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CREDIT 2022 OUTLOOK

LOOKING FOR A COMFORTABLE SPREAD CUSHION

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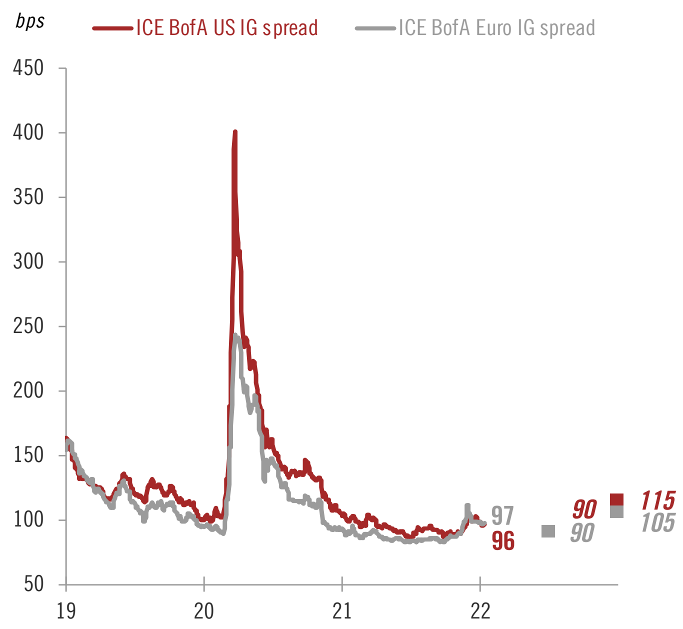
SUMMARY

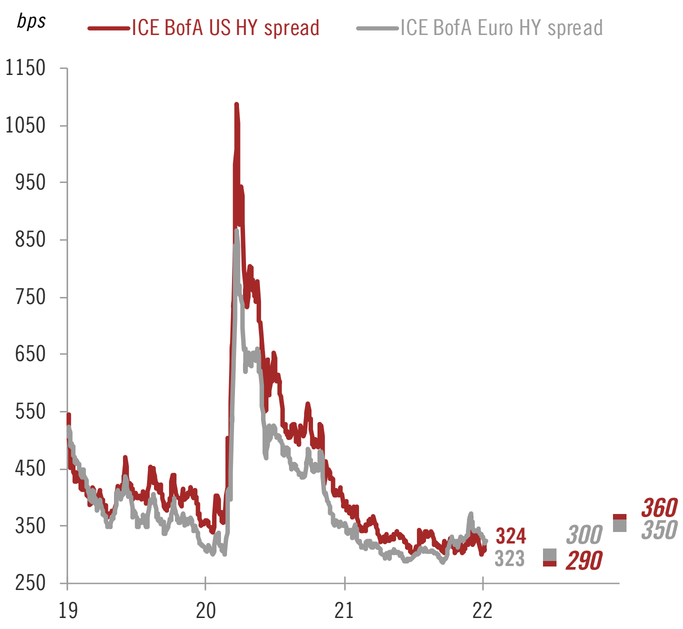
- Rising government bond yields and bullish equity markets mean US and euro high yield (HY) bonds outperformed their investment-grade (IG) counterparts in 2021.
- This year, we expect H1 to be a mirror of 2021. But our return expectations are lower for the year as a whole as credit spreads are tight by historical standards. However, as the Fed starts its rate-hiking cycle, we would expect market participants to become more selective, especially in the HY segment, where default rates could pick up slightly from low levels. This is likely to mean wider credit spreads into year-end 2022.
- We continue to favour segments where spread cushions are comfortable. One area is financials' subordinated debt, which offer high coupons. Another is US leveraged loans, whose floating-rate features and generous credit spreads could help them outperform US high-yield bonds as monetary policy tightens.
- Less accommodative central banks will mean a higher cost of debt and perhaps slower growth. But we still see opportunities in rising stars. Also, post-pandemic economic stimulus has a decidedly green hue. We therefore like ESG bonds with a focus on renewable energy, pollution reduction and sustainable-development goals.
- We have recently moved to neutral from underweight on euro HY, aligning our stance with that on its US counterpart. We remain underweight on IG corporate bonds. We expect the spread cushion in HY to be comfortable enough to compensate for rising sovereign bond yields in the coming months.

