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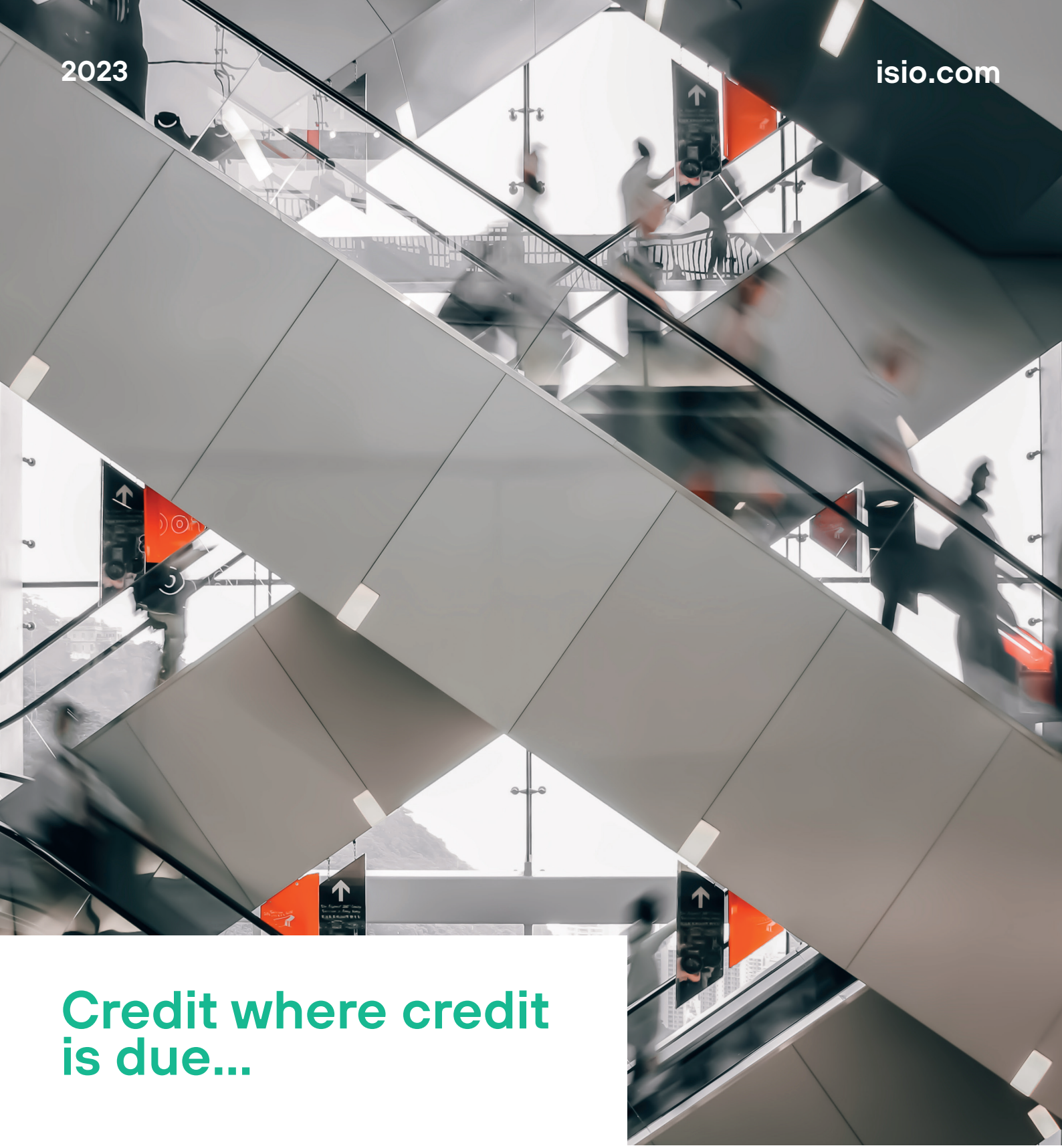

Credit where credit is due...

