Credit Market Themes in 5 Charts

Q4 2023

Highlighting Key Drivers for 2024

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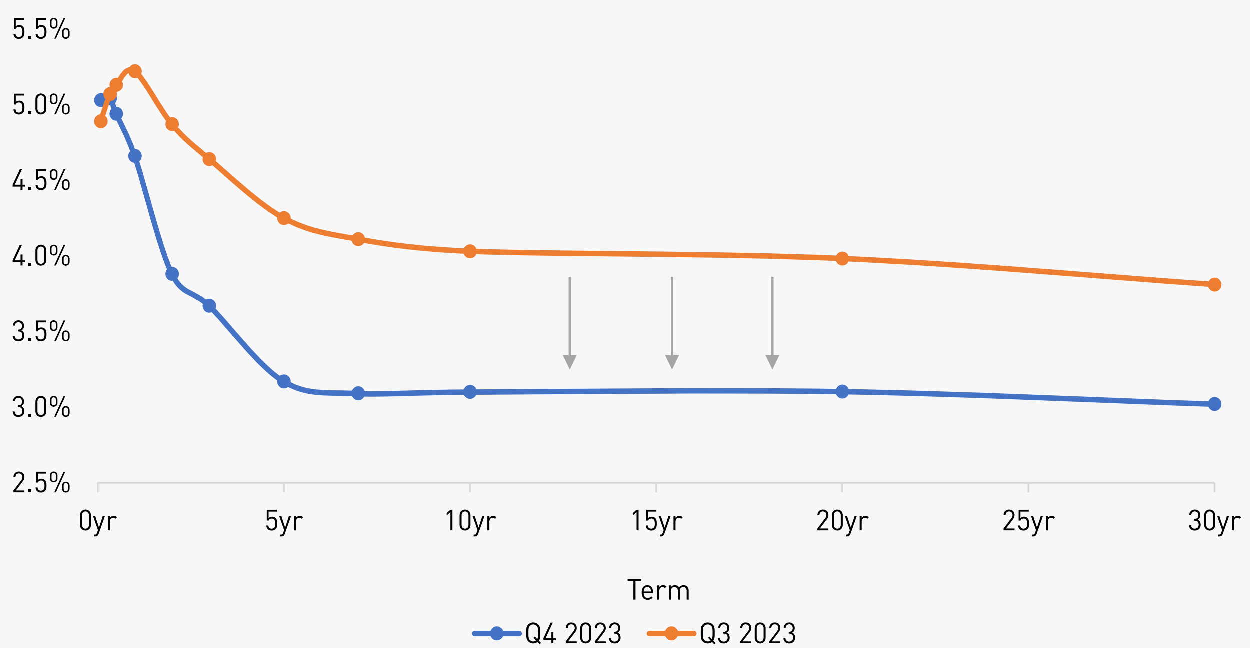
Coming into 2023, many analysts talked about "the year of bonds." A decisive shift in markets during Q4 allowed 2023 to live up to the hype after a very bumpy ride during the year. Fixed income investors saw significant gains following a pivot in central banks' tone and increased confidence from markets regarding the chance of an economic "soft landing."

As we head into 2024, we gathered some key themes and observations we believe will define the year ahead. Given the current economic outlook and valuation levels, we believe there is an opportunity for investors to de-risk portfolios by adding to active credit strategies. These strategies can act as an effective yet simple solution in a potentially choppy environment. The opportunities for active management continue to be attractive given heightened volatility and market dislocations.

Please feel free to contact us if you would like to discuss further or learn how we could help you meet your risk-return objectives.

1 Long-Term Bond Yields Dropped Sharply in Q4 as Investors Sensed a Central Bank "Pivot"

Q4 has seen a significant repricing of the Canadian Yield Curve as markets took the increasingly dovish central bank narrative as a "pivot" they had been waiting for. In response, bond yields dropped by around 100 basis points for all tenors beyond the front end of the yield curve. The US shared similar market sentiment, with employment projections remaining unchanged and inflation expectations decreasing. As a result, the Federal Open Market Committee ("FOMC") took a final 2023 hike off the table and started talking about cuts in 2024.