CHART 1: US AND EURO INVESTMENT GRADE CREDIT SPREADS FORECASTS



Source: PWM - AA&MR, Factset, 10.01.2022

CHART 2: US AND EURO HIGH YIELD CREDIT SPREADS FORECASTS



Source: PWM - AA&MR, Factset, 10.01.2022

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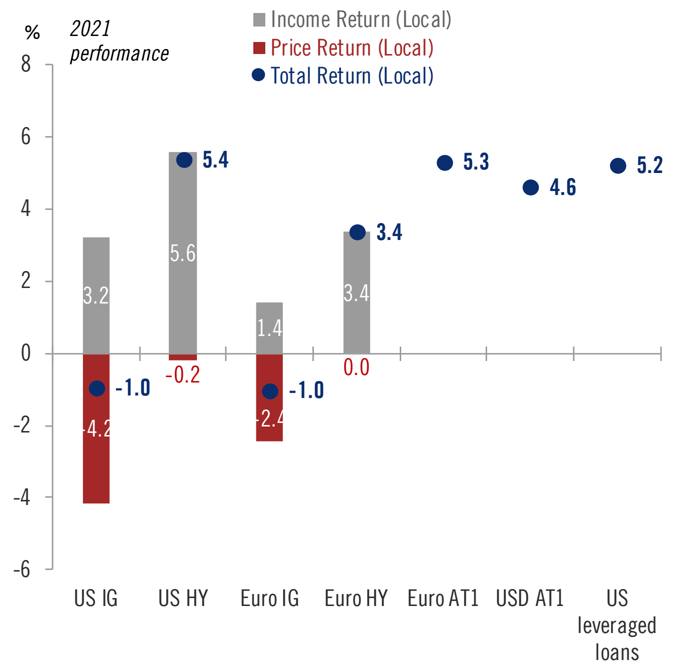
A supportive credit environment

Rising government bond yields and bullish equity markets mean **US and euro HY bonds have generally outperformed their IG counterparts in 2021** (based on ICE BofAML indices, *see chart 3*). Looking in more detail, we see that **the income return offered by HY bonds' higher coupon outweighed the negative price return** linked to rising sovereign bond yields. Euro and US dollar financials' subordinated debt also posted a strong performance, with US leveraged loans sitting among the top performers in 2021.

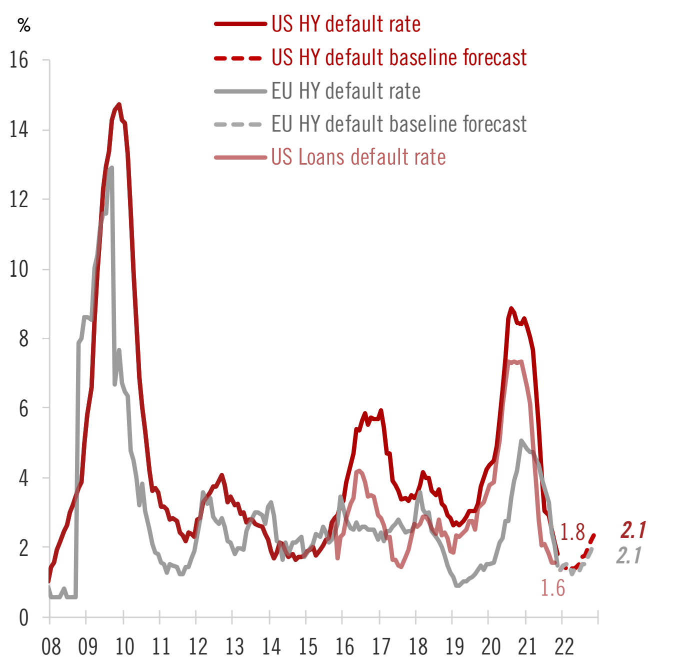
We expect H1 2022 to be a mirror image of 2021. But our return expectations are lower for this year as a whole as credit spreads are tight by historical standards (*see charts 1 and 2*). Spreads were close to 100 bps for both US and euro IG bonds, and to 320 bps for their HY counterparts on 10 January 2022. Driving spreads to historical lows was the steady decrease in the default rate on HY bonds and loans last year. **November data showed the default rate below 2% both in the US and in Europe.** This year, ratings agency Moody's expects a further decline in defaults in H1 before a slight pick-up towards 2% by the end of 2022, mostly driven by some moderation in economic growth and tightening in financial conditions as the Fed starts its rate hiking cycle. This is likely to make market participants more selective, especially in the HY segment, and could lead to slightly wider credit spreads into year-end.

