

Schroders



Schroders Credit Lens

Perspective of USD investor

Q4 2020

Marketing material for professional investors or advisers only.

Important information

- **These do not represent the investment views of Schroders' credit teams**
- Marketing material for professional investors and advisors only
- Past performance is not a guide to future performance and may not be repeated
- Yields and returns are shown hedged to GBP unless stated otherwise
- All credit spreads are option-adjusted spreads (OAS) unless stated otherwise
- Spreads are quoted in basis points (bps) where 100 basis points = 1%
- Full list on indices on page 48

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[Emerging market debt \(EMD\)](#)

Schroders



Cross-credit summary

Summary

- Credit spreads are slightly above historical medians although relatively tighter in investment grade (IG) vs. high yield (HY)
- Lower quality HY bonds have continued to outperform after lagging earlier in the recovery. This indicates a greater appetite from investors to back the most troubled issuers
- Banks are much more cautious than corporate bond investors, rightly or wrongly
- USD issuance remains relatively brisk as companies continue to build cash reserves. Issuance has been mostly of higher quality bonds in both IG and HY
- Corporate leverage is at an all-time high but better than expected Q2 earnings prevented it from being even worse. However, interest coverage remains adequate in most markets. US HY fundamentals are the most challenging
- Defaults in US HY seem to be peaking. The HY energy default rate is approaching the previous high from 2016. Euro HY defaults remain surprisingly muted
- The value in emerging market debt (EMD) is in EM currencies and HY hard currency bonds, with local currency yields and IG spreads more or less back to pre-crisis levels

Summary table

Cross-credit overview

Date: 30 September 2020

	IG GBP non-gilts	IG GBP corporates	IG Euro	IG USD	HY GBP	HY Euro	HY USD	Hard EMD	Local EMD	Corp. EMD
Yield to worst	1.5%	1.8%	0.5%	2.1%	6.2%	4.1%	5.8%	5.2%	4.5%	4.3%
Yield to worst (hedged to USD) ¹	1.8%	2.1%	1.4%	2.1%	6.5%	5.0%	5.8%	5.2%	-	4.3%
Spread (bps)	129	153	118	144	607	472	541	432	421	370
Spread (percentile) ²	50%	52%	52%	52%	74%	57%	64%	65%	43%	67%
Risk premium (bps) ³	80	97	61	87	418	288	316	285	340	241
Duration	8.1	8.7	5.4	8.4	4.2	4.2	5.0	8.1	5.4	4.6
Market value (billion \$)	924	718	3,290	8,312	49	456	1,447	706	1,160	529
Rating	A2	A3	A3	A3	BB3	BB3	B1	BBB3	BBB	BBB3
Nr. of issues/countries	1,215	1,039	3,613	8,746	101	670	2,013	73	19	1,681
Since Jan 1997 or inception										
Annualised return ⁴	6.0%	6.2%	5.4%	6.1%	8.9%	6.3%	6.7%	8.2%	6.3%	7.1%
Annualised volatility	5.1%	5.8%	3.5%	5.4%	10.7%	11.7%	9.0%	10.6%	11.9%	7.6%
Return/volatility	1.2	1.1	1.6	1.1	0.8	0.5	0.7	0.8	0.5	0.9
Max drawdown	-10.3%	-17.3%	-7.2%	-16.1%	-28.5%	-39.8%	-33.2%	-29.5%	-12.1%	-24.3%
Correlation with S&P500	0.2	0.2	0.3	0.3	0.5	0.6	0.6	0.6	0.6	0.5
Correlation with MSCI World	0.2	0.3	0.3	0.3	0.6	0.7	0.7	0.6	0.7	0.6
Correlation with US Treasuries	0.4	0.4	0.3	0.5	-0.2	-0.3	-0.2	0.1	0.1	0.2

Past performance is not a guide to future performance and may not be repeated.

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2020.

¹Local currency yield minus annualized 3-month hedging cost/return.

²Percentile shows where the current spread is relatively to the historical range of spreads, within a range of 0 to 100. The greater the percentile the higher the spread compared to history.

³Spread minus average historical default and downgrade losses (see slide 12).

⁴All returns USD hedged returns, except EMD Local which is unhedged USD return.

Performance table

Cross-credit overview

	IG GBP non-gilts	IG GBP corporates	IG Euro	IG USD	HY GBP	HY Euro	HY USD	Hard EMD	Local EMD	Corp. EMD
Return (local)¹										
1 month return	0.6%	0.5%	0.4%	-0.3%	-0.2%	-0.6%	-1.0%	-1.9%	-2.0%	-0.5%
YTD return	4.6%	4.7%	0.7%	6.6%	-1.7%	-2.6%	-0.3%	-0.5%	-6.3%	2.6%
1 year return	3.9%	4.2%	0.2%	7.8%	1.5%	-0.6%	2.3%	1.3%	-1.4%	4.9%
Return (USD hedged)										
1 month return	0.6%	0.5%	0.4%	-0.3%	-0.2%	-0.5%	-1.0%	-1.9%	-2.0%	-0.5%
YTD return	5.3%	5.5%	1.8%	6.6%	-0.6%	-1.3%	-0.3%	-0.5%	-6.3%	2.6%
1 year return	5.0%	5.4%	2.0%	7.8%	3.0%	1.3%	2.3%	1.3%	-1.4%	4.9%
Spread										
1 month OAS change	4	5	4	8	25	26	39	9	3	19
YTD OAS change	15	21	24	43	162	164	181	141	68	103
1 year OAS change	0	1	6	22	90	106	139	95	54	63
Latest OAS	129	153	118	144	607	472	541	432	421	370

Past performance is not a guide to future performance and may not be repeated.

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2020.

¹Local EMD is USD return.

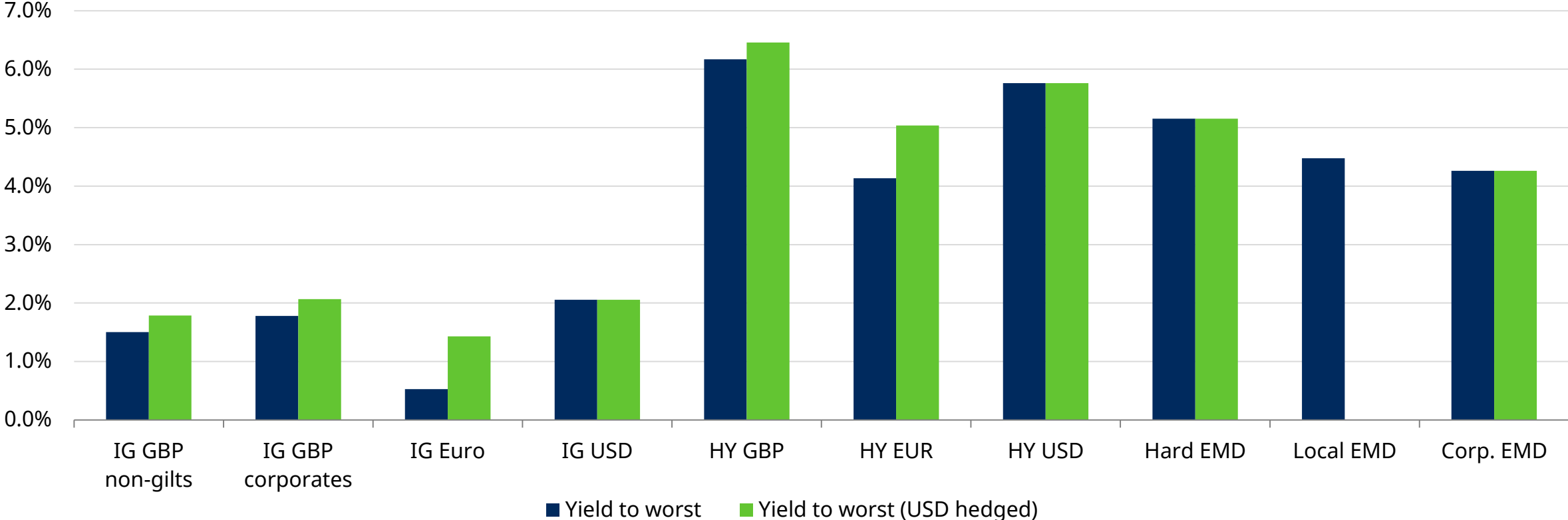
Schroders



Cross-credit analysis: key insights

Cross-credit yield

Yield to worst



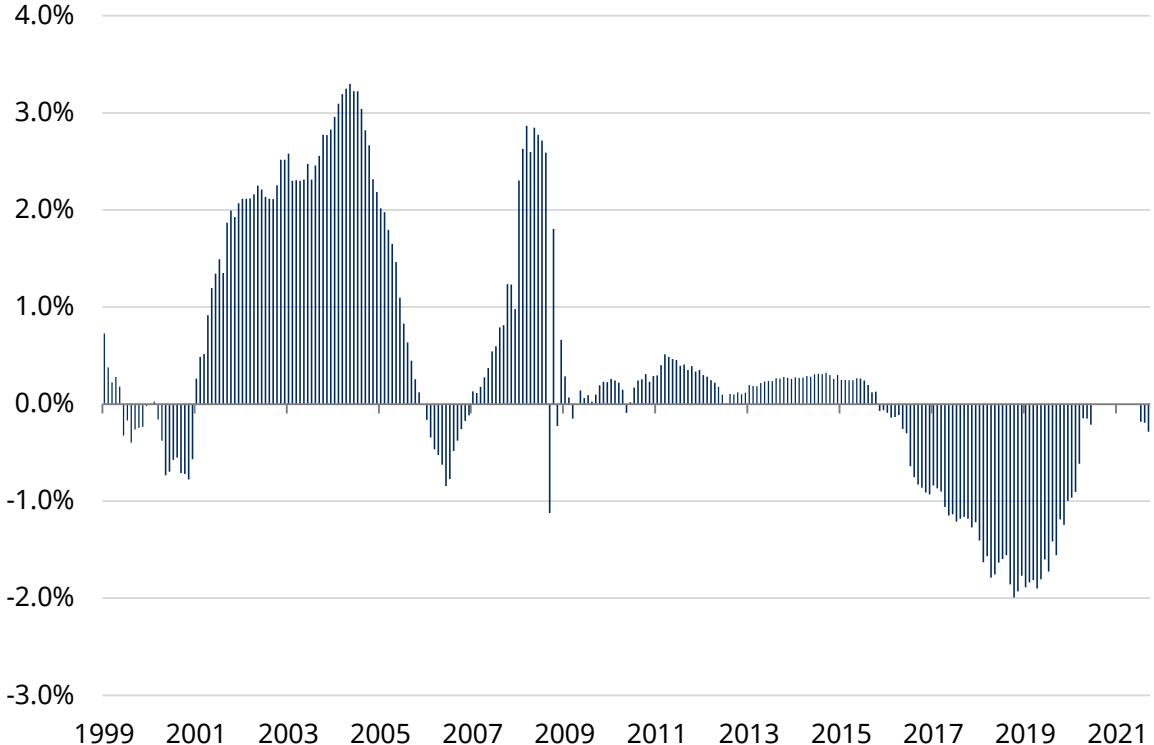
Currency-hedged EUR and GBP corporates do not provide a yield pick over USD corporates

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan, Bloomberg. Data as at 30 September 2020. Hedged yield is local currency yield minus annualised 3-month FX hedging cost/return (see next slide).

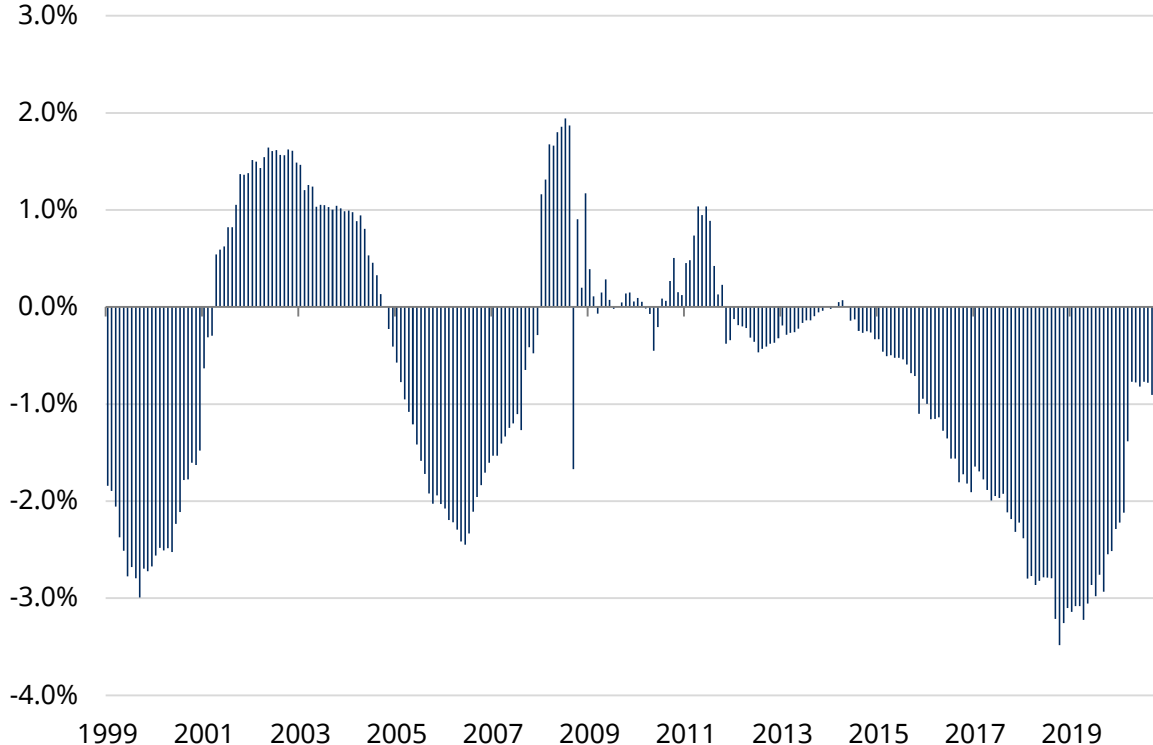
FX hedging cost or return

Using 3-month FX forwards

Annualised GBP to USD hedging cost (pos) or return (neg)



Annualised EUR to USD hedging cost (pos) or return (neg)



GBP yields will be 0.3% higher in USD once hedging taken account

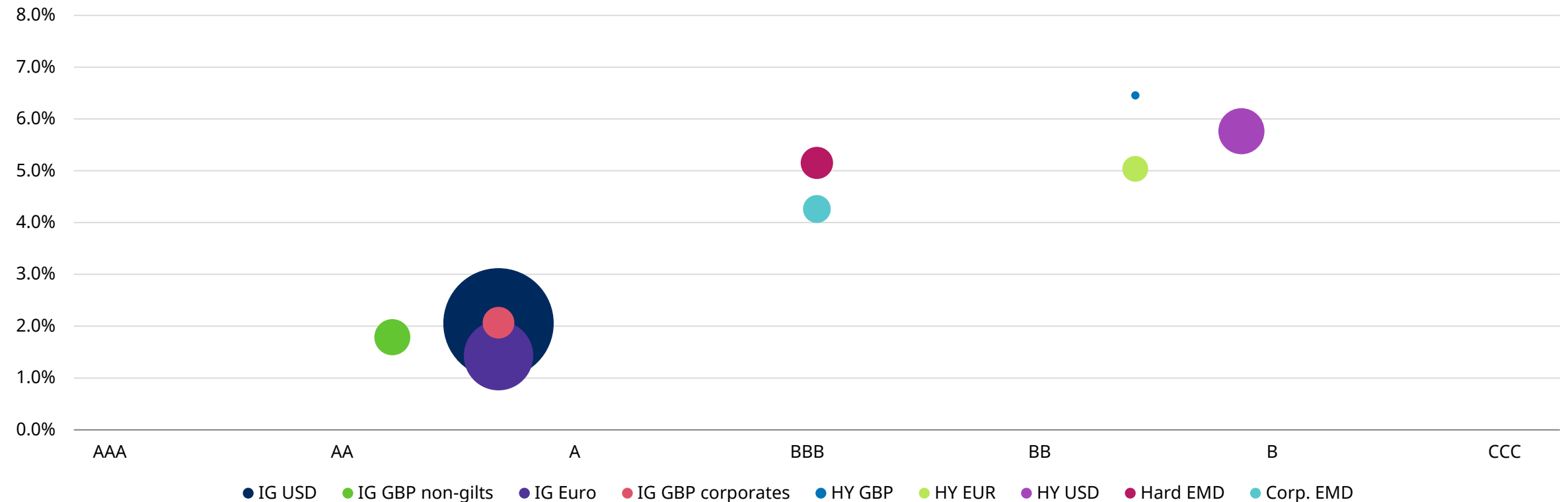
EUR yields will be 0.9% higher in USD once hedging taken account

Source: Refinitiv Datastream. Data as at 30 September 2020.

Yield vs. credit rating vs. market size

The size of bubble is proportionate to the size of the market

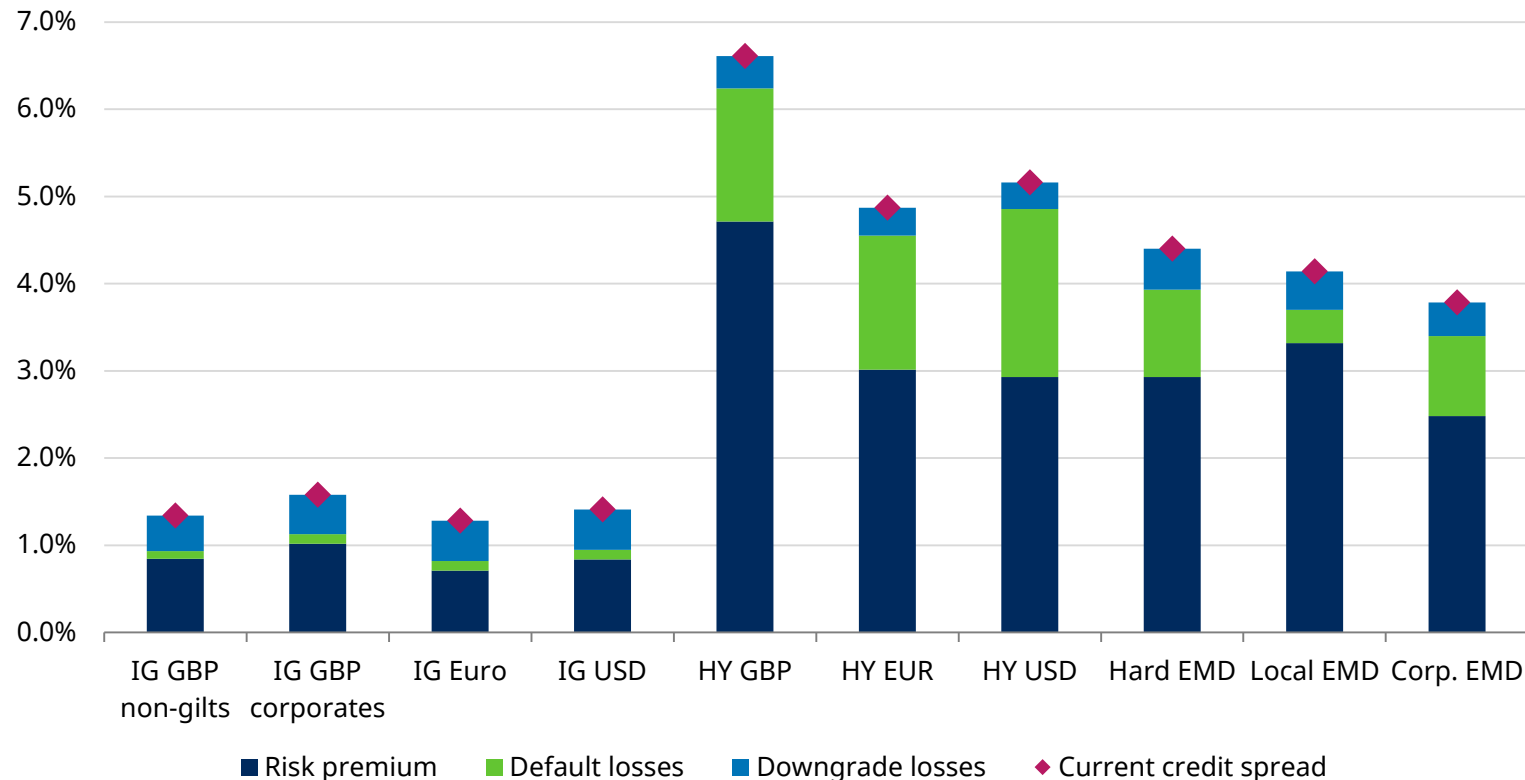
Yield (USD hedged) vs credit rating vs market size



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2020.

Risk premium/net spread in credit

Decomposition of credit spread into expected losses and expected risk premium



- IG is more exposed to **downgrade losses** (value of a bond falling after a downgrade), while **default losses** have been negligible
- Major losses in HY come from defaults that mostly happen in recessions
- Historically, investors have received a **risk premium** for having exposure to credit, as the average default and downgrade losses have been less than the average spread

Source: Schroders, Moody's default and recovery study 2019, ICE Data Indices, J.P.Morgan. Are expected to be Data as at 30 September 2020.

