360°

Can strong technicals lead to stronger fundamentals?

Fixed Income Report

Q2 2024

Federated Hermes Limited

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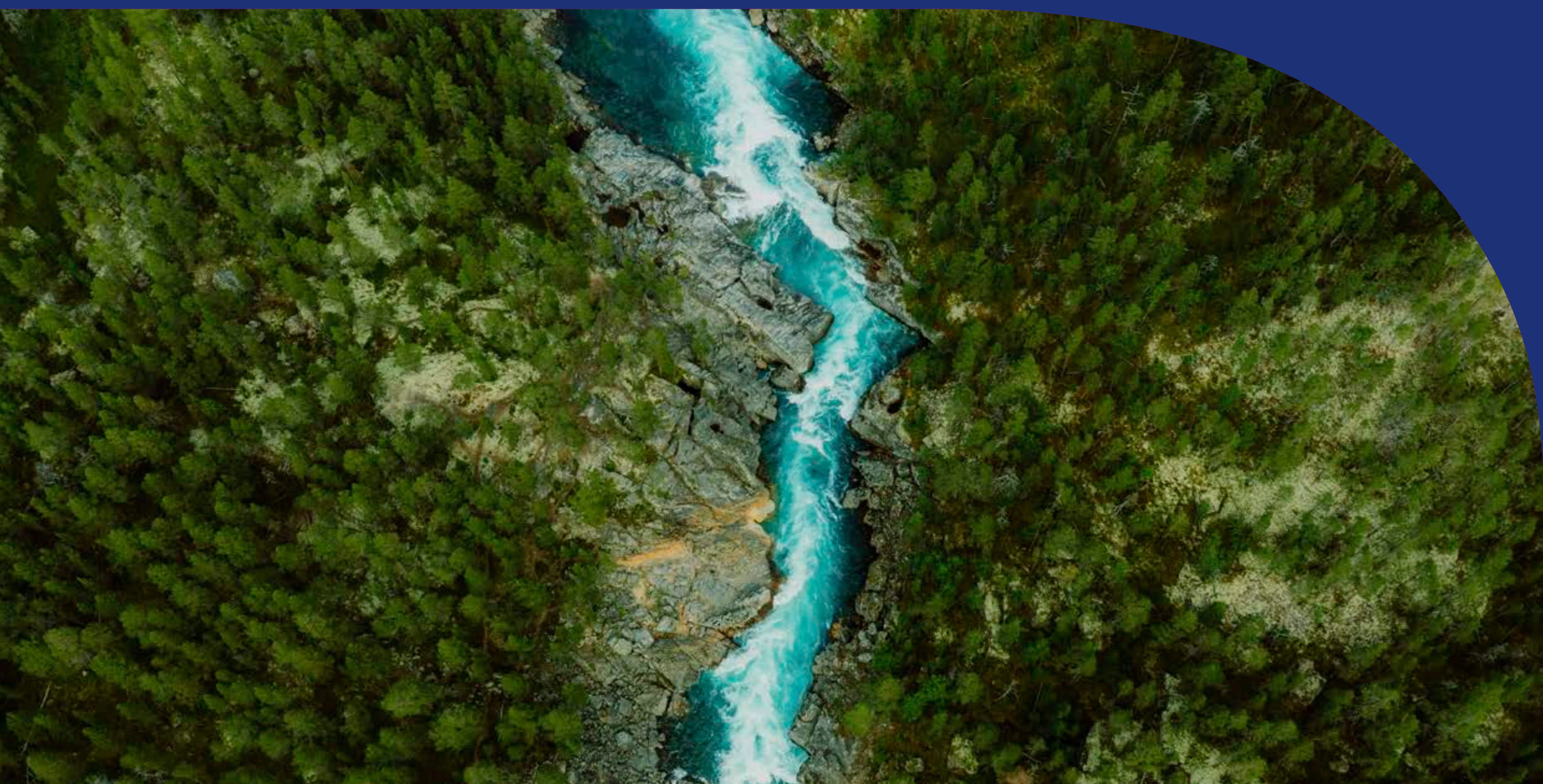

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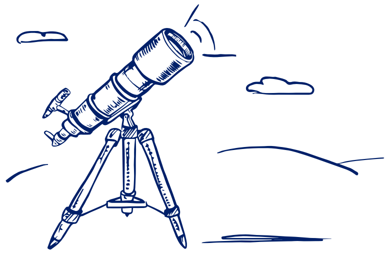

Commentary

Can strong technicals lead to stronger fundamentals?

Credit investors can be forgiven for feeling perplexed when trying to marry rosy sentiment and extreme valuations with the many risks and uncertainties muddying the current outlook for corporate bonds.

The technical picture is dominating the fundamental like never before, with the former requiring less logical justification than the latter. It's not long after a bond shoots higher in the market without an obvious reason that someone on our desk quips "more buyers than sellers". This sentiment is true of credit more broadly today. Moreover, both sides of it – the demand and the supply – are equally responsible.

The demand side is perhaps more obvious at first glance: yields in credit are standing on their own two feet in a way rarely seen since the global financial crisis (GFC). Boosted by underlying government bond yields, credit is now delivering more superior income than dividend stocks. At a time of uncertainty over companies' ability to protect margins and maintain growth rates, the certainty of coupons over the discretionary nature of dividends is attracting asset allocation flows from equities to credit. Knowing that these elevated yields may not last much longer due to impending central bank monetary policy easing, there is also a growing stream of money moving from 'the sidelines' of cash and near cash into credit to lock in favourable levels. In short, we believe all routes are leading to credit as a sweet spot for asset allocators.

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Less well appreciated is the supply side, where there is a distinct lack of paper to buy. This is most pronounced in the high-yield market, whose size has shrunk by 10% in a little over a year. Companies are issuing less as they reduce their debt burdens to adjust to the new normal of higher interest rates, and therefore lower levels of debt appropriate to maintain sensible interest coverage ratios. M&A, having fallen off a cliff, has also restricted the amount of issuance slated for the purpose of sponsor funding. Lastly, many treasurers have been choosing to hold off refinancing activity until nearer existing debt comes due. Why replace a 5% coupon with an 8% coupon until you have to? Rating agencies have been busy upgrading, fuelling impressive levels of 'rising stars' relative to 'fallen angels'. All of this is before we contend with a new competitor for debt capitals funding – the private credit market – which has now grown to some 30% of all leveraged finance from less than 10% just a decade ago.

The counter to joining the 'grabathon' is based on declining fundamentals and tight spreads. At current levels, very little in the way of a default cycle is priced in. While balance-sheet health and earnings momentum have been impressively robust in the face of rising interest rates, it is hard to argue for continued improvement on either.

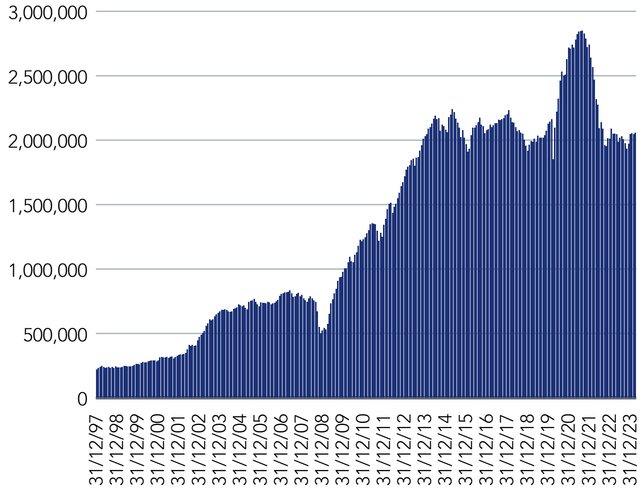
However, there is an element to all of this that is self-fulfilling. With the primary market starved of action and increasingly wide open for refinancing – and with the presence of amend-and-extend deals and the like – the 'wall' of maturities corporates face in 2025 and 2026 is being eroded away. In turn, this means that positive technicals are creating positive fundamentals and driving down default rate expectations.