CHART 3: CREDIT 2021 TOTAL RETURN PERFORMANCE BREAKDOWN



Source: PWM - AA&MR, Factset, 31.12.2021

CHART 4: US AND EURO HIGH YIELD AND US LOANS DEFAULT RATE



Source: PWM - AA&MR, Moody's, November 2021

As the Fed prepares to start its rate hiking cycle in the coming months, there is a risk that bond volatility rises, in particular in the riskiest credit segments. Yet, in 2017 (the last time the Fed started raising rates in earnest) the gap between the highest and lowest US HY spreads was actually the narrowest since 2012. Despite Fed rate rises, looking at six-month annualised volatility of US HY total returns, **we calculate that volatility**

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averaged 2.2% both in 2017 and 2018, which is much lower than the 5.3% in 2016 for example. The figure is even lower for **US leveraged loans, where volatility was closer to 0.5% at the time**.

Based on this precedent, we do not expect a sharp rise in volatility for HY bonds this year, because what seems to matter more than Fed monetary policy is economic growth. As long as growth remains as robust as we expect (our economist forecasts US real GDP growth to reach 3.4%), volatility should stay in a low-to-medium range as **investors continue to look for high coupons and low duration in credit due to the risk of higher sovereign bond yields**.

Coupon to compensate for rising sovereign bond yields

We continue to favour credit segments with comfortable spread cushions, which could compensate for the price loss we expect due to higher core sovereign bond yields this year (see Our 2022 scenario for US and German government bonds).

One area is financials' subordinated debt (in particular additional tier-1 instruments (AT-1)). **Spreads on AT-1s have widened since September**, partly because of concerns that some issuers would not find it economical to redeem credits at their call date due to rising long-term sovereign bond yields. But we believe that current valuations already discount most of this extension risk.

Euro financial subordinated debt carries higher coupons than euro IG bonds, because the former are often rated HY even though the issuers typically have an IG rating (*see chart 5*). We prefer euro AT-1s over US dollar ones, which have thinner spread cushions. We also dislike long-dated calls, which could still underperform in our view.

The other area we like is US leveraged loans, whose floating-rate features and generous credit spreads could help them **outperform US HY bonds** this year should the Fed hikes rates three times as we expect. **The default rate on US leveraged loans has been declining sharply** (to 1.6% in November, *see chart 4*). In addition, using the same measure of **volatility described above for HY, we see that it has historically been lower in leveraged loans than in US HY** and stands currently close to 0.5% versus 2.4% for US HY (on 10 January). Part of the reason for this is the rise of collateralised loan obligations (CLOs, USD834 bn at end December), which now represent 63% of US leverage loans outstanding. The turnover of CLO holdings is usually low, bringing down turnover in the overall leveraged loan market.

Another attractive feature of leveraged loans is their floating rate. This means that, for example, the modified duration of a loan based on the US dollar three-month LIBOR (London Interbank Offered Rate) is 0.25 years, as the coupon adjusts every three months. **Floating-rate instruments are typically attractive when the Fed hikes rates because the coupon paid increases with each hike**. US leveraged loans outperformed US HY bonds in 1999-2000, 2005 and 2018 (periods of rising rates) thanks in part to this floating-rate feature.

