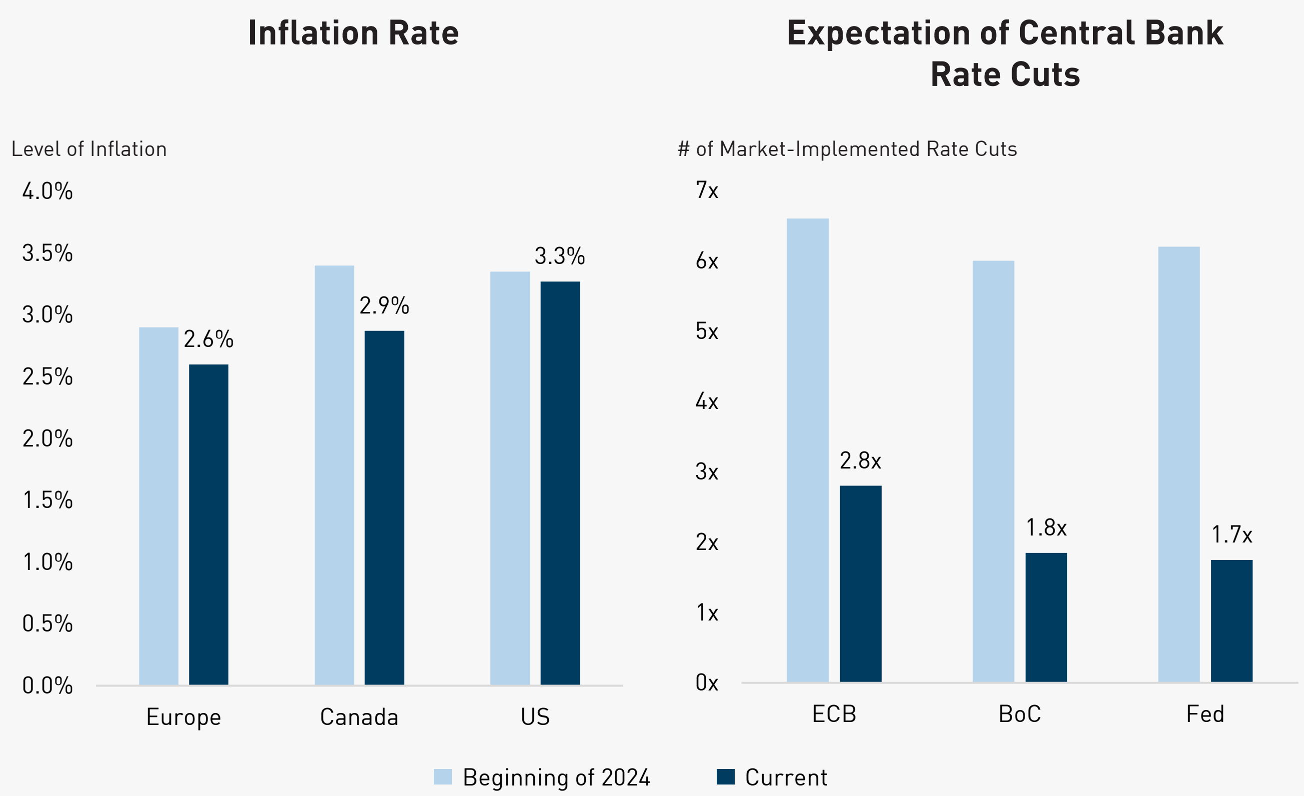
Credit Market Themes in 5 Charts

Q2 2024

1 Sticky Inflation Leads to Lower Rate Cut Expectations

Major central banks began cutting rates modestly in Q2, with the Bank of Canada and the European Central Bank both cutting by 25bps. In contrast, the U.S. Fed held at its current level to avoid potentially reigniting inflation concerns.

The stickier inflation picture has led markets to price in a meager 2-3 cuts in 2024, down from the 6-7 cuts expected at the beginning of the year. Rates may remain higher for longer throughout the second half of 2024 and into 2025 if inflation remains above 2%, which would limit the interest rate contribution to traditional fixed income returns.