Schroders

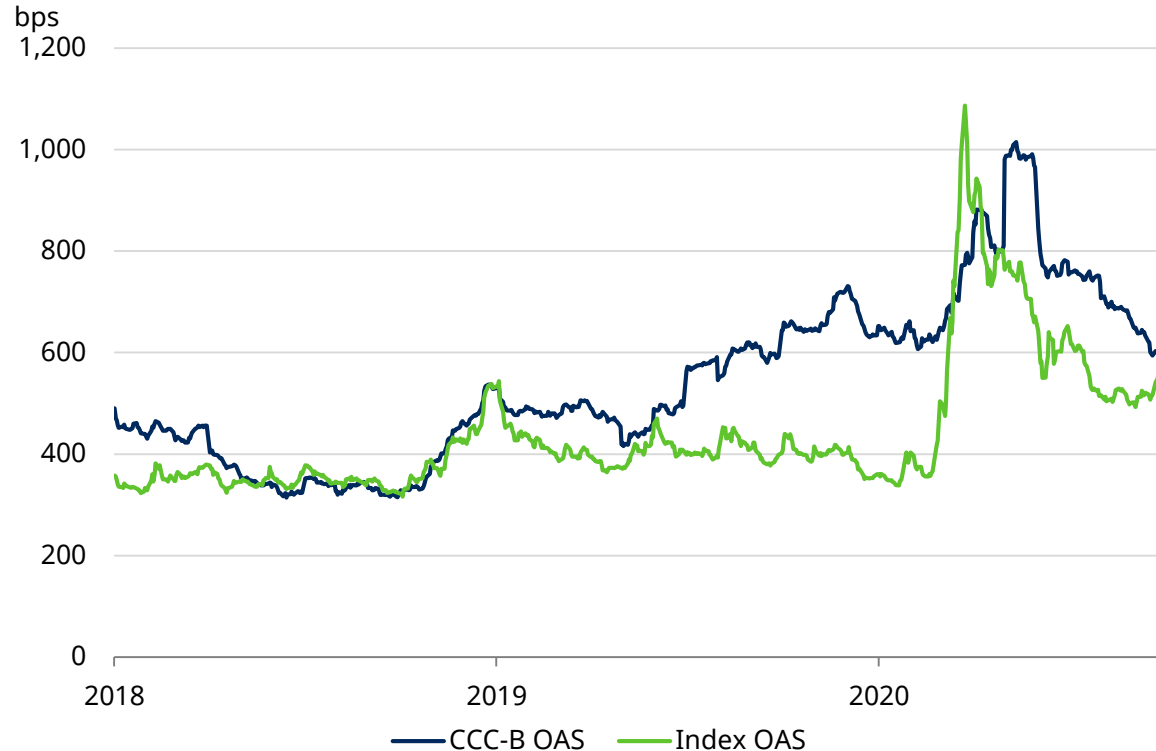


Hot topics

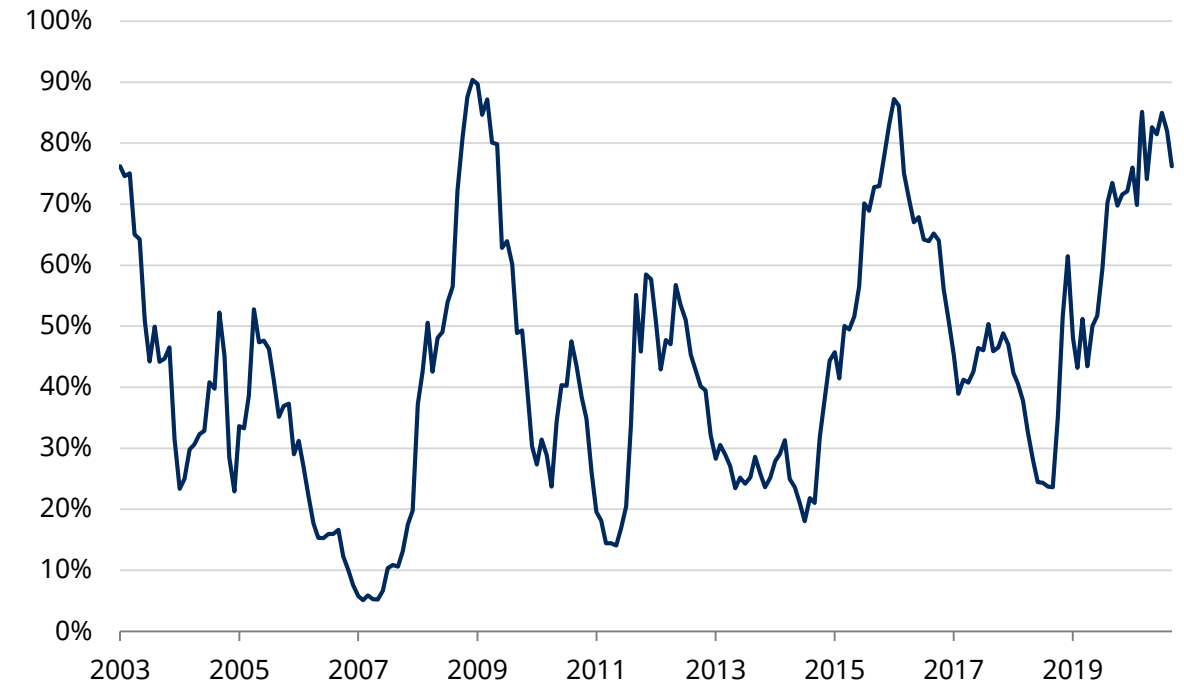
US HY CCC spreads continue to narrow

Lowest rated bonds outperforming the overall HY market

US HY CCC minus single-B credit spreads



US HY CCC spread dispersion¹



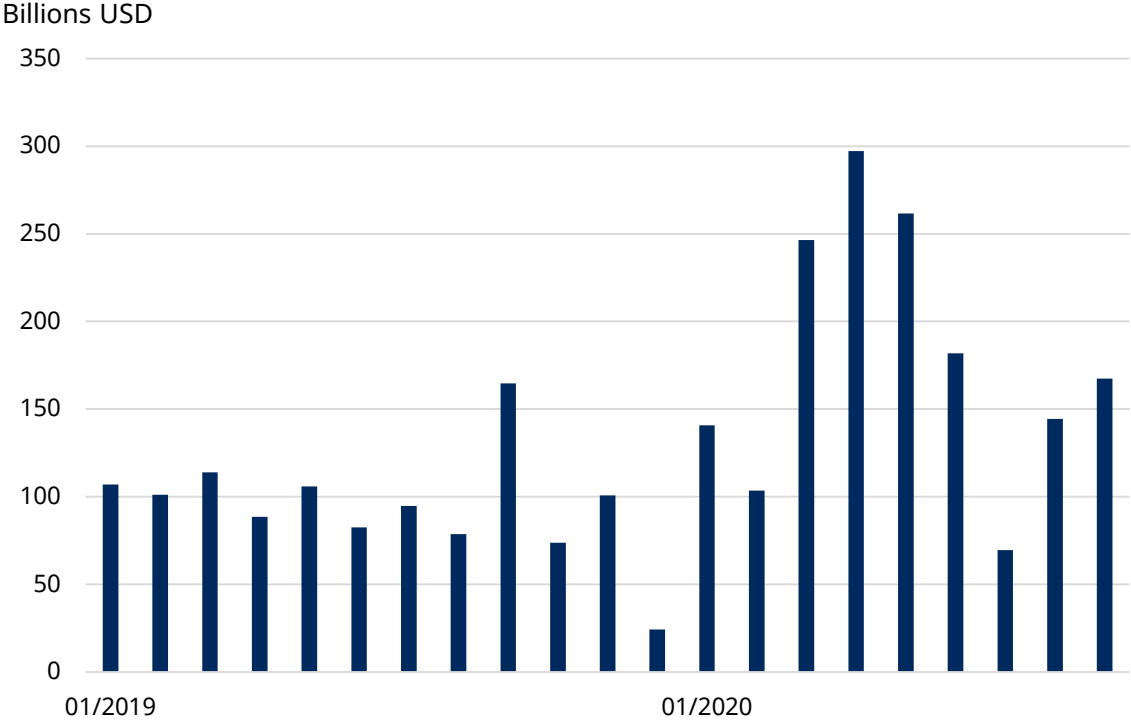
Despite narrower CCC spreads, dispersion within CCCs remains wide, indicating a varying level of risk premium in these bonds

Source: Refinitiv Datastream, BofA Merrill Lynch. Data as at 30 September 2020.

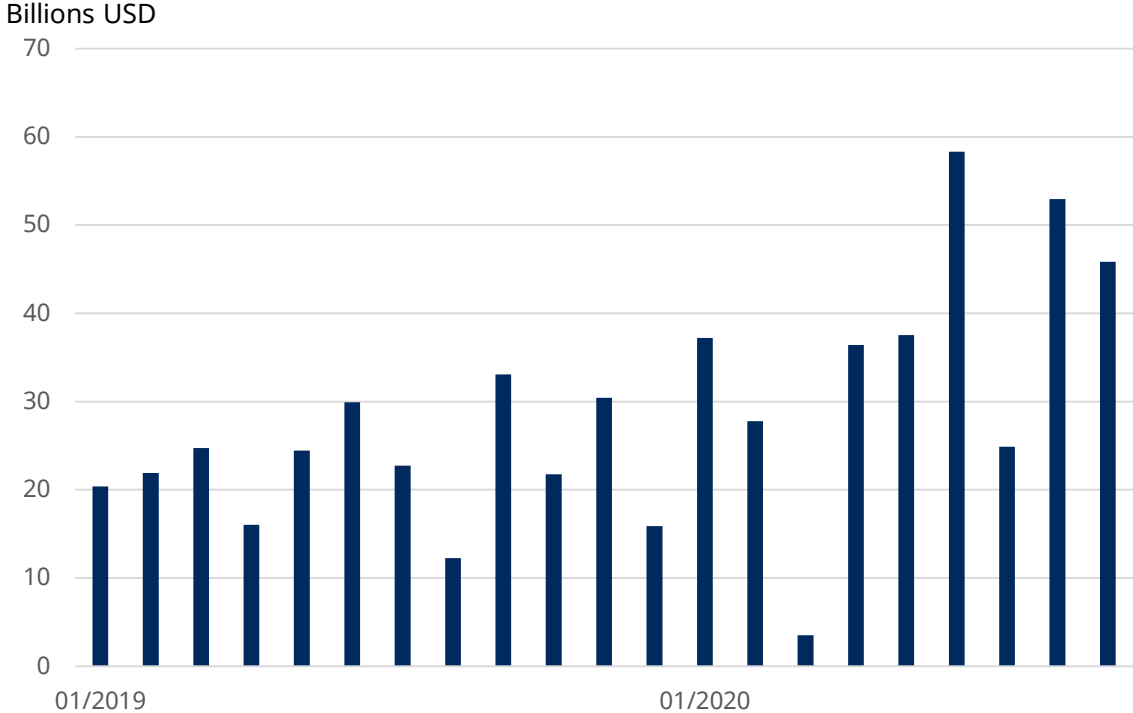
¹Defined as the proportion of face value marked outside +/-400bps of the index level.

USD issuance is still elevated

US IG monthly gross new issuance



US HY monthly gross new issuance



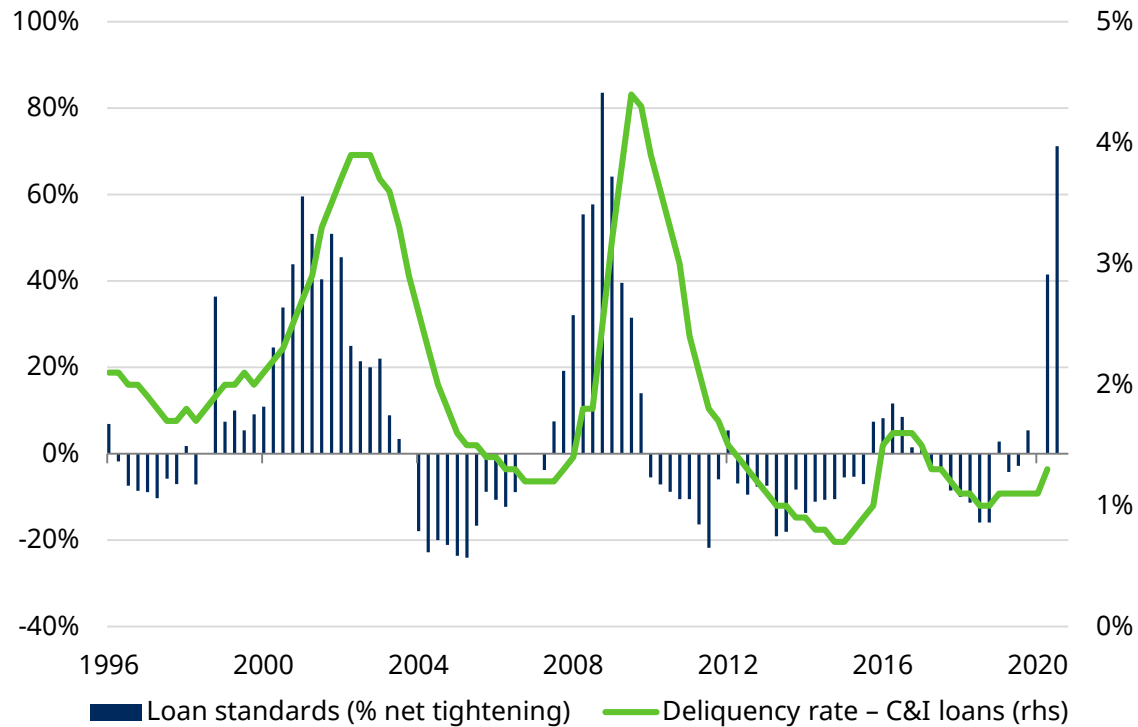
US HY issuance has been above \$40 billion in three of the last four months; nonetheless, the issuance has been mainly from higher quality HY issuers

Source: Sifma. Data as at 30 September 2020.

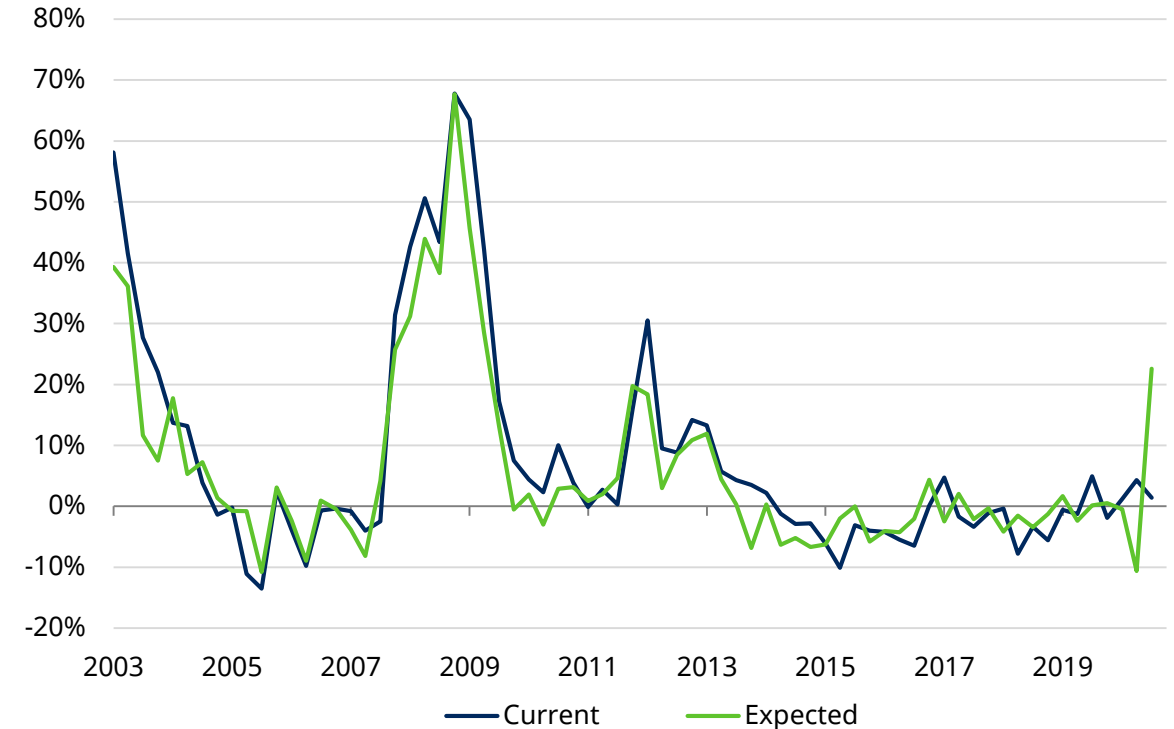
US and euro area bank lending standards

Banks remain more cautious than corporate bond investors

US C&I loan standards and delinquency rates



Euro area corporate lending standards¹



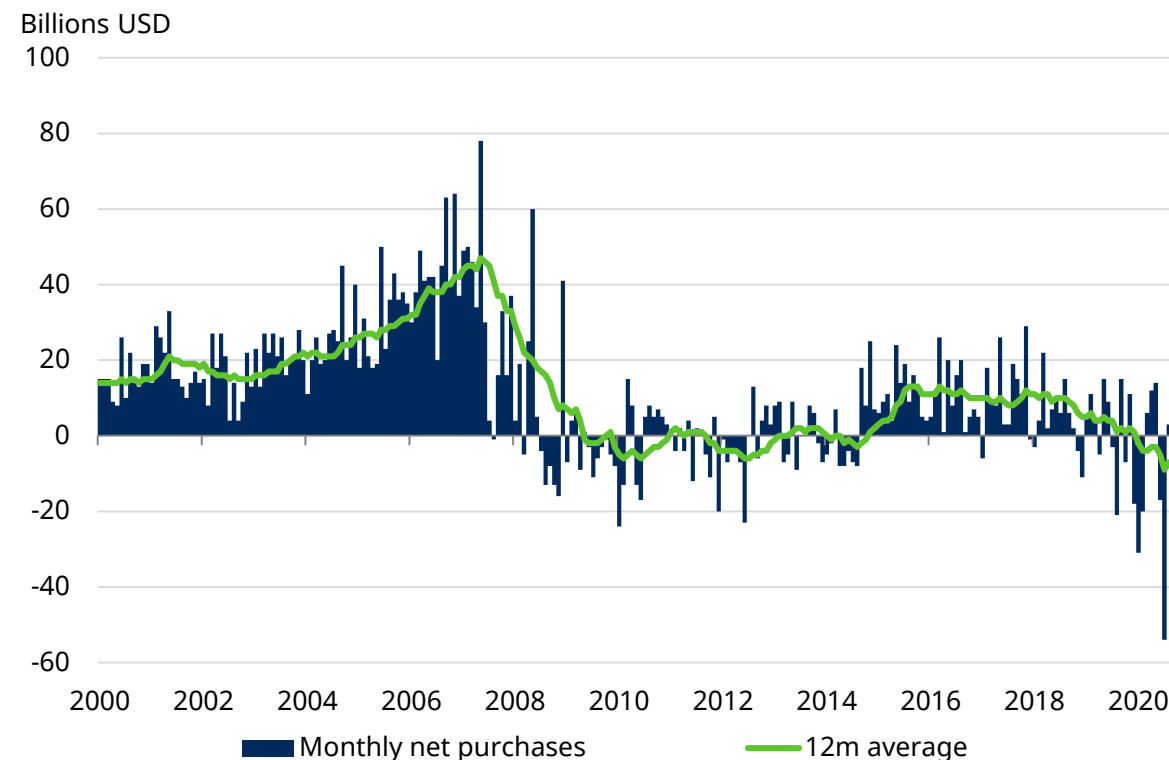
US bank lending standards tightened further in Q3; Euro area corporate lending standards are expected to tighten from Q4

Source: Schroders, Refinitiv Datastream. C&I stands for commercial and industrial loans. Data as at Q3 2020.

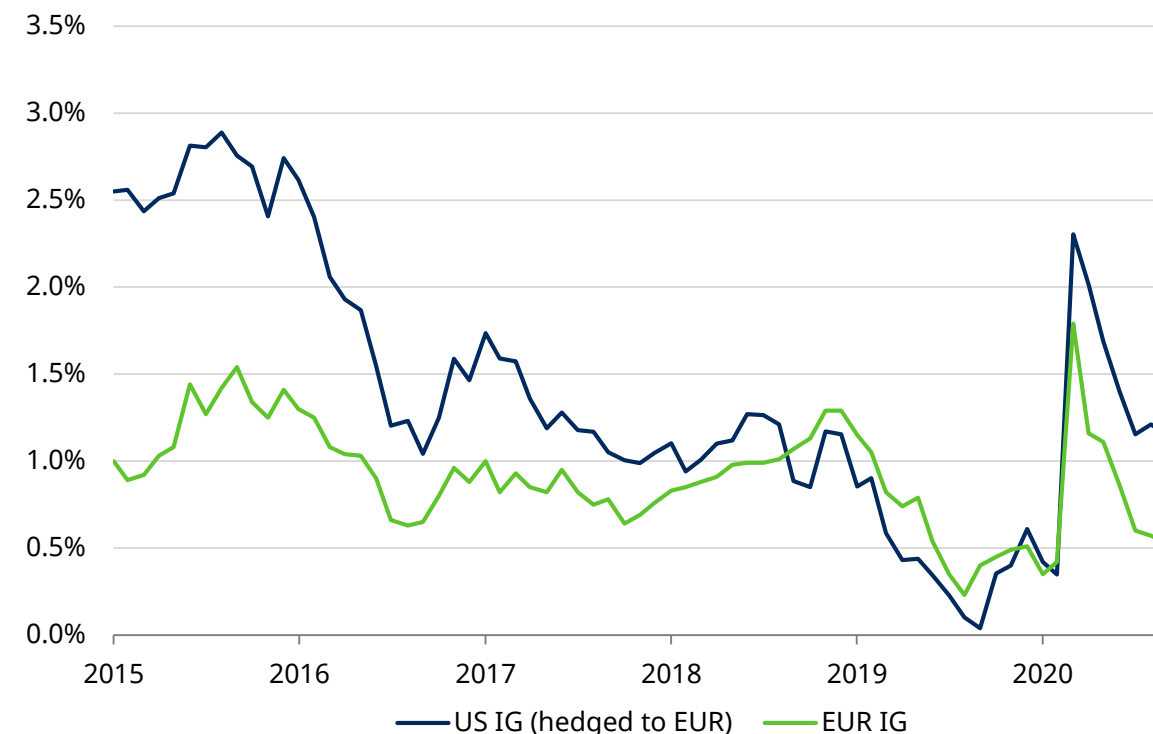
*Negative number means looser lending standards.