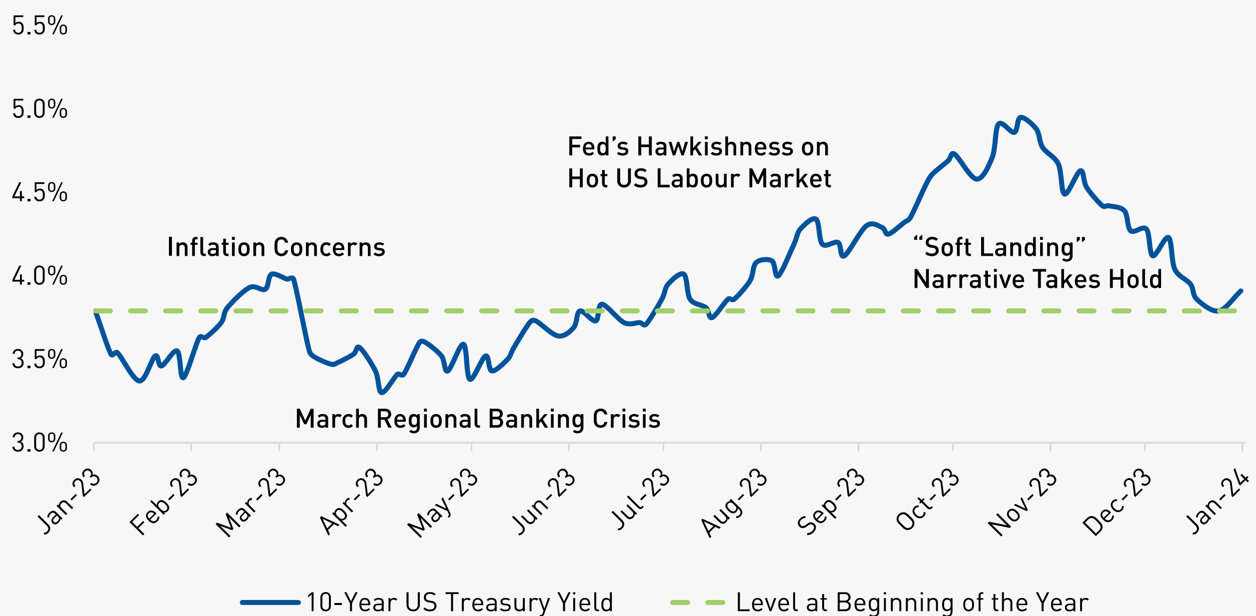


Source: YCharts. Data as of December 31, 2023.

2 Consequently, US 10-Year Yield Finished the Year Almost Unchanged, Having Been as High as 5% in Late October

The 10yr Yield was a rollercoaster in 2023, with moves higher and lower driven by economic data and the perceived response function of central bankers. The US 10yr closed around 3.9% and the Canadian 10yr bond at 3.1%. Most analysts are calling for long-term interest rates to fall further in 2024 – although volatility is expected to remain elevated.

As 2023 Wraps Up, US 10-Yr Yield Has Ended the Year Roughly Where it Started

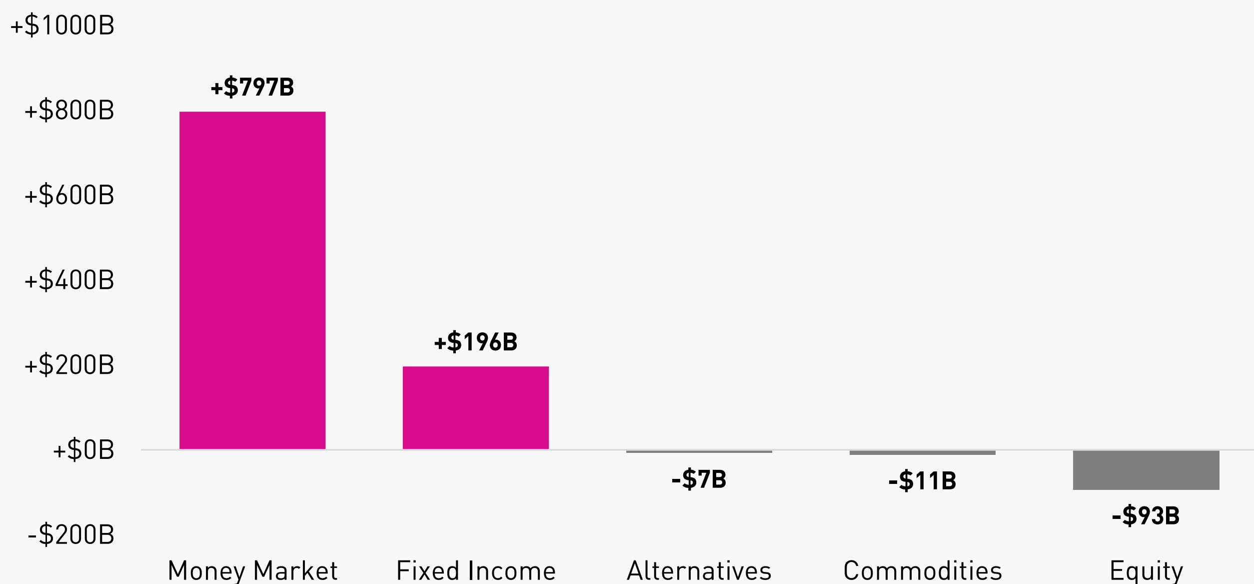


Source: CapitalIQ. Data as of December 31, 2023.

3 During 2023, a Huge Amount of Investor Capital Flowed into Money Market Funds

The asset class that experienced the largest inflow in 2023 was Money Market Funds. The result of this is a nearly $6 trillion cash hoard parked in ultra-safe investments. In the end, risky assets posted strong returns in 2023 thanks to market moves during Q4.