That is a difficult backdrop to fight against. Investors will inevitably encounter various obstacles and dangers in the form of idiosyncratic cracks appearing in the lowest rungs of the market, ready to dispense permanent loss of capital.

Lower quality does not enjoy the resilience of the rest of the spectrum. Already in the leveraged loan market, capital structures are straining with the reality of non-zero interest rates. Indeed, in these segments we are seeing twice the ratings downgrades to every upgrade, significant structural issues in troubled sectors such as telecoms and media, and some governance issues popping up as cash flows come under scrutiny.

The path from here for most credits is constructive, and is arguably getting more constructive feeding off the strong technicals. But we expect idiosyncratic events, dispersion in the lowest tier, and some losers to emerge. In such an environment, company selection based on rigorous fundamental analysis will once again come to the fore – a theme that is evident throughout this edition of 360°.

Figure 1: Global high yield full market value, historically



Source: ICE BofA Global High Yield Constrained Index, as at 31 March 2024.

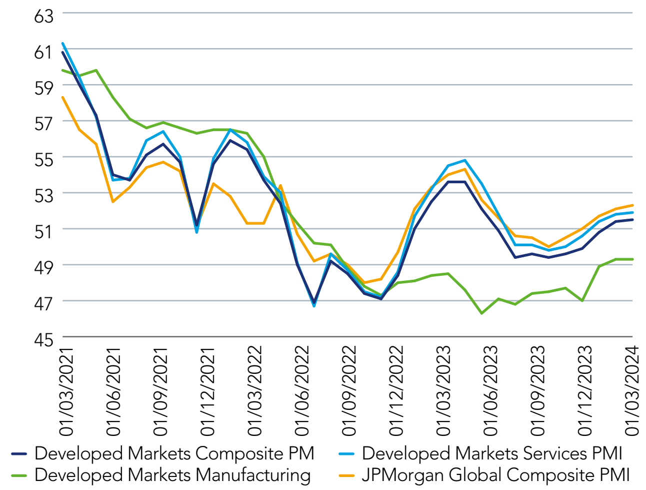
Fundamentals

Economic outlook

The macroeconomic outlook is fraught with risks; marked by elevated geopolitical tension, commercial real estate (CRE) stress, growing deficits, the potential for goods disinflation to become less supportive, and an uncertain policy outlook. Data from the first quarter of 2024 has been volatile but has broadly beaten expectations. In this environment, we expect central banks to proceed with caution.

While the global economy is still showing resilience, growth is expected to weaken to slightly below trend in 2024. This weaker growth is concentrated in developed markets (DM) and premised on a slowing service sector, softness in manufacturing, and less supportive fiscal policy. Global headline and core inflation have fallen meaningfully through 2023, with core goods back to pre-pandemic levels but core services growth still almost double the pace. The outlook for services inflation remains challenging in an environment where low unemployment has supported wage growth. Following robust growth in 2023, wage growth is now cooling, but is still above pre-pandemic levels.

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



Source: Bloomberg, as at 30 April 2024.

In 2023, US growth was strong in both outright and relative terms, with the unusual environment of simultaneous deficit expansion and savings drawdown providing a supportive set-up for corporate profits and tight labour markets supporting wage growth. Q1'24 data has, once again, surprised to the upside and challenged the market pricing of Federal Reserve (the Fed) cuts. While job growth remains strong, some leading indicators of employment are suggesting slowing and the surge in immigration is supporting the idea that the equilibrium level of employment growth is currently higher. The Fed is likely to take a 'risk management' approach and begin loosening policy later this year, with the path of cuts uncertain going forward.

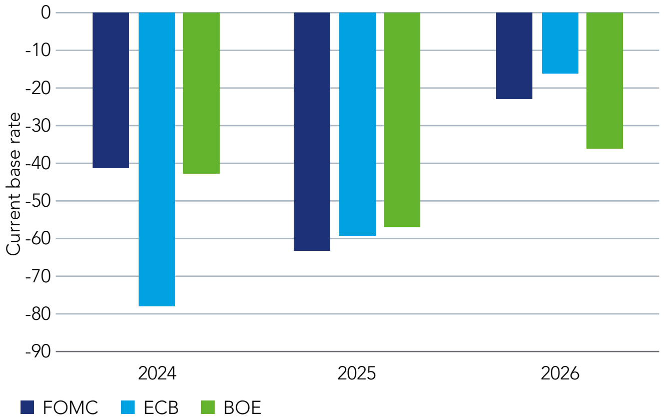
Euro area growth continues to be weak, with divergence between the core and peripheral countries notable and the latter benefitting from last year's fiscal stimulus. The European central bank (ECB) continues to push June as its base case for the first cut. Fiscal rules have been reinstated and governments are no longer ignoring the fiscal slippage, supporting the idea that growth will continue below trend and require supportive policy from the ECB as we progress through 2024 and 2025.

Recession was confirmed in the UK in Q4'23 and, while growth has recovered slightly in Q1'24, it can only be described as stagnant. The Consumer Price Index (CPI) has made steady progress towards target through 2023 and is expected to continue lower this year as the impact of Ofgem[1] price cuts come through in late spring.

The labour market is loosening slowly and elevated wage pressure is dissipating as per survey data. Activity will most likely remain subdued as we see fiscal consolidation and a continued drag from tight monetary policy. The Bank of England (BoE) needs to loosen policy, with a failure to act soon implying a more dramatic easing cycle in the future. Risks around the UK persist on the political front with an election likely in November this year.

[1] Ofgem is the Office of Gas and Electricity Markets, a government department regulating and overseeing the UK's gas and electricity networks.

Figure 3: Net central bank pricing



Source: Bloomberg, as at 17 April 2024.

The market has tested central bank pricing this year and valuations are now much less challenging. We prefer to own markets where the growth outlook is weaker and the potential for further unchecked deficit expansion is more limited. In that sense, we own euro area and UK rates as opposed to US.

Curve steepening remains high conviction. Today, the market is almost solely focused on individual data points and what they mean for the next central bank meeting and, given the stronger-than-expected data, this is flattening the curve. However, as we move forward we see several potential scenarios in which steepening resumes:

i) **The Fed pushes ahead with easing in the current environment – i.e. the economy continues to grow, inflation sits at around 3%, with high deficits and large issuance needs.**

ii) **There is a steepening in front end contracts, rippling out across the curve.**

iii) **Labour market weakness broadens and more cuts are priced back in.**

Rates volatility has come off gradually but in a volatile fashion from the highs of 2023. With risks rising, particularly around deficit expansion and markets pricing out central bank cuts, the MOVE Index is again heading upwards after a brief sub-100 period. We expect this to remain volatile, but unless the debate moves convincingly to further hikes it is likely to remain contained for the moment.

Figure 4: Our macro scores

Duration	Curves	Volatility
+1	+2	+1

Source: Federated Hermes, as at April 2024.

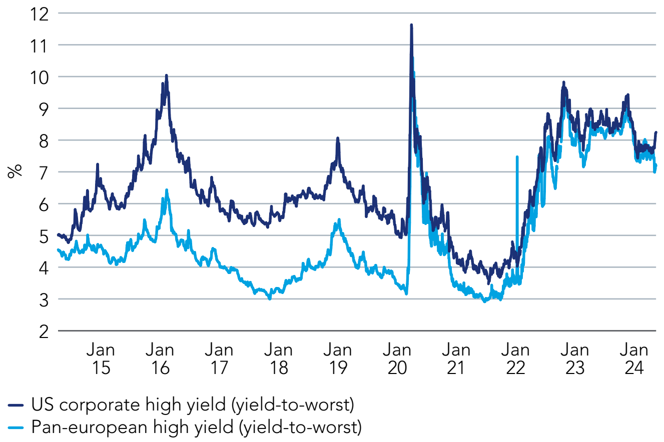
Corporate fundamentals

With the higher rate environment starting to impact corporate credits, selection remains key.

