

Schroders



Schroders Credit Lens

Perspective of USD investor

Q3 2021

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 USD 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 54

Index

[Cross-credit summary](#)

[Cross-credit analysis: key insights](#)

[Hot topics](#)

[Corporate credit: valuation](#)

[Corporate credit: fundamentals](#)

[Corporate credit: technicals](#)

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

Schroders



Cross-credit summary

Summary

- Credit spreads continue to inch lower. Dispersion between bonds has fallen to 2007 levels in some markets. Valuations are unattractive vs history in both investment grade (IG) and high yield (HY). There is slightly more space in HY for spreads to fall further because of improvements in credit quality over time
- Credit rating agencies are upgrading issuers in volume. Periods of net ratings upgrades have historically been associated with stable/tightening spreads
- On average, companies are deleveraging, assisted by buoyant earnings growth. Many companies have managed to reduce their interest bill through refinancing existing, higher-yielding debt
- Issuance has remained high in 2021, despite already large cash balances. Very low nominal and negative real corporate bond yields are encouraging issuance with little obvious need for extra cash. Demand from derisking defined benefit pension funds could help to digest the issuance
- More worryingly, US leveraged buyout deal (LBO) volume has increased sharply recently. This is could to lead to a fall in the quality of US HY issuance
- Foreign demand for US corporate bonds remains strong as currency hedged USD yields are attractive
- In emerging market debt (EMD), local currency bonds and EM currencies have recovered most of the sell-off seen earlier this year, aided by stability in US bond yields and rate hikes by EM central banks

Summary table

Cross-credit overview

Date: 30 June 2021

	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%	0.3%	2.1%	4.1%	2.5%	3.9%	4.9%	5.0%	3.6%
Yield to worst (hedged to USD) ¹	1.6%	1.8%	1.1%	2.1%	4.2%	3.2%	3.9%	4.9%	-	3.6%
Spread (bps)	91	108	84	86	372	296	304	340	412	249
Spread (percentile) ²	20%	21%	27%	6%	26%	14%	11%	42%	43%	19%
Risk premium (bps) ³	41	51	26	29	187	120	89	192	337	119
Duration	8.0	8.6	5.5	8.4	4.1	4.2	5.3	7.9	5.3	4.5
MV (billion \$)	918	712	3,417	8,609	63	561	1,641	775	1,487	645
Rating	A2	A3	A3	A3	BB3	BB3	B1	BB1	BBB3	BBB3
Nr. of issues/countries	1,228	1,049	3,751	9,108	108	771	2,110	74	20	2,067

Since Jan 1997 or inception

Annualised return ⁴	5.8%	6.1%	5.4%	6.0%	9.1%	6.5%	6.9%	8.1%	6.3%	7.1%
Annualised volatility	5.1%	5.8%	3.4%	5.4%	10.6%	11.5%	8.9%	10.5%	11.8%	7.5%
Return/volatility	1.1	1.1	1.6	1.1	0.9	0.6	0.8	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	0.5	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	0.6	-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 June 2021.

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 13).

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

Performance table

Cross-credit overview

Date: 30 June 2021

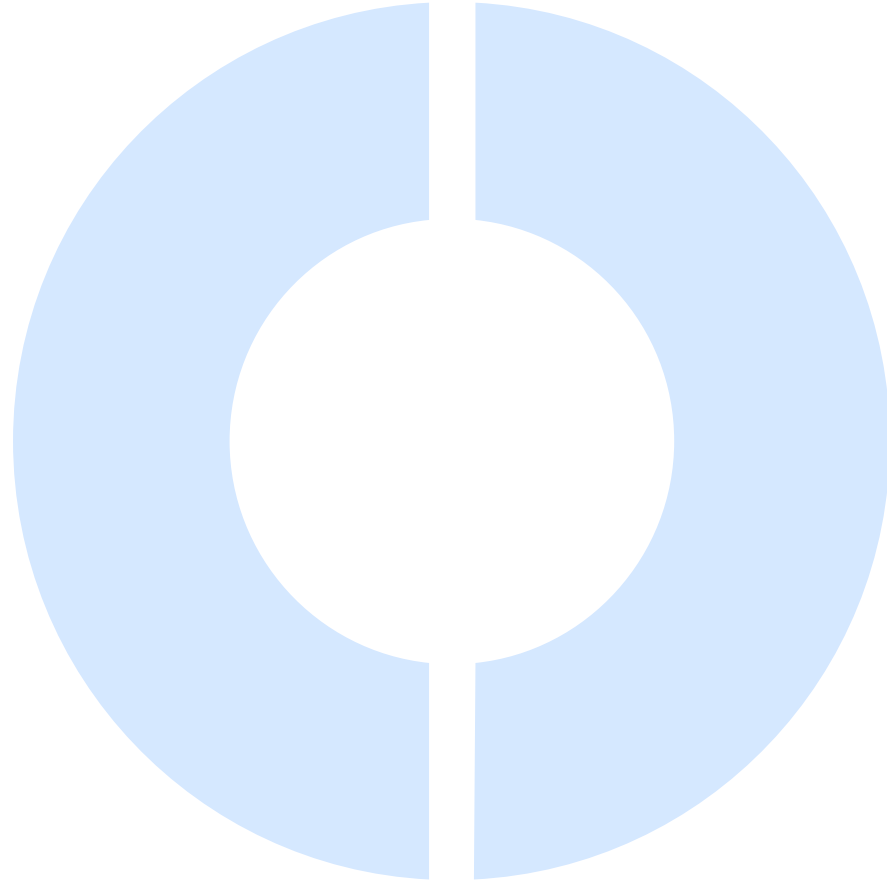
	IG GBP non-gilts	IG GBP corporates	IG Euro	IG USD	HY GBP	HY Euro	HY USD	Hard EMD	Local EMD	Corp. EMD
Return (local)¹										
1 month return	0.8%	0.9%	0.4%	1.7%	0.7%	0.6%	1.4%	0.7%	-1.0%	0.8%
YTD return	-2.5%	-2.6%	-0.4%	-1.1%	3.3%	3.0%	3.7%	-0.7%	-3.4%	1.3%
1 year return	1.8%	2.7%	3.5%	3.6%	12.9%	11.5%	15.6%	7.5%	6.6%	8.7%
Return (USD hedged)										
1 month return	0.8%	0.9%	0.5%	1.7%	0.7%	0.6%	1.4%	0.7%	-1.0%	0.8%
YTD return	-2.5%	-2.6%	-0.1%	-1.1%	3.4%	3.4%	3.7%	-0.7%	-3.4%	1.3%
1 year return	2.2%	3.0%	4.5%	3.6%	13.5%	12.7%	15.6%	7.5%	6.6%	8.7%
Spread										
1 month OAS change	-2	-3	-2	-5	3	-7	-30	7	-4	-3
YTD OAS change	-8	-9	-9	-17	-91	-59	-82	-12	25	-21
1 year OAS change	-56	-68	-64	-74	-349	-225	-340	-134	-11	-167
Latest OAS	91	108	84	86	372	296	304	340	412	249

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 June 2021.

¹Local EMD is USD return.

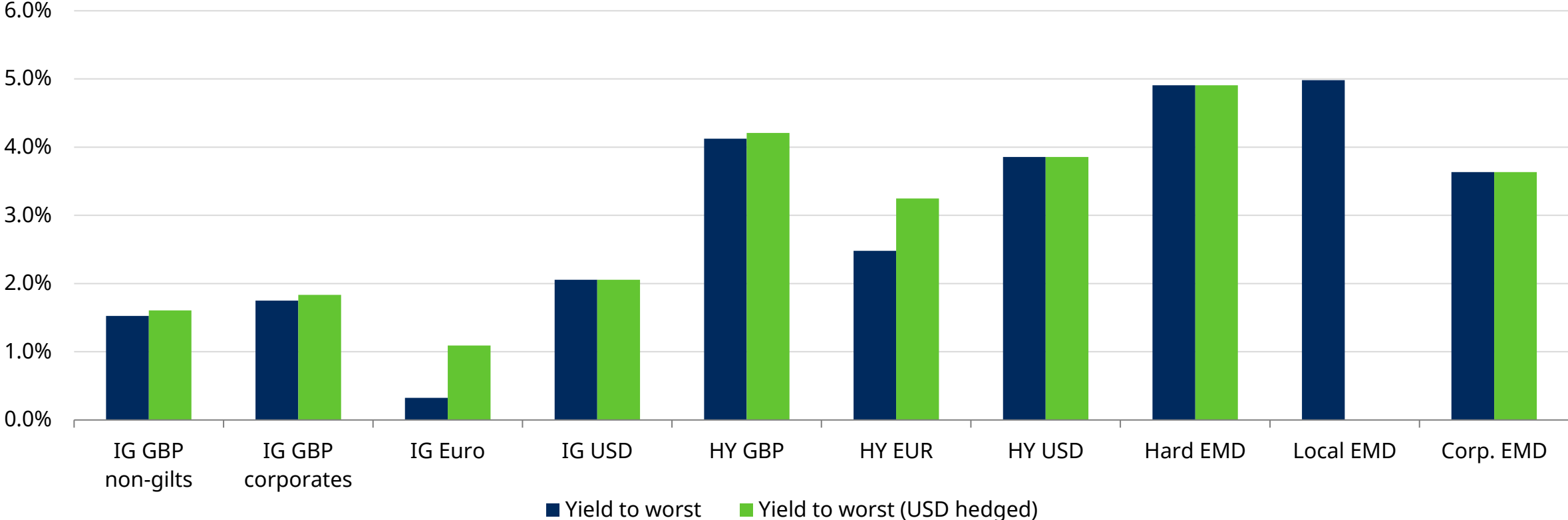
Schroders



Cross-credit analysis: key insights

Cross-credit yield

Yield to worst



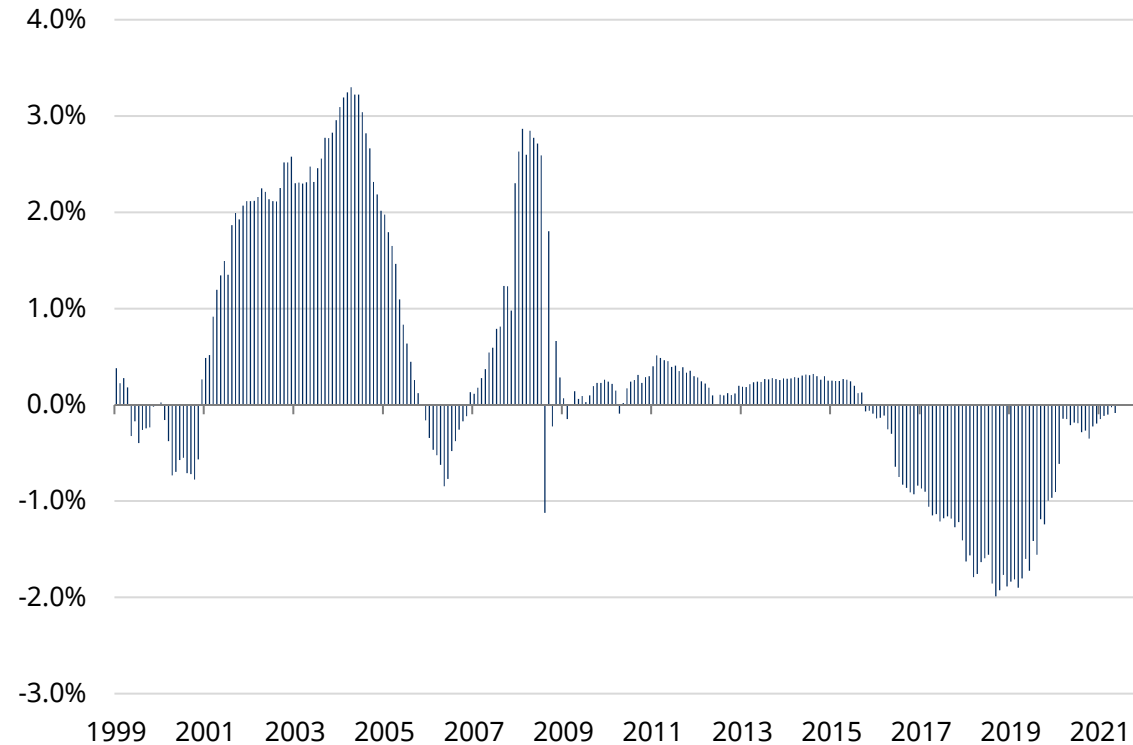
Currency-hedged EUR and GBP corporates are not attractive for USD investors

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan, Bloomberg. Data as at 31 June 2021. Hedged yield is local currency yield minus annualised 3-month FX hedging cost/return (see next slide).

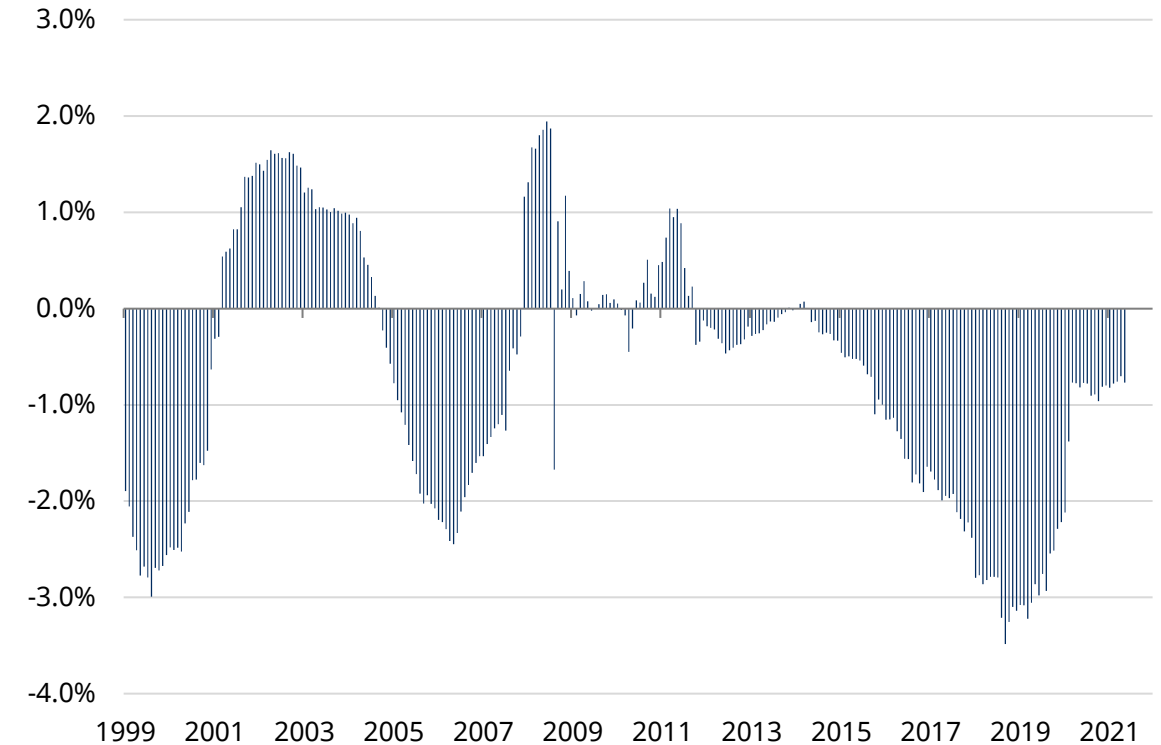
FX hedging cost or return

Using three-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 0.1% higher in USD once hedging taken account

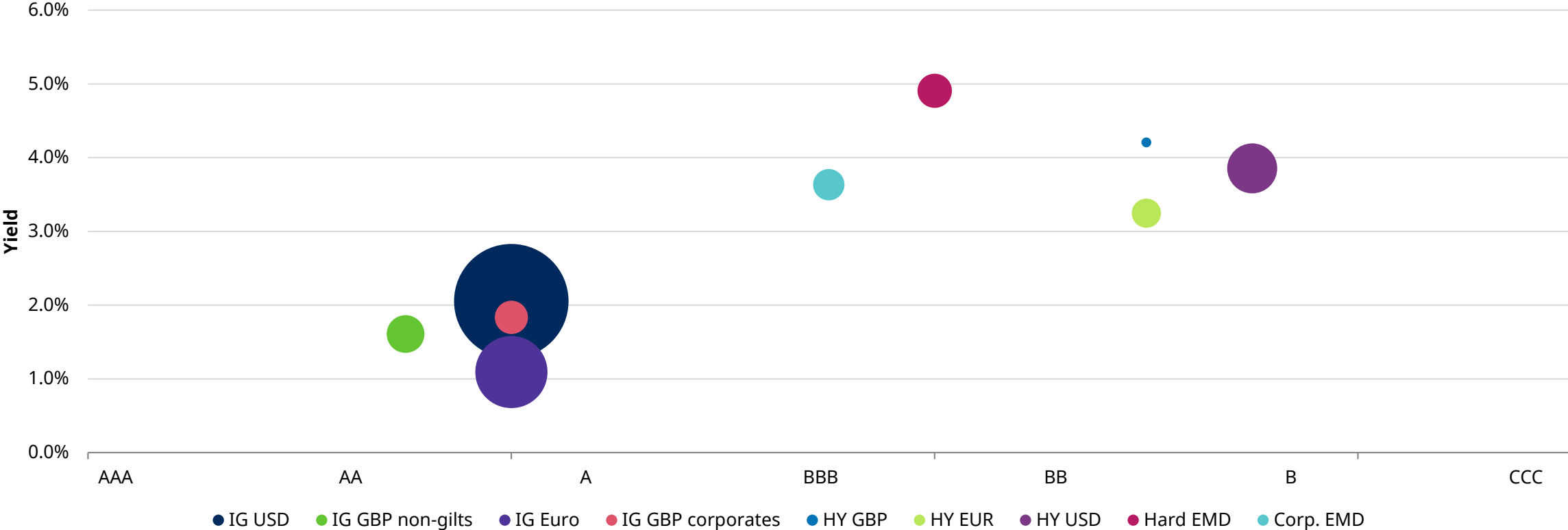
EUR yields will be 0.8% higher in USD once hedging taken account

Source: Refinitiv Datastream. Data as at 30 June 2021.

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

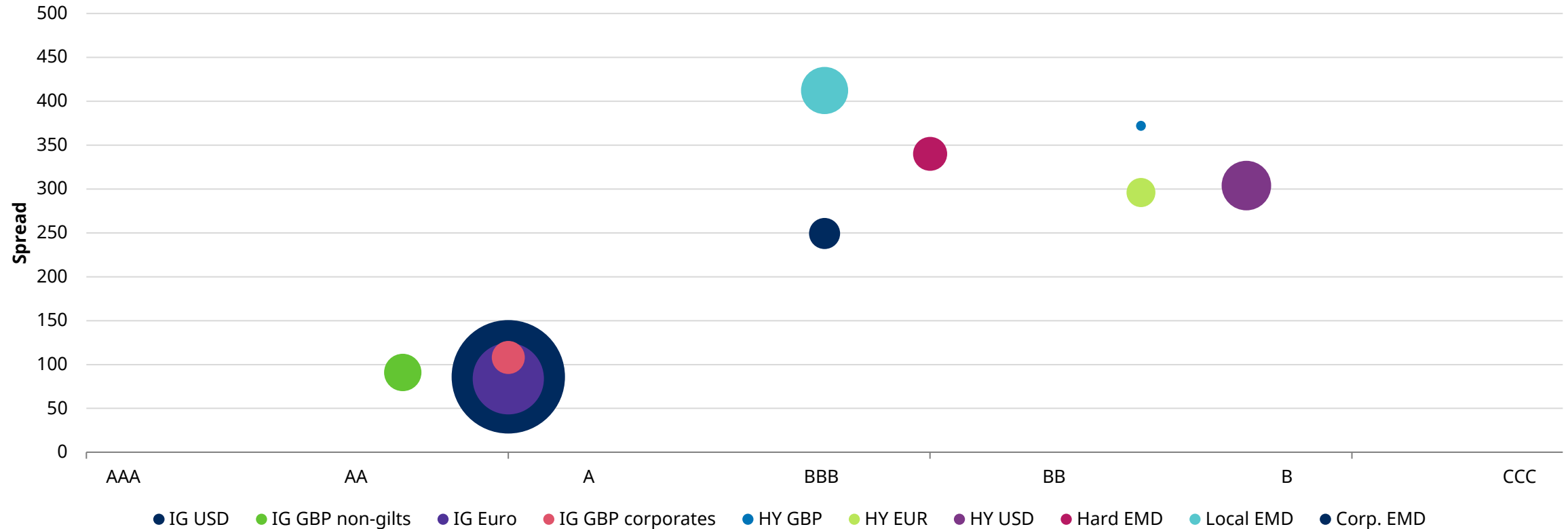


Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 June 2021.

Spread vs. credit rating vs. market size

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

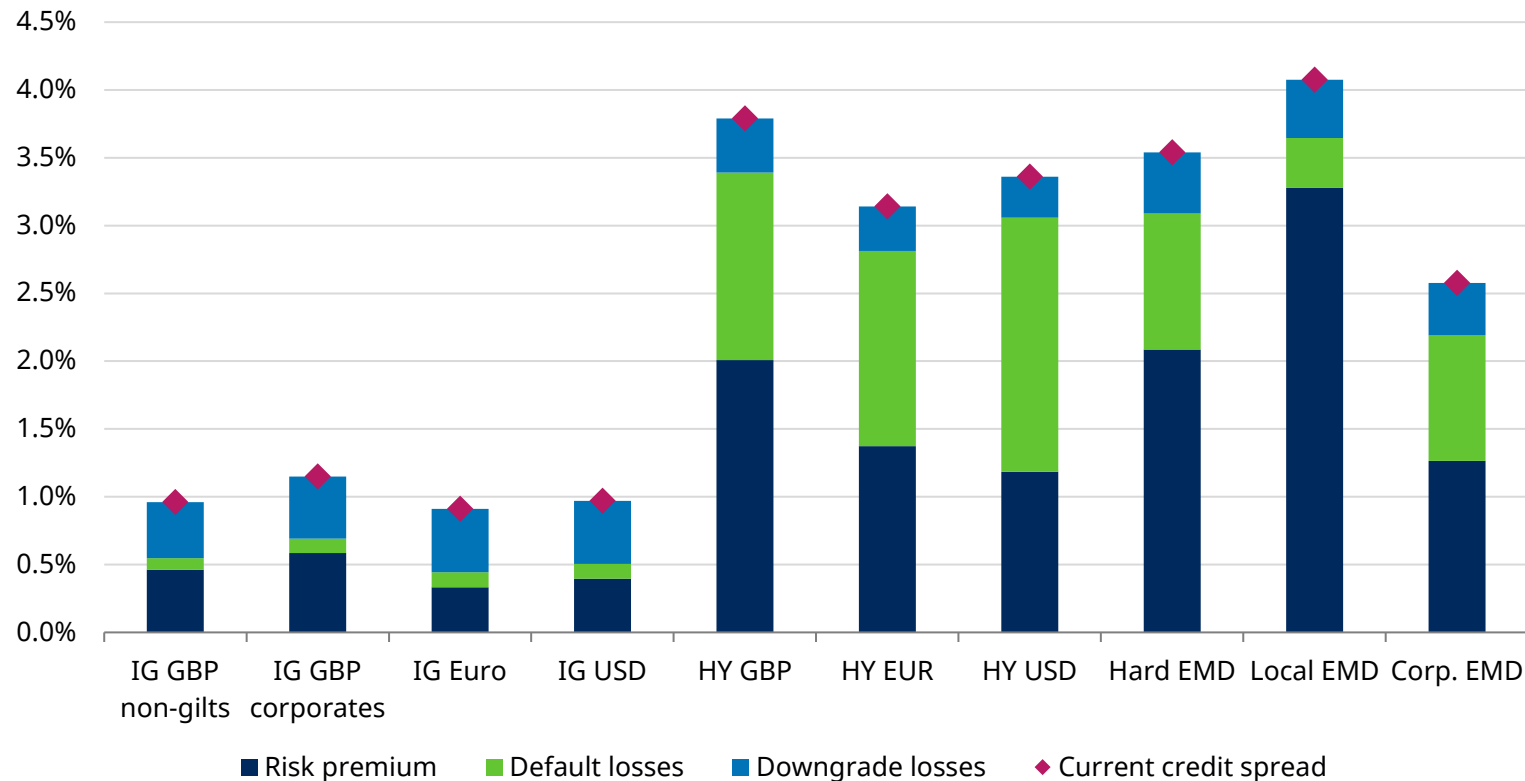
Spread vs credit rating vs market size



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 June 2021.

