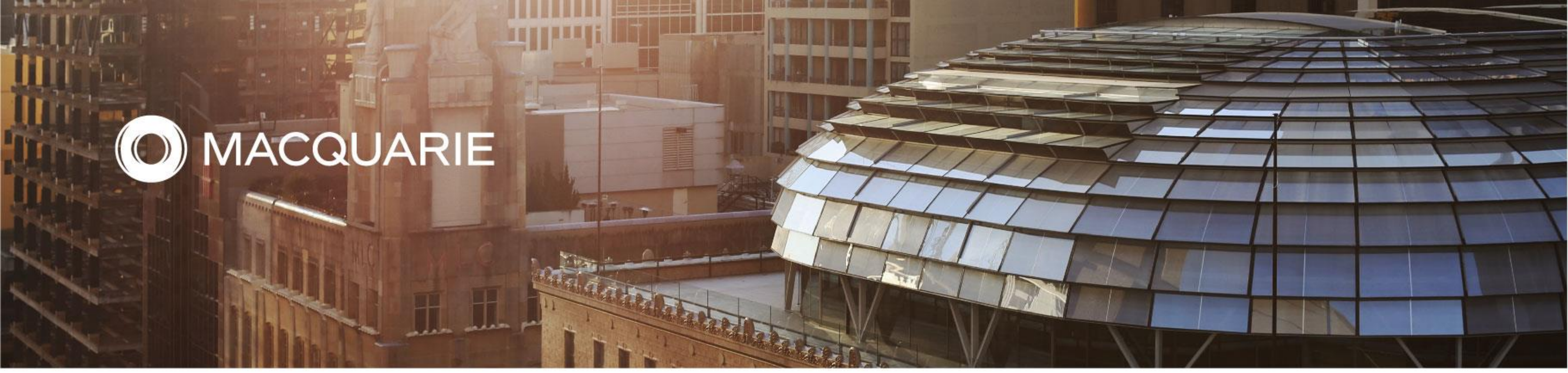


Investment Strategy Update #101

Fixed Income - Credit: Expect further spread widening

- **Bond markets have suffered one of their worst declines in decades** through late 2021/early 2022 as both higher and stickier than expected inflation has driven a rapid reset in interest rates and policy expectations.

- **To date, bond market weakness has infected equities but left credit markets relatively immune** with spread widening largely confined to the lowest quality issuers. But, with economic growth set to slow (a US recession is now Macquarie's base case in late 2023) and corporate fundamentals unlikely to get any better, we think spread widening will continue.

- **It is possible that the fear pervading markets begins to settle down** as inflation and rates expectations stabilise and recession fears (at least in the near term) decline. This could see equities bounce and credit spreads move tighter. But this is likely to be a short-term reprieve and the trend out through the rest of the cycle is wider and not tighter.

- **On balance, credit conditions are solid.** Financial conditions are not yet restrictive, balance sheets are in their best shape in recent years and default rates are expected to remain at low levels in the year ahead. But these are peak conditions and are likely to deteriorate rather than undergo a sustained improvement if central banks continue their crusade against elevated inflation.

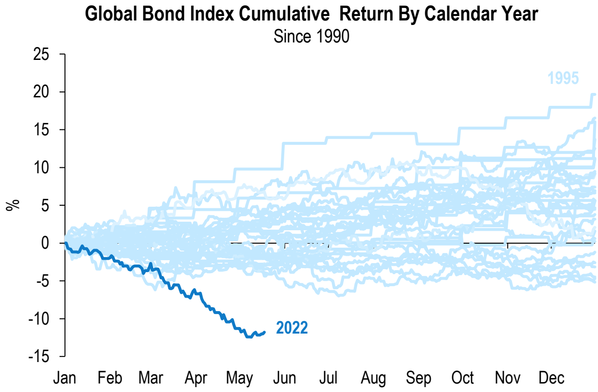
- **We recommend staying underweight credit.** We have already seen the first cracks appear in credit markets, starting with the weakest link and ultimately, we expect this to also infect the strongest**.** Given the rapid decline in bonds, we think credit will underperform sovereigns from this point forward, particularly at the longer duration end.