The current backdrop of higher interest rates appears to be catching up with a number of corporate credits, as we note an increase of companies that have been exploring liability management options. We have also seen a recent shift in issuer behaviour, especially in more stressed parts of the market; from efforts to de-lever the balance sheet in a credit friendly way such as asset sales, to more issuers expecting creditors to take a haircut as companies try to 'right size' the balance sheet. Given these latest developments, credit investors must remain vigilant.

Over the last few months, we have witnessed a significant increase in negative credit stories, especially relating to larger capital structures – and a few of them have experienced severe downward price movements as a result. We note that most of these negative developments relate to weak operational performance, high leverage, and companies realizing their capital structures are likely unsustainable. (This is especially the case for companies having to refinance upcoming maturities at significantly higher cost as compared to the last few years, as illustrated in Figure 5, below.).

Figure 5: Higher rate environment drives higher refinancing costs for issuers



Source: Bloomberg, as at 18 April 2024.
Past performance is not a reliable indicator of future returns.

As a result, we have seen a number of companies – at least eight in the month of March, including large capital structures such as Altice France and Ardagh – exploring options, including hiring advisors to review their capital structures, exploring liability management options or announcing they will not be able to pay upcoming maturities. In our view, these latest developments are a clear reflection that higher rates are starting to negatively impact corporate credits and it is becoming more difficult for companies to 'kick the can down the road'.

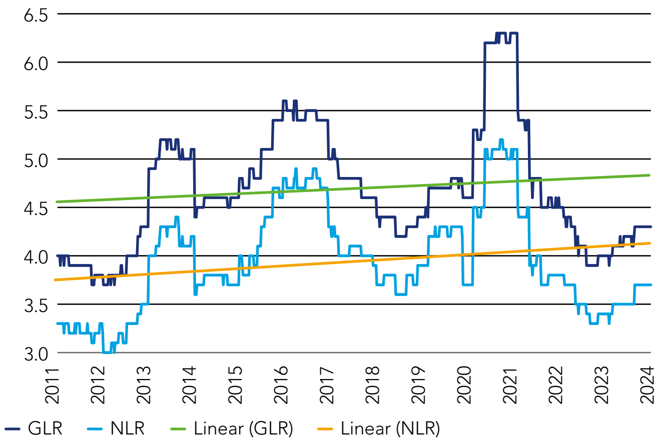
[2] Earnings Before Interest, Taxes, Depreciation, and Amortization.

Earnings to improve in the second half, credit metrics continue to worsen, but from a high base

Consensus expectations for high yield corporates point to flat revenue and slightly negative EBITDA[2] growth in the first quarter, with gradual improvement throughout the year. This is consistent with what we have been hearing from companies in the healthcare, chemicals and packaging sectors. Throughout reporting season, we will be listening for any further specifics, such as the end of destocking or any signs of a faster-than-second-half-2024 recovery in the more challenged sectors.

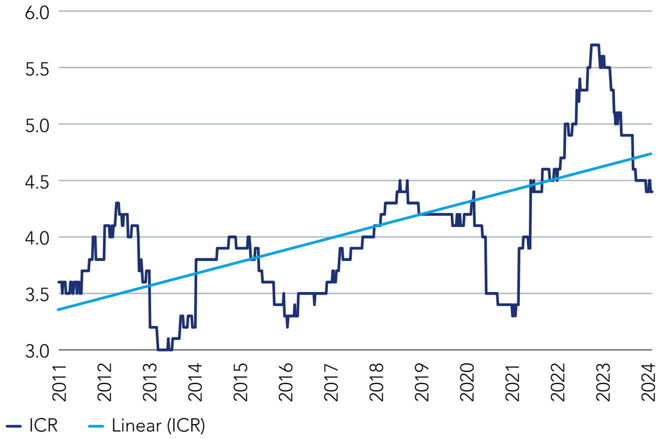
Credit metrics continue to deteriorate with leverage rising, but still remain below long-term averages as seen in Figure 6. Interest coverage has dropped sharply, as demonstrated in Figure 7, and it will likely continue to erode as companies continue to refinance at higher rates.

Figure 6: Leverage continues to increase



Source: BofA Global Research, as at 31 March 2024.

Figure 7: Interest coverage has dropped sharply



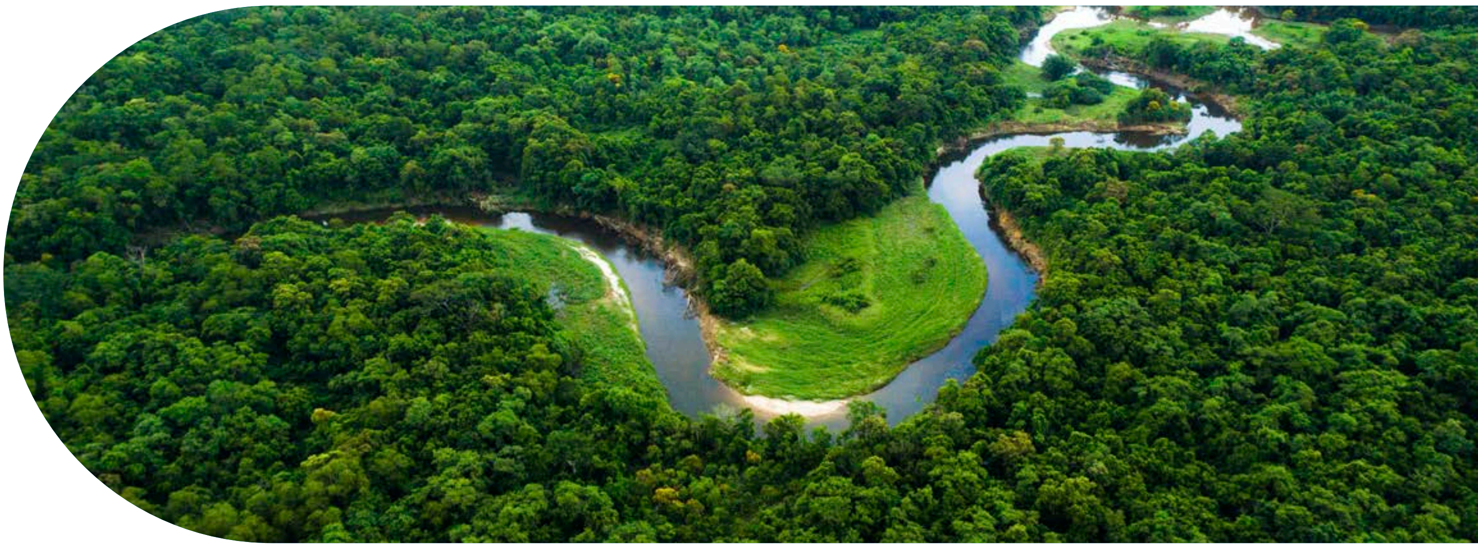
Source: BofA Global Research, as at 31 March 2024.

Issuer behaviour:

We have seen a marked shift in issuer behaviour in recent weeks. This is particularly evident in the stressed part of the market which is currently trying to 'delever' and 'right size' bloated capital structures which are not sustainable in the current rate environment. Some of these issuers have shifted in tone on deleveraging methods from creditor friendly, such as asset sales, to indicating creditors need to also participate to help with the deleveraging efforts.

Creditor-on-creditor violence has become a 'buzz phrase', with certain lenders positioning themselves to prime existing debt and/or receive higher recoveries in liability management exercises. Issuer behaviour has appeared opportunistic and not necessarily 'friendly' to the wider creditor groups here, pulling down our view of creditor behaviour at this point in time. However, in better rated, lower default-risk issuers, behaviour remains more balanced.

