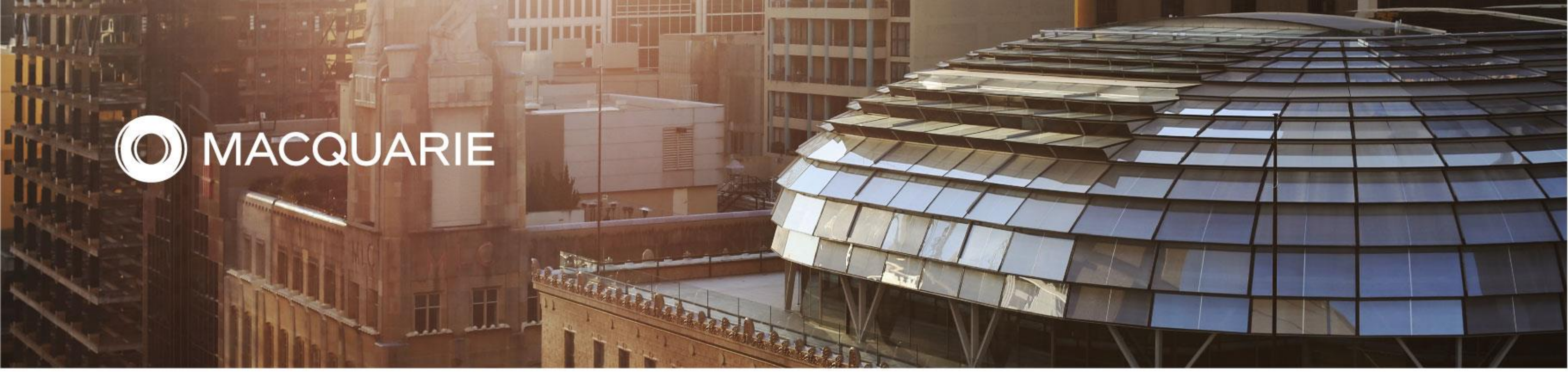


Investment Strategy Update #115

Fixed income – Credit: Not yet priced for ongoing uncertainty

- We expect further widening in credit spreads. Current valuations, while attractive relative to levels seen in the last decade, do not reflect economic uncertainties and/or the potential for rising defaults.
- Investors should remain defensively positioned across fixed income markets. We recommend an overweight position to developed market sovereign bonds where risk-adjusted yields are currently attractive and provide downside protection. We prefer high-quality investment grade bonds to provide a boost to income.
- We think credit markets are priced for a soft economic landing, given limited systemic concerns. This may prove to be correct, but there is limited cushion in spreads if it is not.
- In the near term, we are likely to see default rates increase from recent lows driven by company and/or country specific factors in contrast to a wave of defaults/systemic default cycle given the lack of broad-based credit vulnerabilities.
- Several factors suggest default rates will be modest relative to those seen during an average recession including strong corporate balance sheets, limited refinancing needs and a well-capitalized banking system and so we think the major risk to credit markets is at the lower quality end of the spectrum rather than across all issuers
- But, the path of policy rates, the impact of central bank balance sheet reduction on bond market liquidity, the extent of demand destruction and the risk of spill overs from the current distress in low quality issuers in high yield (HY) and emerging markets (EM) suggest credit markets will remain volatile are not likely to undergo a sustained tightening for some time.

The global growth outlook is deteriorating as central banks continue to raise policy rates to bring inflation back under control. In line with a deteriorating economic backdrop, credit markets are also vulnerable to a deterioration in fundamentals. While spreads have widened to reflect increased macroeconomic uncertainty (IG at ~180 bps and HY at ~470 bps), they are still pricing in a relatively benign credit cycle.

Although spreads are relatively appealing in an absolute sense (particularly given the rise in risk free rates), we think they are more likely to widen than contract. We just don't quite know how much and for this uncertainty, we would rather have more cushion should defaults rise more than currently implied or should the soft-landing expectations prove optimistic (see *Investment Strategy Update #114, Downside economic growth risks intensify*).

Credit markets are not worried enough about default risk...

Source: Factset, MWM Research, September 2022

Credit markets priced for moderate rise in defaults

At present, implied default rates would indicate that markets are only moderately worried about systemic risks and that any deterioration in credit fundamentals would be well less than that experienced in an average recessionary period.

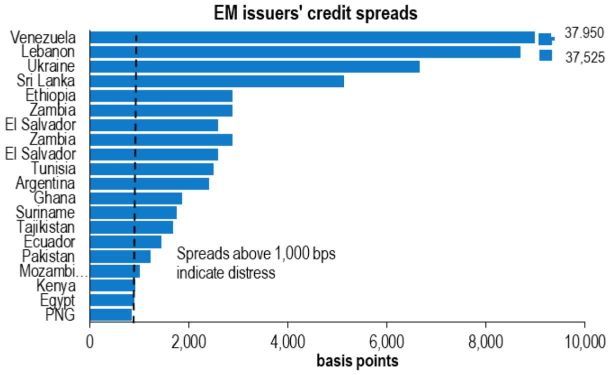
Room for spreads to move wider

	Current spread (bps)	5 Yr average spread (bps)	20 Yr average spread (bps)
Investment grade	181	167	210
High yield	477	413	562
Emerging markets (hard currency)	319	302	371

Source: FRED, MWM Research, September 2022

High yield spreads are currently implying a default rate over the next year of around 3.5%. versus 8-12% in a typical recession. While there are pockets of weakness (~9% of the high yield market that are showing signs of distress), this is largely contained to the most speculative, low quality areas (CCC-rated).The same can be said for EM debt markets, where pockets of distress concentrated in small, low-quality countries that issue in debt in USD (~20 EM's), but there is limited systemic concerns with average yields around 7-8%. However, further rate hikes by the Fed will underpin the USD vis-a-vis EM currencies and make servicing EM debt more expensive. For these issuers, the risk of a negative feedback loop developing is elevated, where issuers need to raise USD, placing further pressure on their local currency and reserves, and further increasing debt servicing costs.

