Creditably building into risk positions amid falling markets

A series of bear market catalysts punctuated 2022 – from ongoing supply chain issues to Russia's invasion of Ukraine, political instability in parts of Europe, rising inflation and higher interest rates. While the economic environment would prescribe taking a step back to crouch and observe as the cycle plays through, government bond and credit valuations tell a different story, writes **Gaurav Chatley, a Senior Portfolio Manager for European Credit at M&G Investments.**

While the various bear market catalysts have contributed to significantly wider credit spreads, this has occurred at a slower velocity and across a narrower range of sectors than the preceding Covid-19 market shock. This slow evolution of market weakness relative to the pandemic has also bred investor uncertainty, with investors equally slow to add risk, even as we approached Covid levels of credit spreads.

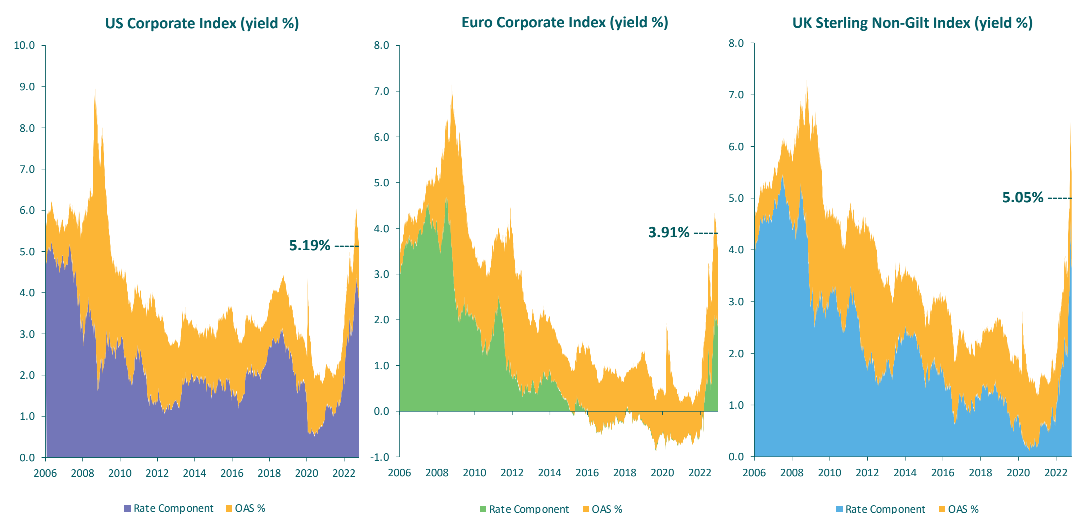
Amid a tricky economic backdrop with uniformly poor growth forecasts, central banks are focused on higher rates in order to tame inflation and help set a direction of travel. Meanwhile, consumer economies are struggling with a lack of demand as rising food and energy prices increase the cost of living and constrain consumer wallets and balance sheets. The key question for investors is: to what extent has the bad news now been priced-in and how are credit markets positioned?

Global credit markets have clearly repriced, with euro and sterling investment credit spreads during early October approaching levels seen at the height of the Covid crisis. Given the rapid re-risking that took place at Covid-wides, it would not be unreasonable to see near comparable levels as a good place to begin to accrue investment grade risk once again. Indeed, spread implied levels of default across all investment grade rating bands offer more than sufficient returns to compensate for historic average and worst case levels of default. So if not now, when?

The charts on the top right of the page show the yield on the corporate indices across major markets with the underlying government bond yield component (the 'risk free rate') and the spread on top of that. To achieve comparable yields across most markets requires one to go back to 2011/12 (Euro) or indeed to the Global Financial Crisis for Sterling and Dollar denominated credit markets. The rapid pick-up in underlying governments bond yields, and wider credit spreads mean that markets today offer all-in yields in excess of those available in high yield debt last year, but without the attendant default risk. Government markets continue to price in further interest rate rises, albeit at a slower pace, while credit markets have yet to fully translate the macro weakness through into balance sheets; opportunities to access credit markets remain, but should always be examined through the prism of a deep understanding of the issuer specific risks, and whether the market is sufficiently compensating for them at current levels.

All available yields in US, UK and European markets look attractive in our view, but importantly, this new level of yields provides greater support. The fact we're now in a range where potential disagreement between where terminal rates – where interest rates finish and where they are today – is much smaller than it was at the beginning of 2022 means a likelihood of less volatility in government bond markets, and that lack of volatility – or range-bound markets – would imply better total returns from credit. That, in turn, provides further stability to those markets. The valuation opportunity, however, is not uniform – and this is where markets become interesting.

