

Schroders



# Schroders Credit Lens

## Perspective of USD investor

Q4 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 52

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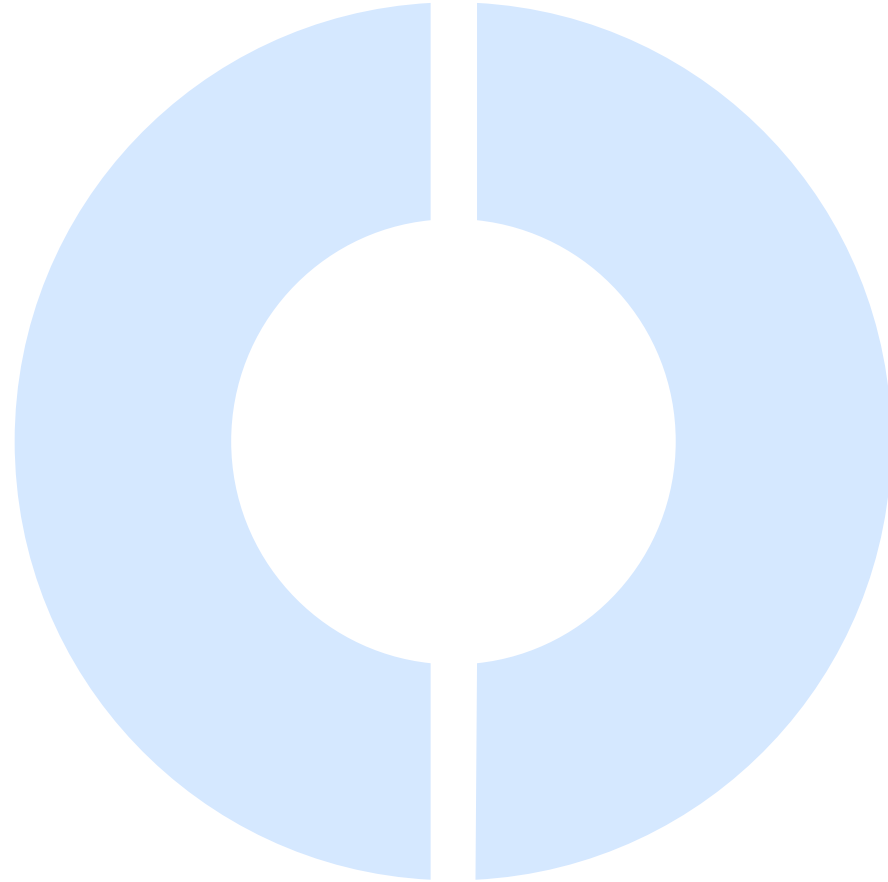
[Corporate credit: valuation](#)

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[Corporate credit: technicals](#)

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

**Schroders**



**Cross-credit summary**

# Summary

- **Credit spreads have exhibited more volatility after the summer lull. The sharp increase in energy prices is weighing on Europe. The euro high yield (HY) spread is the widest since February (as of 12 October)**
- Valuations are generally unattractive. There is slight more space in HY for spreads to fall because of improvements in credit quality over time
- Low quality issuance has increased significantly in 2021, especially in US leveraged loans. Record investor demand for loans has allowed more speculative issuance to flourish
- In investment grade (IG) credit, M&A related issuance has also increased in 2021, but it is still much lower than in the 2015-2018 period. A greater share of M&A deals have been financed by shares or cash
- Credit rating agencies are upgrading issuers on the back of improving corporate fundamentals. Upgrades have countered the negative impact of low quality issuance so far
- In hard currency emerging market debt (EMD), spreads of HY bonds remain well above pre-Covid levels and difference between these bonds is wide. The fallout from Evergrande has been minimal
- Real yield differential between emerging market (EM) and developed market (DM) bonds has increased significantly in 2021 on the back of accelerating US inflation. This implies solid value in local currency EM bonds and EM currencies

# Summary table

## Cross-credit overview

Date: 30 September 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	1.7%	1.9%	0.3%	2.1%	4.1%	2.6%	4.1%	5.1%	5.3%	3.8%
Yield to worst (hedged to USD) <sup>1</sup>	1.8%	2.0%	1.2%	2.1%	4.3%	3.4%	4.1%	5.1%	-	3.8%
Spread (bps)	87	105	85	89	353	304	315	357	432	258
Spread (percentile) <sup>2</sup>	18%	20%	28%	7%	21%	17%	13%	49%	48%	24%
Risk premium (bps) <sup>3</sup>	37	48	27	32	168	77	51	208	357	128
Duration	7.9	8.5	5.4	8.4	4.2	4.2	5.3	8.0	5.2	4.6
MV (billion \$)	909	699	3,371	8,612	64	560	1,632	774	1,483	645
Rating	A2	A3	A3	A3	BB3	BB3	B1	BB1	BBB3	BBB3
Nr. of issues/countries	1,239	1,056	3,815	9,210	107	793	2,127	73	21	2,088

### Since Jan 1997 or inception

Annualised return <sup>4</sup>	5.7%	6.0%	5.3%	5.9%	9.0%	6.5%	6.8%	8.0%	6.1%	7.0%
Annualised volatility	5.1%	5.8%	3.4%	5.4%	10.5%	11.5%	8.8%	10.4%	11.7%	7.5%
Return/volatility	1.1	1.0	1.5	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	0.3	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	0.5	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 September 2021.

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

<sup>2</sup>Percentile 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.

<sup>3</sup>Spread minus average historical default and downgrade losses (see slide 14).

<sup>4</sup>All returns USD hedged returns, except EMD Local which is unhedged USD return.

# Performance table

## Cross-credit overview

Date: 30 September 2021

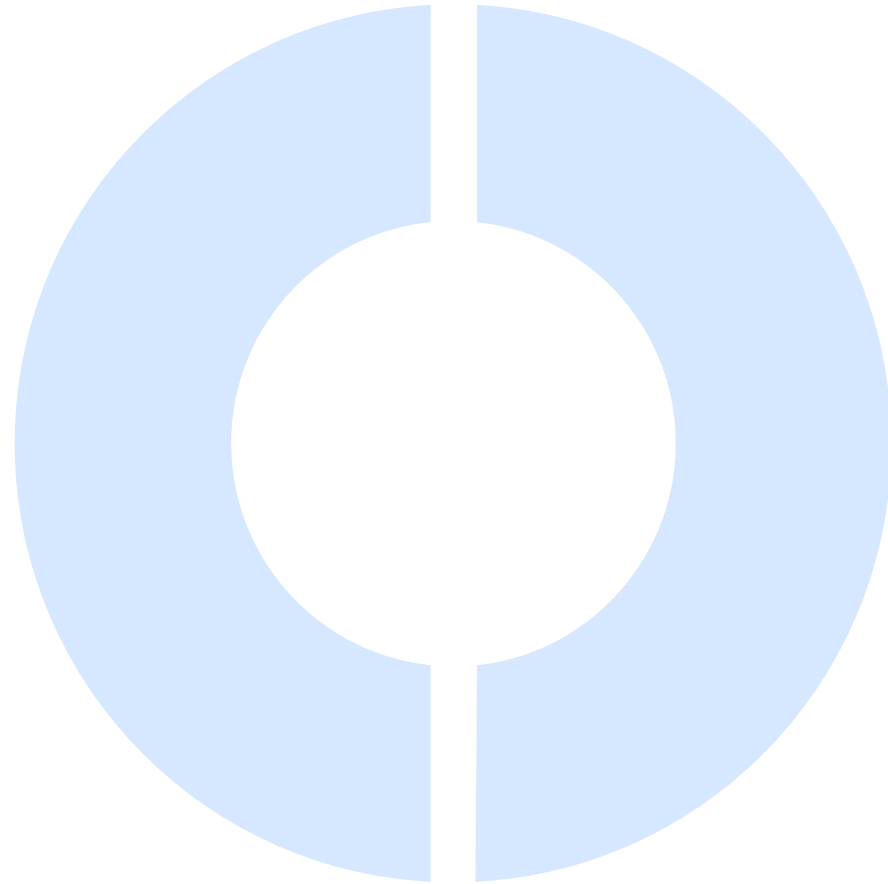
	IG GBP non-gilts	IG GBP corporates	IG Euro	IG USD	HY GBP	HY Euro	HY USD	Hard EMD	Local EMD	Corp. EMD
<b>Return (local)<sup>1</sup></b>										
1 month return	-2.1%	-2.3%	-0.7%	-1.1%	0.1%	-0.1%	0.0%	-2.1%	-3.4%	-0.7%
YTD return	-3.4%	-3.5%	-0.4%	-1.1%	4.4%	3.7%	4.7%	-1.4%	-6.4%	1.5%
1 year return	-0.3%	0.2%	1.6%	1.8%	11.0%	9.3%	11.5%	4.4%	2.6%	6.0%
<b>Return (USD hedged)</b>										
1 month return	-2.1%	-2.3%	-0.6%	-1.1%	0.1%	0.0%	0.0%	-2.1%	-3.4%	-0.7%
YTD return	-3.3%	-3.4%	0.2%	-1.1%	4.5%	4.3%	4.7%	-1.4%	-6.4%	1.5%
1 year return	0.0%	0.5%	2.5%	1.8%	11.4%	10.4%	11.5%	4.4%	2.6%	6.0%
<b>Spread</b>										
1 month OAS change	-2	-1	-1	-3	-6	1	-6	14	9	5
YTD OAS change	-12	-12	-8	-14	-110	-51	-71	5	44	-11
1 year OAS change	-42	-48	-33	-55	-254	-168	-226	-75	10	-112
Latest OAS	87	105	85	89	353	304	315	357	432	258

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 2021.

<sup>1</sup>Local EMD is USD return.

**Schroders**

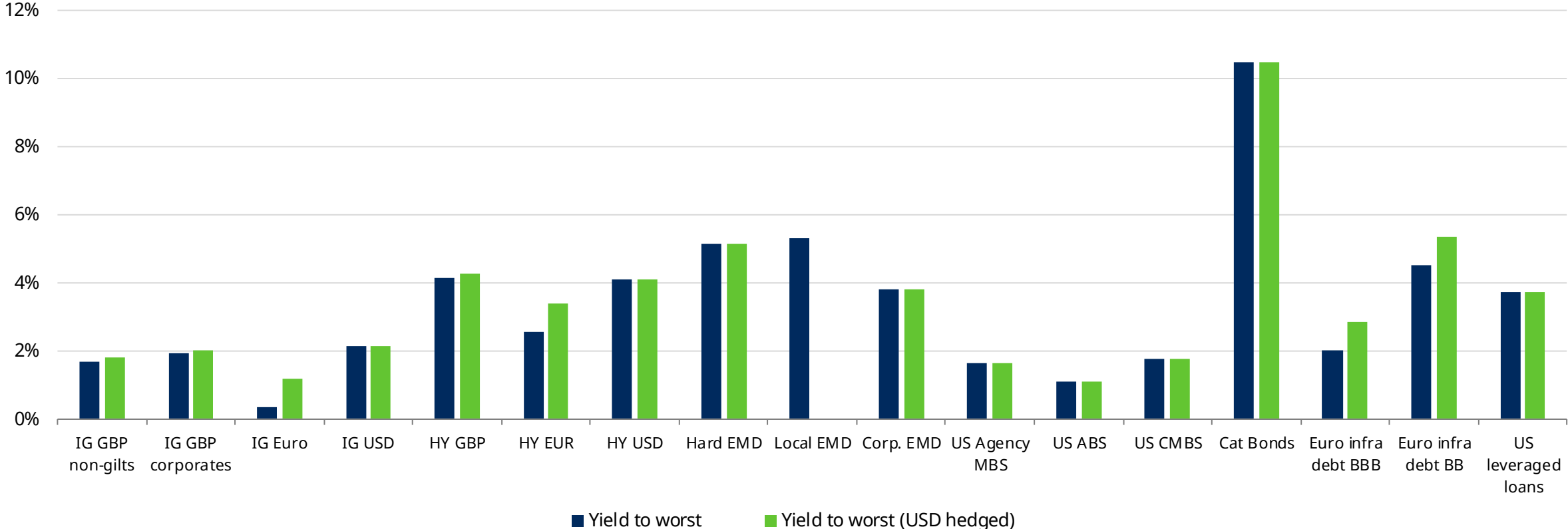


**Cross-credit analysis: key insights**



# Cross-credit yield

## Yield to worst



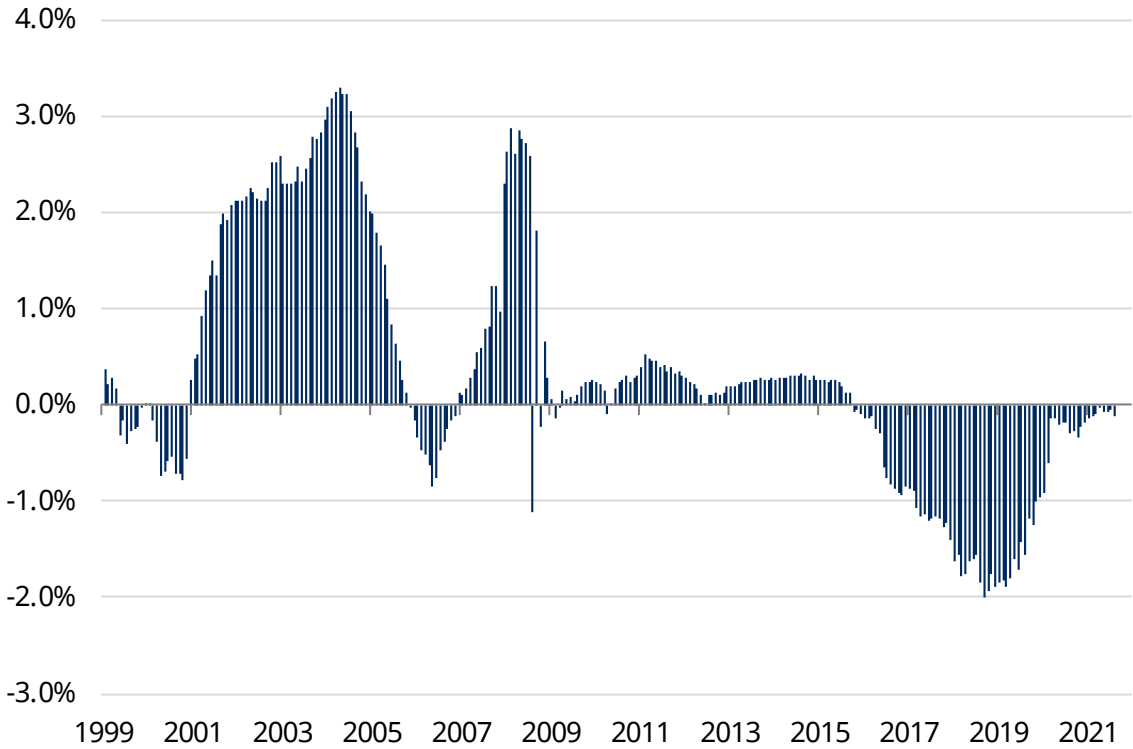
**Currency-hedged EUR and GBP corporates are not attractive for USD investors**

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan, Bloomberg. Data as at 30 September 2021. Hedged yield is local currency yield minus annualised 3-month FX hedging cost/return (see next slide).

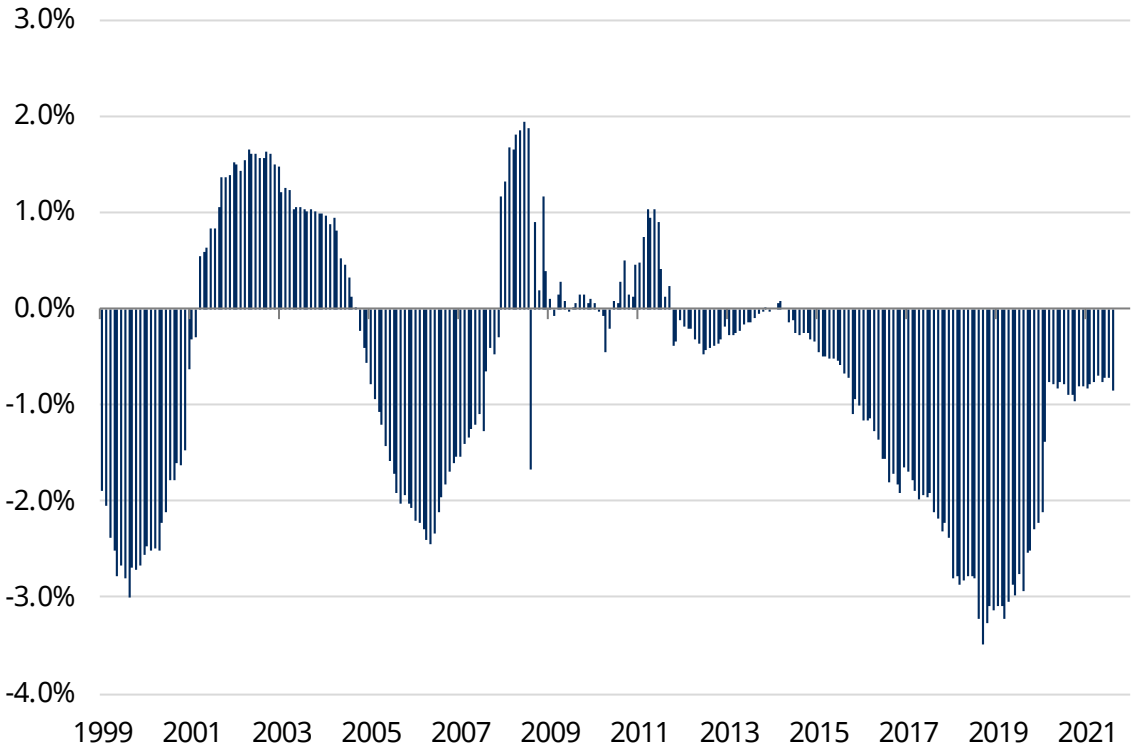
# FX hedging cost or return

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)

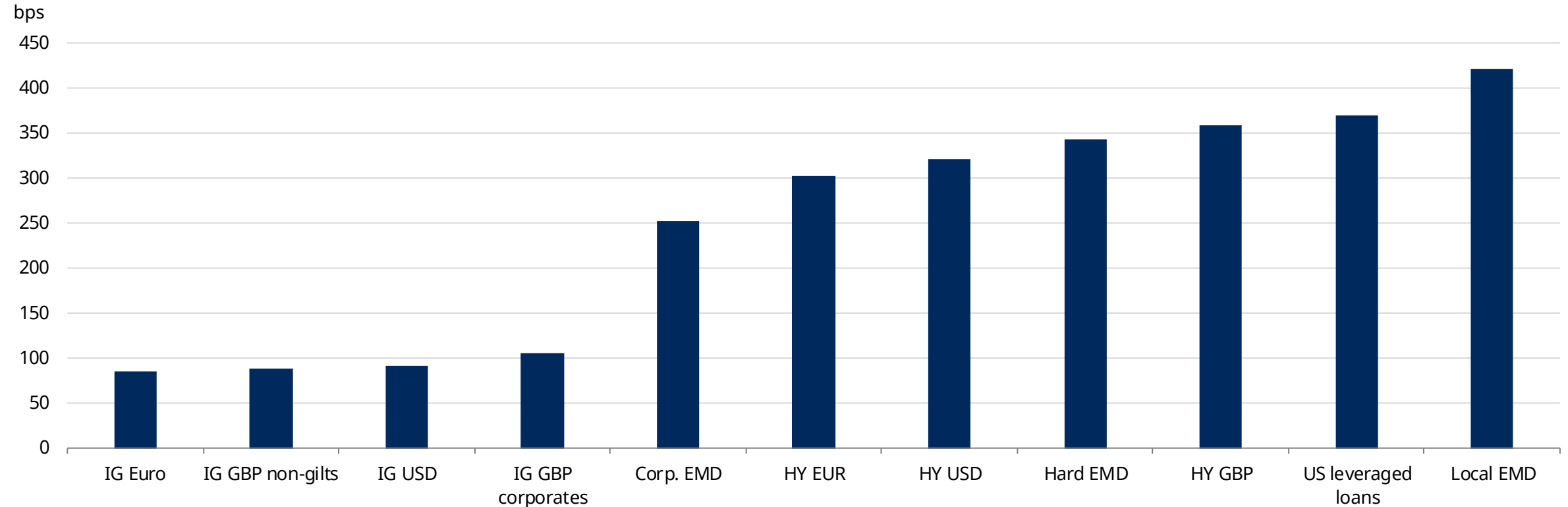


**GBP yields will be 0.1% higher in USD once hedging taken account**  
**EUR yields will be 0.8% higher in USD once hedging taken account**

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

# Cross-credit spread

## Spread

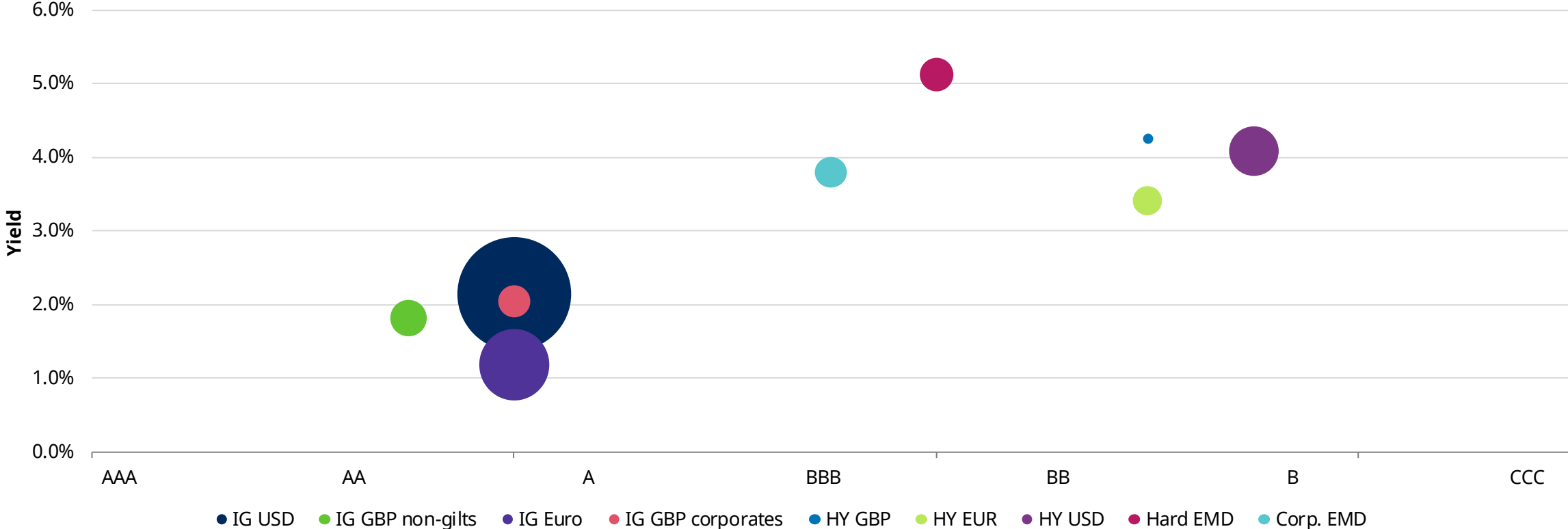


Source: Refinitiv Datastream, ICE Data Indices, J.P. Morgan, Bloomberg. Data as at 30 September 2021. Local EMD has been estimated as a spread over Treasuries of similar maturity.