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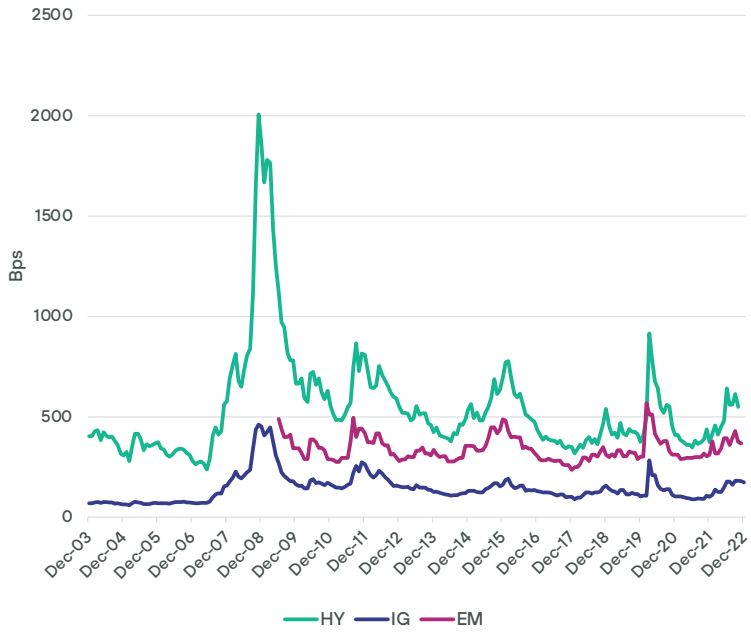
2022 was a year to forget for investors. Concerns around inflation, tightening monetary policy and forecasts for a recession have continued to weigh on markets. The combination of rising rates and widening credit spreads (yield or compensation above the risk-free rate) have been a double whammy to investors, including those invested in traditional safe havens such as investment grade ("IG"), in addition to the riskier parts of the market such as high yield ("HY") and emerging markets ("EM").

Figure 1: Investment grade spreads are close to covid (2020) level peaks



Source: PIMCO, OAS, as at 30 December 2022

The impacts of the recent LDI induced liquidity crisis potentially limit the ability of the average UK-based pension schemes to invest in the current environment. Nevertheless, if your scheme has a different liquidity profile and has cash to invest, current valuations in public credit markets look attractive on an absolute basis. However, the high level of macro-economic uncertainty and the heightening expectations of a global recession are potentially pointing towards a challenging period for credit markets where credit spread volatility may increase, in addition to corporate defaults potentially increasing compared to historical averages. **Therefore, the question is, are these valuation levels still attractive even after adjusting for higher potential defaults and if that still is the case, which parts within this market are the most attractive?**

To answer the above questions, we have conducted a two-part analysis focusing on the following:

1.

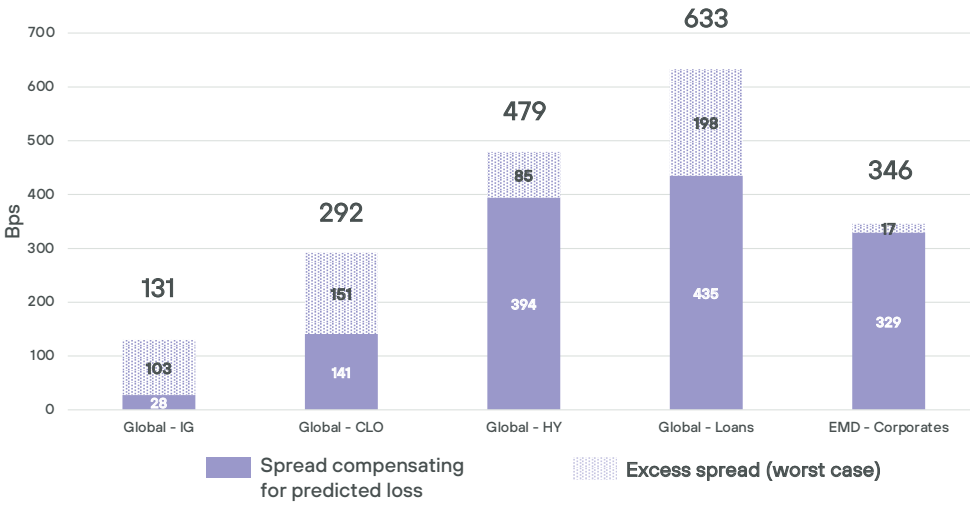
Historically, what has been the level of losses under both a "worst-case" (defined as the worst annual default rate in the index's history) and "average-case" (defined as the rolling 5-year average default rate in the index's history) scenarios; and if so, are investors still being appropriately compensated if they were to experience the losses seen in either scenario going forward?