All of this requires continuous caution and vigilance from credit investors, with fundamental credit analysis remaining at the core of our investment process.



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 ICE BofA ML Option Volatility Estimate Index (MOVE), a yield curve-weighted index of the normalized implied volatility on one-month treasury options.

Over the last six months sentiment has been positive on the market – even verging on complacent at times. However, recent hot prints on inflation coupled with increasing tension in the Middle East have mitigated this view. As a result, our usual risk metrics charts, such as the Morgan Stanley Global Risk Demand Index or the bull versus bear equity tracker, are now in less extreme territory.

It is also worth noting that, despite its spike back above local wides, the MOVE Index is not only on a downward trajectory, but has also managed to break under 100 for the first time in some time.

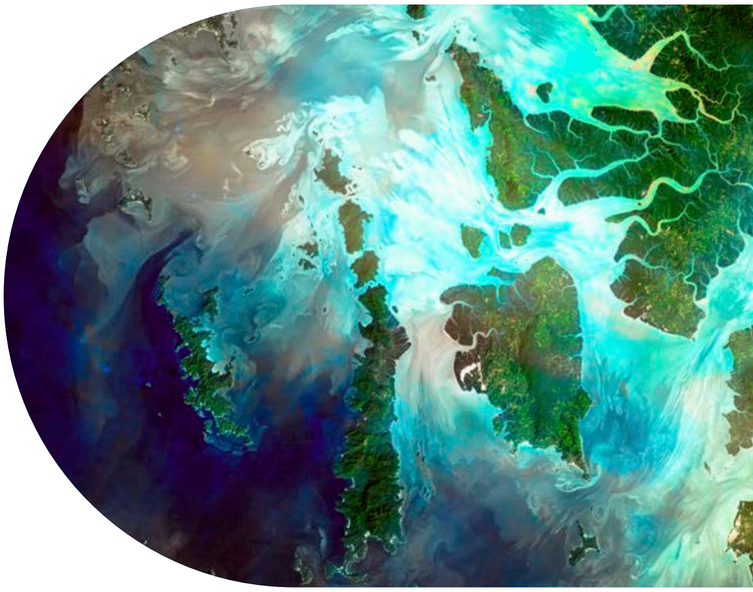


Figure 8: The MOVE Index

Source: Bloomberg, as at April 2024.

Based on these observations, we upgrade our Sentiment score to -1 from -2, reflecting a less complacent tone.

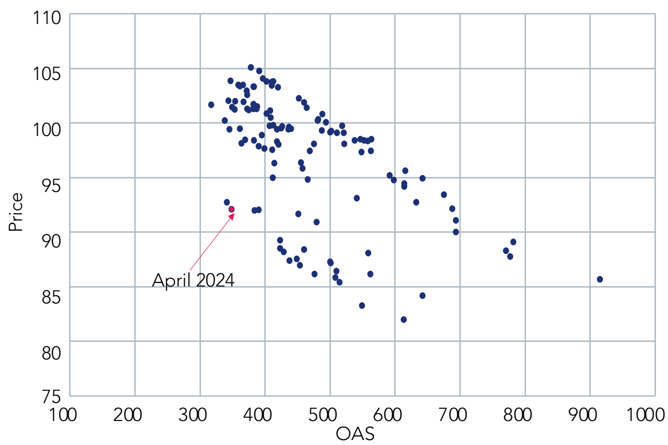
ii) Technicals

In the meantime, technicals remain in strong shape. The combination of regular, solid flows entering the market coupled with negative net supply on the high yield side remains the best support for a tight spread environment. As discussed in previous editions, the high yield market continues to shrink month after month and investors are hunting for paper. As a consequence, new issue premiums are compressed and the overall credit market exhibits limited downside catalyst. We maintain a Technicals score of +2.

iii) Relative value

Relative value presents an interesting conundrum. On the one hand, we acknowledge the tight level of spreads across all rating spectrums, with the notable exception of stressed credit. On the other hand, we believe spreads should not be looked at in isolation and that other factors apply. We consider relative value to be a triangulation between spreads as well as a price and yield. While the first metric looks stretched, the other two metrics are at a multi-year low/high, respectively, making the overall value proposal fair to slightly rich, and more than just rich. We maintain a Relative Value score of -1.

Figure 9: Global credit – Credit spread vs. cash price since 2019



Source: ICE BAML and Bloomberg, as at 31 March 2024.

Catalysts

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

Negative catalysts: As we move through 2024, our catalyst for disappointment around central bank dovishness has started to play out. Nonetheless, we continue to think changes to the expectations around rates cuts by central banks will be a key catalyst for markets, and represents both a key upside and downside catalyst.

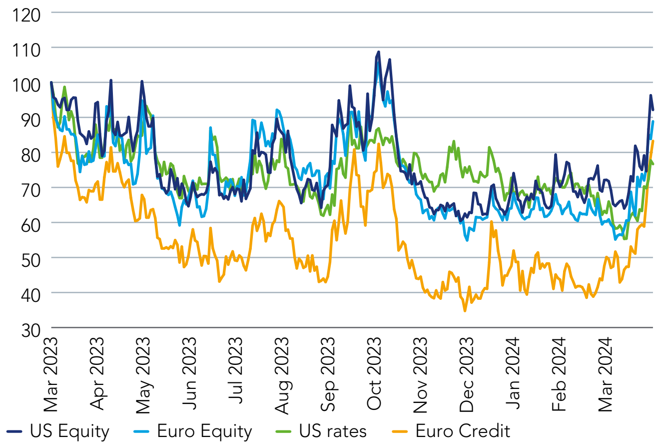
Geopolitical tensions are currently high, and we note both the ongoing Ukraine and Russia conflict as well as rising tensions in the Middle East. We also think the underlying threat of US-China tensions is worth watching. The ability for corporates to manage the higher-rate environment, and the refinancing risk associated with high leverage capital structures, is another key downside risk. This has again started to play out with a number of liability-management exercises announced or rumoured at the time of writing.

Positive catalysts: Our key upside catalysts include dovishness from central banks, a potential de-escalation of geopolitical tensions and better-than-expected economic data out of China.

Overall, our catalysts are weighted towards the downside at this point in time, based on expected impact and probability.

On the pricing side, implied volatility has moved in line with the market and therefore appears on the cheaper side. The Middle East headlines have triggered a repricing across all asset classes which, in our view, may be an overreaction. It is worth noting, however, that credit volatility remains cheap on a cross-asset class basis as highlighted by Figure 9, and we expect this repricing to fade.