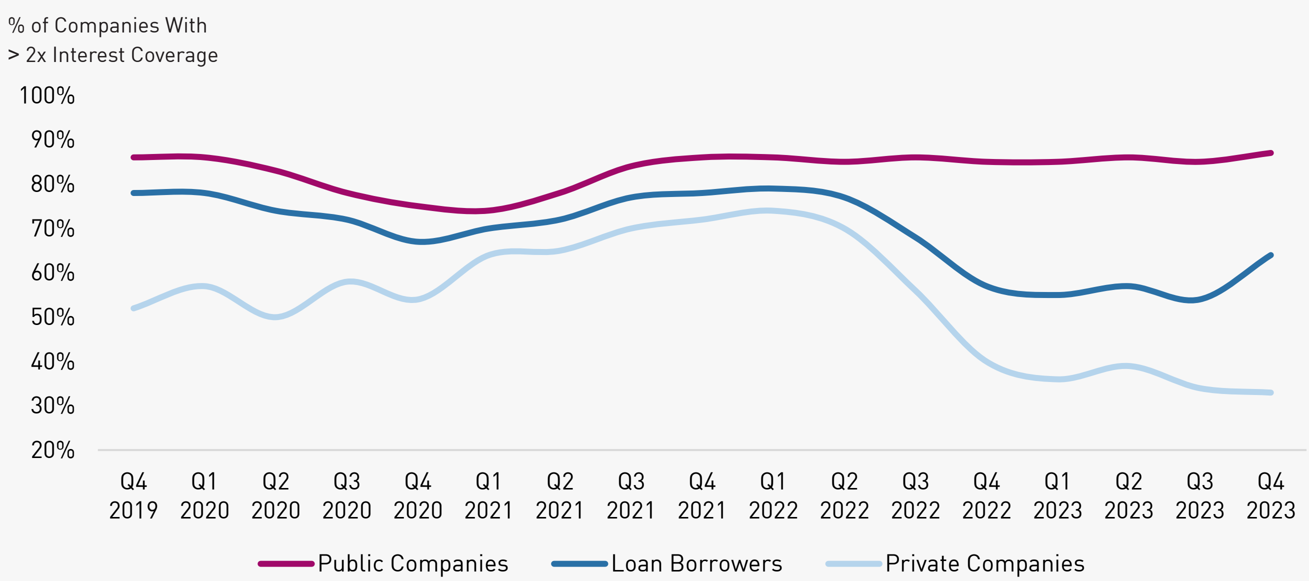
Source: YCharts. Bloomberg. Central bank rate cuts data as of June 28, 2024. Inflation data as of May 31, 2024.

2 Public Firms are Better Positioned for a Higher Rate Environment Than Private Firms

As a "higher for longer" environment persists, public debt looks favourable to private credit and private loans. For example, interest coverage (i.e., how easily a company can service its debt) is notably better for public companies relative to private firms. The average public company's ratio stands at 4.3x, more than double that of private firms. This gap has widened in the past 5 years as interest rates have begun to bite borrowers.

Many public companies took advantage of lower interest rates after the pandemic and refinanced at a lower cost to strengthen their balance sheets. This, combined with the recent strength in earnings and revenue, resulted in improved financial health. In contrast, private credit issuers have, on average, experienced a smaller earnings recovery and tend to have less diversified revenue streams.

A Significantly Higher Percentage of Public Companies Have an Interest Coverage Greater Than 2x



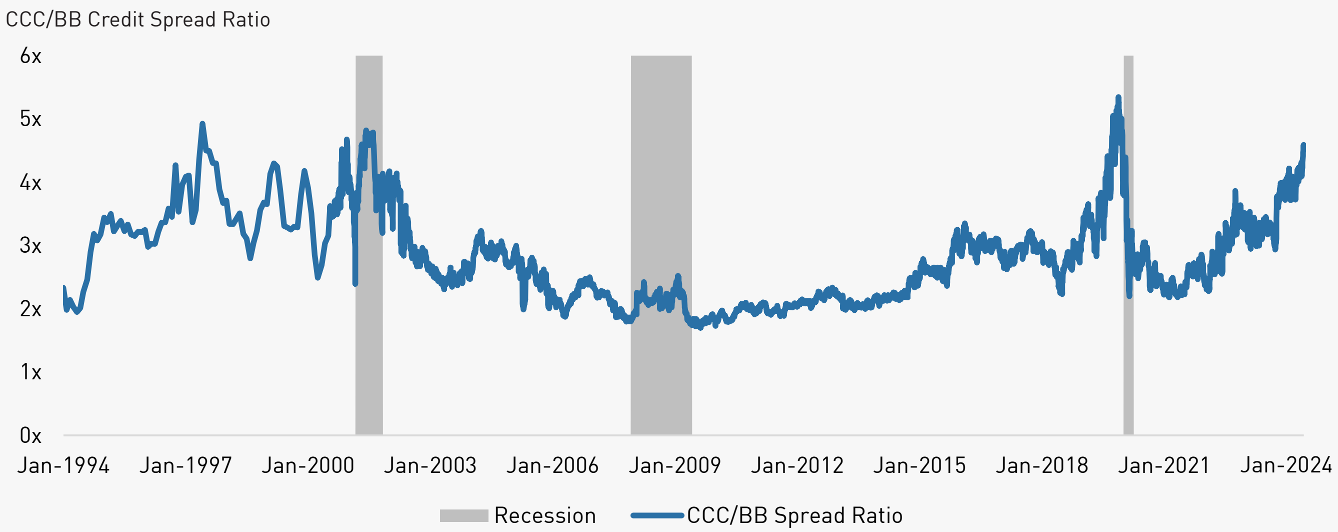
Source: JP Morgan, CapitalIQ. Interest Coverage based on LTM EBITDA/Net Interest Expense.
Data as of December 31, 2023.