Risk premium/net spread in credit

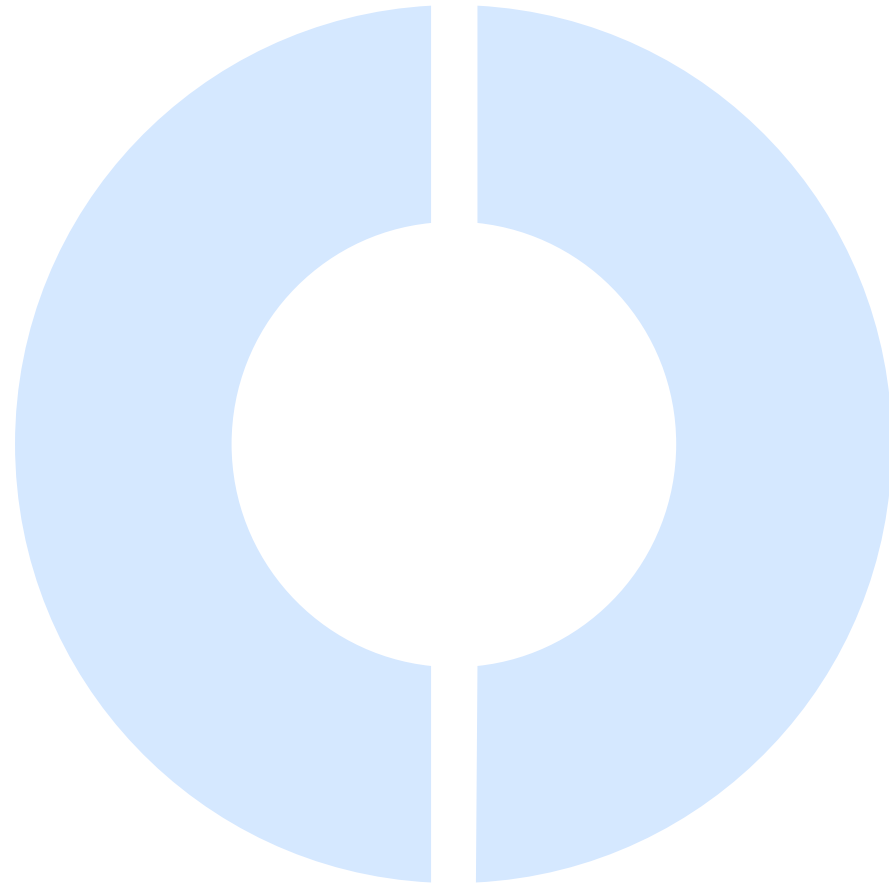
Decomposition of credit spread into expected losses and expected risk premium



- 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. Data as at 30 June 2021.

Schroders



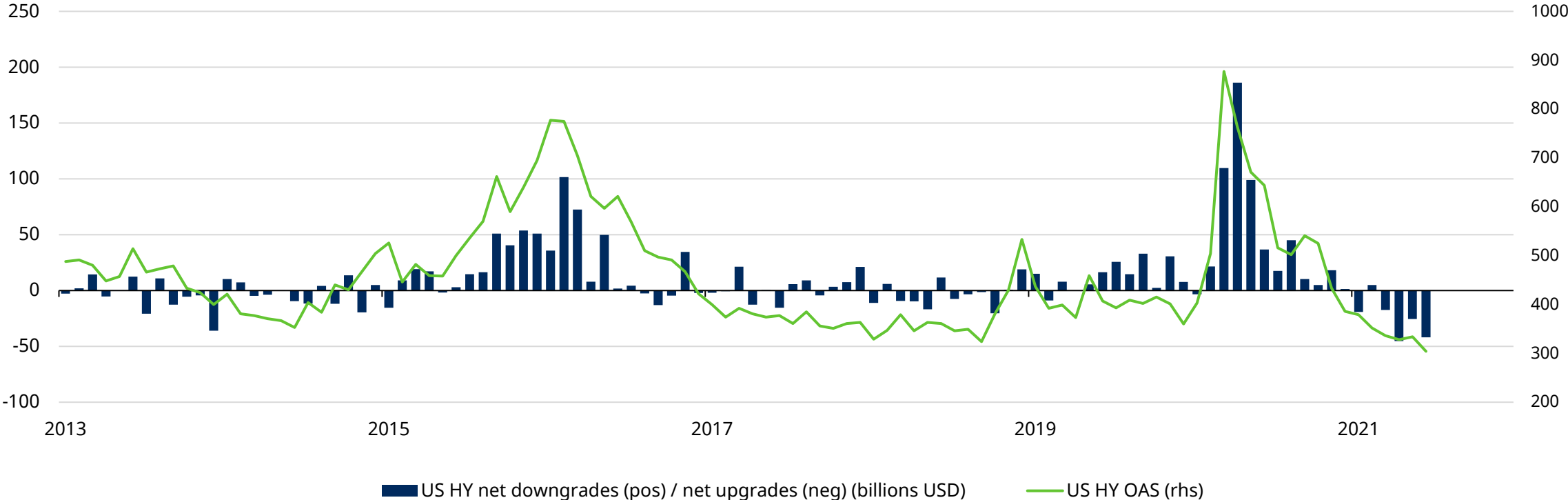
Hot topics

US HY rating upgrades are coming in at a record volume

Ratings agencies incorporating more benign outlook in the credit ratings

US HY monthly net downgrades (positive) / upgrades (negative)

Billions USD



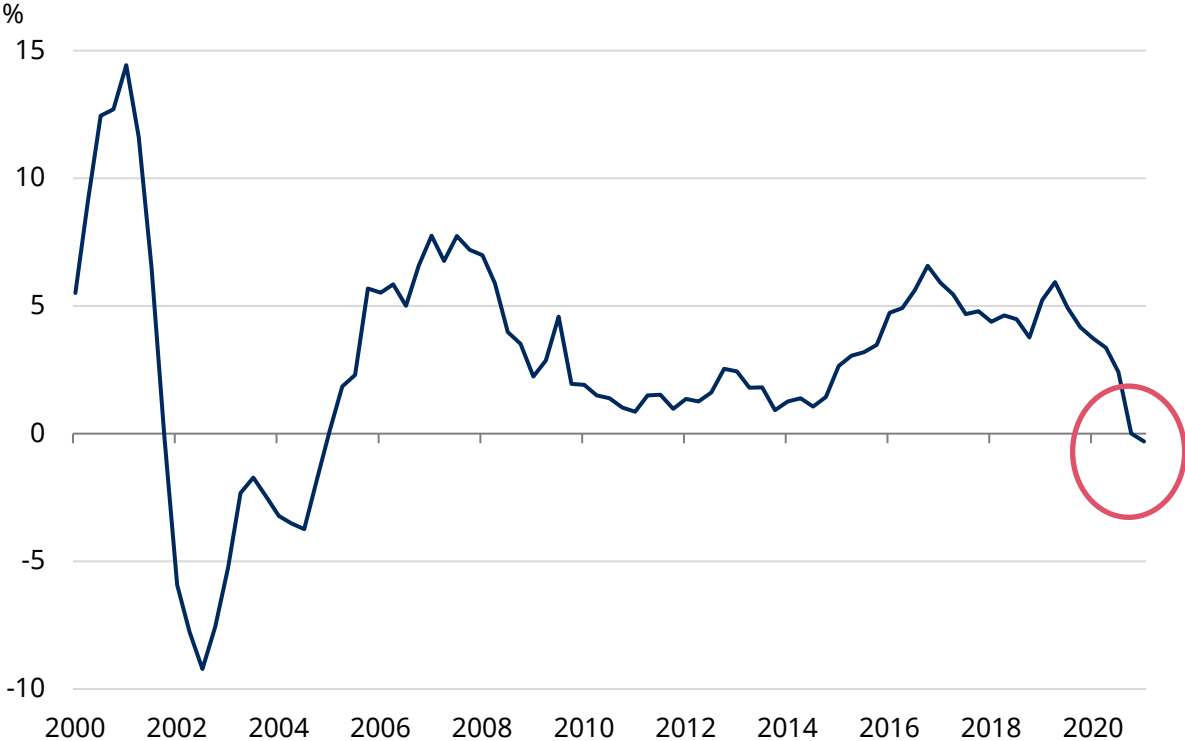
Periods of net ratings upgrades have historically been associated with stable/tightening spreads

Source: BofA Global Research, Refinitiv Datastream. Data as at 30 June 2021.

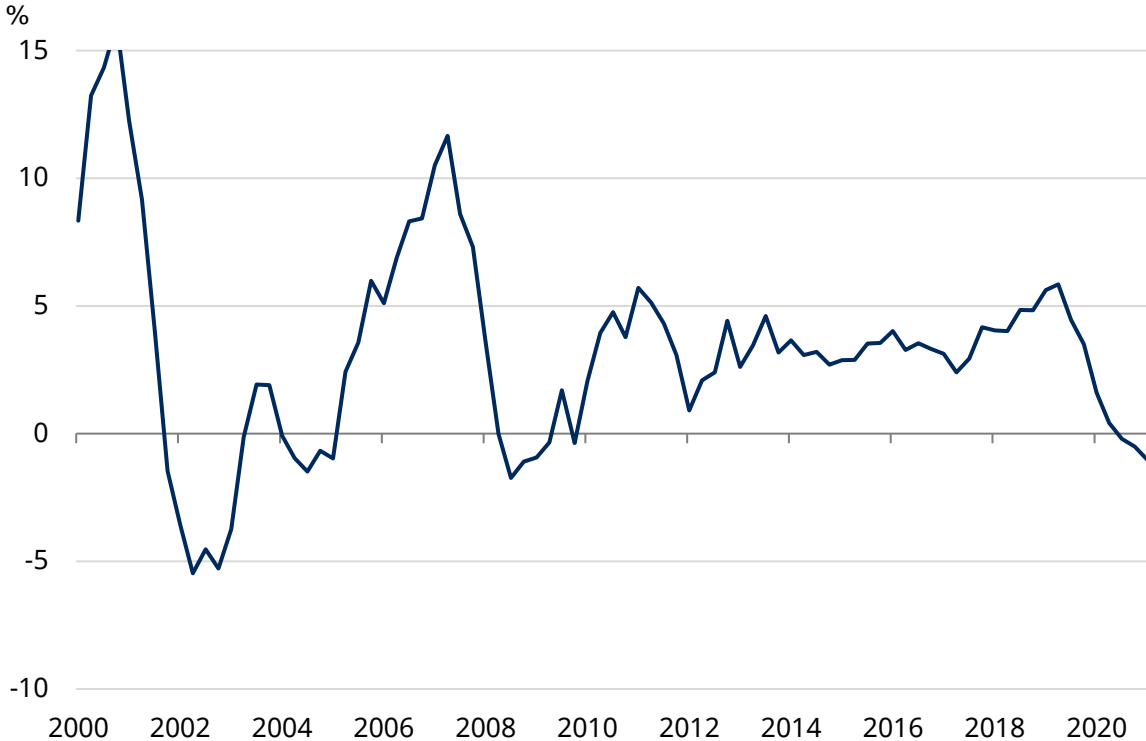
Lower interest expense despite higher debt load

Companies refinancing debt at significantly lower yields

US IG annual interest expense growth



US HY annual interest expense growth



Interest expense = total debt x weighted average cost of debt

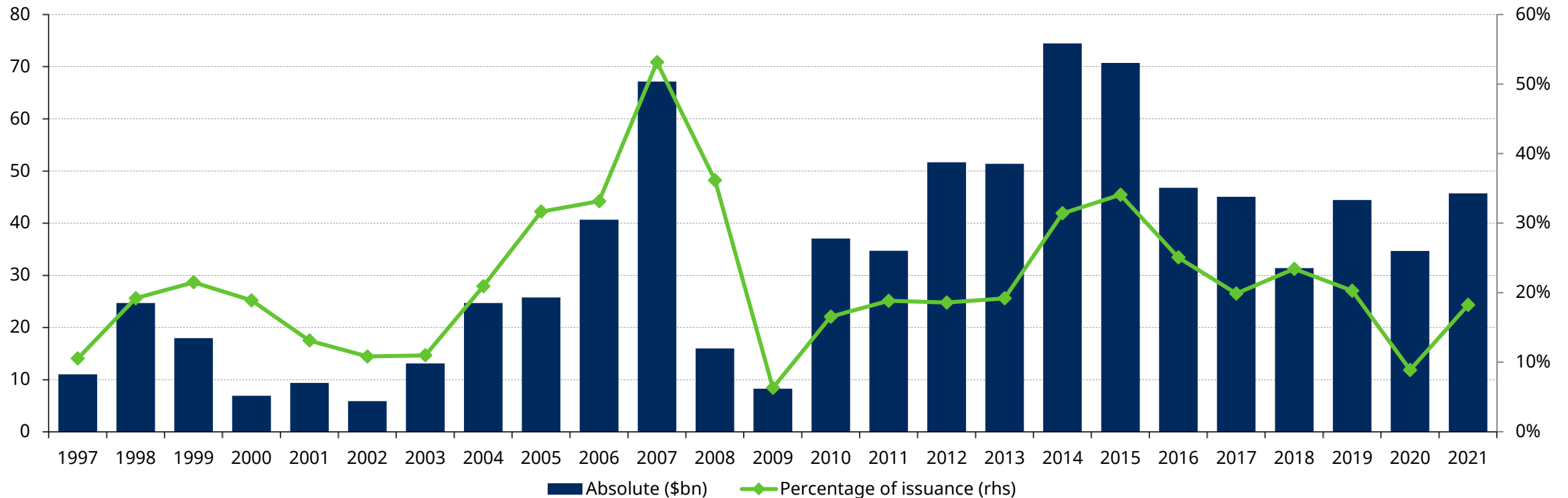
Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as at Q1 2021.

Leveraged buyouts are back

Buyout deals need to be financed by debt issuance

US HY LBO related issuance

Billions USD



The share of LBO related issuance has risen in the US HY market; recent sharp increase in US buyout volume is likely to result in more lower-quality LBO issuance

Source: BofA Global Research. Data as at 30 June 2021.

US HY dispersion the lowest since 2007

US HY dispersion¹



Euro HY dispersion¹



Historically, dispersion has not stayed very low for too long

Source: BofA Global Research. Data as at 30 June 2021. 1. Proportion of face value in the DM USD HY index marked outside +/-100bps of overall index level

US IG real yield remains negative

Why not issue bonds if you have to pay back less in real terms?

US IG real yield¹

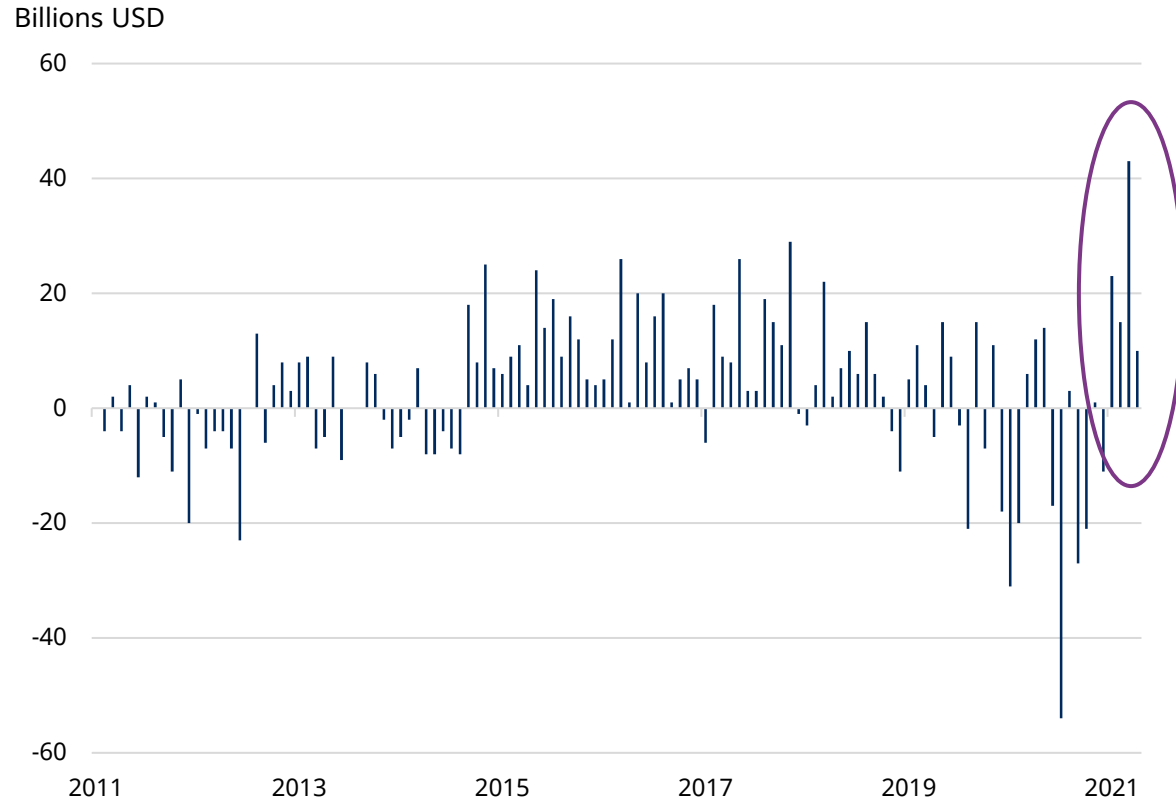


Despite abundant cash on balance sheet, Amazon recently issued almost \$20 billion of debt

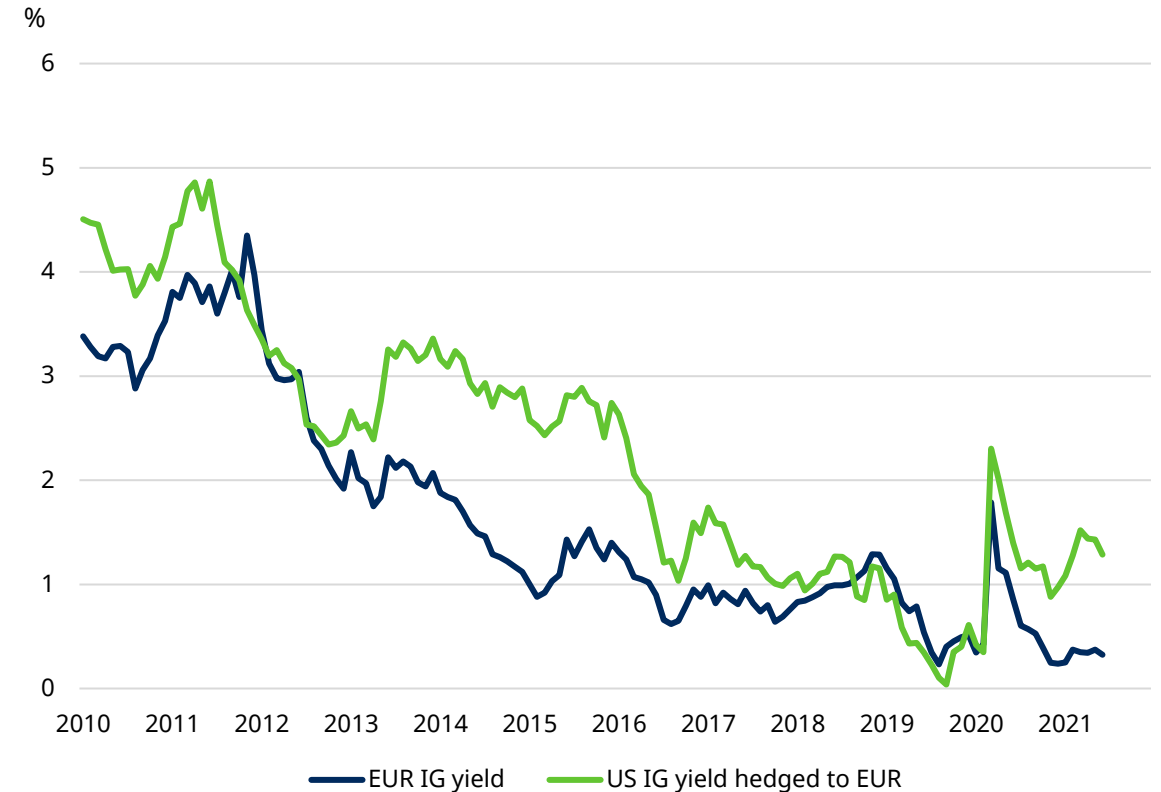
Source: Refinitiv Datastream. Data as at 30 June 2021. 1. ICE BofA US Corporate Index yield minus US 10-year breakeven inflation.

Relatively high currency-hedged USD yields are attracting foreign buyers

Foreign net purchases of US corporate bonds

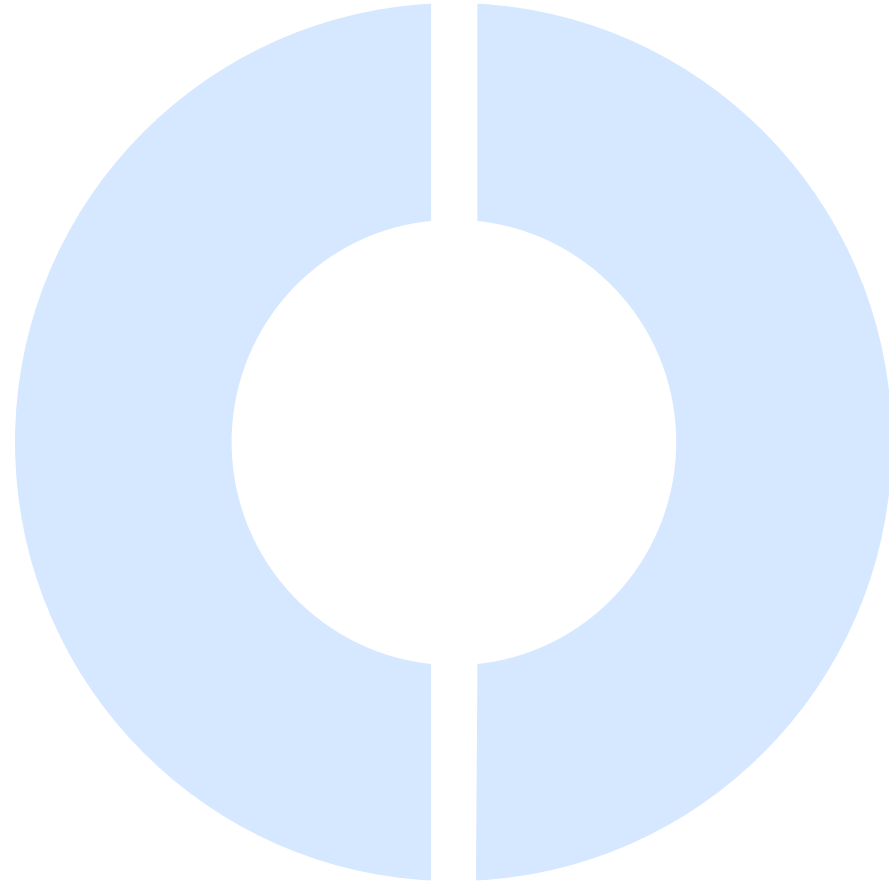


IG yields for euro investors



Source: Refinitiv Datastream. Data as at 30 June 2021. Hedged yield is local currency yield minus annualized 3-month hedging cost/return.

