

»Outlook 2023 Investment Grade Corporate Bonds



December 2022

Marketing material



Maria Stäheli
Senior Portfolio Manager

Executive Summary

- Global investment grade (IG) corporate bonds suffered record losses in 2022 as interest rates moved sharply higher given the paradigm shift in monetary policy, and credit spreads widened on the back of weakening growth prospects.
- We see risks of further volatility in IG spreads going into 2023 given the ongoing geopolitical tensions, tighter monetary policy, and increased headwinds for corporate earnings.
- As we move from rates volatility to recessionary concerns, we expect IG corporate bonds to outperform high yield (HY) bonds given the higher resilience to economic downturns in IG credit quality and the reduced risks of further upward spikes in interest rates.
- We expect mid-single-digit returns in global IG corporates (EUR hedged) in 2023, with carry returns being the main contributor to performance given the substantially higher starting yield levels. Depending on the depth and duration of the impending economic downturn we also see scope for returns from spread tightening.

Review of 2022

The Russian invasion of Ukraine, and the ongoing conflict since February, has exacerbated supply shortages resulting in more acute inflationary pressures and increased the downside risks to the growth outlook. The hawkish reaction by major central banks to bring down inflation led to the sharp rise in sovereign bond yields and substantial flattening across yield curves as markets priced-in an aggressive rate hiking path.

The tightening of monetary policy was the main driver behind the sharp losses in IG corporate bonds, combined with the broad-based widening in credit spreads given the deteriorating prospects of business and credit conditions. IG corporate bonds have markedly underperformed HY credit given the higher underlying duration risk. Moreover, new bond supply in EM and HY markets was very limited given both, the strong liquidity position of HY issuers and the preference for local market refinancing for EM issuers, which in turn provided some relative technical support to these market segments. Conversely, DM IG saw more normal levels of issuance with the consequence that the higher supply and the larger new issue premiums have dragged the spreads on existing bonds wider. Within IG, financials have markedly underperformed industrials due to the comparatively higher net issuance and the substantial underperformance of subordinated bank debt.

Our Global Corporate Bond strategy outperformed its benchmark primarily thanks to our cautious stance in steering credit risk. Particularly, our underweight in EM bonds paid off. We continuously lowered the portfolio beta by reducing exposure to LatAm, reinvesting the proceeds in developed market (DM) IG bonds, mainly by increasing exposures to EUR IG and financials. We have also rotated away from HY, given its

outperformance, into IG. Part of this re-allocation also came from rising stars, which we positioned in ahead of their upgrade. The outperformance was further supported by the short duration bias retained throughout the year, which provided some buffer against losses from adverse interest rate movements.

Our Investment Grade Corporate Bond strategy also outperformed its benchmark. This was similarly partly due to our bias of holding a shorter duration position as well as our overall cautious risk positioning by maintaining a tilt towards lower-beta names. Moreover, we correctly identified some of the most meaningful rising stars and positioned for the upgrades ahead of time.

Outlook 2023

The substantial repricing in rates and credit spreads during 2022 brings us to yield levels in global corporate bonds that have not been seen since the great financial crisis. After suffering significant losses in 2022, our outlook for credit spreads is turning more constructive on higher-quality corporate bonds, which offer attractive valuations and resilient fundamental characteristics against an expected deterioration in economic conditions.

» The incremental yield for going down in credit quality is relatively thin.

Credit rating upgrades have until recently outpaced downgrades across the quality spectrum as business activity recovered from the pandemic. Now, given the ongoing Russia-Ukraine conflict and tightening monetary conditions, credit conditions are at an inflection point given the increasing risk that a global economic contraction will weigh on credit quality. HY issuers are more vulnerable to economic stress than IG issuers as their profit margins do not offer as much buffer against rising cost pressures from production factors and financing. While spreads have already moved materially higher, we note that the ratio of HY to IG spreads is at the tighter end of the range when considering the last two decades (see chart 1). This shows that the incremental yield for going down in credit quality is relatively thin, especially in the context of increased downside risks.

We are equally cautious in our view on emerging market credit. The ongoing geopolitical tensions, trade disruptions and the general strength in the US Dollar continue to put pressure on EM economies. Moreover, the weakness in the real estate sector in China continues to dominate the negative sentiment in EM HY. Conversely, EM IG credit has been comparatively resilient, primarily for issuers in energy-exporting countries. Spreads in EM IG are now comparable to those in DM IG and, in some cases, even tighter. At these levels, we prefer to remain underweight EM IG in favour of DM IG and would consider exposure in EM only on a very selective basis.

