RPIA
Global Fixed Income Experts

Credit Market Themes in 5 Charts

June 2022

Midway through an unusually volatile year, here are some key themes in global credit markets. We believe identifying these trends and positioning our portfolios accordingly will enable us to capitalize on investment opportunities through the second half of the year.

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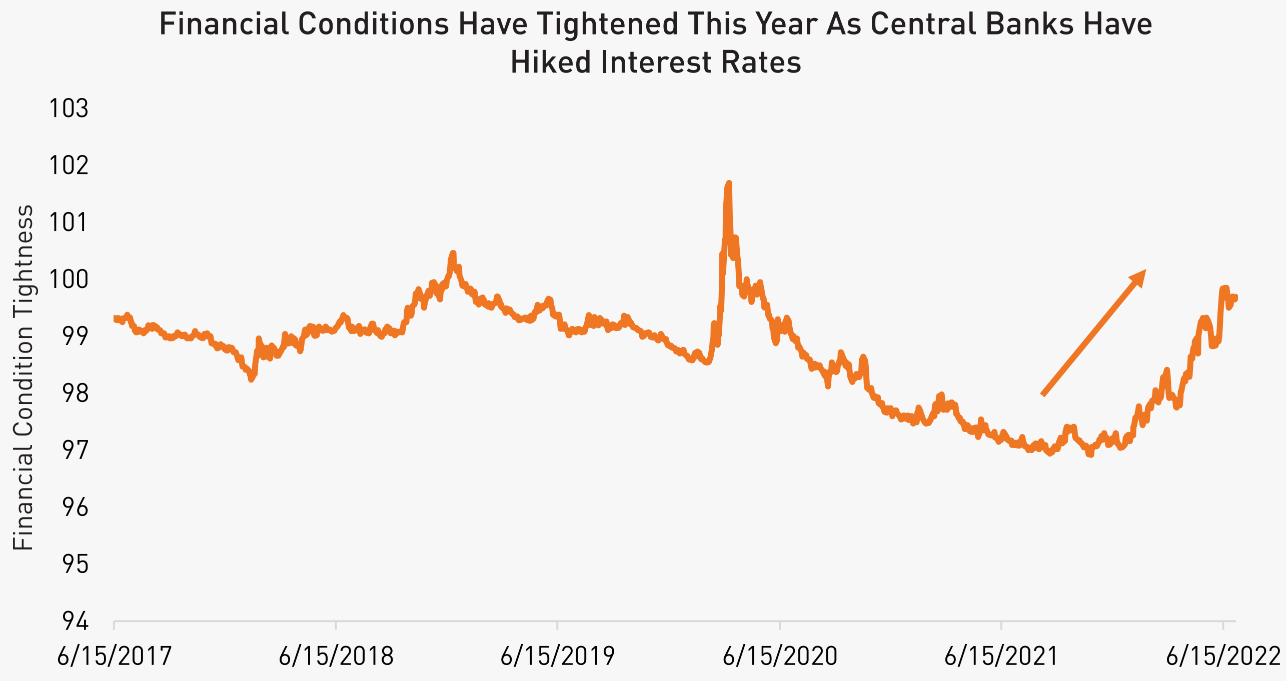
1 Tightening Financial Conditions

Global central banks have raised short-term interest rates to tighten financial conditions and thereby reduce demand. The chart below estimates the "tightness" of financial conditions and comprises a weighted average of risk-free interest rates, the exchange rate, equity valuations, and credit spreads.[1] Given continued concerns around inflation, we expect central banks to continue increasing interest rates in the second half of 2022, meaning a further tightening in financial conditions to reduce demand.



