MAY 2023

FIXED INCOME
WHY NOW FOR CREDIT?

CREDIT INVESTING WILL NOT BE WITHOUT RISK, PARTICULARLY IN UNCERTAIN ECONOMIC TIMES, BUT CONDITIONS IN THE MARKET HAVE CHANGED MARKEDLY OVER THE LAST YEAR, SO WE BELIEVE THERE ARE MANY FEATURES THAT MEAN CONSIDERING CREDIT NOW MAY MAKE SENSE.

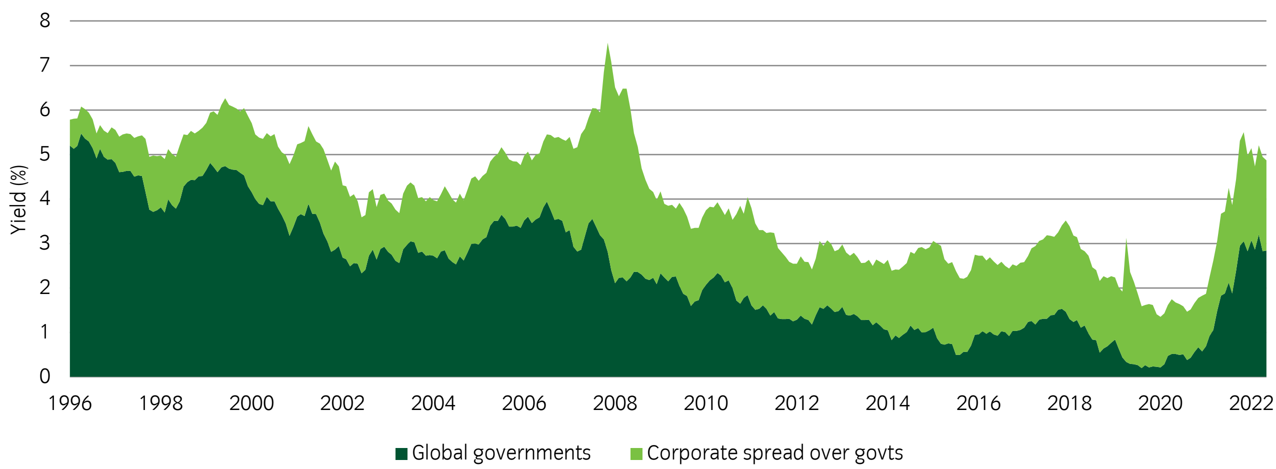
- **Increased income opportunities and scope for capital gains** – Yields and spreads have risen markedly, such that there may be real potential for generating meaningful income from the asset class for the first time in a decade or more, while also having the potential for enjoying capital gains should yields decline over time.
- **Fixed income may offer its traditional role as a diversifier relative to other risk assets** – There may be the potential for diversifying risk, achieving meaningful returns from credit, if other asset classes such as equities lag behind in a future downturn.
- **More attractive entry point** – Valuations have improved rapidly as credit spreads have risen and remain well above historic norms and at levels rarely experienced in more than 25 years.
- **Increased spread dispersion provides greater scope to identify and capture relative valuation opportunities** – Market turbulence and volatility has created divergent perceptions among market participants about the appropriate pricing of individual bonds and issuers. This has driven a generally wider dispersion of credit spreads across the market, which may allow managers the chance to capture relative value opportunities.
- **Increased credit spread more than compensates for default risk** – In our view, credit spreads have risen above levels required to compensate investors for the risk of default.
- **The peak in the interest rate cycle may be approaching** – If inflation has peaked and begins to moderate, expectations for gradual improvements in the economic backdrop, which have the potential to be more supportive for corporates, may start building.

THE RETURN OF ATTRACTIVE FIXED INCOME FEATURES

Income-based long-term returns now more achievable

We believe 2023 presents a more attractive environment for credit investors following the volatility seen in 2022. In driving absolute yields back to levels not seen since before the global financial crisis (see Figure 1), credit markets potentially offer a way to achieve long-term return objectives via income alone for the first time in many years, without the drawdown risk inherent in equity markets.