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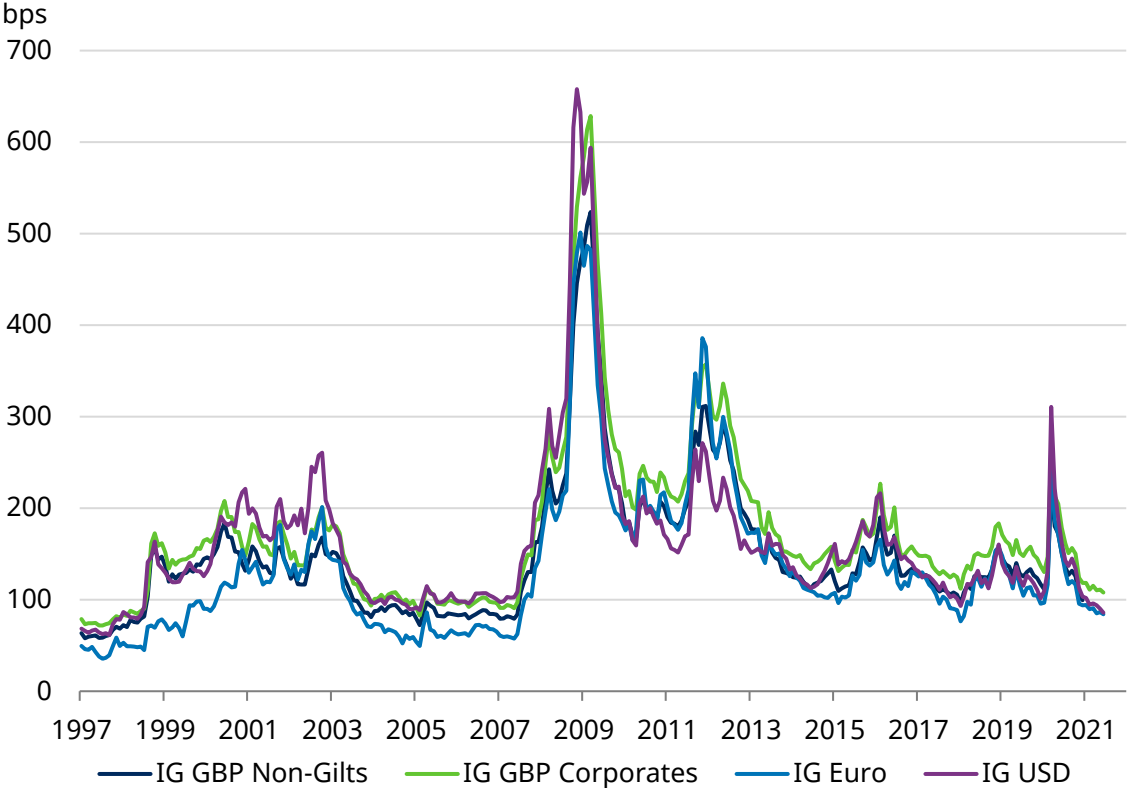


Corporate credit
Valuation

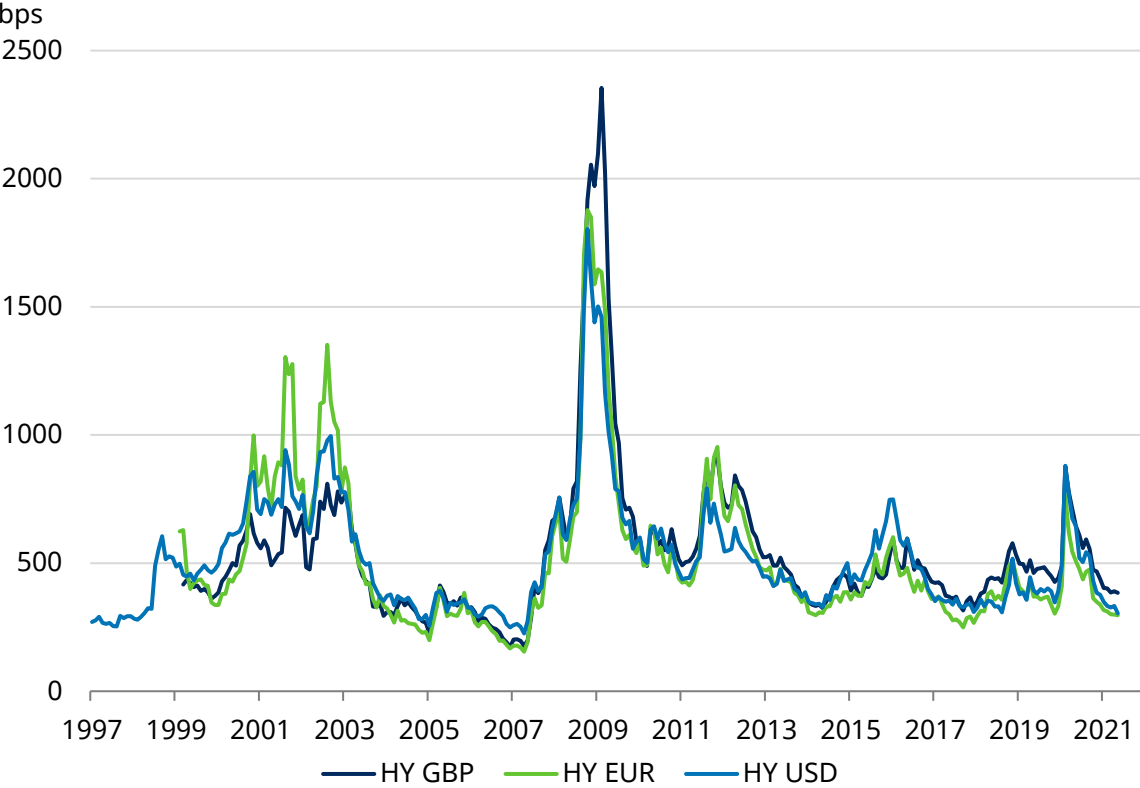
IG and HY valuation

Historical ratings-adjusted credit spreads

IG adjusted spreads



HY adjusted spreads

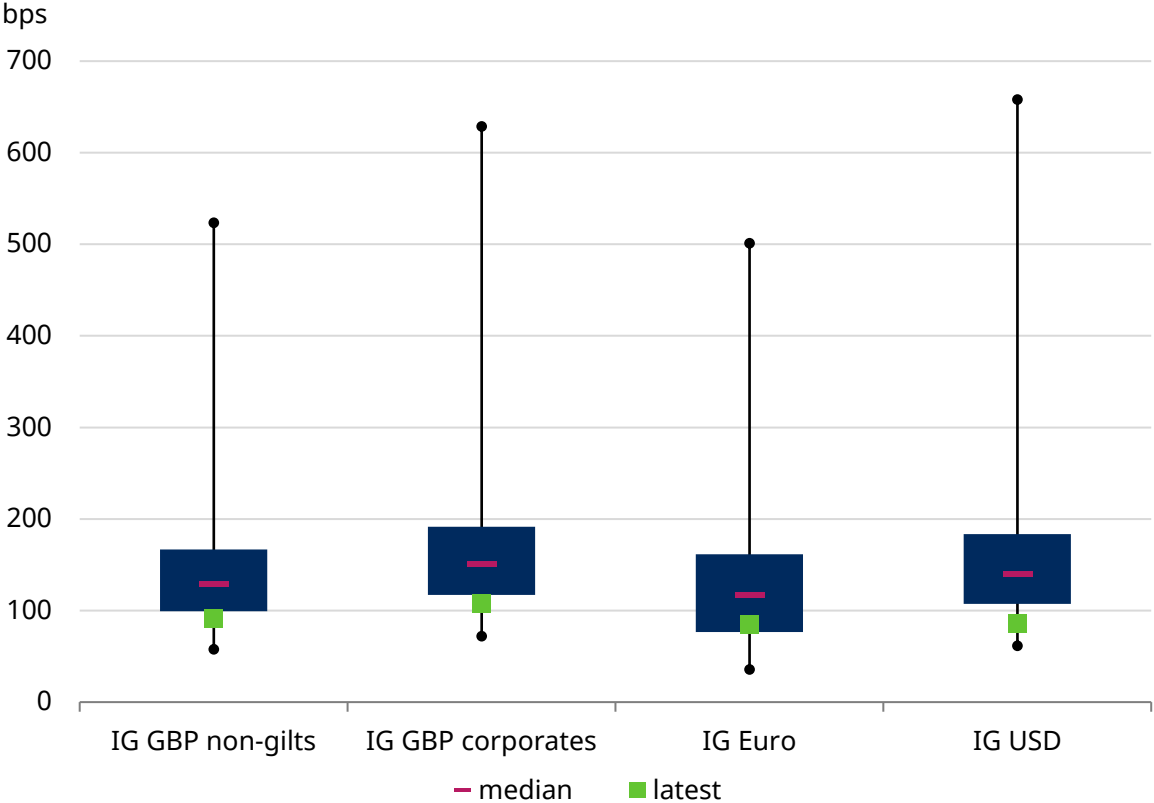


Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 June 2021. Spreads are adjusted for changes in the distribution of credit ratings within each index over time.

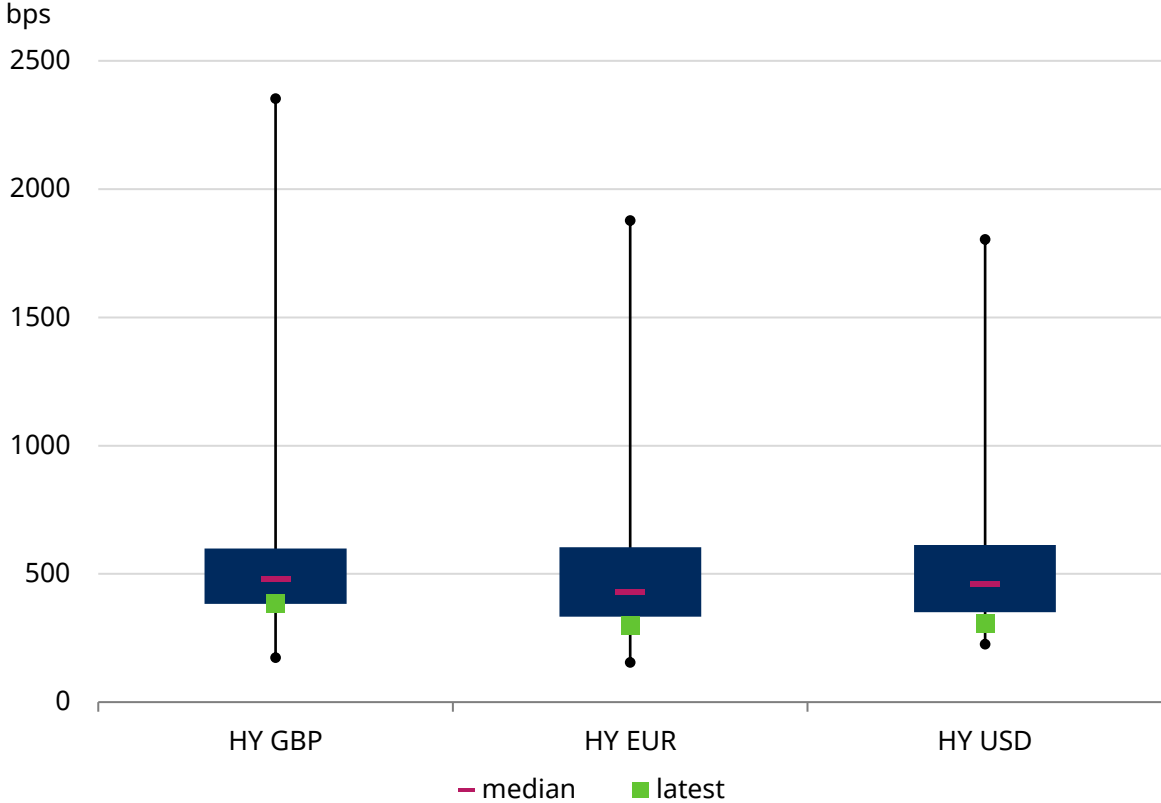
IG and HY valuation

Spread percentiles¹

IG adjusted spreads

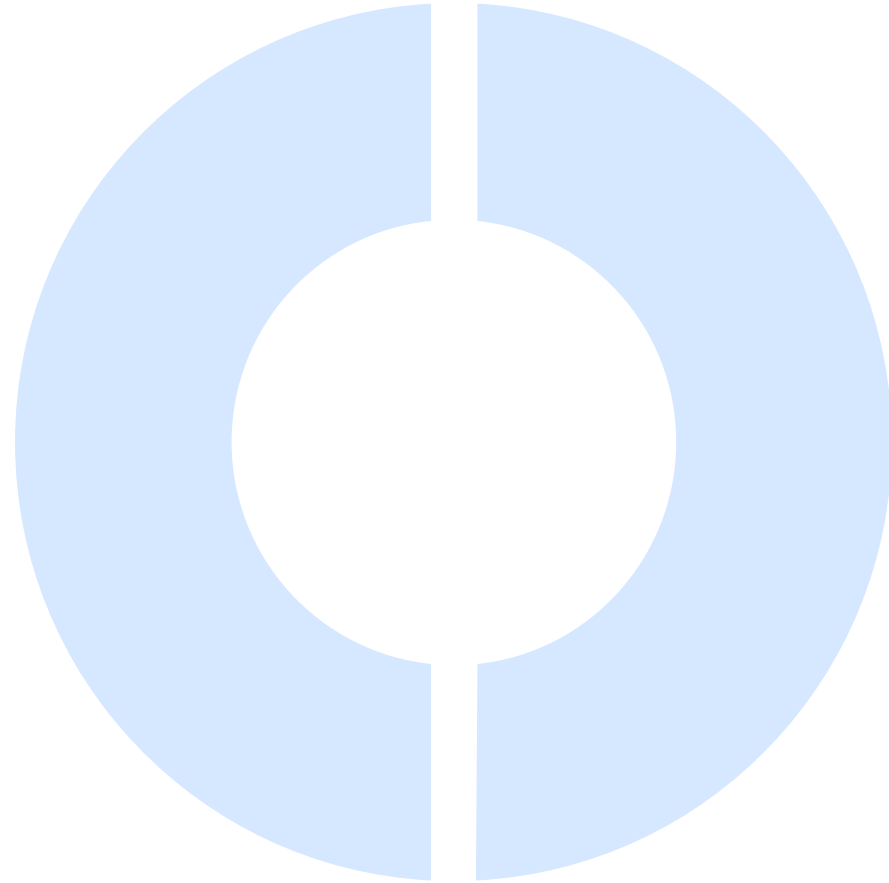


HY adjusted spreads



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 June 2021. Spreads are adjusted for changes in the distribution of credit ratings within each index over time.
¹Percentiles 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.

Schroders



Corporate credit
Fundamentals

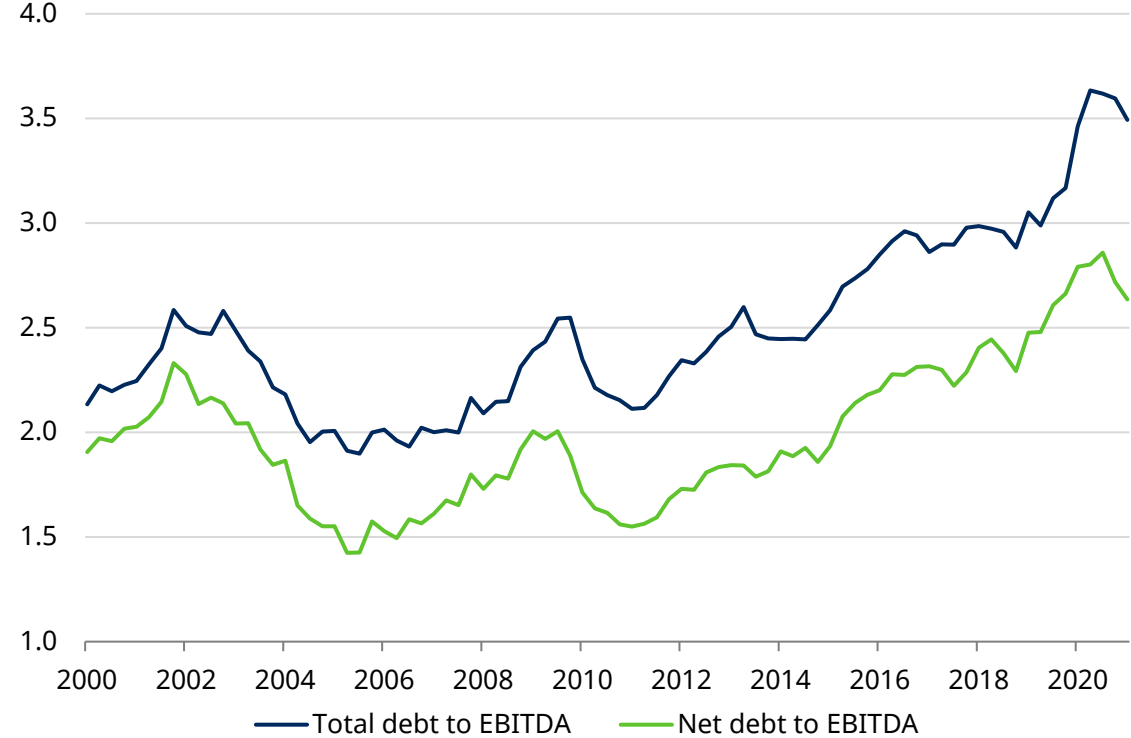
Q1 corporate fundamentals update

- **Corporate leverage is falling, although not universally. Recovering earnings should remain a tailwind at least for the next few quarters**
- Net leverage is falling faster than gross because of elevated cash balances. In the US, leverage is falling faster in more cyclical IG sectors and in the HY market
- The benefit of refinancing is reflected in the interest cost numbers. Despite higher debt loads compared to a year ago, US IG interest costs fell year-over-year for the first time in 16 years in Q1
- Cash levels finally stabilised (Europe) or started to tick down (US), although they remain historically elevated. It is likely that companies will start to put at least some the cash in use
- The danger is that good times can induce companies to take more risks, which can lead to a deterioration in fundamentals and problems down the line
- **See more from: <https://www.schroders.com/en/uk/tp/markets2/markets/are-corporate-fundamentals-heading-in-the-right-direction/>**

US IG leverage is falling from very high level

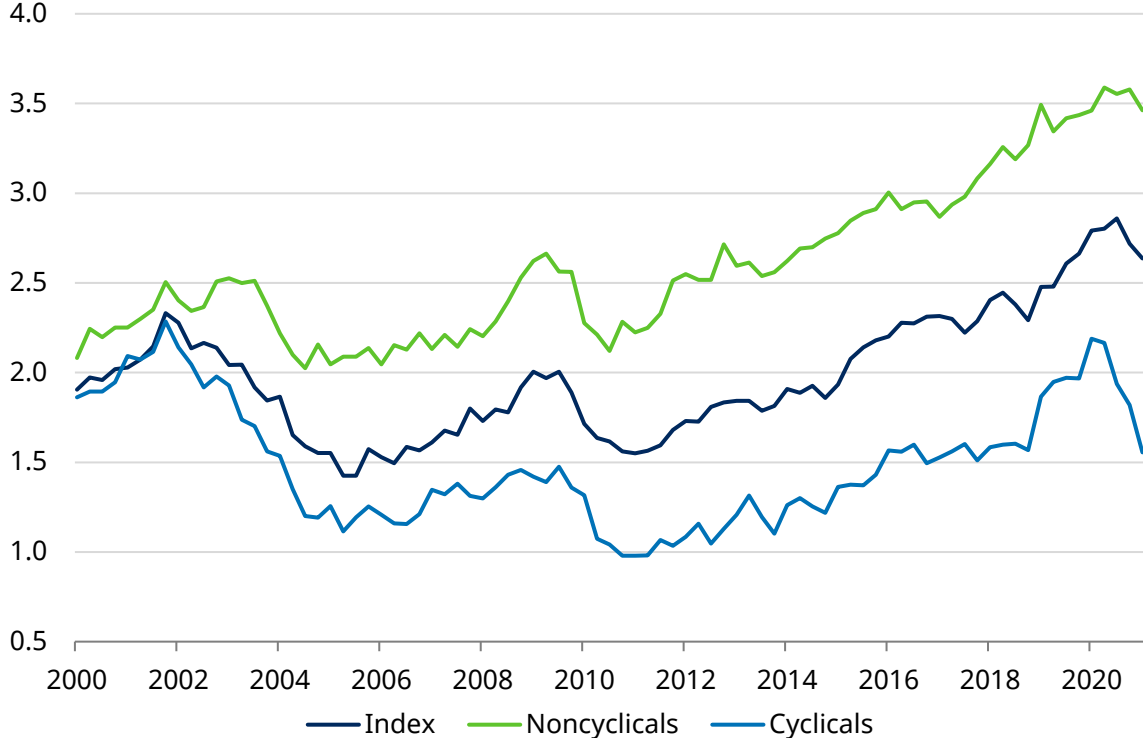
US IG leverage

Debt to last twelve month EBITDA



US IG net leverage

Debt to last twelve month EBITDA



US IG leverage continues to fall with net leverage leading the way; however, leverage is falling much faster in cyclical sectors

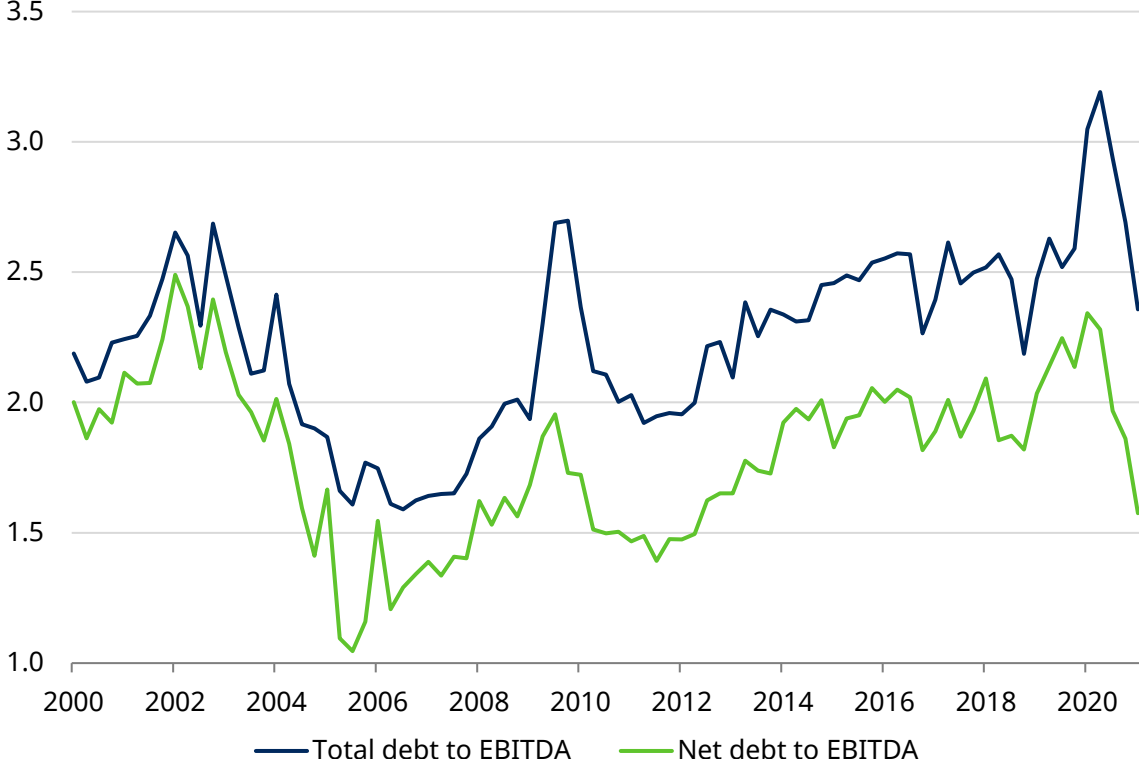
Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q1 2021. **Cyclical sectors:** Basic Materials, Consumer Discretionary, Industrials, Technology. **Noncyclical sectors:** Communications, Consumer Staples, Utility, Health Care.

Corporate behaviour varies between sectors

More cyclical sectors are aggressively cutting leverage

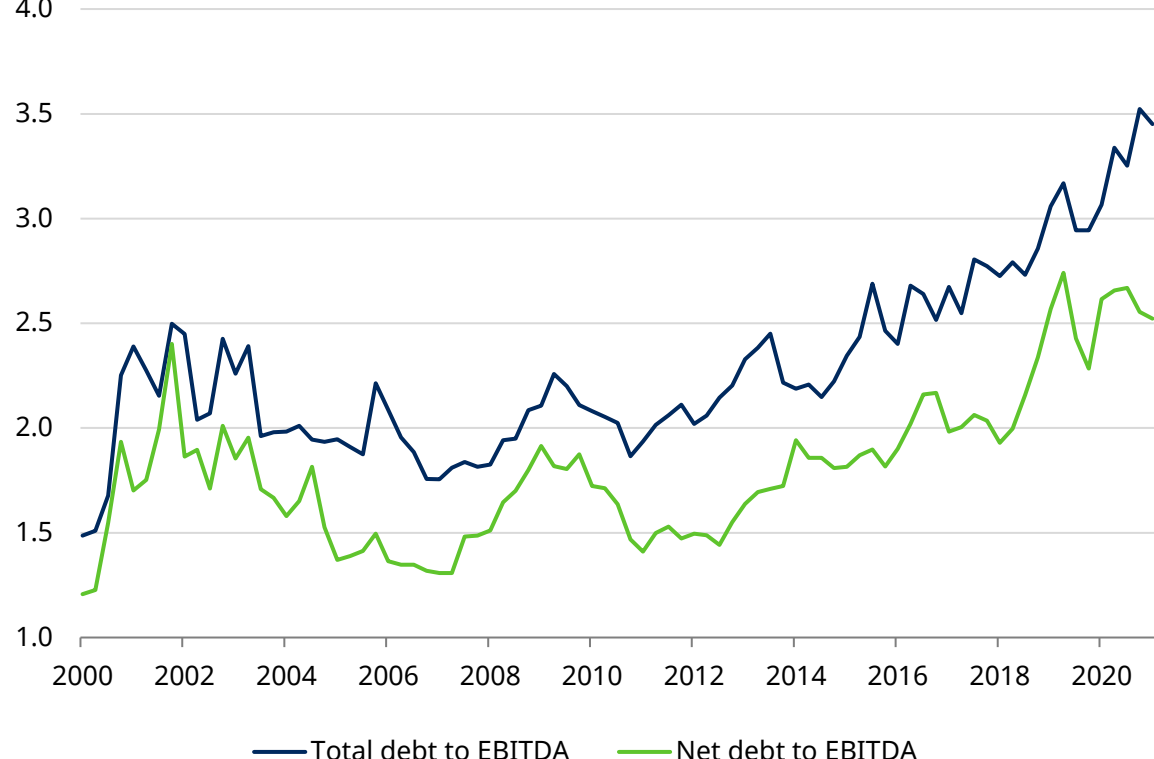
US IG Materials sector leverage

Debt to last twelve months EBITDA



US IG Communications sector leverage

Debt to last twelve months EBITDA



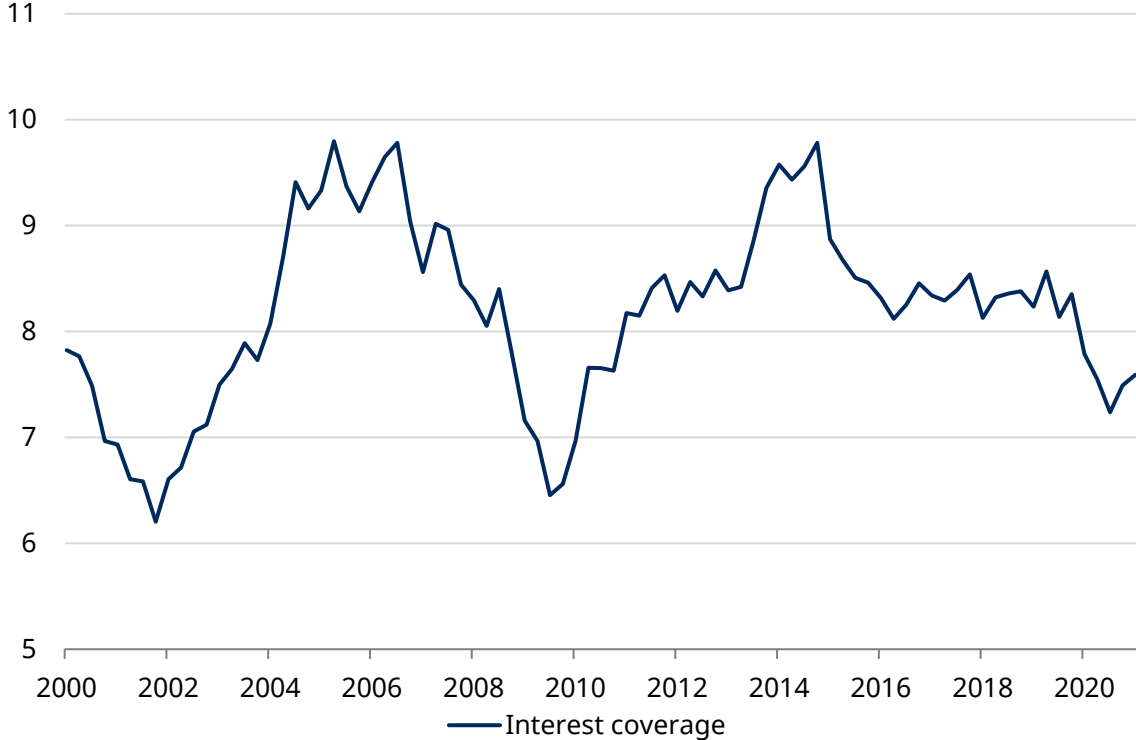
While most companies in cyclical sectors have started to materially cut leverage, companies in non-cyclical sectors seem to have taken a more relaxed approach

Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q1 2021.