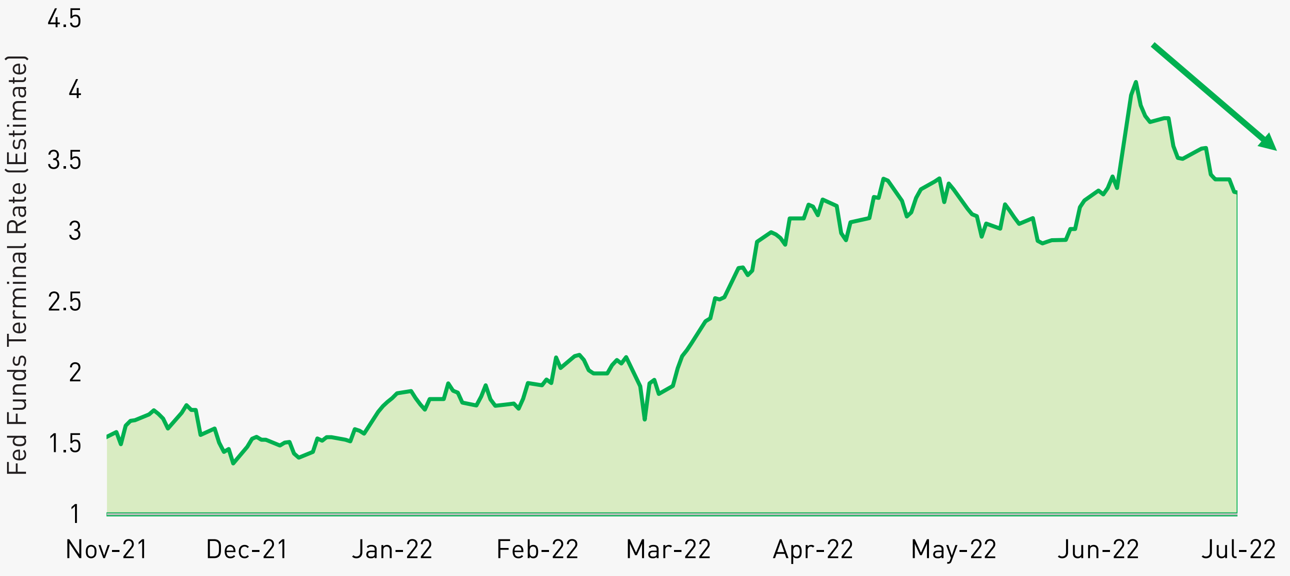
Source: Goldman Sachs Financial Conditions Index (FCI)

[1] Source = Goldman Sachs, Bloomberg. Note that weights correspond to the estimated impact of each variable on GDP.

2 Inflation and Recession The Fed's Balancing Act

After peaking above 4% in June, the estimate for the terminal Fed funds rate in the US has since fallen to around 3.25% in early July. This reflects the fact that investors are seeing an increased probability of recession. As the Fed responds to economic indicators, they are playing a balancing act between curbing inflation and ensuring room for economic growth to curb the likely recession. Now, the expectation is that central banks may actually need to cut interest rates twice in 2023.

Since June the Assumed Terminal Fed Funds Rate Has Fallen From 4% to 3.25% Owing to Recession Fears

