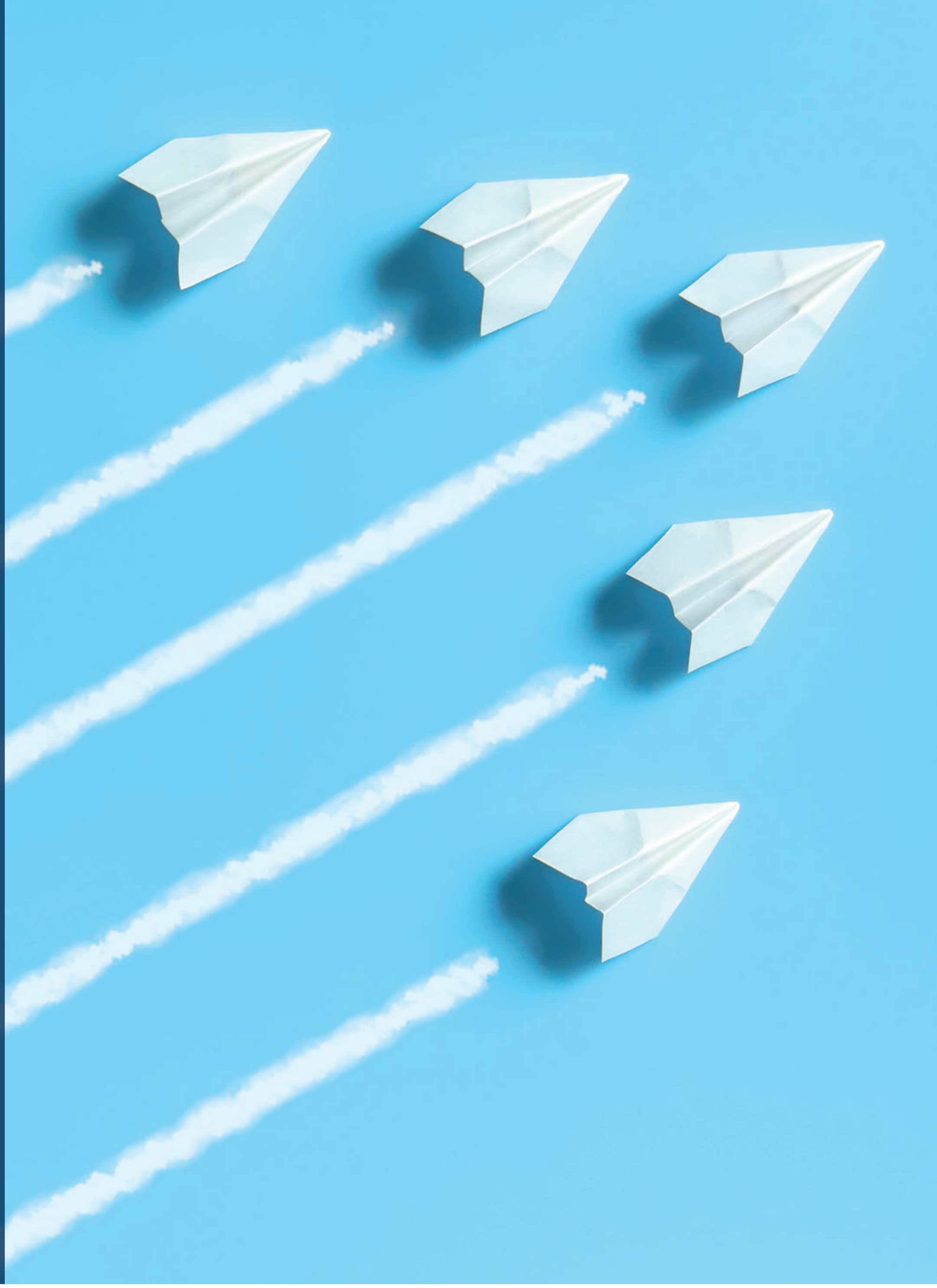

Insights

June 2022

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Five Credit Views in Five Charts

In the face of the significant volatility in financial markets, we must rationalise and digest the recent turbulence to identify deep, underlying thematics. In doing so, we have identified five key Credit market ideas that may help us mitigate long-term investment risk and generate long-term alpha.

1

Volatility is Expected to Remain High

As central banks around the world shift from Quantitative Easing (QE) to Quantitative Tightening (QT), markets are exhibiting uncertainty and volatility as investors adjust to a more "normal" environment. The changes we are witnessing are unparalleled after a decade of record low interest rates, which led to almost $17tn of negative-yielding debt. Now, we are experiencing generation-high inflation rates that have led to the need for numerous interest rate hikes. This transition, and the volatility that comes with it, is expected to continue as we adapt to a new economic paradigm.