# 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

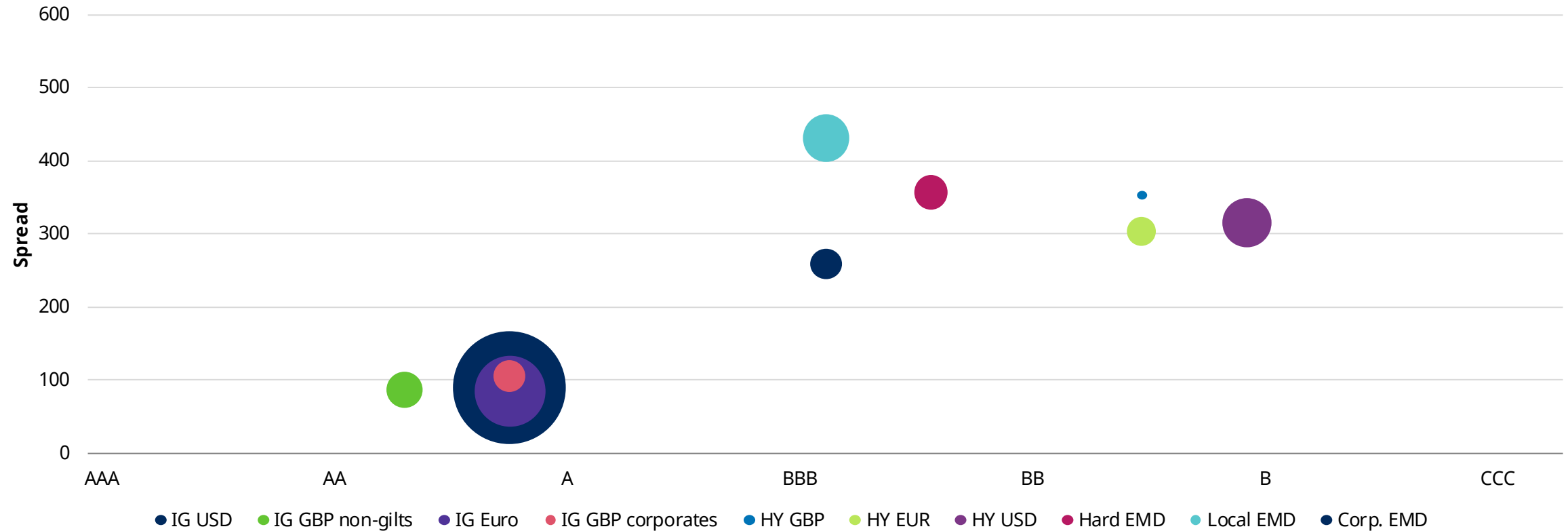


Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2021.

# Spread vs. credit rating vs. market size

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

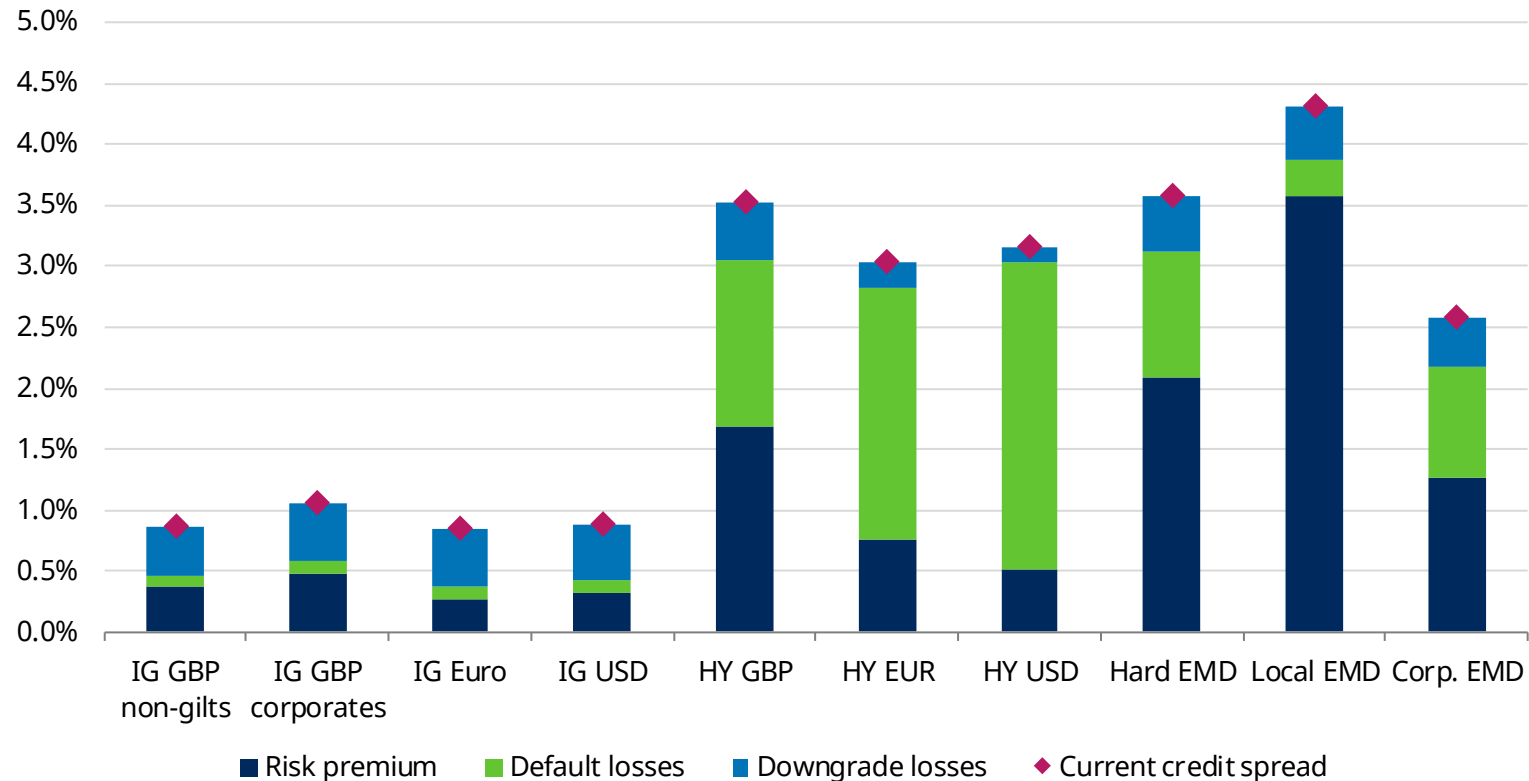
## Spread vs credit rating vs market size



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

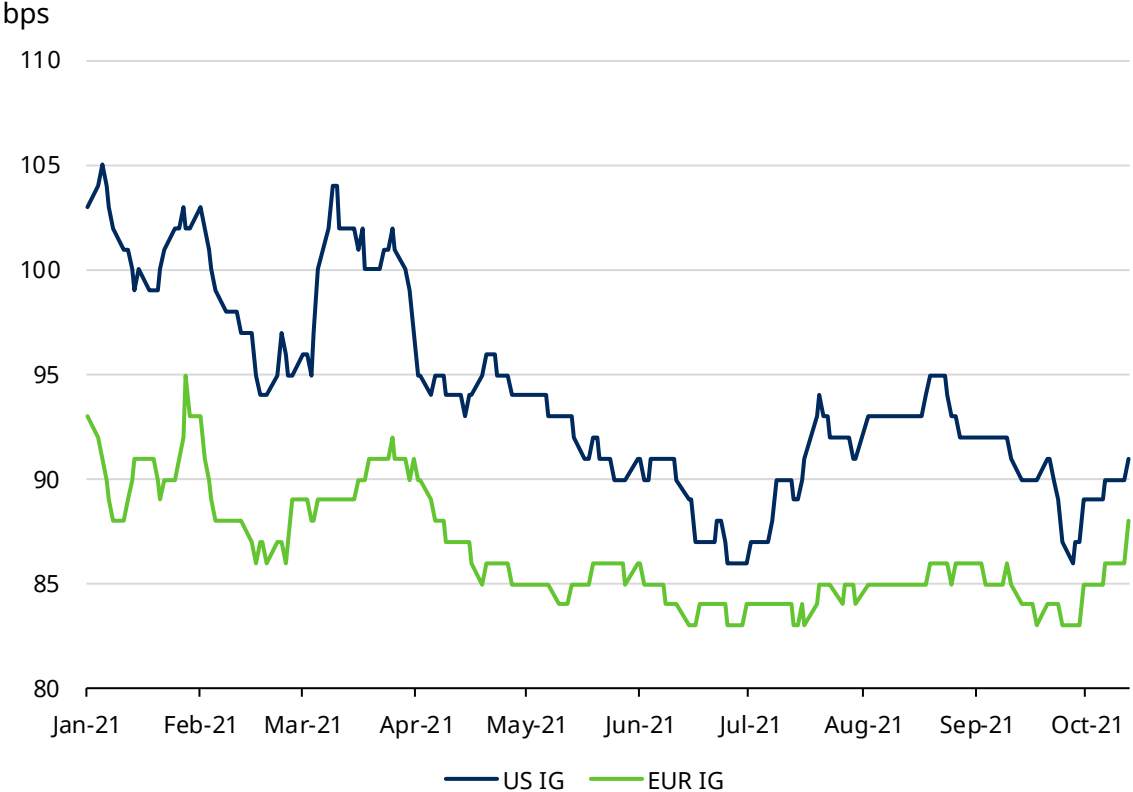
**Schroders**



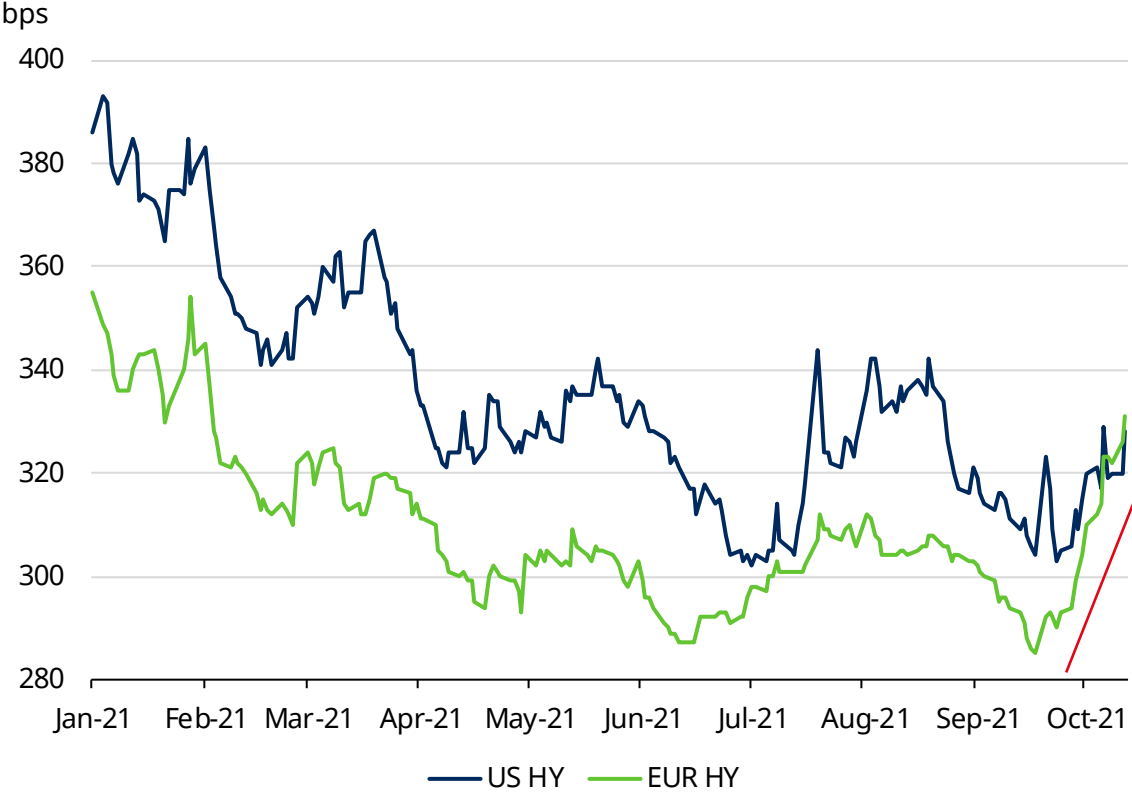
**Hot topics**

# Euro HY has underperformed other markets since mid-September

## Year-to-date IG spreads



## Year-to-date HY spreads



## Euro HY spread the widest since February

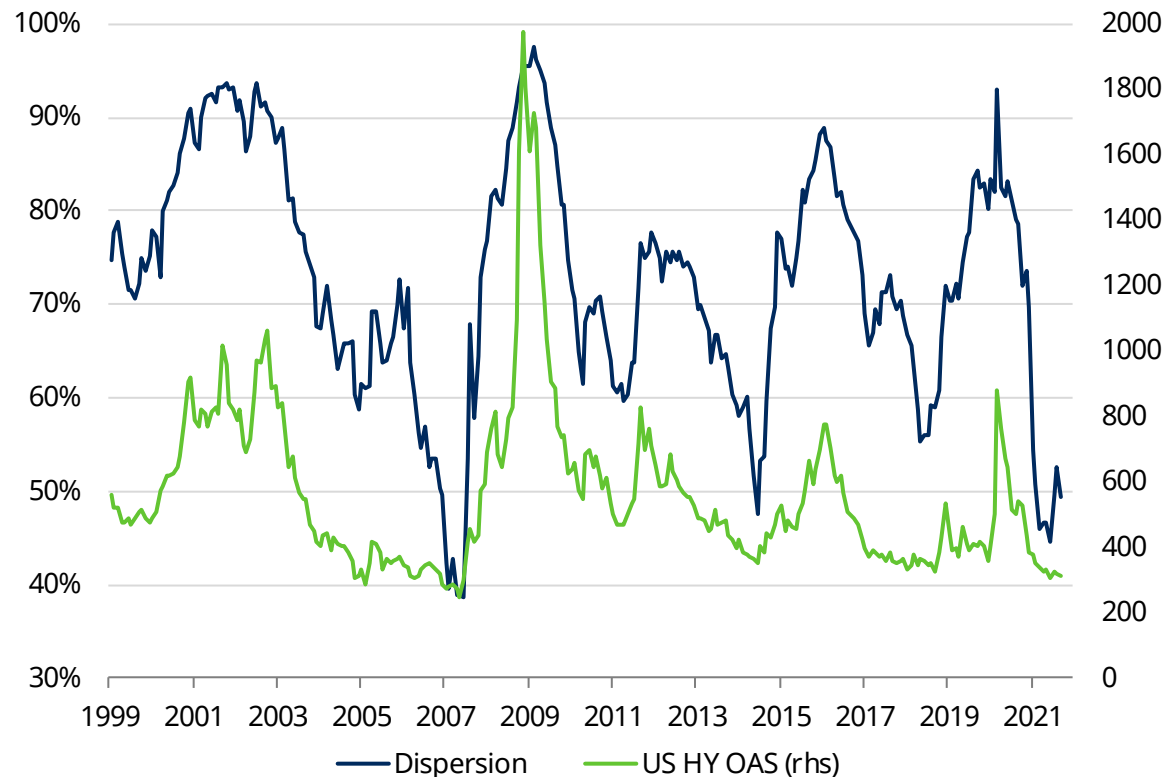
Source: Schrodgers, Refinitiv Datastream. Data as at 11 October 2021.



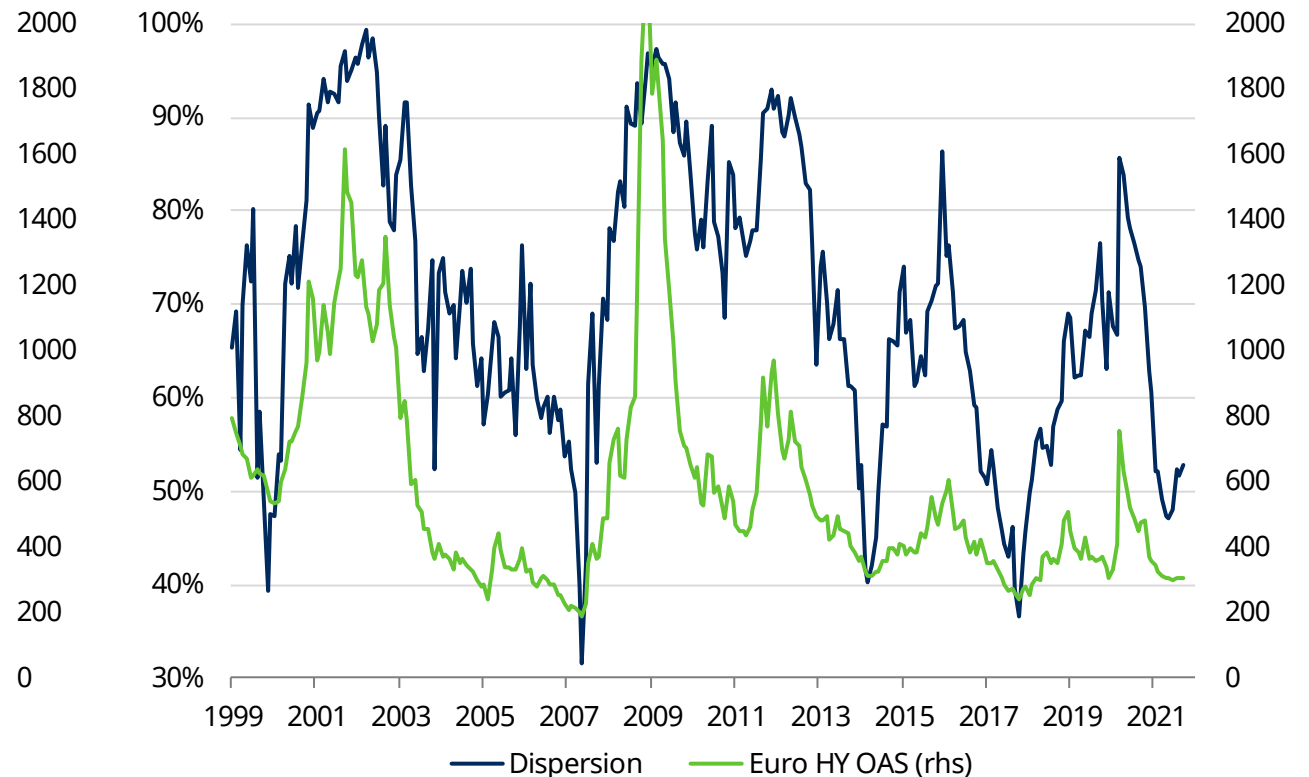
# HY spread dispersion has crept higher from summer lows

Indicating a greater differentiation between issuers as the reopening tailwind fades

## US HY dispersion<sup>1</sup> vs US HY spread



## Euro HY dispersion<sup>1</sup> vs Euro HY spread



**Higher dispersion has historically been a headwind for spreads**

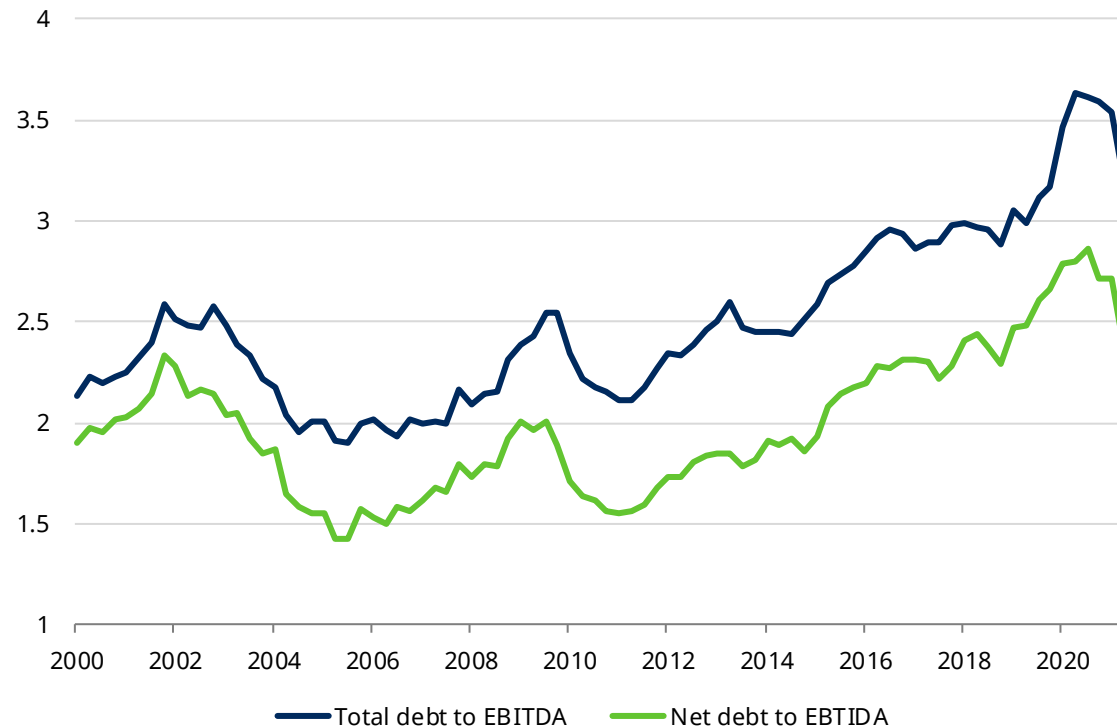
Source: Schroders, BofA Global Research. Data as at 30 September 2021. <sup>1</sup> Proportion of face value in index marked outside +/-100bps of overall index level.

# Stellar earnings growth is facilitating fast deleveraging

See page 25 for the section on corporate fundamentals

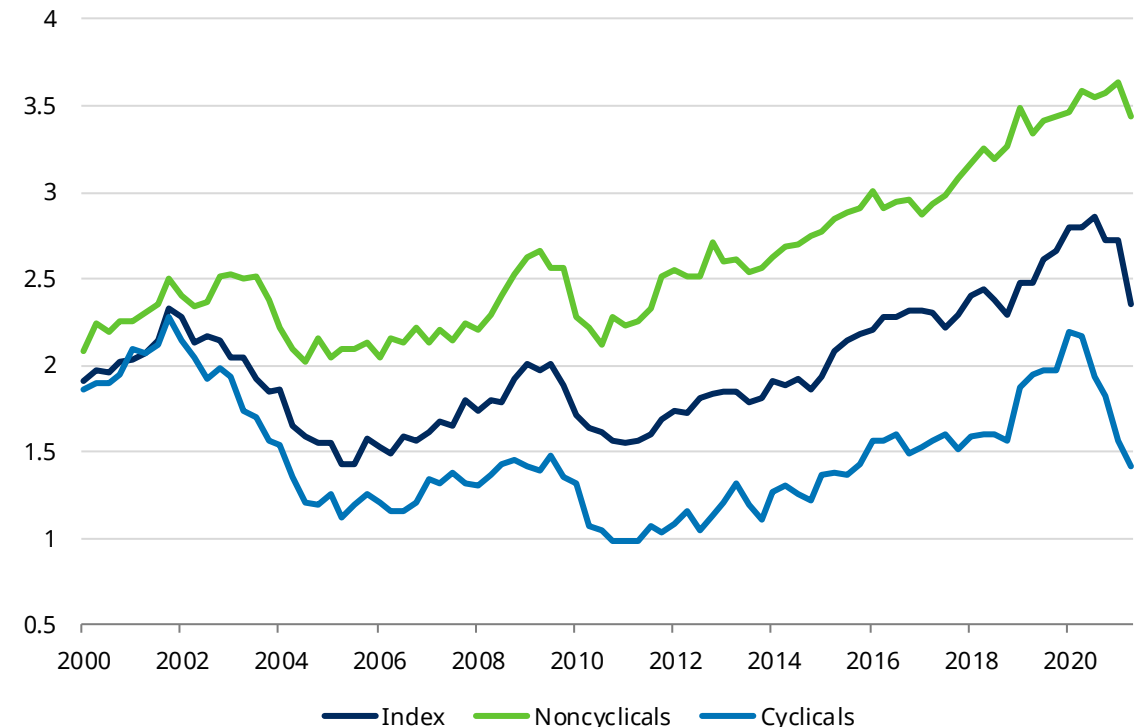
## US IG leverage

Debt to last 12 months EBITDA



## US IG net leverage

Net debt to last 12 months EBITDA



## US IG net leverage of cyclical sectors is now the lowest since 2015

Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as of Q2 2021.