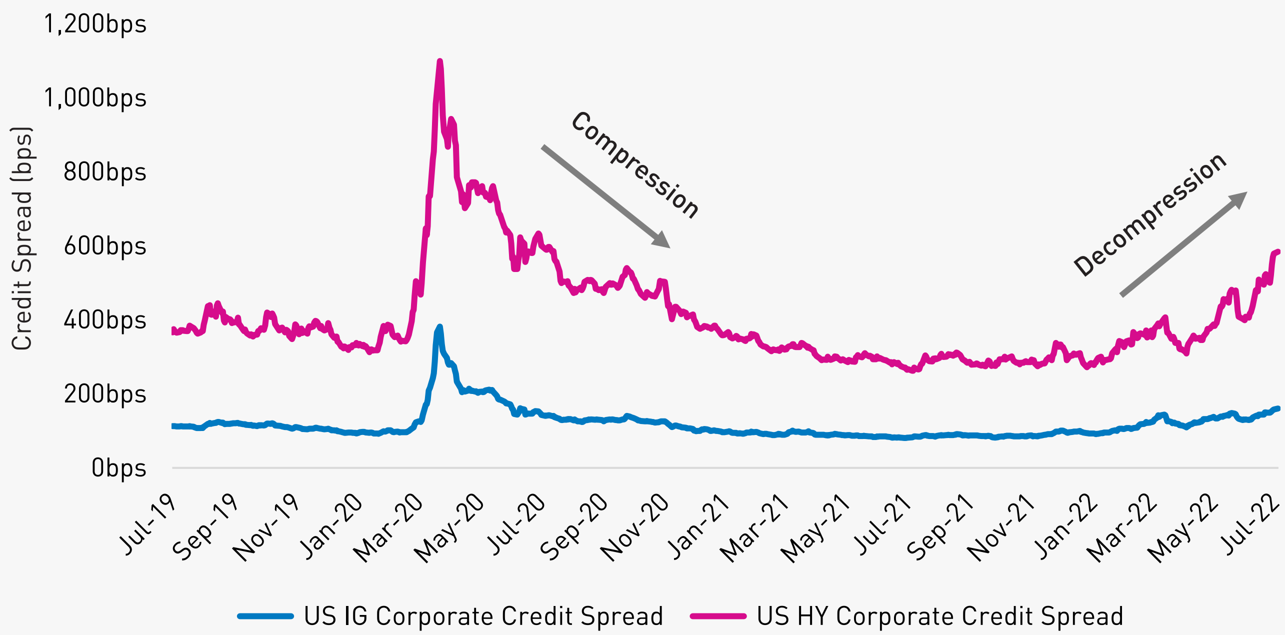


Source: Bloomberg

3 Decompression of Credit Spreads

When interest rates were low and central bank liquidity was plentiful, there was significant compression in credit spreads between High Yield and Investment Grade. In other words, high yield spreads tightened more than investment grade spreads due to a "reach for yield." With the recent paradigm shift in central bank policy, there has been a "decompression" of credit spreads, with High Yield securities underperforming Investment Grade bonds. This decompression speaks to the importance of active portfolio positioning across rating bands at different phases of the credit cycle.

Recession Fears Have Hit Lower Rated Corporate Bonds Hardest

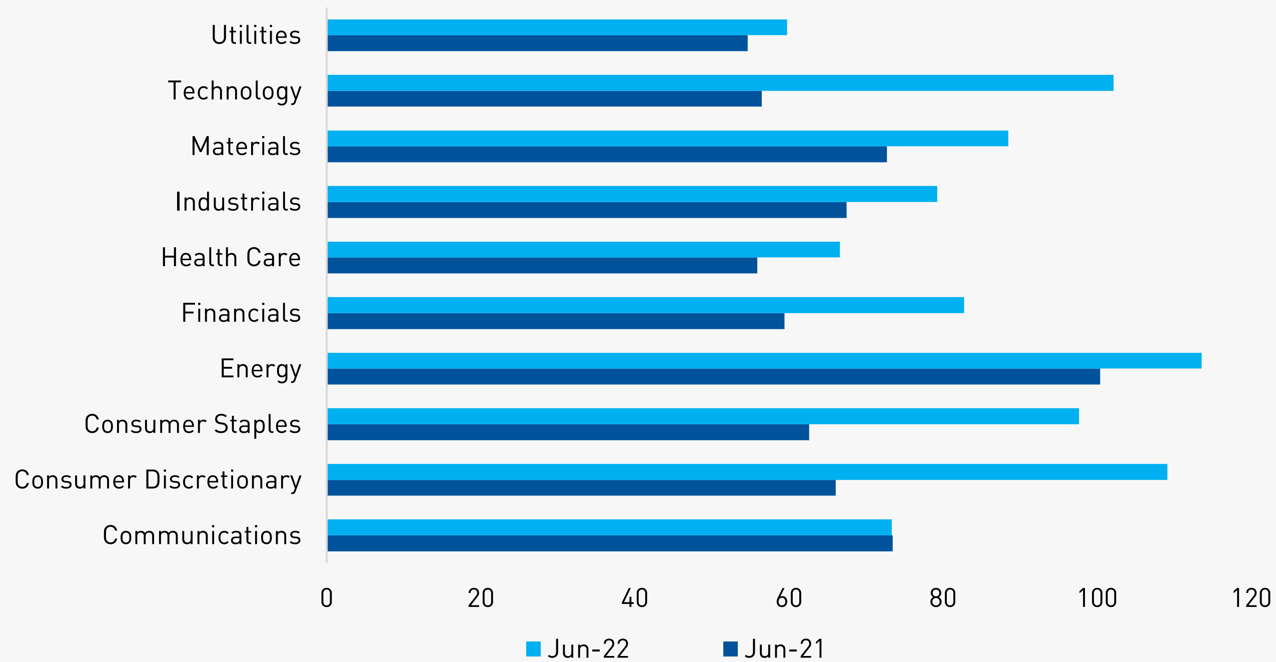


Source: Bloomberg

4 Better Opportunities for Alpha From Security Selection

Year over year, there is significantly more dispersion in credit spreads between the companies in any given industry. This broader range of valuations spells opportunity for us – we are able to compare company fundamentals with the broader spectrum of security valuations with the aim of identifying investments with the best risk-adjusted return potential. We also use active management to dynamically adjust our portfolios as the matrix of value changes.