3 Risk of Low-Quality Bonds Not Worth the Reward

Credit spreads of BB-rated bonds – the least risky section of the high-yield market – have rallied this year, supported by resilient growth and robust demand. However, spreads in even riskier pockets of the credit market, like CCC-rated bonds, have not fared as well. Lower-quality issuers tend to carry more leverage and are more cyclical in nature, making them vulnerable to higher borrowing costs and potential defaults.

The graph below illustrates how the CCC-rated segment of the market notably repriced higher relative to the BB-rated segment. Investors now demand greater compensation for buying these lower quality bonds, and while they also offer higher yields, we believe a higher-quality bias is warranted to avoid potential landmines in this uncertain environment. Valuations remain high relative to historical standards.

CCC-Rated Credit Spread Decompression Currently Sits at Recessionary Levels Relative to BB-Rated Credit Spreads

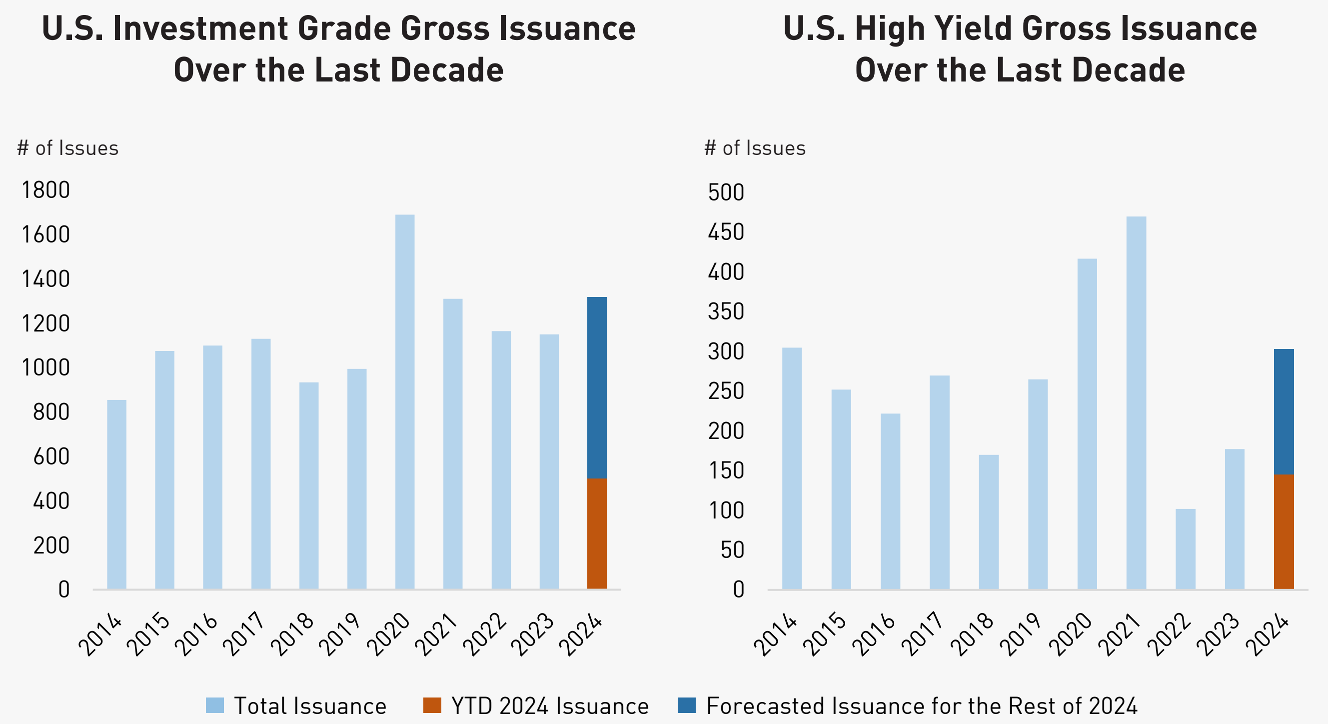


Source: Bloomberg, NBER. Data as of July 2, 2024.