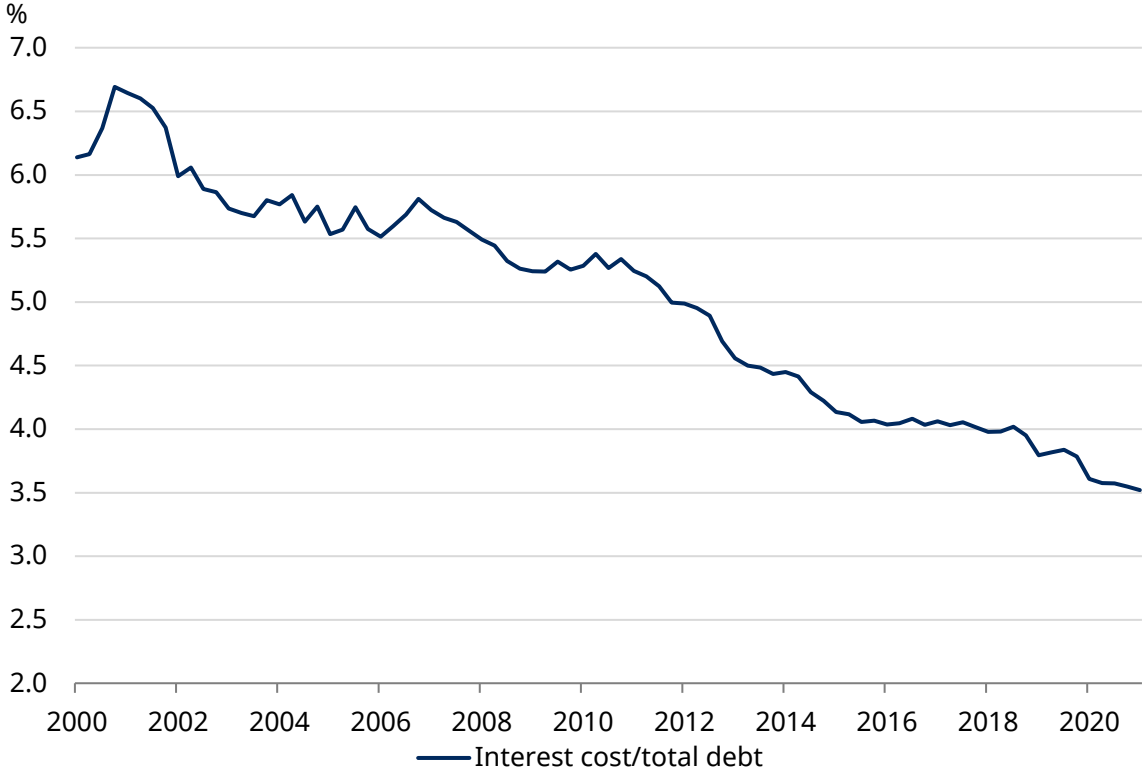
US IG interest coverage ratio

US IG interest coverage ratio¹

Last twelve month EBITDA to interest expense



US IG cost of debt



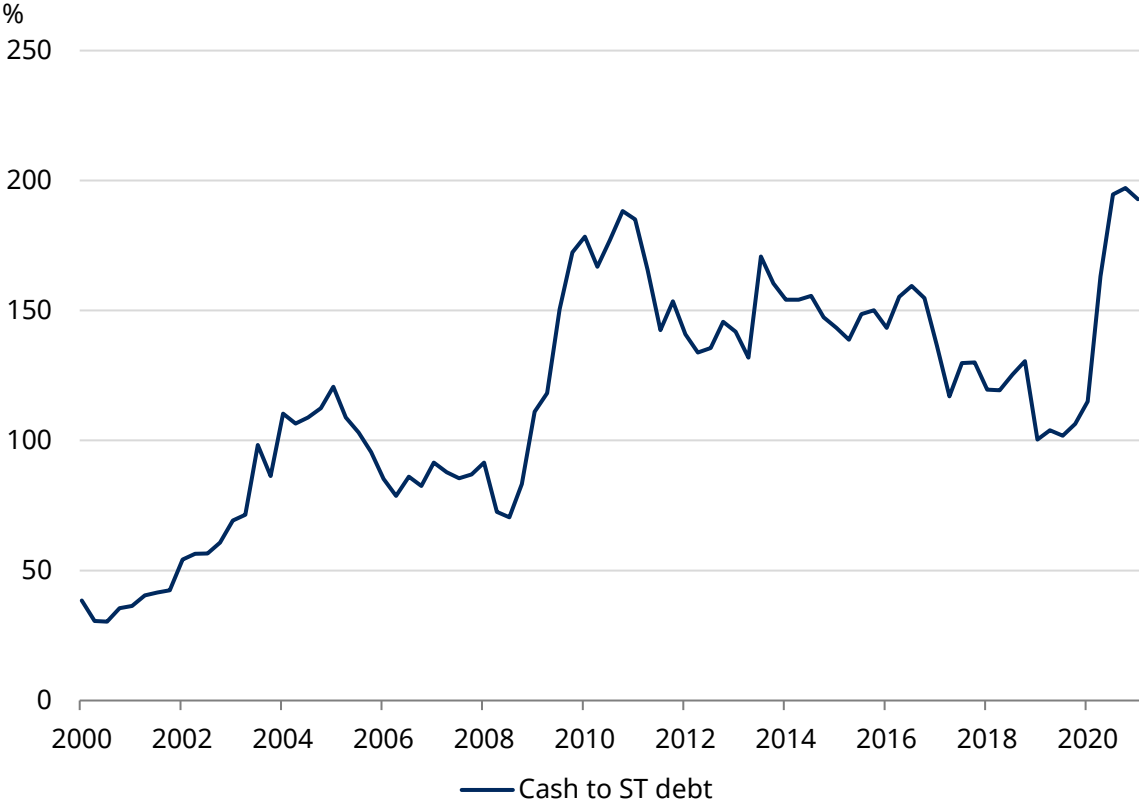
Interest coverage has started to improve as EBITDA is rising and cost of debt remains very low

Source: Schrodgers, Bloomberg, J.P. Morgan. Median issuer ex-Financials. Data as at Q1 2021. ¹Calculated as last twelve month EBITDA divided by interest expense on the income statement

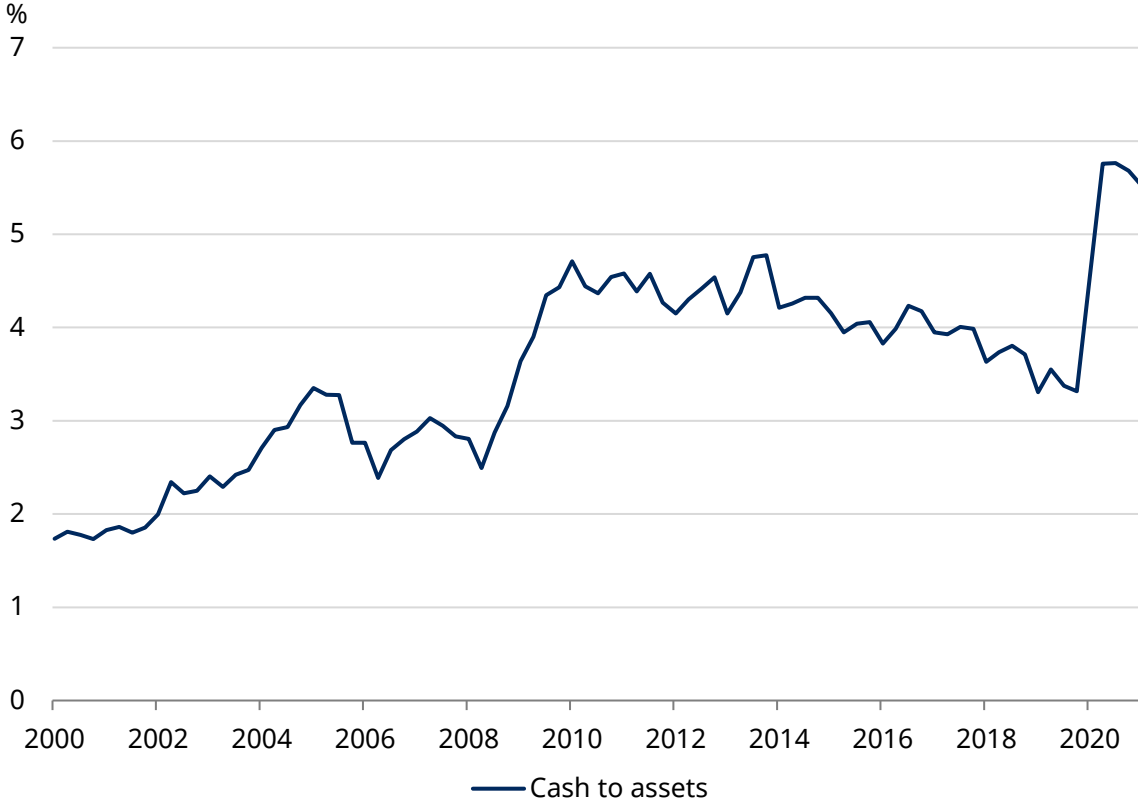
Cash on balance sheets finally fell in Q1

The end of cash hoarding?

US IG cash to short term debt



US IG cash to assets



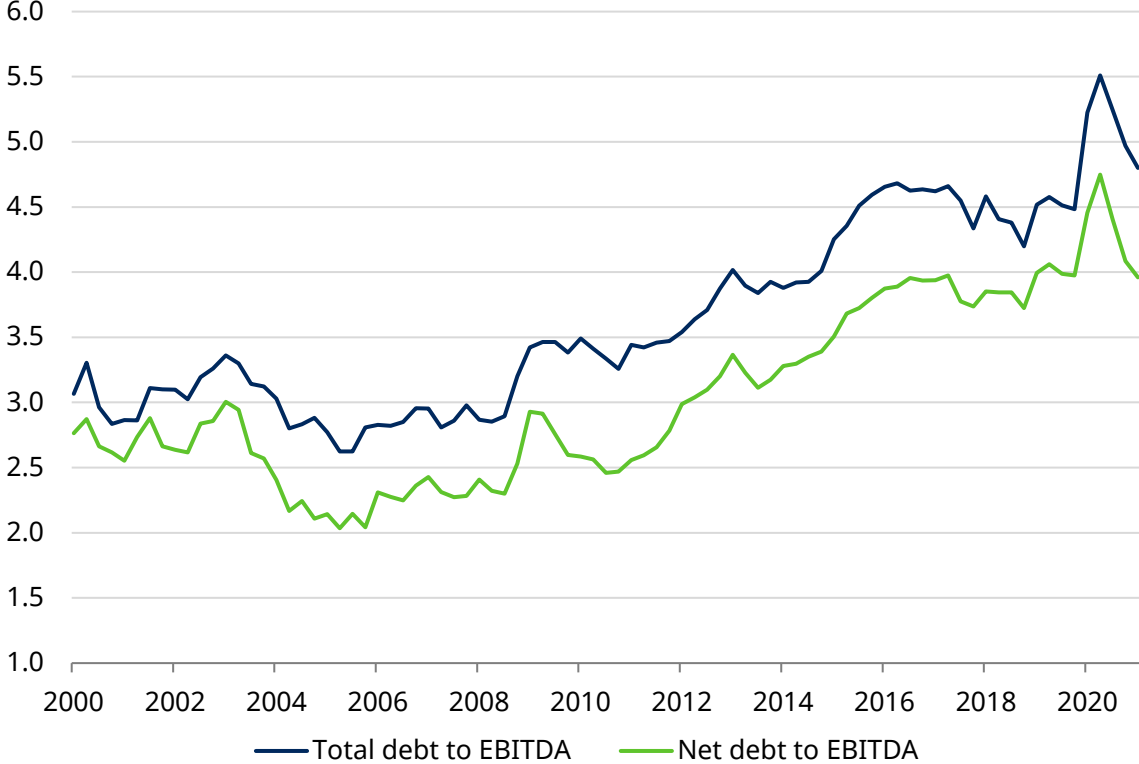
Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q1 2021.

US HY leverage has made an impressive reversal

Ex-energy net leverage is now lower than pre-Covid

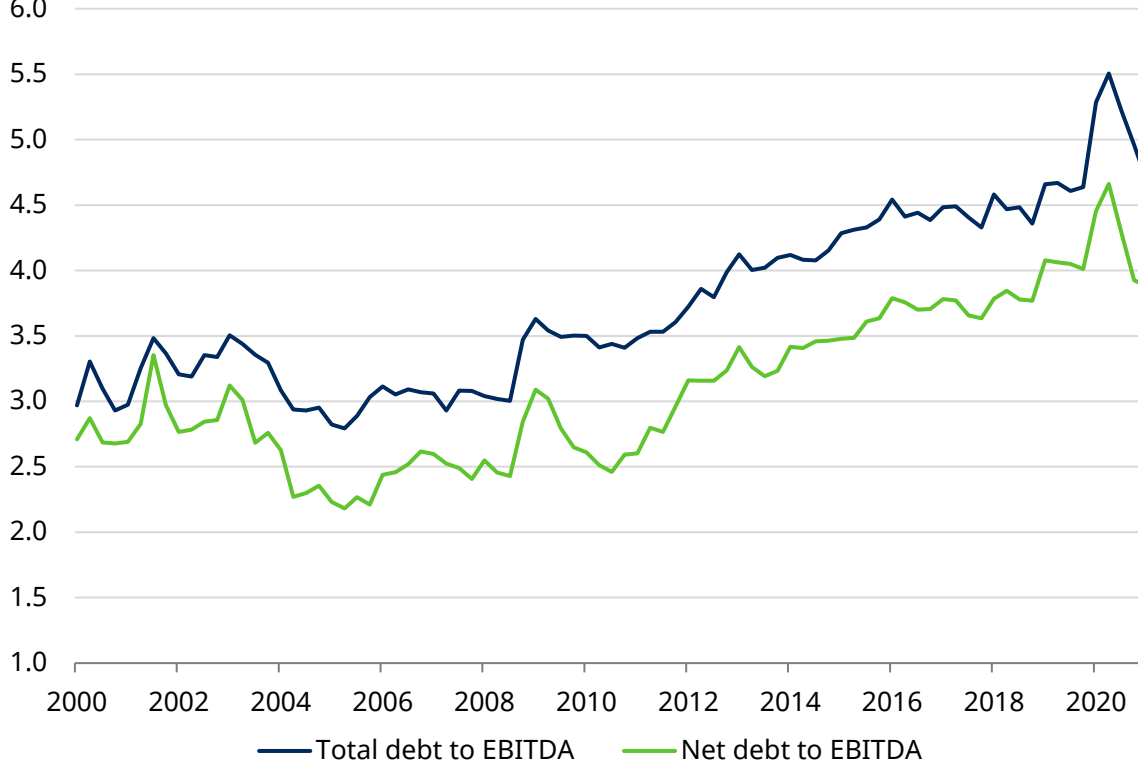
US HY leverage

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 Q1 2021.

US HY interest coverage ratio

US HY interest coverage ratio

Last twelve months EBITDA to interest expense



US HY cost of debt

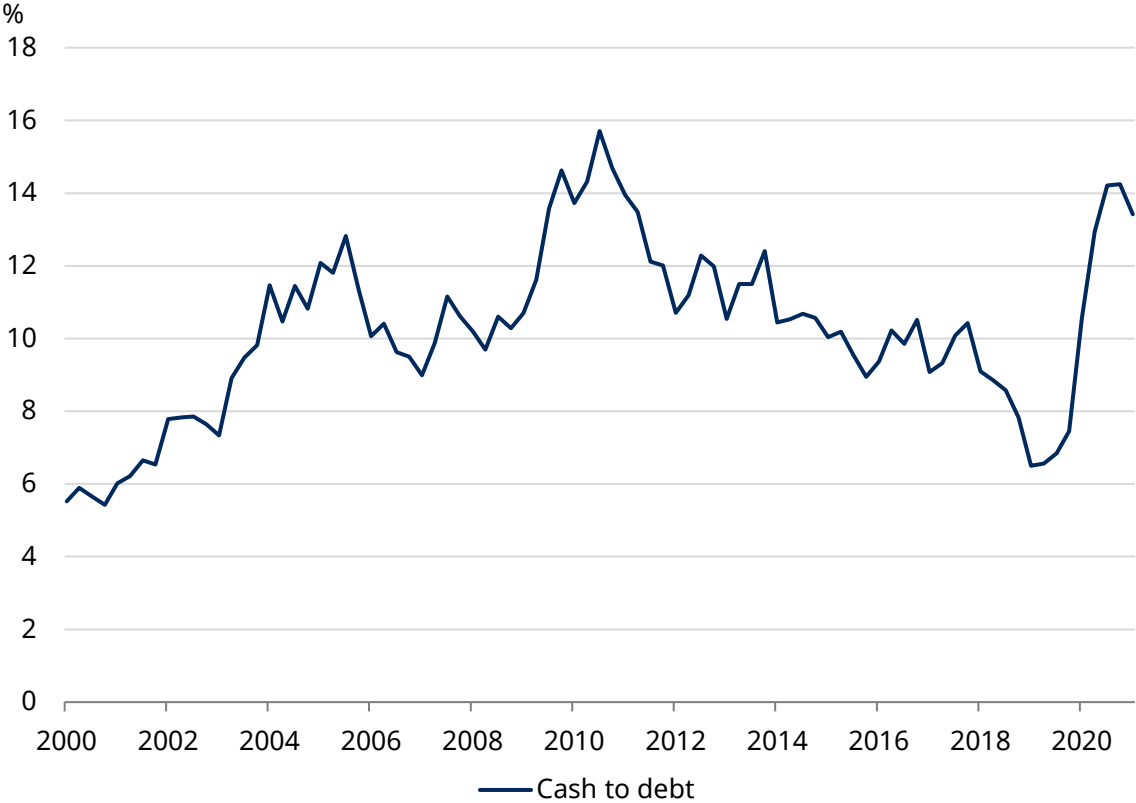


Interest coverage has started to improve; rebounding EBITDA should continue to be a tailwind

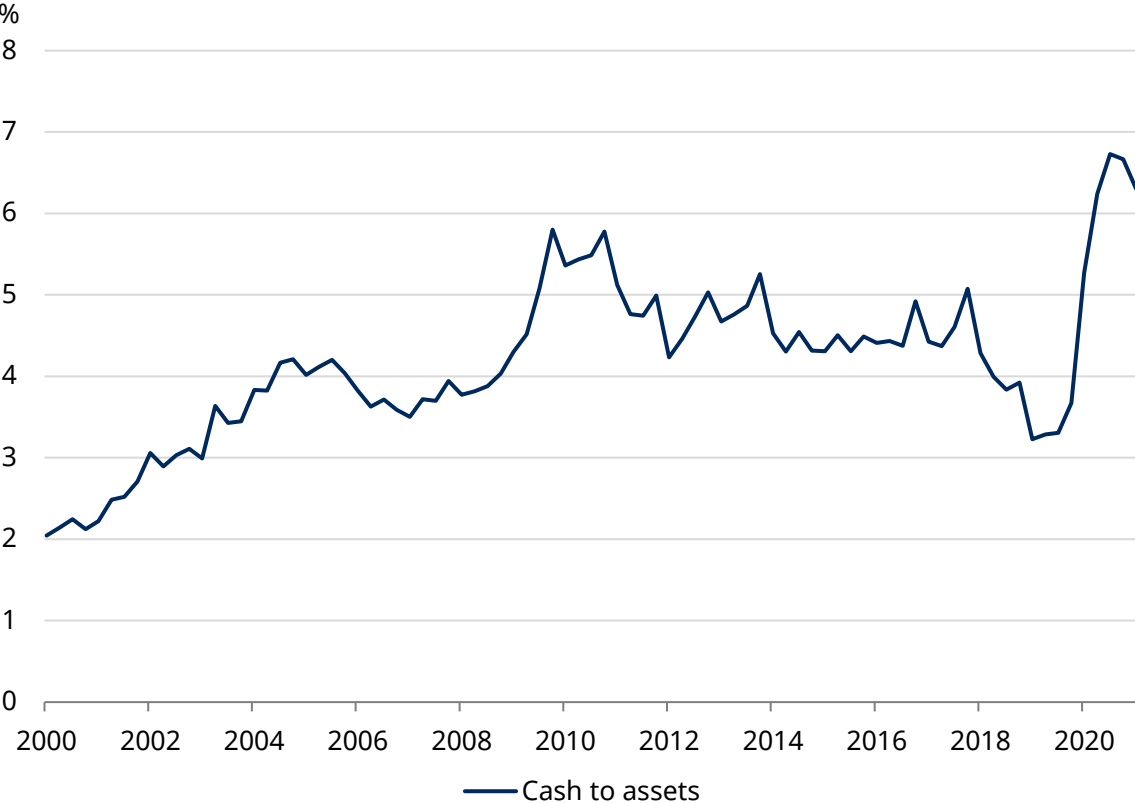
Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as at Q1 2021.

US HY cash levels finally starting to fall

US HY cash to debt



US HY cash to assets

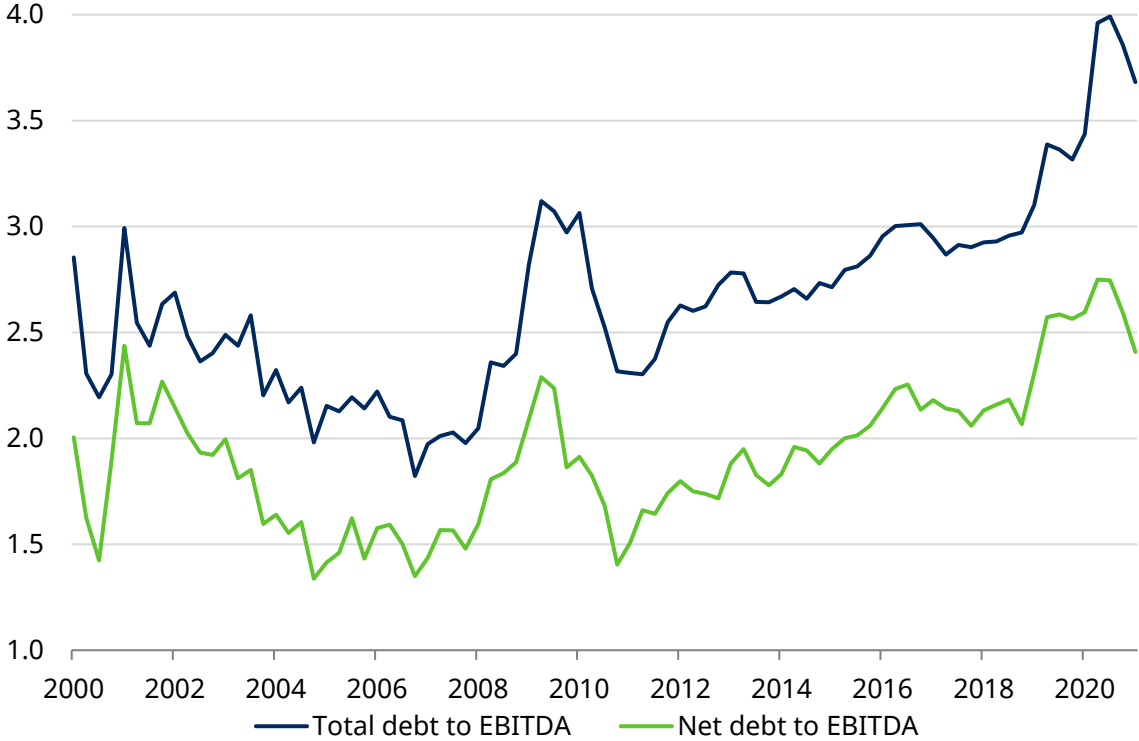


Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q1 2021.