Difference Between Average Spread in 1st Quartile and 4th Quartile

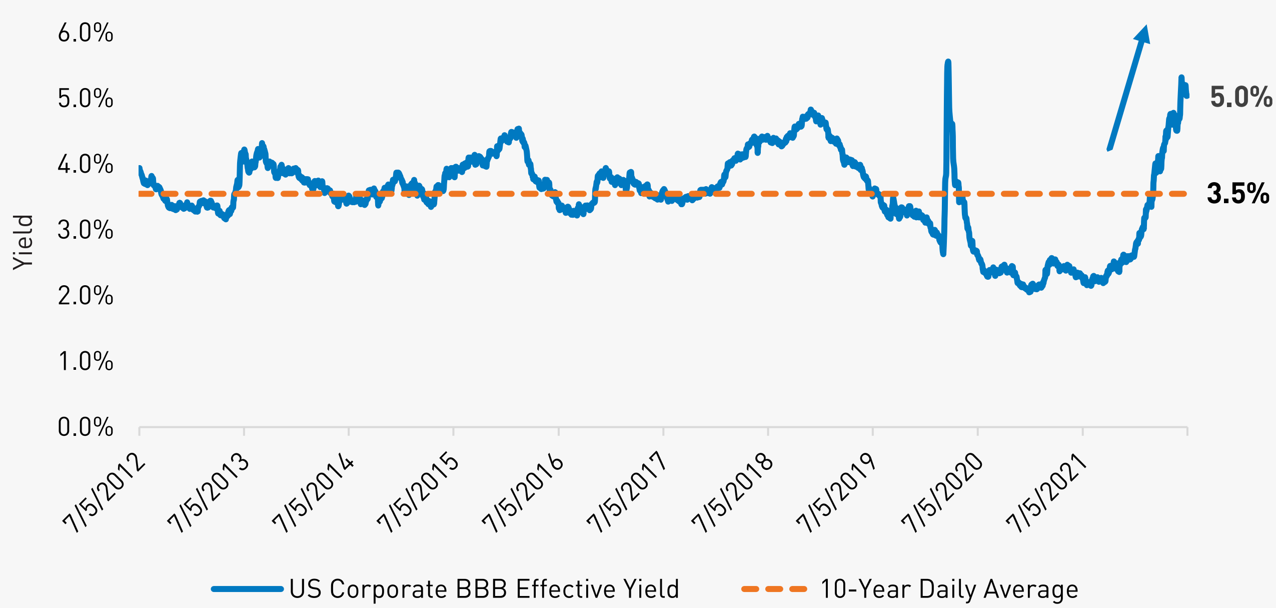


Source: Bloomberg. Index: Bloomberg US Corporate Total Return Value Index

5 The Margin of Safety in Fixed Income is Back

This year's increase in yields and credit spreads has led to negative returns for most bond investors. The silver lining is higher yields bode well for future returns. Higher yields also mean fixed income portfolios can better withstand market volatility as the "income cushion." In short, there is a much greater margin of safety in fixed income today than we have seen in many years.

Fixed Income Yields Have Increased and Now Incorporate a Greater Margin of Safety



Source: ICE BofAML

Opportunity in Uncertainty: Where Active Credit Fits

Investors find themselves at the intersection of rising inflation and interest rates and a looming recession, resulting in continued uncertainty and volatility. The further tightening of financial conditions, the terminal Fed funds rate estimate dropping from its peak, High Yield securities underperforming Investment Grade bonds, and greater dispersion in credit spreads all speak to the changing paradigm in financial markets. However, we believe that active management provides unique opportunities in such an environment. Active portfolios can adjust positioning and security selection as we go through different phases of the credit cycle. Coupled with the return potential higher yield provides for the future, we believe that credit can provide investors with an "income cushion" to seize opportunities and mitigate risks.

Institutions and Foundations continue to face new and unique challenges in this ever-changing, difficult market environment. Our recent publications address these challenges and offer solutions for how organizations can overcome these challenges and achieve their investment objectives.

The Hurdles Facing Foundations Have Never Been Higher

What Should An Allocator Do With Their Core Bond Portfolio?

The Right Mix - Active Credit as a Complement to Private Debt

Important Information

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