Foreigners sold a record amount of US corporate bonds in July

Monthly net purchases of US corporate bonds



IG yields for Euro investors

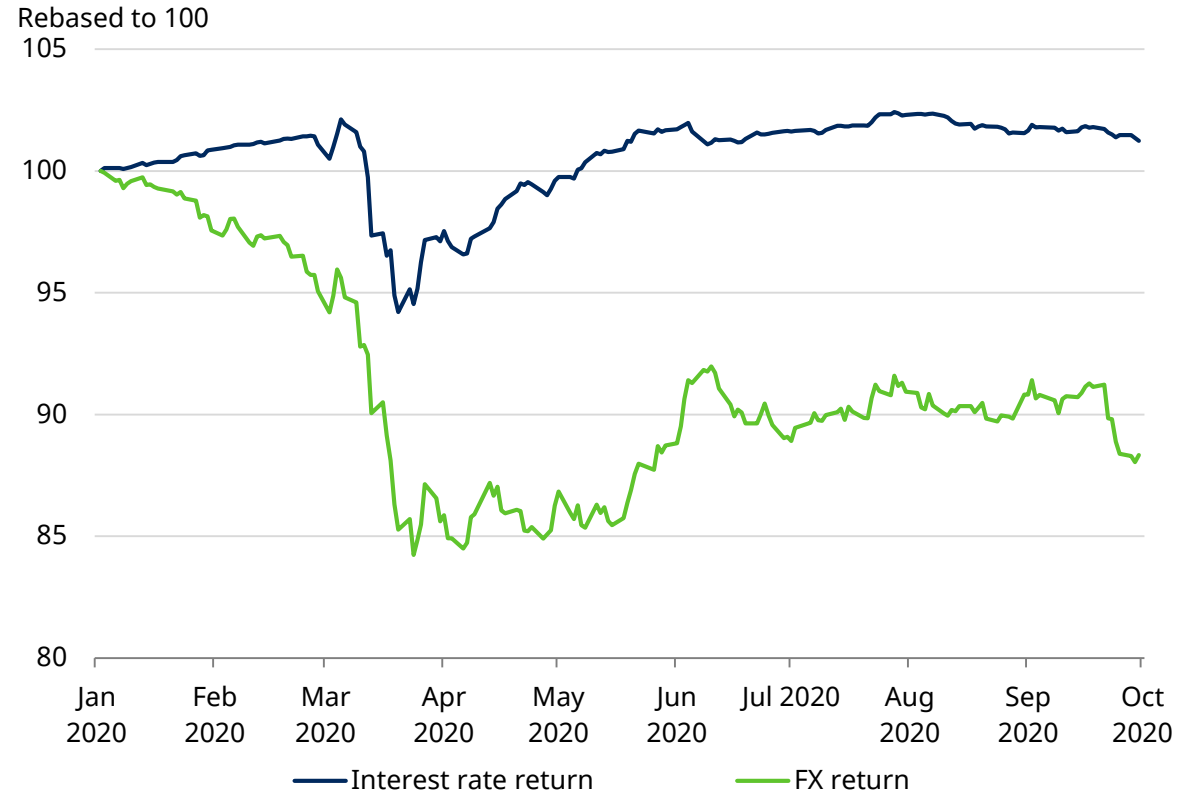


Foreigners sold a record \$54 billion of US corporate bonds in July despite relative attractiveness of hedged USD yields; weaker dollar could have induced selling by unhedged foreign investors

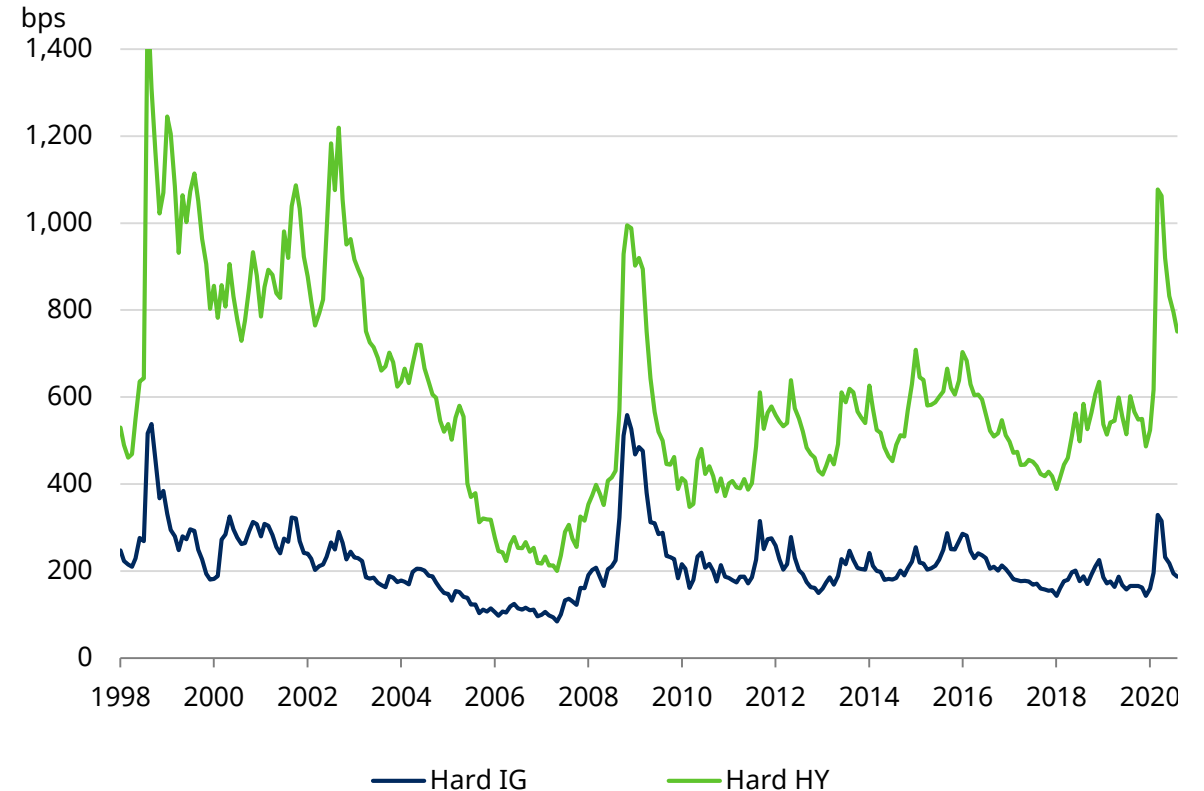
Source: Refinitiv Datastream. Left-hand figure data as at 31 August 2020, right-hand figure data as at 30 September 2020.

Value in EMD is in EM currencies and HY hard currency bonds

EMD Local FX and interest rate return in 2020



EMBI Global Diversified IG and HY spread

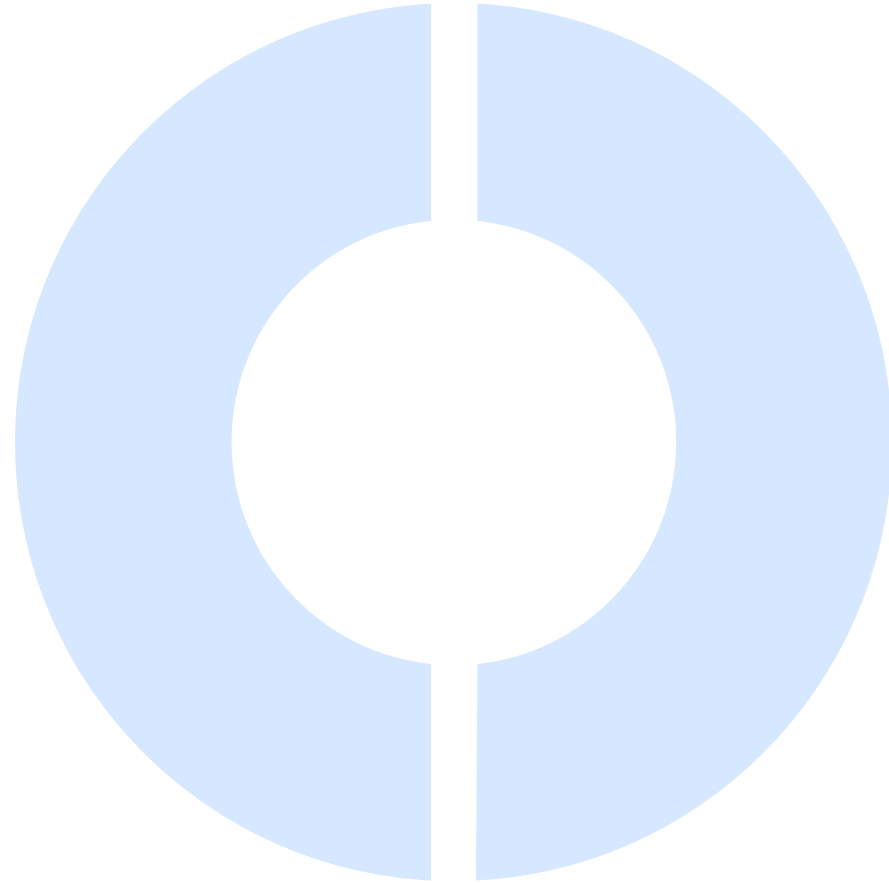


Local currency yields and IG spreads back to pre-crisis levels

Past performance is not a guide to future performance and may not be repeated.

Source: J.P. Morgan. Data as at 30 September 2020.

Schroders

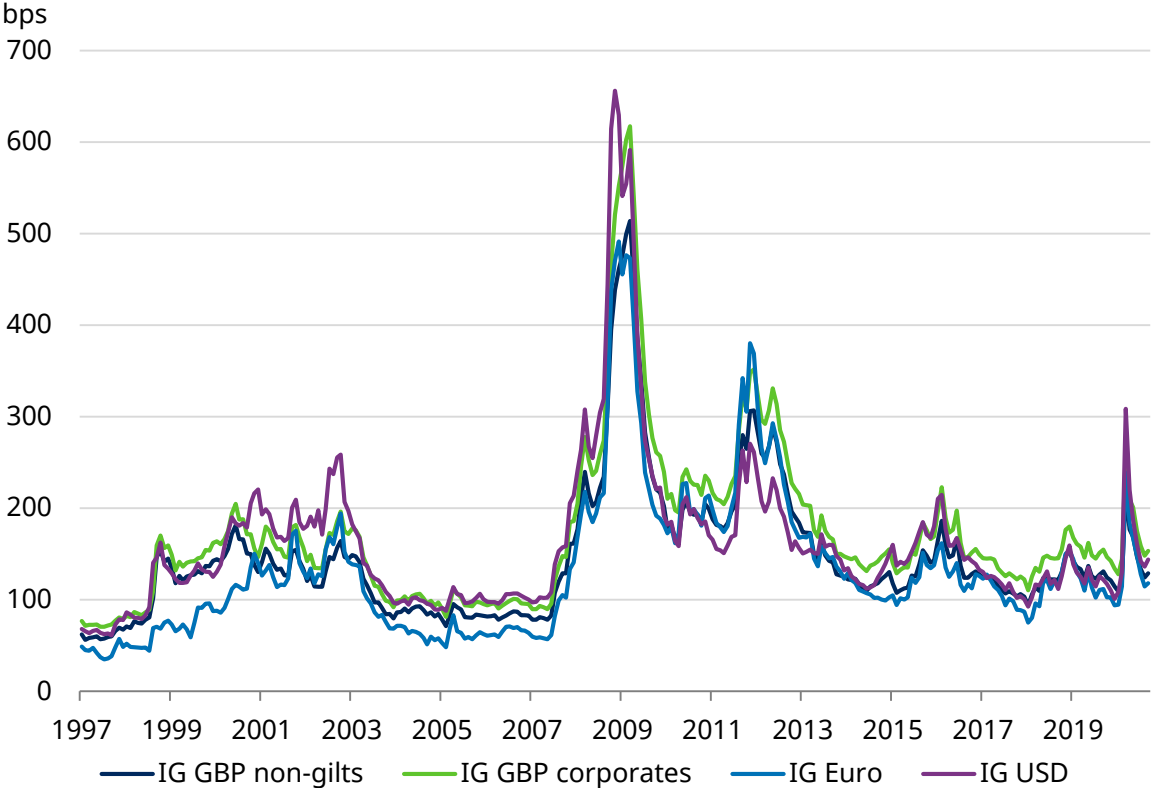


Corporate credit
Valuation

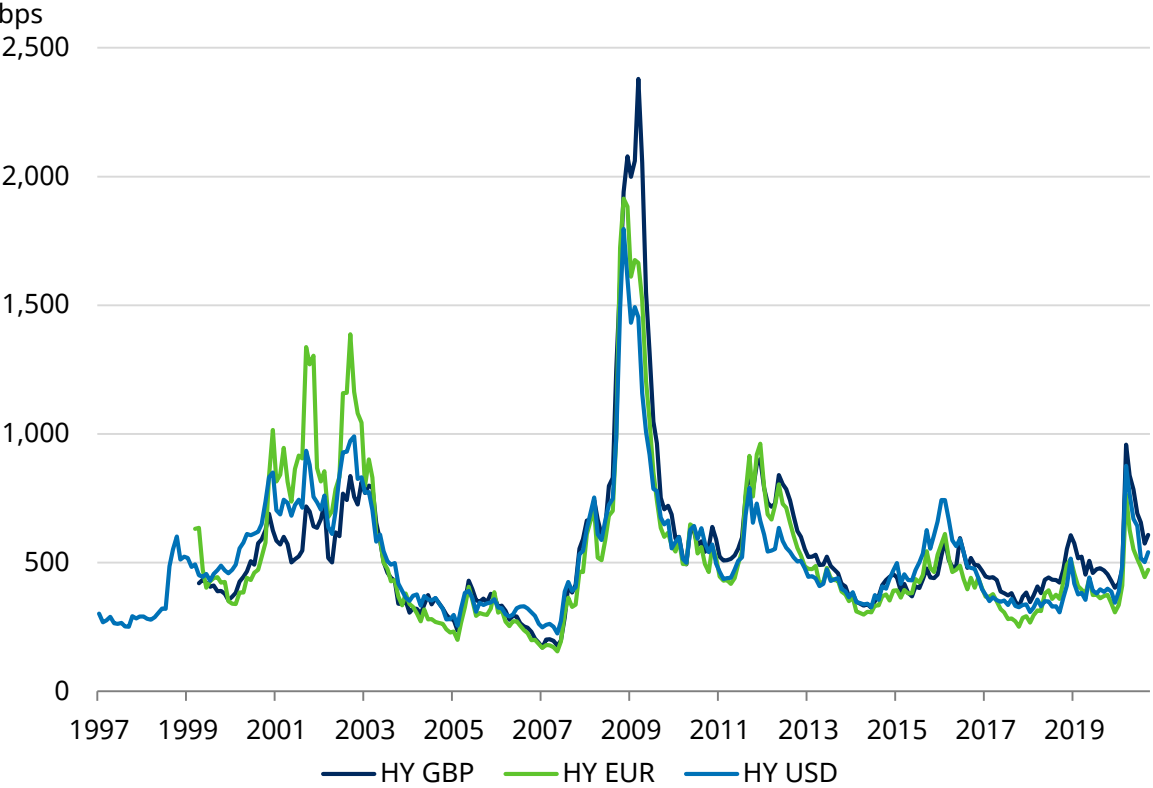
IG and HY valuation

Historical ratings-adjusted credit spreads

IG adjusted spreads



HY adjusted spreads

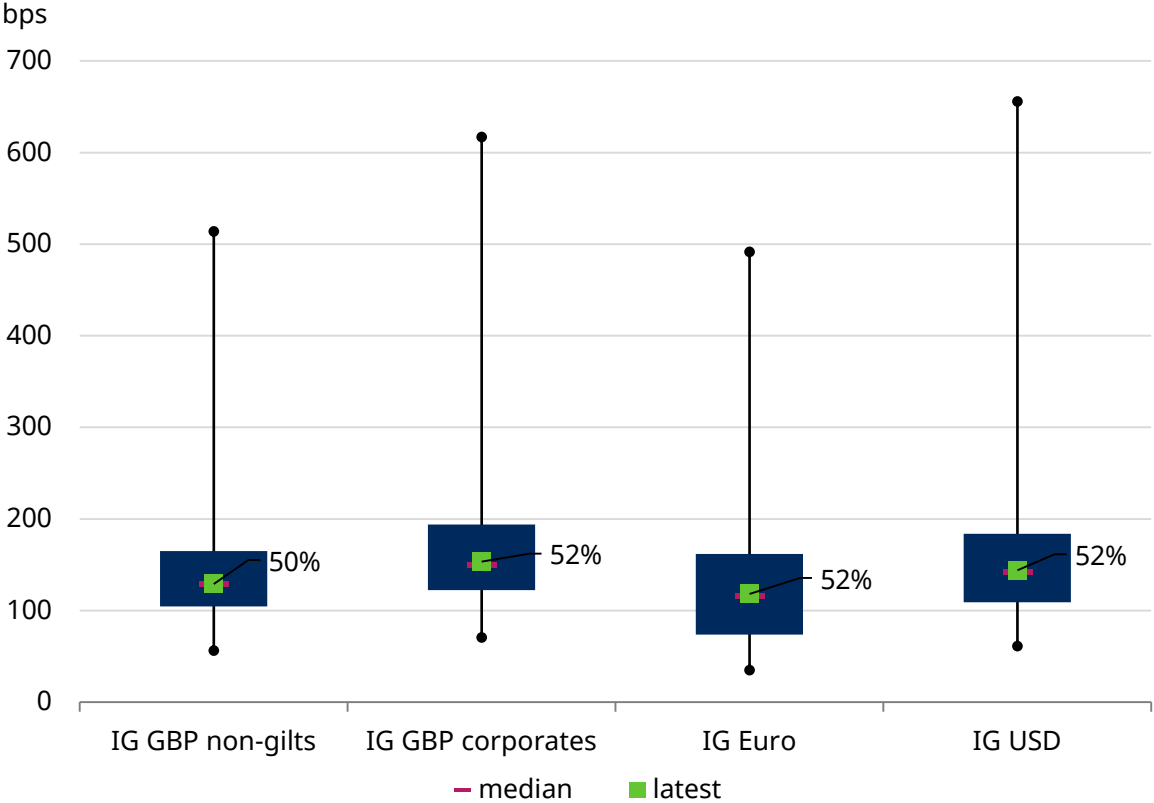


Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2020. Spreads are adjusted for changes in the distribution of credit ratings within each index over time.

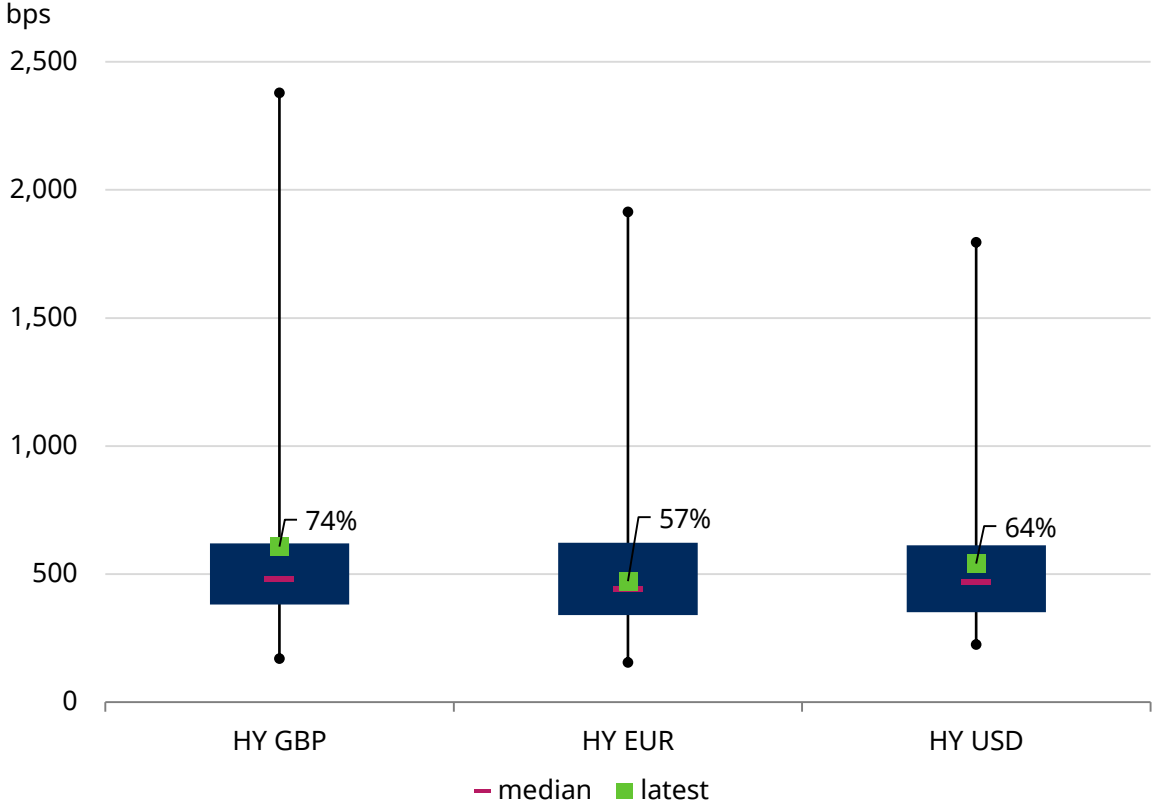
IG and HY valuation

Spread percentiles¹

IG adjusted spreads

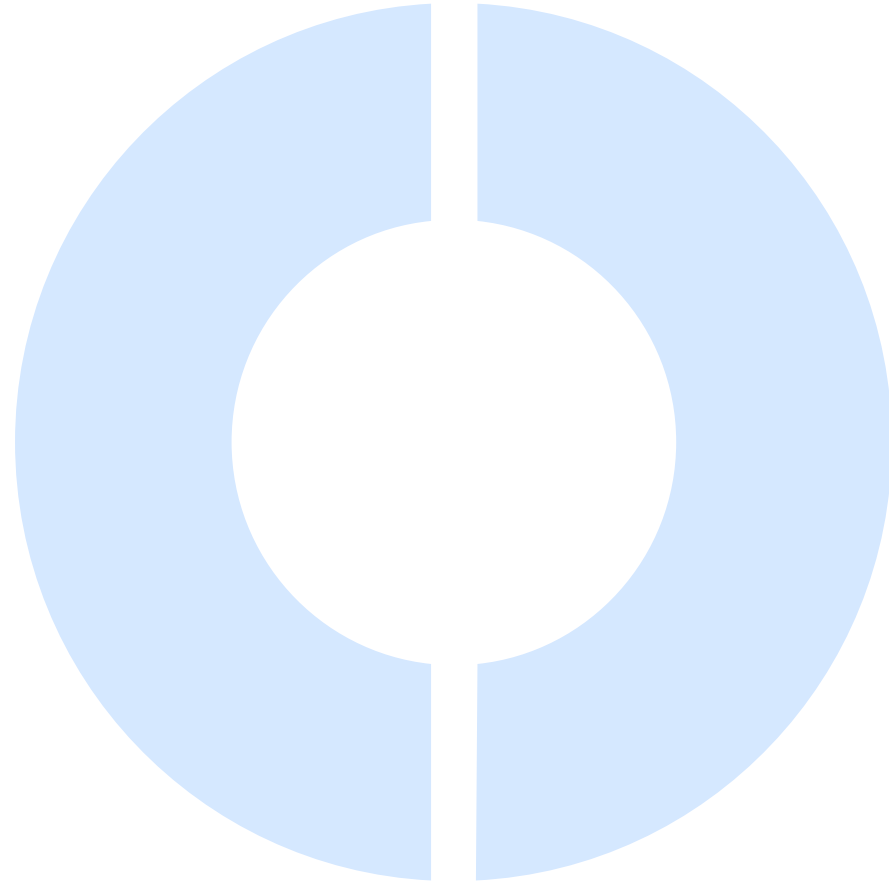


HY adjusted spreads



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2020. Spreads are adjusted for changes in the distribution of credit ratings within each index over time.
¹Percentiles show where the current spread is relatively to the historical range of spreads. The greater the percentile the higher the spread compared to history.

