FLASH NOTE

PICTET WEALTH MANAGEMENT
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US AND EURO CREDIT - UPDATE

LOOKING FOR 'SAFE' CARRY

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SUMMARY

› US and euro corporate bond yields have risen sharply year-to-date, driven by both wider credit spreads and higher sovereign bond yields. According to the ICE Bank of America Merrill Lynch US investment-grade (IG) and high-yield (HY) indices, yields on average have reached 3.94% and 6.54%, respectively (on April 12).

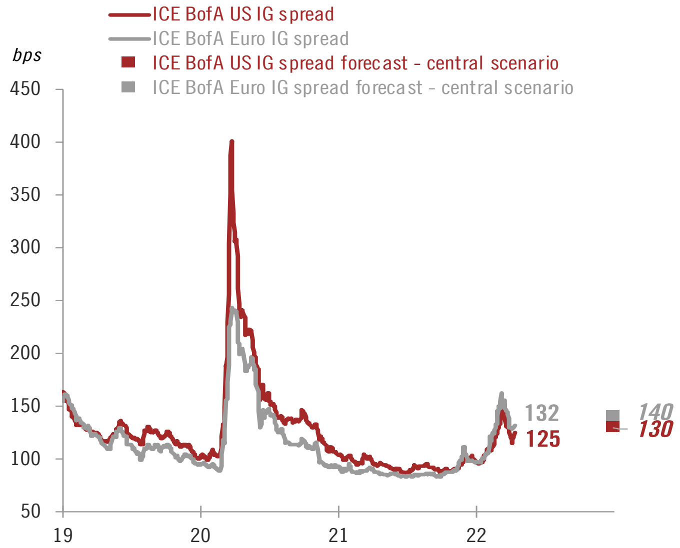
› The surge in corporate bonds yields is likely to lead to a higher cost of funding for longer for corporates. The lag effect of higher rates, coupled with the surge in commodities prices and less accommodative fiscal policies, are likely to weigh on US and euro area GDP growth in H2.

› However, the fundamentals (i.e. coverage ratios and net leverage ratios) of non-financial IG-rated companies remain solid in the US. As such, we expect IG companies, and in particular US ones, to be better placed to navigate the current challenging environment and to deliver positive expected returns by year-end.

› Taking stock of the more challenging environment for companies we have revised up our year-end spread forecasts in our central scenario. We expect US and euro IG spreads to widen slightly from current levels to 130 and 140 bps, respectively. Due to the potential for lower resilience of many HY companies, we expect US and euro HY spreads to widen more significantly to 450 and 470 bps, respectively.

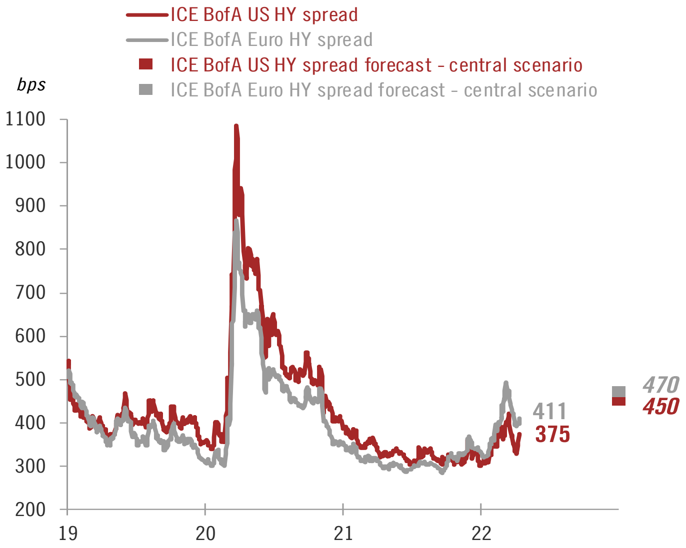
› We have moved from underweight to neutral on global and US IG corporate bonds to take advantage of the higher carry. However, our anticipated slowdown in GDP growth in H2 makes us wary of HY corporate bonds, so we are moving both global and US HY from neutral to underweight.