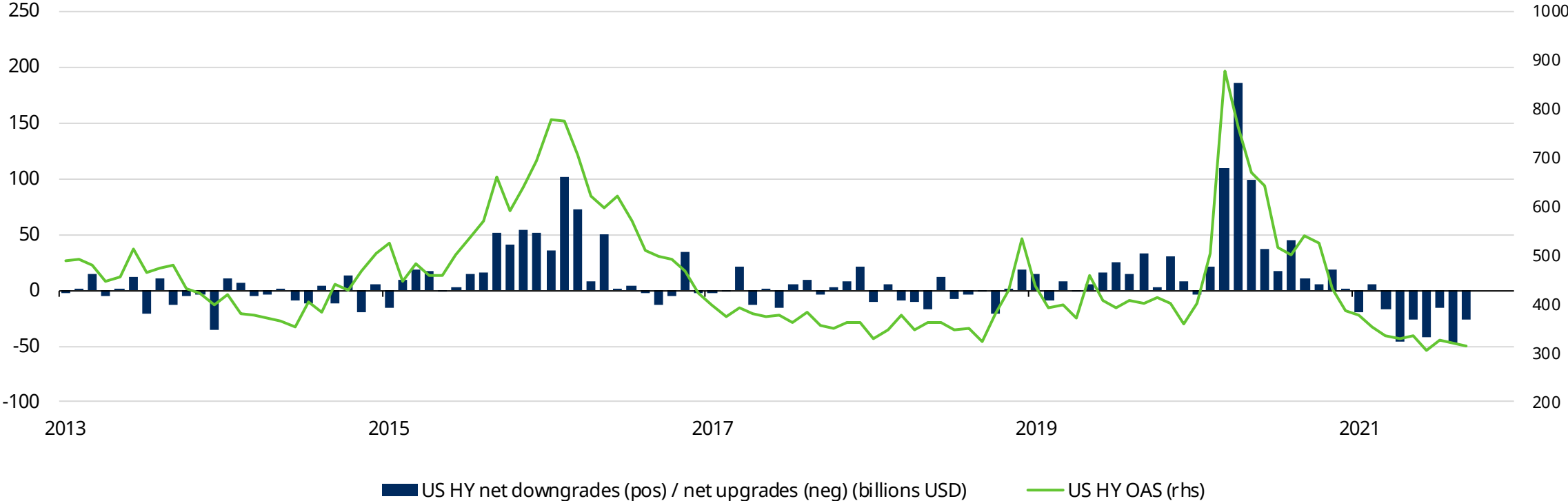
**Cyclical sectors:** Basic Materials, Consumer Discretionary, Industrials, Technology. **Noncyclical sectors:** Communications, Consumer Staples, Utility, Health Care.

# Rating upgrades are still coming in strong

Ratings agencies incorporating a more positive fundamental outlook in the ratings

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

Billions USD

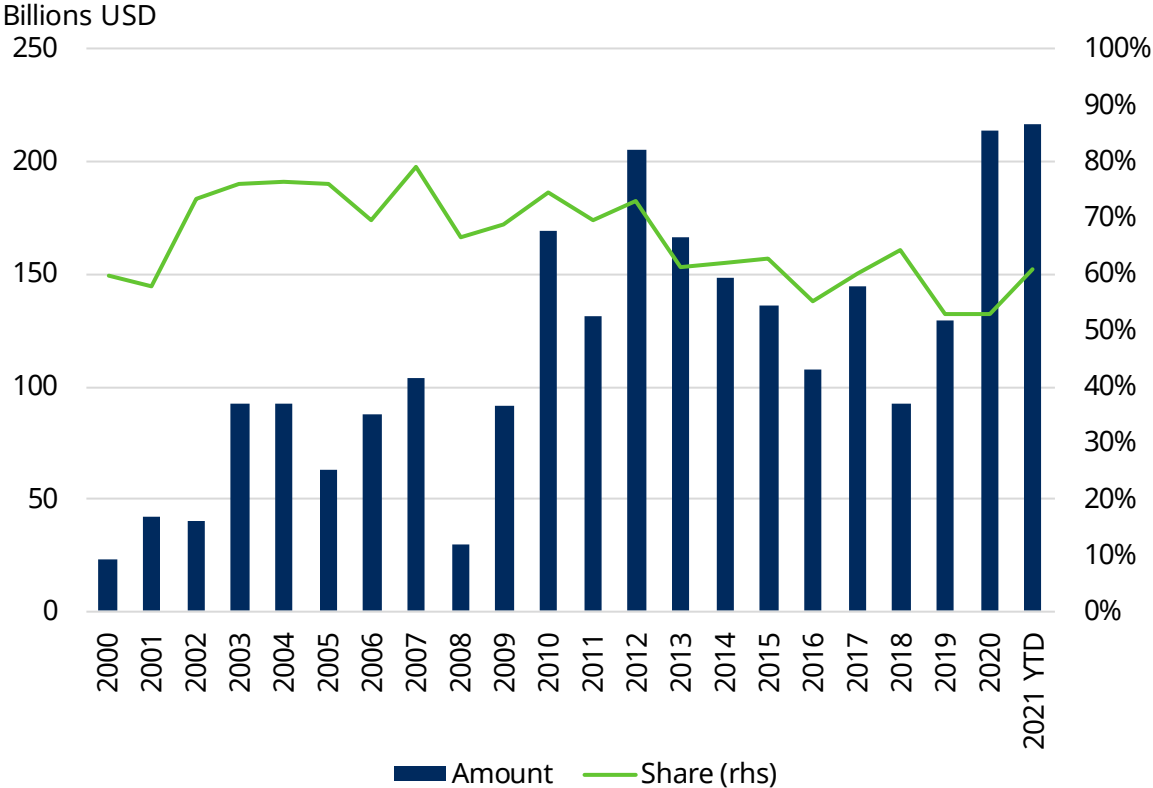


Source: BofA Global Research, Refinitiv Datastream. Data as at 30 September 2021.

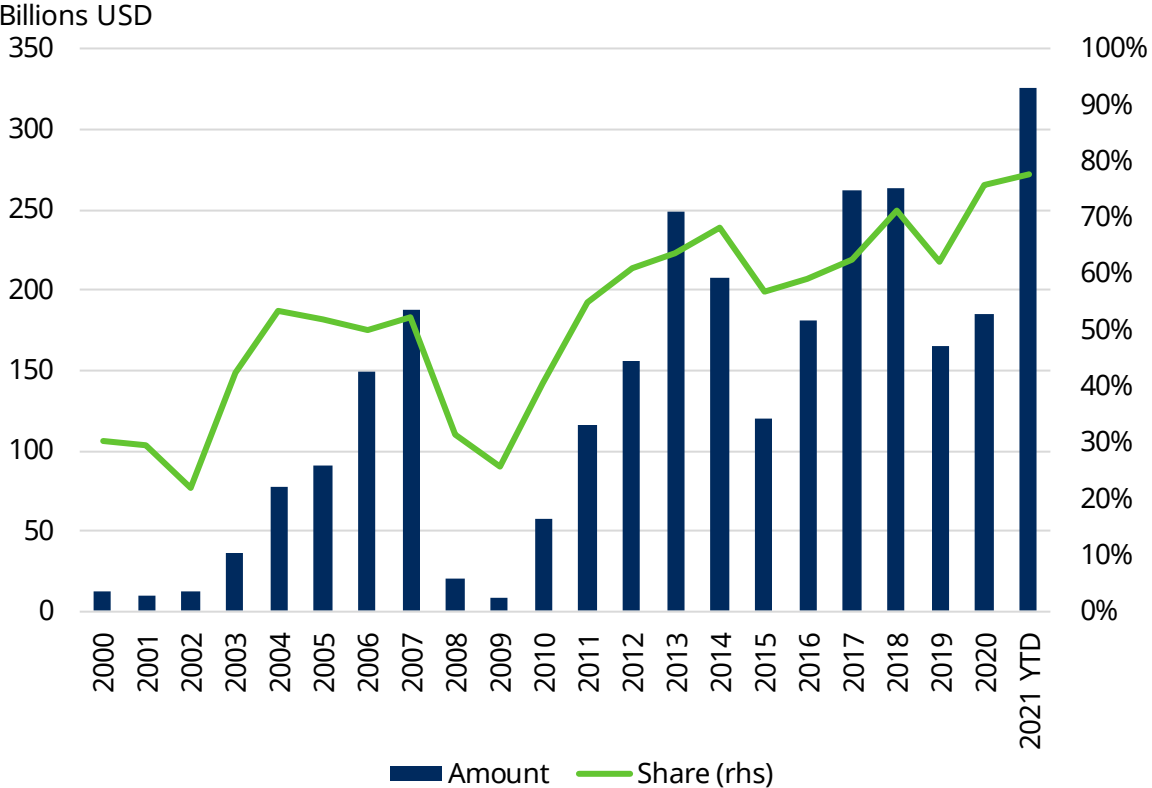
# Low quality issuance has increased significantly in 2021

Single-B or lower issuance is already the highest ever, with 3-months still to go

## US HY single-B or lower rated issuance



## US leveraged loans single-B or lower rated issuance



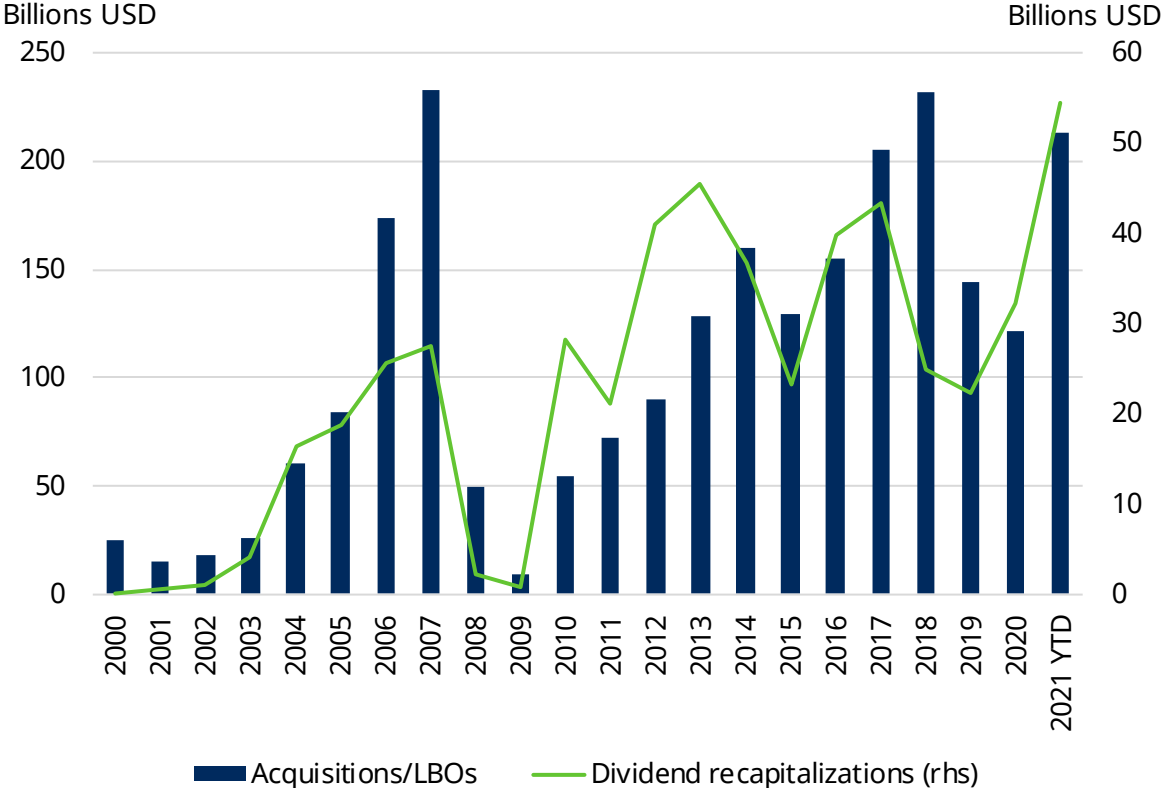
**Increase in lower quality issuance has been much more dramatic in the leveraged loan market where single-B or lower issuance already tops \$300 billion**

Source: Schrodgers, BofA Global Research, S&P LCD. Data as at 30 September 2021.

# Private equity and loan investors - a match made in heaven

The search for yield meets the need for leverage

## US leveraged loans issuance by use of proceeds



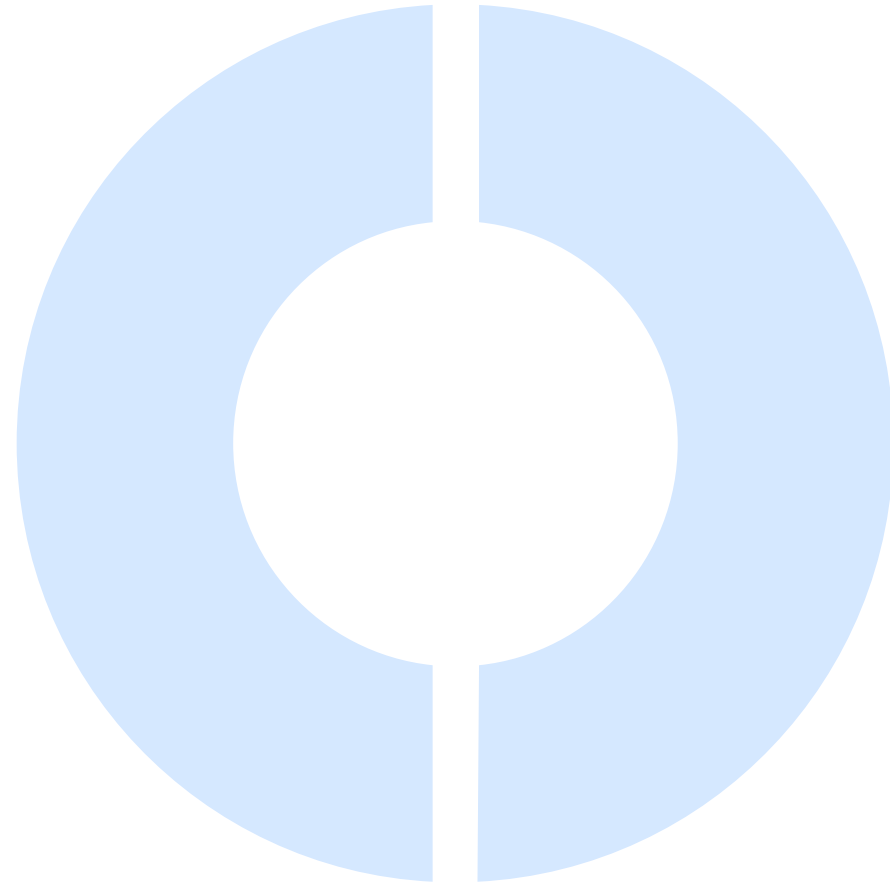
## US CLO net issuance (rolling 12-months)



**Record demand for leveraged loans is financing sharp increase in private equity related issuance; YTD dividend recapitalizations related issuance is at an unprecedented level at \$55bn**

Source: Schroders, BofA Global Research, S&P LCD. Data as at 30 September 2021. A dividend recapitalization happens when a company takes on new debt in order to pay a special dividend to private investors or shareholders.

**Schroders**

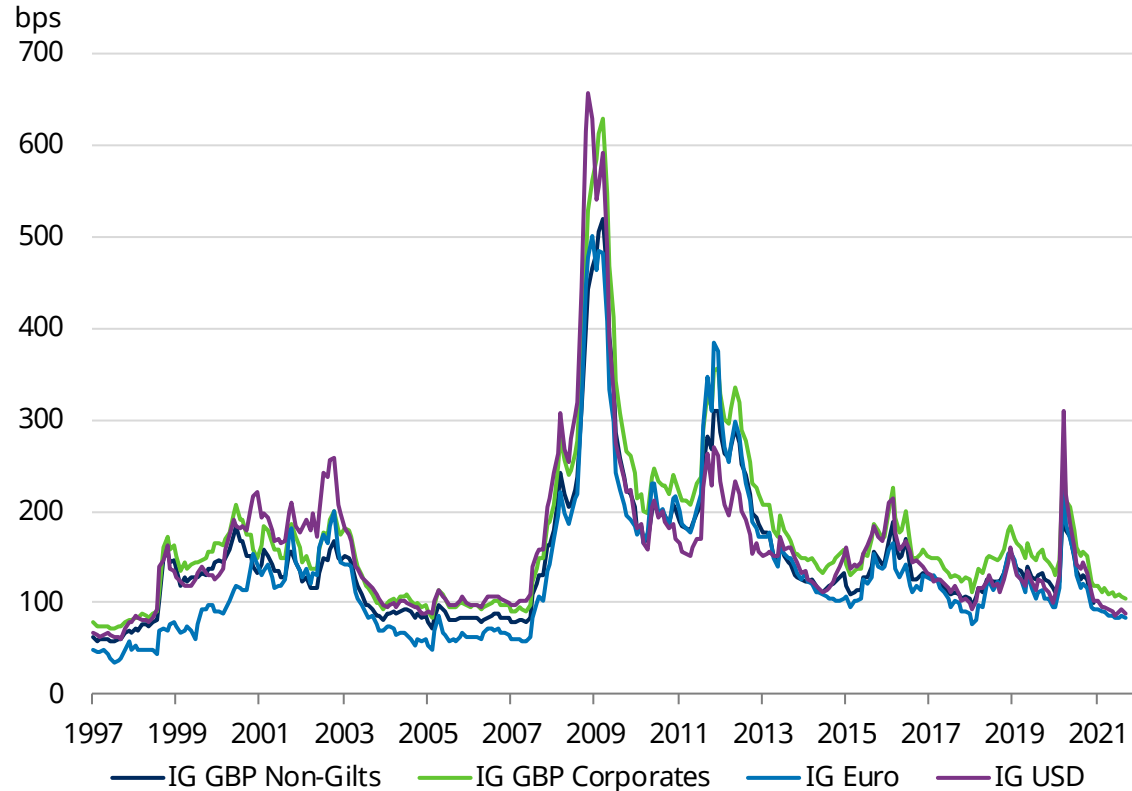


**Corporate credit**  
Valuation

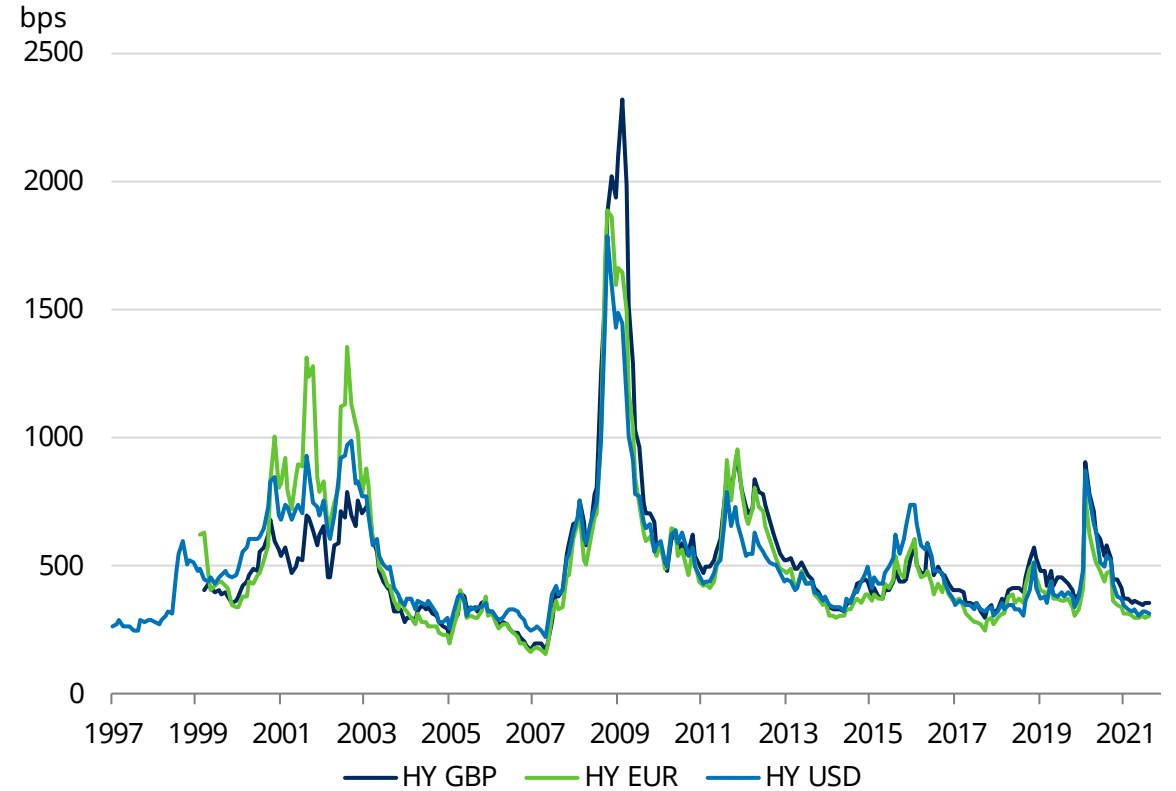
# IG and HY valuation

## Historical ratings-adjusted credit spreads

### IG adjusted spreads



### HY adjusted spreads

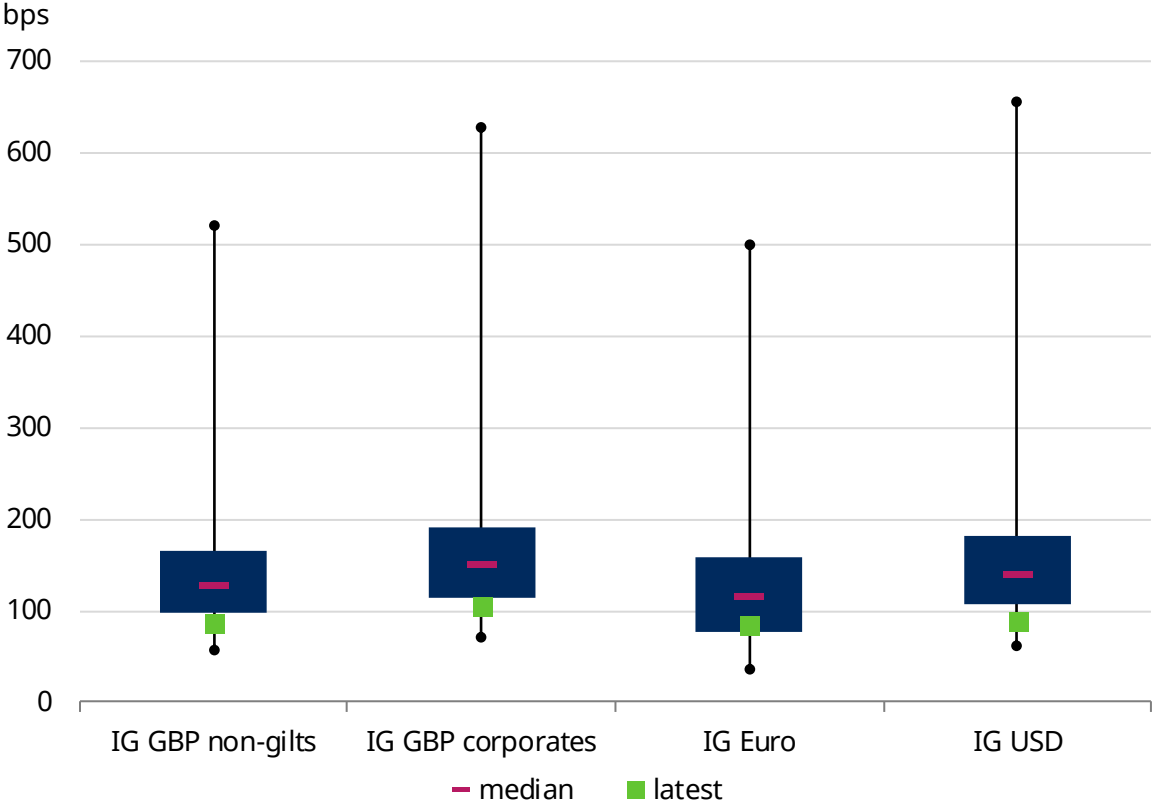


Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2021. Spreads are adjusted for changes in the distribution of credit ratings within each index over time.