2.

What does history tell you about buying credit assets at valuation levels that are similar to current levels?

Are investors being paid for a historic "worst-case" level of losses going forward?

Figure 2: Excess spread (worst case) relative to the total spread



Across the liquid credit spectrum, our analysis suggests that **investors are being paid in excess of historical realised losses even under our 'worst case' scenario.** Taking IG Corporates as an example, its current total credit spread is 1.31% (**purple highlight + purple shade**) and based on historical worst case loss rates[1] and adjusting for other premiums such as liquidity, we have calculated the excess compensation even after adjusting for 'worst case' losses to be 1.03% (**purple shade**).

In terms of relative ranking within various sub-asset classes in credit markets, based on this analysis, IG Corporates and CLOs look the most attractive in the current environment. Although the sub-IG asset classes (HY and Loans) do not score as highly as IG Corporates or CLOs in terms of excess compensation as a proportion of their respective total spreads, their total yield and absolute excess spread look attractive for investors who are happy with their return/risk profile.

What does history tell us about buying assets at current spread levels?

We have separately tested the relationship between the credit spread at the time of purchase and the asset class's subsequent return over the next 2 years (see figure 4 for further details on our analysis). Using HY as an example, investing at levels similar to current spread levels[2] (c.480 bps) is associated with a c.5% return per annum over the following 2 years. Our results suggest that **investors have historically been compensated with above average returns when entry levels have been similar to today's market conditions.** Whilst too much reliance should not be placed on a historical relationship, it is worth consideration in the current environment.

[1]JP Morgan EMBI GD
[2]As of 30/12/22

What are the implications for an average pension scheme?

In contrast to recent years, we believe there are improved opportunities across the board in credit markets, potentially allowing investors to take advantage and support a range of possible investment objectives.

For instance, those **looking to de-risk** following improvements in funding levels are being supported by more attractive valuations in higher quality credit areas. This could mean **extending allocations to buy and maintain IG credit mandates** or using **high quality ABS to support LDI collateral pools.**

Conversely, wider spreads in other areas such as **HY and Loans** may facilitate those looking to **reinvest illiquid allocations into the liquid space** without materially compromising on expected return. As such, we favour allocating to **flexible credit managers** who can dynamically allocate across various areas of the credit markets to capture relative value opportunities in a low governance manner.

However, these views should be balanced against the current macroeconomic and monetary backdrop – central bank interest rate rises, quantitative tightening and a potential recession. **Risk assets are therefore likely to remain volatile next year, and we can see a scenario where credit spreads widen further from current levels.**

While 2022 has been a painful year for bond investors, the beginning of a new credit cycle is a welcome change for investors with cash to invest.

Under the hood – details of our analysis

Excess Compensation

Credit investors are predominantly concerned with default and downgrade risk, and they typically use **credit spreads** to price this risk. This represents the premium available above the risk-free benchmark rate that compensates investors for two risk categories: pure credit risk (expected loss given the probability of default) and other risks (liquidity, complexity, tax).

We first take the current total spread and split this into two buckets – "pure credit risk" and "other risks" (we have made the following assumptions for the proportion of the total spread this risk comprises[3]: IG/Global: 10%, HY 30%, EM: 30%, Loans: 40%). We then run this "pure credit risk" component against two scenarios for losses – the historical[4] worst case and the average[5] case. The difference between the "pure credit risk" component of the current total spread and the compensation required to withstand the two types of losses (worst and average case) is what we define as the excess spread. This is the additional return current spread levels are offering, even in the event of the modelled defaults being realised under the two scenarios (all else equal).

Figure 3: Excess spread based on worst/average case – adjusted for LGD and liquidity

Asset Class	Credit spread bps	Credit spread bps (adjusted for liquidity premia)	Excess spread bps (average case scenario)	Excess spread bps (worst case scenario)
Global - IG	131	117	111	103
Global - CLO	292	175	173	151
Global - HY	479	335	201	85
Global - Loans	633	380	297	198
EMD - Corporates	346	242	145	17

Using IG Corporates as an example, it currently[6] has a total spread of 131 bps, of which the "pure credit risk" component is 117 bps. The compensation required to withstand the worst and average historical annual loss rates in the index[7] have been spreads of 14 bps and 6 bps respectively. Using this analysis, we have derived a 'worst' and 'average' case excess spread of 103 bps (117 – 14 bps) and 111 bps (117 – 6 bps) respectively.