CHART 1:US AND EURO IG SPREADS AND YEAR-END FORECASTS



Source: Pictet's wealth management division - AA&MR, Factset, 12.04.2022

CHART 2: US AND EURO HY SPREADS AND YEAR-END FORECASTS



Source: Pictet's wealth management division - AA&MR, Factset, 12.04.2022

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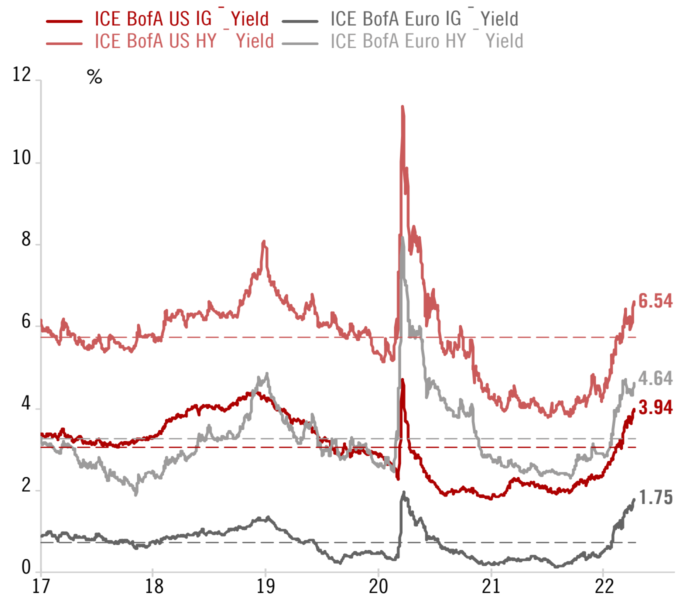
Recent sharp rise in yields could mean more defaults if it lasts

US and euro corporate bond yields have risen sharply year-to-date, driven by both wider credit spreads and higher sovereign bond yields. Although in the wake of Russia's invasion of Ukraine on 24 February credit spreads rose abruptly, they have tightened again since late-March. According to ICE Bank of America Merrill Lynch (BofAML) US and euro investment-grade (IG) indices, yields on average have reached 3.94% and 1.75%, with credit spreads at 125 and 132 bps, respectively (on April 12, *see charts 1 & 3*).

US high-yield (HY) bond spreads have been more resilient than euro HY during the sell-off in the wake of Russia's invasion, thanks to the larger exposure of the former to the energy sector. Additionally, Europe's growth is likely to suffer more from high energy prices. As such, although euro HY spreads are relatively wide at 411 bps, US HY ones are lower at 375 bps on April 12 (*see chart 2).* This translates into yields that have surpassed their average since 2017 at 6.54% and 4.64%, respectively (*see chart 3*).

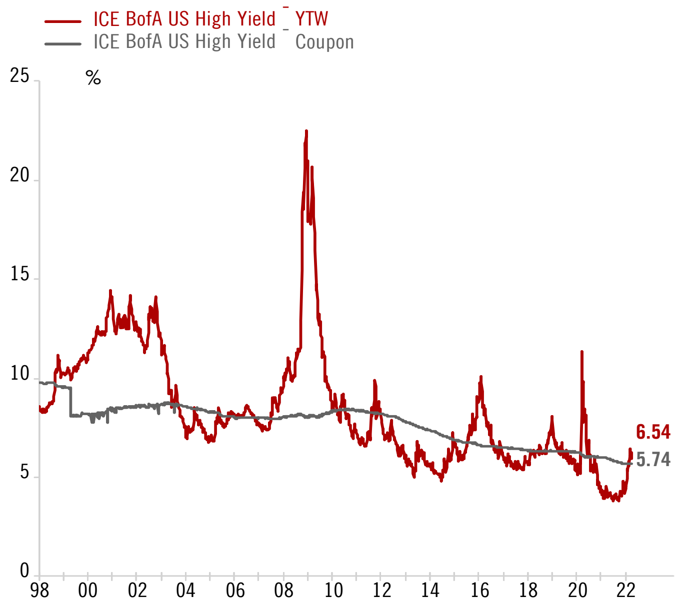
This surge in corporate bonds yields is likely to lead to a higher cost of funding for longer for corporates. Based on ICE BofAML indices, we see yields are already above average coupons for US and euro IG and HY indices. For US HY, each time this has occurred it has translated into wider credit spreads over subsequent months and a spike in yields (*see chart 4*). HY credit spreads usually tend to widen when economic activity decelerates sharply (leading to lower company profits) or when financial markets turmoil hinders market access.