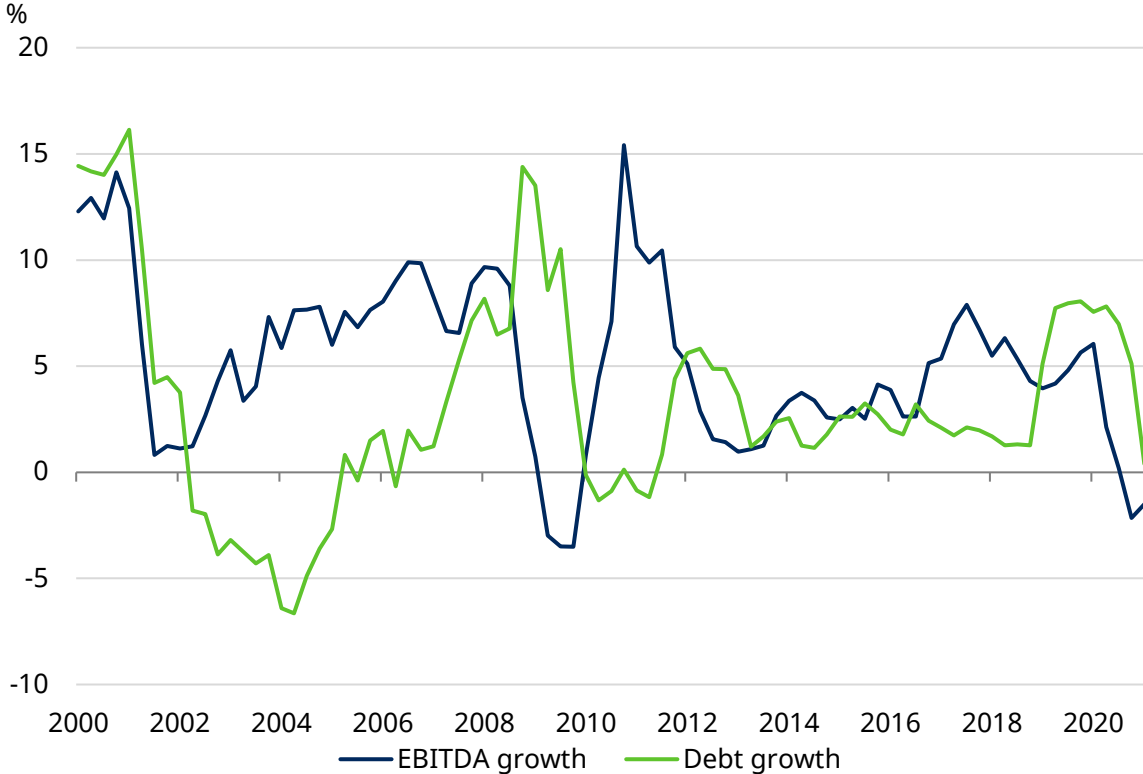
Euro IG leverage is falling

Euro IG leverage

Debt to last twelve months EBITDA



Euro IG EBITDA and debt growth (last twelve months)



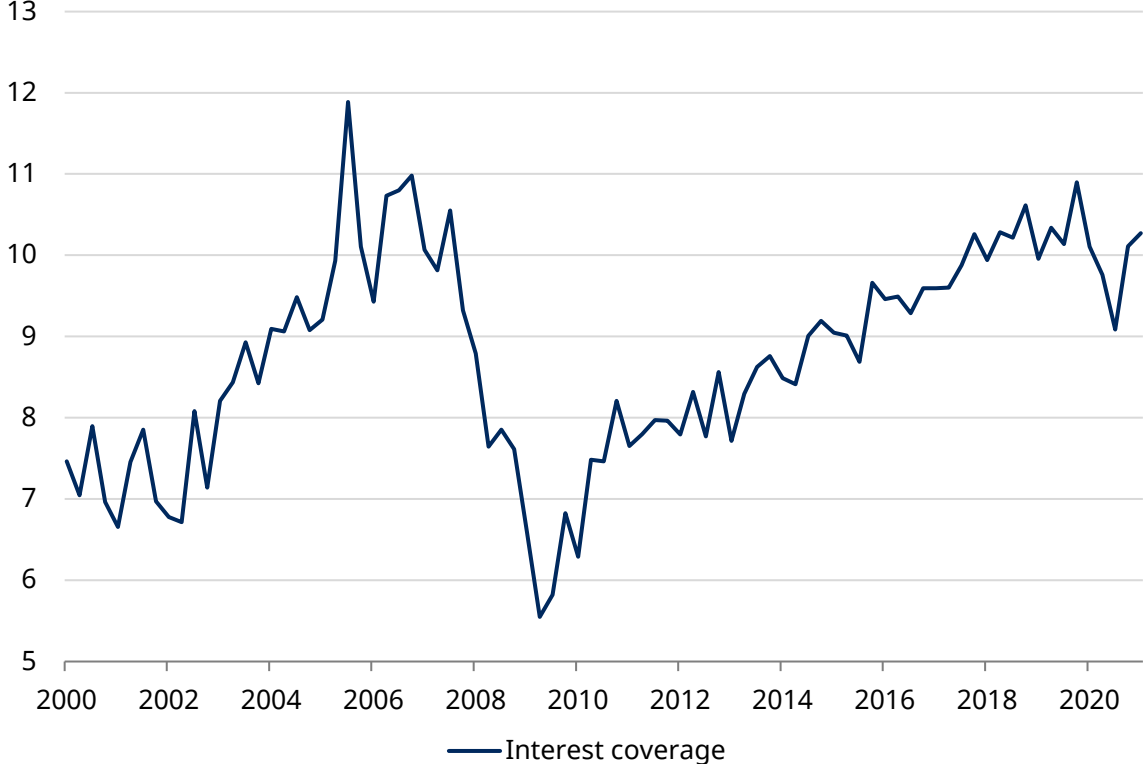
Net leverage is now lower than pre-COVID, implying that companies have not spent most of the emergency borrowing

Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as at Q1 2021.

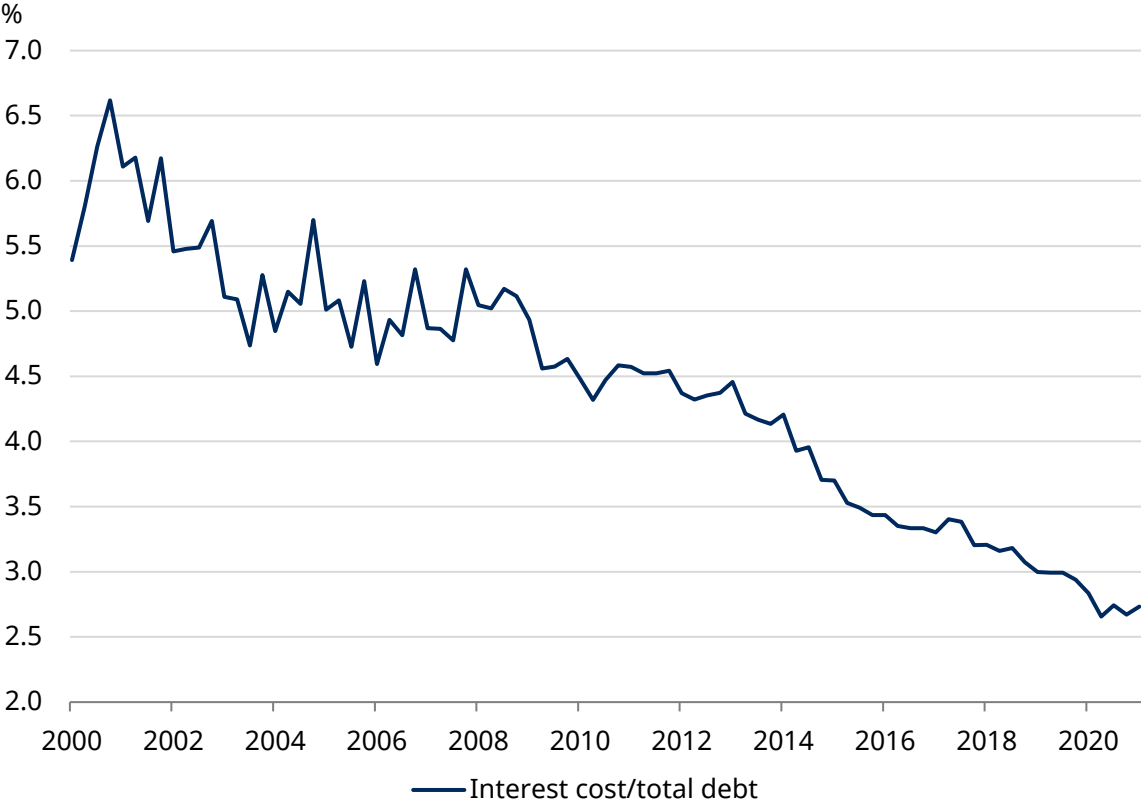
Euro IG interest coverage is rebounding swiftly

Euro IG interest coverage ratio¹

last twelve months EBITDA to interest expense



Euro IG cost of debt



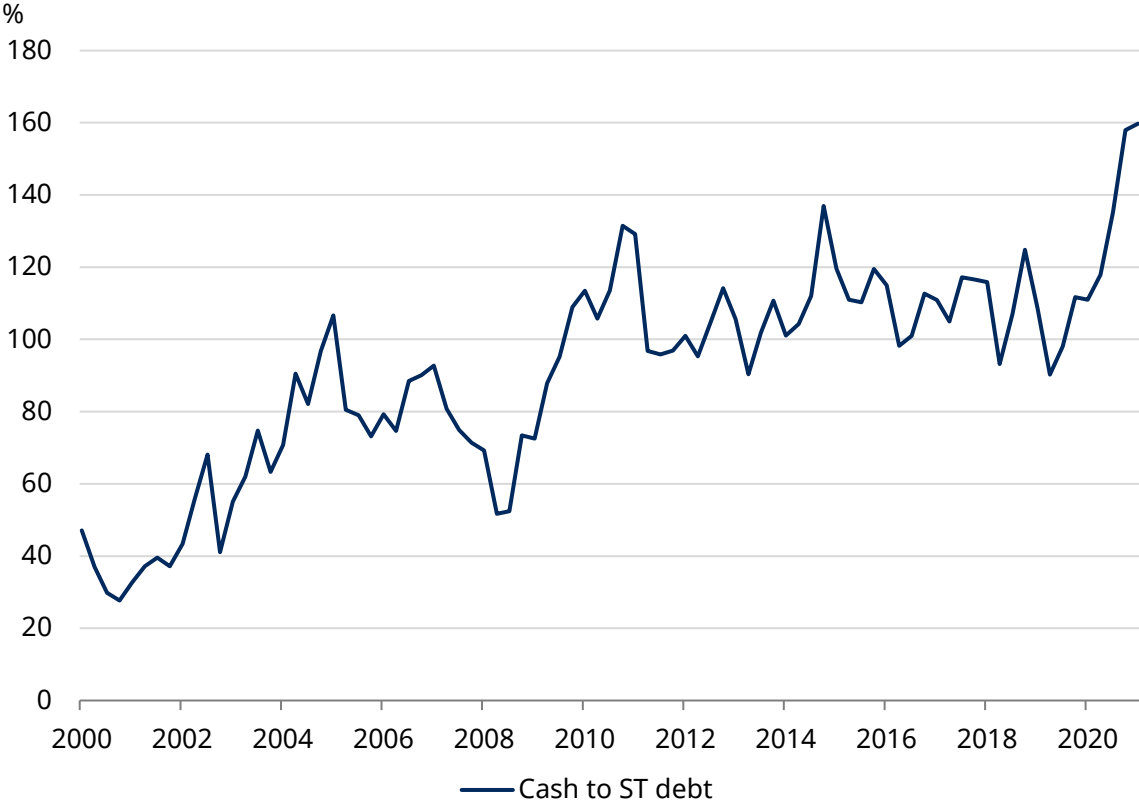
Interest coverage is significantly higher than in US, driven by lower cost of debt in the euro area

Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as at Q1 2021. ¹Calculated as last twelve month EBITDA divided by interest expense on the income statement

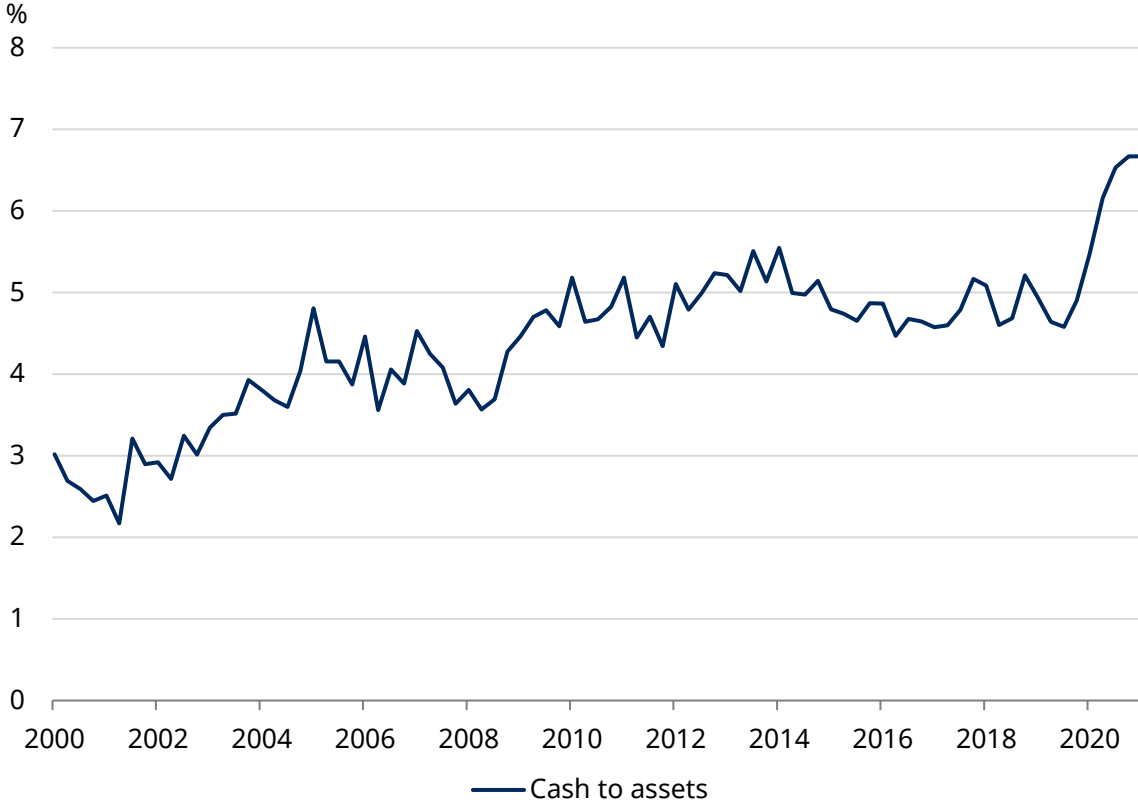
Cash levels have stabilised but remain elevated

Cash to short term debt at record high level

Euro IG cash to short term debt



Euro IG cash to assets



Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q1 2021.

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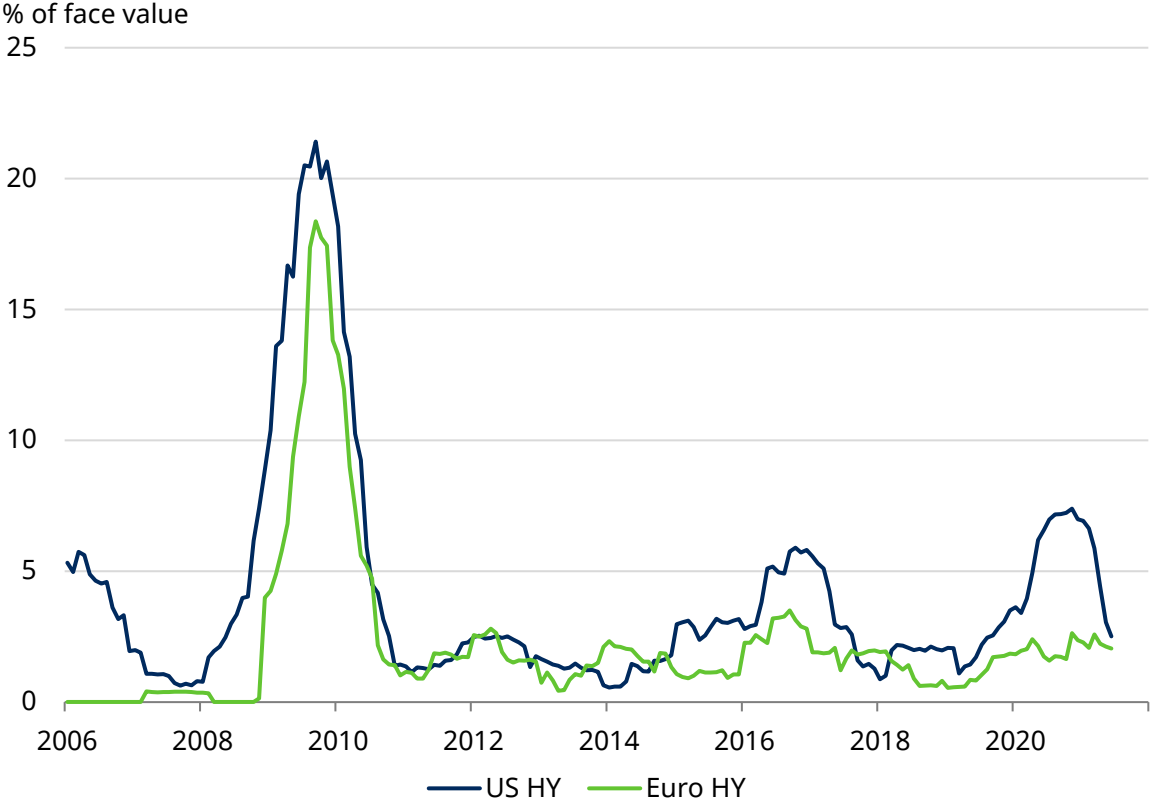


Corporate credit

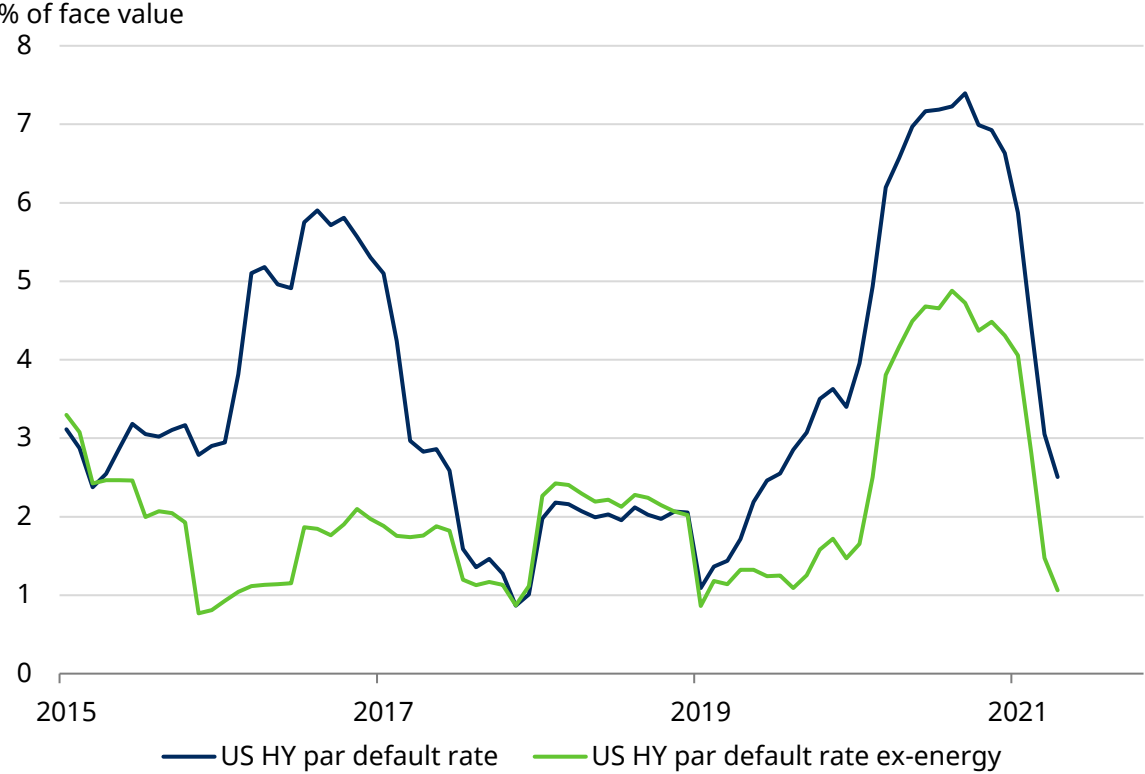
Technicals

HY default rates

HY par default rate (last 12 months)



US HY par default rate (last 12 months)



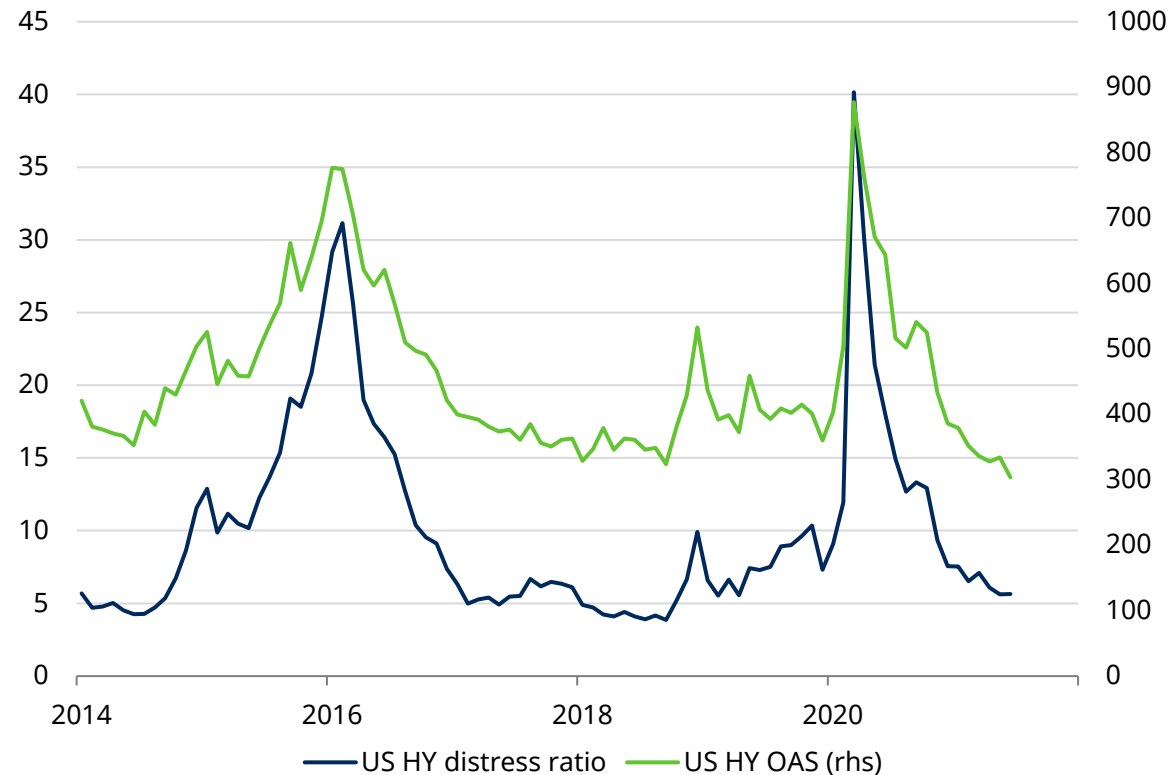
US HY ex-energy default rate at just 1%; Euro HY default rate remains muted

Source: Schroders, BofA Global Research, Moody's. Data as at 30 June 2021.