Schroders



Corporate credit
Fundamentals

Corporate fundamentals summary

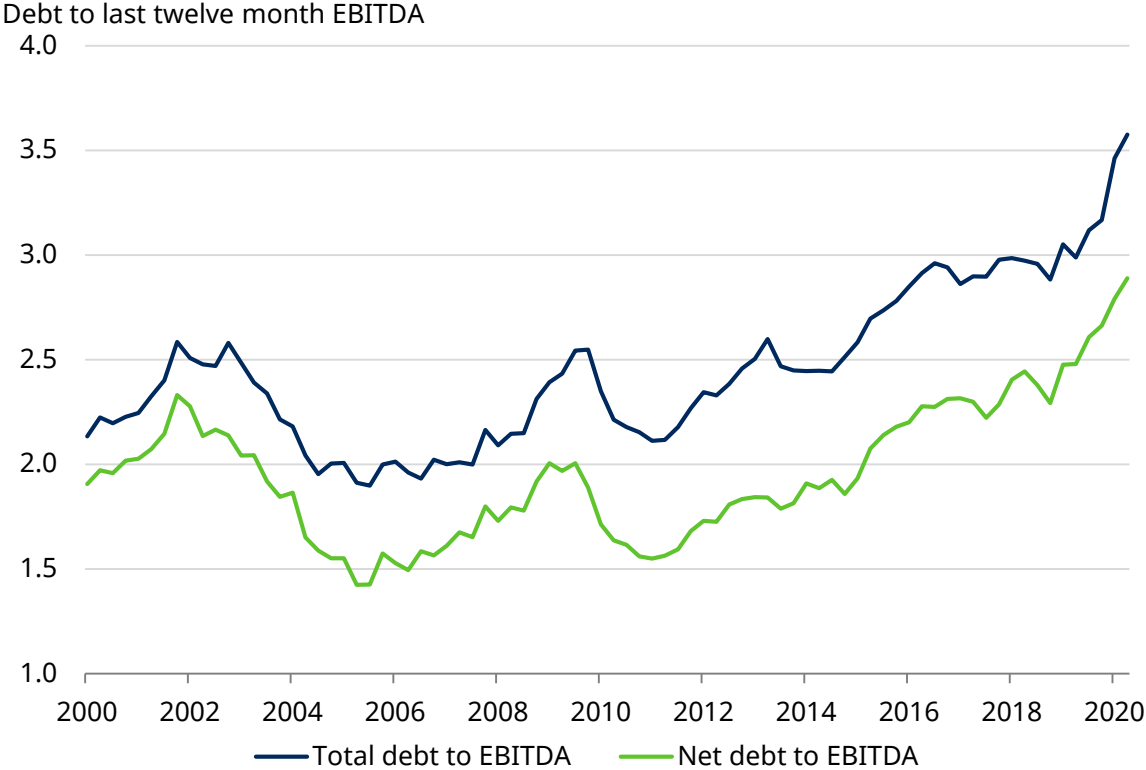
- US and Euro IG leverage (the debt to EBTIDA¹ ratio) is at a record level, reflecting companies' very large debt burdens
- Leverage increased sharply in Q2 because of the Covid-19 induced drop in earnings, but the increase was less than expected as earnings mostly exceeded analysts' expectations
- Debt growth is finally showing signs of peaking as companies focus on balance sheet repair
- US IG interest coverage ratio fell to the lowest since 2010 but is still higher than in previous cycle bottoms. Euro IG interest coverage remains very strong
- Cash levels have increased sharply across the board because of emergency borrowing. Companies are likely to continue to carry more cash, improving the short-term flexibility
- HY, especially US HY, remains vulnerable because of high leverage, low interest coverage and weak margins. Successful efforts to bolster liquidity alleviate near term concerns

EBTIDA is earnings before interest, tax, debt and amortisation

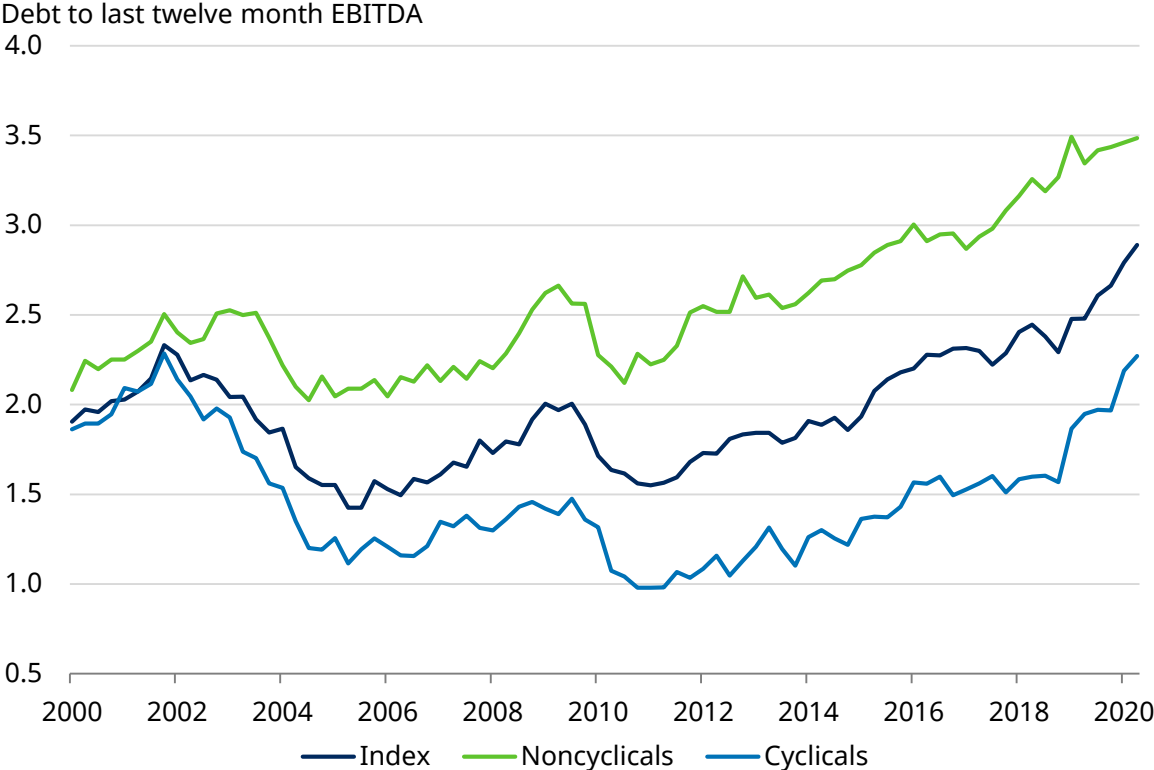
US IG leverage

At record levels but was expected to be even worse

US IG leverage



US IG net leverage



US IG leverage increased less than feared in Q2; compared to the history, the leverage of noncyclical companies is more extended than cyclical companies

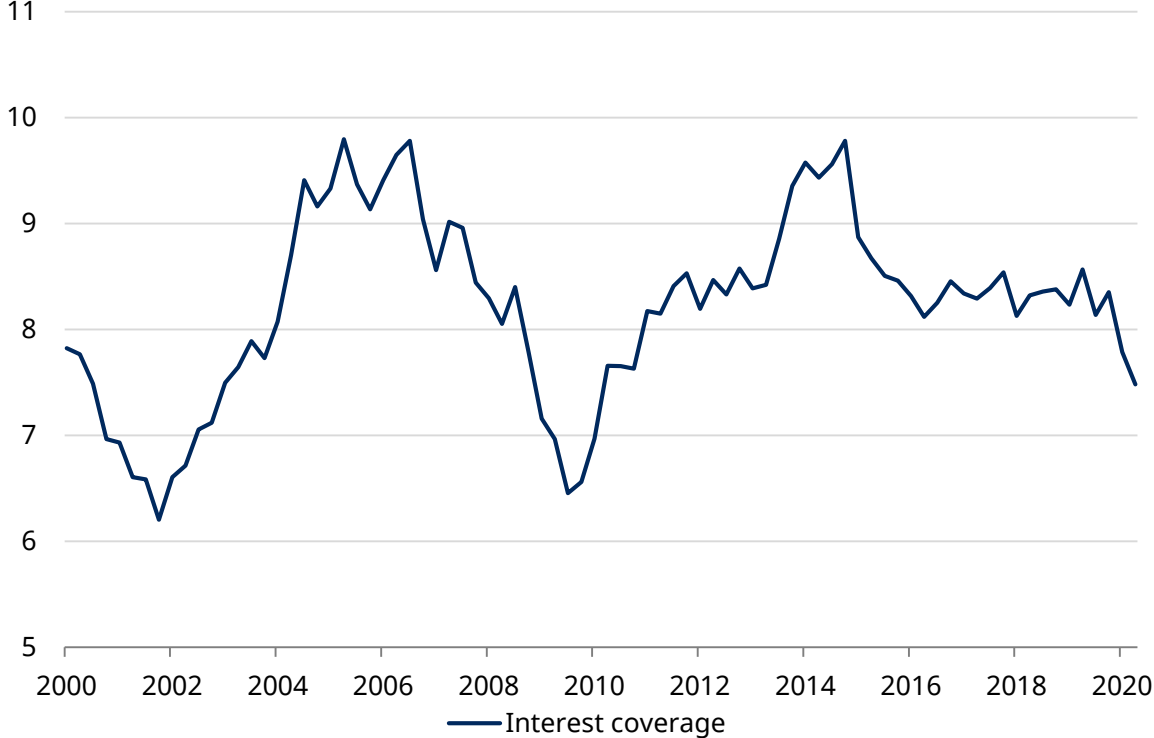
Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q2 2020. Cyclical sectors: Basic Materials, Consumer Discretionary, Industrials, Technology. Noncyclical sectors: Communications, Consumer Staples, Utility, Health Care.

US IG interest coverage ratio

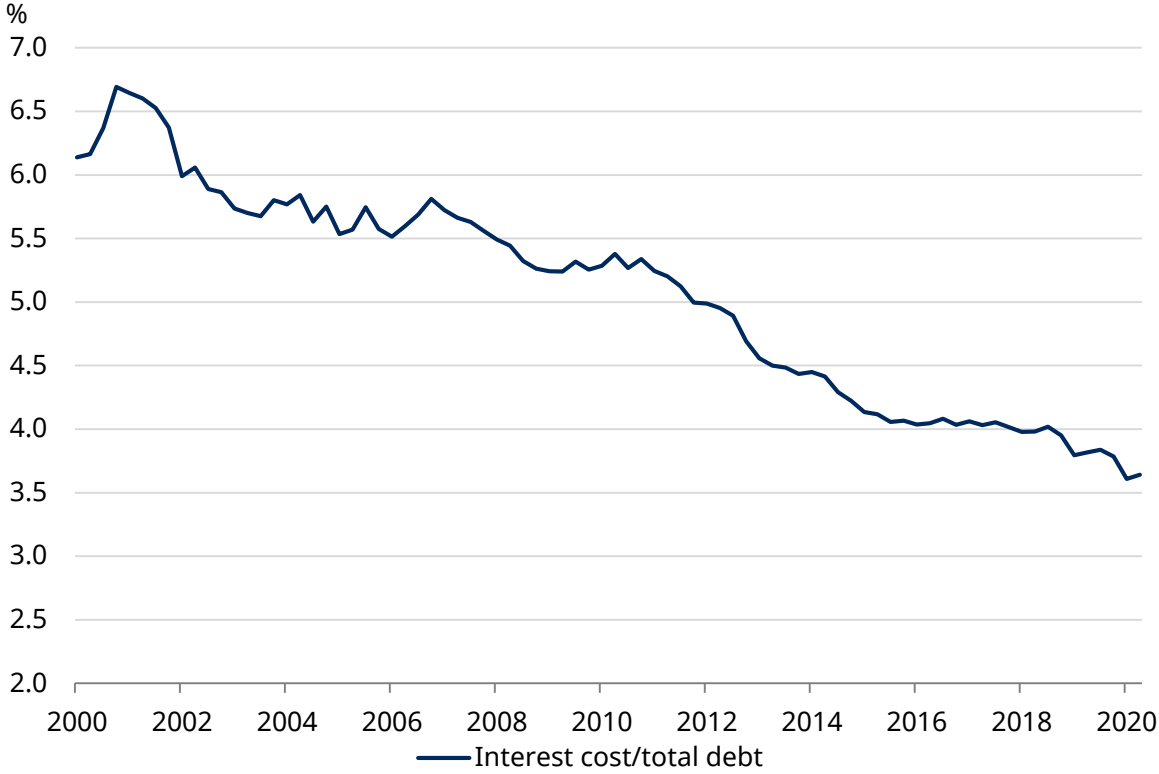
Interest coverage the lowest in nine years

US IG interest coverage ratio¹

Last twelve month EBTIDA to interest expense



US IG cost of debt



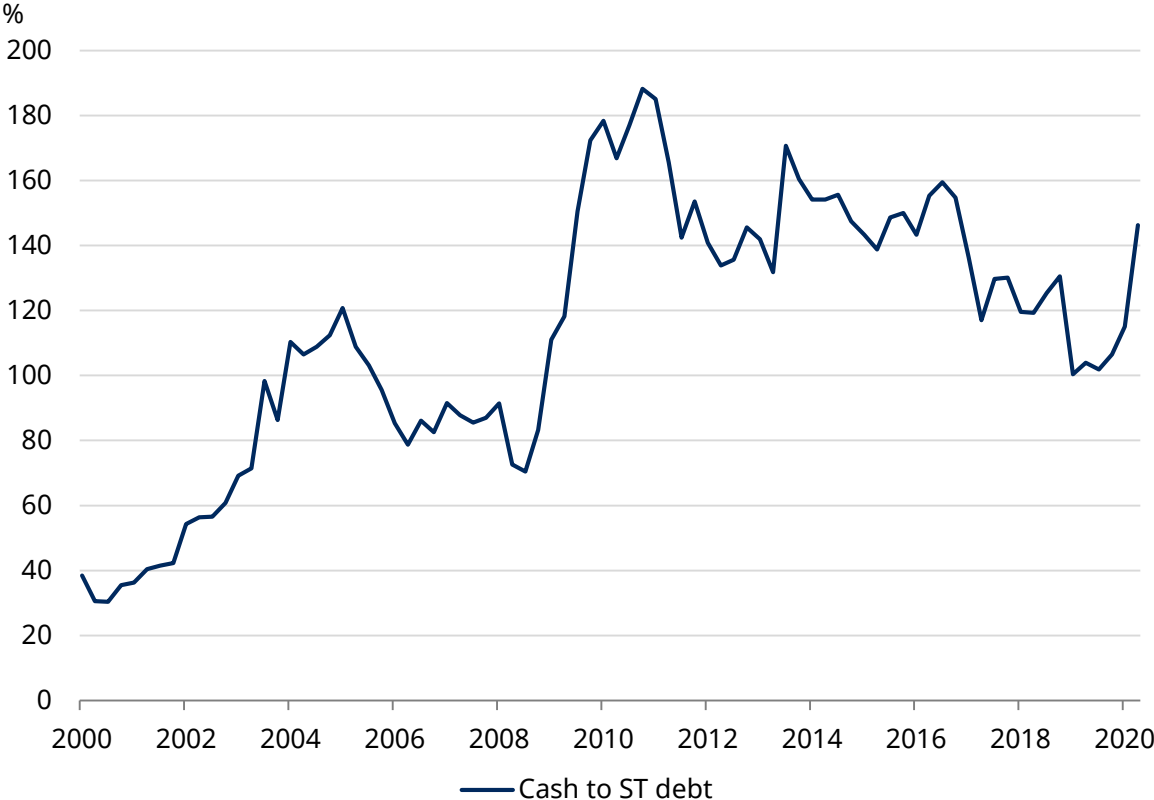
Despite the recent drop interest coverage is higher than in 2002 and 2009 because of much lower cost of debt

Source: Schrodgers, Bloomberg, J.P. Morgan. Median issuer ex-Financials. Data as at Q2 2020. ¹Calculated as last twelve month EBTIDA divided by interest expense on the income statement

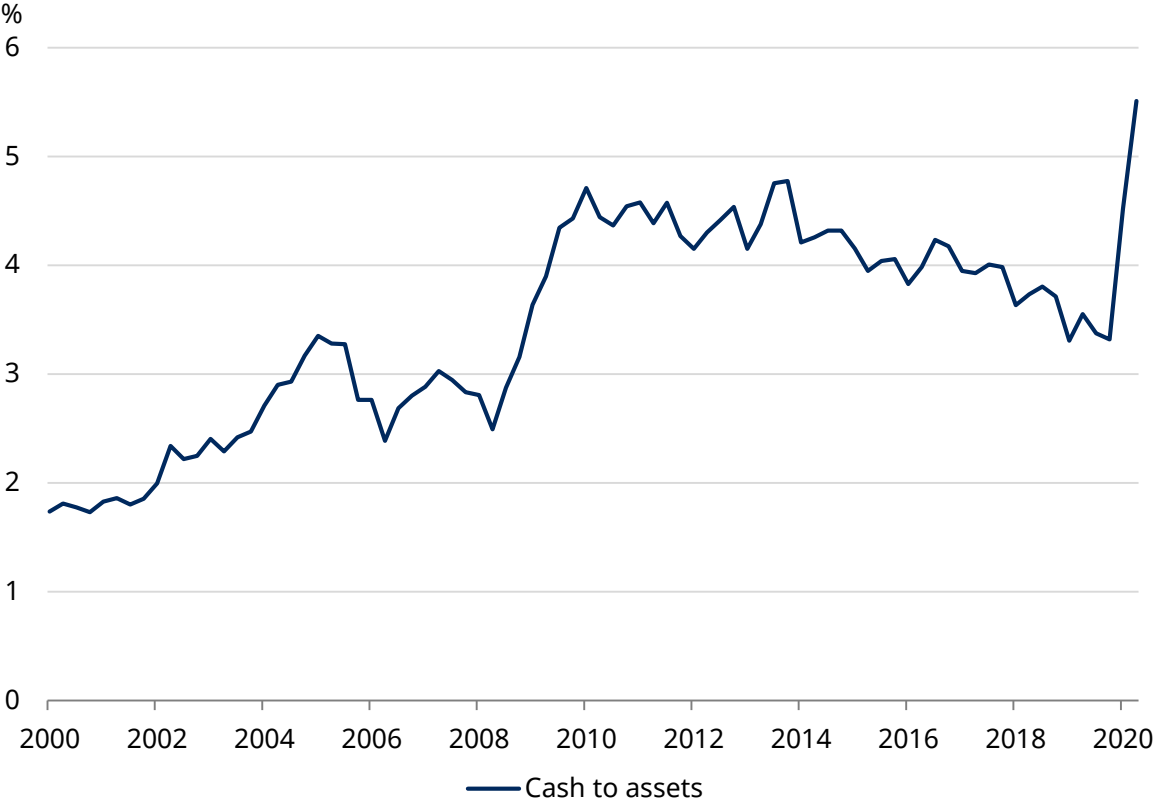
Cash on balance sheets increased further in Q2

Cash to assets at a record level

US IG cash to short term debt



US IG cash to assets



Cash has increased faster than short-term debt, meaning that liquidity position has improved

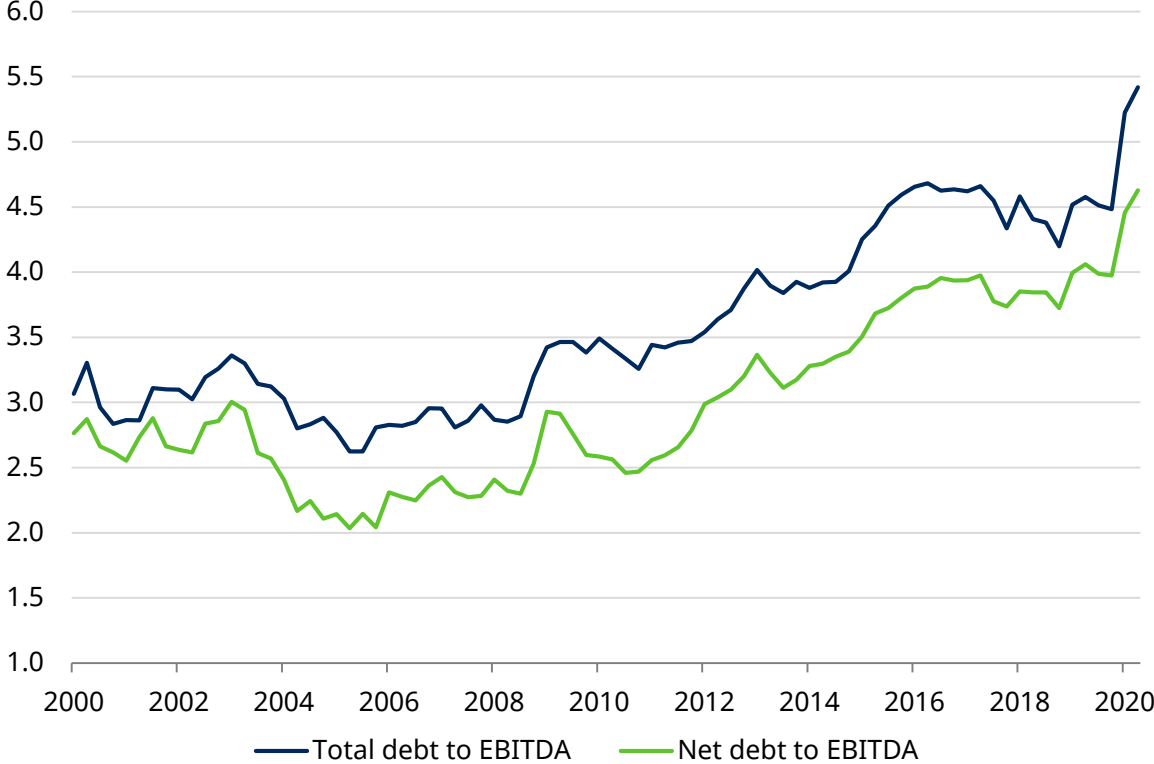
Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q2 2020.

US HY leverage

At the record levels after increasing sharply in 2020

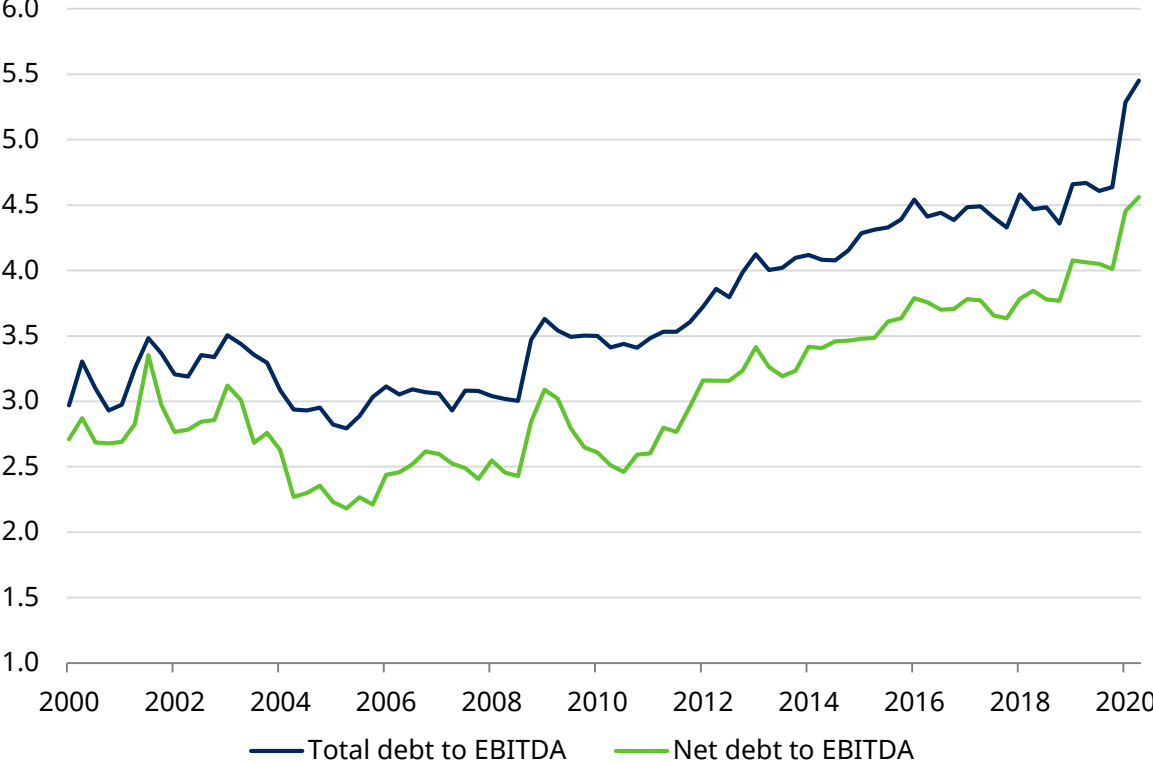
US HY leverage

Debt to last twelve months EBITDA



US HY ex-energy leverage

Debt to last twelve months EBITDA



Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q2 2020.