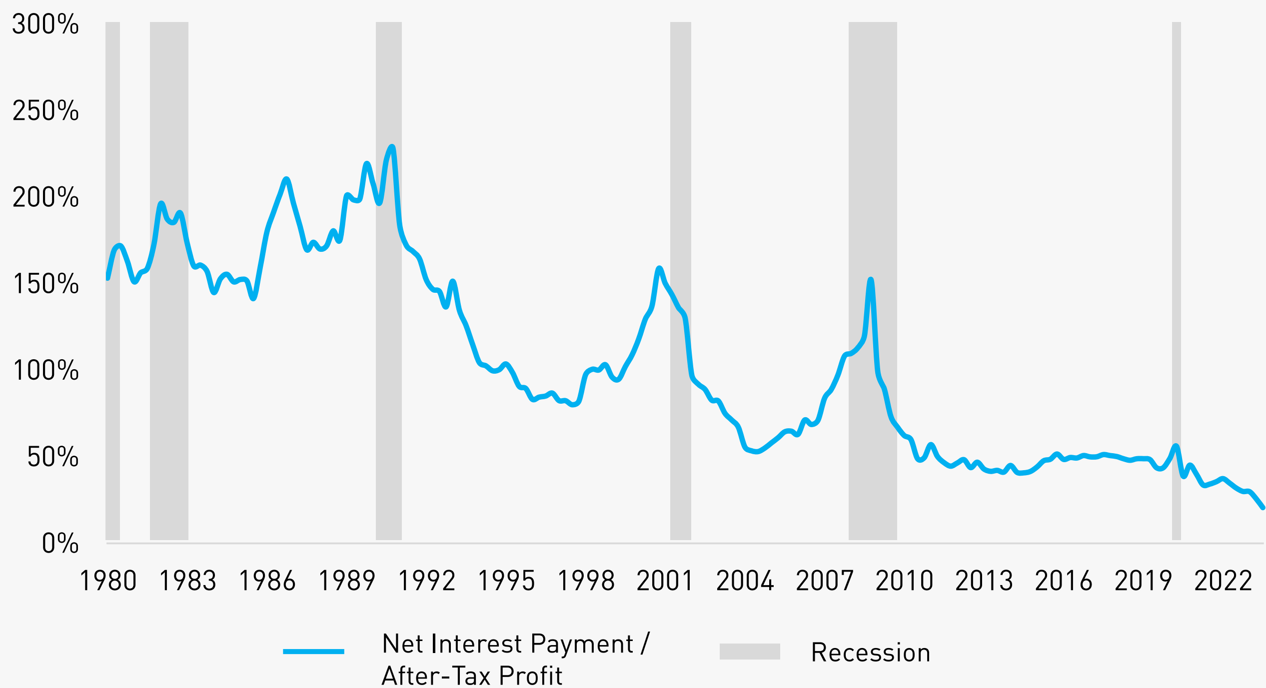
Assuming investors do see a soft landing, we believe a significant portion of those funds may be deployed into corporate bonds and equities, which would support the performance of these asset classes.



Source: YCharts. Data as of September 30, 2023.

4 Interest Costs for Corporations Will Rise from Historically Low Levels

This chart illustrates that interest burdens have been artificially low in recent years. The increase in interest rates over the past two years will lead to higher borrowing costs in the future as existing debt obligations come due for refinancing. Although some companies prudently locked in long-term debt at attractive levels prior to the rate hike cycle, the ultimate impact of these costs on each company varies. A key element of our credit analysis is looking at refinancing needs for issuers and how that will impact their interest expense going forward.



Source: U.S. Bureau of Economic Analysis, Bloomberg. Data as of September 30, 2023.

5 Credit Valuation for Consumer Segments at the Tight End of the Range, But Not for Financials and REITs

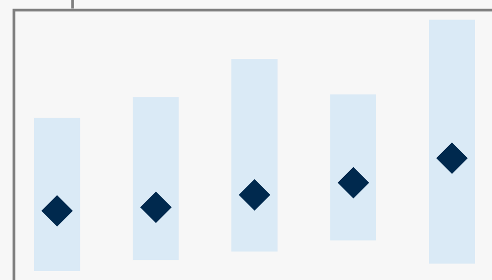
Credit spreads narrowed in Q4 across all industries and sectors. In consumer-focused sectors (retailers, pharmaceuticals, consumer staples, etc.), credit spreads are approaching the narrowest levels they have been in recent years. Valuations are more generous for Financials (banks and insurance companies) and REITs. However, these sector averages only tell part of the story – the reality is that within each sector, there is a wide range of valuations and plenty of opportunities for active security selection.

Current Level of Credit Spread vs. 5-Year Range

Level of Credit Spread

350bps
300bps
250bps
200bps
150bps
100bps
50bps
0bps

On average, bonds issued by Financial and REIT issuers have lagged the move tighter in credit spreads in Q4.



Retailers, Pharmaceuticals, Technology, Consumer Staples, Communications, Energy, Utilities, Financials, Healthcare REITs, Retail REITs, Life Insurance, Office REITs

5 Year Range Range ◆ Now

Source: BarclaysLive. Data as of December 31, 2023. Past 5-Year Range excludes covid period (March - May 2020).

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