4 Persisting High Levels of Bond Issuance May Not Lead to Lower Prices

Total bond issuance across Investment Grade and High Yield markets ended the quarter with the second largest year-to-date supply in history. New issuance has been high as firms try to precede their upcoming maturity walls and fortify their balance sheets to prepare for an uncertain U.S. election and other risky geo-political scenarios.

To counteract this high supply of credit, demand has been equally robust and contributed to muted volatility in credit spreads during the year. This provides comfort that future supply can also be absorbed well as record cash levels are redeployed from money market instruments and into corporate fixed income in H2 2024. Additionally, increasing coupon payments and redemptions are expected to push net issuance into the negative territory for both IG and HY and could present a positive technical for credit spreads in the coming quarters.



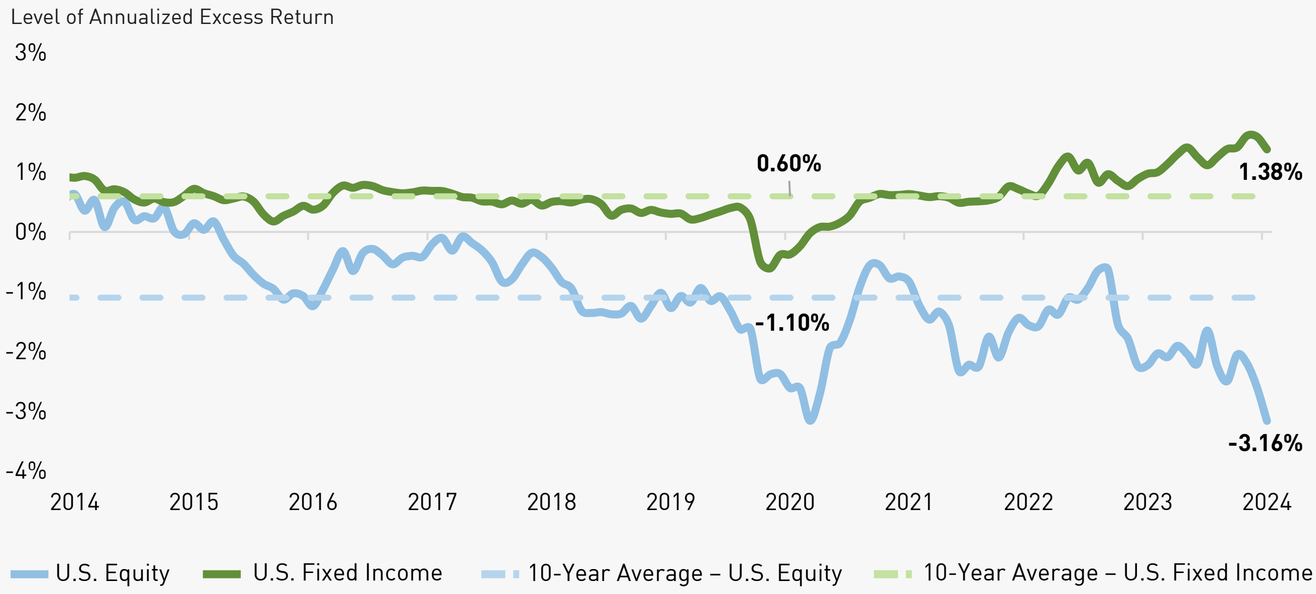
Source: BarclaysLive. Data as of June 30, 2024.

5 Active Credit Managers Can Deliver Higher Alpha Than Equities

Our recent analysis highlighted how active fixed income can better deliver long-term alpha compared to equity strategies. The data revealed that, on average, fixed income strategies outperform the U.S. aggregate bond market by 60 basis points on an annualized basis. In contrast, equity managers have been underperforming the broader equity market for most of the past decade, and especially today as stocks continue to perform well.

Although equity beta can provide sufficient returns in the short-term, the inherent inefficiencies of the credit market create numerous opportunities to generate additional value, making active credit managers a more advantageous choice for long-term alpha generation.

Active Credit Strategies Continue to Provide Investors With Better Long-Term Excess Returns Than Equity Strategies



Source: eVestment. Data as of June 30, 2024, US Equity annualized excess return = median performance of All US Equity strategy universe (~3600 strategies) vs. S&P 1500 Index (the index covers 90% of US market capitalization). US Fixed Income annualized excess return = median performance of All US Fixed Income strategy (~2700 strategies) vs. US Aggregate Bond Index. 5-year rolling basis.

Important Information

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