- **Within credit, we prefer exposure to high quality and funds that focus on bottom up selection.** For investors seeking consistent income, we recommend alternative strategies such as private debt.

Bond markets have been hit hard…

Since the start of 2022, global sovereign bonds have suffered one of their worst declines in decades as inflation picked up and central banks reset rate hike expectations. A lot is already being priced into long bond yields but until we see some evidence that inflation is stabilising and/or a more dovish message out of central banks (which will be contingent on inflation), then bond yields will continue to exhibit two-way volatility and so we are not yet prepared to upgrade our underweight that we have run with for over a year.

Bonds have had their worst start of year ever

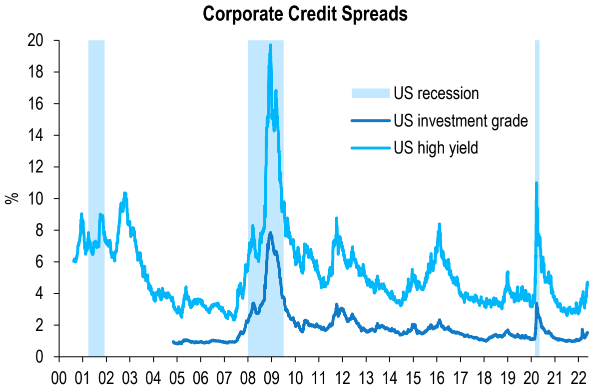


Source: Factset, MWM Research, April 2022

…with cracks now starting to appear in credit

Credit markets, until recently, had remained relatively immune because the correction in bonds was seen only as an inflation and tightening issue and not a growth issue. However, as fears over the global growth outlook have increased and evidence that corporate fundamentals are beginning to weaken cracks have started to appear in the weakest areas of the credit spectrum.

Credit spreads are beginning to widen

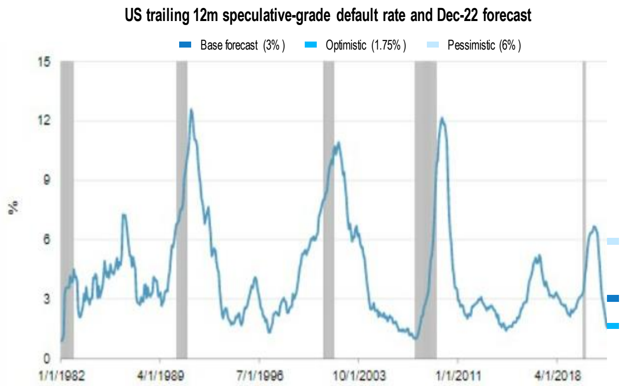


Source: Factset, MWM Research, April 2022

Fundamentals are still sound (for now)…

At this stage, corporate fundamentals remain solid with strong interest coverage and profit margins continuing to service high levels of corporate debt. However, margins are peaking, revenue growth has slowed and a weaker macro-outlook means we have already seen the lows for credit spreads in the current cycle and that the risk is that they continue to move higher.

Default rates to rise but remain below historical averages



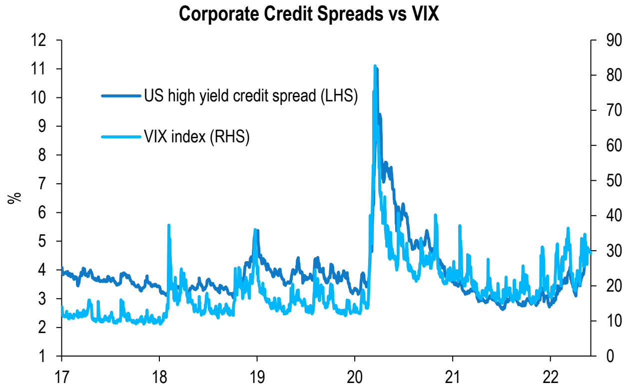
Source: S&P Global, April 2022

We do not see systemic concerns around corporate health or the functioning of credit markets (the plumbing of the system despite the decline in liquidity levels). While default rates are likely to rise in the year ahead, this will be from very low levels and there is little evidence to suggest they approach historical averages (~4% for HY bonds, ~3% for loans) due to several reasons:

- Balance sheets are well positioned. Corporates took on cheap debt in the last few years, reducing their interest costs and pushing out debt maturities.
- Commodity price strength is highly supportive for energy issuers that have previously accounted for a disproportionate number of defaults in previous cycles when prices have collapsed.
- A high survivorship bias means the overall quality of the market is close to its highest level on record.