US HY interest coverage ratio has fallen to all-time low

Questioning the ability to carry high leverage

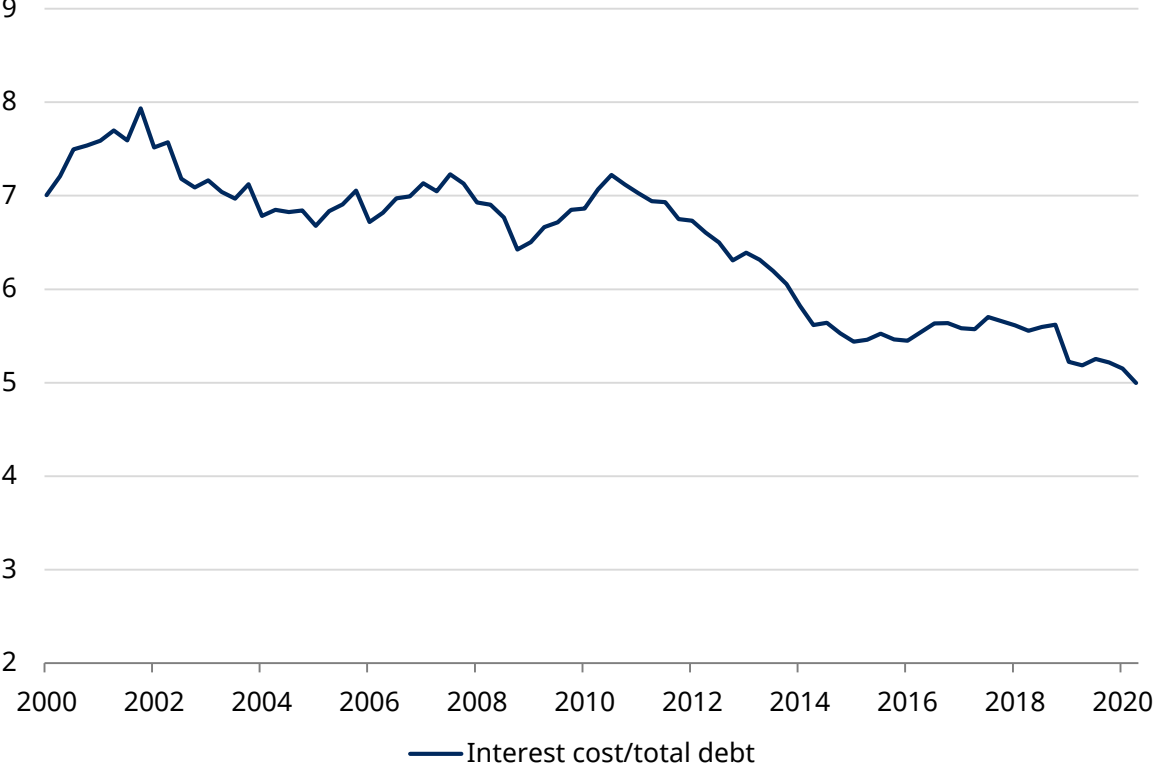
US HY interest coverage ratio

last twelve months EBTIDA to interest expense



US HY cost of debt

%

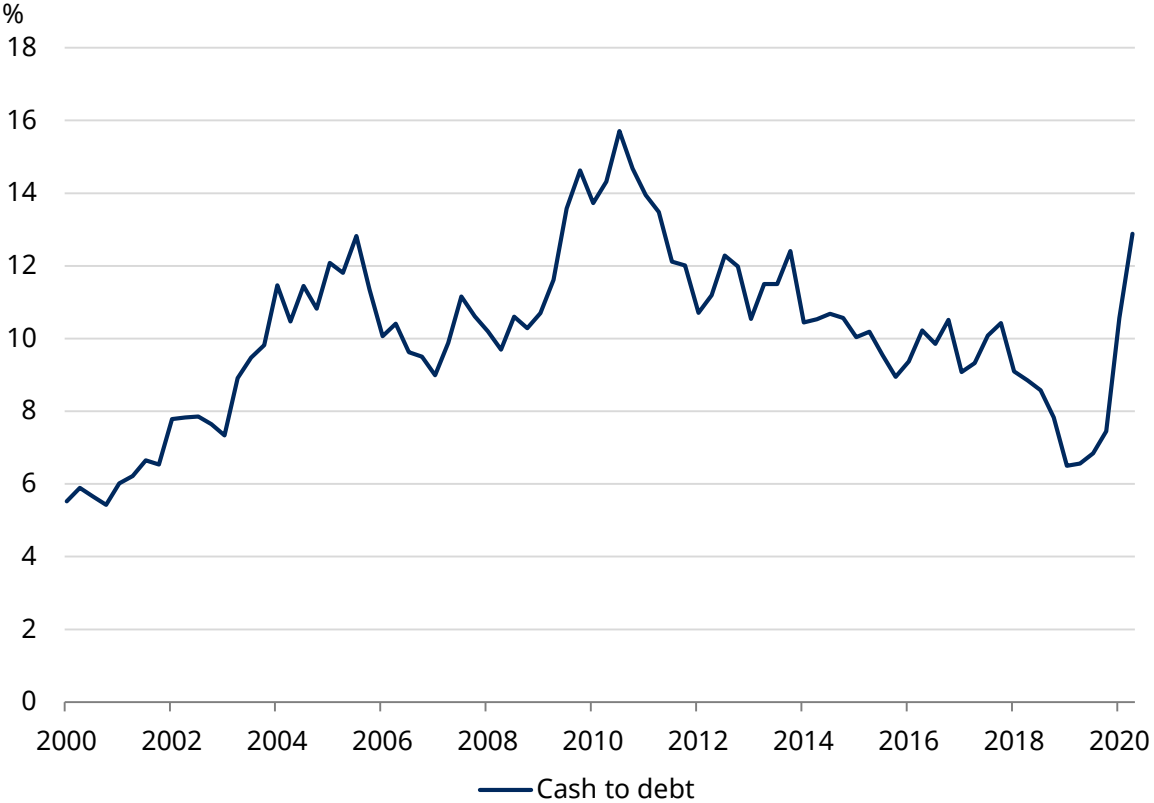


Smaller companies have not benefitted as much from lower interest rates as large ones

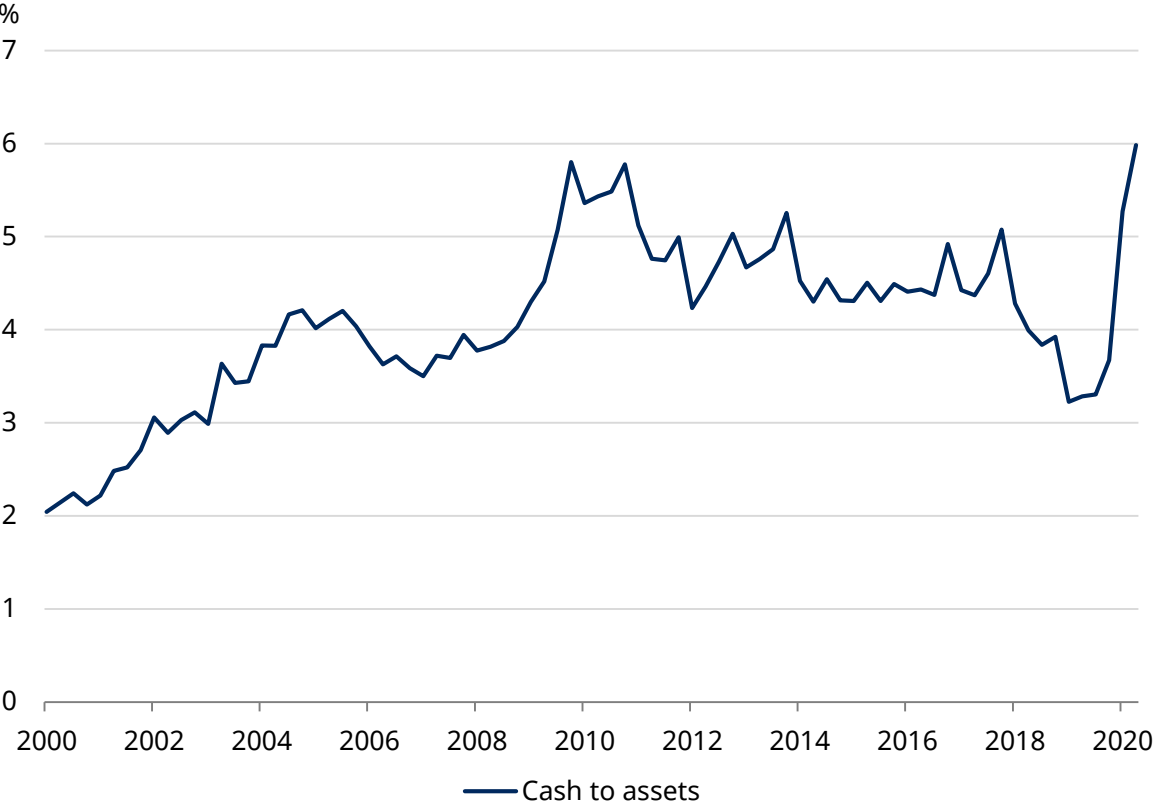
Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q2 2020.

US HY cash levels increased sharply in Q2

US HY cash to debt



US HY cash to assets



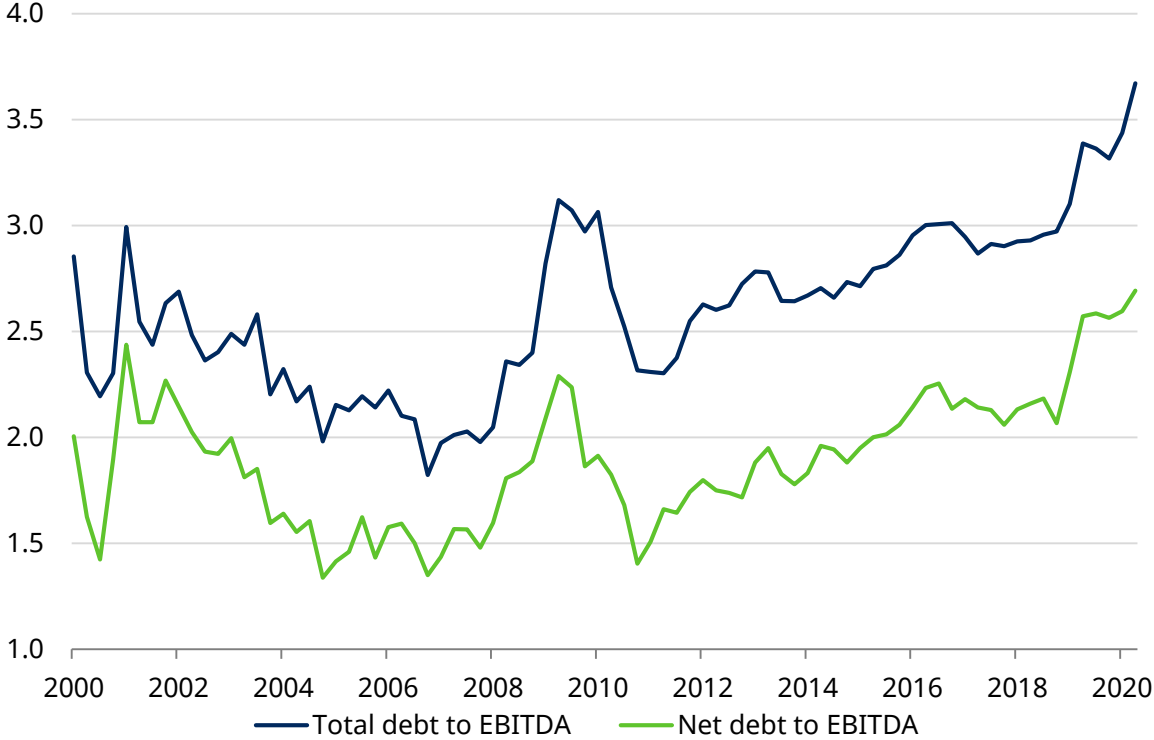
Comfortable cash position somewhat alleviates the worries on structurally weak US HY fundamentals

Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q2 2020.

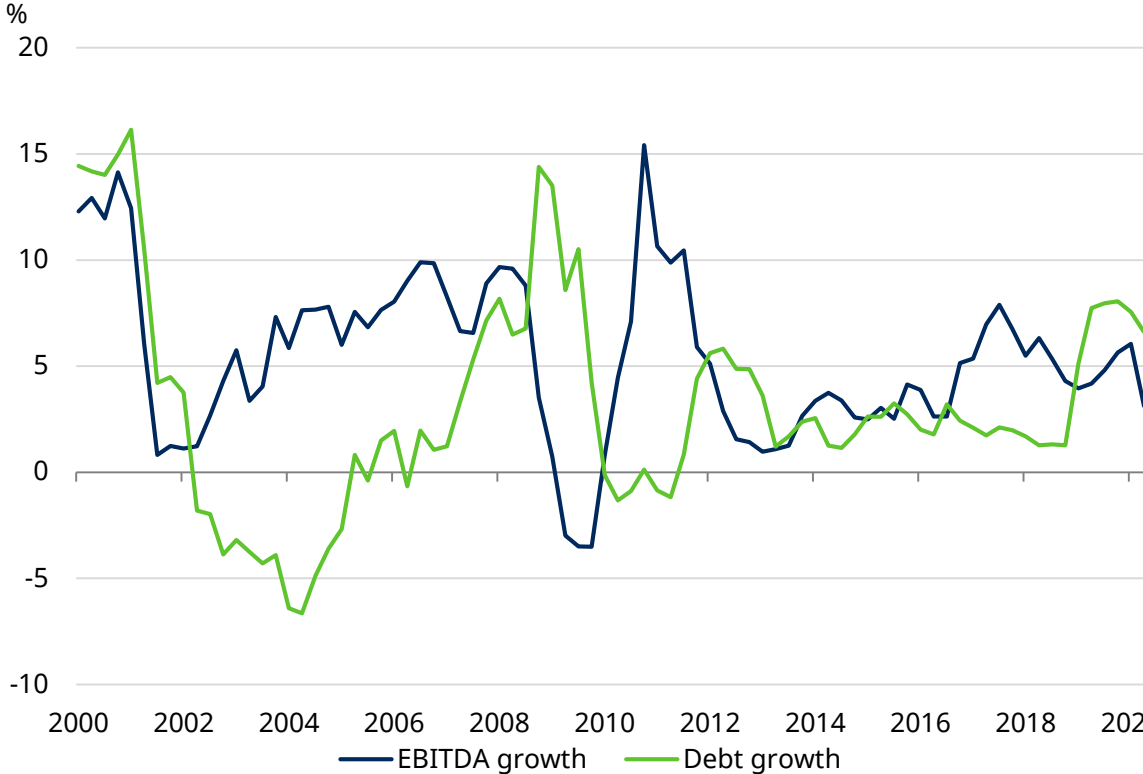
Euro IG leverage at record high because of Covid-19

Euro IG leverage

Debt to last twelve months EBITDA



Euro IG EBITDA and debt growth (last twelve months)



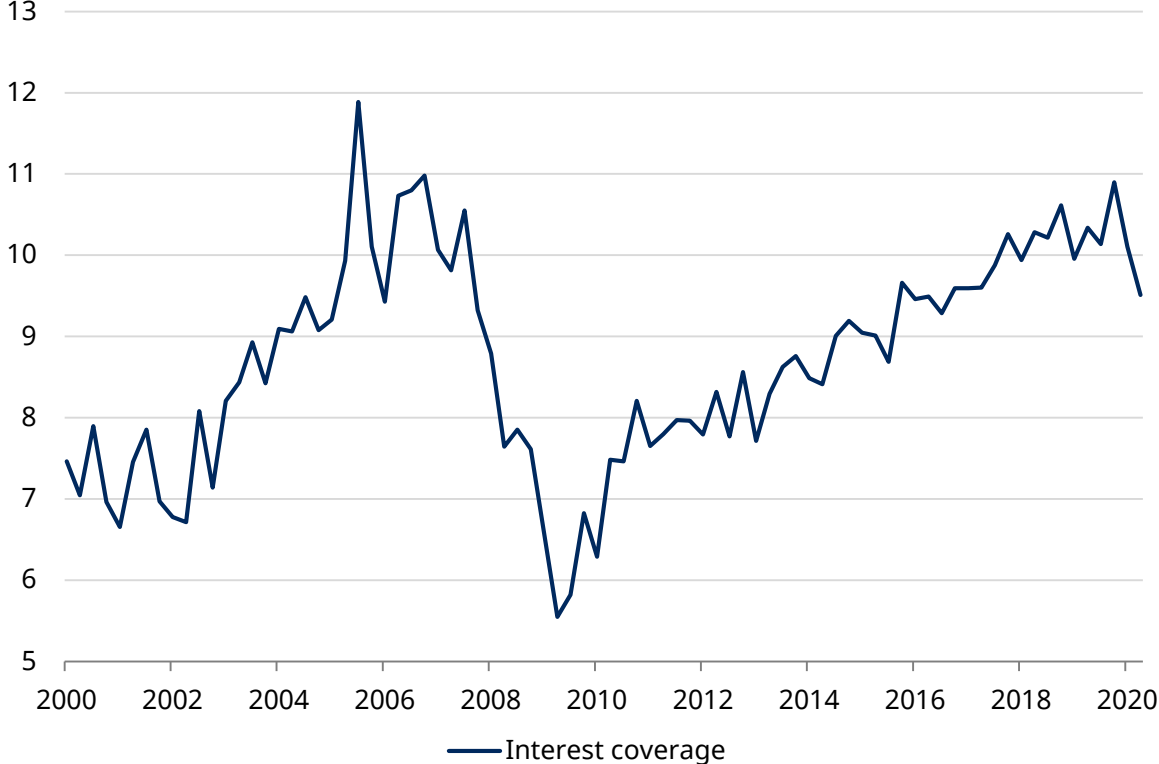
**Net leverage has increased much less,
implying that companies have not spent most of the emergency borrowing**

Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q2 2020.

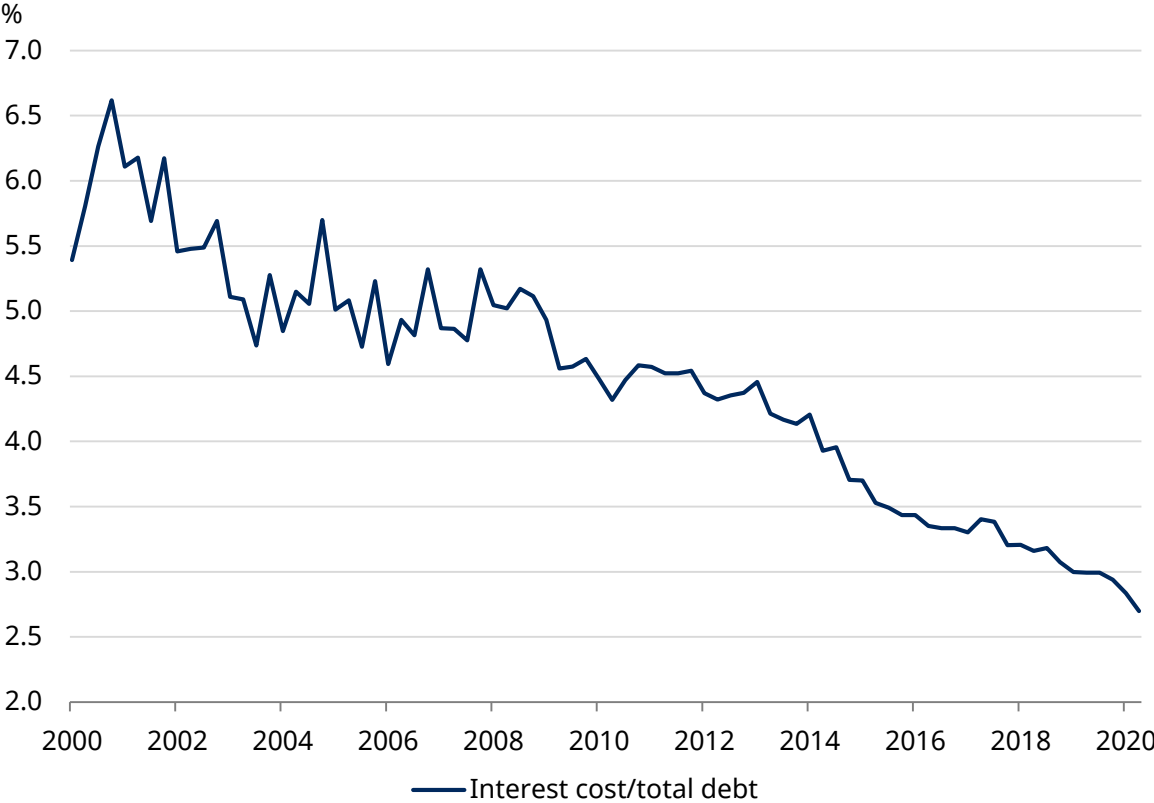
Euro IG interest coverage ratio has fallen only slightly

Euro IG interest coverage ratio¹

last twelve months EBTIDA to interest expense



Euro IG cost of debt

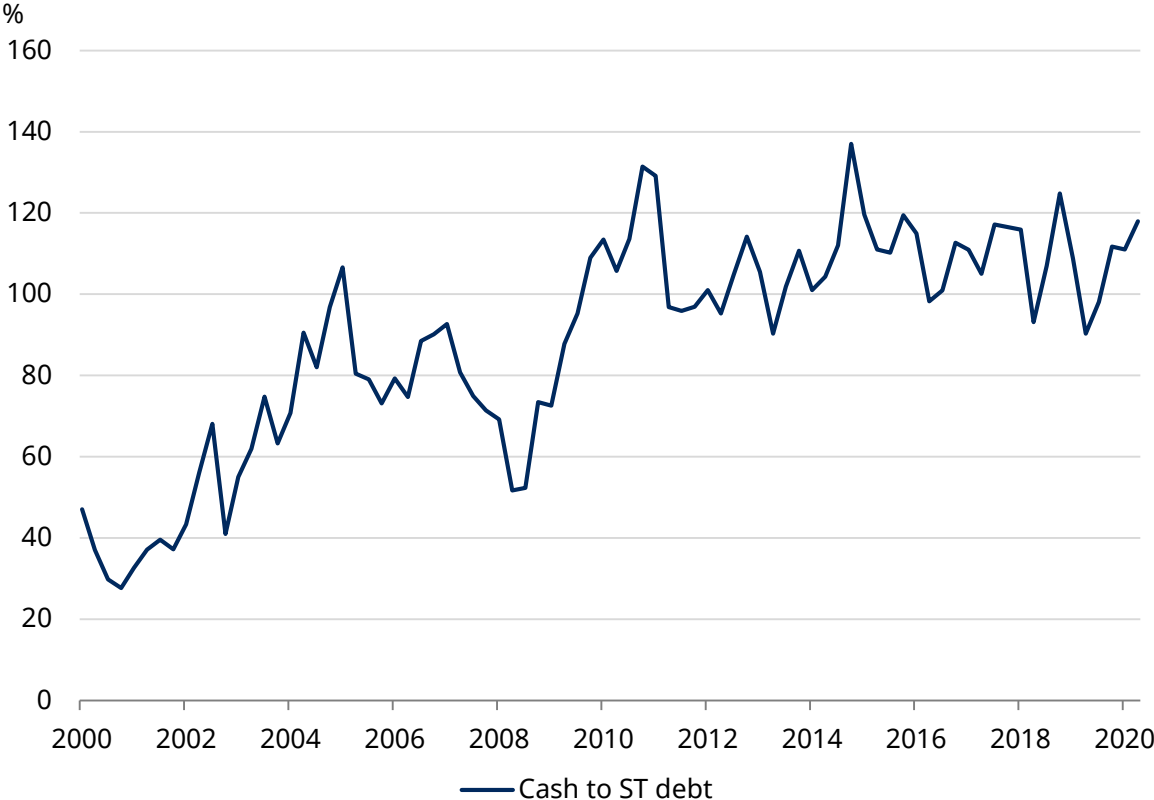


Interest coverage is significantly higher than in US, driven by lower cost of debt in the euro area

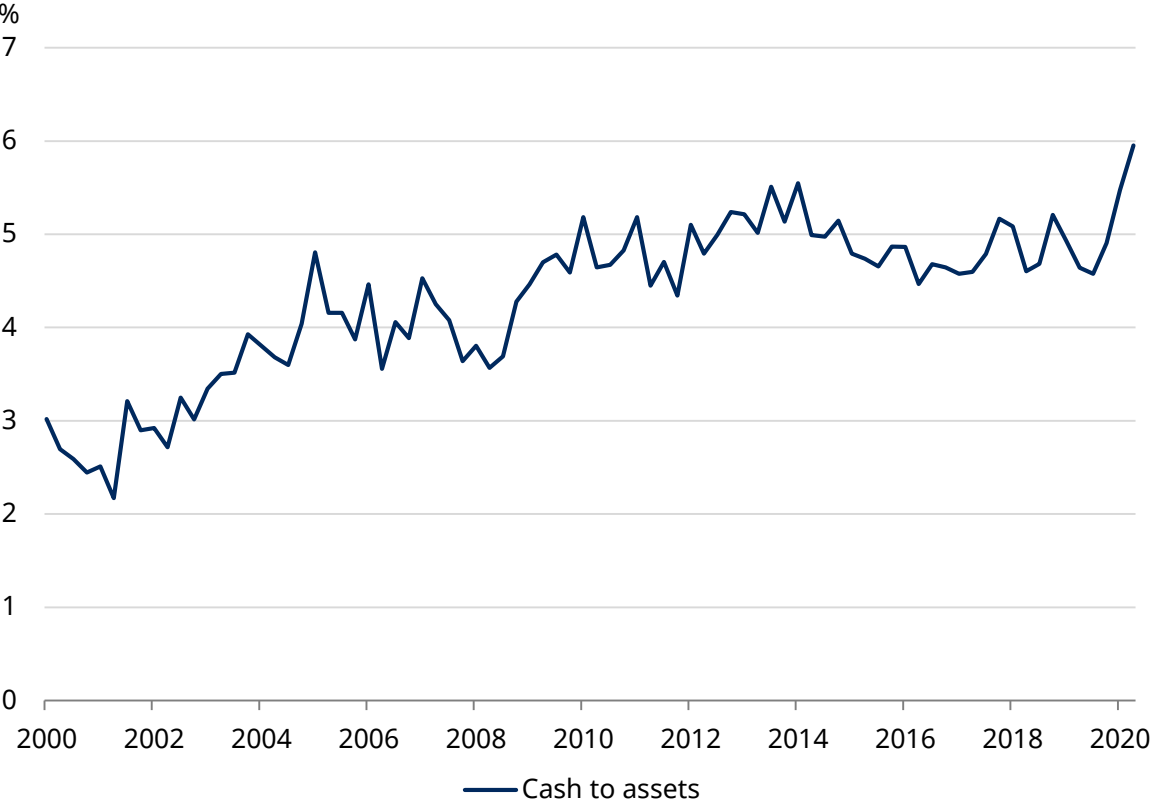
Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as at Q2 2020. ¹Calculated as last twelve month EBTIDA divided by interest expense on the income statement

Cash levels have increased but not as much as in US IG

Euro IG cash to short term debt



Euro IG cash to assets



Liquidity position has improved in the last two quarters because of emergency borrowing of companies

Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as at Q2 2020.