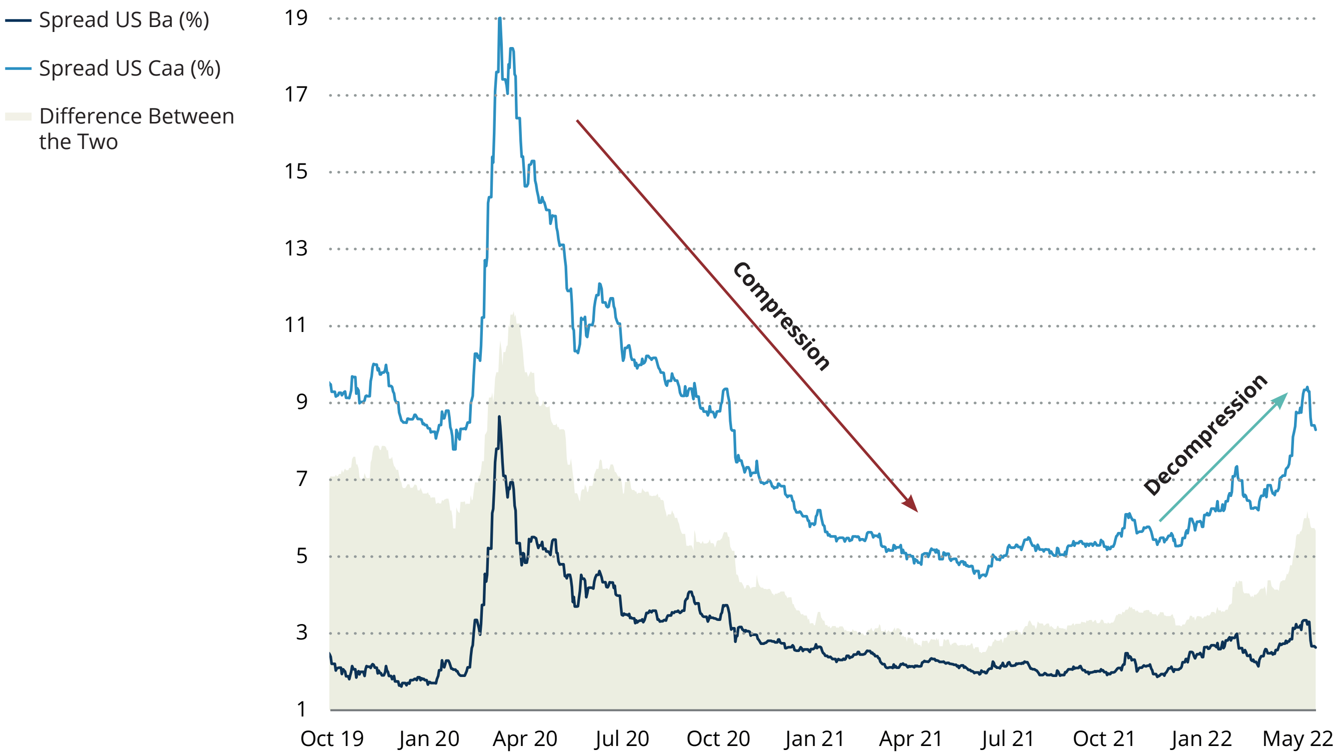
Chart 1: Volatility Brought Back by the Transition From QE to QT

Source: Bloomberg as at 31 May 2022.

2 Spread Decompression

The era of cheap debt and monetary stimulus that triggered growth has resulted in limited dispersion in Credit spreads, whether that be by rating, geography or sector. However, the narrative has now changed with a variety of factors likely to increase the need for active Credit portfolio positioning. Recent price moves have highlighted this: lower-rated CCC bonds, which outperformed during "risk-on" times, have underperformed the higher quality BB debt.

Chart 2: Recession Fears Hit Riskier Assets More



Source: Bloomberg as at 31 May 2022. Spread is measured by Option-Adjusted Spread (OAS). The indices used are the Bloomberg Ba US High Yield Average OAS and the Bloomberg Caa US High Yield Average OAS.