CHART 3: US AND EURO CORPORATE BOND YIELDS



Source: Pictet's wealth management division - AA&MR, Factset, 12.04.2022

CHART 4: US HIGH-YIELD BOND YIELD AND AVERAGE COUPON



Source: Pictet's wealth management division - AA&MR, Factset, 12.04.2022

In an environment of high yields, and with spreads off their recent lows, companies' ability or willingness to refinance their debt is likely to fall. Looking at the maturity

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wall for both US and euro IG and HY companies, we observe that on average by the end of 2024, about 30% of all their bonds outstanding is due to mature. Although **we are not concerned about IG companies' ability to come to the primary market at times of financial market turmoil**, the fact that few HY companies issued during the agitated period following Russia's invasion is a reminder of the weak position of many HY companies.

Even though both US and euro HY default rates have fallen sharply in 2021 and remained low in February 2022 (at 1.2% and 2.1%, respectively), **the lag effect of higher rates, coupled with the surge in commodities prices and less accommodative fiscal policies, are likely to weigh on US and euro area GDP growth in H2** 2022 and beyond. As such, **we expect HY default rates to start picking up again**, even if the rating drift (issuer upgrades minus issuer downgrades, divided by rated issuers), which we consider as a good harbinger of the default cycle, has stabilised in positive territory for now. We would need to see rating downgrades surpassing upgrades (i.e. a negative rating drift) for a confirmation that the default cycle has turned, with default rates likely to pick up meaningfully.

Looking at the Q4 2021 reporting of US and euro IG and HY non-financial companies, we observe that fundamentals (i.e. interest coverage ratios[1] and net leverage ratios[2]) remain solid. **Net leverage ratios have fallen since the peak of 2020 as profits have recovered, enabling many companies to pay down their debt.** Looking with more granularity at US non-financial IG-rated companies, we see that cash as a percentage of gross debt remains elevated by historical standards at 12.3% (*see chart 5*). Nevertheless, **the recent sharp increase in yields leads us to expect a fall in interest coverage ratios in 2022**, as the rise in profits is unlikely to compensate for the rise in interest expense in the context of slowing economic growth and falling fiscal support from governments.

We expect IG-rated companies, and in particular US ones, to be better placed than HY ones to navigate the current challenging environment thanks to the ample cash at their disposal and their easier access to financial markets for refinancing purposes.

Expecting a reversal of fortune in H2

Taking stock of the more challenging environment for US and European companies **we have revised up our year-end spread forecasts in our central scenario** compared to the projections in our 2022 outlook (see Our 2022 scenario for corporate bonds). **We expect US and euro IG spreads to widen slightly from current levels to 130 and 140 bps**, respectively. Due to the potentially lower resilience of many HY companies, **we expect US and euro HY spreads to widen more significantly to 450 and 470 bps**, respectively (*see charts 1 &2*).

Although year-to-date ICE BofAML US and euro HY bond indices have outperformed their IG counterparts thanks in part to their lower duration exposure and thicker spread cushion (aligned with the expectations underlined in our outlook), we would expect the reverse to be true in H2. Nonetheless, year-to-date total returns for the major US and euro

[1] The interest coverage ratio equals earnings before interest and taxes (EBIT) divided by interest expense.
[2] The net leverage ratio equals net debt divided by earnings before interest, taxes, depreciation and amortisation (EBITDA)

