IG Credit Outlook 2023: Adding balance to portfolios

Income is back in fixed income

It has been a difficult year for fixed income in general. Stocks and bonds rarely decline in tandem in a calendar year, and 2022 was the only exception in the 45-year period dating back to 1977. This reflects the fact that the US Federal Reserve (Fed) hiked aggressively when interest rates were near zero, which should change in 2023. Lower inflation prints coupled with growth concerns could allow the Fed to slow down and bonds could offer some relief from volatile equity markets as recession concerns take centre stage.

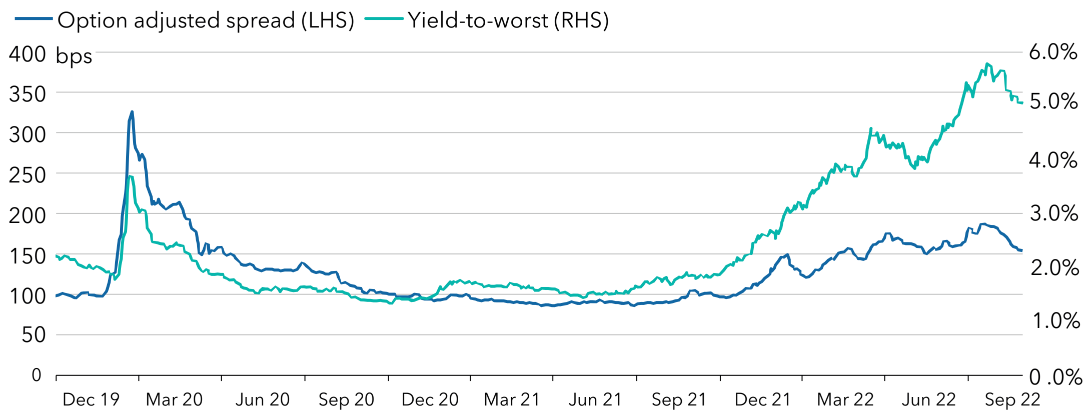
Interest rate turmoil hit bonds hard in 2022. But with the Fed expected to end its hiking cycle in mid-2023, investors are faced with two options: sit on the sidelines or invest.

High inflation and hefty rate hikes by the Fed have given rise to a bond market rout. While painful to endure in the moment, these losses can set the stage for higher income down the road. Starting yields are now a lot higher. Over time, income levels should increase since the total return of a bond is made up of price changes and interest paid — and the interest component is now much higher. Higher yields mean that investors now have the potential to earn more income from bonds. This can provide more of a cushion for total returns, even if price movements remain volatile. For an active manager, the market could present compelling opportunities to find value, though careful selection in companies and sectors remains key.

Caution is warranted, however, as the risk of recession, or at least a material slowdown in growth, is rising and spreads could widen further, though not as wide as lower quality corporate debt.

Investment-grade credit (BBB/Baa and above) may continue to suffer if the backdrop for risk assets continues to weaken. Continued interest rate hikes could also negatively impact the sector. Looking ahead, we expect issuance to remain soft given the potential for market volatility and ongoing uncertainty.

Volatility for investment-grade corporates will likely continue



Past results are not a guarantee of future results. Data as at 28 November 2022 based on daily data. Index used is the Bloomberg Global Aggregate Corporate Index. bps: basis points. Source: Bloomberg, Capital Group

Investment-grade credit is supported by fundamentals and strong demand

The resilience of consumers has helped to keep corporate balance sheets in pretty good shape. However, slowing growth and inflation pose risks to the sustainability of corporate profit margins. That said, a deep recession is not currently our base case scenario given still strong balance sheets for both financial and non-financial issuers.

Investor sentiment has turned negative though, and appetite for credit could continue to wane, especially if the asset class posts negative total returns for a prolonged period. Policy and economic uncertainty in China also remain a drag for global growth, acting as a further headwind to credit markets. On the other hand, investment-grade benefits from a captive buyer base, including foreign, long duration and liability-driven investors, which can underpin support. Cross over buyers also tend to purchase these assets as prices become more appealing.

Furthermore, financials represent almost 40% of the Bloomberg Global Aggregate Corporate Index and are the most frequent issuers. Overall, they're in good shape heading into a downturn, given the regulatory structure in place since the 2007-2008 global financial crisis.

Investment-grade credit can add balance and resilience to portfolios

Investment grade credit can also play a vital role in terms of adding balance and resilience to a portfolio. Investment grade credit can help limit the downside during market volatility, particularly in the contraction phase of the business cycle. Should a mild recession transpire, and interest rates begin to fall, the duration profile of investment grade bonds could offer a degree of resilience. In addition, investment grade spreads tend to widen much less relative to high yield when the economy slows, and fundamentals weaken due to its higher credit quality.

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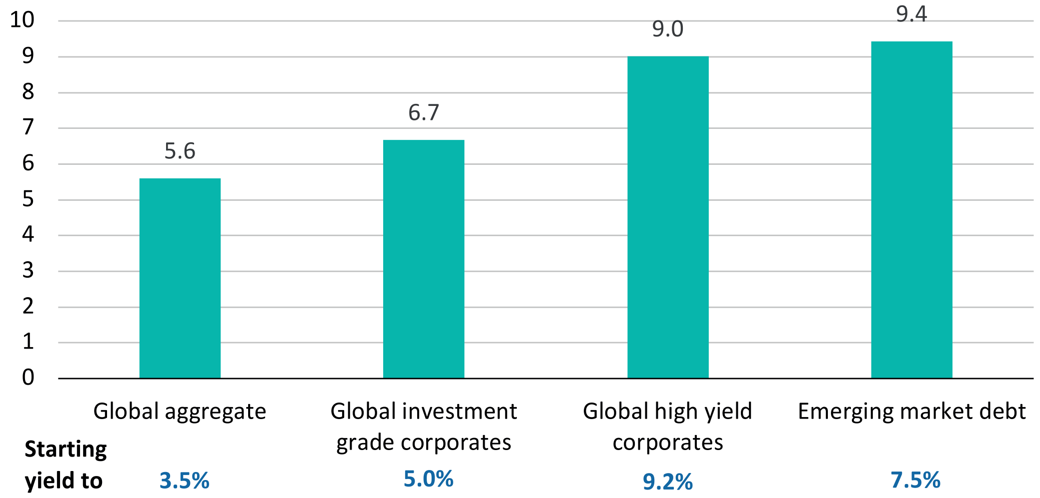
Investing at current yields has provided attractive returns

Average five-year forward returns at recent yield levels (%)



Yields and returns as at 30 November 2022, in USD terms. Data goes back to 2000 for all sectors except for emerging markets debt, which goes back to 2003 and global high yield corporates, which goes back to March 2001. Based on average monthly returns for each sector when in a +/- 0.30% range of yield to worst. Sector yields above include Bloomberg Global Aggregate Index, Bloomberg Global Aggregate Corporate Index, Bloomberg Global High Yield Corporate Index and 50% JPMorgan EMBI Global Diversified Index / 50% JPMorgan GBI-EM Global Diversified Index blend. Sources: Capital Group, Bloomberg, JPMorgan

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