Fixed income markets have repriced to reflect the new environment



Source: M&G, ICE BofA Indices (Ref. C0A0, ER00 UN00), as at 16 December 2022

Putting time into context – history may not repeat, but it rhymes

The green euro corporate line in the chart below is at similar levels to March 2020, when Covid-19 abruptly ushered in a very different world which saw lockdowns, production ceasing as people were sent home and an unprecedented global environment. With uncertainty around vaccines and an ensuing economic fallout as people looked to governments for support, the markets reacted with fear and panic.

By comparison, what transpired over 2022 was a relatively stable, well-maintained, orderly sell-off, pushing us to similar valuations following the Covid sell-off. This begs the question: do we face that same level of uncertainty as March 2020?

To go back further, the last time we saw spreads at these levels was during the euro sovereign debt crisis period when markets were questioning the very

Investment grade credit spreads

Spreads are widening reflecting economic and political uncertainty

Source: M&G, ICE BofA indices (Ref. ER00, UN00, C0A0), OAS, as at 16 December 2022.

survival of the eurozone and peripheral Europe. Putting today's spreads in context of those risks suggests that there is value in these markets today. While we recognise a regime shift is underway in terms of interest rate policy and increasing inflation, in the context of time, these are more "normal" economic conditions for markets to be facing, rather than episodic events.

Dispersion is at cyclical highs

Global credit valuations have re-priced – and diverged, and the valuation opportunity is not uniform. If we consider BBB credit spreads, the US investment grade market is faring much better than the UK and Europe. This could be due to multiple factors, including perception around the US as a beacon of stability in a world of instability, responsiveness of the Federal Reserve, and the softening of inflationary pressures, which – albeit still high – are lower than comparable inflation numbers in the other two marketplaces. The degree of energy independence enjoyed by the US has meant it has been less impacted by the energy crisis resulting from Russia's invasion of Ukraine.

The heightened 'fear factor', particularly around energy costs, has created a significant valuation differential between the US market and the UK and Europe, and we have a strong preference for the UK and Europe over the US for investment grade credit opportunities today.

This is the first time since 2011/12 – the European sovereign debt crisis – where European BBBs are trading at a notably wider spread than US BBBs, however today's context is very different to 2011/12 when the primary concerns were around the survival of the single currency and the single currency zone. In 2023, the opportunity is not uniform – neither globally nor in individual markets – notably, dispersion in Europe is at cyclical highs, as the chart below shows.

This means that the difference in valuation between the cheapest 25% of the market and the most expensive 25% of the market is close to the widest it's ever been. What that says is there is a core grouping of credit that is very expensive in context of the overall market, and there is a non-core group of credit that looks much more attractively valued. The expensive segment of the market has been impacted by non-economic buyers of credit – in this case the European Central Bank (ECB) quantitative easing policies – who have been buyers of credit not because it's a great investment opportunity or because the returns look attractive, but because they're trying to drive spreads down and reinvigorate the economy.

Investors will often fall into the trap of thinking safe and good investments go hand-in-hand, and therefore they move towards assets which they believe carry lower levels of credit risk, but they are also the most expensive parts of that market. In doing so, they can drive those spreads in further, receiving lower compensation for risk, or taking on all the volatility without the reward.

It's important to do two things in this market: One is to focus on where the value is, which we believe is in that cheap segment of the market, but also to disassociate the notion of safe and attractive investment returns. So, where are the opportunities?

The key question: Are we being compensated for taking risk?

Yes, but not uniformly. Real estate companies, for example, were at the forefront of the sell-off in 2022. As interest rates and bond yields rise, the yield on property (and other financial assets) must also rise to compete for investment. As the yield on property rises, its value falls. This means that as real estate companies come to refinance their borrowings they are having to do so at higher loan to values (LTVs) and are thus regarded as a higher credit risk.

One noteworthy phenomena that we saw during the financial crisis was that as credit spreads and the cost of funds rose, the asset values of property companies begin to deteriorate. However, the extent to which we've now seen this move wider in credit spreads, we believe compensates us for the risk we're being asked to bear. Investors also forget that until the last 10 years or so, it was more usual for these companies to finance themselves via direct bank loans – this avenue remains open to them, and they are often misperceived by investors as being wholly reliant on bond market funding.

We've also seen a huge increase in the size of the real estate sector's bond market borrowings over the last decade and there is a healthy stock of good-quality European assets to pick through, assess any fundamental balance sheet concerns and become comfortable with the risks at these wider spreads.