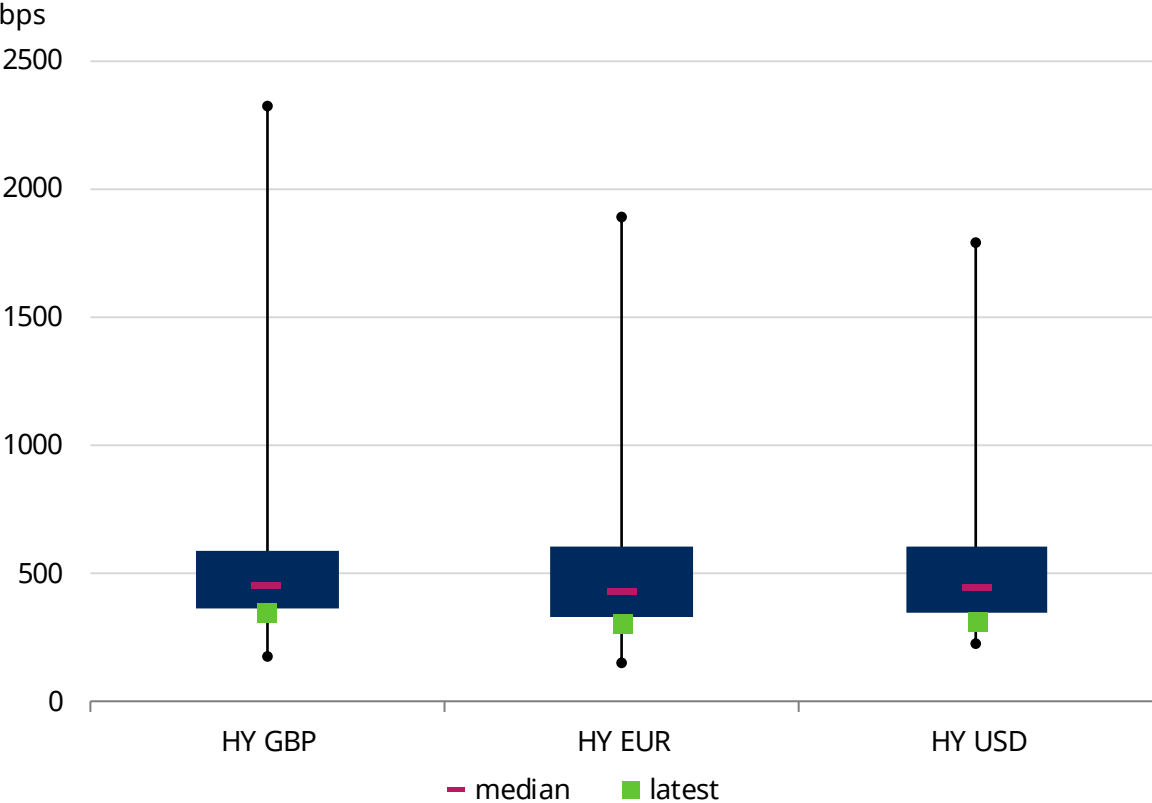
# IG and HY valuation

## Spread percentiles<sup>1</sup>

### IG adjusted spreads



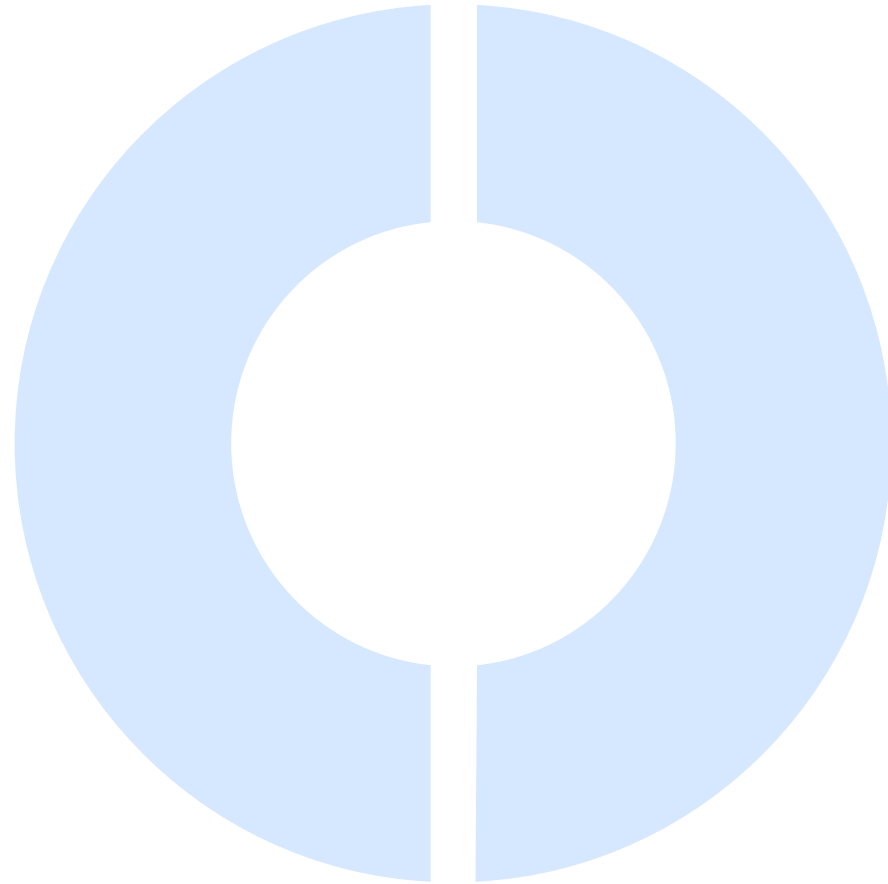
### HY adjusted spreads



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

## Q2 corporate fundamentals summary

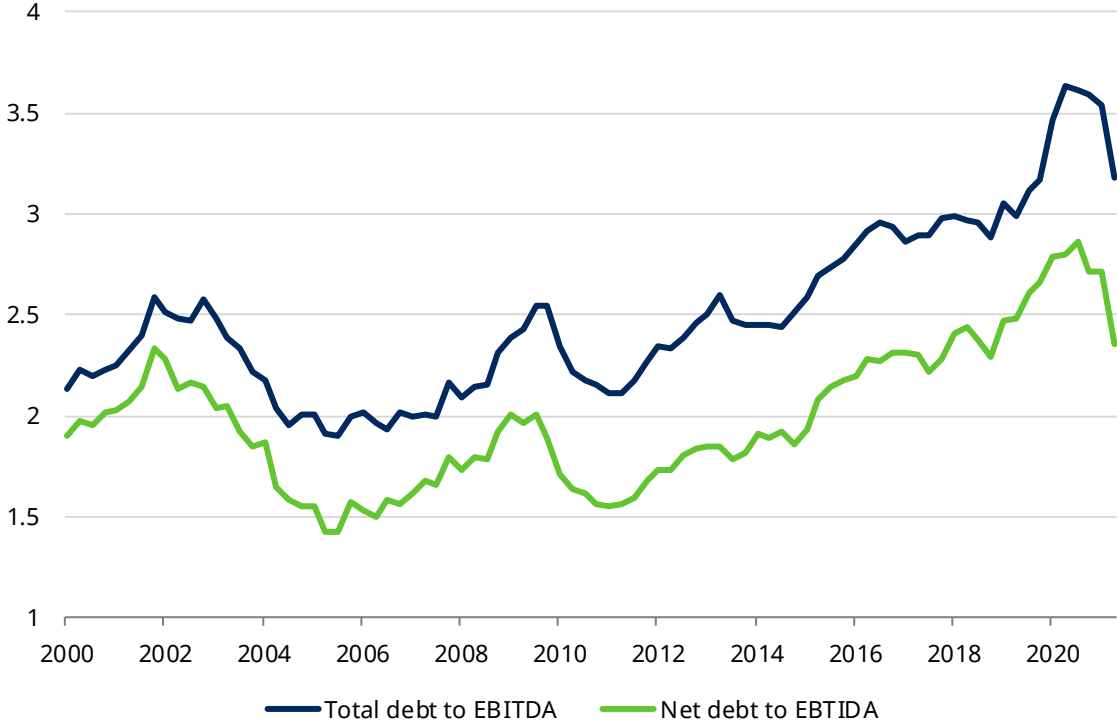
- **Stellar Q2 earnings season is reflected in rapidly improving corporate fundamentals. Europe is slightly lagging the US because of slower earnings growth**
- After falling in the last few quarters, net leverage is now well below pre-Covid levels. In fact, US HY net leverage is the lowest since 2015
- Earnings growth is very strong, especially for cyclical companies. Debt growth has cooled, although has not become negative in all markets
- Despite stable or slightly higher debt levels, interest costs are falling across the board due to refinancing of existing higher yielding debt
- Cash levels have started to tick down, but more so in Europe. Only slight fall in cash balances in the US indicates that most US companies have not yet decided to put the cash in work for capex or buybacks
- Margins continue to improve, reaching record highs in many cases. Granted, higher input costs could start eating into margins over the coming quarters

# US IG leverage

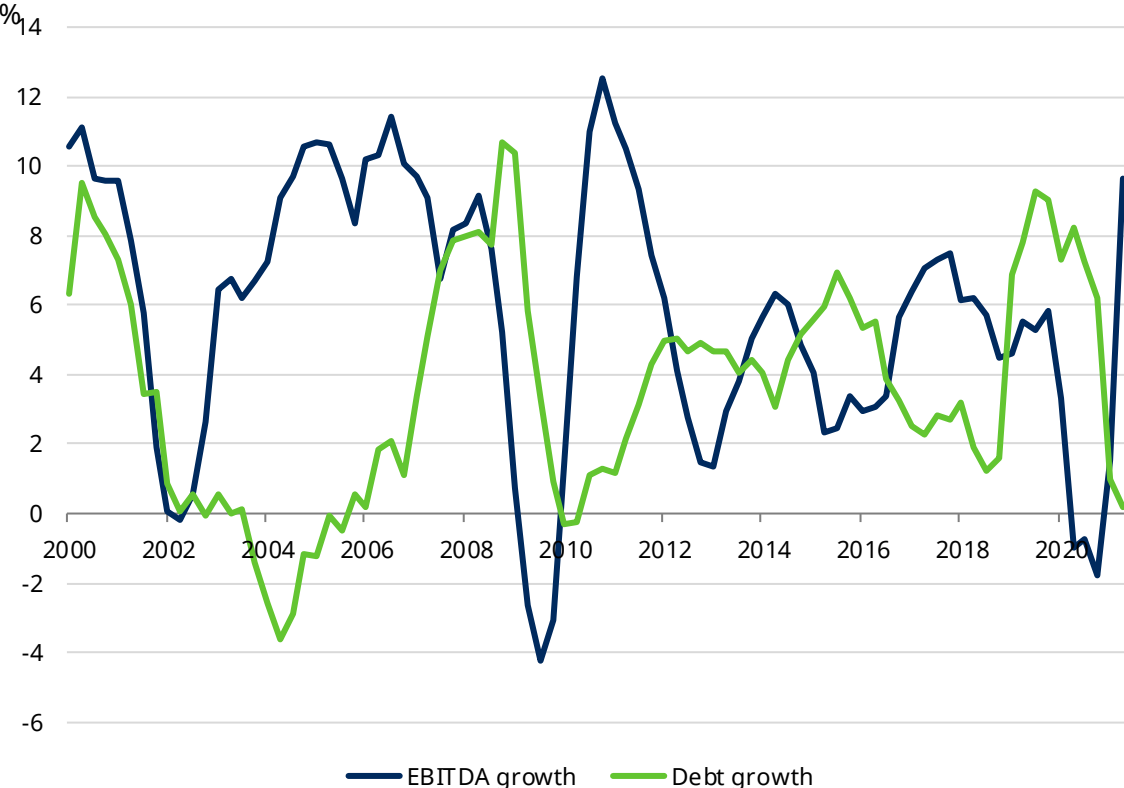
Stellar earnings growth is leading to a significant fall in leverage

## US IG leverage

Debt to last 12 months EBITDA



## US IG EBITDA and debt growth (last 12 months)



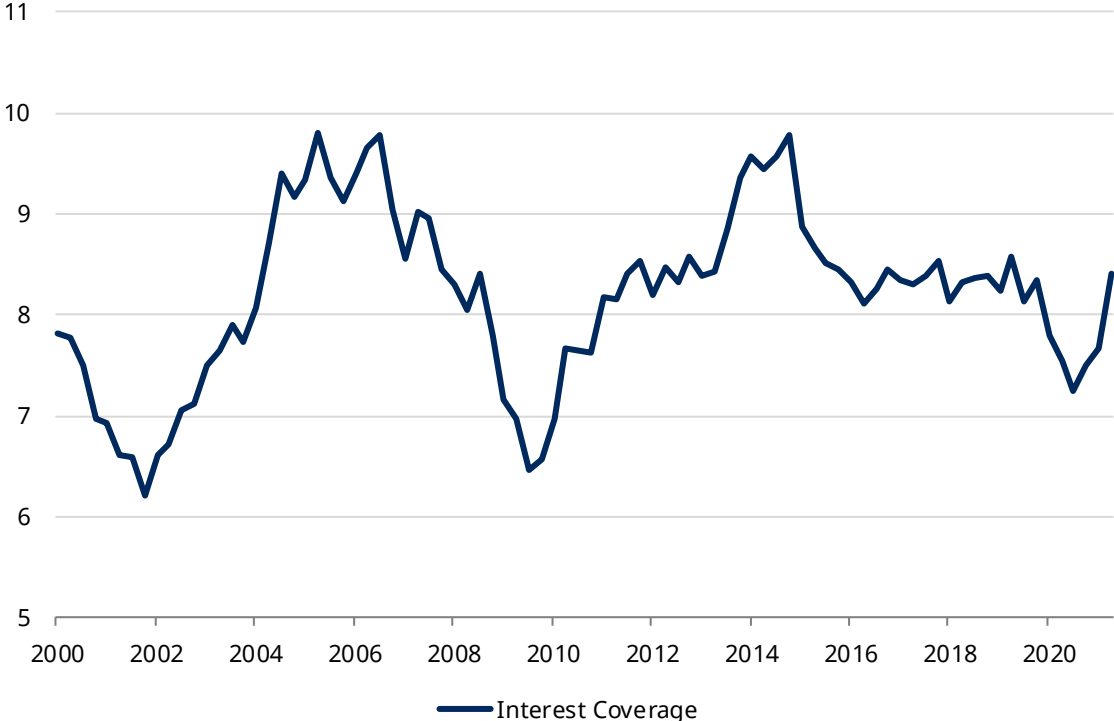
Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as of Q2 2021.

# US IG interest coverage

Interest coverage has returned to pre-Covid level

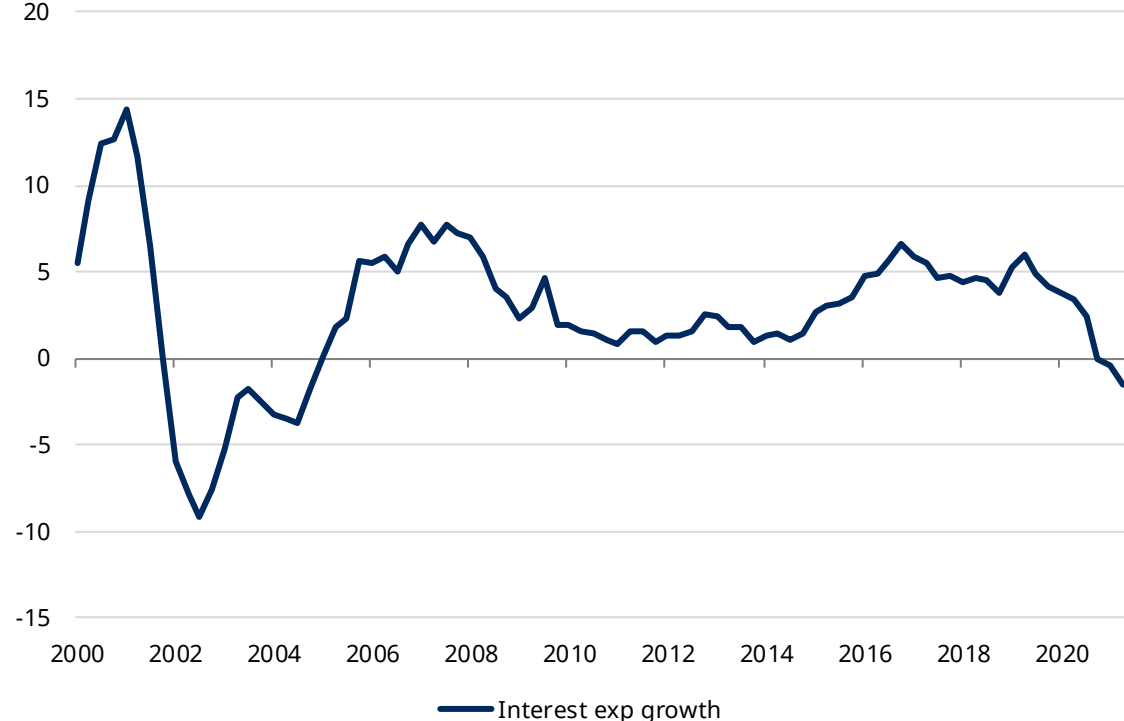
## US IG interest coverage ratio

Last 12 months EBITDA to interest expense



## US IG annual interest expense growth

%



Aggressive refinancing is helping to drive interest costs lower

Source: Schrodgers, Bloomberg, Median issuer ex-Financials. Data as of Q2 2021.

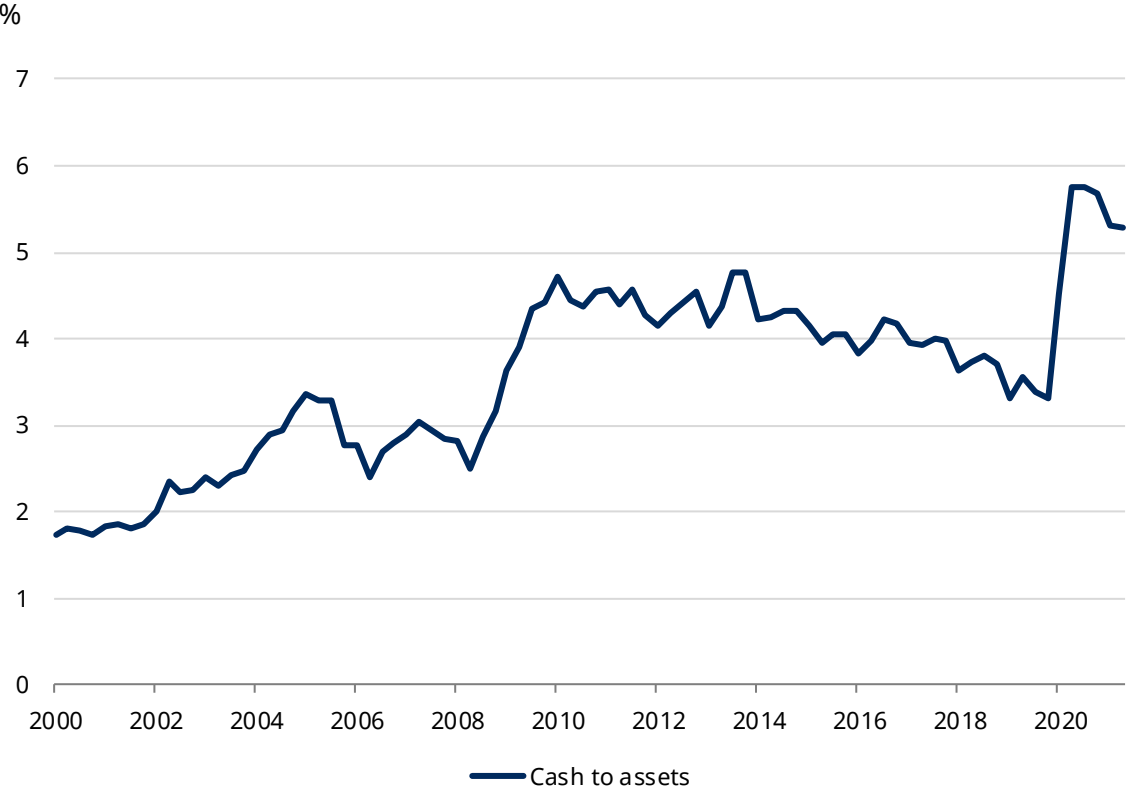
# US IG cash levels

Cash balances have fallen only slightly

## US IG cash to short term debt



## US IG cash to assets



Despite slight fall in cash levels, companies continue to carry large liquidity buffers

Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as of Q2 2021.

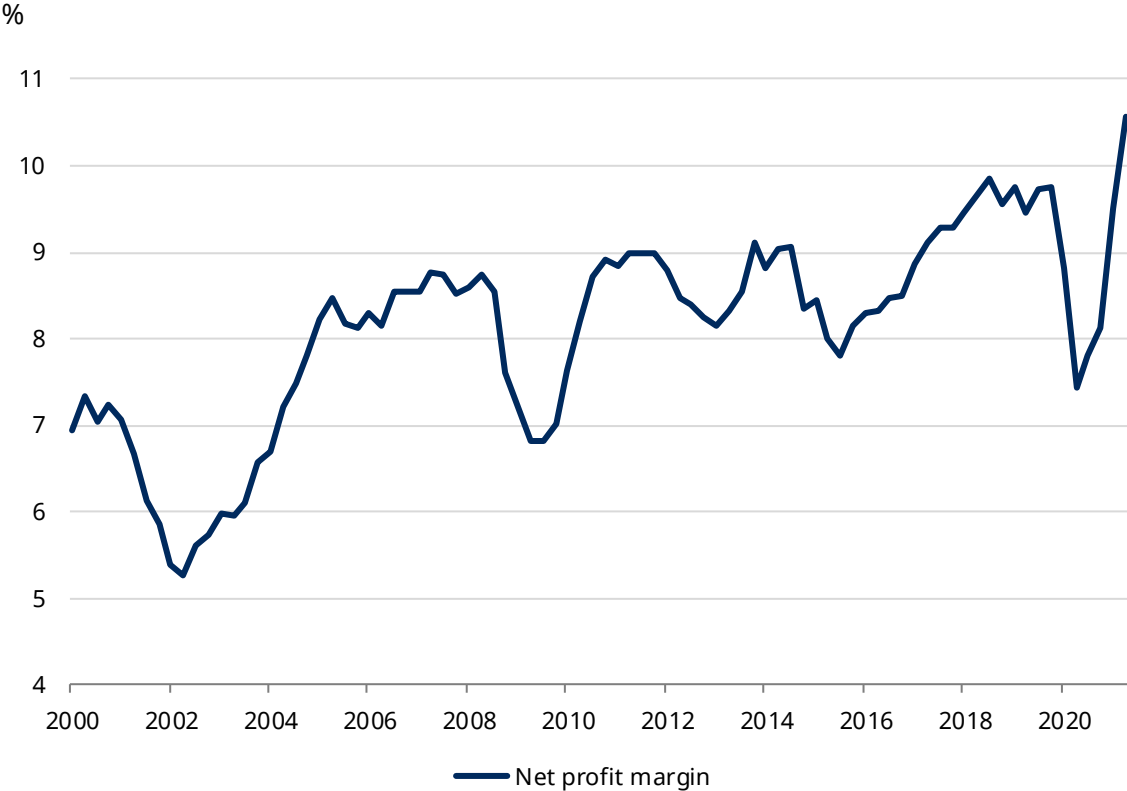
# US IG corporate margins

Margins have rebounded rapidly since Q2 2020

### US IG EBITDA margin



### US IG net profit margin



Cost cutting and rising prices have driven margins to a record high

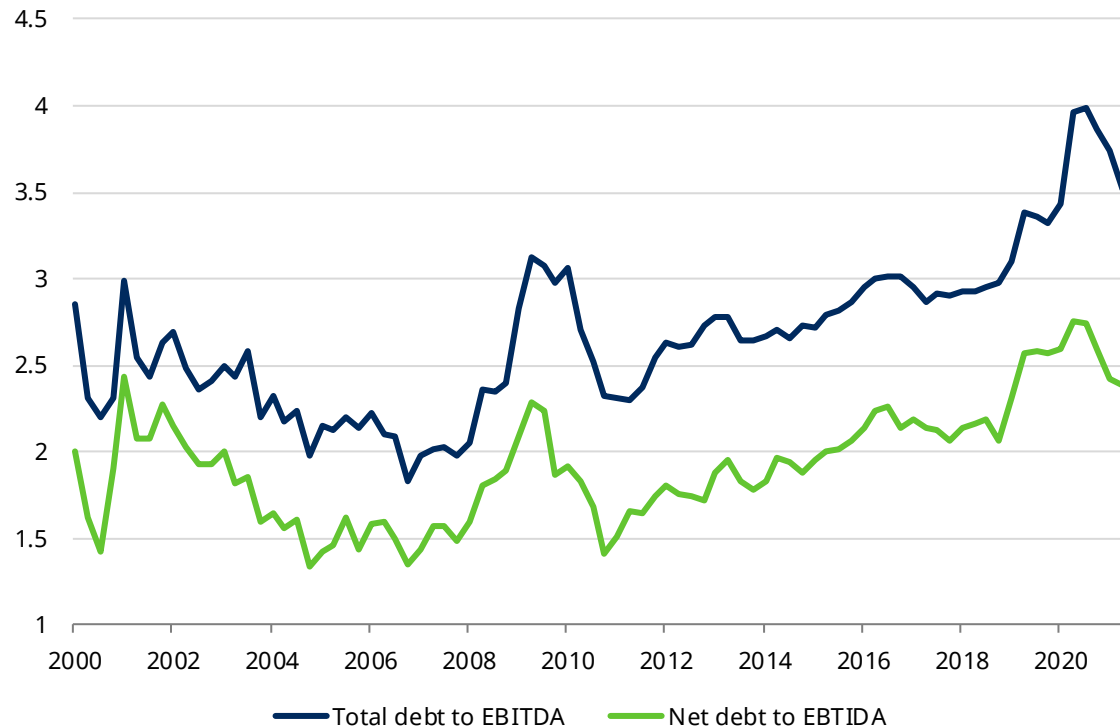
Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as of Q2 2021.