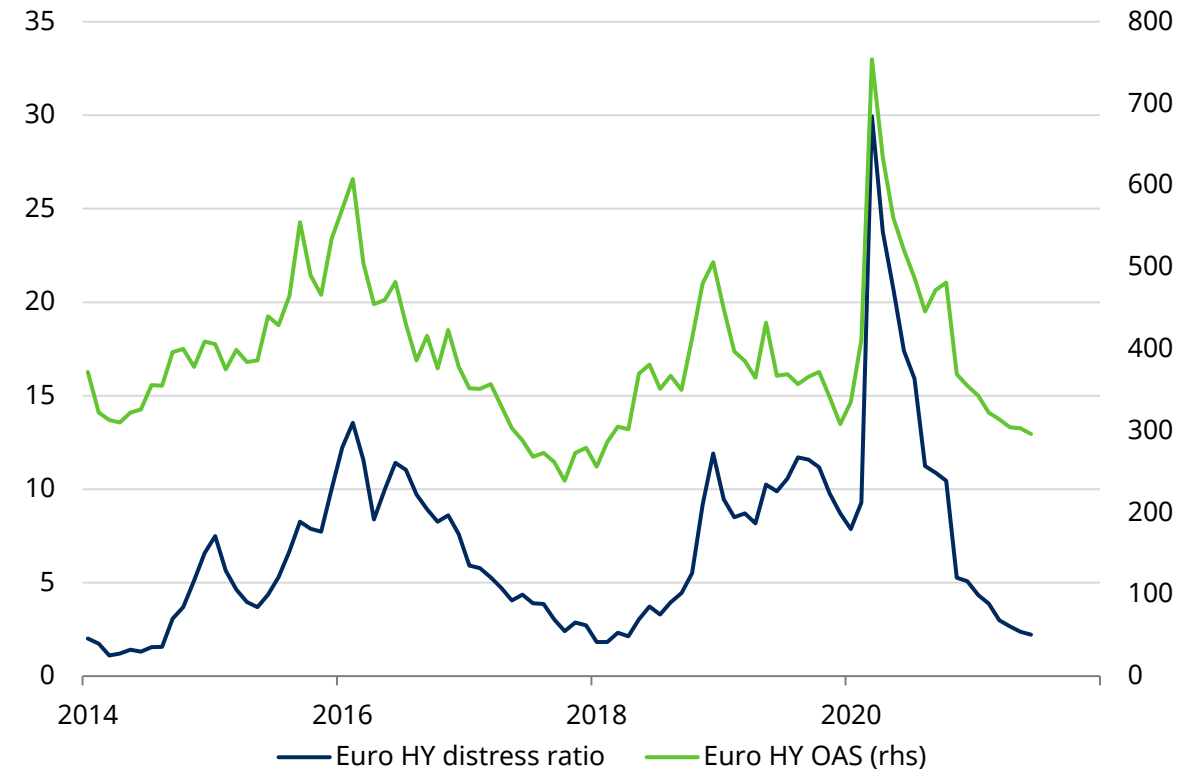
HY distress ratios

Harbinger of defaults

US HY distress ratio¹



Euro HY distress ratio¹



HY distress ratios are very low

Source: Schroders, BofA Global Research, Moody's. Data to 30 June 2021.

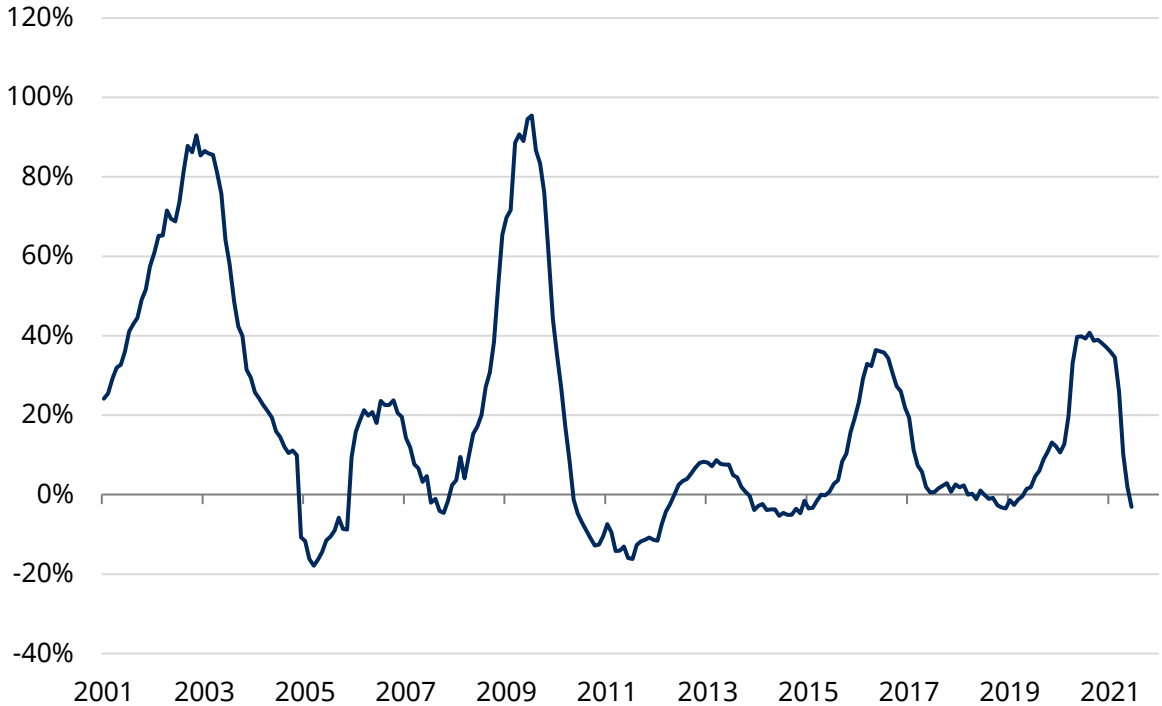
¹HY distress is defined as percentage of issues in the index trading with spreads > 1,000bp.

US HY ratings migration (net downgrades)

Indicator of changes in credit quality

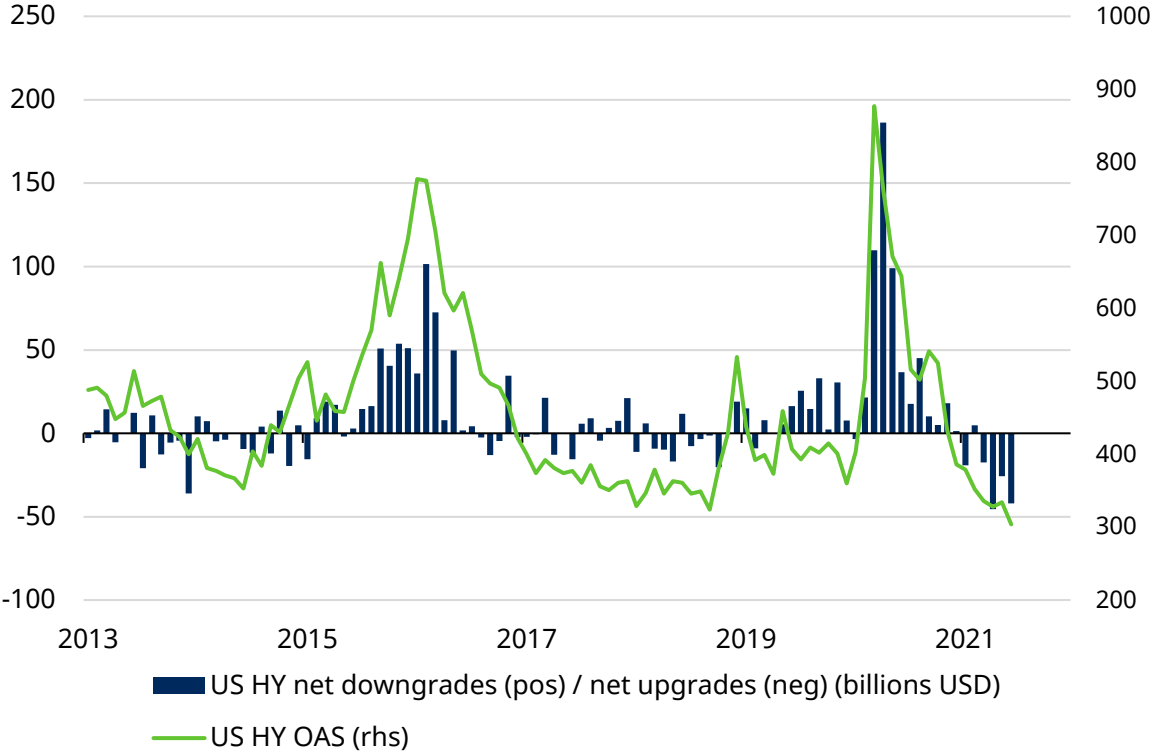
US HY net downgrades¹

Percentage of the HY index, last 12 months



US HY monthly net downgrades

Billions USD



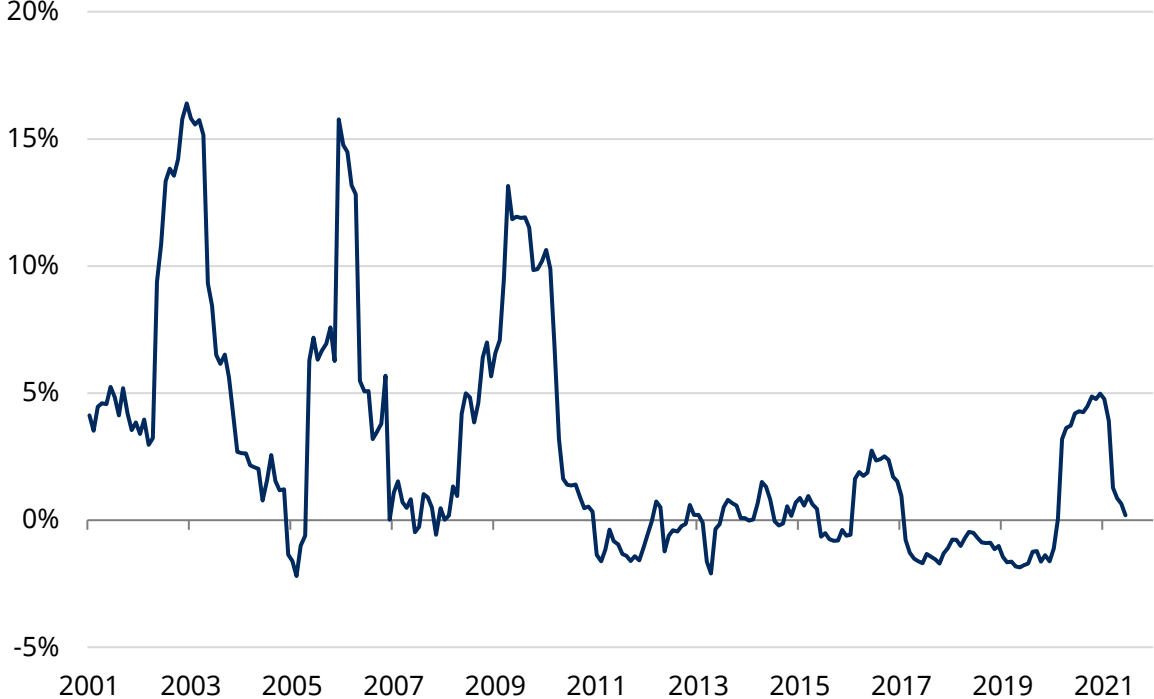
Source: BofA Global Research, Refinitiv Datastream. Data as at 30 June 2021. ¹Face value of downgraded bonds minus face value of upgraded bonds divided by face value of the index.

US IG fallen angels

Bonds downgraded from IG to HY

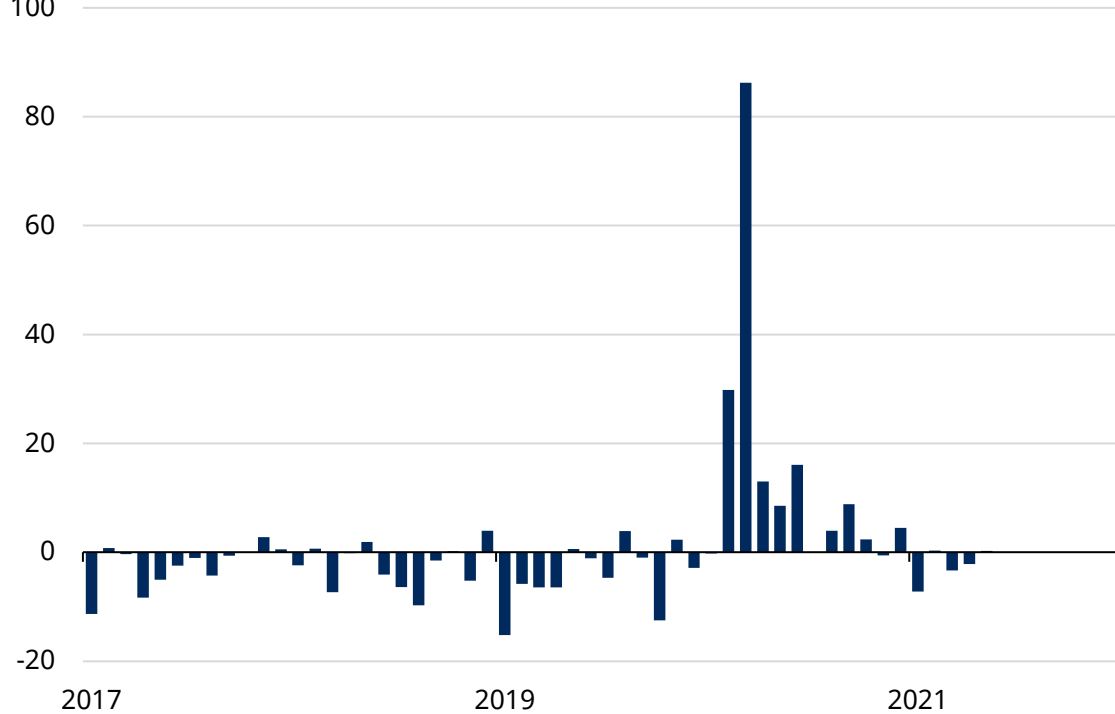
US IG net fallen angels

Percentage of the BBB index, last 12 months



US IG monthly net fallen angels

Billions USD

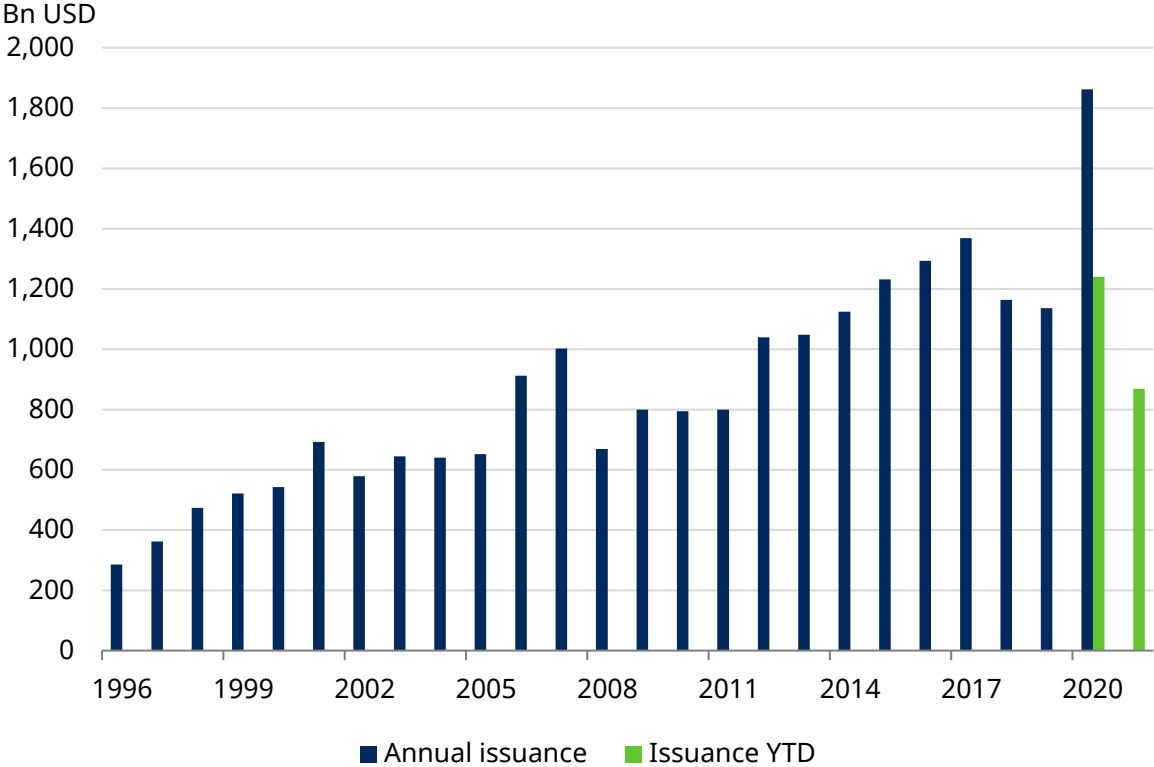


Upgrades from HY to IG could increase as the recovery gathers pace

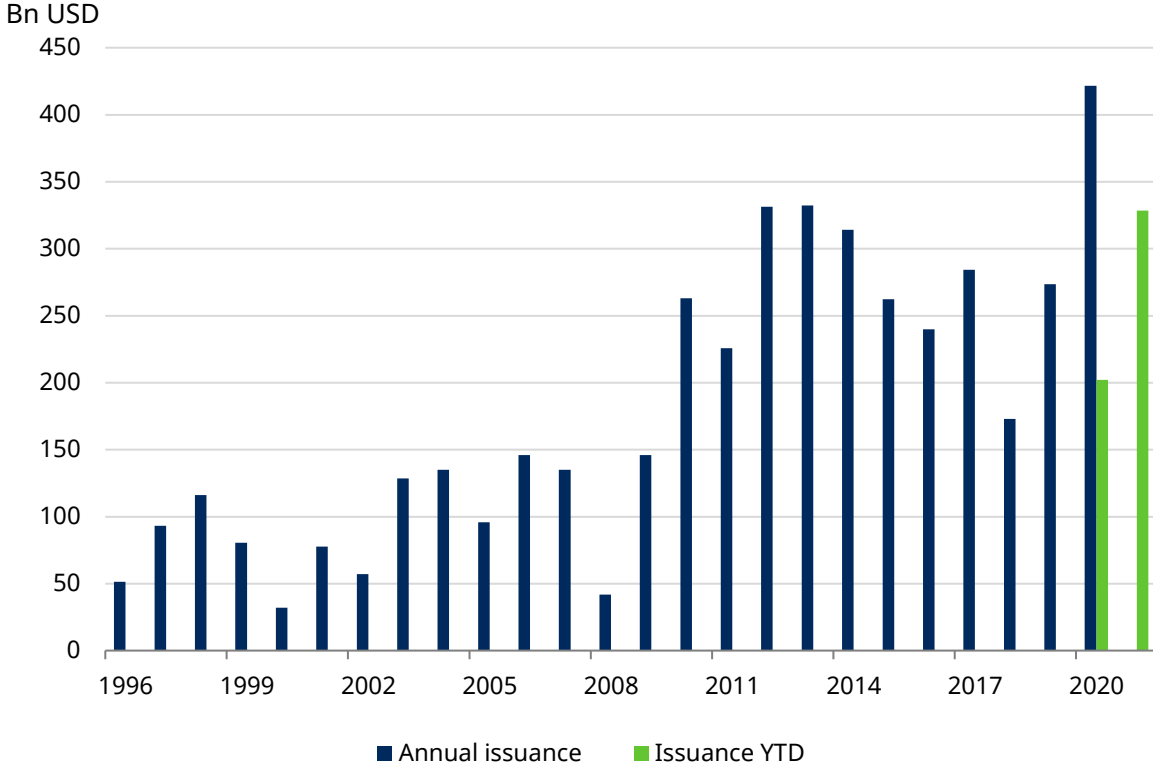
Source: BofA Global Research. Data as at 30 June 2021.

US IG and HY gross issuance

US IG issuance



US HY issuance

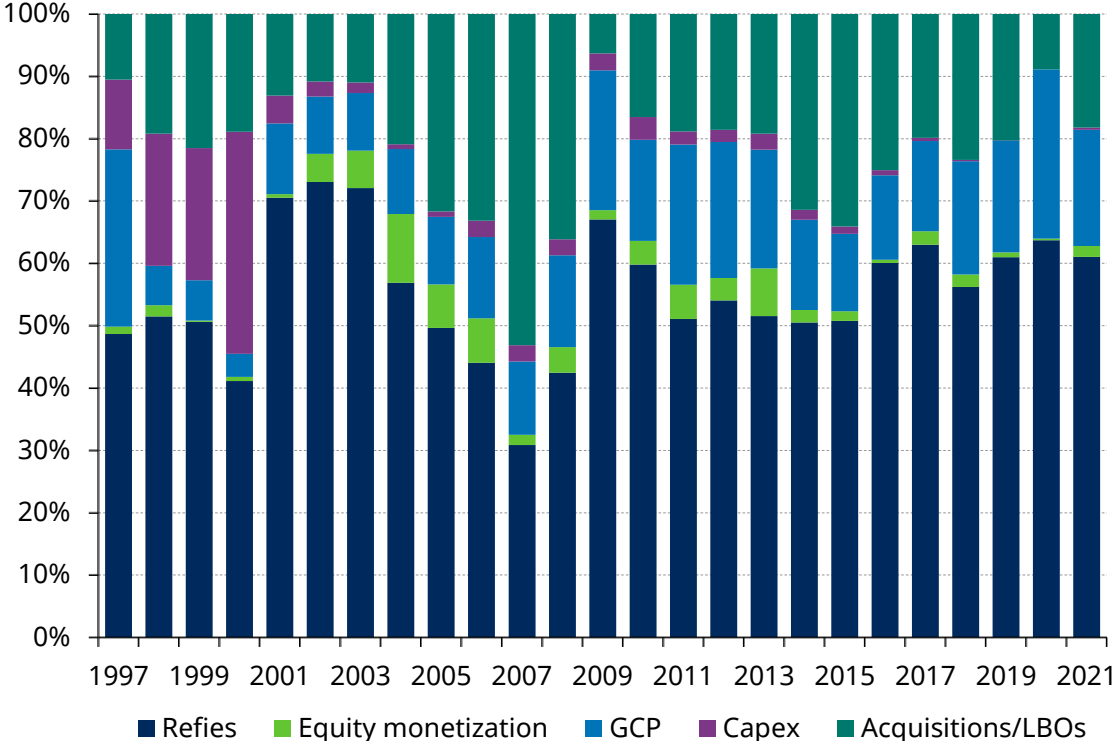


US HY issuance at \$328 billion in the first half of 2021 is more than the full-year level of 2019

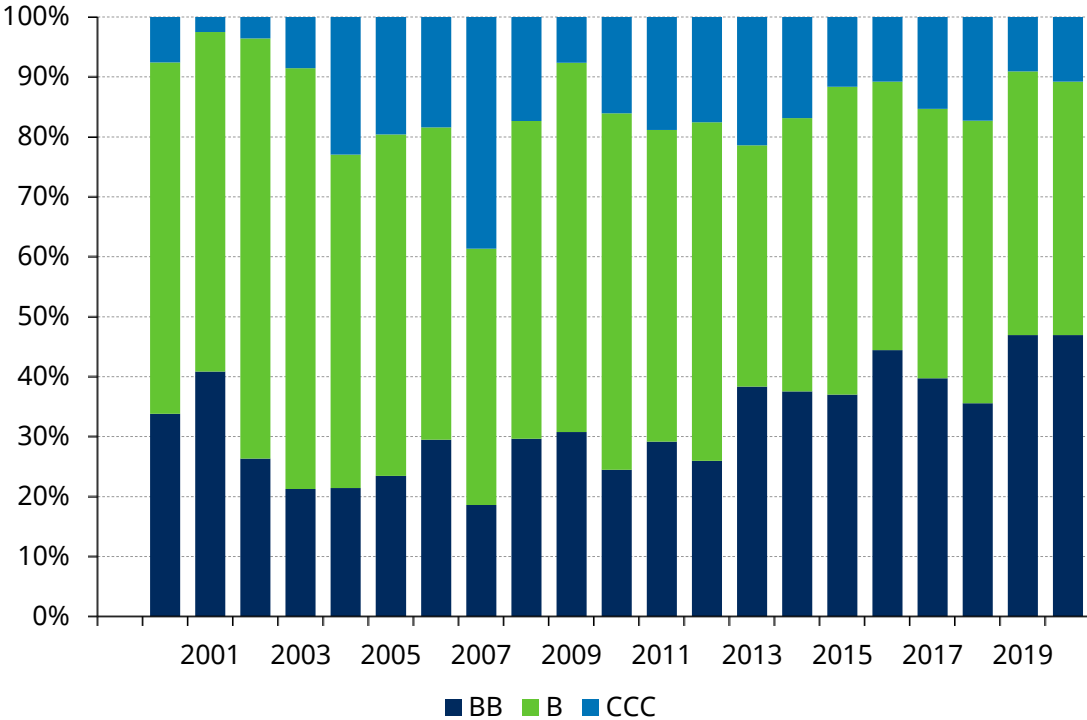
Source: Sifma. Data as at 30 June 2021.

