising again is a cause for optimism. We have a constructive view for at least the first half of 2024, anticipating only a shallow recession in the UK and Europe and possibly only a mild slowdown in the US. Our forecast is also for small and tentative rate cuts, with fundamentals to remain a point of strength coupled with elevated yields – all of which provides a far better breakeven point to absorb any spread volatility.

Provisions are expected to increase but from historical low levels, amid pressure for Net Charge Offs (NCOs) and delinquencies rising. The profitability gains of the last two years will, we believe, slow down on account of higher funding costs and weak loans demand (tightening credit standards), but we expect this to impact equity markets more strongly than credit markets.

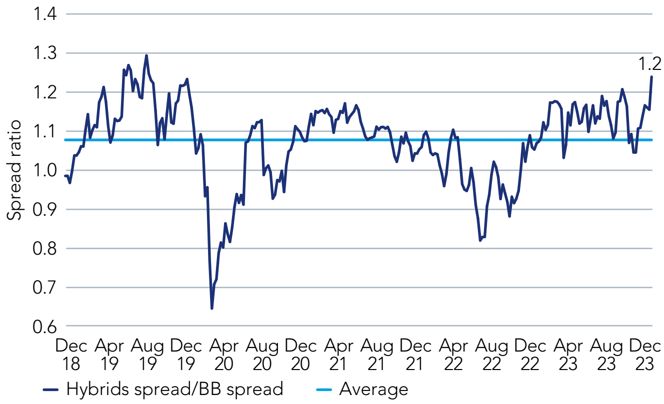
While supply will be big in January, the strong year-end fund performance will drive money into credit to absorb this supply and drive spreads somewhat tighter. Barring the left tail of a hard recession and a steep uptick in unemployment, we see scope for modest spread tightening over the course of the year with dips generally being bought, though we expect much of the return to come from carry.

iv) Corporate hybrids

Despite recent outperformance, hybrids continue to offer attractive relative value

Corporate hybrids saw solid performance in the fourth quarter of 2024, with investment grade and high yield up 6.3% and 5.4% respectively in US dollar hedged terms[8]. This left total returns for both segments above 12% for year-end 2023, outperforming both global high yield and global investment grade. From a valuation perspective, this has compressed sub-senior spreads, excluding real estate, to around 219bps[9], closer to longer-term average levels, while there remains an attractive 1.2x spread pick up versus BB-rated high yield. We continue to view hybrids as representing attractive value for their risk profile, especially in defensive sectors such as telecoms and utilities.

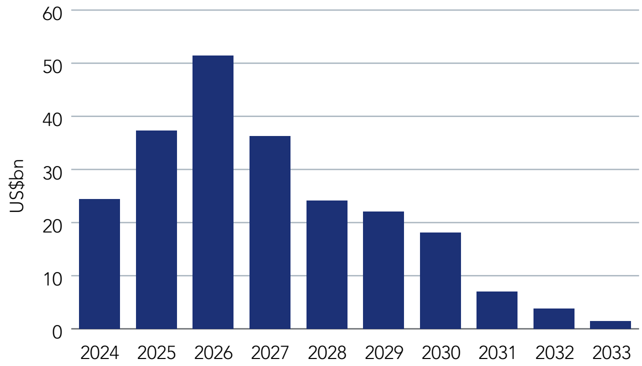
Figure 16: Corporate hybrids vs. pan-European HY BB (excluding financials)



Source: ICE Bond Indices, Federated Hermes as at 15 December 2023.

Strong technicals in the market were among the year's strongest drivers of performance, with limited supply, falling interest-rate volatility and solid flows into credit creating a tailwind for the asset class. We expect a pickup in supply into 2024 with over US$24bn of hybrids coming up to their first call date. In our view, this is likely to be manageable and well-digested by the market as investors continue to target higher coupon bonds for income.

Figure 17: Notional of US and European corporate hybrids by first call date



Source: ICE Bond Indices, Bloomberg, Barclays, JP Morgan, Federated Hermes Limited.