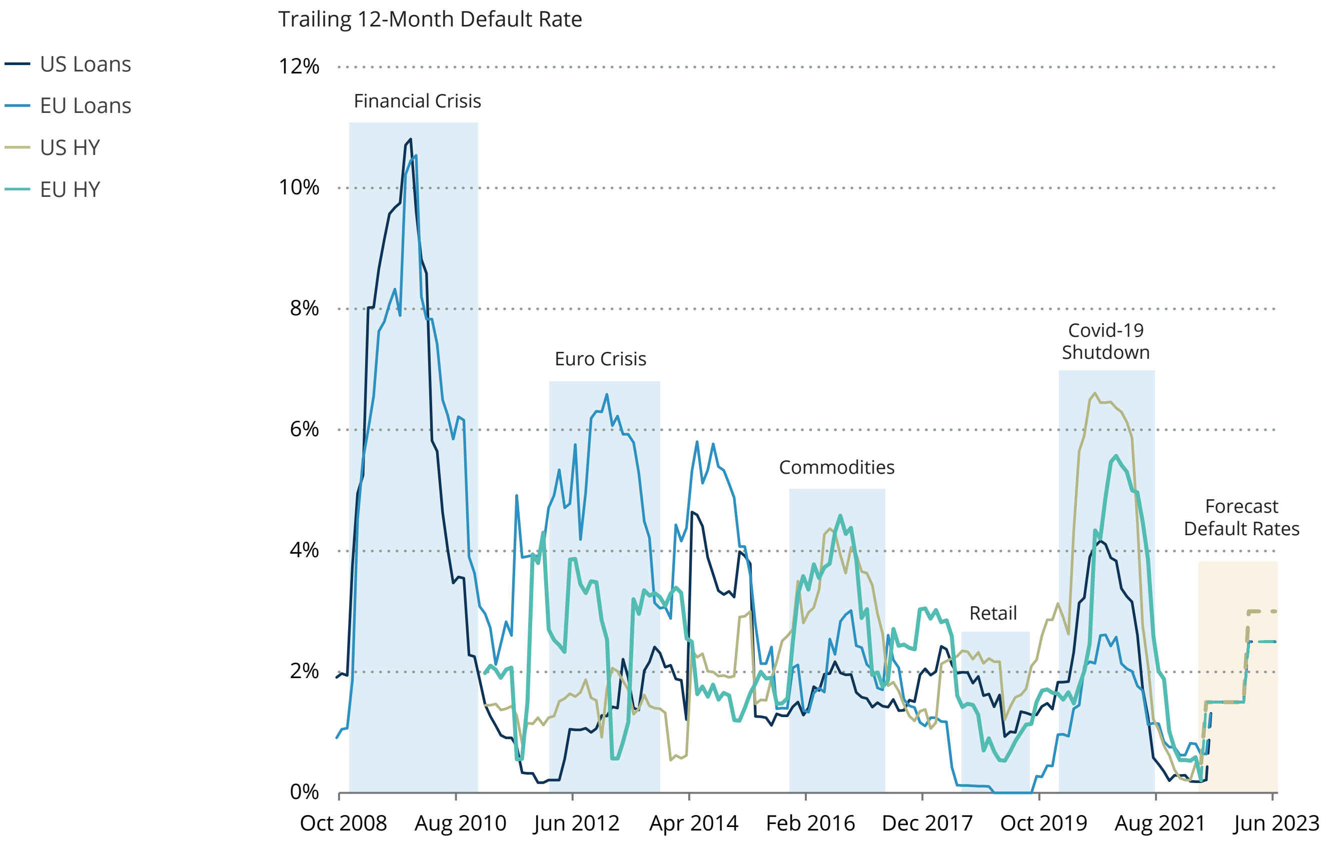
3 Default Rates to Normalise

In some cases, cheap debt has helped keep default rates artificially low – a situation that will normalise as interest rates start rising to levels more in tune with inflation. The resulting higher interest rates will squeeze margins and cashflow generation and therefore will lift default rates from historic lows.

However, we do not believe this is a systematic issue and expect default rates to remain manageable. This is because many companies have improved their balance sheets over the past few years, reducing leverage and costs. For instance, in Europe the leading STOXX Europe 600 index is forecast to post a net debt-to-EBITDA ratio of 2.2 this year, down from 3.09 in 2020, and 3.15 in 2019 (it was as high as 4.55 in 2014).

According to a recent S&P Global Ratings[1] report, the trailing 12-month High Yield default rate in Europe could increase to 3% by March 2023, which is still relatively low relative to previous economic cycles.