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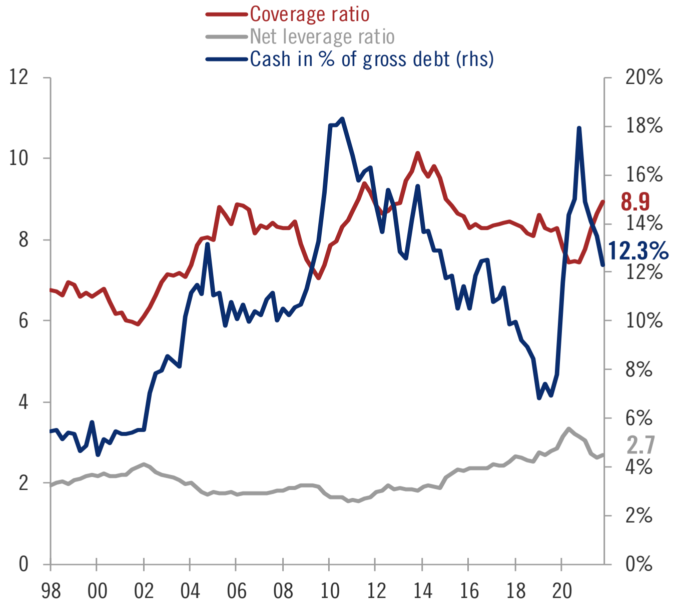
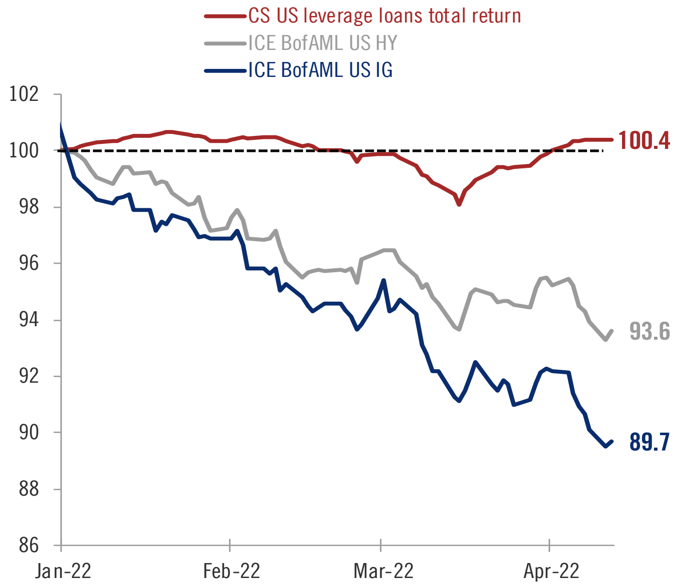
credit indices are deeply negative. For example, US IG bonds posted a total return of -10.3% and their HY counterparts -6.4% (on 12 April *see chart 6*).

CHART 5 : US INVESTMENT-GRADE NON-FINANCIAL FUNDAMENTALS (BASED ON MEDIAN VALUES)



Source: Pictet's wealth management division - AA&MR, BofAML, Q4 2021

CHART 6: US LEVERAGED LOANS, HIGH-YIELD AND INVESTMENT-GRADE BONDS TOTAL RETURN (REBASED TO 100 ON JANUARY 1, 2022)



Source: Pictet's wealth management division - AA&MR, Factset; Credit Suisse, 12.04.2022

One segment that stands out by posting a positive total return of 0.4% year-to-date is US leveraged loans (according to the Credit Suisse US leveraged loans index, *see chart 6*). As highlighted in our outlook, **we expected US leveraged loans to outperform US high-yield bonds thanks to their floating-rate features and generous credit spreads**. Looking ahead, this is **a theme that is likely to remain valid for H2**, as the US Federal Reserve (Fed) will probably hike the Fed funds rate aggressively, with market participants currently expecting 211 bps of cumulative rate hikes by the end of this year (as at 12 April).

However, with US leveraged loans discount margins usually widening in tandem with US HY credit spreads, because the Credit Suisse US leveraged loans index has a majority of B-rated companies (against a majority of BB-rated companies for the ICE BofAML US HY index), **total return performance could suffer somewhat should discount margins widen in sympathy with US HY spreads as per our year-end projections**.

Adjusting our stance, **we have moved from underweight to neutral on global and US IG corporate bonds to take advantage of the higher carry** they offer after their year-to-date rise in yields. However, our anticipated slowdown in GDP growth in H2 makes us **wary of HY corporate bonds, so we are moving both global and US HY from neutral to underweight.**

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