[3]Botao Wu: Increasing Corporate Bond Liquidity Premium and Post-Crisis Regulation

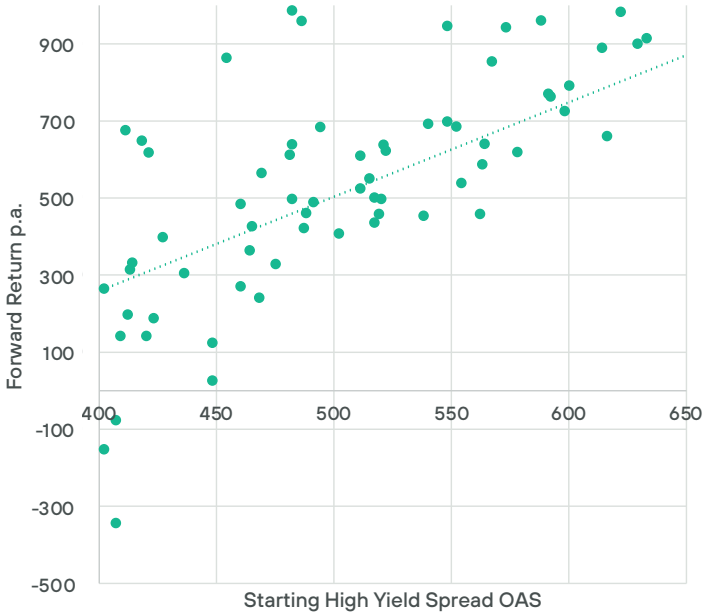
[4]Based on annual historical default and loss rates across the major indices since their inception (please see appendix for further details)

[5]Based on historical rolling 5-year average annual default and loss rates across the major indices since their inception (please see appendix for further details)

[6]As of 30/12/22

[7]JP Morgan EMBI GD

Figure 4: High Yield Return p.a. (2-year forecast)



As the above chart shows, history suggests that investing at the spread level HY traded at on 31 December 2022 (c.515 bps) corresponds to a c.5% per annum return over the next 2 years. There is a strong relationship between the two variables, albeit with a degree of variation around the trend line.

Looking at the outliers across our sample, there have been three scenarios under which HY has delivered a negative return over the subsequent two years after spreads have traded around the 400 bps level. In all these instances, the returns were precipitated by major macroeconomic events – the global financial crisis (2007 – 08) and the oil price shock of 2014 – 2016, leading to considerable credit spread widening. As such, it should be noted that, even when credit spreads look attractive, further macroeconomic shocks and spread widening can impact mark-to-market returns. As addressed above however, these spreads look attractive relative to historic default rates, which drive long term returns.

A further point of consideration for the major components of credit returns is the risk-free rate (i.e. prevailing government bond yield). A similar analysis comparing both the risk-free rate and the HY credit spread against subsequent returns for this asset class, implies the same relationship.

Conclusion

In summary, valuations have improved in credit markets and historical data suggests investors are currently being well compensated for default risk over the long term. While high income levels will help to cushion any further short-term volatility, we are wary that recessionary risks are a tailwind for bond markets. Furthermore, macro trends such as central bank policy and supply factors may exacerbate financial market uncertainty, thus impacting medium term performance. As such, we have focused our analysis on the single most important factor that drives returns for long-term investors – default risk – and this should give some comfort regarding the suitability of a credit heavy strategy in today's market conditions.

Appendix

Indices used:

Global – IG: Bloomberg US Aggregate Corporate (Inception date: 29/09/2000)
Global – CLO: JPM CLOIE (Inception date: 01/03/2012)
Global – HY: ICE BofA Global High Yield Index (Inception date: 29/09/1999)
Global – Loans: Credit Suisse Global Loans Index (Inception date: 01/01/2017)
EMD – Sovereign: JP Morgan EMBI GD (Inception date: 1992)
EMD – Corporates: JP Morgan CEMBI BD (Inception date: 2001)

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