# Euro IG leverage

Leverage is falling but slower than in US IG

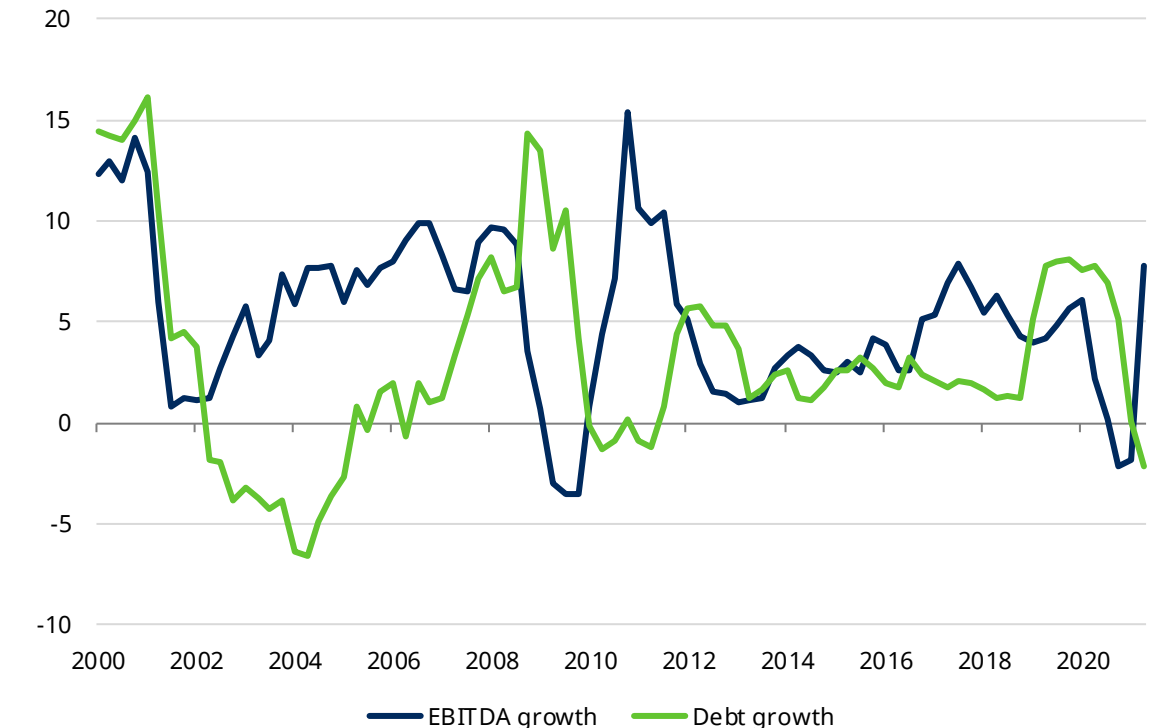
## Euro IG leverage

Debt to last 12 months EBITDA



## Euro IG EBITDA and debt growth (last 12 months)

%



Net leverage is well below pre-Covid level, gross leverage is still slightly higher

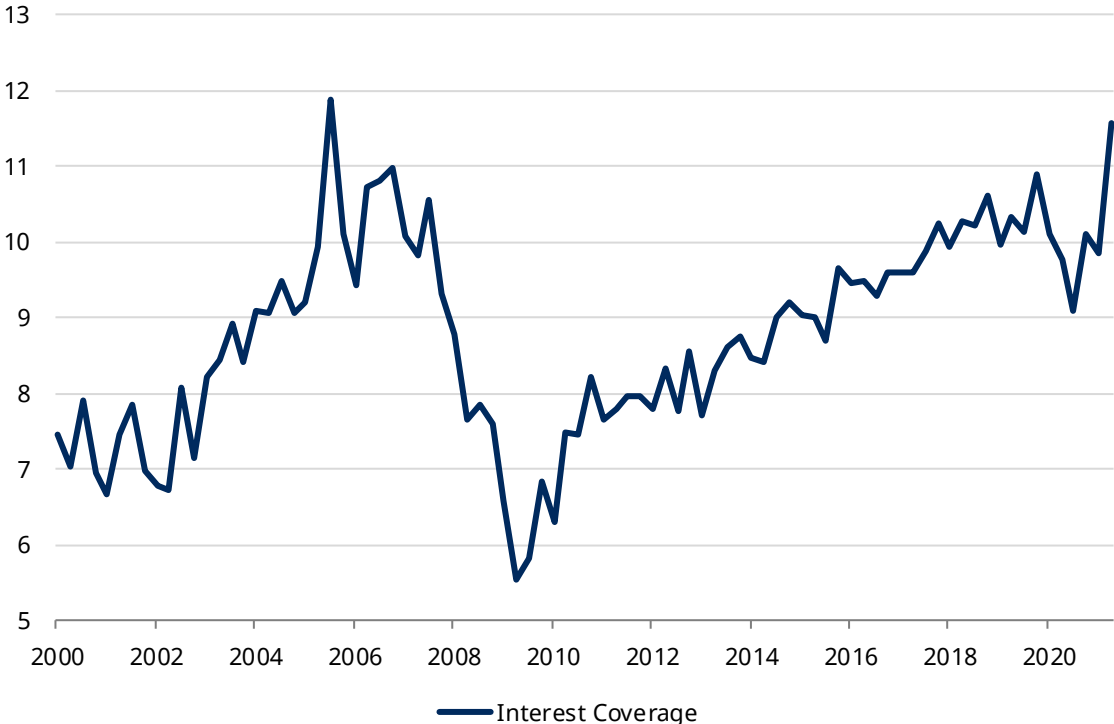
Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as of Q2 2021.

# Euro IG interest coverage

Interest coverage rising ever higher because of very low interest costs

## Euro IG interest coverage ratio

Last 12 months EBITDA to interest expense



## Euro IG annual interest expense growth

%



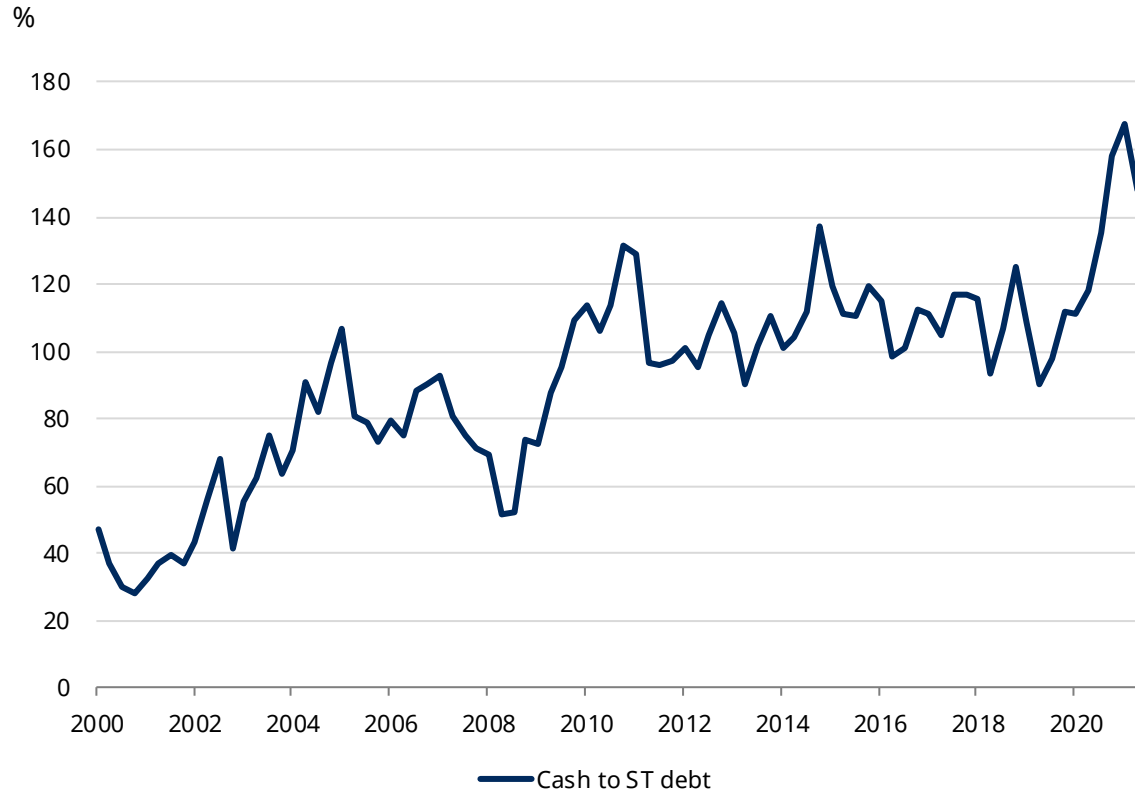
Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as of Q2 2021.



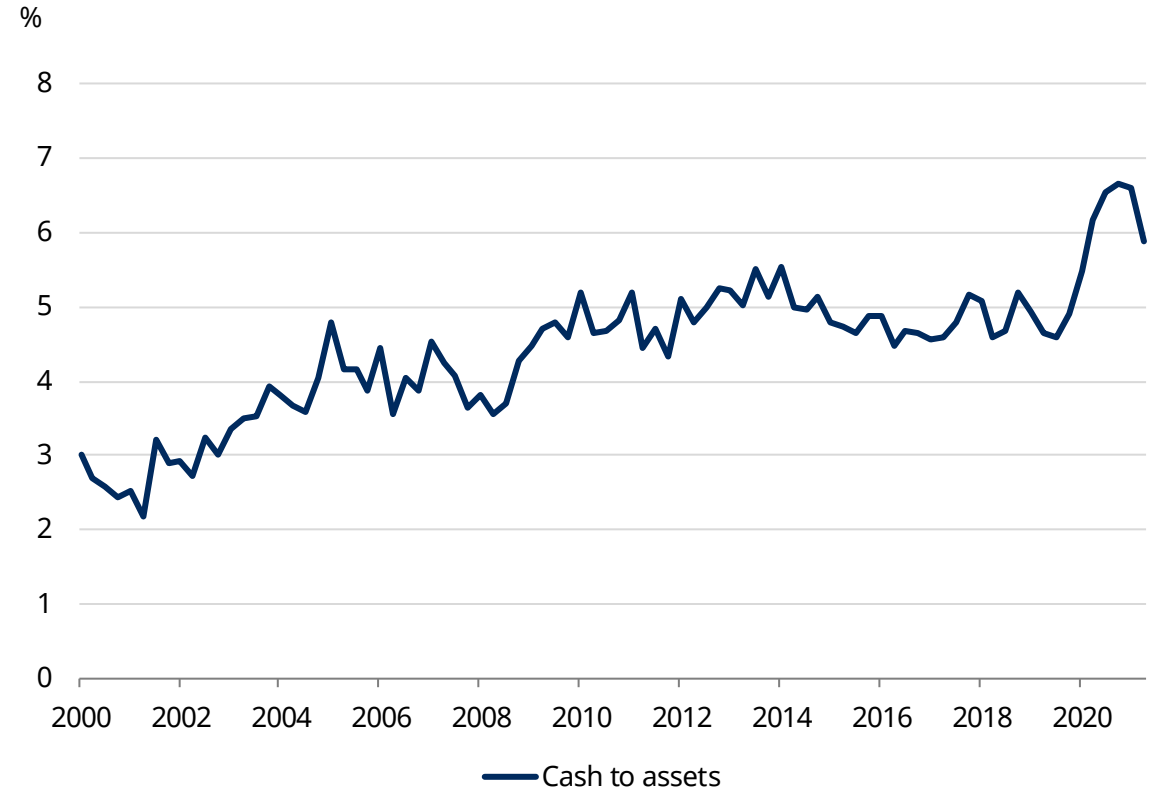
# Euro IG cash levels

Cash balances have fallen in the last two quarters

## Euro IG cash to short term debt



## Euro IG cash to assets



**Slower recovery in Europe might have forced companies to put some of the cash to work**

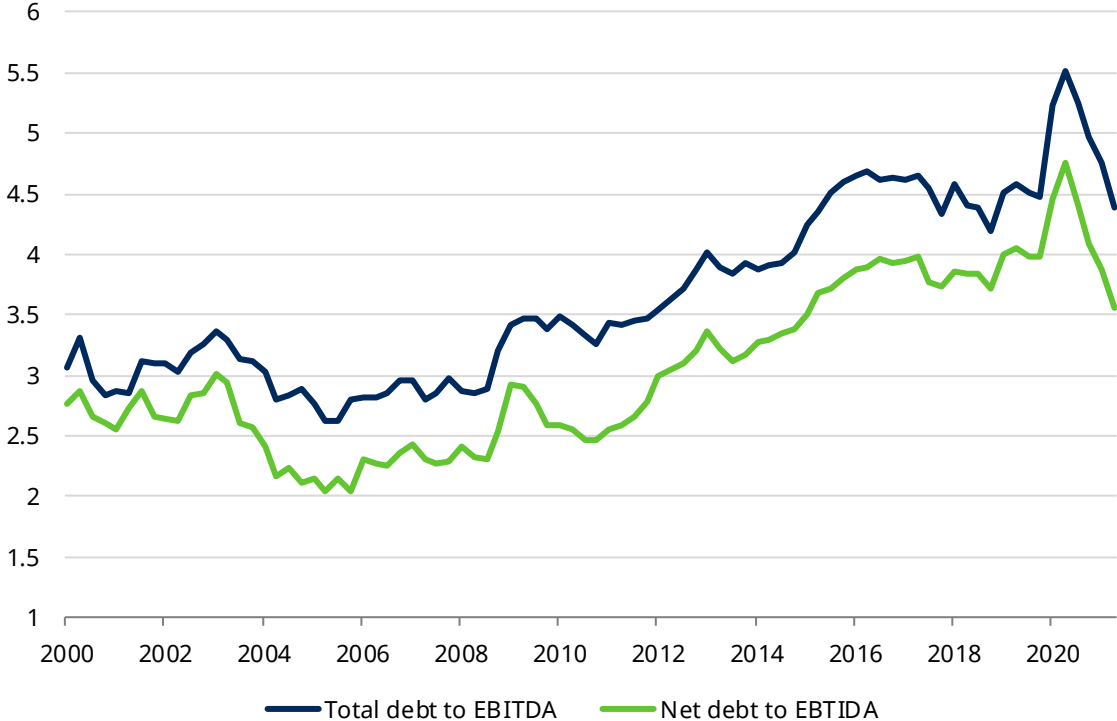
Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as of Q2 2021.

# US HY leverage

Leverage is falling because of fast earnings growth and falling debt levels

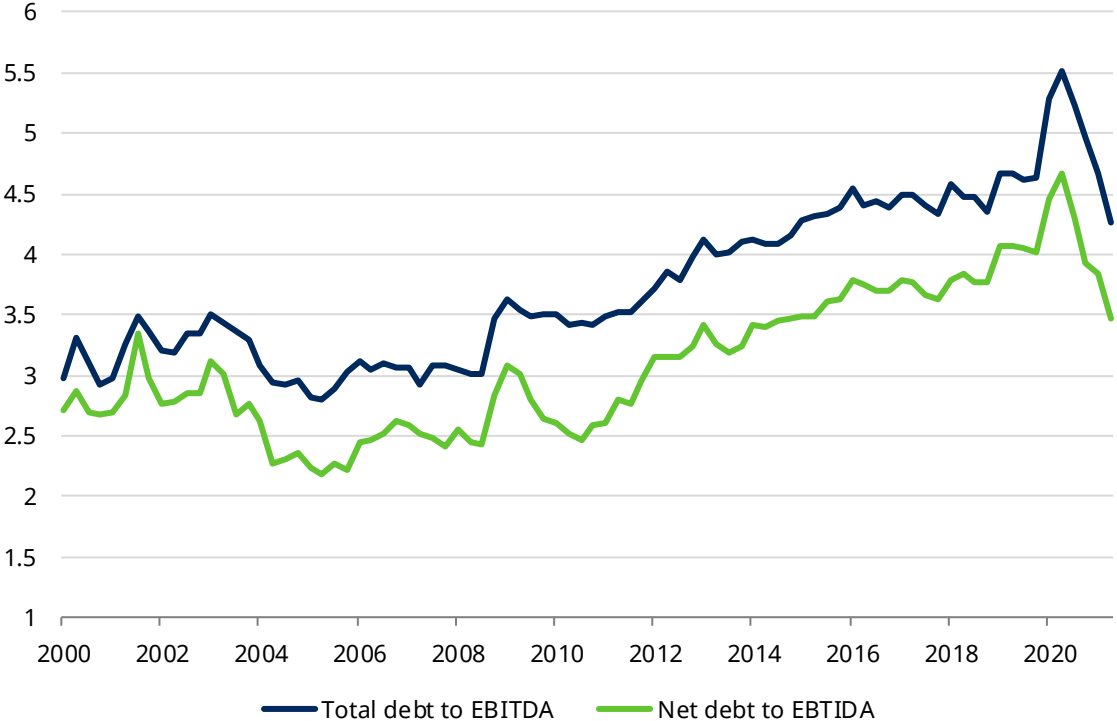
## US HY leverage

Debt to last 12 months EBITDA



## US HY ex-energy leverage

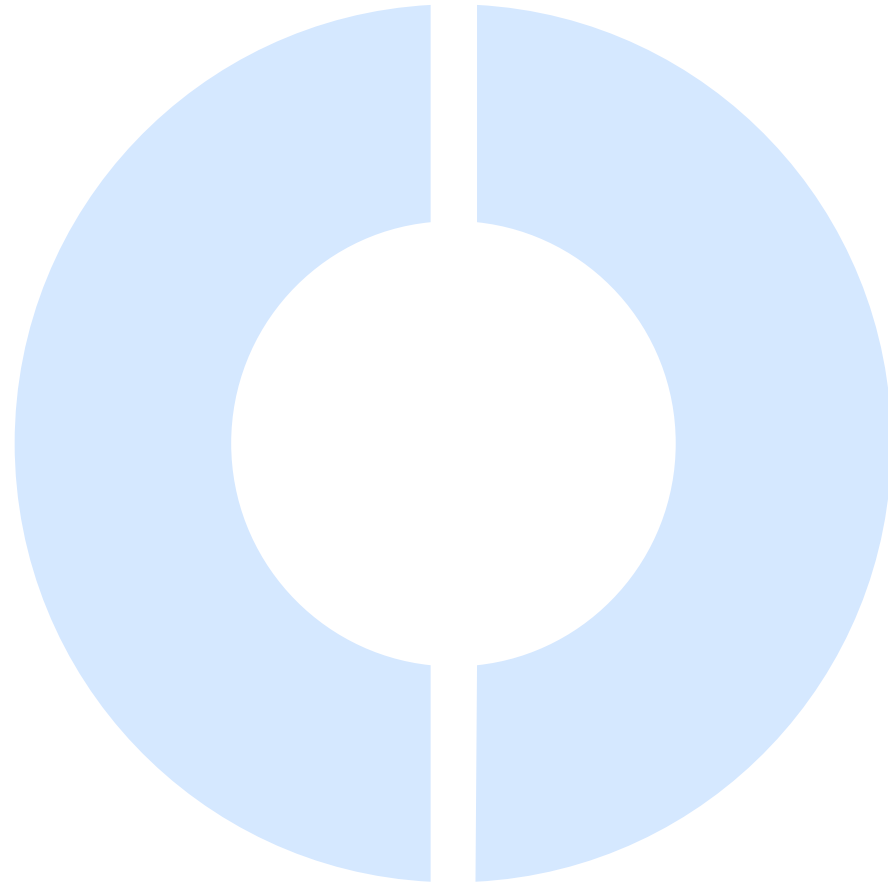
Debt to last 12 months EBITDA



US HY leverage is the lowest since 2015

Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as of Q2 2021.

