Global Credit outlook for 2023

Fundamentals remain broadly supportive

First Sentier Investors

For adviser/institutional use only

December 2022

Despite the significant volatility in financial markets that was such a defining feature of 2022, credit fundamentals remain broadly supportive; particularly in the US and Europe. Interest coverage ratios – which measure how comfortably companies can service their debt repayment obligations – remain favourable on the whole. Even if company profitability moderates a little owing to a slowdown in economic activity levels, we are not anticipating a material uptick in default rates. Accordingly, current spreads currently offer sufficient compensation for risk, in our view, and the asset class could benefit as investors put cash to work in income-generating assets.

Perhaps most importantly of all, following the widening in credit spreads and an increase in 'risk free' rates (comparable government bond yields) over the past year , prospective 'all in' yields from credit have risen to their highest levels for a decade. Now might therefore be an attractive entry point for long-term investors, particularly given valuations of asset classes that have not revalued as substantially. In our view, the improved prospective return profile of corporate bonds and the structural benefits of the asset class versus comparable equities places credit in a strong position to perform relatively well in the period ahead.

We expect credit risk to remain the primary driver of spreads in the year ahead, as fundamentals adjust to persistent and evolving uncertainties. There are tail risks to be mindful of, including geopolitical tensions between the US and China (regarding Taiwan), the ongoing conflict in Ukraine, and the possibility of policy error as central banks aggressively strive to tame inflation. All of these – and others – demand caution with portfolio positioning, although these challenges will present opportunities as well as risks for active managers to exploit.

The performance of individual companies could vary greatly

Encouragingly, we are still seeing more upgrades than downgrades from major credit rating agencies, although the rate of upgrades has been moderating most recently. Defaults have risen from historically low levels and we expect them to increase back towards long-term averages. Defaults are expected to pick up most meaningfully in China, emerging markets and parts of Europe although again, skilled analysts able to identify deteriorating issuers early should help active managers avoid some of these potential pitfalls.

The prospect of regulatory change remains a risk for Chinese issuers, as does a moderating outlook for economic growth. China is struggling to balance a zero Covid policy and associated lockdowns with a desire for growth to rebound back towards pre-pandemic levels. For emerging markets more broadly, higher interest rates are acting as a strong headwind and could continue to adversely affect growth and liquidity. In Europe, the lingering conflict in Ukraine continues to cloud the outlook for firms, particularly given the possibility of a damaging energy crisis in the winter months.

Refinancing risk appears manageable for now

Separately, companies have 'termed out[1]' debt levels effectively on the whole. Ample capital has been raised over the past three years through new bond issuance, as companies took advantage of historically low borrowing costs. Many firms have issued bonds with relatively long maturities, thereby reducing refinancing risk. A large number of companies will not be required to raise additional capital or refinance existing bonds for many years, meaning higher borrowing costs are not currently a concern. Of course there are parts of the market that this is less so including very low rated European companies and floating rate loan borrowers who are more exposed to the prevailing market conditions and costs.

1. Source: Bloomberg 3 December 2022, covering the period 1 January 2022 to 3 December 2022

The outlook for central bank policy seems likely to remain the dominant driver of sentiment and volatility in financial markets more broadly, with concerns that substantial policy tightening in the face of spiralling inflation will strangle growth and push major economies into recession. Inflation readings in the US have recently seen a reversal in direction, signalling that the peak may have passed and that further softening could be on its way. In line with this, we expect both commodity and energy prices to ease early next year even if core inflation remains sticky for a while longer. While a moderation in company profitability is possible against this background, as outlined above, debt refinancing requirements are expected to remain manageable in the period ahead. Most companies should have time to prepare for higher borrowing costs.

Valuations appear fair, especially relative to other risk assets

From a valuation perspective, we believe that credit offers better value than 12 months ago following a year of spread widening. Credit valuations are currently close to long-term averages in the US, albeit above average levels during previous recessions, but are already edging towards recession levels in Europe. Essentially markets have broadly priced in the risks outlined above, which should provide reassurance for potential investors.

Disclaimer

This material has been prepared and issued by First Sentier Investors (Australia) IM Ltd (ABN 89 114 194 311, AFSL 289017) (FSI AIM), which forms part of First Sentier Investors, a global asset management business. First Sentier Investors is ultimately owned by Mitsubishi UFJ Financial Group, Inc (MUFG), a global financial group. A copy of the Financial Services Guide for FSI AIM is available from First Sentier Investors on its website.

This material is directed at persons who are ‘wholesale clients’ (as defined under the Corporations Act 2001 (Cth) (Corporations Act)) and has not been prepared for and is not intended for persons who are ‘retail clients’ (as defined under the Corporations Act). This material contains general information only. It is not intended to provide you with financial product advice and does not take into account your objectives, financial situation or needs. Before making an investment decision you should consider, with a financial advisor, whether this information is appropriate in light of your investment needs, objectives and financial situation.

Any opinions expressed in this material are the opinions of the individual author at the time of publication only and are subject to change without notice. Such opinions: (i) are not a recommendation to hold, purchase or sell a particular financial product; (ii) may not include all of the information needed to make an investment decision in relation to such a financial product; and (iii) may substantially differ from other individual authors within First Sentier Investors.

To the extent permitted by law, no liability is accepted by MUFG, FSI AIM nor their affiliates for any loss or damage as a result of any reliance on this material. This material contains, or is based upon, information that FSI AIM believes to be accurate and reliable, however neither MUFG, FSI AIM nor their respective affiliates offer any warranty that it contains no factual errors. No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of FSI AIM.

Any performance information has been calculated using exit prices after taking into account all ongoing fees and assuming reinvestment of distributions. No allowance has been made for taxation. Past performance is not indicative of future performance.

Copyright © First Sentier Investors

All rights reserved.