Signs of distress in low quality EM borrowers



Source: Factset, MWM Research, September 2022

Idiosyncratic factors likely to drive defaults

While broad economic risks are high, conditions remain broadly supportive for credit markets. As a result, we think default rates will remain below average recession levels even if the global economy does slip into a shallow recession. Outside of an economic hard landing (we would peg this to sub 1.5% global growth), our base case is that default rates will rise to between 3-4% by 1H23 albeit from a very low level of approximately 1.5%. We think that this default cycle will be mostly driven by company and/or country specific factors in contrast to systemic/industry factors for a number of reasons:

1. **Broad based credit vulnerabilities are low**. Leverage remains low and asset quality high versus other periods leading into an economic slowdown.

2. **Corporate balance sheets are exceptionally strong**. Despite rising rates, interest coverage ratios remain strong with many corporates raising capital during the COVID downturn. Pressure on supply chains, labour shortages and rising input costs is adding to add to margin and cash flows concerns but not universally.

3. **Corporates are well capitalized.** Along with ultra-low interest rates available over the last two years, most corporate issuers moved to lock in ultra-low rates for as long as possible; across US high yield markets only ~9% are likely to need to refinance their debt in the next 2 years.

4. **Banks are well capitalised**. Post the global financial crisis, financial regulators have been largely successful at increasing capital requirements to strengthen bank balances sheets, which was aimed at minimising risks to the financial system in the event of wide-spread deterioration in the default outlook.

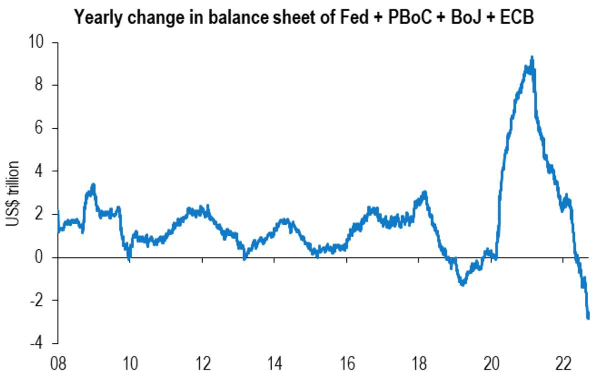
Elevated uncertainty surrounds our base case

There are many reasons to believe that regardless of a weakening economic growth backdrop that there will be a relatively benign credit cycle with limited systemic risk. However, there are significant uncertainties surrounding the economic outlook both here and abroad and this means a lot could go wrong. Broadly speaking, we think credit markets remain priced for a soft economic landing with limited systemic risks and strong idiosyncratic supports. But each of these assumptions has downside risks that investors must recognize, and we do not yet think the risk-reward is appealing enough given a long list of concerns including:

1. **The length of time central banks may have to maintain cash rates at restrictive levels.** The longer rates are held at restrictive levels, the greater the risk around refinancing and default risk. Current pricing in credit markets reflects expectations of a Fed pivot in late 2023. We view this as optimistic.

2. **The impact of quantitative tightening (QT) on bond market liquidity.** For some time, central banks have provided liquidity (quantitative easing) in times of market stress to ensure financial conditions remained loose and financial markets functioning. This tailwind is gone except under more severe conditions.

Impact of the withdrawal of CB liquidity is unknown



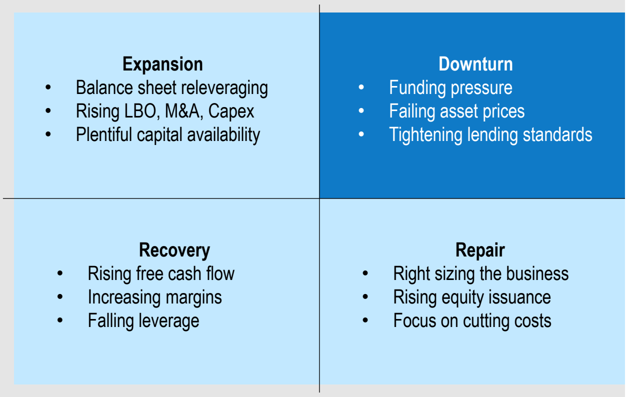
Source: Factset, MWM Research, September 2022

Anatomy of a credit cycle

Credit cycles follow the direction of the broad economy and have four phases:

1. **Expansion:** The economy will typically be entering its late cycle, where lending standards are still relatively easy and there is availability of capital. Companies will look to maintain growth via borrowing, increasing leverage metrics.
2. **Downturn:** Economic growth will begin to stall or move to negative territory. Available capital will decrease as liquidity diminishes, lending standards will tighten and borrowing costs will rise. Companies may struggle to meet the resulting increased financial obligations and start to fail; default rates will rise.
3. **Repair:** Companies will work to stem the decline in fundamental credit conditions by adding liquidity and stabilising their balance sheets; leverage may be reduced by various measures such as cost cutting or issuing equity.
4. **Recovery:** Companies enter recovery as free cash flows start to grow and margins increase but will remain cautious and focus on conservative balance sheet management until solid, sustainable growth is achieved.

Phases of the credit cycle



Source: Western Asset, MWM Research, September 2022

Macquarie WM Investment Strategy Team

The report was finalised on 15 September 2022.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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