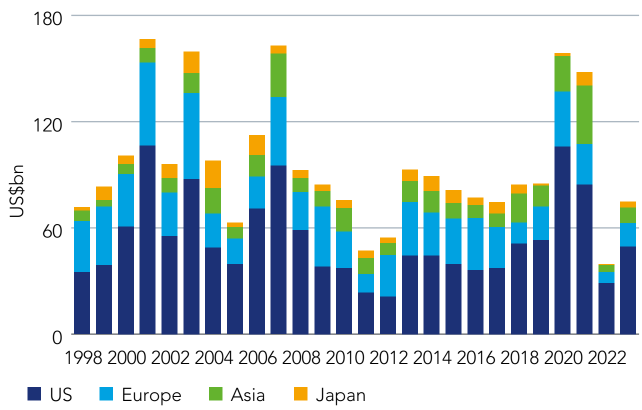
In terms of market segments, we have seen strong demand for shorter-call hybrids, with investors looking to benefit from steep front end curves as they gain comfort around extension risk. We expect extension risk to remain low going in to 2024 and may see additional return generated from liability management exercises as companies start to focus on approaching 2024 and 2025 call dates.

v) Convertible bonds

While it may not have been as large as investors had initially expected when formulating outlooks towards the turn of the year, global convertible bond primary volumes improved significantly from 2022 and, in fact, returned to around pre-Covid averages.

Issuance in 2023 amounted to just under US$75bn[10], reflecting an increase of over double the US$35bn printed in the same period last year.

Figure 18: Global convertible bonds – gross issuance (US$bn)



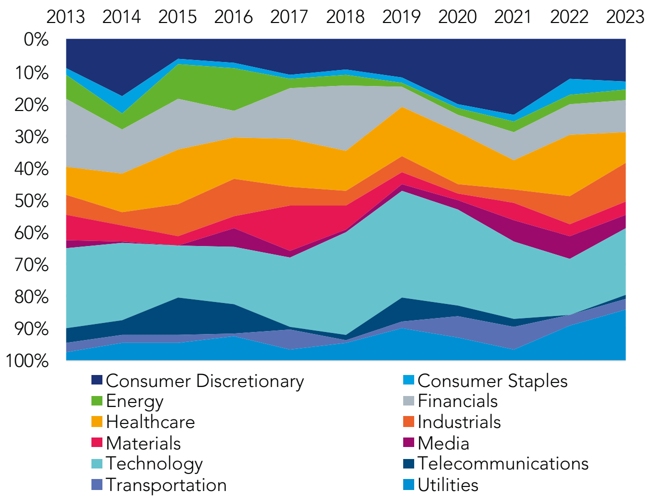
Source: BofA Global Research, as at 30 November 2023.

[8] ICE bond indices, as at 19 December 2023.
[9] Barclays research, as at 1 December 2023.
[10] As at the end of November 2023.

We have witnessed the prospect of higher interest rates across developed markets starting to reshape the convertible bond universe. Corporates are issuing at relatively more attractive terms for investors with regard to higher coupons and lower conversion premiums. Refinancing has played an outsize role in driving a rebound in volumes, as companies increasingly recognise the relative cash interest benefit in lieu of more traditional sources of funding. In turn, this has prompted an increase in breadth of the issuer base.

Historically, low-rated, small-/ mid-cap technology names have dominated the market. Now, we are seeing greater representation from companies in sectors such as industrials and utilities that are taking share, as well as a larger proportion of investment grade issuers coming to the space.

Figure 19: Global convertible bonds – sector composition



Source: BofA Global Research, as at 30 November 2023.

We remain positve about issuance dynamics in the near term and see scope for further increases in breadth from historically underrepresented segments of the universe. Considering the interest rate backdrop in combination with the upcoming maturity wall, we continue to expect issuance growth to continue in 2024.

vi) Emerging markets

2023 was a surprise success story for emerging markets. What will 2024 bring?

Overall, 2023 was better year for emerging markets (EM) than originally anticipated, with returns turning around from the weakest seen since the global financial crisis in 2022 to the strongest since 2019. EM hard currency corporates returned 9% which was slightly below EM hard currency sovereigns of 11%[11]. As with other credit sub-segments, we also saw spread tightening in corporates of c.40bps[12]. It was interesting to see that spreads in general stayed within a fairly tight range throughout the course of last year, and moves were mainly driven by changes in market expectations regarding a soft landing and a recession.

However, the default rate for corporates remained elevated and above developed market levels, particularly as we saw continued pressures in the Chinese property space. The EM corporate default rate was 8.7% last year[13]. We expect some moderation this year, particularly as most of the obvious candidates from bigger jurisdictions such as Russia and China have already defaulted or restructured. As with developed market credit we saw issuance at the lower end of our expectations last year and net financing staying negative, at c.US$160bn. Chinese supply has, in particular, diminished materially and sits roughly 50% lower last year at US$35bn[14].

