Insight INVESTMENT

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Q&A: THE OUTLOOK FOR GLOBAL CREDIT

PORTFOLIO MANAGERS ADAM WHITELEY AND ALEXANDER SCHIFFELDRIN OFFER THEIR THOUGHTS ON THE OUTLOOK FOR GLOBAL CREDIT IN 2025

IS THERE STILL VALUE IN CREDIT MARKETS?

Spreads are currently at or near their historic lowest levels. However, a combination of favourable fundamentals and strong technicals arguably justifies these valuations. In the US, strong corporate earnings and resilient economic growth have persisted despite a higher rate environment. Also, interest rate repricing since 2022 has made investment-grade credit very attractive on a yield basis versus recent history. Relatively high yields have led to significant inflows into the asset class, allowing spreads to tighten even in the face of elevated levels of new issuance. As long as absolute yields remain at levels that generate attractive long-term returns, we think investors are likely to overlook the tight level of spreads.

HOW WORRIED ARE YOU ABOUT THE BROADER IMPACT OF THE RECENT RISE IN YIELDS?

Rising government bond yields could impact risk markets. As yields rise, financial conditions tighten, putting equities and credit spreads at risk. The recent moves have been driven by concerns over inflationary US policies and the deficit, which have increased yields on longer bonds. Additionally, a series of strong data prints and a hawkish Federal Reserve are leading the market to reassess the number of rate cuts expected in 2025. While the market reaction has been orderly so far, a further sustained increase in yields or a sharp repricing of credit, resulting in higher spreads, would likely be poorly received by risk assets.

WHAT ARE THE GREATEST RISKS TO CREDIT MARKETS IN THE YEAR AHEAD?

The economic tail scenarios are likely the biggest potential disruptors for credit markets in 2025. If the US economy overheats, rising yields could cause concern in risk assets, prompting the market to consider a new Fed hiking cycle and leading to wider spreads. Additionally, if inflows into credit reverse, perhaps due to mounting total return losses as Treasury yields continue to rise, this could further drive spreads wider. On the flip side, recessions driven by trade wars would cause a typical repricing of risk in a negative growth environment. While both tail scenarios are unlikely, they would have a significant impact on credit markets.

DO YOU SEE ANY SECTORS/REGIONS WHERE OVERLEVERAGE IS A PROBLEM?

We're not seeing many problematic areas in the investment grade market in terms of leverage. Management teams have been very disciplined in recent years in capital allocation and leverage targets, partly due to the expectation of a US growth slowdown. The higher yield environment has not been an issue for large investment grade corporates either. However, some areas of real estate are in a weaker position fundamentally compared to previous years. Commercial real estate and other real estate subsectors, particularly in Europe, are more pressured from an interest coverage and leverage position than they were historically. Then again, with the European Central Bank cutting rates, there is less concern from investors about leverage than there was in 2023.

Looking ahead, we believe the risk is that growing confidence in the economy and the potential for reduced scrutiny on merger/acquisition transactions could encourage a releveraging environment. For credit investors this would require careful monitoring.

WHAT IS THE CHANCE OF RECESSION IN 2025? ARE THERE ANY SECTORS PARTICULARLY VULNERABLE TO BAD ECONOMIC NEWS?

We believe the risk of a US recession is low. The economy continues to show impressive resilience, and although we predict lower growth in 2025 than in 2024, we still expect the US economy to expand, and at a faster pace than the eurozone and UK. In Europe, growth is running at levels where there are clearer risks of a technical recession, but lower interest rates should be sufficient to keep growth in positive territory.

However, that is reflected in credit markets, with no premium in spreads to reflect recession risks. If we did see a traditional recession, then we'd expect commodity prices to be an early casualty; sectors such as metals, miners and oil companies would be likely to be under pressure should this materialise.

BEYOND INVESTMENT GRADE CREDIT, WHAT OTHER FIXED INCOME ASSETS OFFER VALUE?

In a world of compressed valuations and little cyclical premium, higher quality securities likely offer the most risk adjusted value currently. This includes high quality asset backed securities and investment grade credit.

WHAT IS THE POTENTIAL CREDIT RISK IF AI BECOMES A DISRUPTOR FOR COMPANIES?

Some considerations are beginning to be priced into credit markets. On a positive note, the ultimate outcome may be increased productivity, particularly for large corporates. In the investment grade market, one of the initial sector reactions is a greater focus on the US utilities space. As the energy needs for AI grow, power generation and transmission will be increasingly important.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and costs incurred when purchasing, holding, converting or selling any investment, will impact returns. Costs may increase or decrease as a result of certain currency conversions, such as currency hedging, investment exposure to international markets, and exchange rate fluctuations.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialise or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

- Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.
- A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.
- The issuer of a debt security may not pay income or repay capital to the bondholder when due. The return risk to a portfolio is higher where a portfolio is highly concentrated in such an issuer.
- Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.
- Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.
- Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.
- The investment manager may invest in instruments which can be difficult to sell when markets are stressed.
- Leveraged funds: as a result of market conditions, the value of the assets held by a Fund may fall and result in a higher degree of leverage than is deemed appropriate by the Investment Manager. In order to reduce the degree of leverage, the Investment Manager may seek to reduce a Funds' total asset exposure. Investors would need to subscribe for additional Shares in order to maintain the level of sensitivity to market movements. Where such an event is unanticipated, this may result in the investors having less sensitivity to market movements than they might consider appropriate to their individual requirements until they have subscribed for additional Shares.

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