However, the ongoing transition from the LIBOR benchmark rate also represents a risk for investors. The US dollar LIBOR is set to be phased out completely by June 2023, but new contracts cannot use the LIBOR as a reference rate since 1 January this year. No substitute benchmark has emerged yet, although this could be the Secured Overnight

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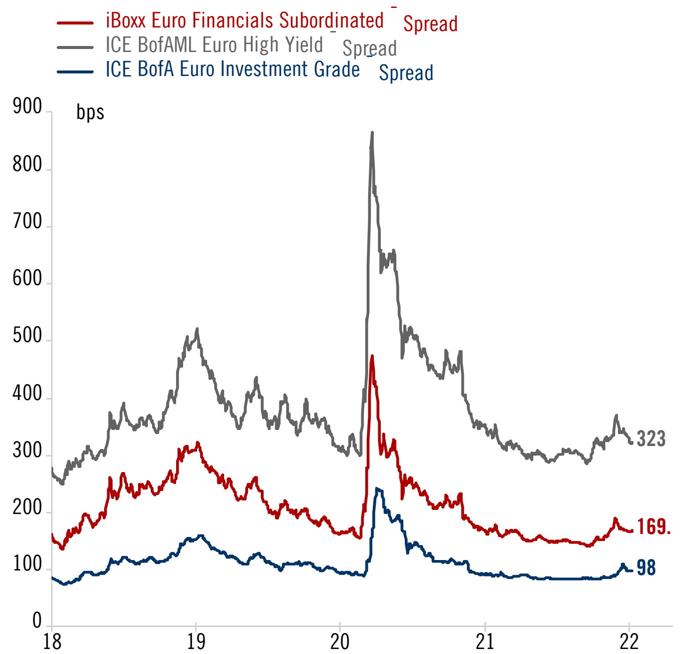
Financing Rate (SOFR), which is being increasing referenced as a fallback in derivative and loan contracts. **Generalised adoption of the SOFR as an accepted benchmark is likely to mean reduced returns for investors** since, as an overnight collateralised rate, it lies close to the lower-bound of the Fed fund target (0.05%), compared to 0.24% for the Libor (both on 7 January). The LIBOR also tends to rise sharply at times of financial stress.

Another risk regarding leveraged loans is the rise in covenant-lite issues, which now represent 92% of leveraged-loan issuance. Although in times of robust growth reduced protection for creditors is not a concern, the rise in covenant-lite could mean a lower recovery rate in the next economic downturn.

CHART 5:EURO SENIOR AND SUBORDINATED CORPORATE BONDS



Source: PWM - AA&MR, Factset, 10.01.2022

CHART 6: YIELDS ON US IG AND HY BONDS AND ON US LOANS

Source: PWM - AA&MR, Bloomberg, 10.01.2022

Looking for rising stars and ESG bonds

Less accommodative central banks will likely mean a higher cost of debt and perhaps slower economic growth. As spreads are tight by historical standards and as we expect core sovereign bond yields to rise this year, **we are adopting a solidly bottom-up approach to credits.** In particular, **we still see opportunities in rising stars** (high-yield bonds on the cusp of upgrade to investment grade).

After turning negative in 2019 in the US and in 2020 in Europe, the rating drift turned positive again last year (*see chart 7*). This means that **rating upgrades have been outstripping downgrades – an environment that tends to favour the emergence of rising stars**. Although credit spreads on rising star candidates usually tighten in advance of their ratings upgrade**, we have identified a few issuers where we still see room for further spread tightening**.