In terms of our outlook for 2024, in the past we have seen EM credit spreads generally widen in mid-cycle US slowdowns and, given the starting point for spreads this year, we expect the same situation to materialise.

As well as growth, or, rather, a lack of it, geopolitics will continue to act as an overhang and be responsible for bouts of volatility. Over 50 countries, home to half of the world's population, will host national elections this year. For us, as well the US and UK elections, the focus will be on key EM economies as the world navigates geopolitical uncertainties.

Mexico's presidential elections in June of this year, for instance, will be important for quasi-sovereigns like PEMEX[15] and CFE[16], the credit profiles of which depend on the level of sovereign support, and investors will be closely watching the new government's policies. The US elections in November will also impact EMs, with investors keeping a close eye on US policy direction around trade, support for Ukraine, Venezuela sanctions and US-China relations.

vii) Leveraged loans

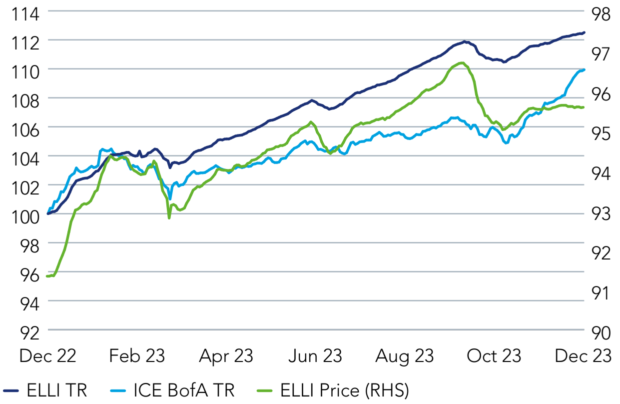
2023 was a strong year for the European leveraged loan market, with the Morningstar European Leveraged Loans Index (ELLI) returning +12.5% year to mid-December[17] – the highest reading since 2009. European loans outperformed European bonds, with the ICE BofA Euro High Yield Index returning +9.9% to the same date[18].

In Q4-23, however, the dynamic was different and we saw European loans recovering slower than bonds after the October sell-off. For Q4 to mid December, the loan index posted +0.8% vs. +3.6% for bonds[19]. We believe that the underperformance of the loans was driven by catalysts

[11] Bloomberg, as at 2023.
[12] Ibid.
[13] Ibid.
[14] Ibid.
[15] Mexican state-owned petroleum company managed and operated by the Mexican government.
[16] Comisión Federal de Electricidad is the state-owned electric utility of Mexico, known as CFE.
[17] All performance data, Bloomberg as at 12 December 2023.
[18] BofA Euro High Yield Index, also as at 12 December 2023.
[19] As at 12 December 2023.

(weaker inflation and hopes for declining rates sooner than expected) favouring fixed-rate convexity which had disappeared previously in the year. This is reflected in the ELLI secondary trading price which, at the time of writing, sat at 95.6 (vs. 96.2 at the end of September) highlighting a punctual disenchantment for the floating rate asset class, while leaving some upside potential.

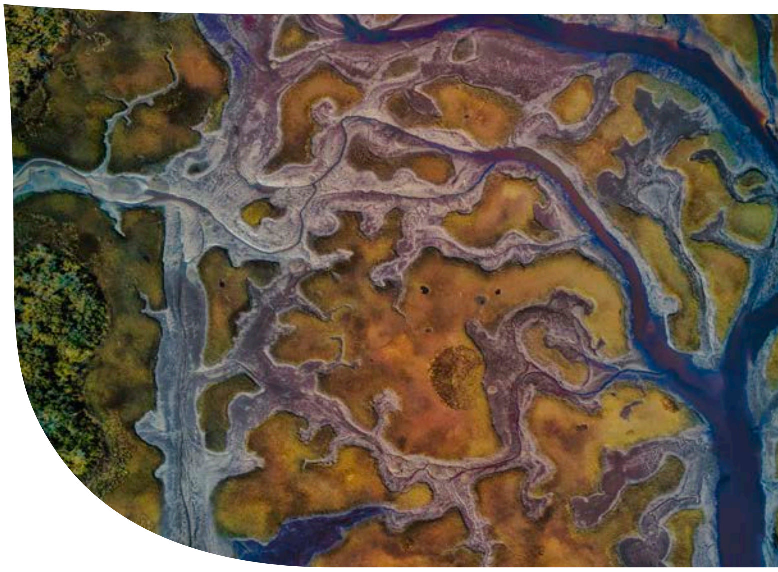
Figure 20: 2023 performance – ELLI total return & ELLI price vs. ICE BofA total return



Source: Leveraged Commentary & Data (LCD), as at 12 December 2023.