**Schroders**

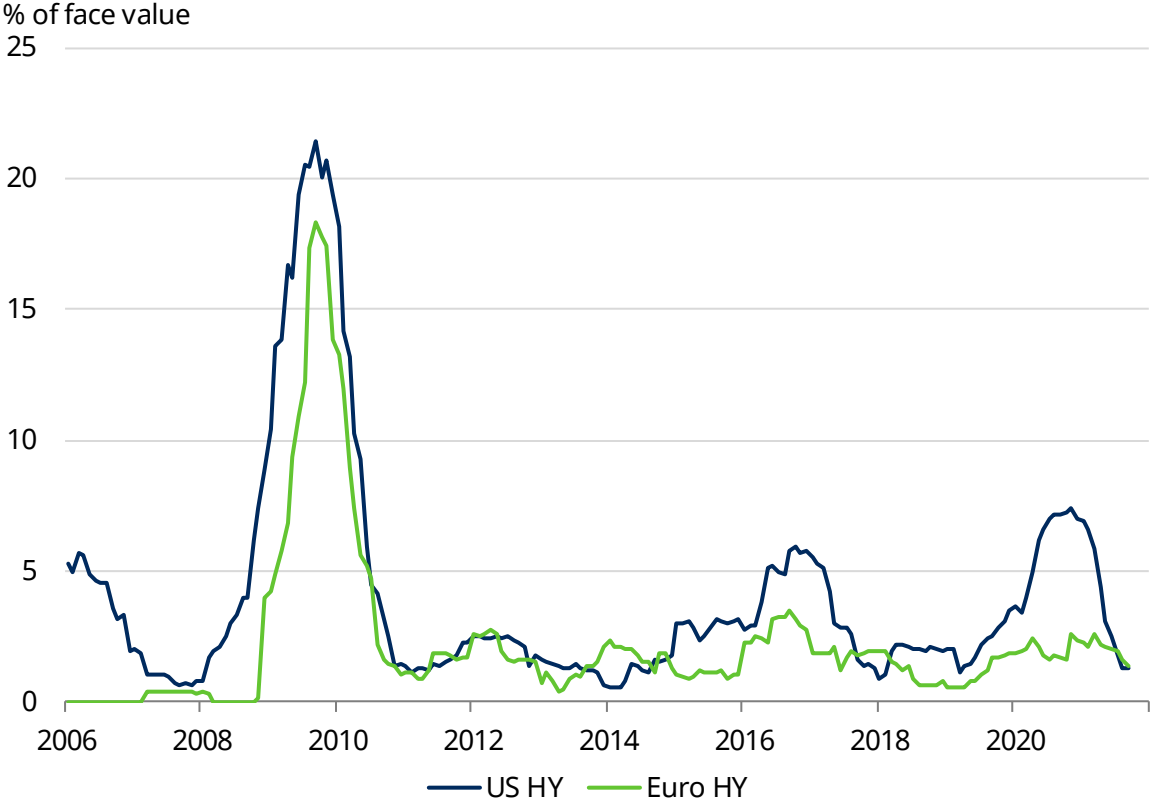


**Corporate credit**

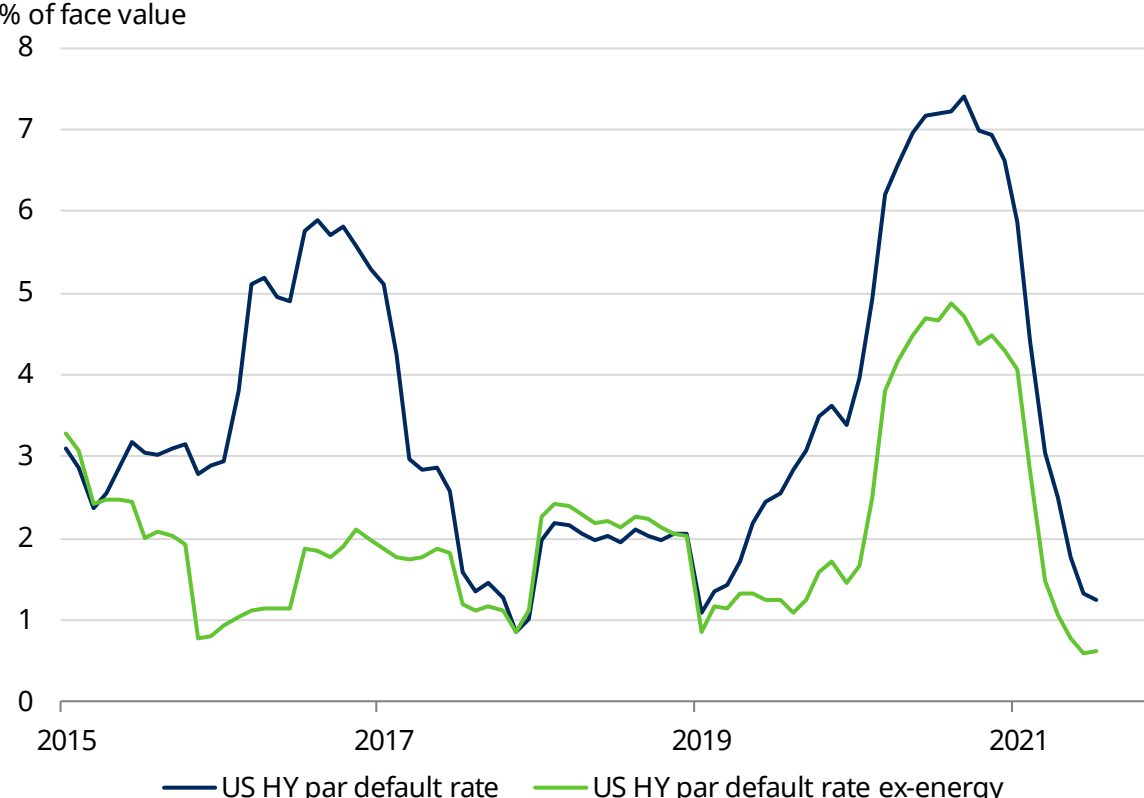
Technicals

# HY default rates

## HY par default rate (last twelve months)



## US HY par default rate (last twelve months)



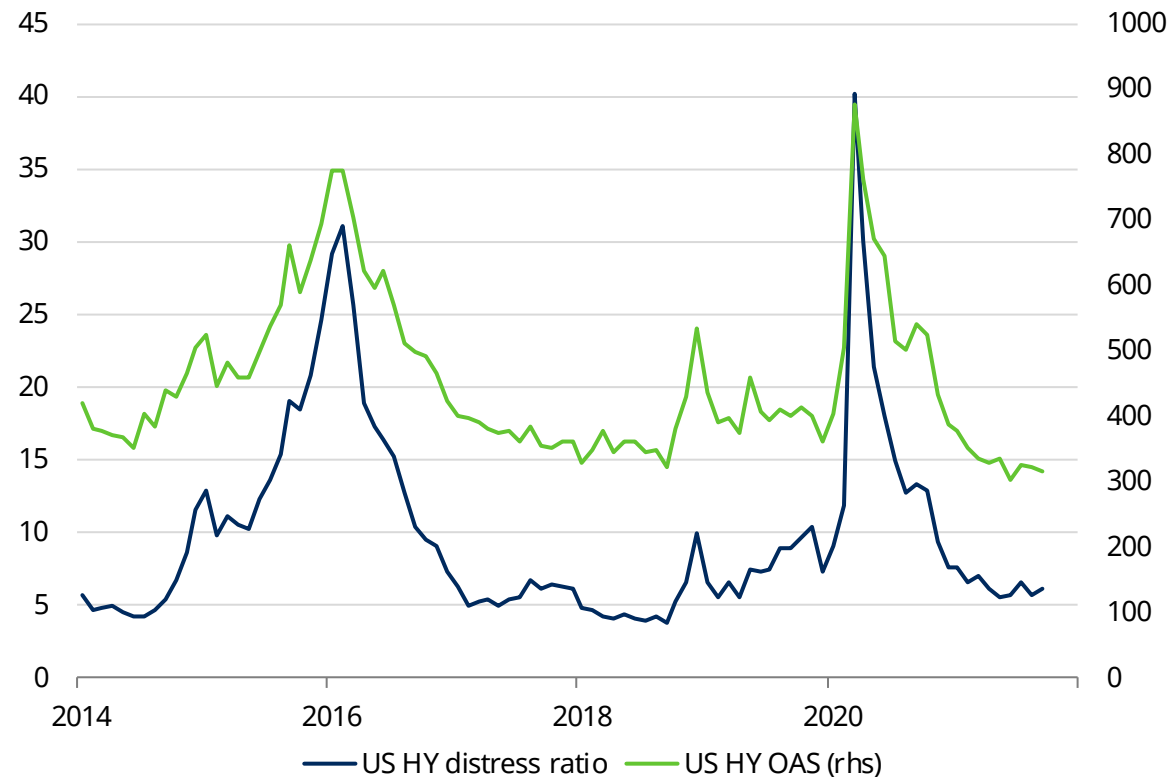
**There were no defaults in US or Euro HY in August and September**

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

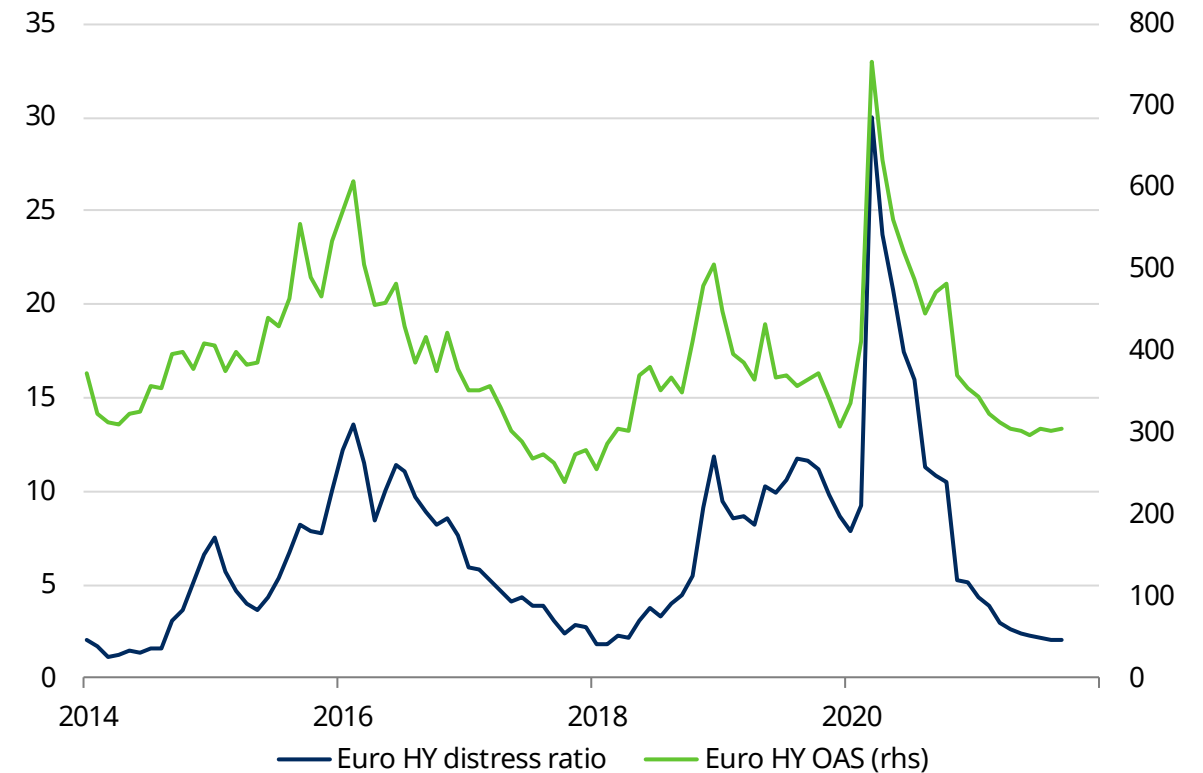
# HY distress ratios

## Harbinger of defaults

### US HY distress ratio<sup>1</sup>



### Euro HY distress ratio<sup>1</sup>



## HY distress ratios are very low

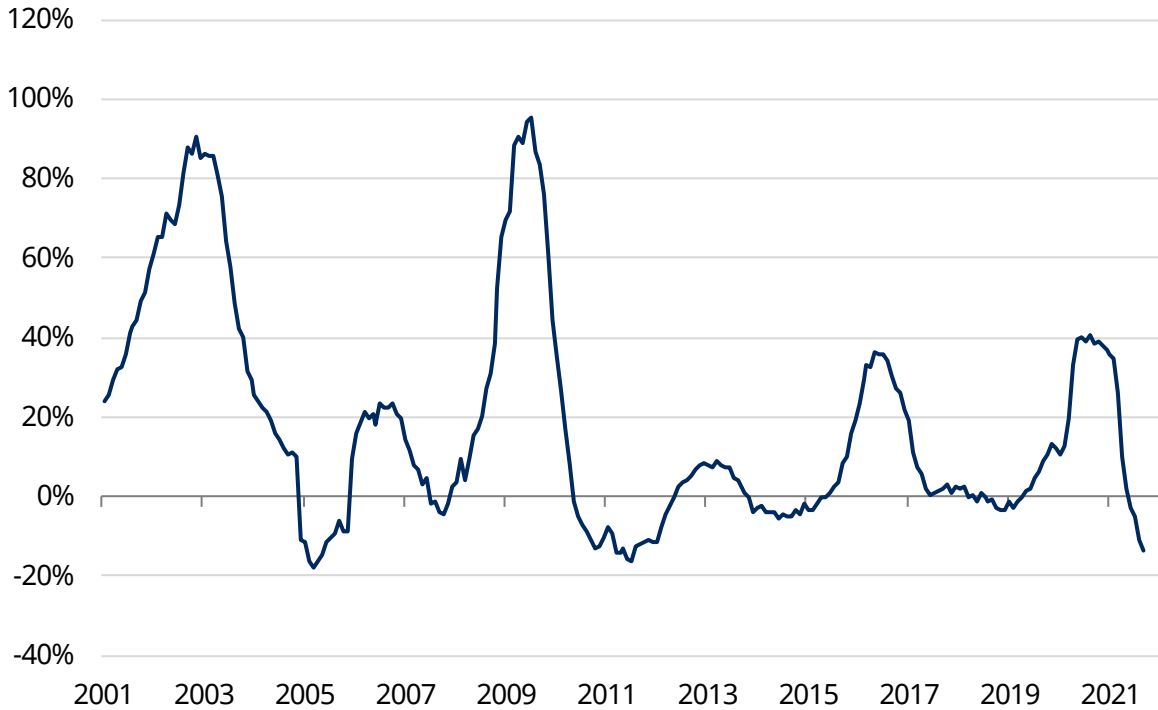
Source: Schroders, BofA Global Research, Moody's. Data as at 30 September 2021.  
<sup>1</sup>HY distress is defined as percentage of issues in the index trading with spreads > 1,000bp.

# US HY ratings migration (net downgrades)

Indicator of changes in credit quality

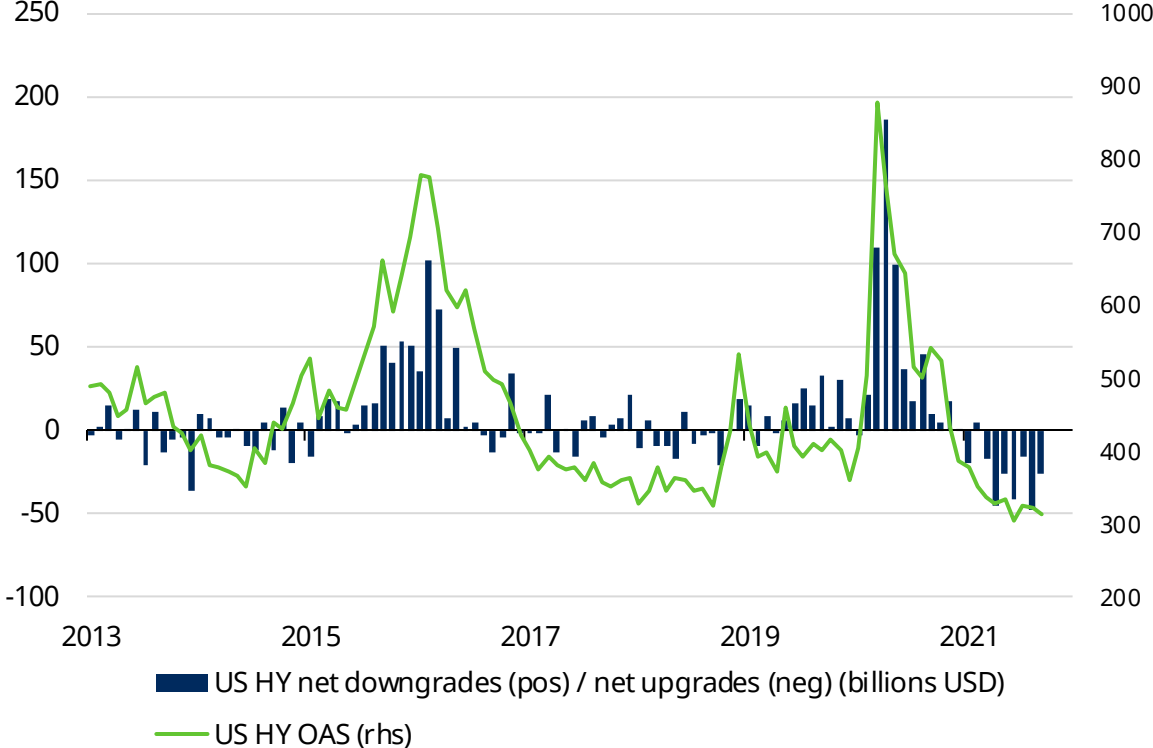
## US HY net downgrades<sup>1</sup>

Percentage of the HY index, last 12 months



## US HY monthly net downgrades

Billions USD



## HY upgrades still coming in strong

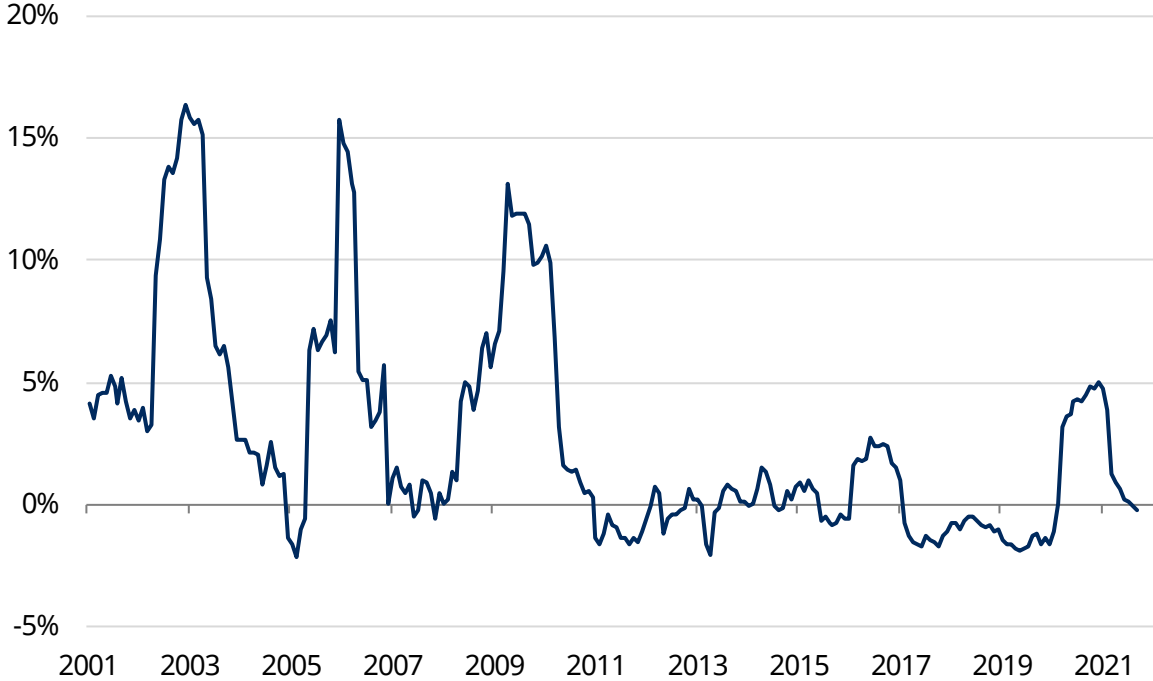
Source: BofA Global Research, Refinitiv Datastream. Data as at 30 September 2021. <sup>1</sup>Face value of downgraded bonds minus face value of upgraded bonds divided by face value of the index.

# US IG fallen angels/rising stars

## Bonds downgraded from IG to HY

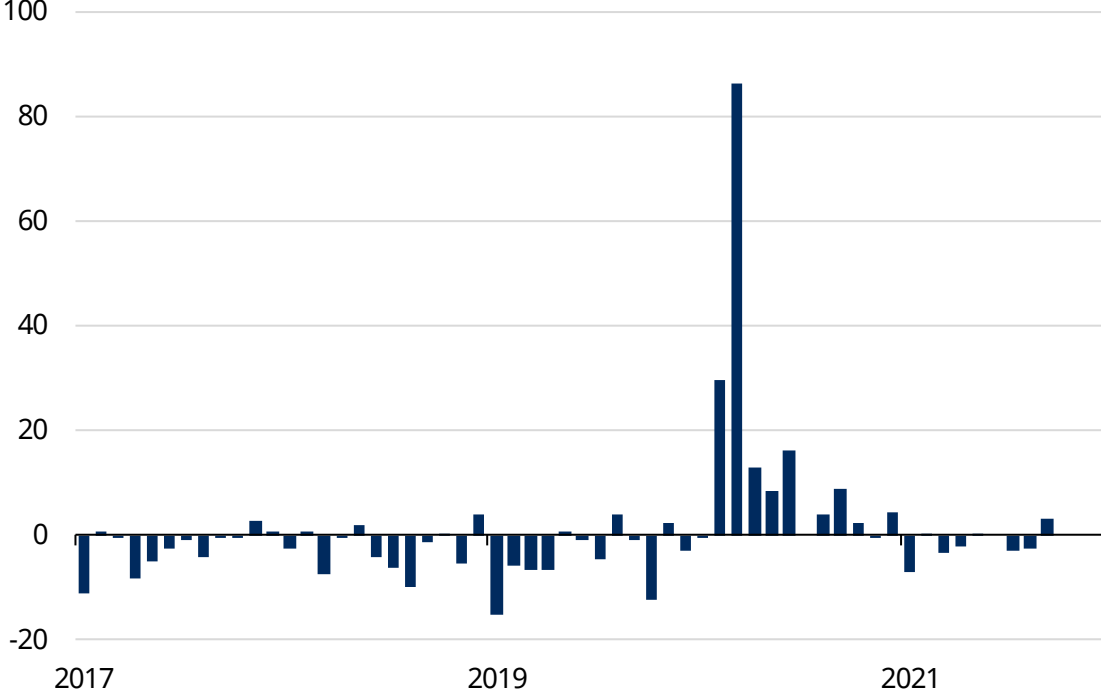
### US IG net fallen angels

Percentage of the BBB index, last 12 months



### US IG monthly net fallen angels

Billions USD

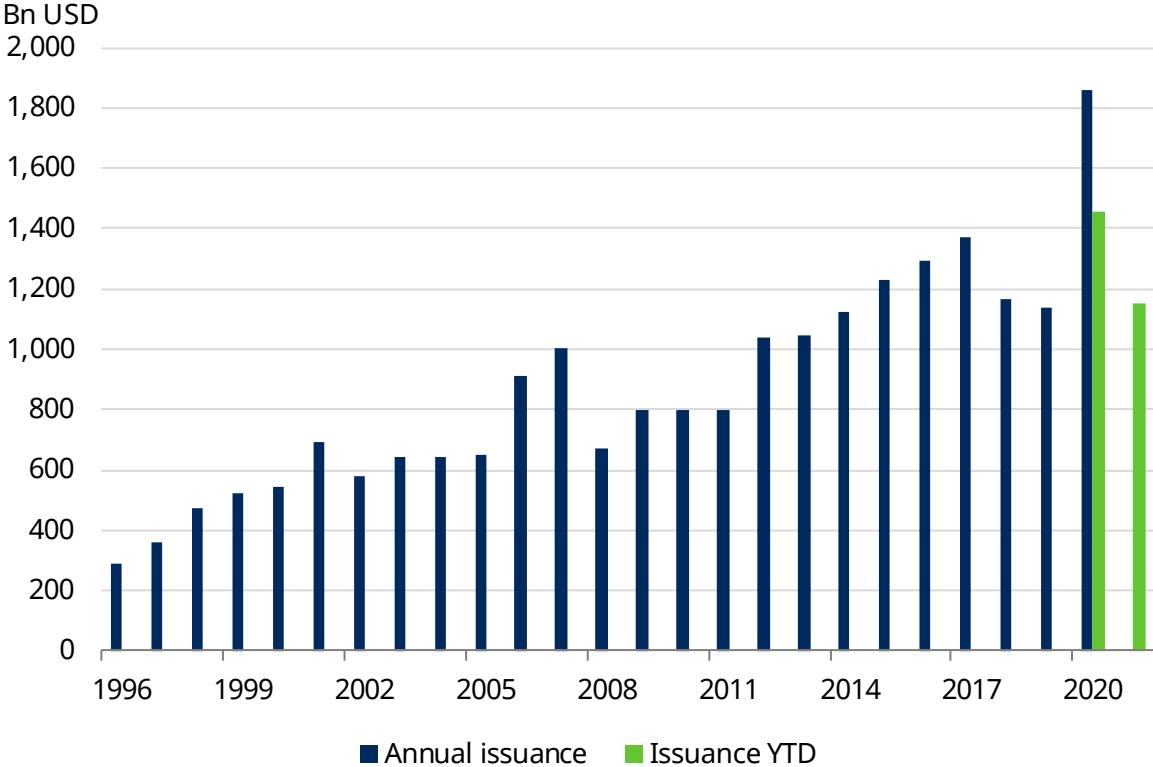


Upgrades from HY to IG have been surprisingly low so far

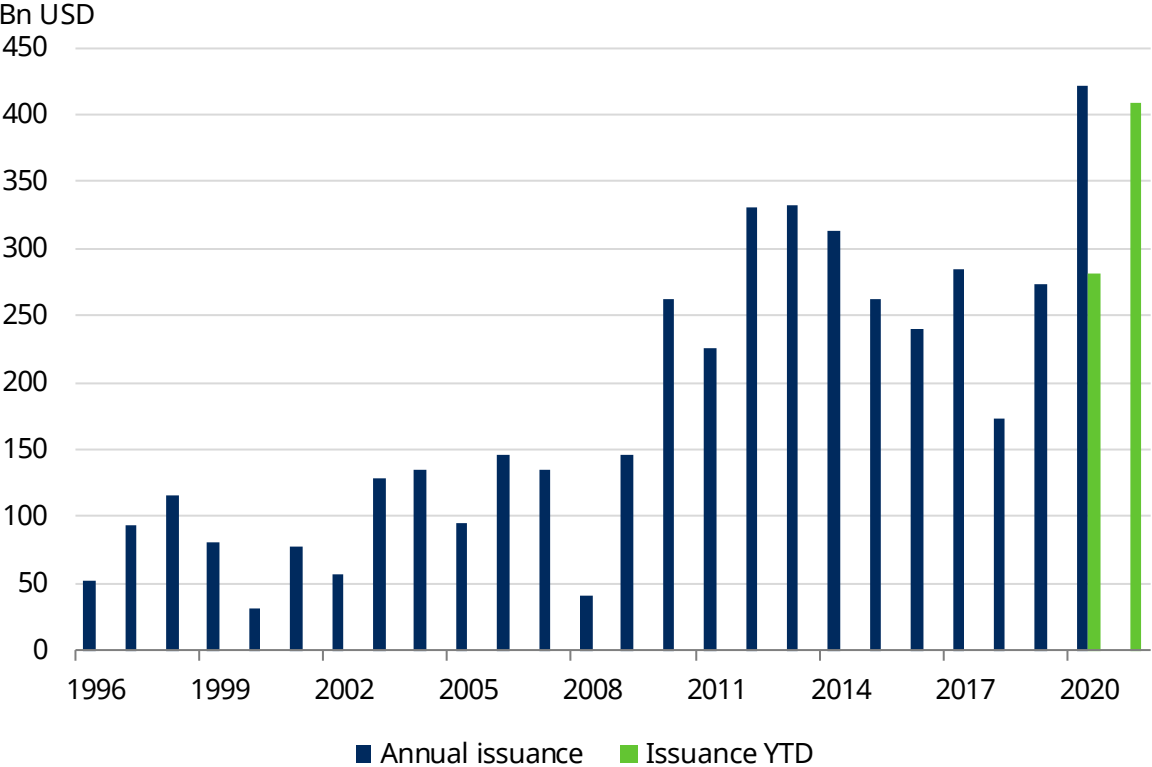
Source: BofA Global Research. Data as at 30 September 2021.