Figure 1: Absolute yields are back to levels where meaningful income returns can be generated



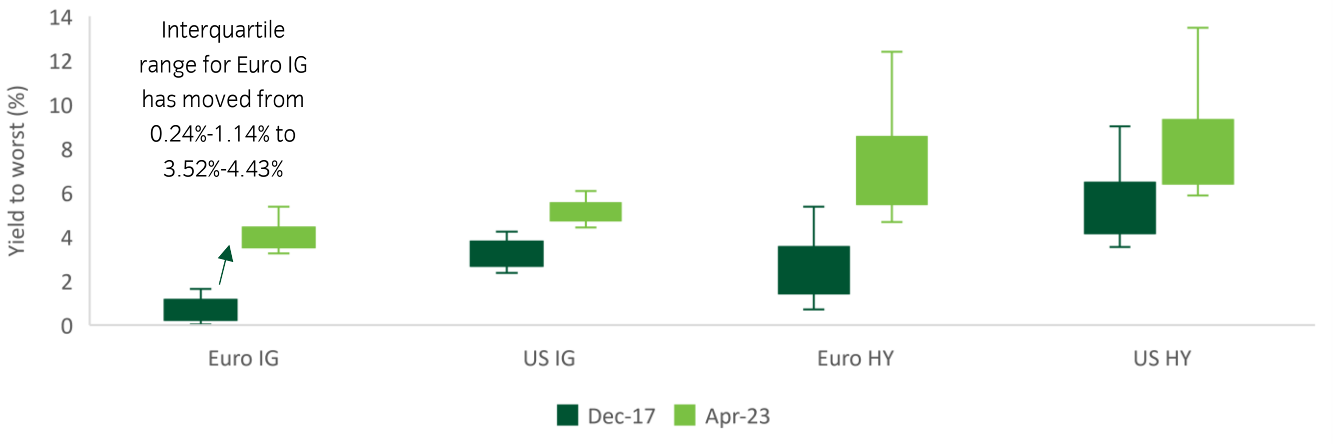
Source: Bloomberg as at 30 April 2023. ICE BofA Global Govt Index (W0G1), ICE BofA Global Corporate index (G0BC).

Credit markets now offer yields well above previous levels

At the end of 2017, effectively all the Euro investment grade (IG) market was yielding less than 1.75%. Market turbulence since then means that at the end of April 2023, more than 90% of that market was yielding more than 3.25%, while more than 40% had a yield greater than 4%. The Euro high yield (HY) market has experienced a similar shift higher in the yields of its constituent base. At the end of April 2023, almost 60% of the index carried a yield of 6% or more, whereas at the end of 2017, barely 5% has a 6% yield. The same has occurred in the US market. As Figure 2[1] shows, a yield of 5%-6% was commonplace in the US IG market, while 7%-10% was widely available in US HY.

The higher levels of yield available across the market, that can be locked in until maturity, may also offer added attraction for investors who have adopted a cashflow driven investment strategy.

Figure 2: Yields available across the bulk of corporate credit markets have risen



Source: Bloomberg, Insight. As at 30 April 2023. ICE BofA Euro Corporate Index (ER00), ICE BofA US Corporate Index (C0A0), ICE BofA Euro High Yield Index (HE00), ICE BofA US High Yield (H0A0) Yield to worst (YTW). Candle charts shows interquartile range (between 25th and 75th percentile) as the solid body, plus 10th and 90th percentile extremes (line extensions).

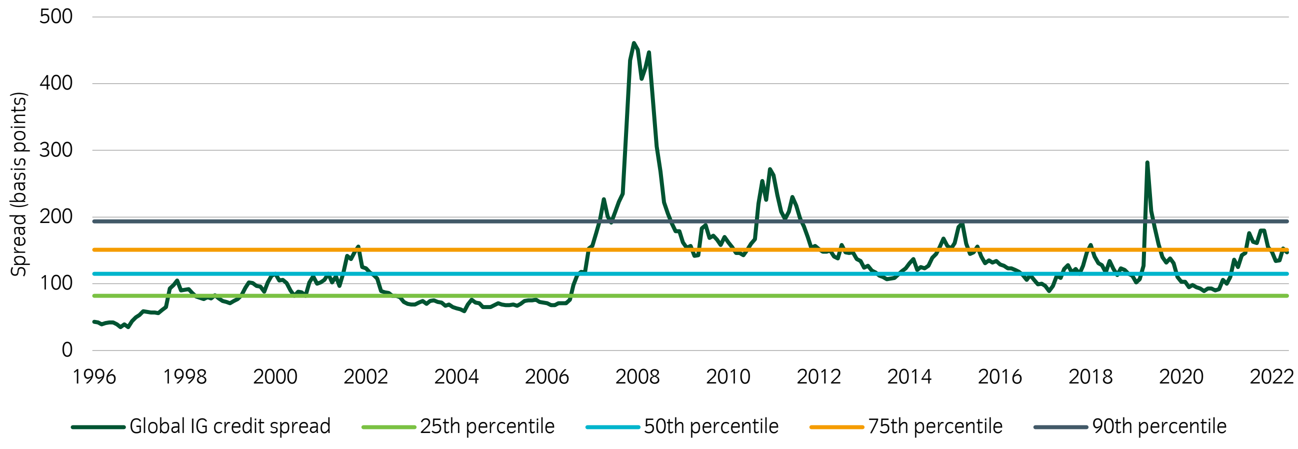
Traditional role of fixed income and credit as a diversifying asset may have returned