In terms of corporate fundamentals, leveraged loan borrowers still resist and the index default rate remains low at 1.4% by principal amount and below the October 2020 level of 2.6%. In this environment where high interest will continue to hurt cash flows and interest coverage ratios (in some cases decreasing from 4.0x to 2.0x), we remain cautious. Our view is reflected in the rating actions recorded by Leveraged Commentary & Data (LCD) as the upgrade/downgrade ratio continues to be below 1, indicating more downgrades than upgrades. Consequently, and beginning at the start of Q4, we observed a 'fly-to-quality' momentum as double Bs loans (+1.2%) outperformed single Bs (+0.7%) and CCCs (-1.0%).

Finally, we think the overall European leveraged loan market will benefit from strong technicals driven by a wave of Collateralised Loan Obligations (CLOs) prints at the end of the summer. From September to November 2023, there were €10.0bn of CLO prints vs. €1.0bn of new loan money (new issues minus repayment) leaving a €9.0bn supply shortage. The Q4-23 trade for European CLOs was to use their fixed bond bucket to capture some of the convexity and to be able to create par in a quick and efficient way given stronger liquidity of fixed bond instruments, but this is not endless. Eventually, CLOs will have to focus on their core investments and investing in leveraged loans. This, we believe, will be supportive of the asset class in the near term.



viii) Structured credit

The structured credit space ended the year in better shape than we, and almost everyone else, could have predicted at the beginning of 2023.

We have seen rates reach levels not seen since before the global financial crisis in the face of stubbornly high inflation numbers, yet the performance of structured credit assets – both Asset Backed Securities (ABS) and collateralised loan obligations (CLOs) – remained robust with only a few of pockets of weakness, namely Irish Residential Mortgage-Backed Securities (RMBS) and UK non-conforming and UK buy-to-let pre 2014 originations.

On the consumer side, the pace of monetary policy moves has filtered through at different speeds depending on the nature of mortgage markets and the length of fixed-rate periods. (This is because rate rises have a delayed impact depending on how long borrowers have fixed their rate for.) Another support to the performance of ABS has been the strong labour market. Here, we have witnessed continuing low unemployment levels (with the exception of geographies like the UK where unemployment levels are rising but still remain far lower than historical peaks) and increased wage inflation.