Schroders

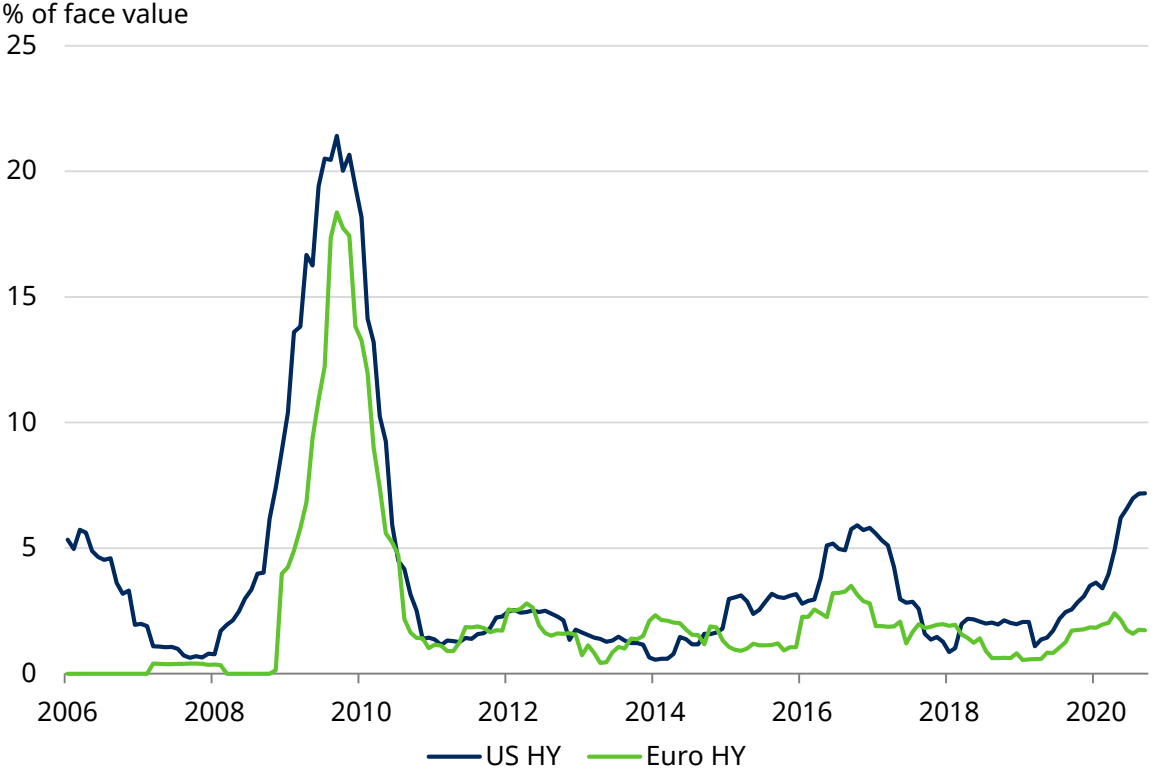


Corporate credit

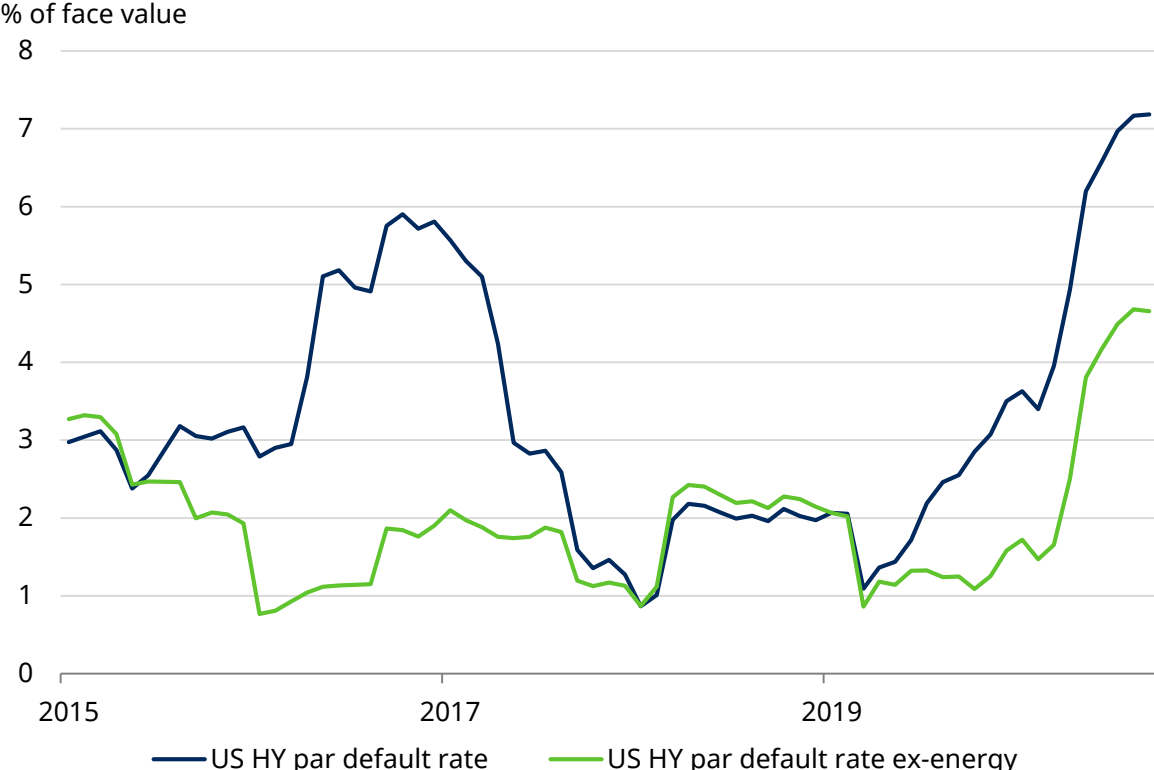
Technicals

HY default rates

HY par default rate (last twelve months)



US HY par default rate (last twelve months)



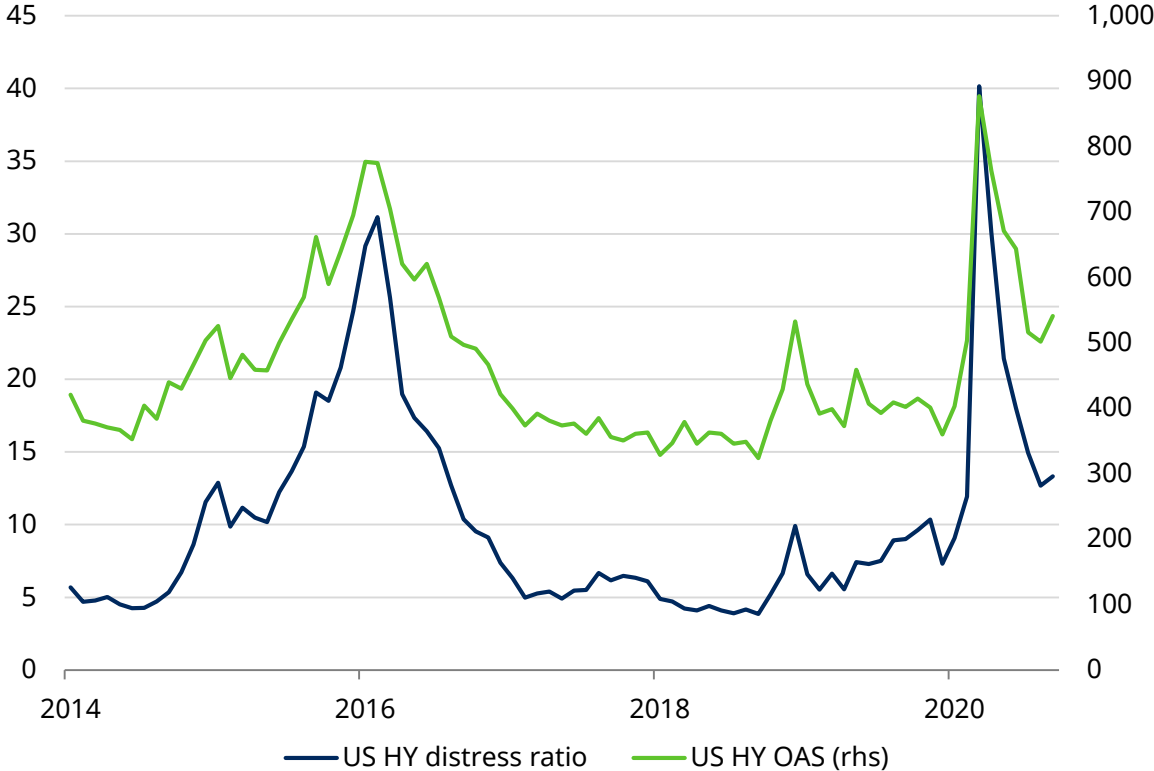
US HY defaults continue to be concentrated in energy and retail; Euro HY default rate remains surprisingly low

Source: Schroders, BofA Merrill Lynch, Moody's. Data as at 30 September 2020.

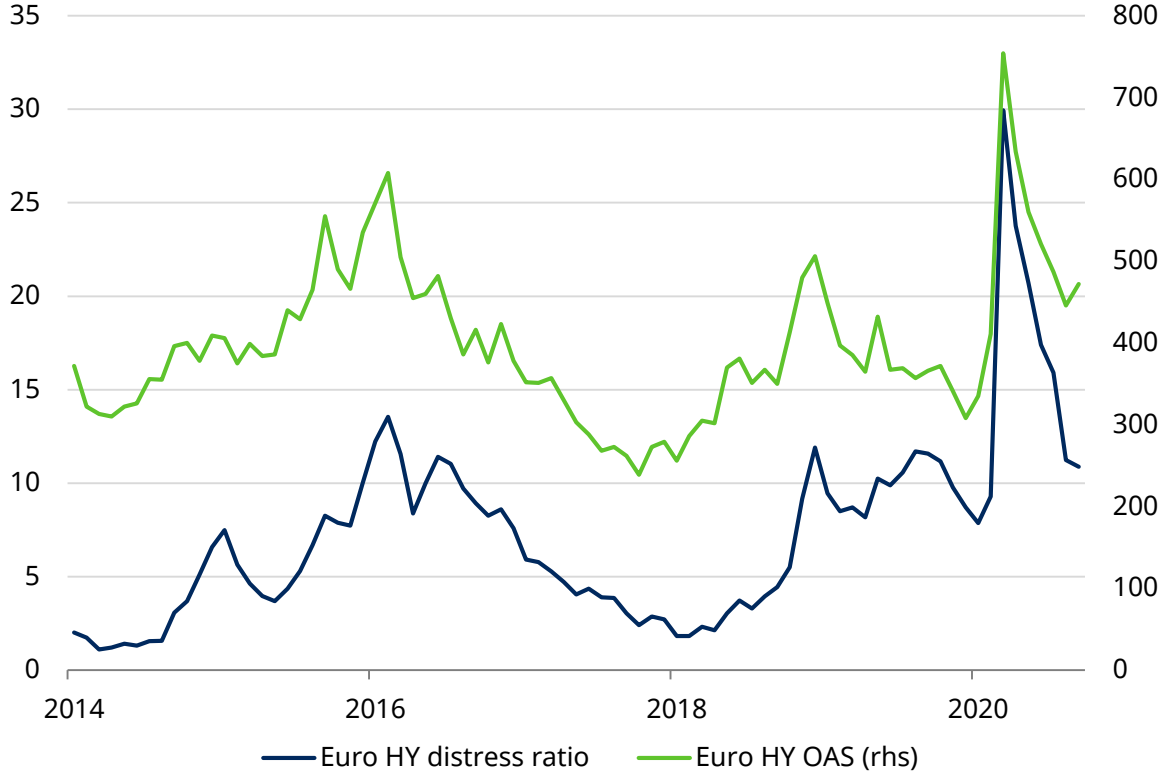
HY distress ratios

Harbinger of defaults

US HY distress ratio¹



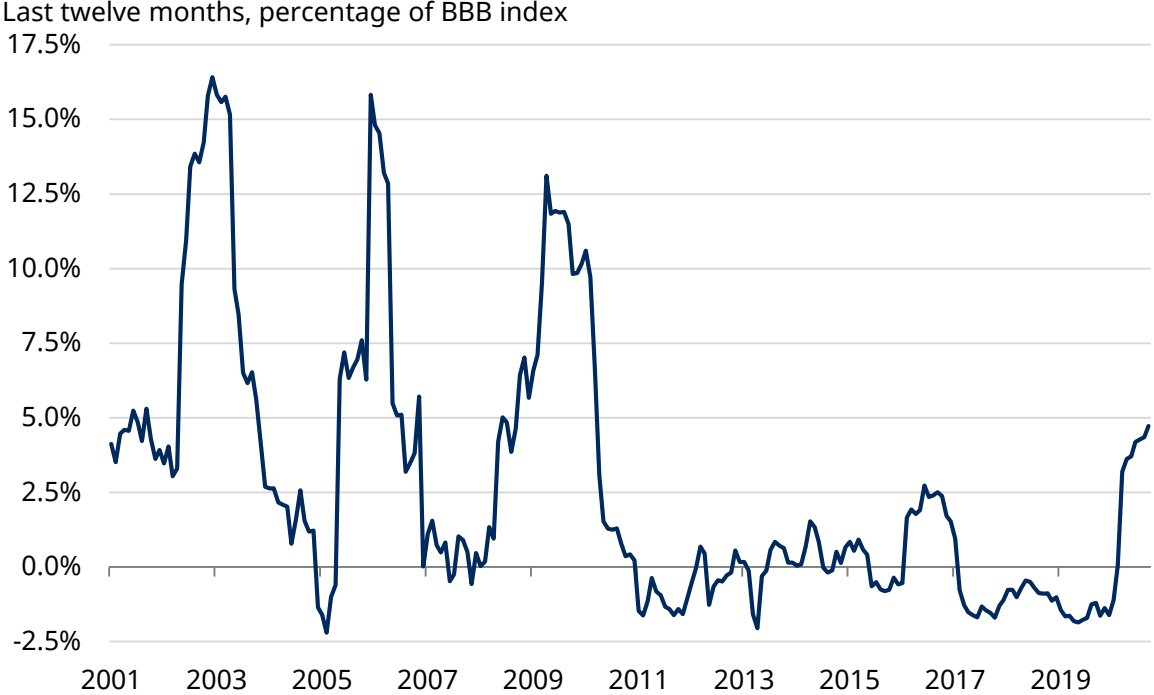
Euro HY distress ratio¹



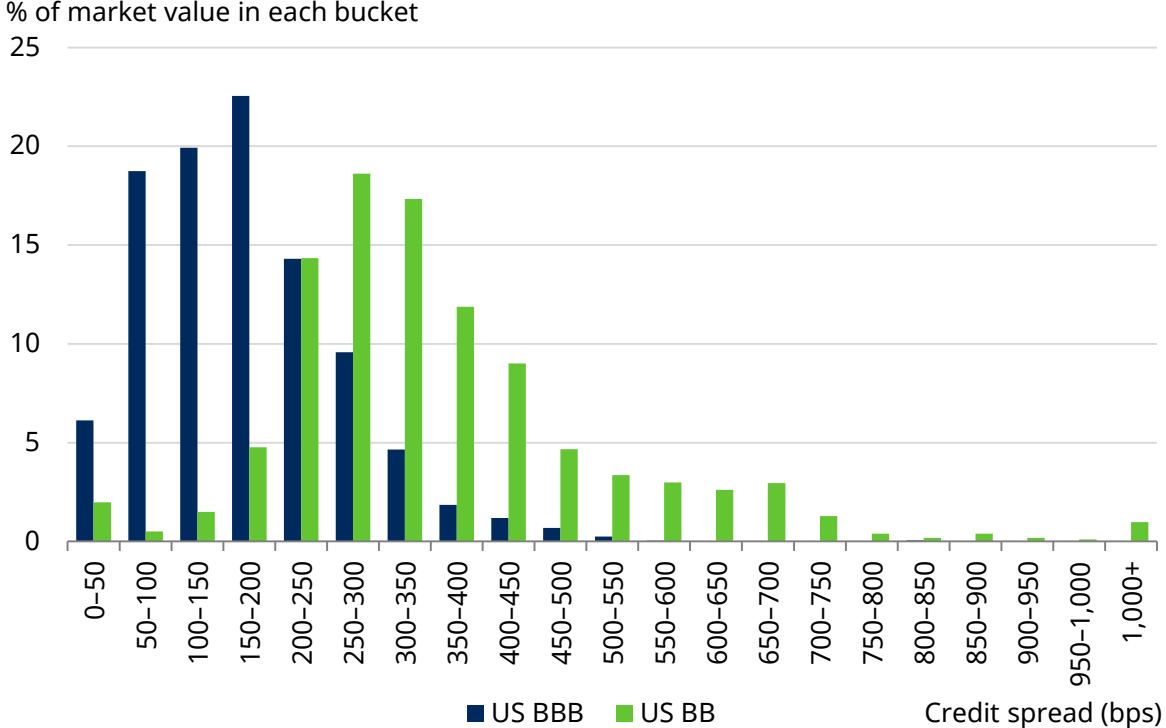
Source: Schroders, BofA Merrill Lynch, Moody's. Data to 30 September 2020.
¹HY distress is defined as percentage of issues in the index trading with spreads > 1,000bp.