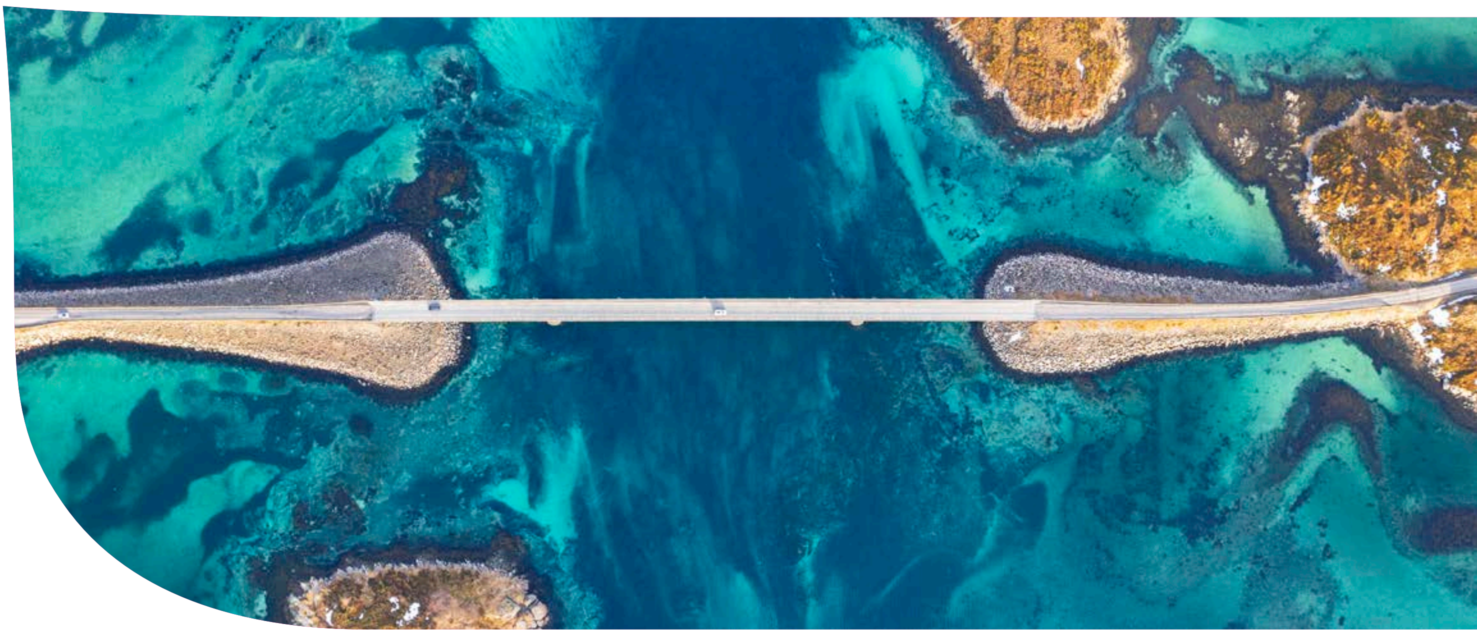
Figure 10: The volatility indices across asset classes



Source: Bloomberg and Federated Hermes, as at 16 April 2024.

However, we cannot disregard the increase in volatility skew, a proxy for tail-risk demand as well as the inversion in the term maturity curve with three months volatility briefly trading inside one month, reflecting investor's nervousness regarding episodes of volatility.

Therefore we assign a score of -1 on the catalysts side as a reflection of this.



Credit relative value

i) Intra-credit opportunities

Global investment grade: Investment grade total returns have been weak year to date, with the global investment grade market returning -1.80% in US$-hedged terms[3]. Performance has largely been driven by volatility in rates, as investors dialled back rate-cut expectations due to stronger-than-anticipated economic data. Recent weakness means yields continue to look attractive, with current average yield-to-worst of 5.19% representing the 87th percentile on a five-year lookback period[4]. News flow around the future path of inflation and interest rates is likely to remain a key driver of performance going forward, however, from a credit perspective, we expect the asset class to be relatively well insulated from the stress likely to be seen in highly levered credit. Corporate fundamentals are still robust despite some softening, and many companies have multiple levers to manage their credit quality should they come under pressure, as well as access to a well-functioning primary market. This, combined with historically low cash prices, gives us comfort in the potential upside from here.

Figure 11: European investment grade utilities vs. global investment grade

Source: ICE Bond Indices, Federated Hermes, as at 19 April 2024.

In terms of market segments, European investment grade continues to trade at attractive levels relative to the US, reflecting the market's perception of the weaker near-term prospects for European growth. Within Europe, the utilities sector stands out as cheap from a historical perspective having lagged the tightening in spreads in the broader market. We note, however, that this is largely the result of weakness in the UK water sector; an area we find unattractive given the extensive regulatory and governance issues it faces.

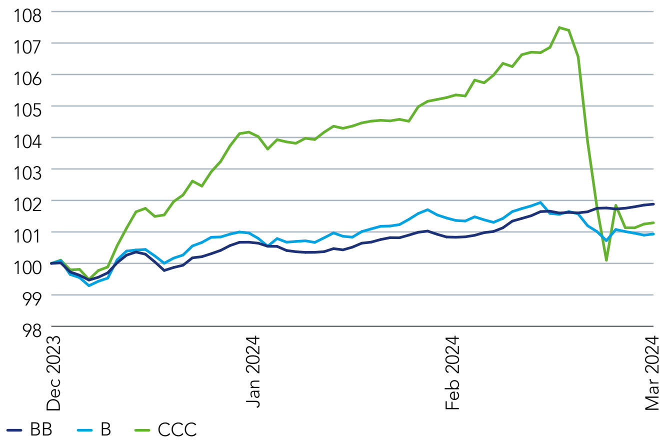
In the US, strong demographic trends and a shortage of housing supply continues to support homebuilder fundamentals, leaving the sector trading at tight valuations. We currently favour defensive sectors such as telecoms as well as national champion European financials where fundamentals remain robust and valuations offer investors an attractive risk reward. From a curve perspective, we continue to focus on the belly (five to ten years) where we see the best balance of convexity and spread available.

Global high yield: Global high yield returns have been positive year to date with the market returning 0.57% in US$-hedged terms[5]. From a regional perspective, initial outperformance of European high yield has now retraced, leaving it trading closer to longer term averages versus the US. With this in mind, investors will need to be selective in finding opportunities to exploit cross currency inefficiencies within the capital structures of issuers.

Over the first quarter of 2024, we have seen dispersion take hold as a number of idiosyncratic stories have affected returns, especially in the more highly leveraged parts of the market. Despite a strong start to the year, the European CCC segment erased all its gains at the end of March as headlines hit the market for several issuers. While we note the European CCC index is concentrated in a small number of issuers, this demonstrates the importance of credit selection as more companies look to navigate over-levered capital structures amid the potential for higher-for-longer rates.

We remain cautious on lower-rated segments of the market, preferring to be up in quality where carry is still attractive but credit fundamentals are more robust. From a sector perspective, we maintain a preference for less cyclically exposed parts of the high yield universe and have found opportunities to add risk in areas such as healthcare.

Figure 12: European high yield total return by rating bucket



Source: ICE Bond Indices, Federated Hermes as at 31 March 2024.
Past performance is not a reliable indicator of future returns.

[3] ICE Bond Indices as at 16 April 2024.
[4] ICE Bond Indices as at 16 April 2024.
[5] ICE Bond Indices as at 16 April 2024.

ii) Stressed, distressed and special situations

From a fundamental point of view, there is a large proportion of debt maturing in the next two years which will need to be refinanced, with CCCs in particular facing a 2026 maturity wall – nearly 32% of CCC bonds will mature by June 2027.

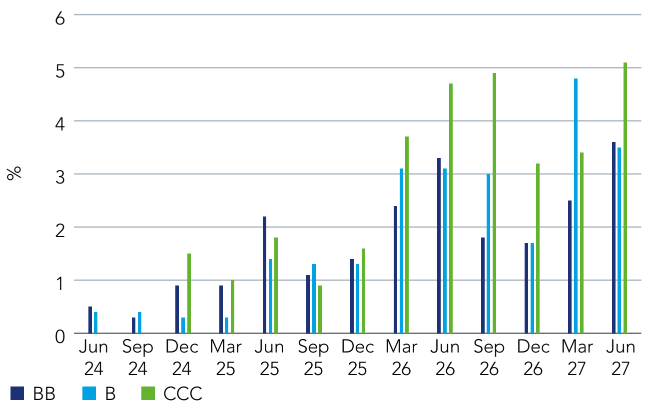
Treasurers who delayed refinancing over 2023 based on the hope of lower rates in 2024 will have been disappointed. For many of these corporates, refinancing bonds at current levels is likely to be significantly more costly versus existing coupons, further stressing balance sheets and cash flow metrics, including interest coverage.

Capital structures are creaking: witness examples of debt larger than EV/EBITDA multiples to imply no equity value in some capital structures. We expect to see continued stress for this part of the market as companies deal with this combination of high leverage and refinancing needs.