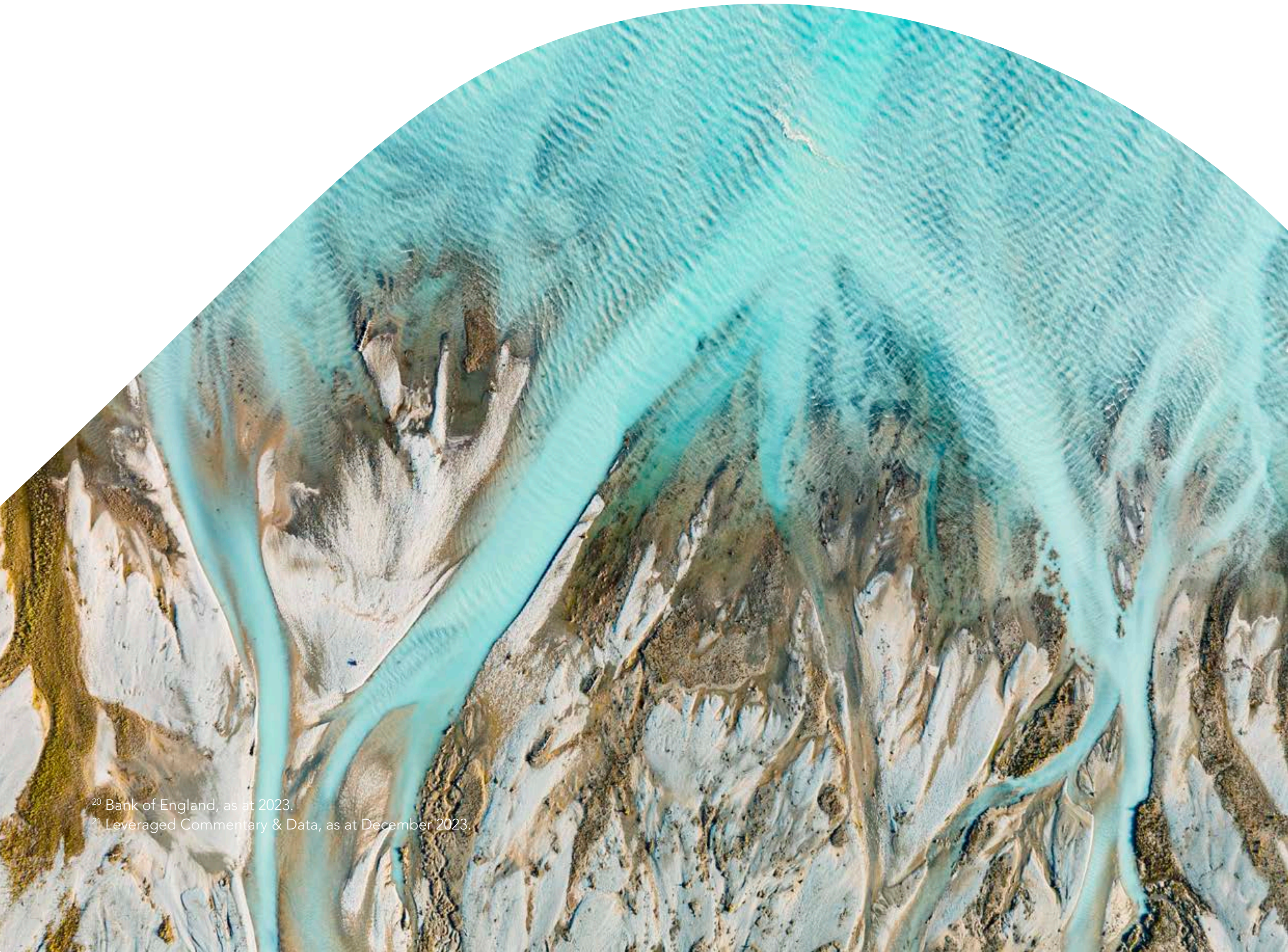
Savings ratios have normalised post pandemic with some recent increases as rates have risen, as the higher rate environment benefits savers. While the US consumer has been willing to spend their excess savings amassed during the pandemic, the picture is different in other geographies. Levels of excess savings remain elevated in countries like the UK, although the distribution of these savings is not even across the population and we do not expect them to act as too much of a buffer except for older generations who tend to be more mortgage and debt free.

Unsecured credit, including credit card balances, has begun to increase. In the UK, the latest Bank of England (BoE) numbers show an increase of £2bn to the highest level in almost seven years[20]. While economists may read this as a sign of increased consumer confidence underpinned by high employment levels and improved wages, it could also be a sign of increased reliance on credit in the face of the higher cost of living and inflation. Despite the increase in credit card balances, the performance of UK pools has remained robust signalling little stress from the UK consumer.

Auto ABS continues to show solid performance in the UK and Europe, unlike in the US where auto ABS delinquencies, particularly in the subprime sector of the market, have risen to all-time highs. One risk we are highlighting in the auto space is the weakness of second-hand car values for electric vehicles (EVs). Although exposure to EVs is limited in many Auto ABS pools, the weakness in the data is something we are keeping an eye on. As technological obsolescence and increased supply weigh on valuations, the penetration rates for EVs are plateauing as consumers likely to switch to EVs have already done so.

On the CLO side, 2023 was a year of strong performance, both in total return terms as investors, but also performance of the underlying collateral pools. However, increased dispersion of performance between managers and deals has been more pronounced, allowing investors to differentiate between managers and investment styles.

The latest rolling 12-month default number for US loans is 1.53% and 1.62% in Europe[21]. This is still relatively low although our view is that the credit fundamentals outlook for loans remains challenging. Picking the right managers and deals will continue to be the key to successful investing in CLOs as we remain in this period of heightened volatility and credit risk, especially for lower-rate corporates active in the leverage loan space. Despite the strong rally at the end of 2023, we believe CLOs still offer an attractive pick-up in yield compared to corporate bonds, with AAA CLOs, which have lagged the rally, giving investors significant returns for minimal credit risk.



[20] Bank of England, as at 2023.
[21] Leveraged Commentary & Data, as at December 2023.

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