Fixed income, and particularly credit, may offer the potential for offering risk diversification. It can achieve this if it has positive returns and other risky asset classes, such as equities, languish in the event of modest economic weakness or an outright downturn. Those offsetting positive returns could occur if central banks end their tightening cycles or began to ease policy to overcome any slowdown.

VALUATIONS HAVE QUICKLY IMPROVED COMPARED TO HISTORIC LEVELS

Credit spreads for investment grade bonds have risen sharply in the past 18 months. When one considers the path of global credit spreads over the for the last 25 years and more, there have been few occasions when the spreads have exceeded prevailing levels. At the end of April 2023, the yield premium of the ICE BofA Global Credit Index was close to the 75th percentile level.

Figure 3: Elevated corporate credit spreads are close to historic extremes



Source: Bloomberg, Insight. As at 30 April 2023. ICE BofA Global Credit Index (G0BC)

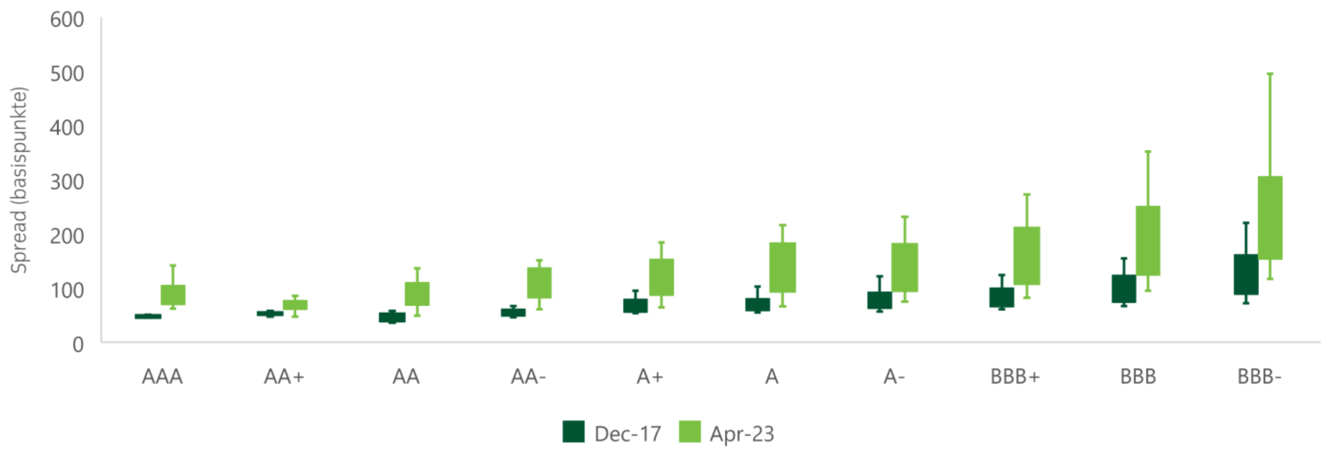
[1] All data sourced from Bloomberg. As at 15 May 2023.

DISPERSION FREQUENTLY CREATES OPPORTUNITY

The turbulence in bond and credit markets can also be seen in a notable increase in credit spread dispersion. A greater dispersion of credit spreads across bonds that have the same credit rating offers active managers greater scope to find and potentially capture attractive relative value opportunities.

Compared to just over five years previously (December 2017), not only are yield levels higher as Figures 1 and 2 show, but there is also greater dispersion of spreads across the credit spectrum. For example, in the Euro IG universe in December 2017, the boxes and whiskers in Figure 4 were much narrower than in April 2023. As the dispersion of credit spreads within each credit bracket has widened, this may mean the capacity for achieving excess returns from relative value positions has the potential to be enhanced.