The combination of the above is leading to some liability management exercises. Here, creditor-on-creditor violence has become a key risk, as creditors look to maximise recoveries in contentious situations. Against this backdrop, attention to covenant flexibility will be key to understanding the ability of this part of the market to execute liability management actions which may be coercive or priming.

These dynamics are pulling spreads out in CCCs making relative value on a spread basis look more favourable (albeit spread is arguably less important than cash price in stressed scenarios). The average cash prices for CCCs is stable around 75-80 since November 2023.

Figure 13: 32% of CCC bonds will mature by June 2027



Source: BAML, as at April 2024.

iii) Financials

After a strong first quarter, the outlook for financials looks promising for the year ahead.

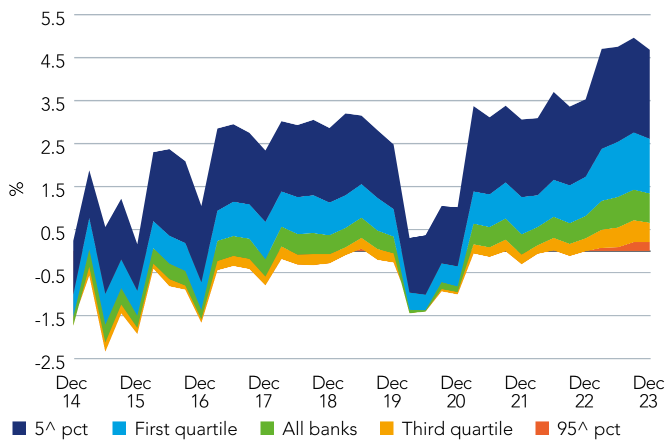
In this environment, however, risks abound – from a quantitative tightening-induced run, to the reverse repurchase agreement operations (RRP)[6], or 'reverse repo', of the US Federal Reserve, to the rise of zero-day-to-expire options, to name several. However, despite this, the data is in better shape than expected.

In January, the European Banking Authority (EBA) released its Q4'23 'Risk Dashboard' which, while backward looking, provides aggregated statistical information based on a sample of 164 EU/EEA banks[7]. As a reader of 360° might expect, the data indicates the financial sector is healthy.

On average, capital is solid. The Common Equity Tier 1 (CET1) ratio sits at historic highs of 15.9%, while non-performing loans (NPLs) have ticked up to 1.9% now, versus 1.8% in Q3'23, and following six quarters of flatlining at historic lows with 'Stage 2' loans rising to 9.6% from 9.2% in Q3'23. Return on equity (RoE), meanwhile, has fallen to 10.3% from a high of 11.0% in Q2'23, with the cost of risk at 48bps and liquidity ratios tracking higher.

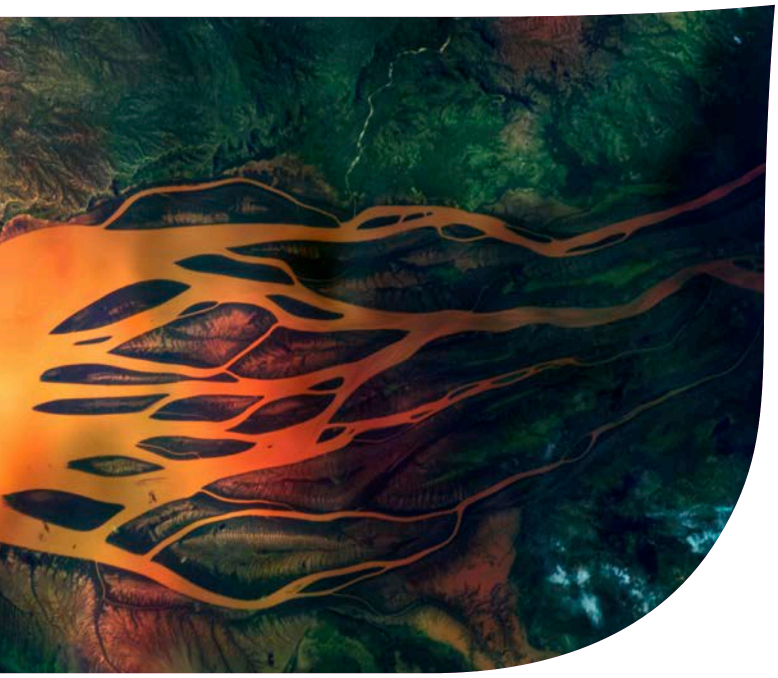
It has been almost 10 years since Europe's banking union was formed, introduced as a component of the EU's existing economic and monetary union in response to the 2008 global financial crisis. The ECB's stress test, known as the 'asset quality review' (AQR), is the largest-ever supervisory exercise and forms part of the ECB's comprehensive bank assessment. It is useful, in the decade since the European Banking Supervision initiative first conducted these tests, to look at what has been accomplished.

Figure 14: European banks, RoA (%), 2014-23



Source: European Banking Authority, as at 31 December 2023. Data released 4 April 2024.

[6] A reverse repurchase agreement (RRP), or reverse repo, is the sale of securities with the agreement to repurchase them at a higher price at a specific future date. A reverse repo refers to the seller side of a repurchase agreement (RP), or repo.
[7] 80% of the EU/EEA banking sector by total assets.



The return on asset (RoA) chart paints a favourable picture, with first-quartile banks achieving a 4.5% RoA, and third-quartile at 1.3%. Can this be put down to higher rates? Not quite. In our view, there are several reasons behind this:

- R^2 LLP and real GDP growth is 58% in Europe
- A cost of risk of 100bps+ was 'normal' 15 years ago versus today's 'normal' of 45bps – granted, with dispersion.
- Bad debt provisions have remained low amid recent crises, including the Covid-19 pandemic and the Russia/Ukraine conflict.
- Low credit growth indicates a flipside of less risk of exuberant lending
- The mixed shift in bank loan books towards low-risk residential mortgages
- Pressure applied by the ECB's SSM to banks to clear out legacy NPLs

Overall this is as we expected, and is consistent with our confidence in EU bank fundamentals given such a strong starting point.

iv) Corporate hybrids

Hybrids offer investors a decent risk-reward profile compared to higher levered corporates

Corporate hybrids have continued to outperform in the first quarter of 2024, with investment grade hybrids returning 2.3% and high yield 4.7% in US$-hedged terms . From a valuation perspective, the outperformance has compressed average sub-senior spreads to 155bps, which is well inside longer term averages. This leaves little room for further compression in some capital structures and we have been looking for opportunities to move up in seniority where it makes sense to do so. Compared to BB-rated high yield, however, hybrids continue to screen as attractive and, in our view, offer investors a decent risk-reward profile compared to higher levered corporates.

Figure 15: Corporate hybrids vs. euro senior non-financals

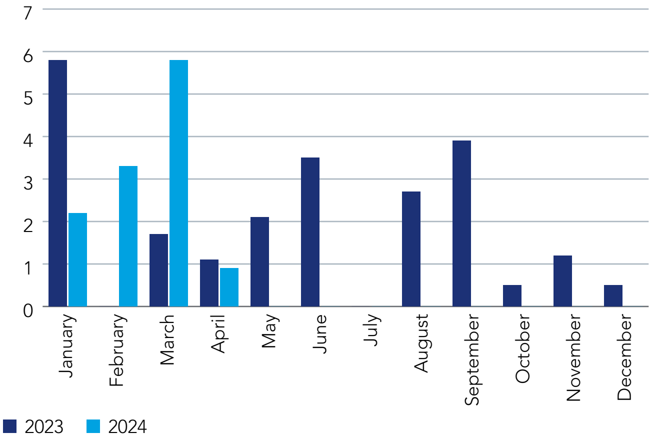
Source: ICE Bond Indices, Federated Hermes as at 16 April 2024.