Chart 1: Spread ratio of global HY vs. IG corporate bonds



Note: The line shows the ratio of option-adjusted spreads over Treasury yields of high yield global corporate bonds versus that of investment grade global corporate bonds.

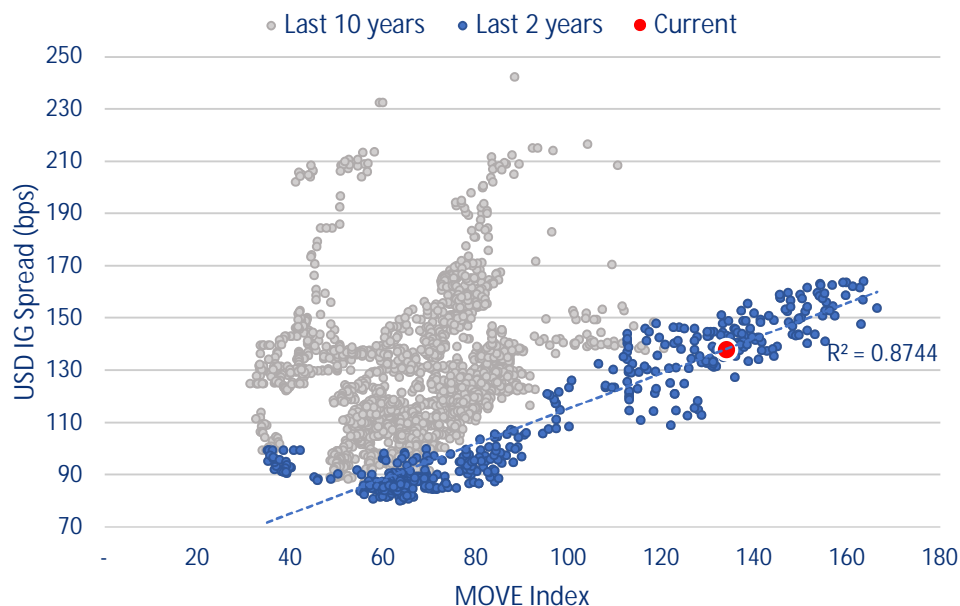
Source Bloomberg, Fisch Asset Management

» A normalisation in rates volatility will be a positive catalyst for IG credit spread performance.

The headwinds for high grade bonds from excessive rates volatility and higher primary market activity, combined with the decline in monetary aggregates, are expected to moderate in 2023, which should lead to improving underlying market conditions for IG credit. As we have moved well into the rate hiking cycle of major central banks and await to see some traction on inflation rates, we expect rates volatility to gradually subside and find more stability in sovereign bond markets. IG credit spreads have historically shown a high degree of correlation with volatility in interest rates under different monetary policy regimes. This has been even more observable now, since the aftermath of the pandemic, with credit spreads widening as central banks grew more hawkish and rates volatility increased (see chart 2). We believe that a normalisation in rates volatility will be a positive catalyst for IG credit spread performance. Lastly, as yields rose significantly and duration has decreased in IG corporate bonds, this space now offers a much higher return buffer (also referred to as "breakeven") against a further adverse movement in yields (see chart 3).

Going into 2023 we remain cautious on rates until we see repeated positive signs on inflation or a pivot in central bank rhetoric with weaker economic data. As the market eventually shifts focus from rates volatility to growth scarcity, we expect IG to outperform in 2023 as the decompression in HY versus IG becomes a more prominent theme in bond markets.

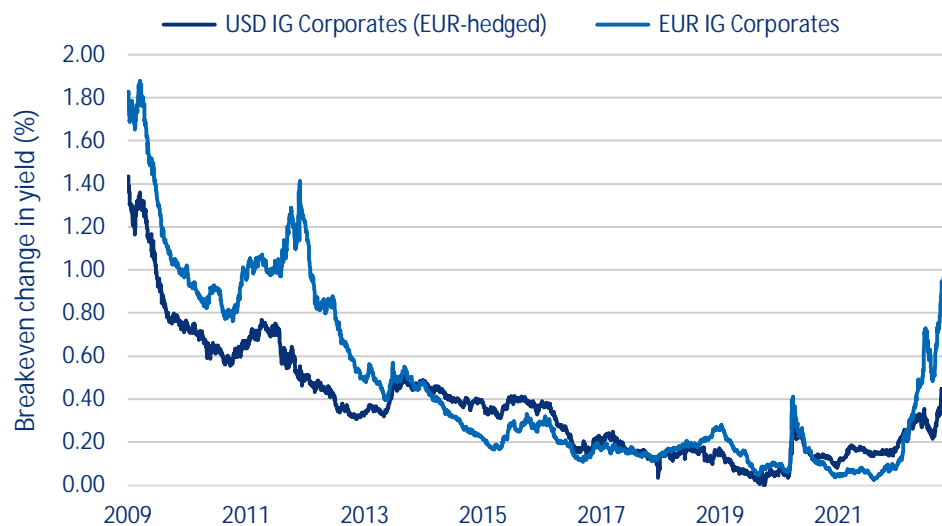
Chart 2: High correlation between rates volatility and IG spreads in the current monetary policy regime