US IG fallen angels

US IG net fallen angels



\$79 billion of US BBB bonds in danger of becoming fallen angels¹

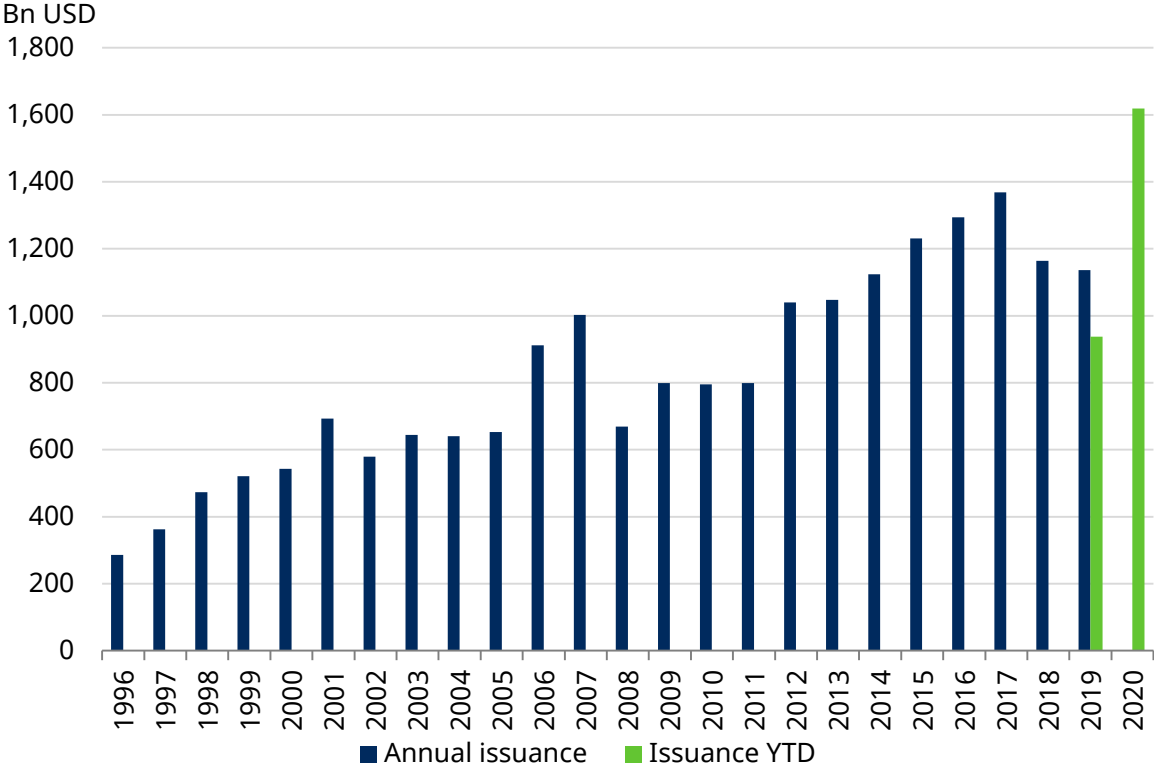


**US IG fallen angel volume remains muted;
better than expected earnings could lead to upgrades in the coming months**

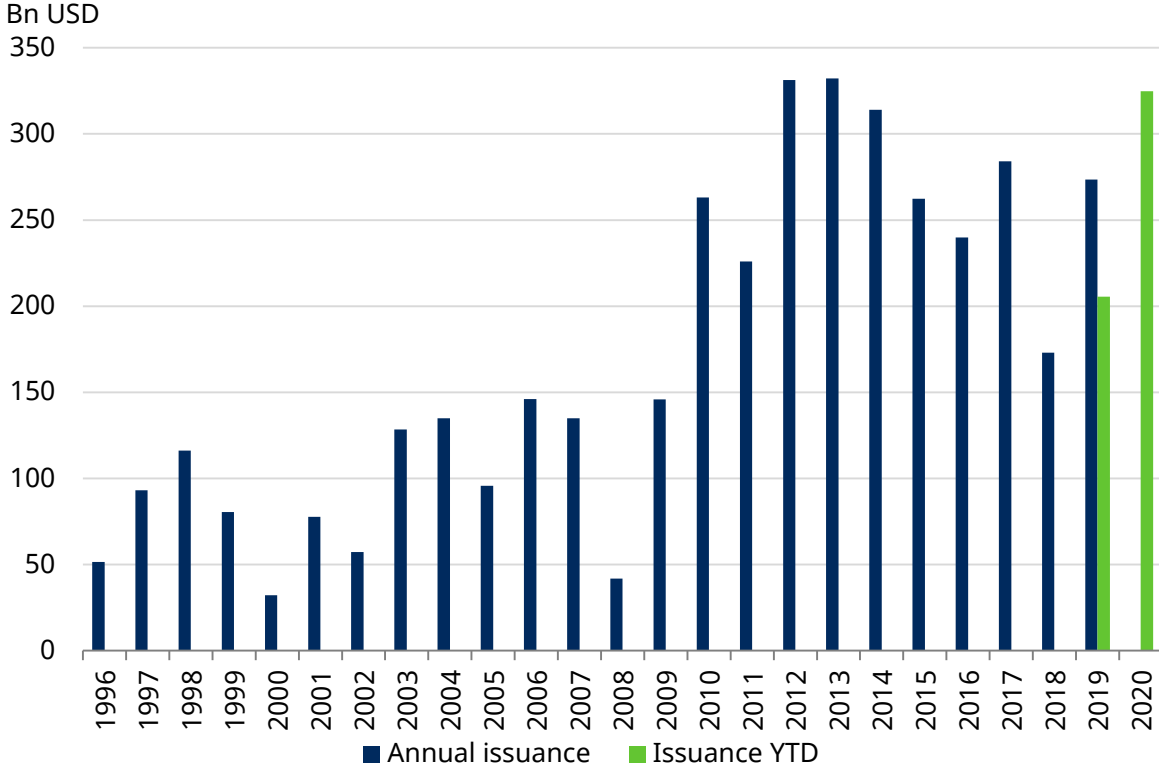
Source: Schroders, ICE Data Indices, Moody's, BofA Merrill Lynch. Data as at 30 September 2020
¹Calculated as the market value of BBB bonds with spreads above the BB spread.

US IG and HY gross issuance

US IG issuance



US HY issuance

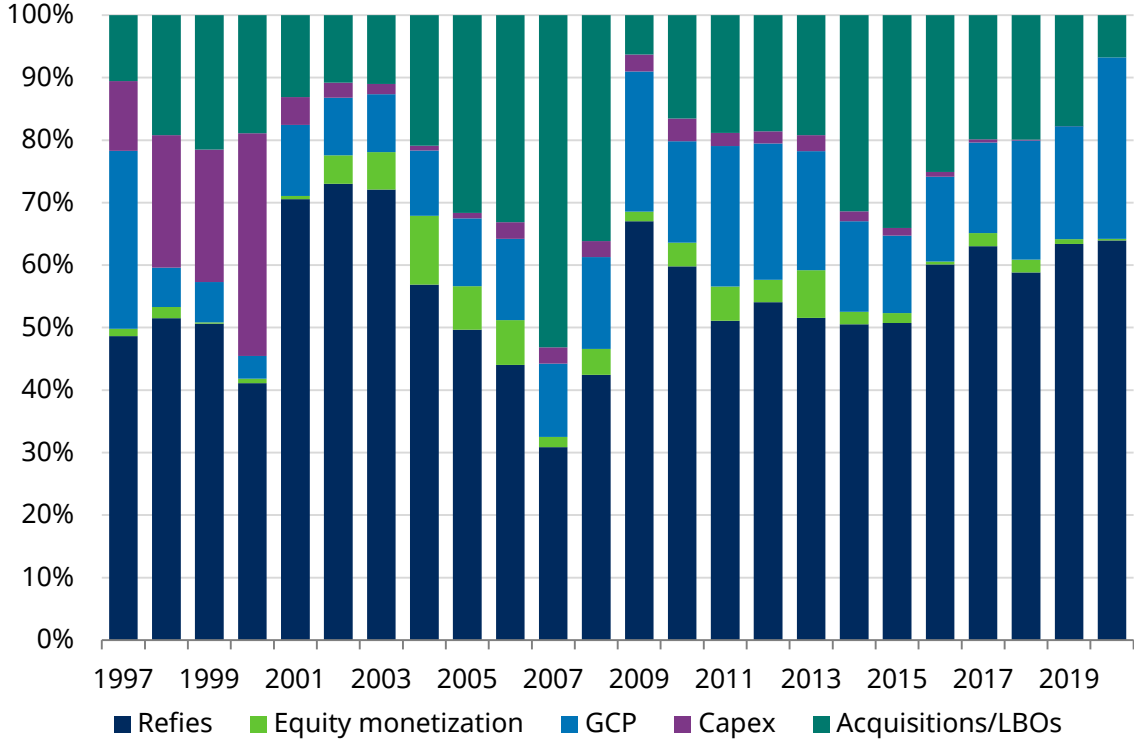


2020 US IG issuance is now more than \$1.6 trillion; HY issuance has been running at a record pace in recent months

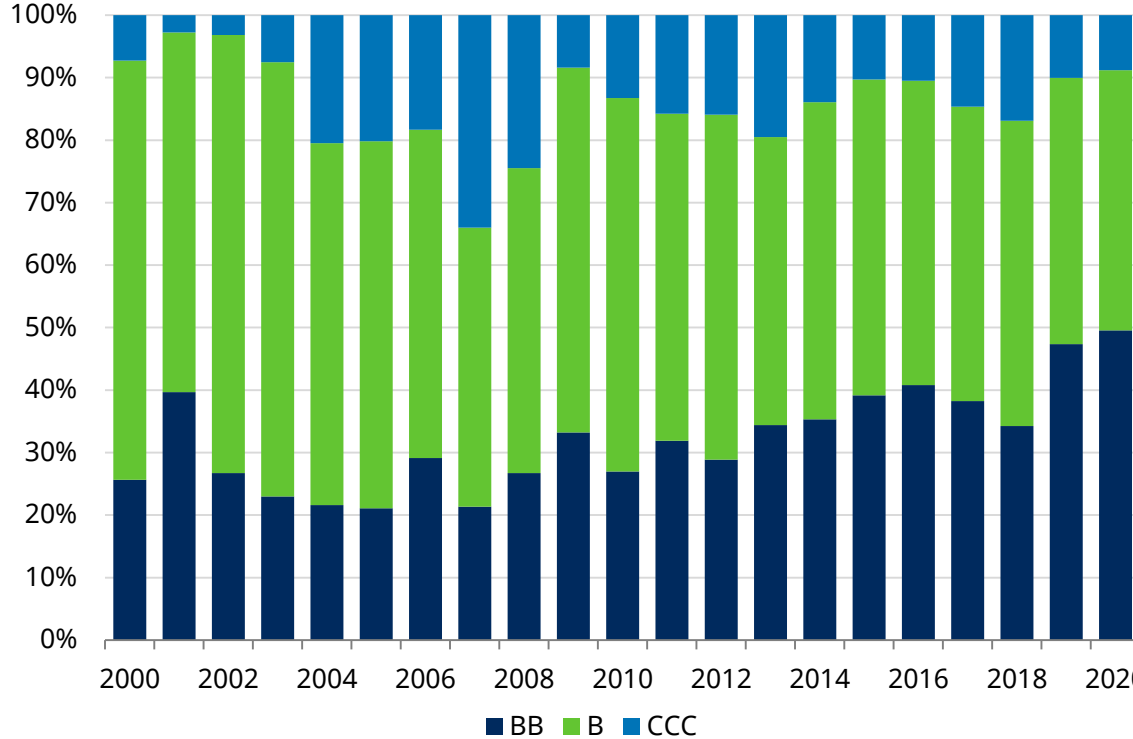
Source: Sifma. Data as at 30 September 2020.

US HY issuance details

Use of proceeds (percentage of issuance)



Issuance by rating



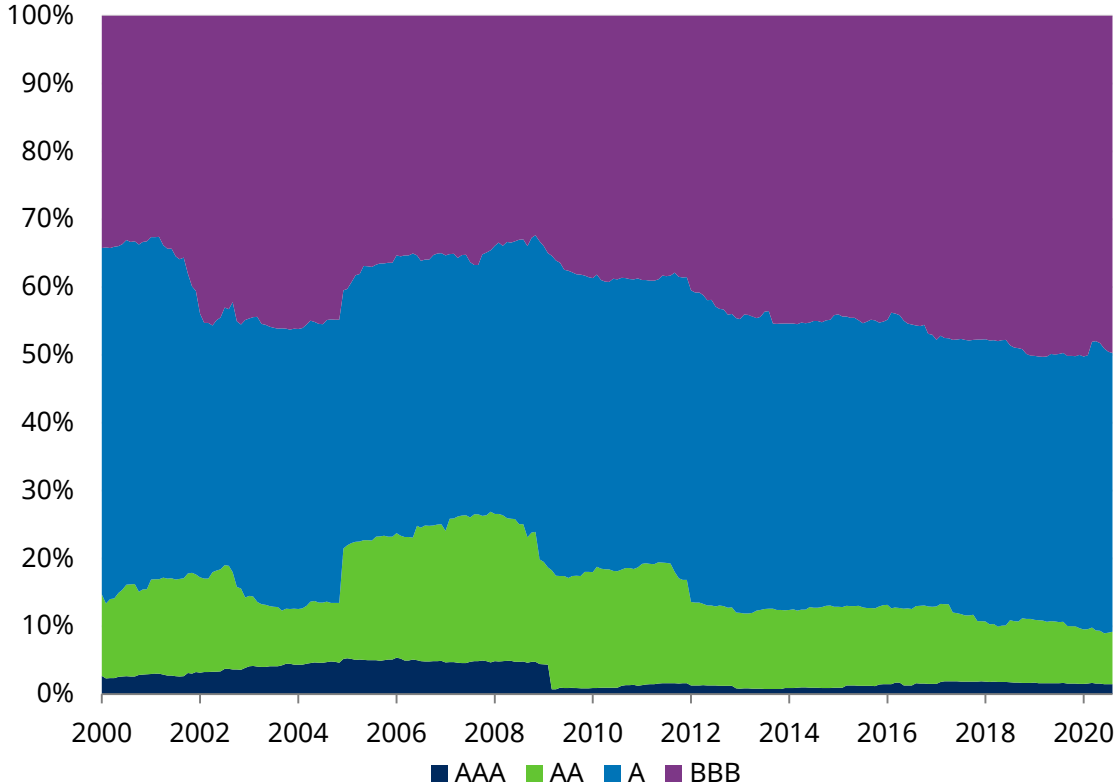
US HY issuance has been concentrated in higher rated HY companies and very little of the issuance has been used for acquisitions and buyouts

Source: Schrodgers, BofA Merrill Lynch, Moody's. Data as at September 30 2020. GCP is general corporate purposes

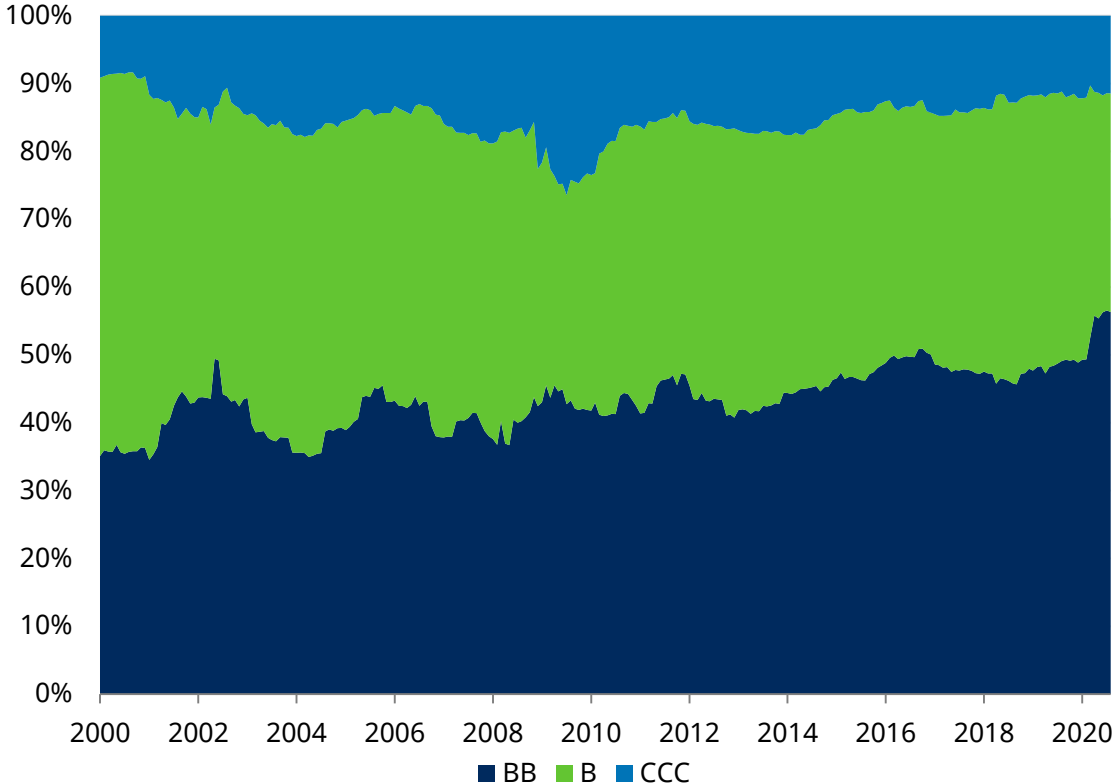
USD credit historical ratings split

IG has been deteriorating in quality but HY improving

US IG ratings split



US HY ratings split



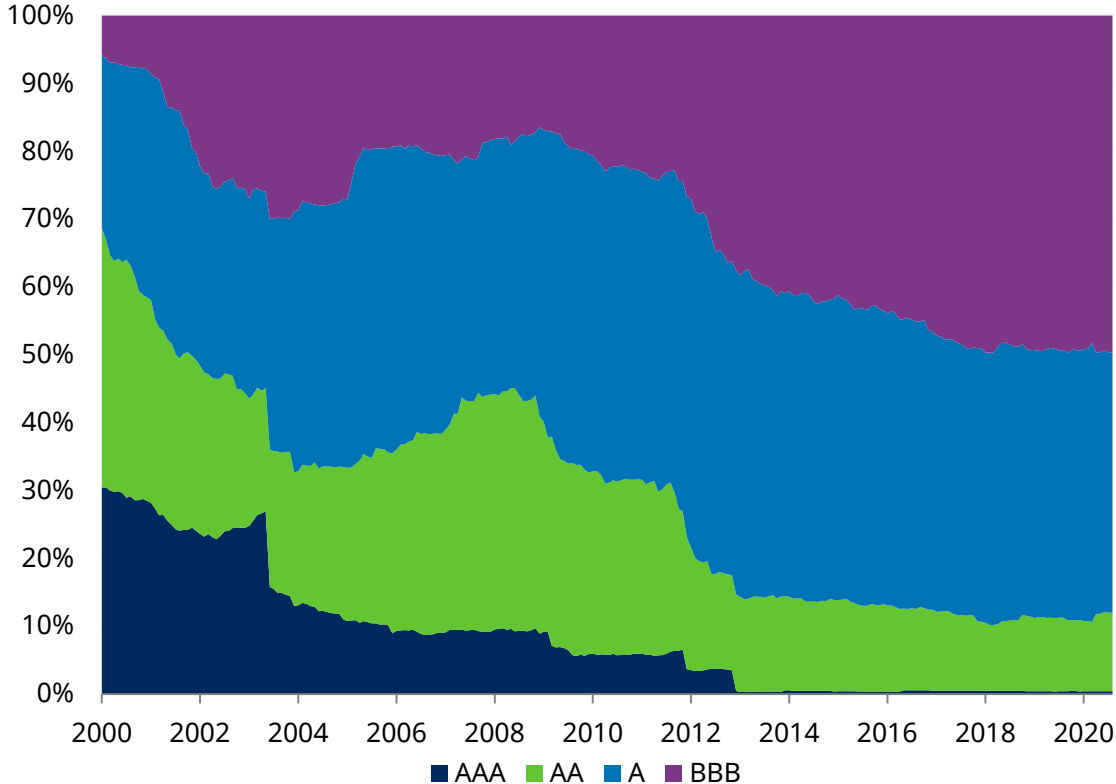
Credit quality has improved in HY in 2020 because of the inclusion of downgraded IG bonds

Source: Schroders, ICE Data Indices. Data as at 30 September 2020.

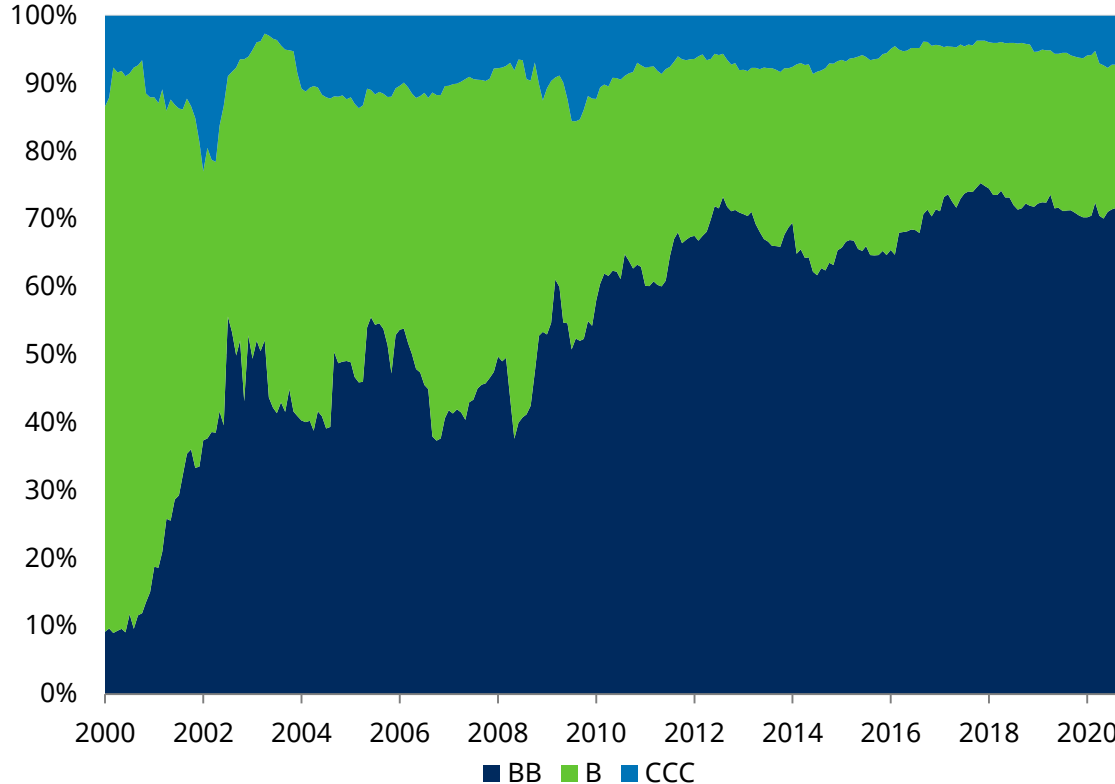
Euro credit historical ratings split

IG has been deteriorating in quality but HY improving

Euro IG ratings split



Euro HY ratings split



Credit quality has been stable in 2020

Source: Schroders, ICE Data Indices. Data as at 30 September 2020.