Recent performance has been buoyed by strong technical drivers within the market. The first quarter of 2024 has been busy from a supply perspective, with US$11.3bn of bonds issued versus US$7.5bn in 2023. However, inflows into credit and issuers choosing to reduce hybrid capital layers has offset the impact of an increase in gross supply.

Investor demand for primary has been robust, with deals continuing to be oversubscribed and limited new issue premium available compared to existing curves. We expect supply to continue to be high over the rest of the year, with over US$19bn of hybrids coming up to their first call date and the potential for some issuers to come to market early to refinance bonds callable in 2025 ahead of time. In our view, this is likely to be manageable and well digested by the market as investors continue to target defensive sector exposures and higher coupon bonds for income.

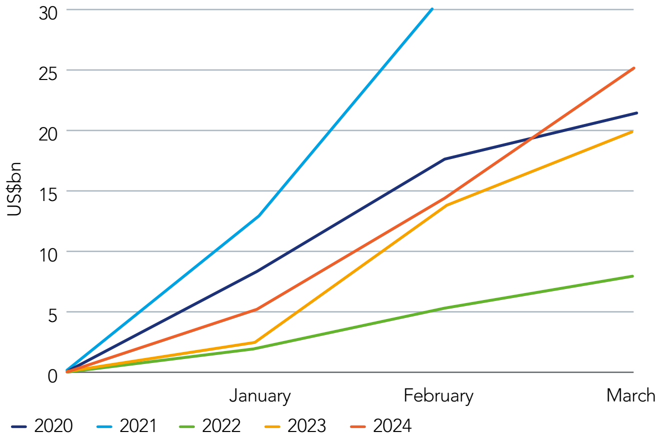
From a sector perspective, real estate still stands out as stressed and we have recently seen another example of an issuer offering exchanges on existing hybrids trading at distressed levels, rather than calling at par or not calling at all. We prefer to access the market in sectors such as telecoms and utilities where issuer fundamentals are robust and hybrids represent a key part of the capital structure, reducing potential extension risk.

Figure 16: Corporate hybrids, amount issued (US$bn)



Source: Bloomberg, Federated Hermes as at 16 April 2024. Includes corporate hybrid securities issued in GBP, EUR and USD in Europe, US and Canada.

Figure 17: Global convertible bond – cumulative new issuance pace (US$bn)



Source: BofA Global Research, as at April 2024.

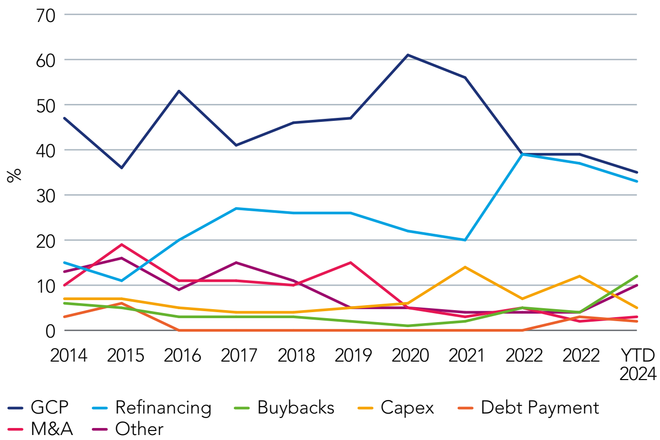
v) Convertible bonds

The new issue market for global convertible bonds has had an upbeat start to the year with around US$25bn pricing in the first quarter.

As expected, volumes had been driven greatly by larger, more well-established corporates that have been gaining more and more representation in the market. With the exception of 2021, new issuance volumes in 2024 have had the strongest start to the year this decade so far. In an environment where some companies have been able to price their converts with a 0% coupon (as a function of the structural characteristics of the instrument) while yields across global corporate credit stand around 5.3%, the early tempo of primary market volumes comes as little surprise[9].

With respect to the use of proceeds, refinancing (across both convertible and non-convertible debt) remains a key driver of activity. In Q1'24, 33% of proceeds across global convertibles were dedicated towards refinancing outstanding debt, towards the highs over the last 10 years.

Figure 18: Global convertible bond – use of proceeds decomposition



Source: BofA Global Research, as at April 2024.

We remain positive about future prospects for issuance dynamics in the convert market and, in particular, anticipate elevated levels of refinancing activity from traditional issuers as well as new entrants seeking to lower their borrowing costs. As a result of upcoming maturity hurdles and an increasing acceptance of the higher-for-longer rate environment from market participants, we continue to expect overall issuance growth to persist.

[9] Source: BofA Merrill Lynch Global Corporate & High Yield Index, as at 31 March 2024.

vi) Emerging markets

Emerging market (EM) corporates lagged their developed markets (DM) counterparts in the Q4'23 rally, but their spreads staged a decent leg tighter in Q1'24, almost catching up to other asset classes.

Corporate fundamentals in EM are largely stable, with companies having deleveraged during the recent cycle and holding strong liquidity. As a result, we think the macro narrative around growth and inflation, the possibility of further Fed rate cuts and geopolitics will remain the main driver of spreads from here. Inflation continues to soften across all major EM economies and the broad outlook continues to be positive for EM inflation, even with the recent move in many commodity prices.

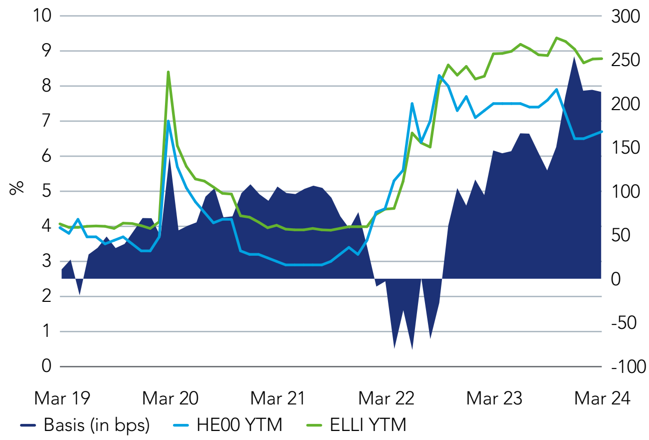
Despite the Q1'24 rally in hard currency EM corporates, we still see a slight EM premium versus their DM counterparts and are looking to capture that by selectively increasing our EM exposure, particularly in countries and sectors that have lagged. A few strategic trades we like include increasing our exposure to Latin American high yield and taking advantage of some steep curves of high quality corporates in investment grade and extending our positioning. Yields continue to stay high for EM corporates versus historical averages and remain the main source of attraction for investors; Q1'24 saw the phenomenon that with stronger demand, spreads compressed and offset the higher rates.

vii) Leveraged loans

In the last edition of 360 we reflected on the strong rally experienced in the high yield market, which left loans in its shadow. 2024 started on a different note and now the mood music has changed, with investors altogether more conservative on the course for future rate cuts and macro perspectives.

In this context, we believe floating-rate instruments continue to be a good source of diversification and positioning; the Morningstar European Leveraged Loan Index (ELLI) outperformed the ICE BofA Euro High Yield Index, delivering +2.53% versus +1.62% in Q1'24. This was driven by stronger yield in leveraged loans than fixed bonds (YTM of 8.78% vs 6.65% respectively at the end of March 2024) and was reflected in the secondary market as the Morningstar European Leveraged Loan Index (ELLI) is now trading at 96.83 versus 96.05 at the beginning of the year.