With wider credit spreads, often equating to cash prices of 60/65 cents, and attractive loan to value levels of 40-45% bonds a highly diversified exposure to borrowers in the real estate sector is an attractive proposition. In a worse case, fire-sale environment, requiring haircuts of even 50% on their property assets, there would still be sufficient capital available to repay bond holders at par, or at worst, very significantly in excess of the 60/65 cent prices paid. This is the value of deep credit research of a sector, having in-house real estate expertise, and a keen eye for value.

Similarly, we think subordinated bank debt, in particular Lower Tier 2 (T2) capital, now offers both an attractive absolute spread, as well as a meaningful spread pickup over equivalent senior debt – with these levels last seen at the peak of the Covid-19 sell-off.

Investors remain unduly cautious about European bank risk, in our view. They worry that banks are heavily exposed to economic weakness, with stretched consumer and business balance sheets often associated with a rise bad loans. While we acknowledge these risks, we would argue that European banks are significantly better capitalised than during the financial crisis, with a better understanding and management of risk. Furthermore, rising interest rates should allow banks to benefit from higher net interest margins, helping to offset any rise in impairments.

Investors may also fear that T2 capital may not be called at the first opportunity given rising borrowing costs. Whilst it is true that a couple of smaller or "storied" banks have not called their T2 at the first opportunity, that is in part because they do not have the regular access to markets that bigger institutions have. It is also worth noting that as the call date passes, these bonds lose their capital benefit and over time they become expensive senior debt. As such we believe that the bigger, more stable, national champion banks will continue to call their T2 bonds and by doing so, offer the potential to deliver attractive returns.

Building in risk positions

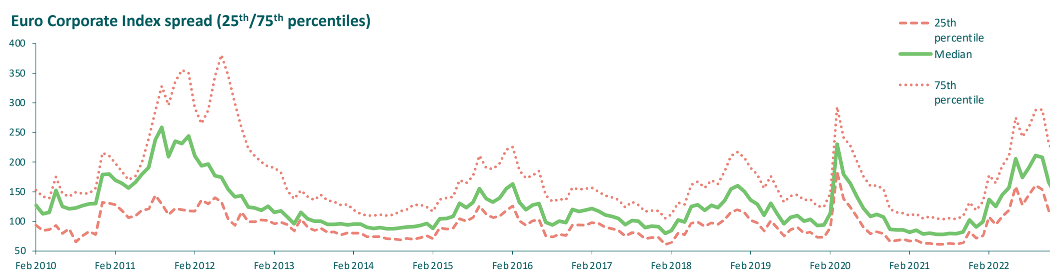
These are just two sectors of the market where we see value opportunities, but there's an array of companies across credit markets where we observe the price and fundamental risks to have jolted out of alignment. To us, this presents an opportunity to react to changing market conditions and build risk positions into the strategy.

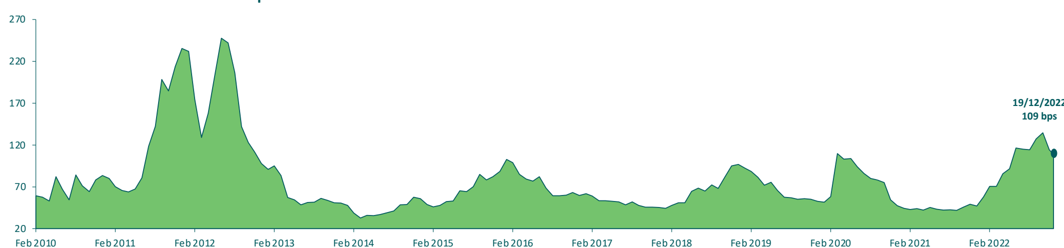
Today, the prospective returns from credit look attractive, but the opportunity set is not homogenous across marketplaces, which highlights the value in both active management and being selective in terms of the risks. Currently, we observe better valuations in European markets versus the US and prefer sectors such as real estate and non-T2 core industrials such as financials and bank issuance. Other than the US, we would avoid assets that are and remain expensive through their inclusion on things like central bank balance sheets or rules-based standard programmes.

We wouldn't forecast or be suggesting that these marketplaces return quickly to expensive levels of valuations, but we don't need that to get decent credit-driven excess returns over the next 12 to 18 months. If markets merely return to 5-year averages over the next 12 months, that could deliver just below 10% return in Euro BBBs. In a world that has become accustomed to being starved of returns, spread and yield, those are attractive returns to be had for relatively modest levels of risk.

**Gaurav Chatley is a Senior Portfolio Manager for European Credit at M&G Investments.*

Significant amount of issuer spread dispersion in Europe





Source: Bloomberg, Bloomberg Euro Aggregate Corporate Total Return Index Value Unhedged EU (ref. LECPTREU) using G spreads as at 19 December 2022

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