# US IG and HY gross issuance

## US IG issuance



## US HY issuance



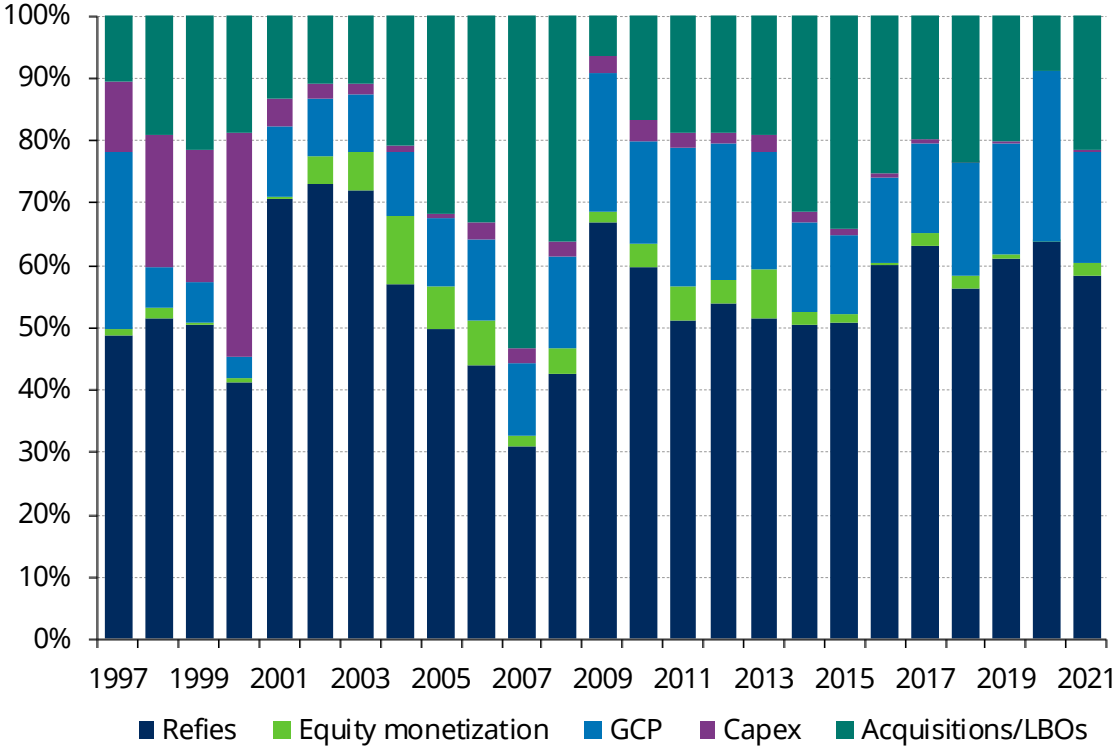
**US HY issuance at \$408 billion in the first nine months of 2021**

Source: Sifma. Data as at 30 September 2021.

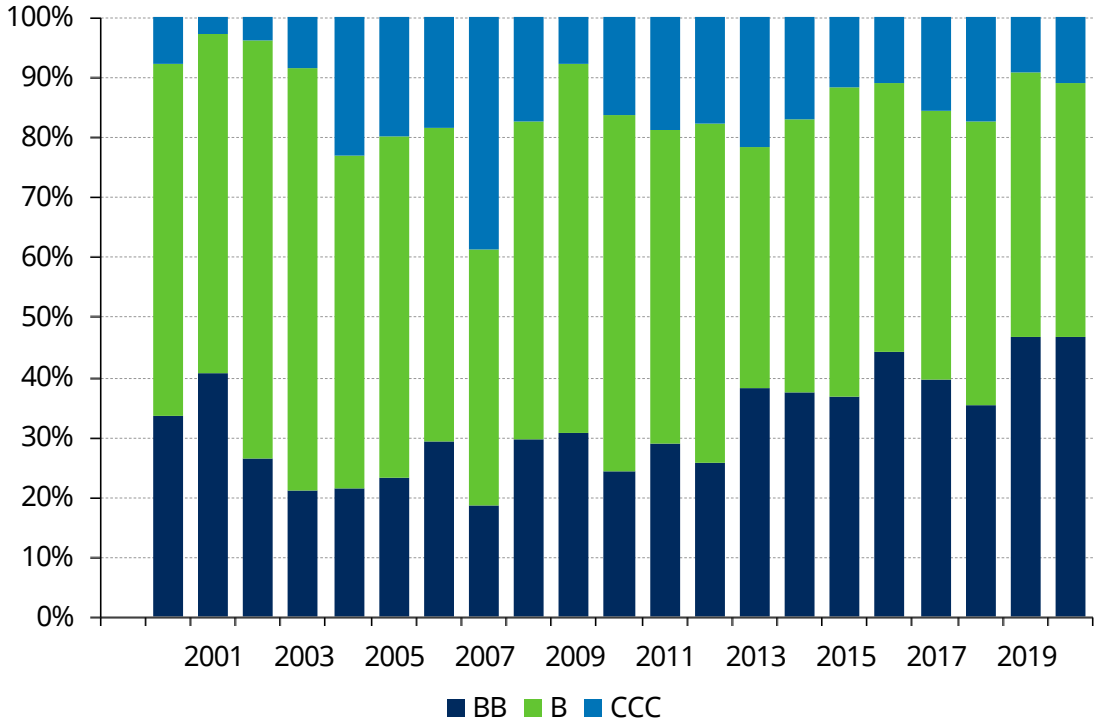


# US HY issuance details

### Use of proceeds (percentage of issuance)



### Issuance by rating (percentage of issuance)



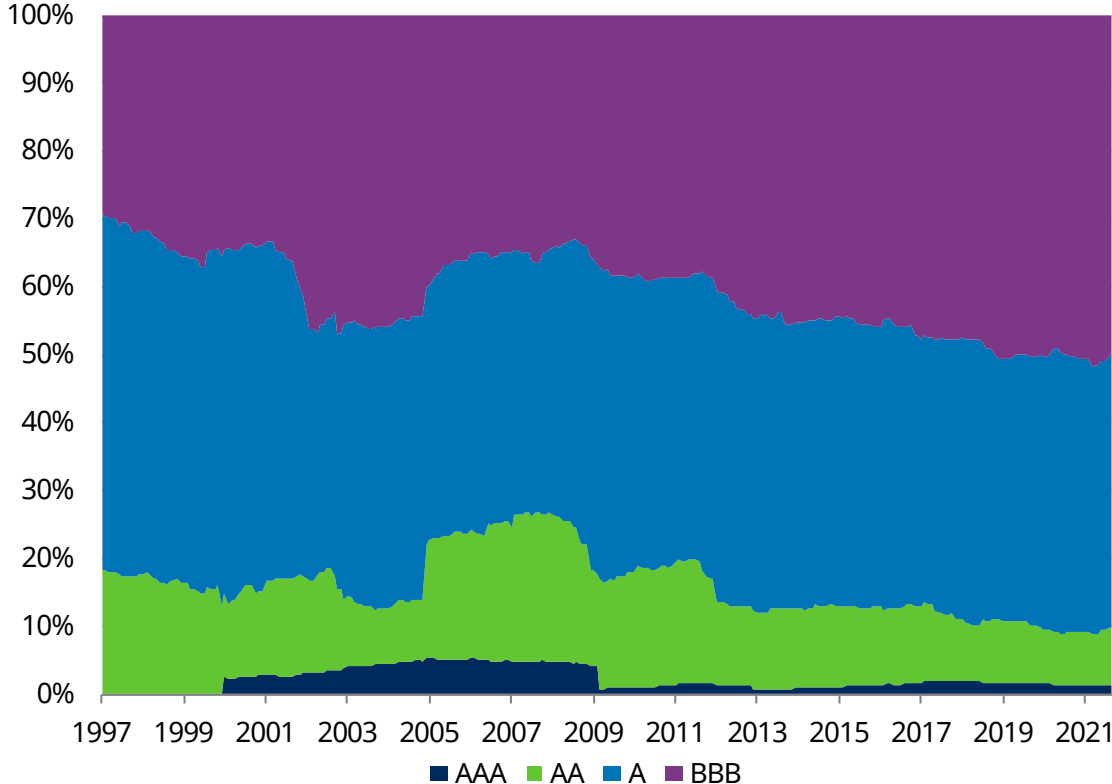
Issuance quality has worsen slightly with higher acquisition/buyout and CCC issuance

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

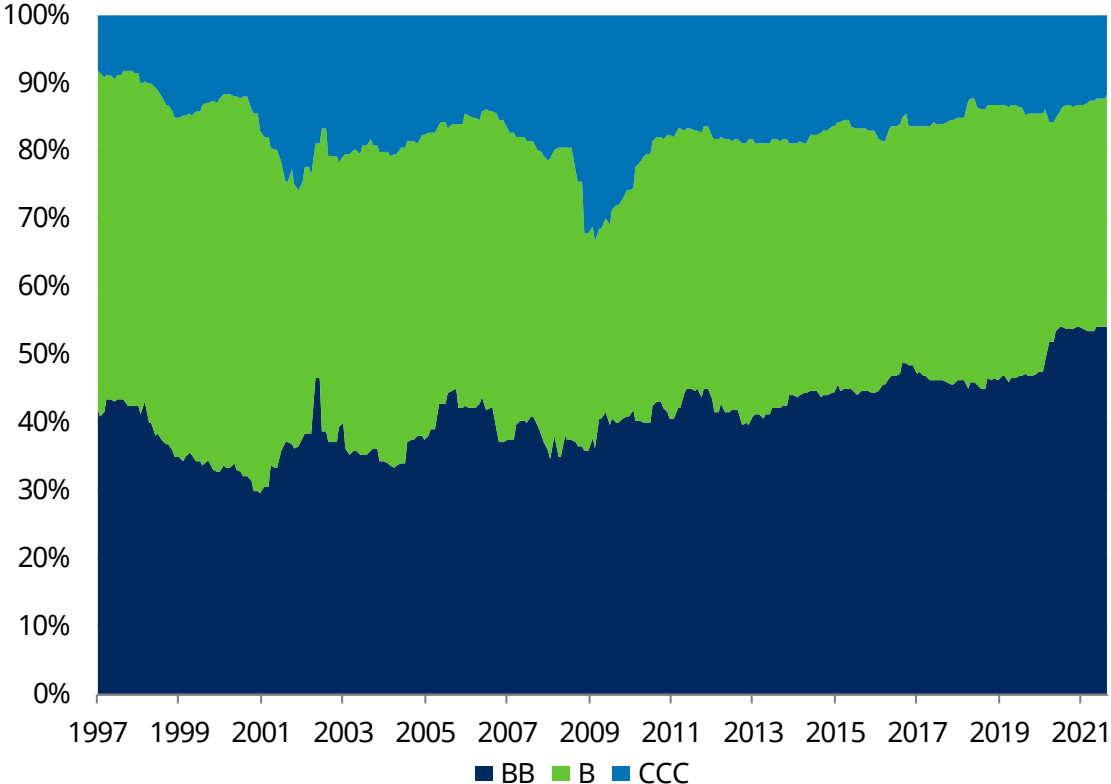
# US dollar credit historical ratings split

Significant changes in credit quality over time

## US IG ratings split



## US HY ratings split



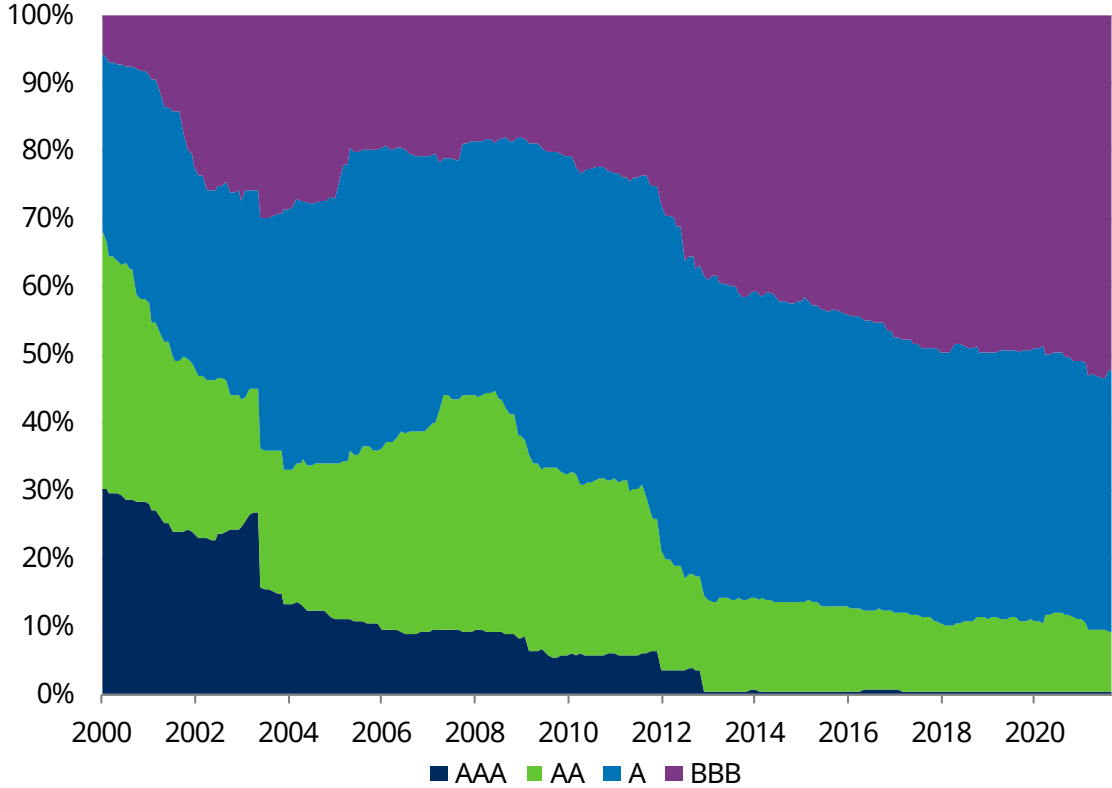
HY credit quality improved in 2020 because of the inclusion of downgraded IG bonds

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

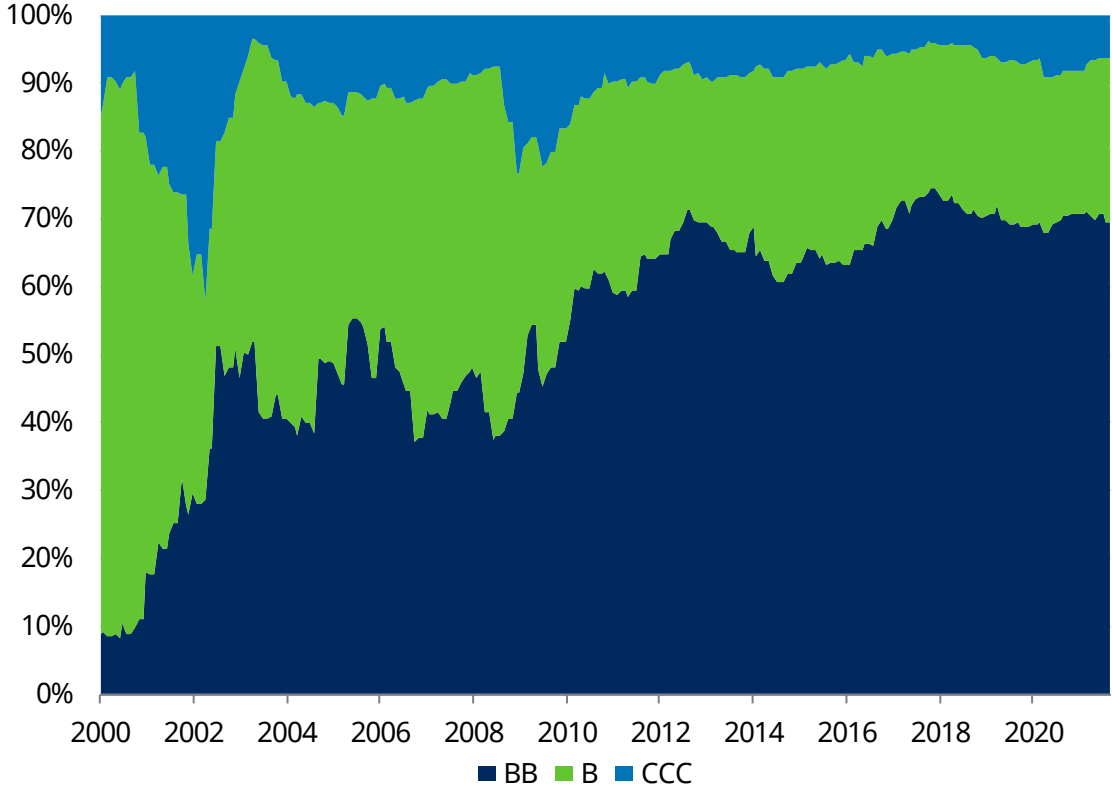
# Euro credit historical ratings split

Significant changes in credit quality over time

## Euro IG ratings split



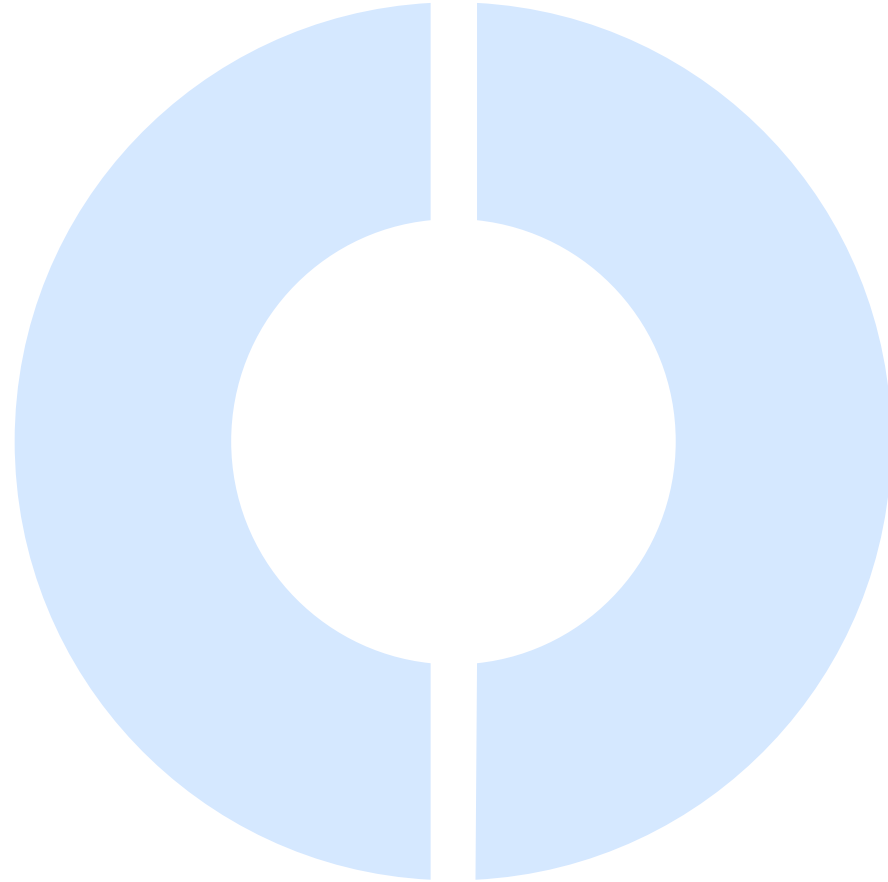
## Euro HY ratings split



IG credit quality has worsened in the pandemic

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

**Schroders**

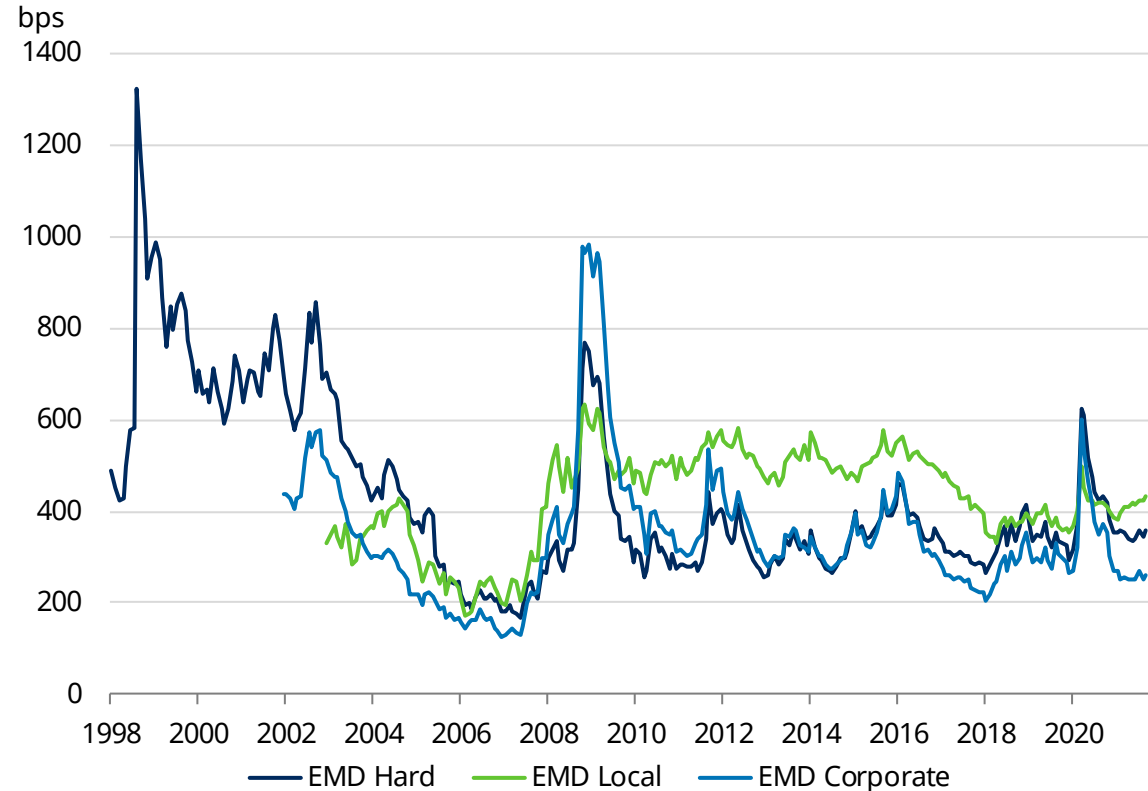


**Emerging Market Debt**

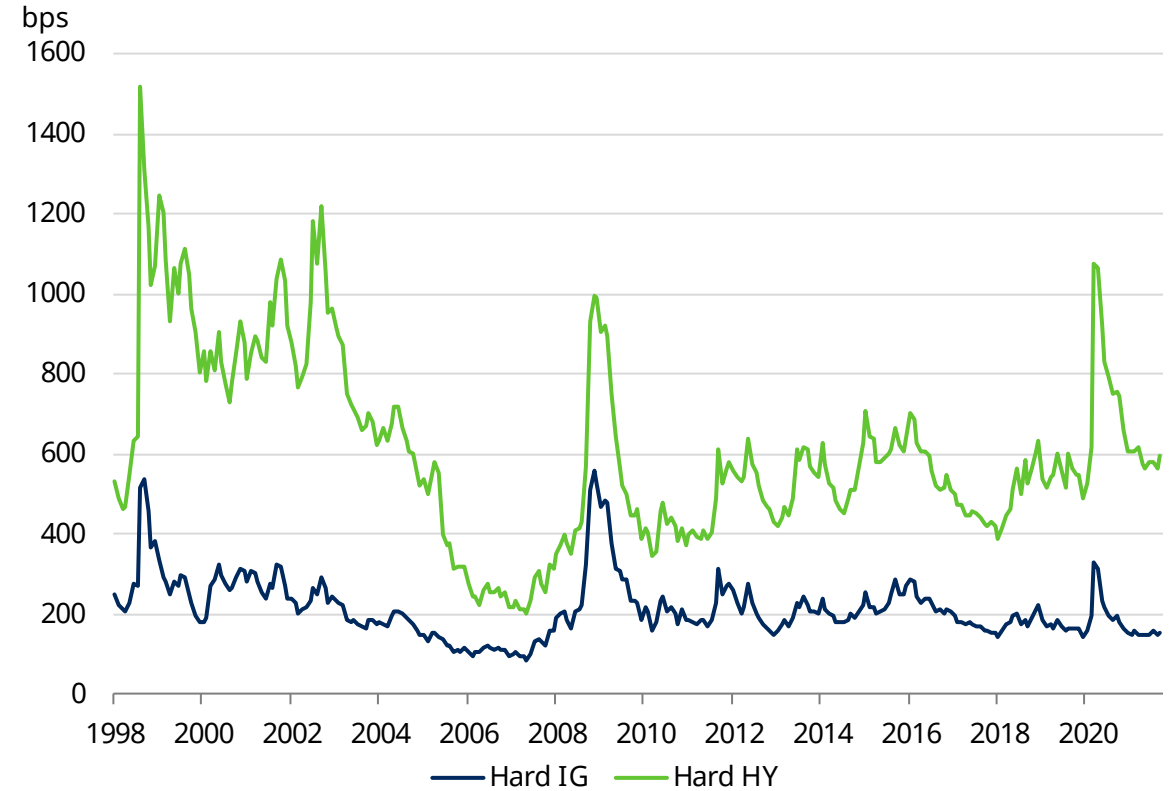
# Valuation EMD

## Historical spreads

### EMD spreads



### EMD Hard IG and HY spreads



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

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

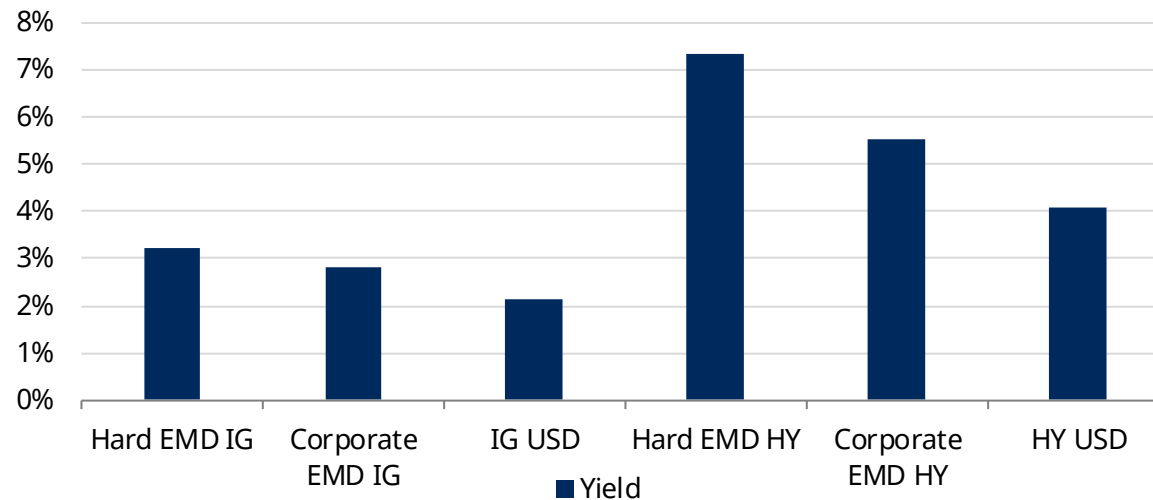
EMD Local is not a spread product, the spread is manually calculated relative to treasuries of approximately equivalent duration.