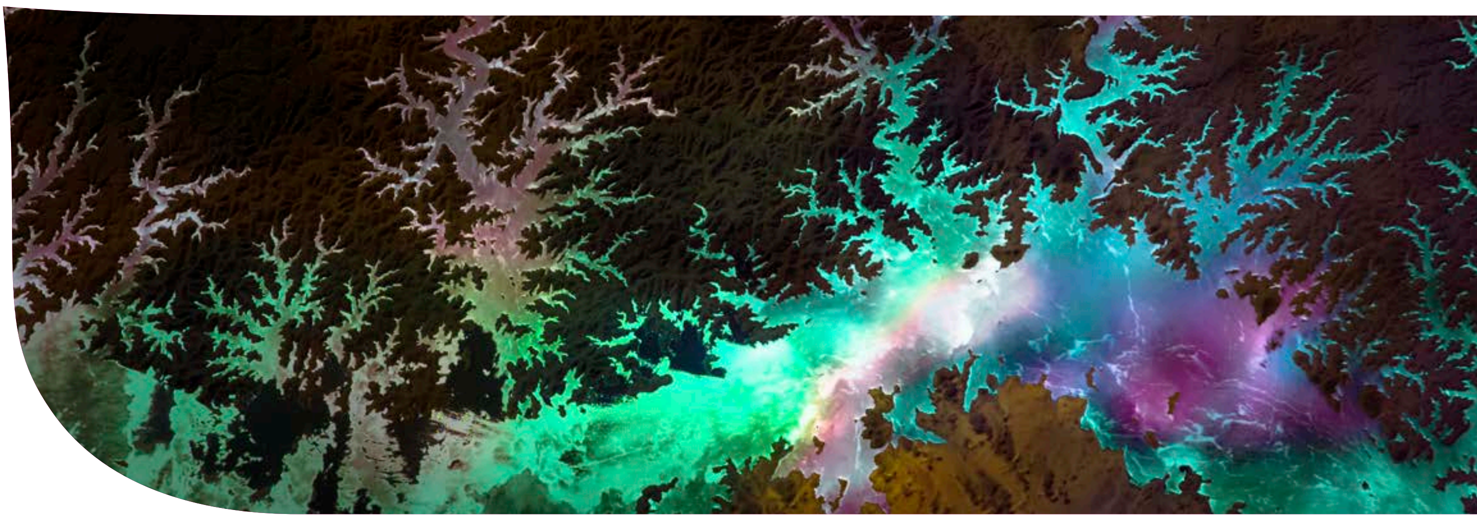
Figure 19: Yield-to-maturity – ICE BofA Euro HY (HE00) vs. ELLI



Source: LCD News, Bloomberg, as at 31 March 2024.
Past performance is not a reliable indicator of future returns.

Looking at corporate fundamentals, we remain cautious although slightly more positive. On the one hand, the default level rose from 0.44% at the end of Q1'23 to 1.65% at the end of Q1'24 (still lower than October 2020 level at 2.61%), and the up/down ratio is still below 1 with over 61 downgrades versus 21 upgrades in the index over the quarter.

On the other hand, CCCs are down from 5.86% at the end of Q1'23 to 3.34% at the end of Q1'24, and the maturity wall is now strongly skewed after 2026 – driven by an increasing repayment rate over the last year (from 0.99% in March 2023 to 2.96% in March 2024). This view was broadly shared by loan buyers as single Bs and CCCs delivered +2.65% and +2.41% respectively – both outperforming BBs (+1.23%) in Q1'24.



In terms of primary activity, it seems there are signs of recovery after a long period of high interest rates and macroeconomic and geopolitical uncertainty. 3ME February recorded €18.7bn of total institutional loan volume (€21.4 bn including Pro Rata Loans) – the highest print since January 2022. Although most of the issuance is driven by refinancing, this should be viewed as a positive to upcoming buy-out activity and the return of private equity, which, according to PitchBook, has accumulated more than €365bn of dry-powder (250% more than 10 years ago).

The overall positive sentiment experienced since Q4'23 was a good opportunity for Collateralised Loan Obligation (CLO) managers to print their deals and benefit from better arbitrage. This was translated in strong CLO prints in Q1'24 (given the usual time delay observed in the structured product market) with €10.9bn of new money from 26 deals (up from €6.7bn in Q1'23). This made for the second-highest quarterly volume total in the CLO 2.0 era, supporting secondary activities as deals get ramped.

Overall we think leveraged loans are an attractive alternative, given their potential to offer strong yields, the support offered by CLO technicals, and their potential to be neutral to interest rate moves.

viii) Structured credit

The structured credit market has proven resilient this quarter, weathering recent geopolitical storms and demonstrating a tendency to ride through periods of volatility.

It has been a positive start to 2024 for structured credit, both Asset-Backed Securities (ABS) and collateralised loan obligations (CLOs), with the year-to-date performance building upon strong returns over the past two years, further strengthening the investment case for structured credit in many respects.

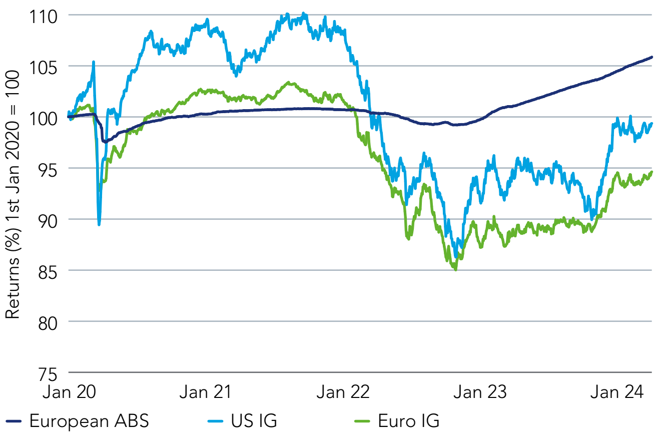
European ABS distributed issuance levels stand at 54% ahead of 2023's numbers for Q1'24, with nearly €20bn of new issues coming to market in 2024 up to the end of March[10]. Taking the previous five years' average, 2024 still stands 23% ahead on distributed issuance. After a slow start to the year, European CLO issuance has built momentum over the first quarter with nearly €11bn of issuance across 26 deals coming to the market.

Despite these sturdy issuance volumes, investor demand continues to outstrip supply. This imbalance is particularly pronounced in the mezzanine tranches of the capital stack, where it is not unusual to see new issue subscription levels reach 7.0x or more in ABS deals. As a result of this demand, spreads have continued to tighten across all asset types and tranches for both ABS and CLOs in 2024. Even the recent softening in the wider credit and equity markets following the escalation of Middle East tensions has had little impact on structured credit.

In fact, looking over a longer time frame, it's fair to say structured credit has weathered recent storms well and has exhibited a tendency to ride periods of volatility with relative equanimity.

Figure 20: Securitised assets vs. other asset classes

European ABS have the potential to provide 'risk' like returns, without the volatility



Source: Bloomberg, as at 28 March 2024.
Past performance is not a reliable indicator of future returns.

During the period from January 2020 to March 2024, European ABS, represented in the above graph by the Bloomberg Pan European Floating ABS Bond Index Total Return Index, has performed better on a total return basis than European IG corporate bonds, and has given investors almost the same level of returns as European HY corporate bonds. Given the higher rating, with the ABS index being predominantly AAA-rated, this has been a remarkable period for the asset class, especially in the rates-driven sell-off from the beginning of 2022 onwards.

With both CLOs and European ABS being made up almost entirely of floating-rate bonds, they have been a good place for investors to allocate in a rate-rising environment. With the consensus landing on a 'higher-for-longer' narrative, the higher rates result in an attractive all-in yield for structured credit which is contributing to the steeper gradient from the end of 2022 onwards.

With attractive yields, lower volatility in these uncertain times, and a pick-up in spreads for any given level of risk, we expect the attraction to the asset class to continue. If geopolitical tensions rise further in 2024, the ability to play across a capital stack from AAA down to typically B-rated tranches should allow investors to move up in credit quality with further protection against volatility while still earning attractive returns.

[10] Bloomberg, as at March 2024.

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