We do expect to see increased defaults in lower rated credits as interest cover ratios come under pressure with inflation and higher rates, especially for borrowers with weak pricing power. Moody's currently expects speculative-grade corporate default rates to edge lower to 1.9% by mid-2022 before rising to 2.9% in March 2023, which would still be below the long-term average of 4.1%.

Elevated volatility means higher credit spreads

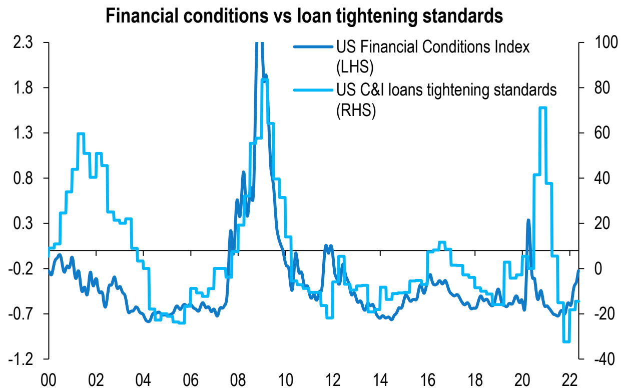


Source: Factset, MWM Research, May 2022

…but credit spreads will widen further

Credit has been the last domino to fall and is now weakening, starting with the most vulnerable. High yield corporate spreads have widened 189bps so far, the biggest move since June 2020. Investment grade spreads have widened by 50bps since the start of the year.

Tightening financial conditions correlate with widening spreads



Source: Factset, MWM Research, May 2022

Credit sentiment is often an important driver of the business cycle and is closely tied with economic activity. Therefore, a weakening credit market is an important leading indicator because it is often the accelerator of further problems to come for the economy.

Positioning with fixed income

We remain underweight fixed income and see returns from fixed income investments to be negative relative to growth assets given tightening policy, an uncertain inflation outlook, slowing economic growth and ongoing equity market volatility. Within fixed income our positioning is as follows:

- **Neutral Emerging Markets:** We like EM debt for its attractive carry relative to DM together with positive real yields. In the near-term, ongoing conflict and elevated inflation are likely to cause ongoing volatility across EM debt markets as central banks continue to tighten policy.

- **Underweight sovereign bonds:** Central banks are prepared to fight the inflation battle aggressively despite the near-term consequences for growth. We are not yet prepared to take a more bullish stance on sovereign bonds until there is greater transparency on the near-term rates outlook. Sovereign bonds will provide some cushion to volatility in risk assets but will potentially post capital loss should bond yields rise further.

- **Underweight credit:** We downgraded credit at the start of 2022 on fears that contagion would eventually infect the last part of fixed income markets. We stay underweight credit due to risk of further spread widening. Returns from credit are expected to be driven by coupons. We see current yields providing a limited return cushion as rates rise and spread volatility increases. While credit is starting to offer more value as spreads widen, they are still below the peaks of recent crisis periods (current high yield spreads at ~4.9%). Further spread widening will present more attractive opportunities in high yield credit, but a faster than expected deterioration in financial conditions would see us shift further towards high quality (IG).

Spreads remain below previous correction peaks

Market correction period	Market loss (%)	High Yield OAS peak (bps)	Average High Yield OAS (bps)
Mar-00 to Sep-02	-49.1	1117	626
Nov-02 to Mar-03	-14.7	913	854
Oct-07 to Mar-09	-56.8	2182	1023
Apr-10 to Jul-10	-16.0	727	663
Apr-11 to Oct-11	-19.4	872	609
May-15 to Aug-15	-12.4	614	502
Nov-15 to Feb-16	-13.3	887	706
Sep-18 to Dec-18	-19.8	535	390
Feb-20 to Mar-20	-33.9	1087	617
Average		**993**	**666**

Source: FRED, MWM Research, May 2022

Macquarie WM Investment Strategy Team

The report was finalised on 29 May 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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