Chart 3: Default Rates: Moving Back to Average[2]



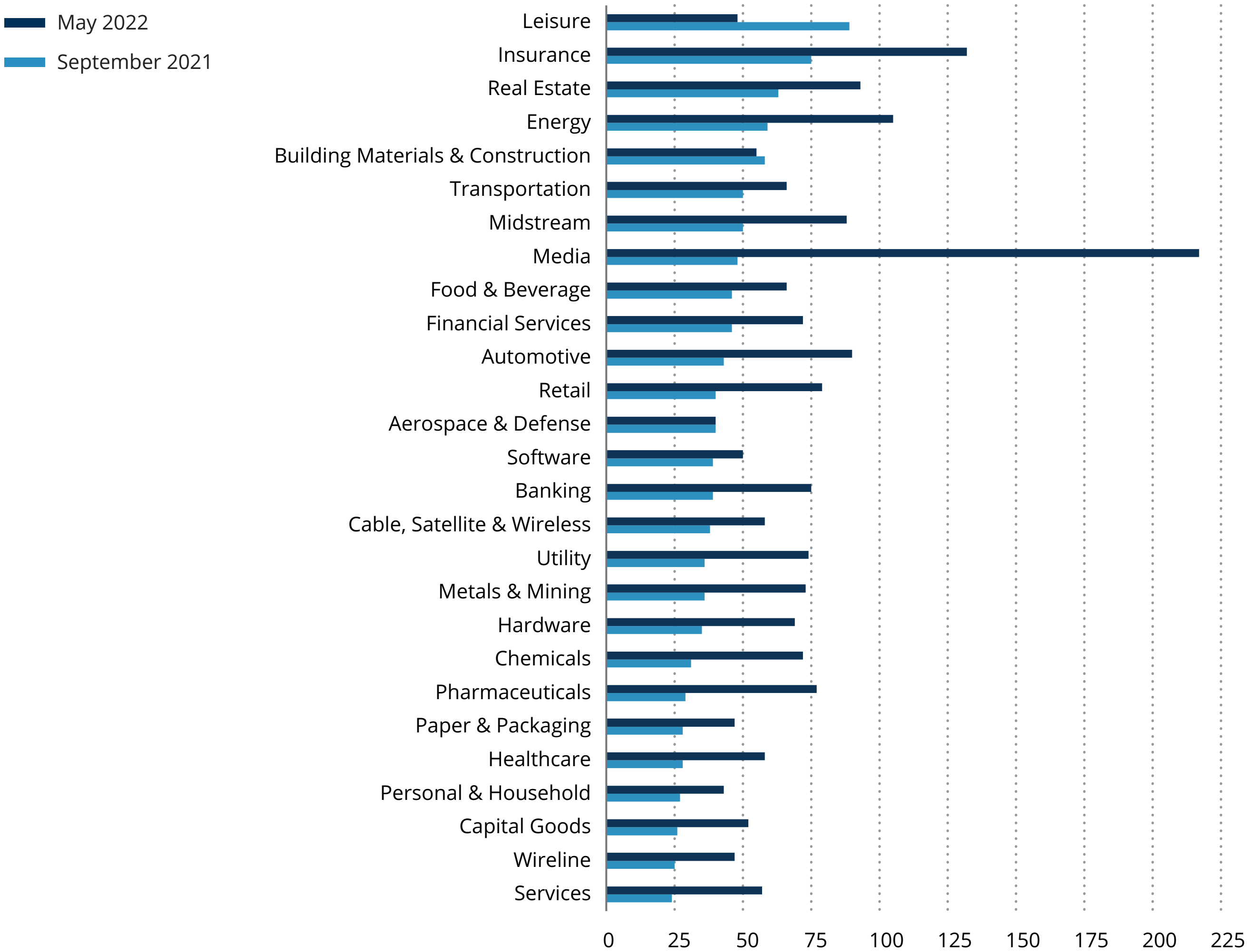
Sources: [1]S&P Global Ratings 'The European Speculative-Grade Corporate Default Rate Could Rise To 3% By March 2023' as at 18 May 2022. [2]CQS Macro and Fundamental Research and LCD as at 31 May 2022. Moody's Default Report as at 29 April 2022.

4 Good Times for Alpha

Whilst volatility and dispersion present substantial long-term opportunities, recession fears also trigger some [well-known investment biases, such as loss aversion and herding mentality](). This can create further attractive entry points for active managers, especially those with the ability to base their decisions on long-term fundamental research, instead of day-to-day market noise. In contrast, passive or benchmark-following investors may be less flexible and therefore less able to capture these opportunities.