US HY issuance details

Use of proceeds (percentage of issuance)



Issuance by rating (percentage of issuance)



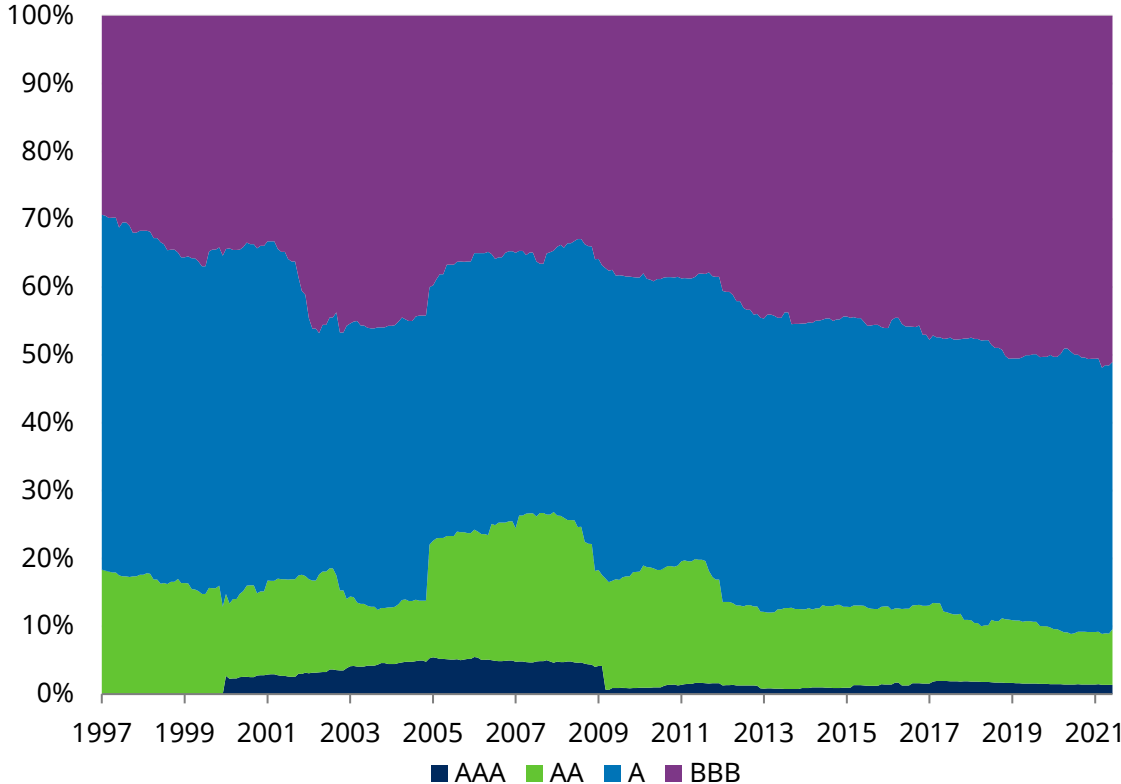
Issuance quality has started to worsen slightly with higher acquisition/buyout and CCC issuance

Source: Schrodgers, BofA Global Research, Moody's. Data as at 30 June 2021. GCP is general corporate purposes, Refies is refinancings, Equity monetization is replacing equity capital with debt

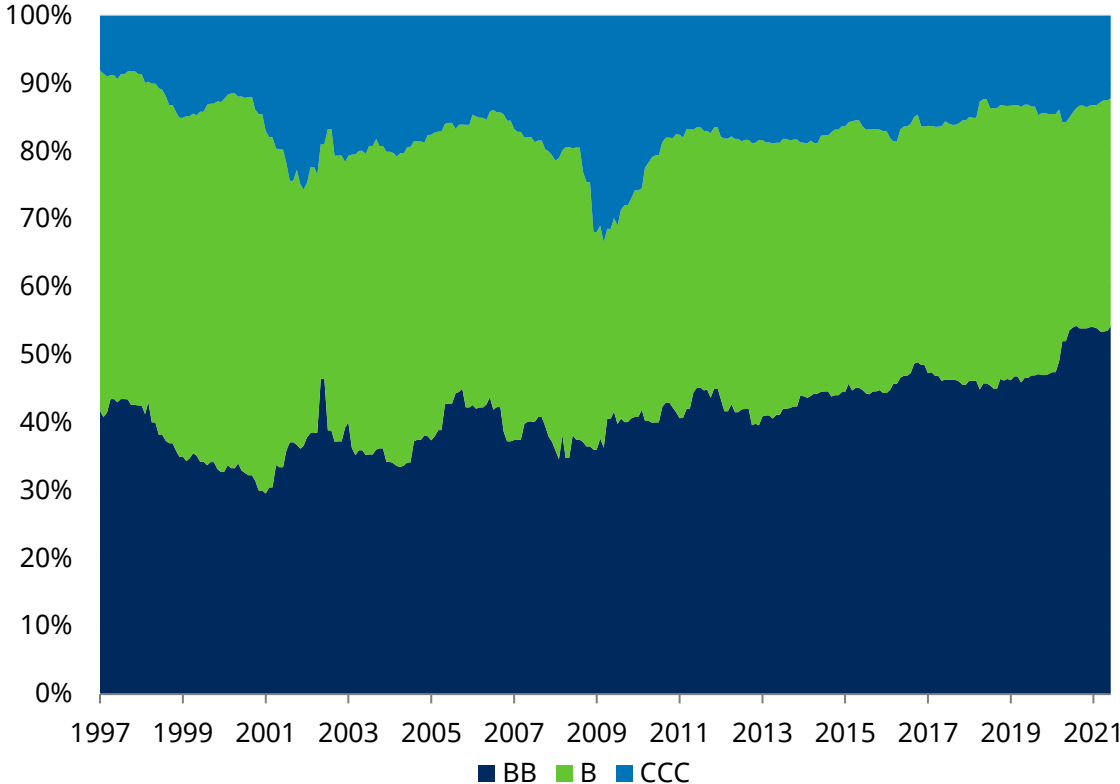
US dollar credit historical ratings split

Significant changes in credit quality over time

US IG ratings split



US HY ratings split



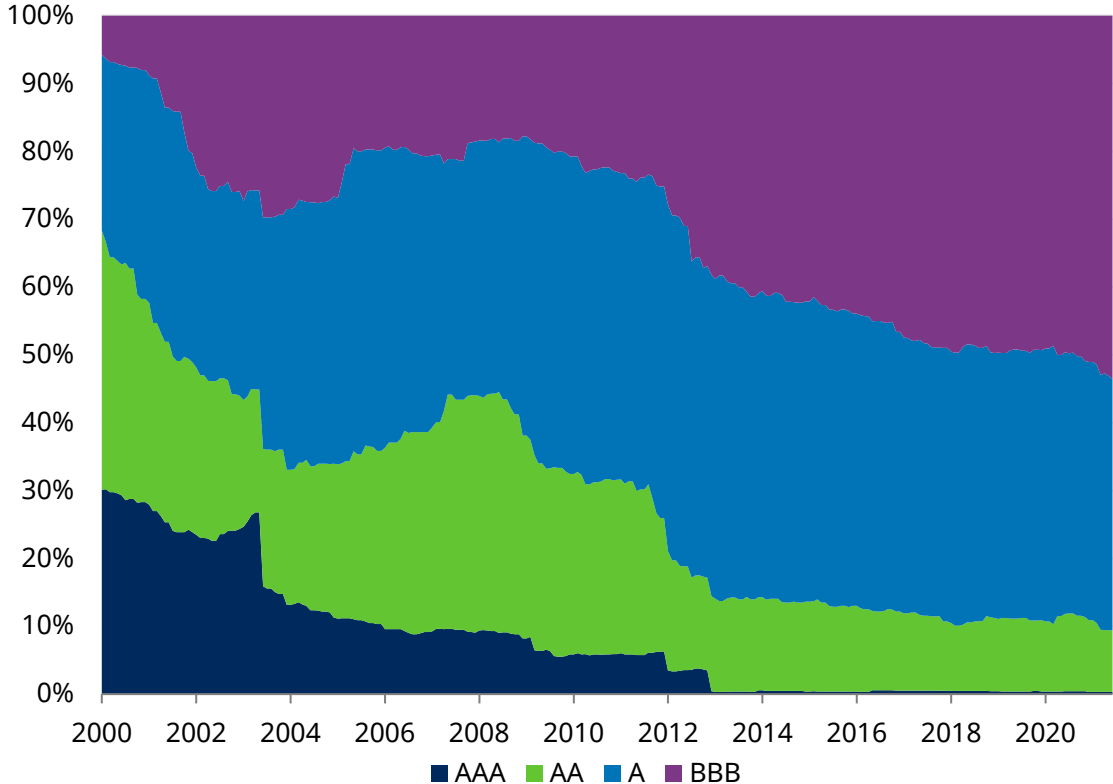
HY credit quality improved in 2020 because of the inclusion of downgraded IG bonds

Source: Schroders, ICE Data Indices. Data as at 30 June 2021.

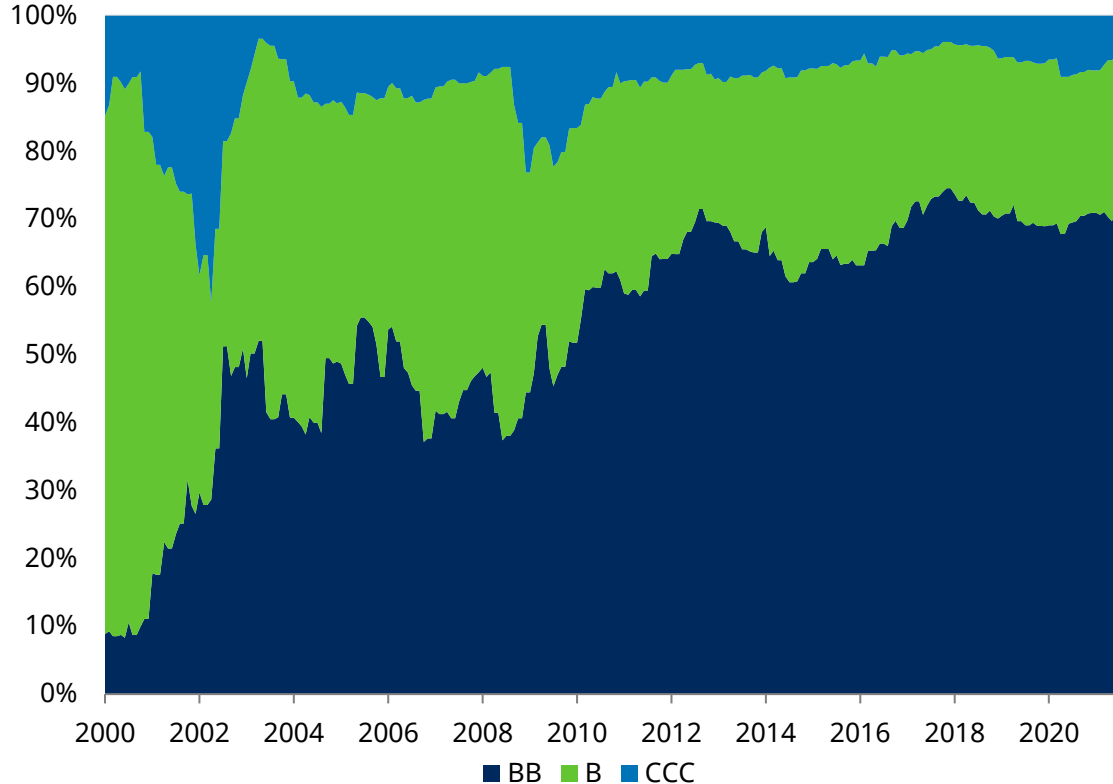
Euro credit historical ratings split

Significant changes in credit quality over time

Euro IG ratings split



Euro HY ratings split



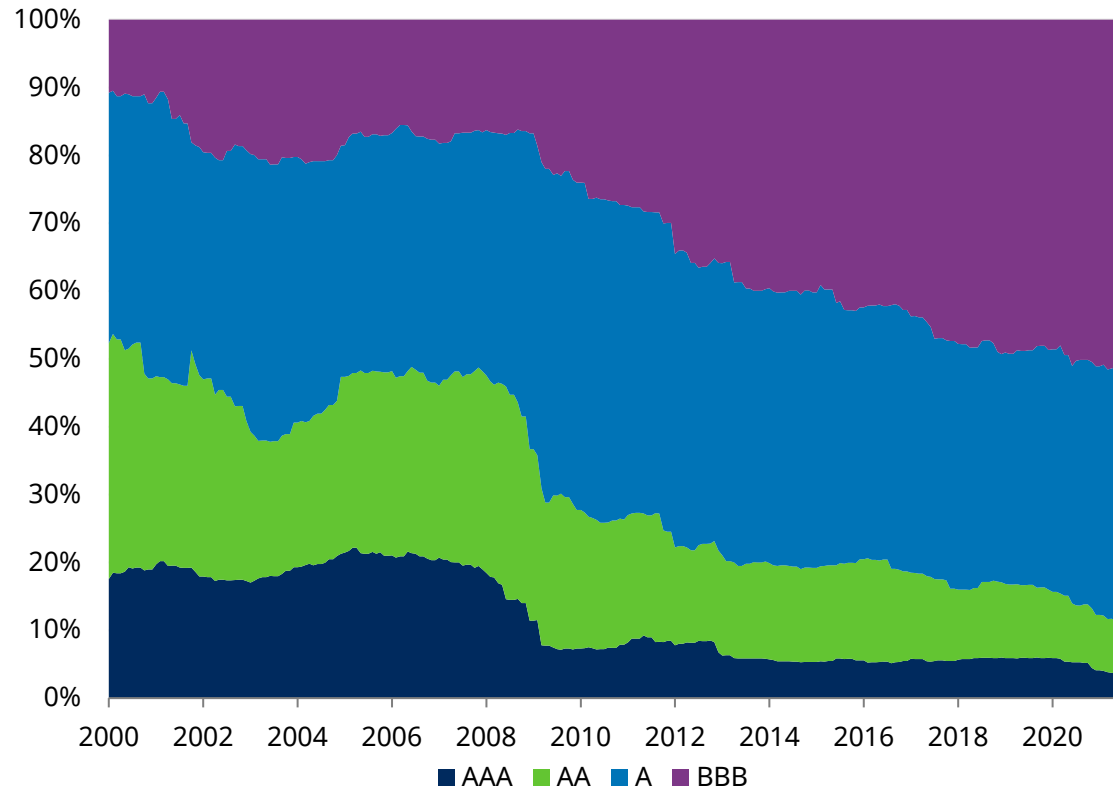
IG credit quality has worsened in the pandemic

Source: Schroders, ICE Data Indices. Data as at 30 June 2021.

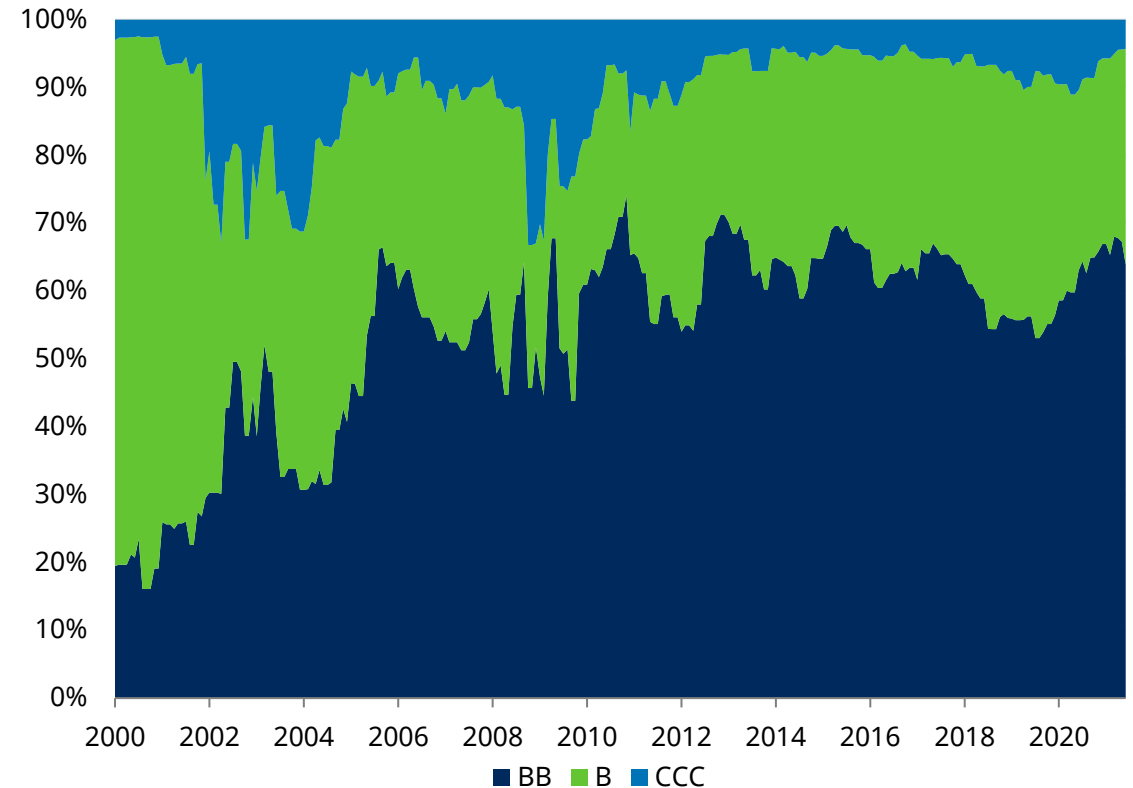
Sterling credit historical ratings split

Significant changes in credit quality over time

GBP IG ratings split



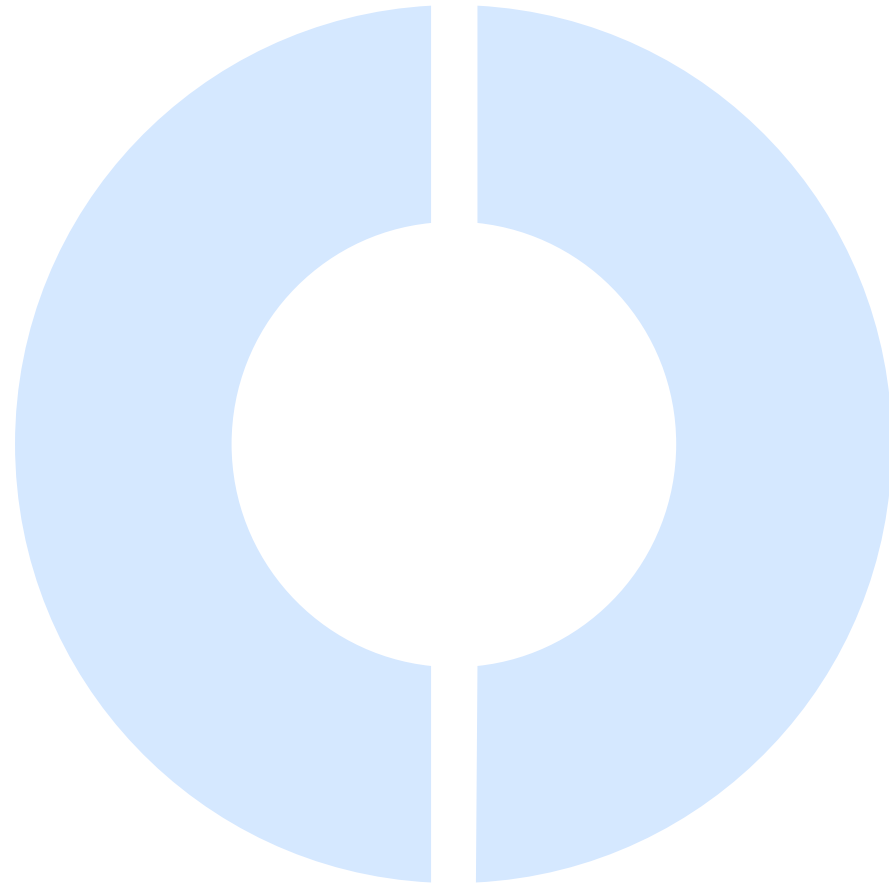
GBP HY ratings split



IG credit quality continues to worsen whereas HY quality is improving

Source: Schroders, ICE Data Indices. Data as at 30 June 2021.

Schroders



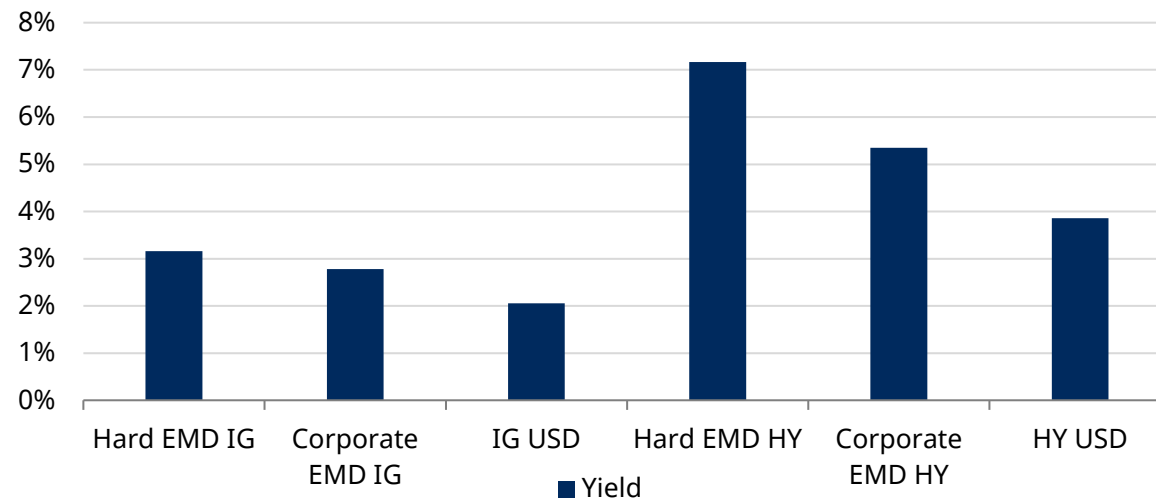
Emerging Market Debt

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	3.2%	2.8%	2.1%	7.2%	5.3%	3.9%
Spread (bps)	150	149	86	582	446	304
Duration	9.2	5.4	8.4	6.4	3.2	5.3
Rating	A3	BBB1	A3	B1	B1	B1
Percentage of EMD index	52.9%	56.5%	-	47.1%	43.5%	-

Yield



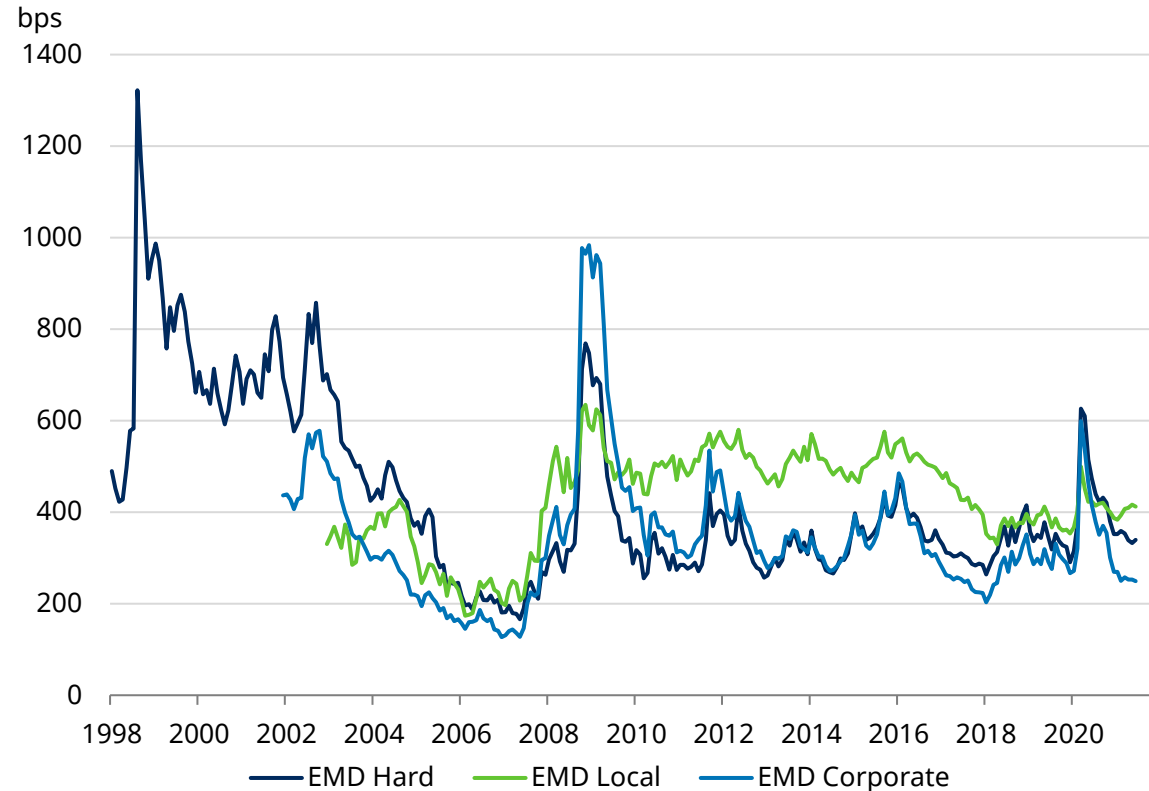
- Allocation to hard-currency EMD is a combination of IG and HY allocations
- Corporate EMD IG rating is one notch below US IG, EMD Hard IG rating is on par with US IG
- Hard EMD HY and Corporate EMD HY ratings are on par with US HY
- **Besides valuations, the decision between EMD (dollar-denominated)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

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 June 2021.