Figure 4: Credit spread dispersion has increased across the whole Euro IG market



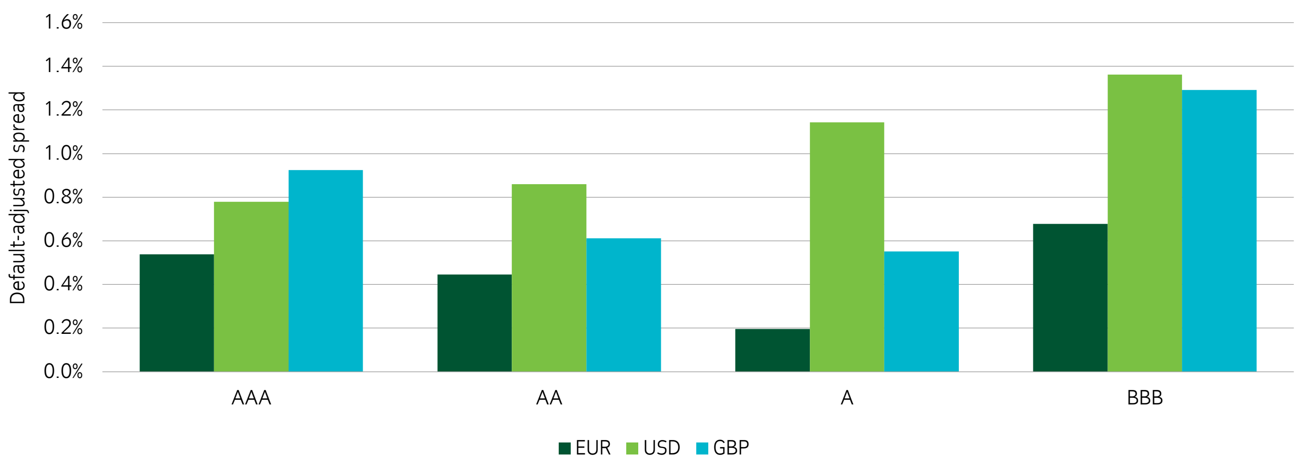
Source: Bloomberg, Insight. As at 30 April 2023. ICE BofA Euro Corporate Index (ER00). Box and whisker charts shows interquartile range (between 25th and 75th percentile) as the solid box, and 10th and 90th percentile extremes (line whiskers). For illustrative purposes.

DEFAULT RISK IS MORE THAN ADEQUATELY COMPENSATED

In our view credit spreads have risen above levels required to compensate investors for the risk of default.

Although also driven by wider spreads, a key factor in the repricing of yields has been a dramatic upward shift in government bond yields. This may have increased the attractiveness of holding government bonds instead of credit, given they are widely regarded as being risk free. Investors may also have considered that credit is now too risky to hold given the uncertain economic outlook. We believe such a change in risk perspective is overstated. As Figure 5 shows, spreads remain sufficiently wide across the credit spectrum in the three main markets, to provide a yield greater than the risk-free alternative, even when they are adjusted to reflect the effects on total spread should extreme levels of default arise (i.e. defaults at the 95th percentile of historic experience).

Figure 5: Spreads over government bonds remain positive even when adjusted for the effects of extreme rates of default



Source: Insight, Moody's and Bloomberg. As at 30 April 2023. We categorise extreme as being 95th percentile of historic default levels, and assuming a 40% recovery rate

A PEAK IN THE RATE CYCLE IS APPROACHING

Although it may be too early to expect a material tightening in credit spreads, we believe there are reasons to be more optimistic in the medium-term. Inflation appears to be past its peak although we do not expect central banks to begin easing their tightening pressure yet: indeed, the European Central Bank is likely to continue raising rates in the near term. The potential for public and political pressure may mean they are likely to begin focussing more on the growth outlook before long if they can be comfortable that inflation is declining.

If credit markets can see that rate decreases may be on the horizon, even if not for many months, and that the economic growth profile could soon improve, the corporate sector outlook could be supported and hence encourage spreads to begin tightening.

IMPORTANT INFORMATION

ASSOCIATED INVESTMENT RISKS

Fixed income

- Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.
- 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.
- 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.
- Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.
- 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.
- Exposure to international markets means exposure to changes in currency rates which could affect the value of the portfolio.
- Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.
- While efforts will be made to eliminate potential inequalities between shareholders in a pooled fund through the performance fee calculation methodology, there may be occasions where a shareholder may pay a performance fee for which they have not received a commensurate benefit.

FIND OUT MORE

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