Chart 4: Dispersion Presents Opportunity

(Interquartile Spread Range, basis points)

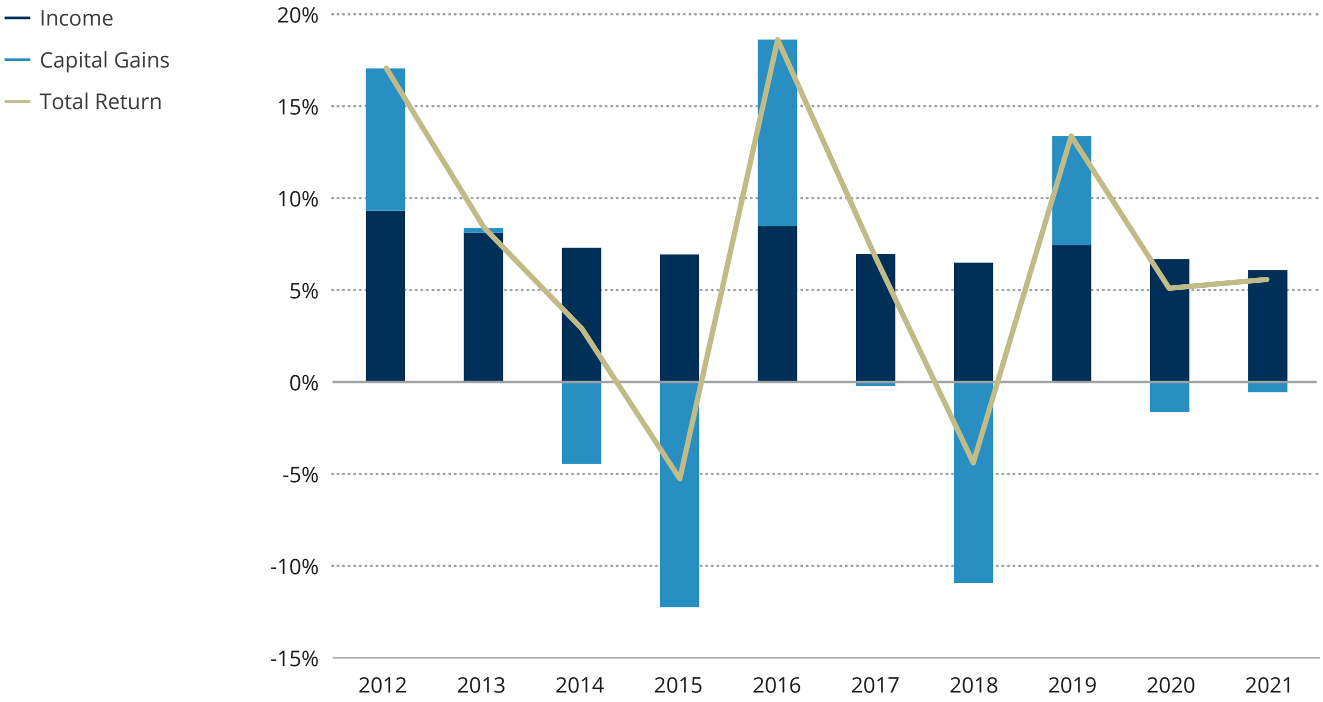


Sources: CQS Macro and Fundamental Research, and ICE as at 31 May 2022.

5 Income as a Shock Absorber

For bond investors, the flipside of rising rates is more attractive levels of yield. For instance, US sub-Investment Grade debt is presently yielding almost 8%, meaning that the asset class would have to fall considerably before investors incurred losses (for more on this, read our recent Q&A with Craig Scordellis, CQS' CIO – Credit, Good Times for Yield). Higher coupons give investors a bigger buffer to absorb any mark-to-market losses. As seen in Chart 5, US High Yield has only delivered negative annual returns in two of the past ten years, bolstered by the return from income.

Chart 5: Income Buffers Help Protect Against Volatility



Source: BBG, ICE and LCD as of 31 December 2021.

Conclusion

World financial markets are undergoing a regime change. After more than a decade of ultra-loose monetary and fiscal policy, investors now face rising interest rates and inflation. We believe Credit can help investors with:

- Interest rate protection: Floating-rate Credit assets can mitigate the effect of rising interest rates
- More yield: Higher rates mean higher yields, increasing returns for investors
- Volatility mitigation: most Credit assets provide regular income, which can dampen the effects of price volatility
- Alpha opportunities: as volatility creates dispersion, active portfolio managers may find attractive entry and selling points

At a time of heightened uncertainty and opportunity, an active, fundamental-based approach is paramount to help investors achieve their goals.

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New two-pager promoting MAC in a valuation year.

Good Times for Yield: Q&A with Craig Scordellis

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