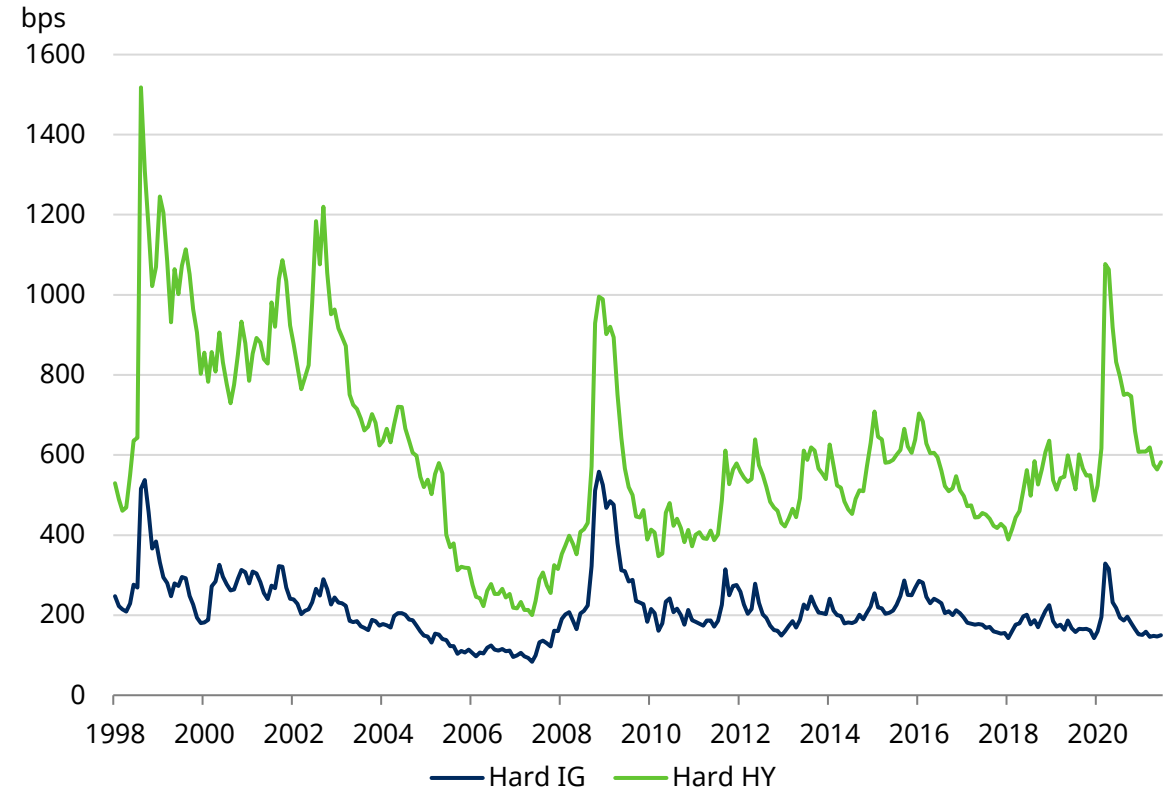
Valuation EMD

Historical spreads

EMD spreads



EMD Hard IG and HY spreads



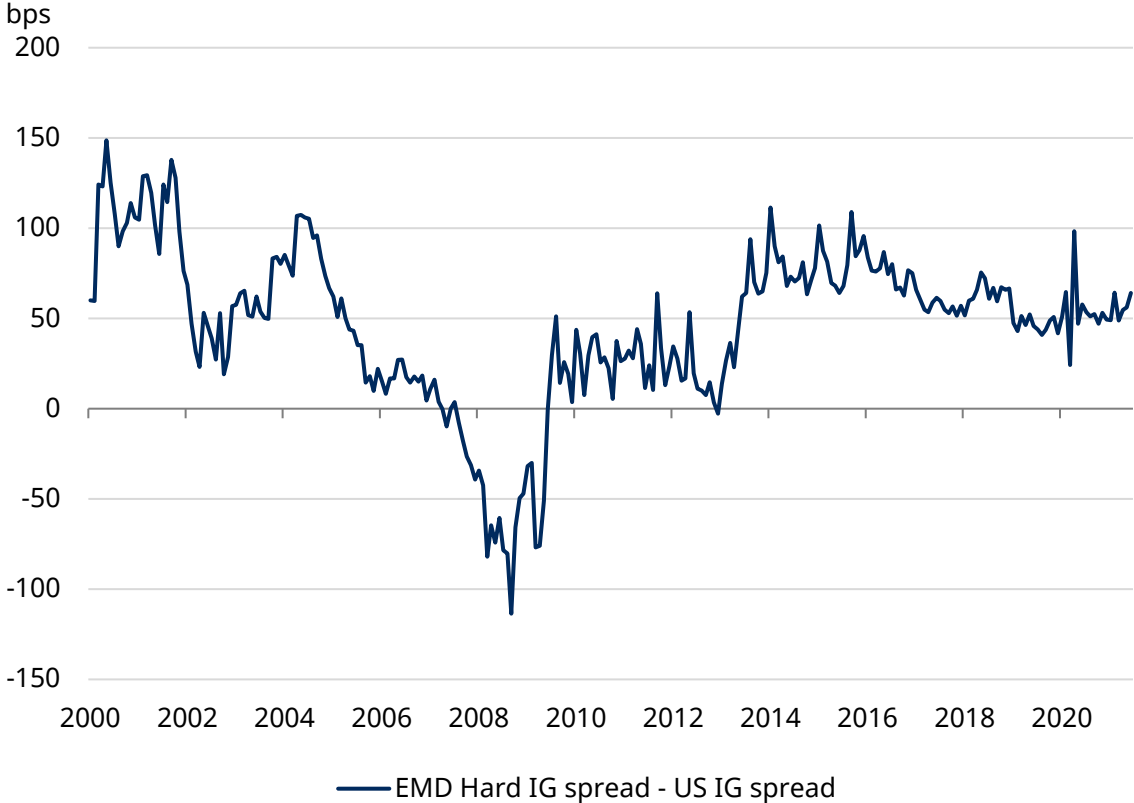
EMD Hard HY spread is still well above the pre-Covid level

Source: Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 June 2021.

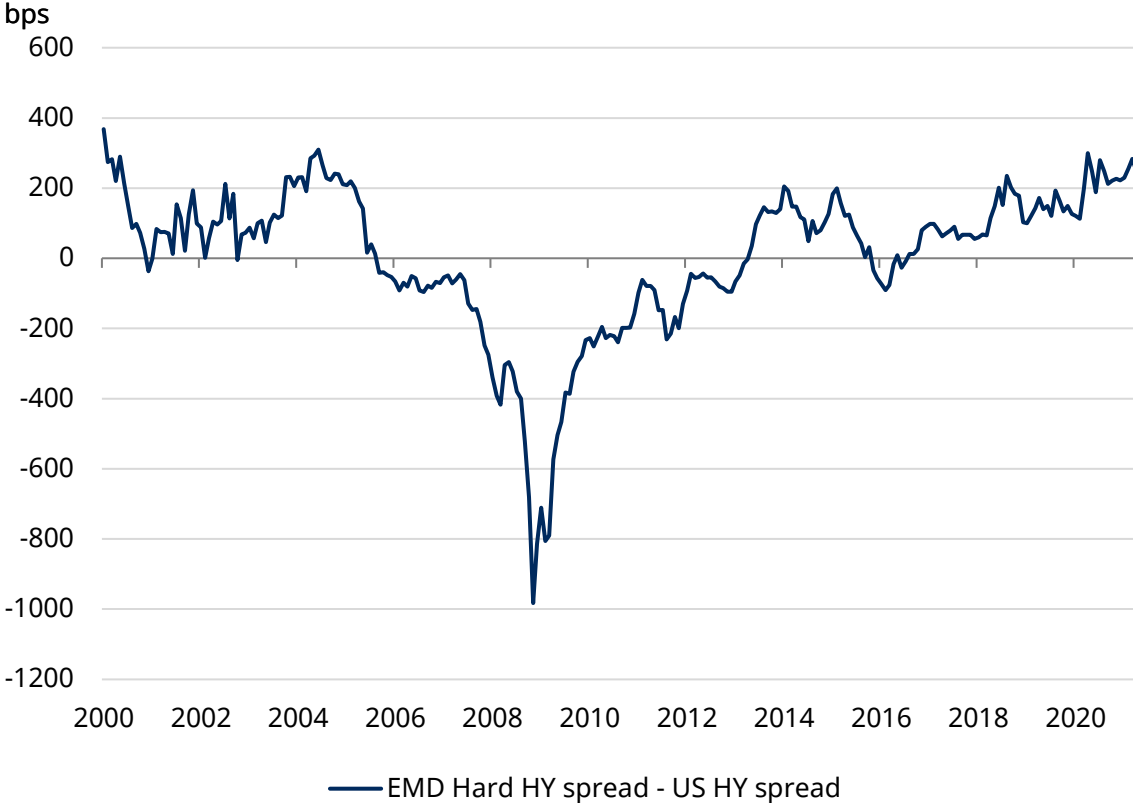
EMD Local is not a spread product, the spread is manually calculated relative to treasuries of approximately equivalent duration.

Dollar debt: EMD Hard vs. US Corporates

EMD Hard IG spread minus US IG spread



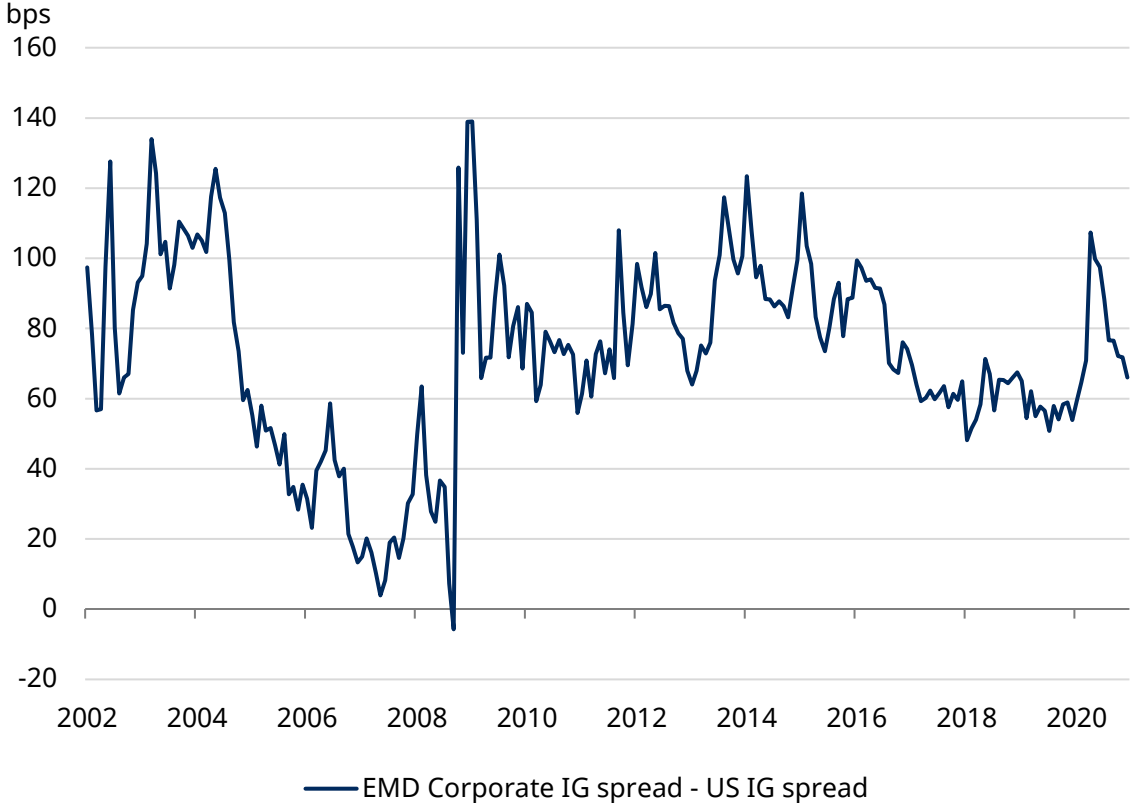
EMD Hard HY spread minus US HY spread



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 June 2021.

Dollar debt: EMD Corporates vs. US Corporates

EMD Corporate IG spread minus US IG spread



EMD Corporate HY spread minus US HY spread

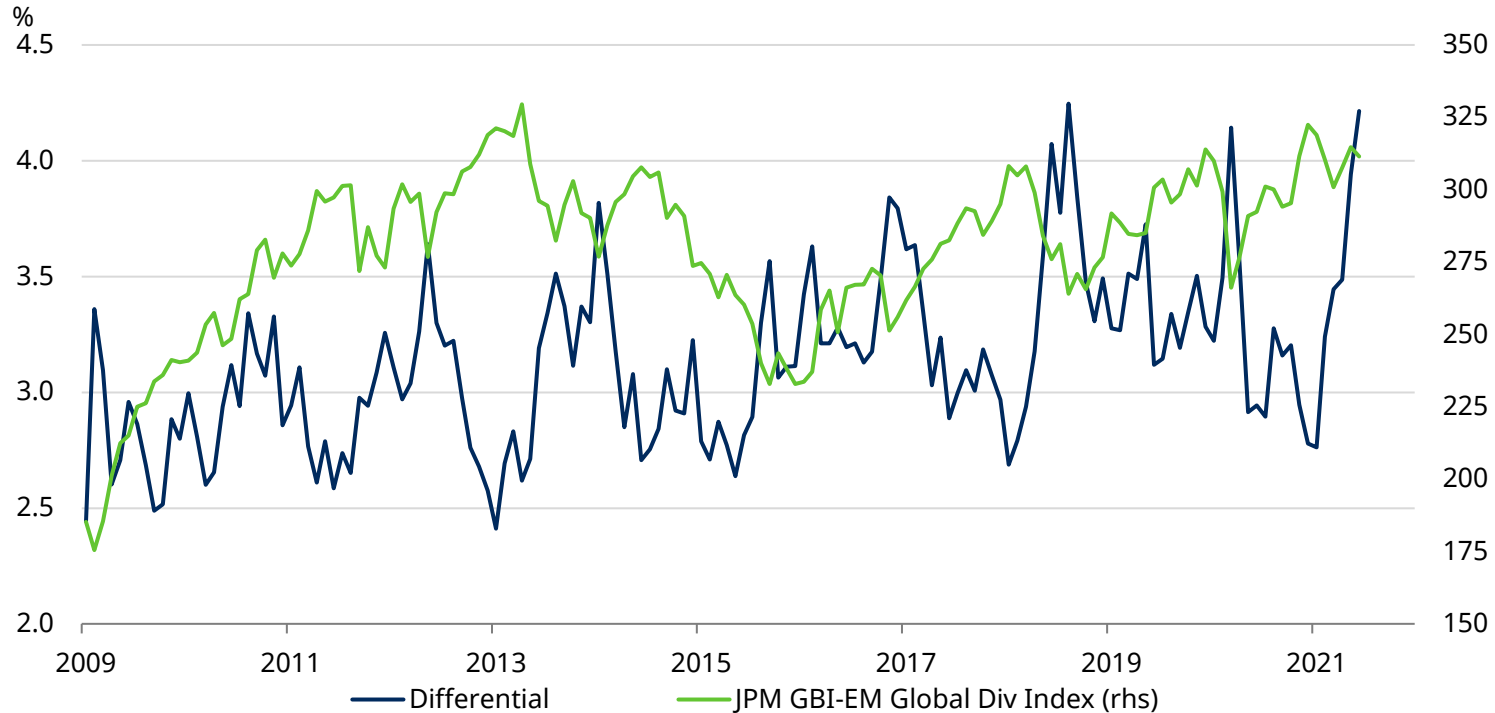


Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 June 2021.

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

Real yield differential implies significant premium for local currency EM bonds

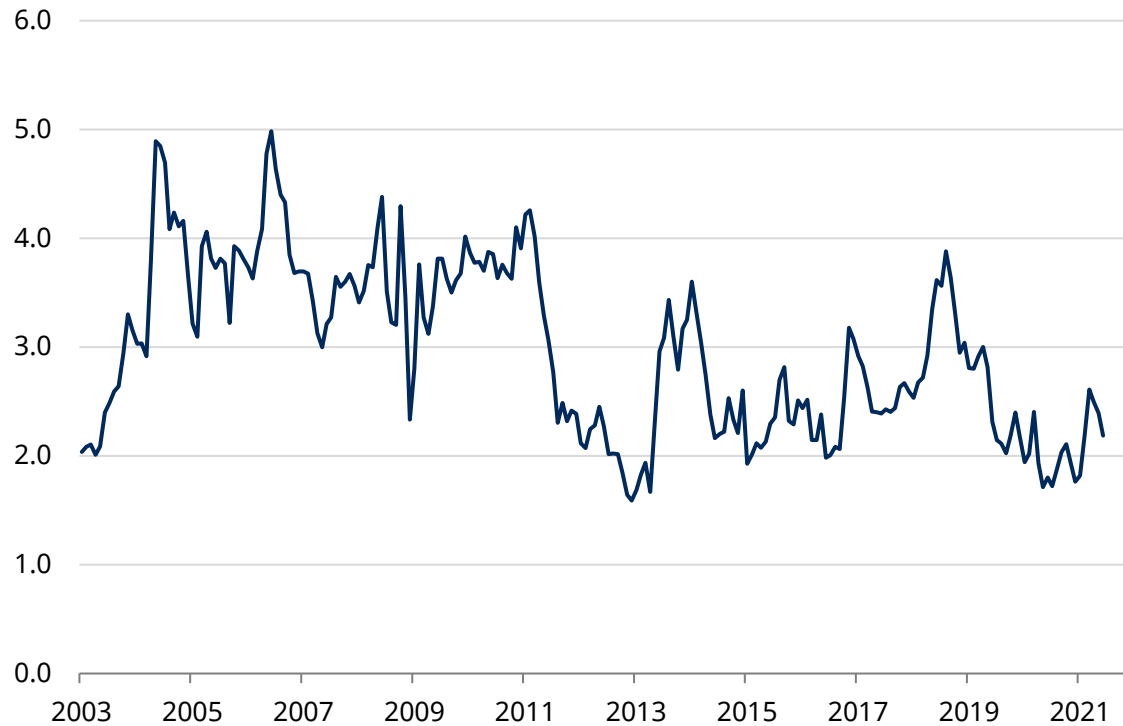
Past performance is not a guide to future performance and may not be repeated.

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 June 2021. 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.

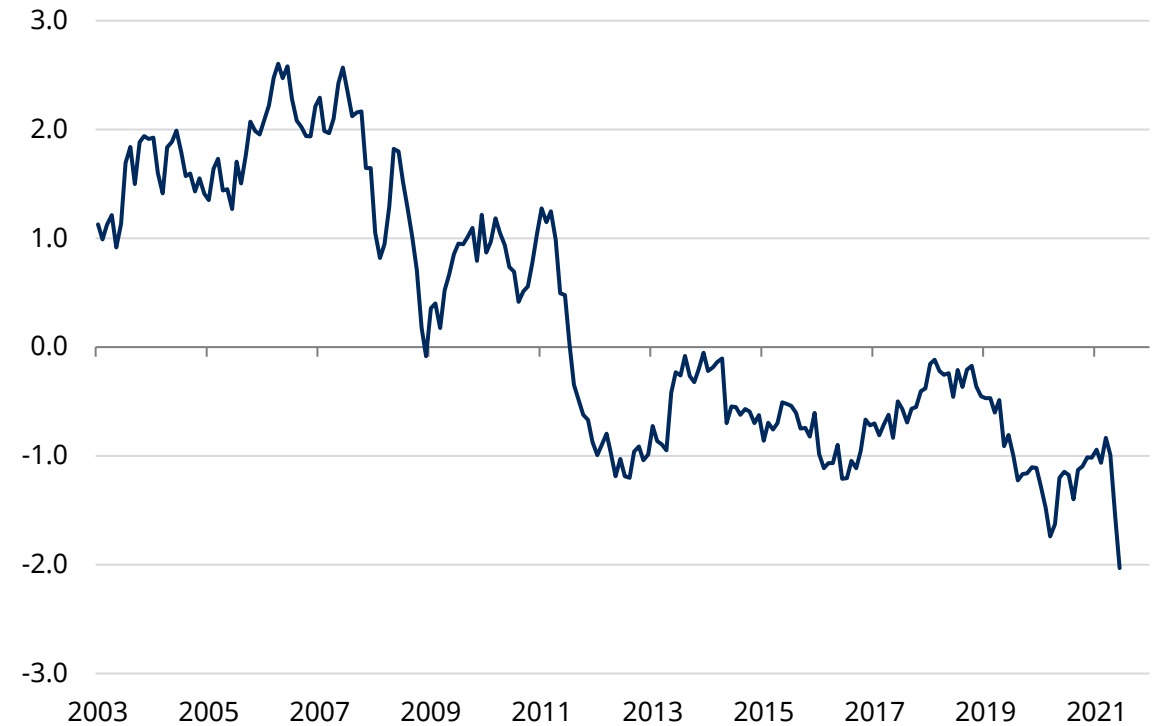
EM/DM real yields

Individual drivers of the real yield differential

EM real yield (%)



DM real yield



DM real yield fell sharply as US core inflation accelerated

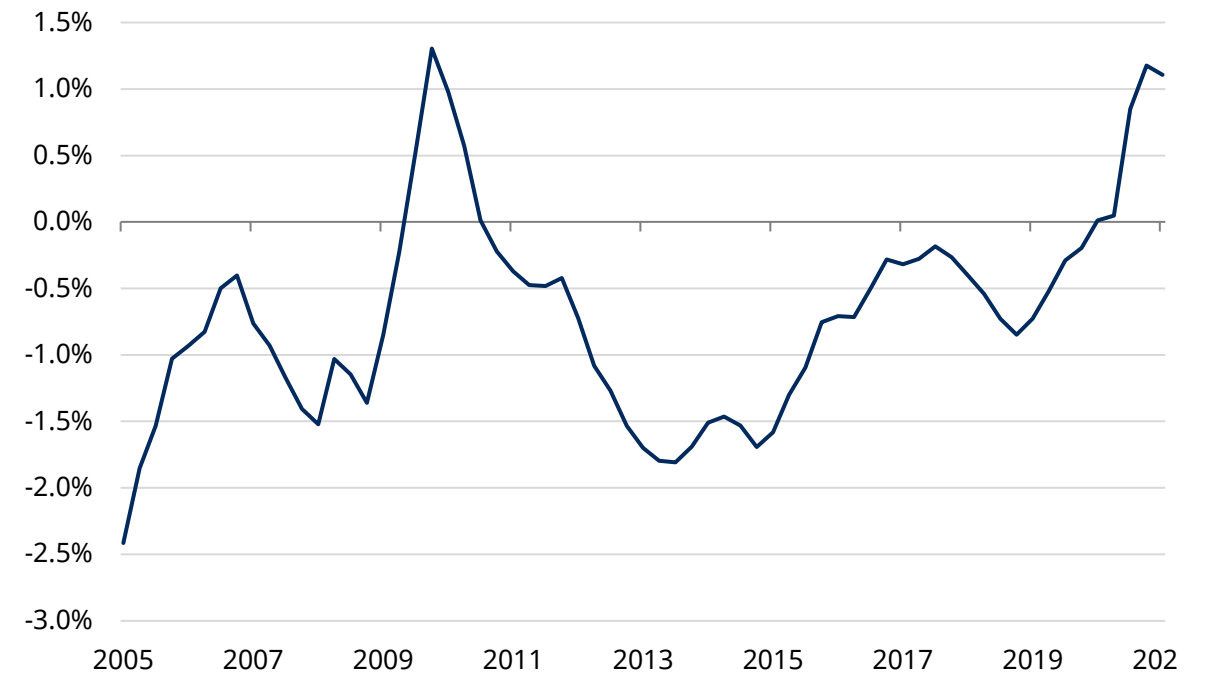
Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 June 2021. EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by core inflation. DM real yield is 5Y government bond yields of US, UK, Euro zone, Japan deflated by core inflation, 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 has turned positive

Source: Schroders, Refinitiv Datastream, J.P. Morgan. Exchange rate data as at 30 June 2021. Current account data as at Q1 2021.

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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