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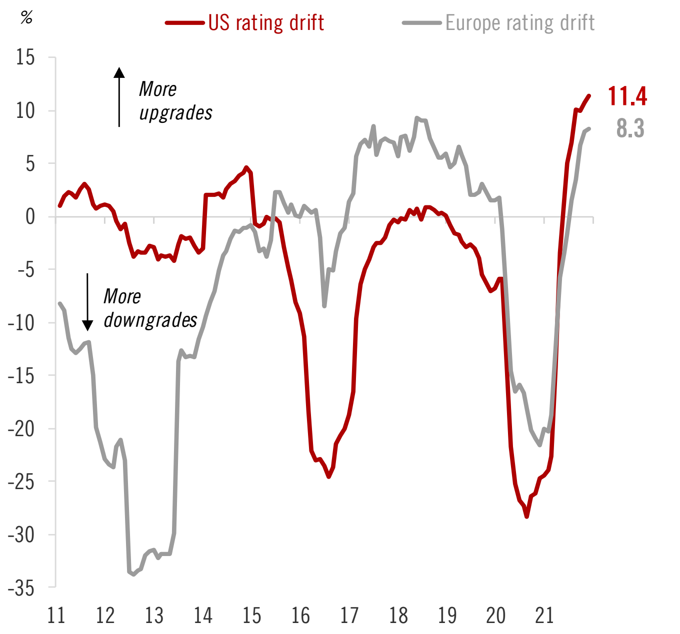
Also, there is a decidedly green hue to post-pandemic economic stimulus. We therefore like Environmental Social Governance (ESG) investments, including **ESG bonds** with a focus on renewable energy, pollution reduction and sustainable-development goals. **Investors and issuers alike are fond of these new instruments.** In 2021, US dollar issuance of ESG bonds increased by 80% and euro issuance by 120%, representing 5% and 20% of total net issuances, respectively (*see chart 8*). A sign of the growing size and maturity of the ESG bond market is the gradual reduction of the premium on ESG bonds (over classic corporate bonds with similar ratings) from about 20 bps back in 2020 to about 6 bps in H2 2021.

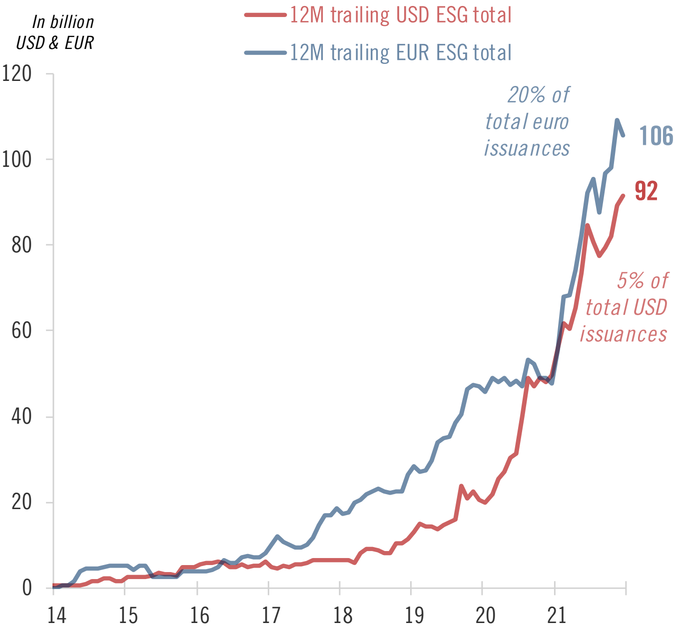
In conclusion, we remain underweight investment-grade credit, as their tight spreads offer little protection against the rise in core sovereign bond yields that we expect. **We have moved to neutral from underweight on euro HY bonds, aligning our stance with that on their US counterparts.** We expect the spread cushion in HY on both sides of the Atlantic to be comfortable enough to compensate for rising sovereign bond yields in the coming months.

CHART 7: US AND EURO CREDIT RATING DRIFT



Source: PWM - AA&MR, Moody's, November 2021

CHART 8: US DOLLAR AND EURO ESG BOND 12-MONTH TRAILING ISSUANCES



Source: PWM - AA&MR, Credit research, Dealogic, December 2021

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