Note: The scatter plot shows the spreads on USD IG corporate bonds (y-axis) versus the weighted average of implied volatilities on 1-month options on 2y, 5y, 10y and 30y Treasuries, the ICE BofA MOVE index (x-axis).

Source: Bloomberg, Fisch Asset Management

Chart 3: USD IG and EUR IG corporate bond break-evens



Note: The line shows how much yields could rise at a given point in time without incurring a negative total return over the course of 12 months.

Source: Bloomberg

» We currently have a preference for non-cyclicals.

With regards to sectors, we have a preference for non-cyclicals given the better risk-return trade-off when considering the weakening macro backdrop. The spread basis of cyclicals versus non-cyclicals is at the tighter end of the range since the great financial crisis across single-A and triple-B rating cohorts, even when excluding the energy sector, which has outperformed strongly in 2022.

We expect credit spreads in cyclicals to come under widening pressure, with weaker global demand and higher costs weighing on margins. However, we continue to see value in energy names given that current energy price levels will continue to support high cash flows and credit quality improvements in the sector. We also find that financials may offer value on a selective basis following the relative underperformance in 2022. Banks' profitability is expected to remain supported by higher interest rates. Conversely, there are concerns over slower loan growth, asset quality deterioration and higher cost of risk on the back of weaker macro variables. With that said, banks have been able to replenish capital levels since the fallout from the pandemic, mostly organically, putting them in a more robust position to withstand an economic downturn.

At the other end of the spectrum, we are seeing headwinds picking up for issuers particularly in utilities given the rise in energy prices and the regulatory pressures to defer cost increases to end consumers. Real estate has also been suffering from the sharp rise in interest rates. Given that the risks of an energy crisis are more acute in Europe, we expect downward revisions in earnings expectations to accelerate in line with the deterioration in manufacturing and services PMI for the region. We see the risk of disappointment to be higher for European corporates, which could lead to a faster decline in fundamentals and credit metrics.

» Reverse Yankees offer "the best of both worlds".

Given these reasons, we prefer to tilt our bond allocations in favour of US-based IG corporate bonds. However, due to the underperformance of euro-denominated credit and the resulting attractive valuations, we find Reverse Yankees (i.e. euro-denominated bonds issued by US issuers) to offer "the best of both worlds", and hence we are comfortable being overweight such securities based on this selection. Within our Global Corporates strategy, we also tilt towards DM IG corporate bonds and remain underweight HY and EM credit.

Conclusion

We anticipate mid-single-digit returns in IG corporates (EUR hedged), with carry returns being the main positive contributor to performance given the substantially higher starting yield levels. We also expect IG spreads to re-tighten in the course of 2023, based on the expectation that inflation decelerates and economic data bottoms out in the first half, which would also add some positive spread returns next year. Our focus remains on protecting against a decompression in spreads and delivering value from skilful selection as we expect to enter a more bottom-up-driven year compared to 2022. Wider dispersion in credit markets should also enhance our success in boosting excess returns from relative-value selection and price dislocations across currencies.

Disclaimer

This documentation is intended for professional investors only. The information and opinions contained in this publication are for information purposes only and do not constitute a solicitation, recommendation, an offer to buy or sell investment instruments or other services, or engage in any other kind of transaction. It is not directed to persons in any jurisdiction where the provision of such information would violate local laws and regulation. No liability shall be accepted for the accuracy and completeness of the information. Any opinions and views reflect the current judgment of the authors and may change without notice. PAST PERFORMANCE IS NOT A RELIABLE INDICATOR OF FUTURE RESULTS OR CURRENT OR FUTURE TRENDS. There is no guarantee that forecasts will be realised. Unless otherwise stated, text, images and layout of this publication are the exclusive property of Fisch Asset Management AG and/or its related, affiliated and subsidiary companies. Fisch Asset Management AG has not independently verified the information from other sources and Fisch Asset Management AG gives no assurance, expressed or implied, as to whether such information is accurate, true or complete.

Fisch Asset Management AG accepts no liability for damages arising directly or indirectly as a result of this document.

© Fisch Asset Management 2022