Schroders



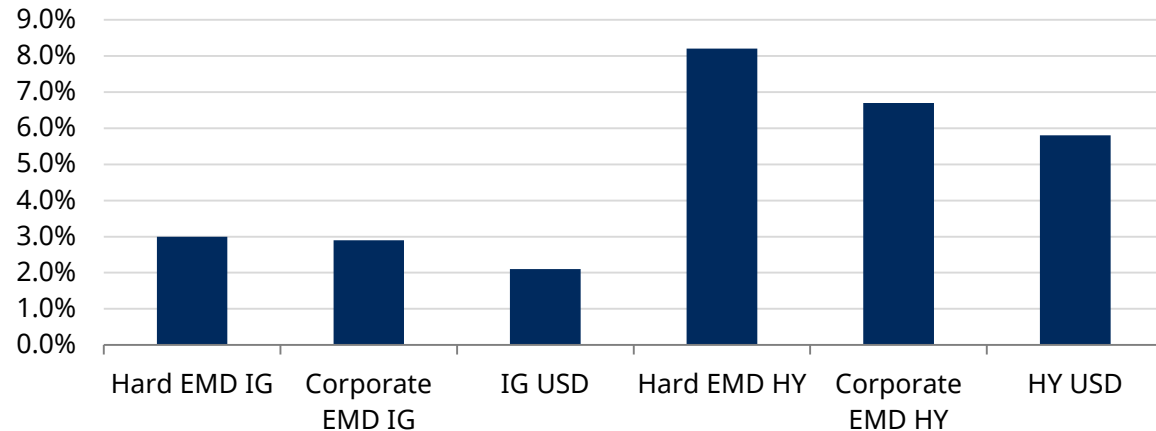
Emerging Market Debt

Dollar debt: EMD \$ vs. US Corporates

Combination of IG and HY

	Hard EMD IG	Corporate EMD IG	IG USD	Hard EMD HY	Corporate EMD HY	HY USD
Yield	3.0%	2.9%	2.1%	8.2%	6.7%	5.8%
Spread (bps)	196	221	144	753	632	541
Duration	9.4	5.5	8.4	6.4	3.5	5.0
Rating	A3	BBB1	A3	B1	B1	B1
Percentage of EMD index	56%	58%	-	44%	42%	-

Yield



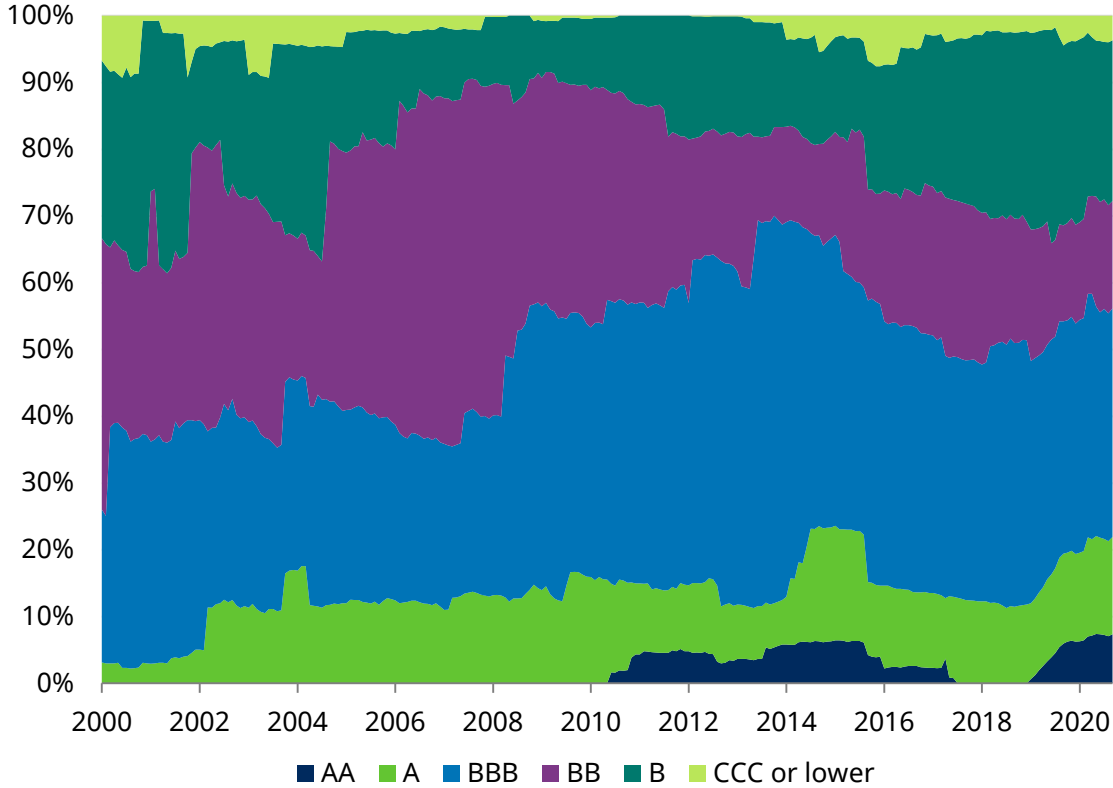
- Allocation to hard-currency EMD is a combination of IG and HY allocations
- Corporate EMD IG rating is one notch below US IG, EMD Hard IG rating is on par with US IG
- Hard EMD HY and Corporate EMD HY ratings are on par with US HY
- **Besides valuations, the decision between EMD \$ and US corporates should take views on credit cycle, issuance and ratings migration**

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2020.

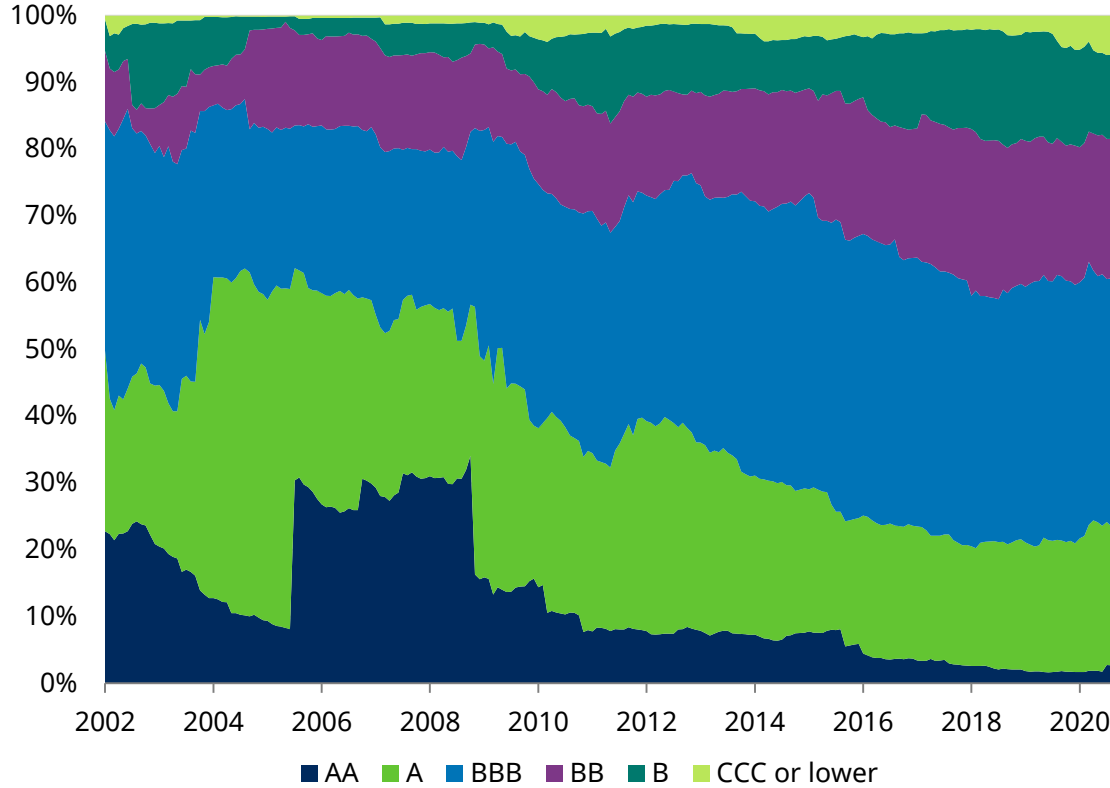
EMD historical ratings split

Credit quality has worsened since 2015

Hard EMD (JPM EMBI Global Diversified Index)



Corporate EMD (JPM CEMBI Broad Diversified Index)



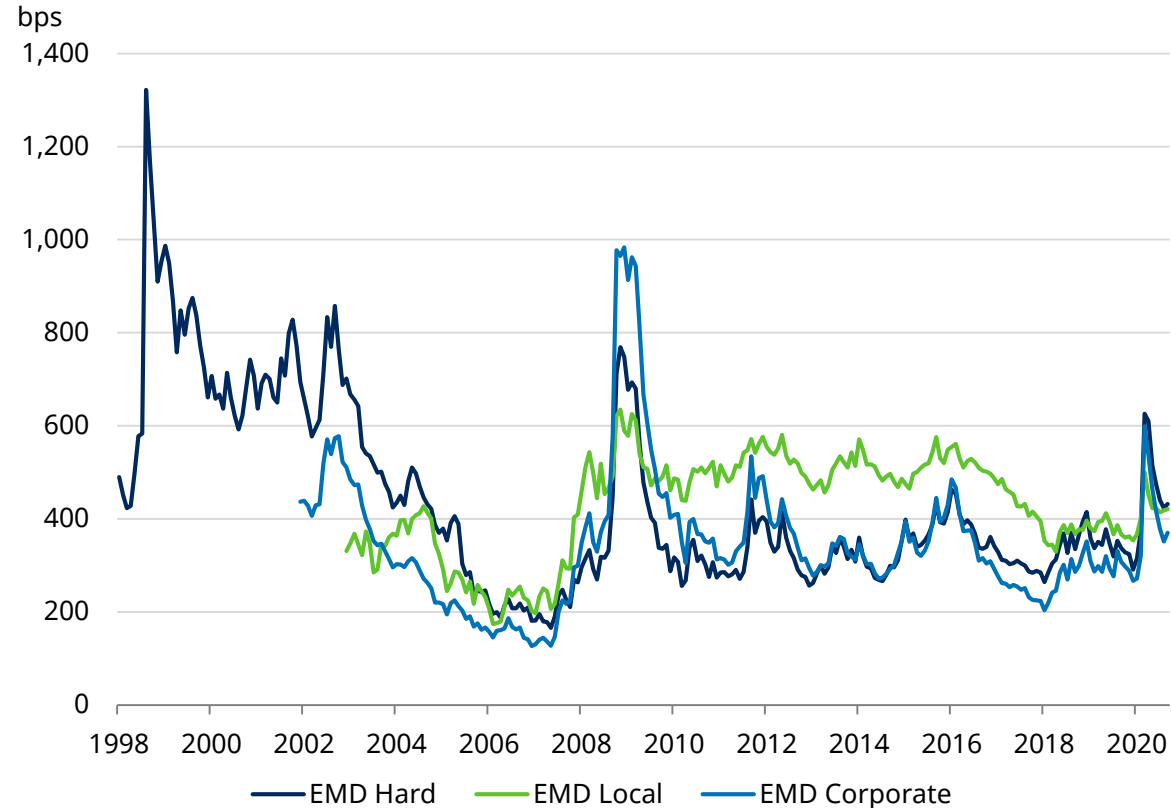
The share of AAs/As in Hard EMD increased in 2018 because of the inclusion of Saudi Arabia, Qatar, the United Arab Emirates, Bahrain and Kuwait in the index

Source: Schroders, J.P. Morgan. Data as at 30 September 2020.

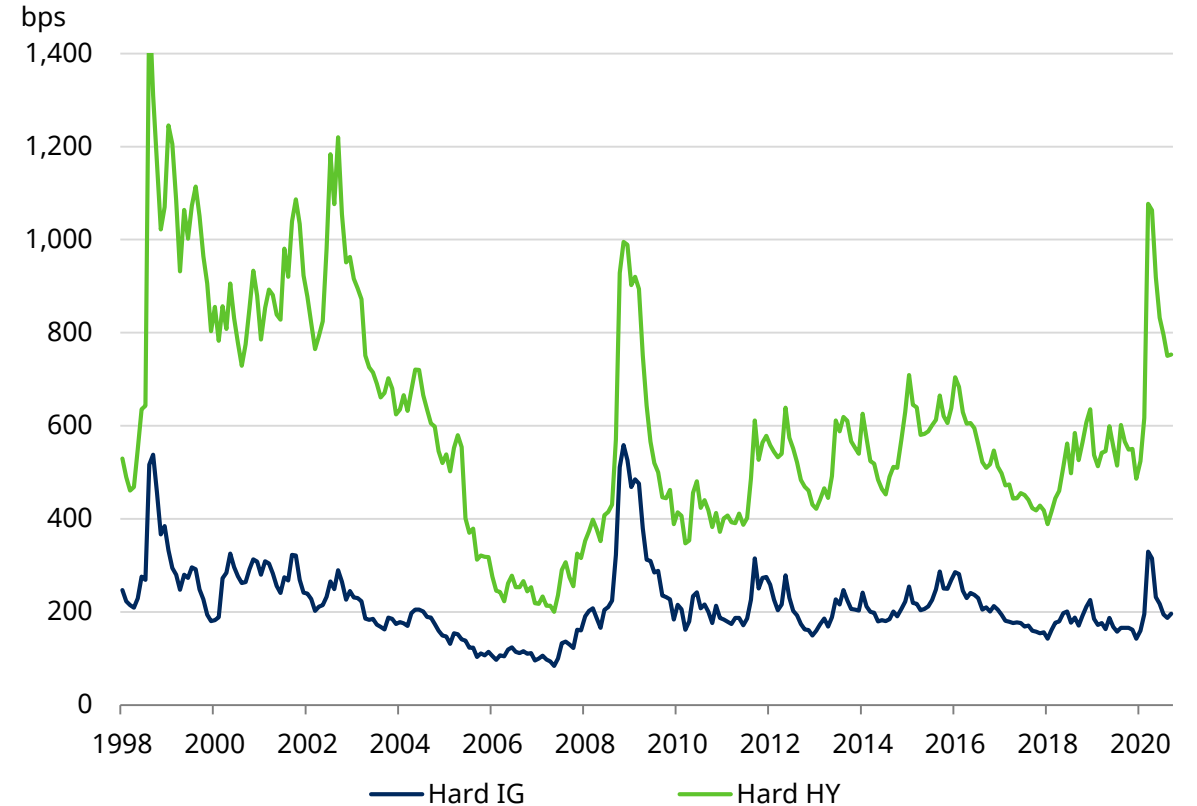
Valuation EMD

Historical spreads

EMD spreads



EMD Hard IG and HY spreads



The spread between IG and HY sovereign issuers remains wide

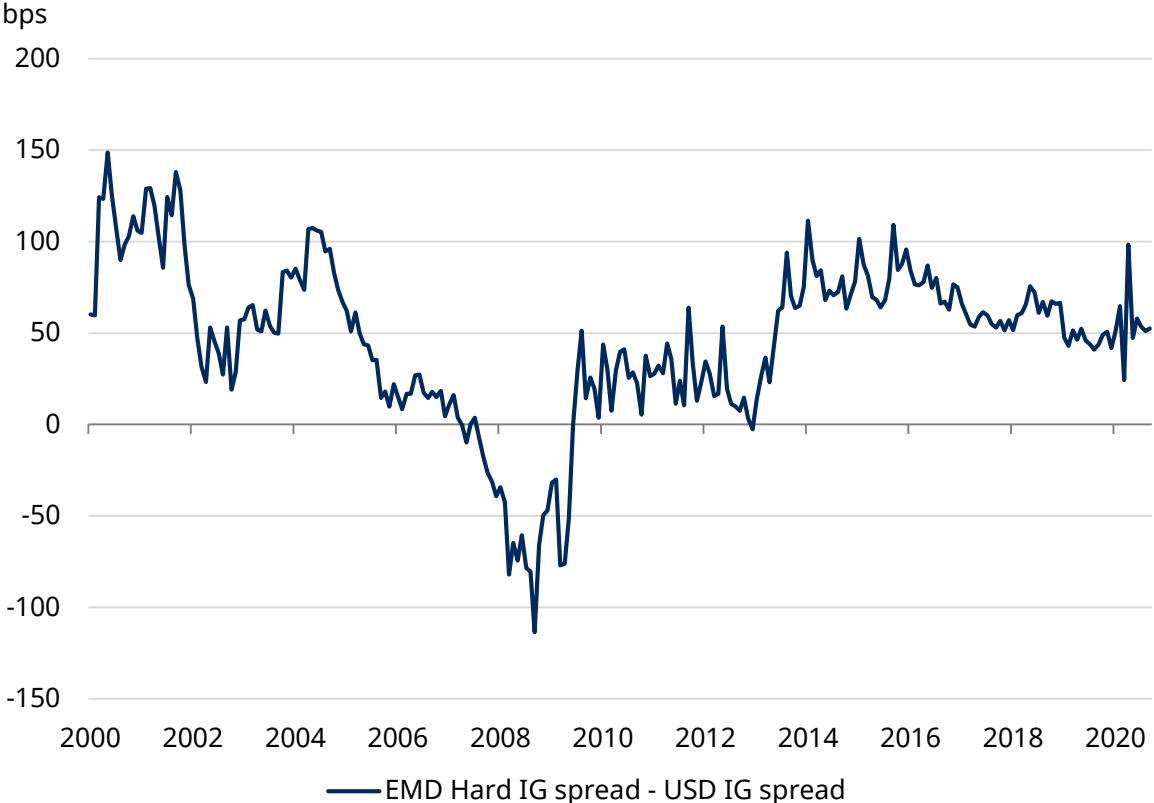
Source: Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2020.

EMD Local is not a spread product, the spread is manually calculated relative to treasuries of approximately equivalent duration.

Dollar debt: EMD Hard vs. US Corporates

EMD Hard HY spread over US HY remains elevated

EMD spreads



EMD Hard IG and HY spreads



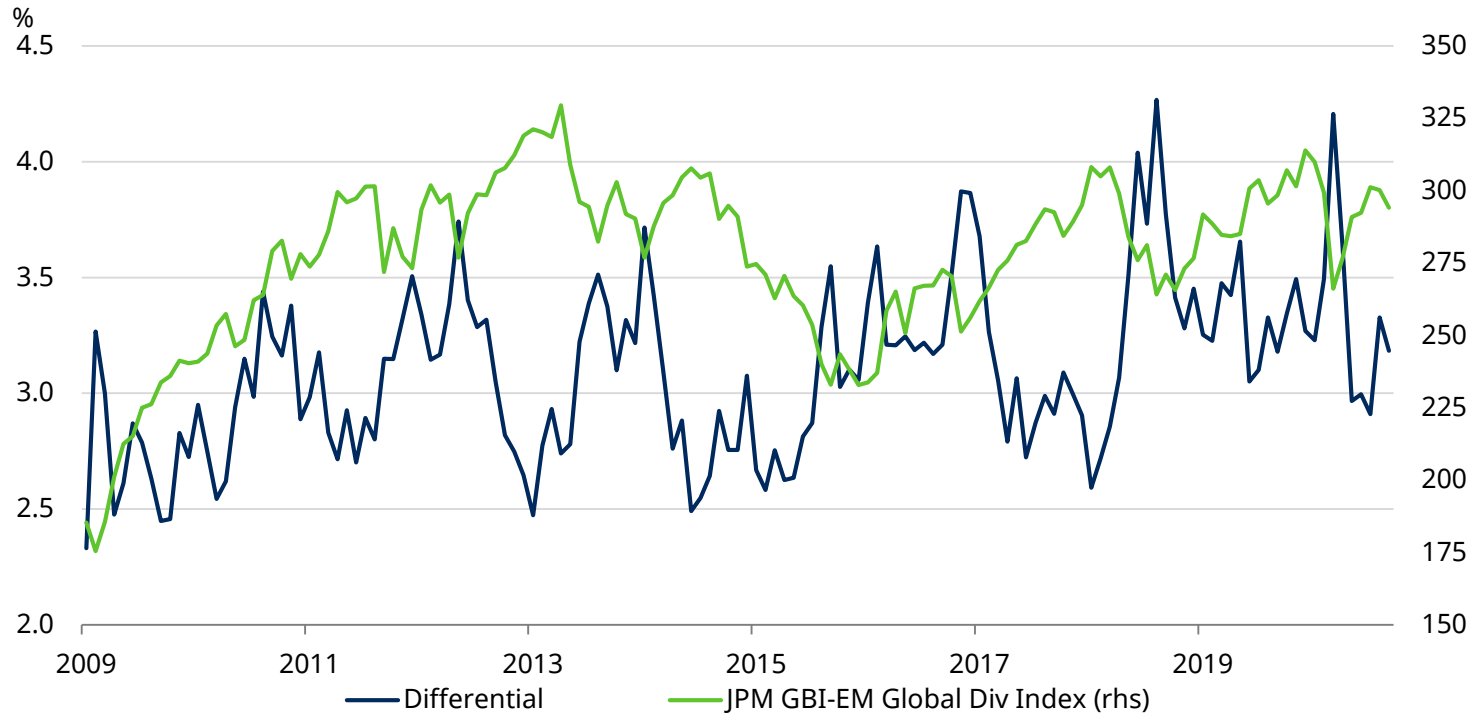
Spread between IG and HY sovereign issuers remains wide

Source: Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2020.
EMD Local is not a spread product, the spread is manually calculated relative to treasuries of approximately equivalent duration.

EMD Local valuation – real yield differential

Valuation of local yields

EM-DM real yield differential



- EMD Local index constituents have historically had higher real yields than DM countries
- A higher real yield is necessary to compensate for the risk of unexpected inflation
- Falling real yield differential is normally associated with positive returns

The real yield differential is currently in the middle of the range, implying moderate value in local currency bonds

Past performance is not a guide to future performance and may not be repeated.

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2020.

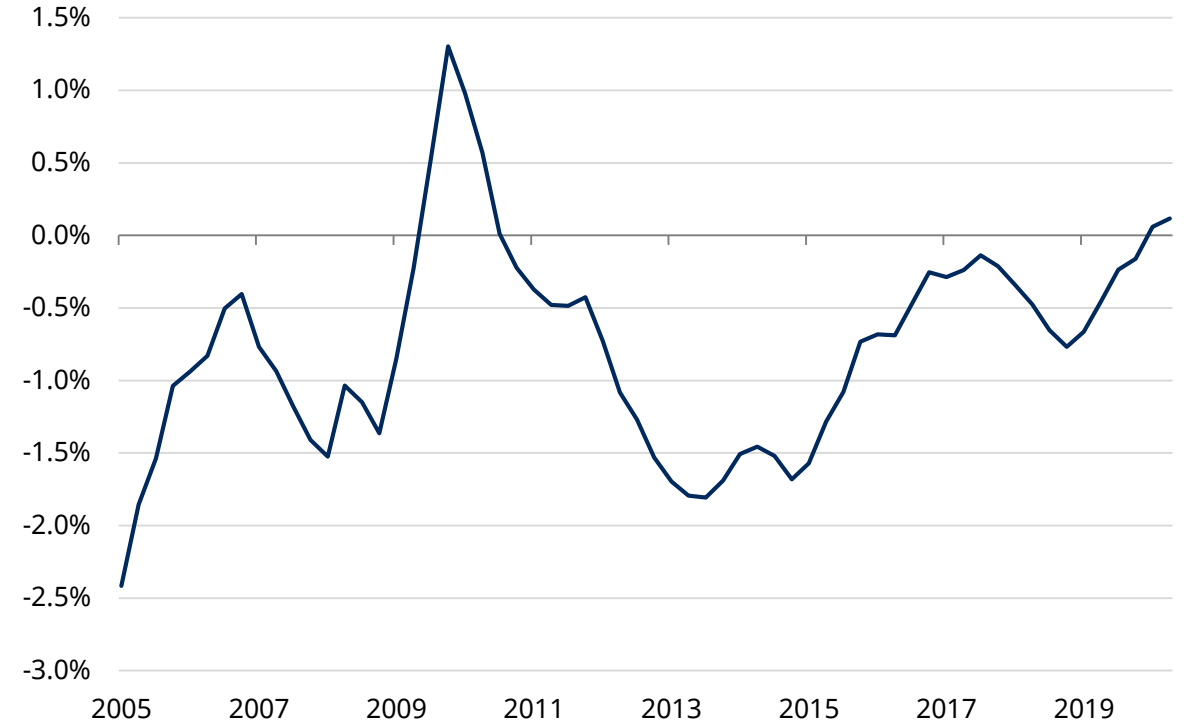
EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by core inflation. DM real yield is 5Y government bond yields of US, UK, Euro zone, Japan deflated by core inflation, weighted by the size of individual government bond market.

EMD Local fundamentals

EM real effective exchange rate¹



EMD Local current account balance (%GDP)¹



EM real trade-weighted currency is cheap and EM current account balances is positive

Source: Schroders, Refinitiv Datastream, J.P. Morgan. Exchange rate data as at 30 September 2020. Current account data as at Q2 2020.

¹Calculated using the country weights of JPM GBI-EM Global Diversified Index. Negative and falling current account balance, all other things equal, could lead to weaker currencies. Conversely, positive and increasing current account balance could lead to stronger currencies.

List of indices

- **IG GBP non-gilts** - The ICE Data Indices Sterling Non-Gilt Index
- **IG GBP corporates** - The ICE Data Indices Sterling Corporate & Collateralized Index
- **IG Euro** - The ICE Data Indices Euro Corporate Index
- **IG USD** - The ICE Data Indices US Corporate Index
-
- **HY GBP** - The ICE Data Indices Sterling High Yield Index
- **HY Euro** - The ICE Data Indices Euro High Yield Index
- **HY USD** - The ICE Data Indices US High Yield Index
-
- **Hard EMD** - JPM EMBI Global Diversified Composite Index
- **Local EMD** - JPM GBI-EM Global Diversified Index
- **Corporate EMD** - JPM CEMBI Broad Diversified Index

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