REYL INTESA SANPAOLO

UNDERSTANDING THE CURRENT CREDIT CYCLE

Xavier Sanjurjo
Research and Product Manager
Asset Management

Two years ago, central banks embarked on the most aggressive monetary tightening in decades to restrain the extraordinarily expansive financing conditions deployed during the pandemic, measures that helped to avert a major economic crisis by containing the wave of defaults that had then begun in credit markets. Benefitting from the strong economic recovery, corporates' fundamentals have returned to pre-COVID levels. This, along with the stronger yields on offer, has attracted investors back to the corporate bond market, which generated returns in 2023 of 8.40% for US Investment Grade (IG) and 13.50% for High Yield (HY).

However, with the economic cycle appearing to be well advanced, a resurgence in interest rates volatility due to uncertainties over the timing of a Fed easing, growing geopolitical risks, and tight credit valuations, how should investors be positioning themselves in fixed income markets?

THE CREDIT CYLE – A ROADMAP FOR EFFECTIVE POSITIONING

Credit cycles refer to the recurring pattern of expansion and contraction in credit availability and pricing within an economy. They are characterised by shifts in lending standards, credit demand, and overall market conditions. They are notably influenced by economic conditions, monetary policy, and market sentiment, and have a large impact on borrowing costs, investment decisions, and overall economic activity. Credit cycles typically consist of four phases: downturn, credit repair, recovery, and expansion/late cycle.

WHERE DO WE STAND IN THE CURRENT CYCLE?

A number of indicators suggest that the US credit cycle is currently in its expansion/late cycle phase, starting with strong, albeit declining, economic growth (1.6% in 1Q24 vs. 3.4% in 4Q23), and inflation of 3.5% as of end of March, which should force the Fed to maintain its restrictive policy for longer.

These developments should further restrict financial conditions, which have eased considerably since last year against a backdrop of resilient economic growth, enabling companies to refinance on capital markets, albeit at a higher cost. At time of writing, the yield offered in US IG corporate bonds markets stands at 5.74% according to ICE BofA indices (close to 15-year highs), and at 8.29% for US HY.

"The Fed's room to manoeuvre is shrinking."

Higher yields, abundant liquidity, and a sustained risk appetite - as evidenced by the outperformance of the riskier credit segments over the past two years - have all contributed to a renewed interest in corporate debt, which has led to a significant tightening in credit spreads, now flirting with historical lows.

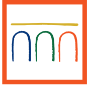
This access to capital markets has thus enabled issuers to improve their debt maturity profile, a priori reducing their refinancing risk in the coming years. Corporate fundamentals also improved sharply in the aftermath of the pandemic, benefiting from a strong economic recovery, with leverage and solvency ratios returning to pre-COVID levels. However, we are seeing a slight deterioration of late owing to higher borrowing costs and slower earnings growth.

This slight deterioration is unlikely to trigger a massive wave of defaults for now, but we are starting to see some cracks. As such, S&P recently reported the highest number of defaults globally since 2009 in the year to the end of February, with defaults mainly concentrated in CCC ratings. Notwithstanding, S&P anticipates a default rate on US speculative debt not exceeding 4.75% by year-end (vs. 4.5% in 2023), albeit mentioning a rate of 6.75% in its pessimistic scenario of recession and stickier inflation, forcing the Fed to keep its key rates higher for longer. A scenario that would suddenly become more plausible in the event of the materialisation of one of the many current latent risks and push the credit cycle into the downturn phase.

IMPLICATIONS FOR FIXED INCOME PORTFOLIOS

While the Fed seems to have succeeded in achieving a soft landing in the current monetary tightening cycle, risks for a harder landing remain with the most significant being persistent inflation. What is certain is that the Fed's room to manoeuvre is shrinking, and it seems to be preparing the markets for higher-for-longer rates, which will no doubt continue to generate volatility in rates and credit markets.

If history is any guide, these considerations, along with relatively tight valuation levels, advocate for a cautious positioning in corporate bond markets, implying a reduction of credit risk in portfolio and favouring high-quality IG corporate bonds as well as US Treasuries.



REYL
INTESA SANPAOLO

IMPORTANT INFORMATION - This content is being provided by REYL & Cie Ltd or/and its affiliates (hereinafter referred to as "REYL") solely for information purposes and is not intended to be a solicitation or offer, recommendation or advice to buy or sell interests in any financial instrument mentioned in it, to effect any transaction, or to conclude any transaction of any kind whatsoever, in particular to any recipient who is not a qualified, accredited, eligible professional or institutional investor. It is intended for the sole use of the recipient and may not be forwarded, printed, downloaded, used or reproduced for any other purpose. It is not intended for distribution/offering to, or use by, natural or legal persons that are nationals of a country or subject to a jurisdiction of which the laws or regulations would prohibit such distribution/offering or use. Whilst REYL shall use reasonable efforts to obtain information from sources which it believes to be reliable, REYL, its directors, officers, employees, agents or shareholders assume no liability regarding this content and give no warranty as to the accuracy, completeness or reliability of any mentioned data and thus assume no liability for losses arising from the use of this content. The information, opinions and assessments contained in the present document shall apply at the time of publication and may be revoked or changed without prior notice. This content is intended only for recipients who understand and are capable of assuming all risks involved. Before entering into any transaction, recipients should determine if the relevant financial instrument mentioned in the content suits particular circumstances and should ensure that they independently assess (together with their professional advisers) the specific risks, the legal, tax, accounting consequences and eligibility requirements of any purchase, holding or sale of financial instruments mentioned in the content. REYL, its directors, officers, employees, agents or shareholders may from time to time have interests and/or underwriting commitments in the financial instruments described herein. REYL makes no representation as to the suitability of the mentioned information, opinions or securities and financial instruments. Historical data on the performance of the financial instruments or on the underlying assets are no indication for future performance. The present content has been compiled by a department of REYL which is not an organisational unit responsible for financial research.REYL is subject to distinct regulatory requirements and certain services and/or financial instruments may not be available in all jurisdictions or to all recipient types. Recipients are therefore responsible to comply with all applicable laws and regulations. There is no intention to offer services and/or financial instruments in countries or jurisdictions where such offer would be unlawful under the relevant laws and regulations.

reyl.com

SUCCESS. TOGETHER.