# 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%	7.4%	5.5%	4.1%
Spread (bps)	152	147	89	594	455	315
Duration	9.4	5.6	8.4	6.4	3.4	5.3
Rating	A3	A3	A3	B1	B1	B1
Percentage of EMD index	50.2%	54.9%	-	49.8%	45.1%	-

## Yield

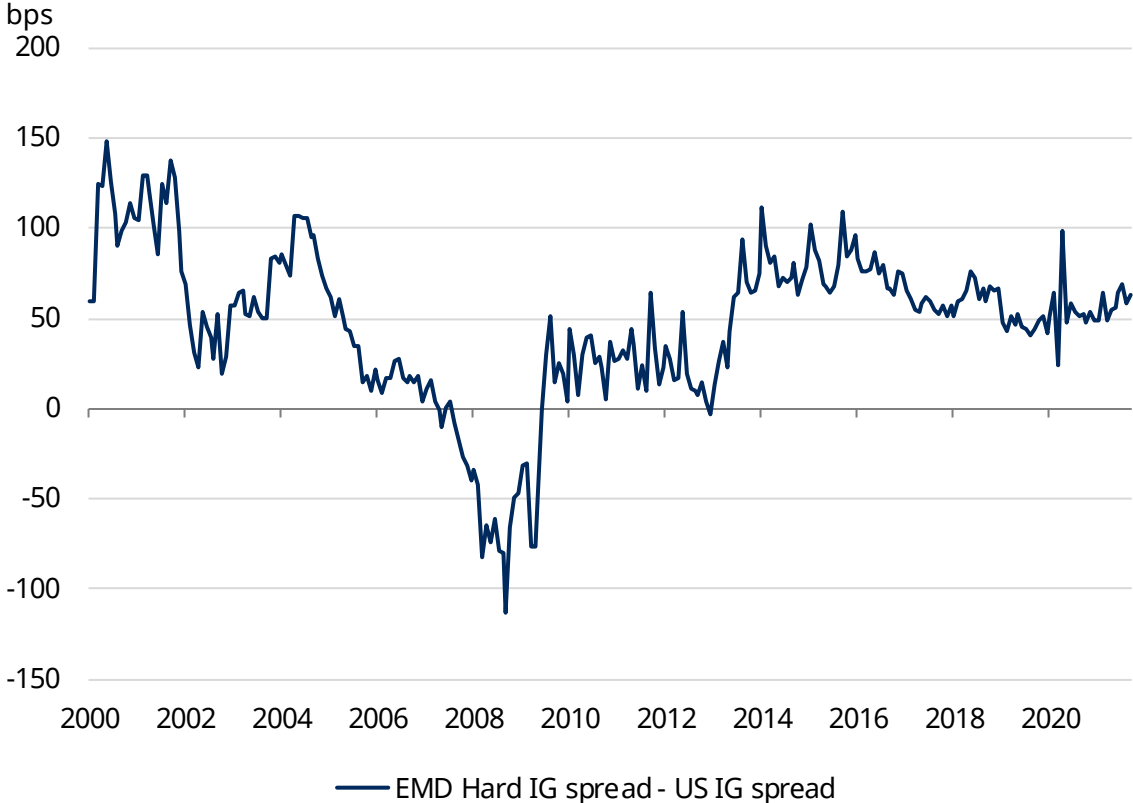


- Allocation to hard-currency EMD is a combination of IG and HY allocations
- Corporate EMD IG rating is one notch below US IG, EMD Hard IG rating is on par with US IG
- Hard EMD HY and Corporate EMD HY ratings are on par with US HY
- **Besides valuations, the decision between EMD (dollar-denominated)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

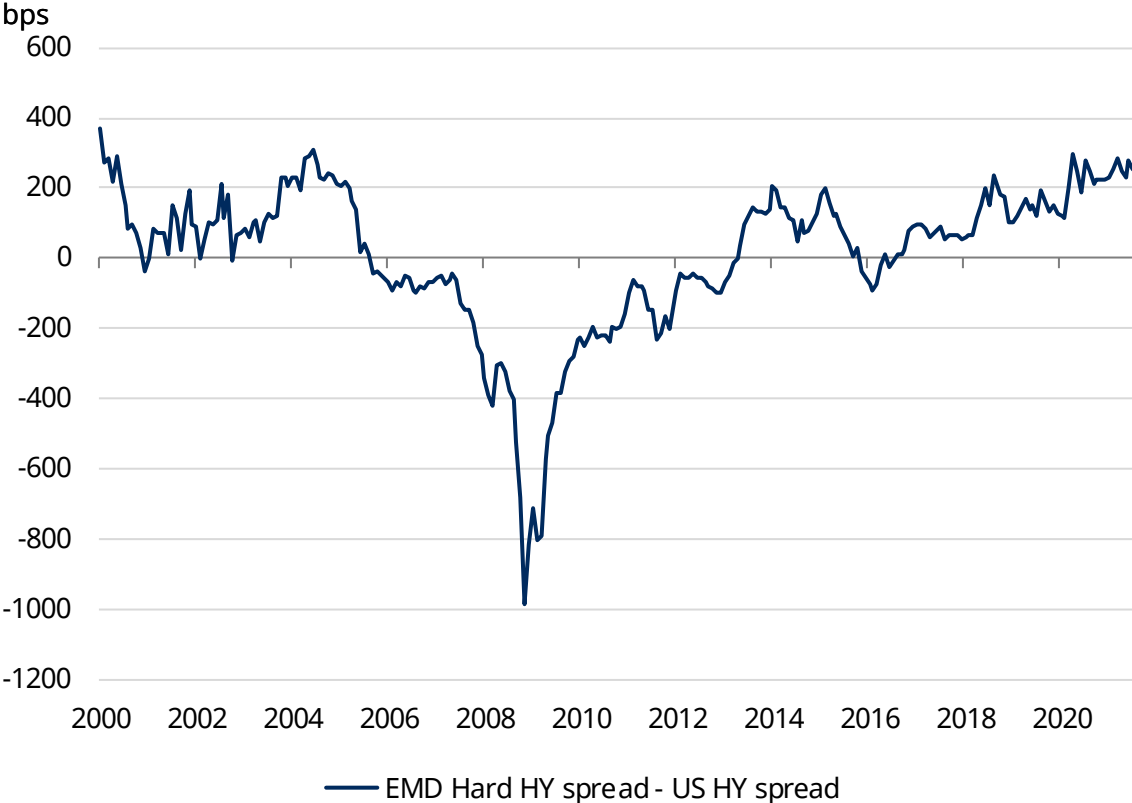
Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2021.

# Dollar debt: EMD Hard vs. US Corporates

### EMD Hard IG spread minus US IG spread



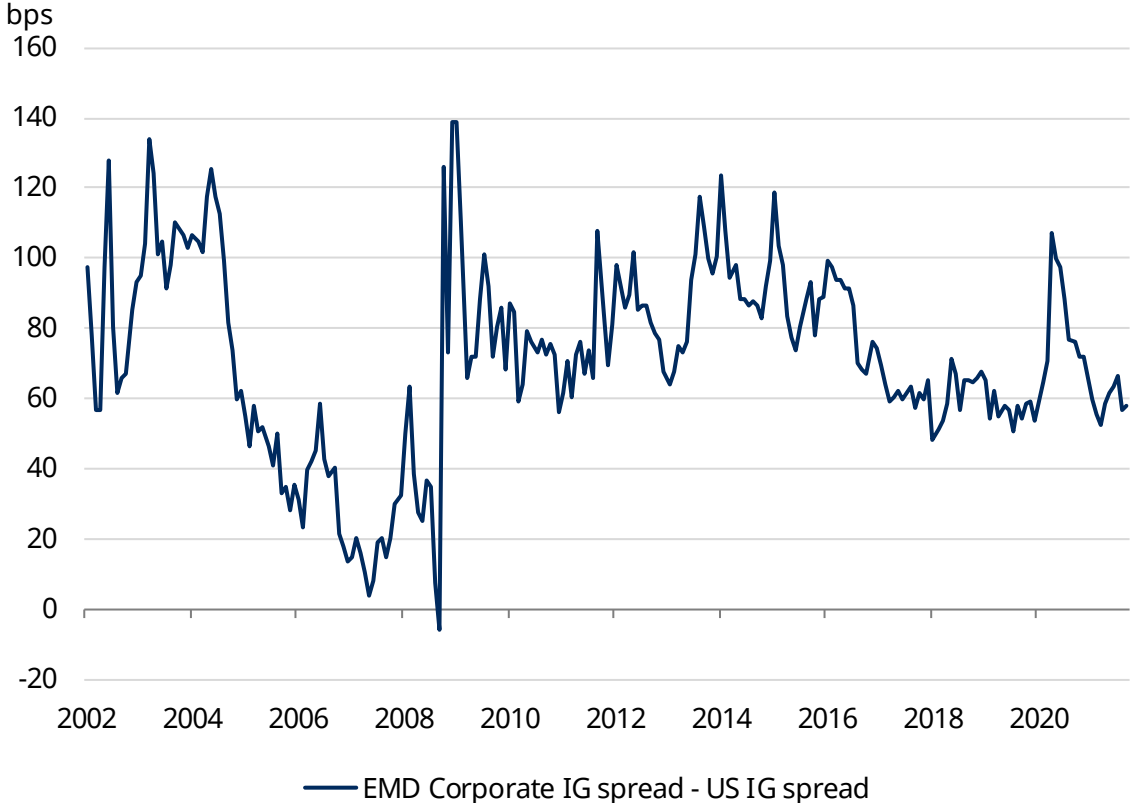
### EMD Hard HY spread minus US HY spread



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

# Dollar debt: EMD Corporates vs. US Corporates

### EMD Corporate IG spread minus US IG spread



### EMD Corporate HY spread minus US HY spread



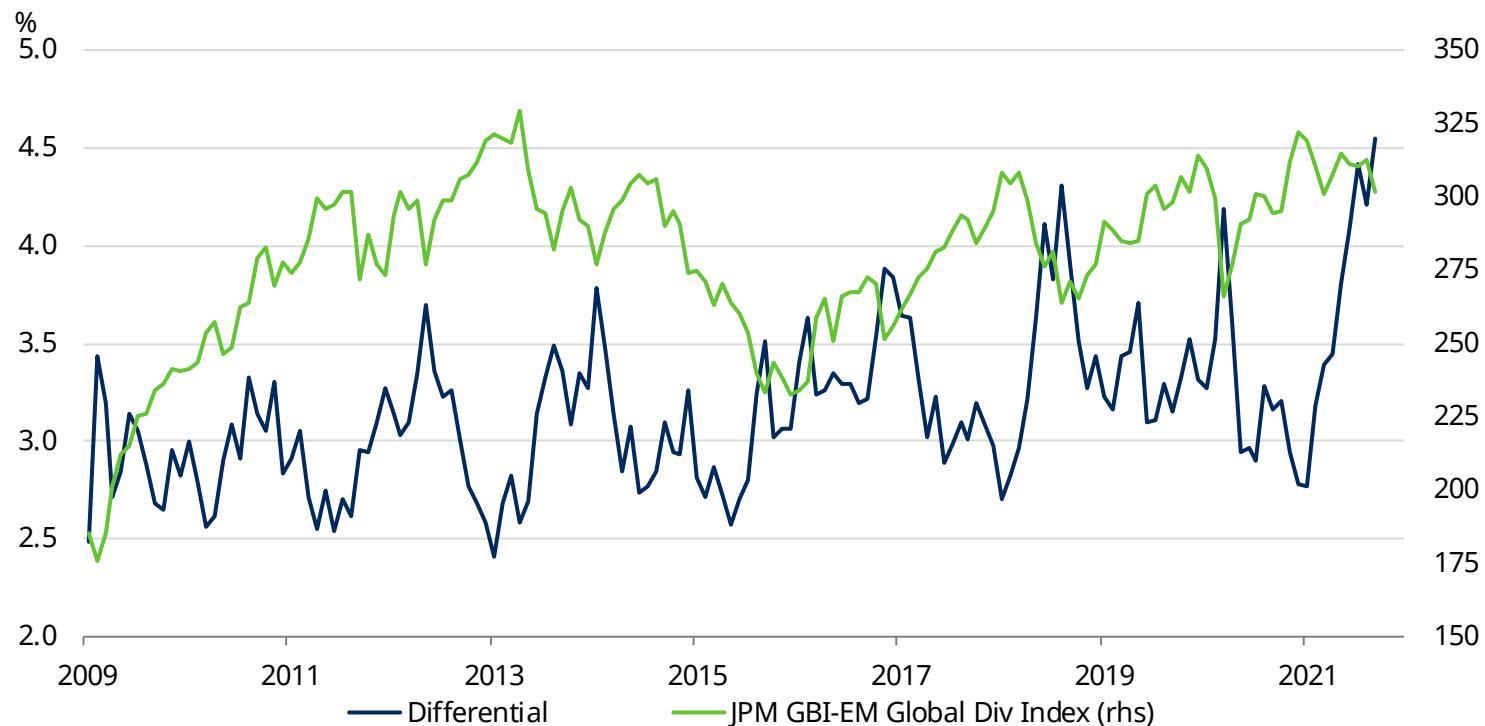
Source: Schrodgers, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2021.



# 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. Historically, this has been supportive for local currency EM bond returns**

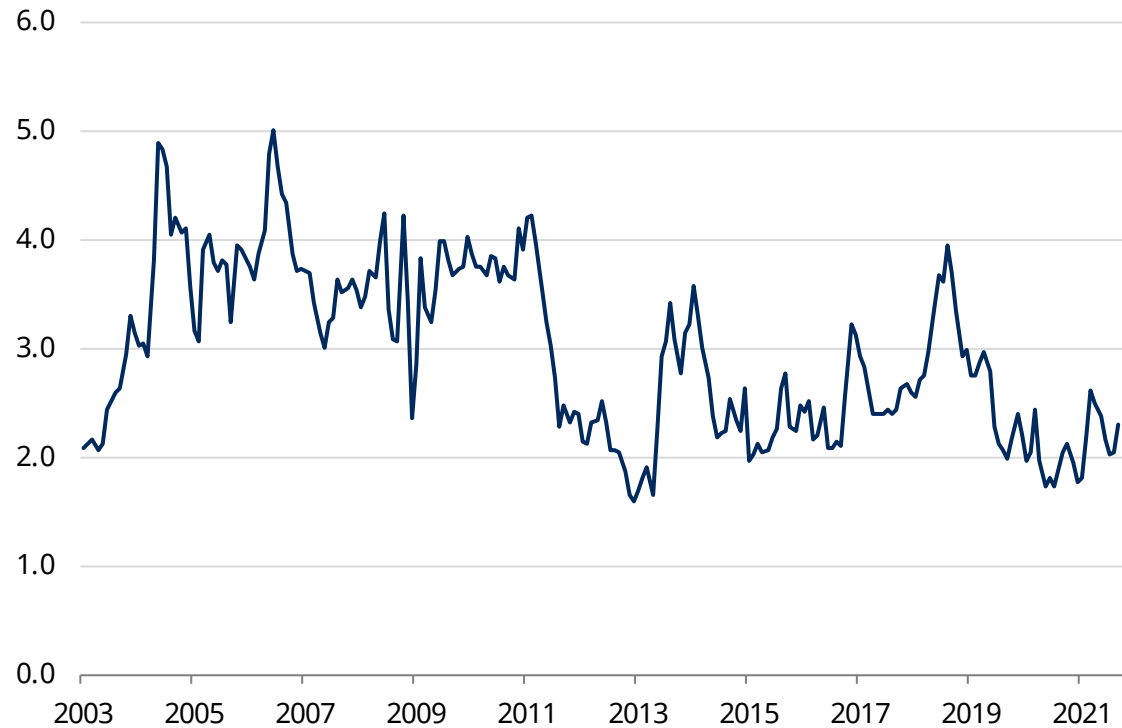
**Past performance is not a guide to future performance and may not be repeated.**

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

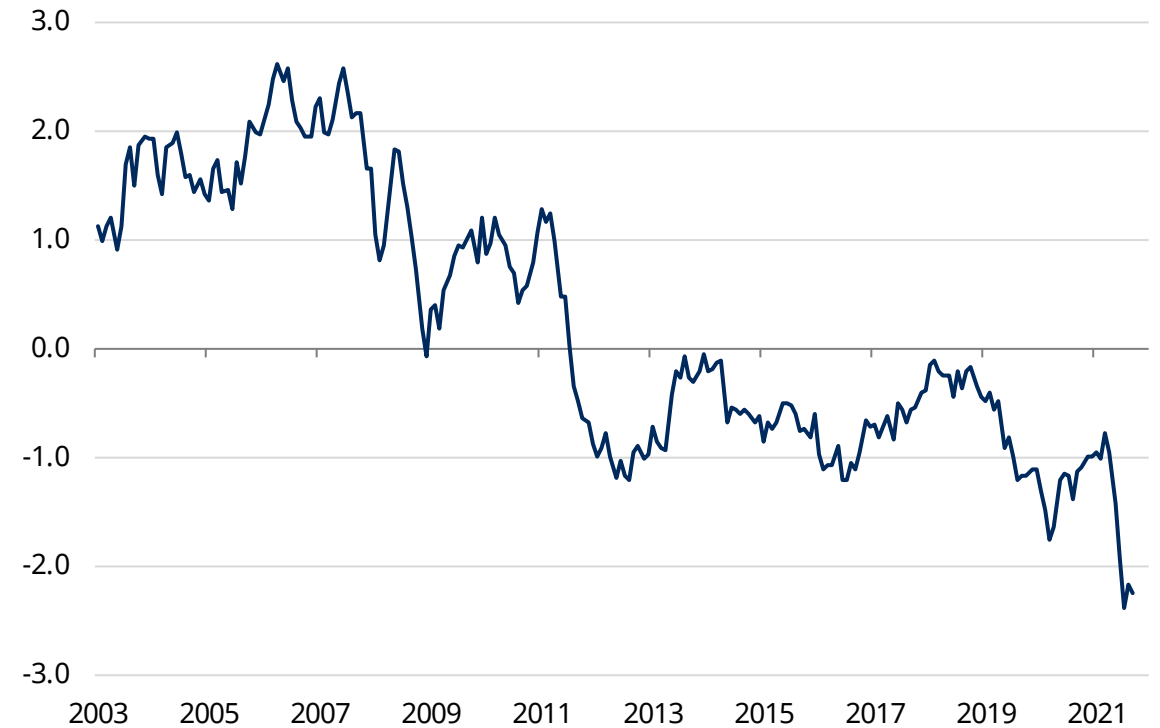
# EM/DM real yields

## Individual drivers of the real yield differential

### EM real yield (%)



### DM real yield

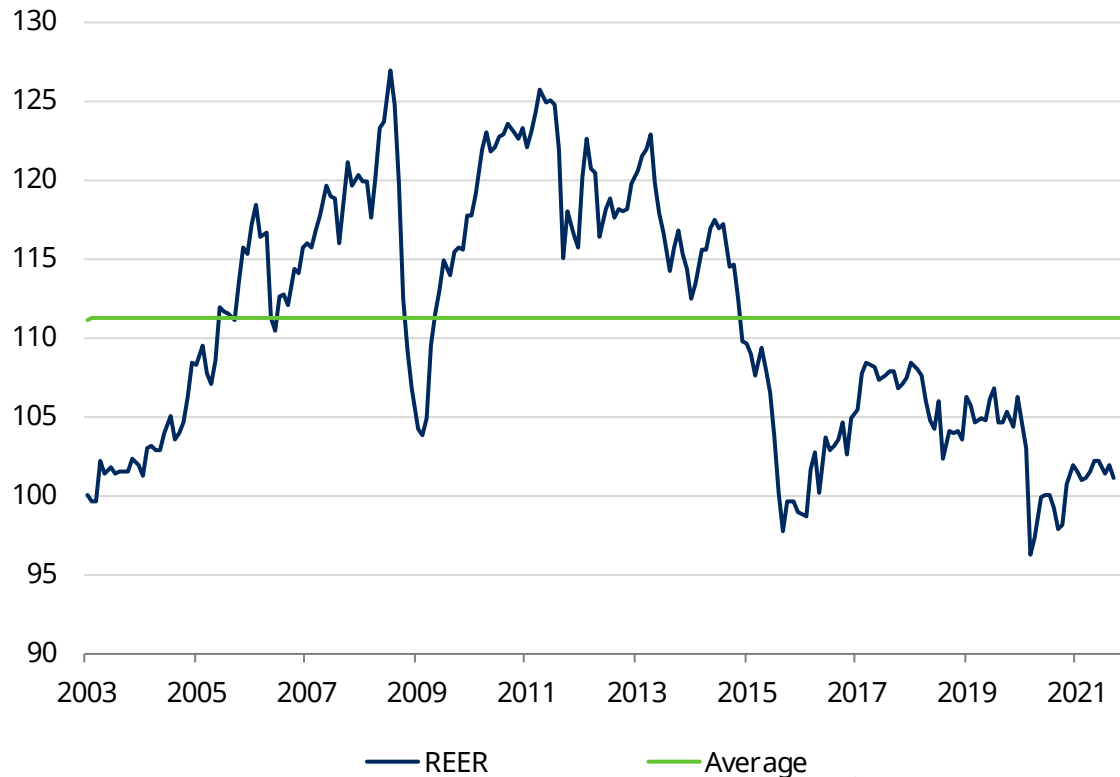


**DM real yield has fallen sharply as US core inflation has accelerated**

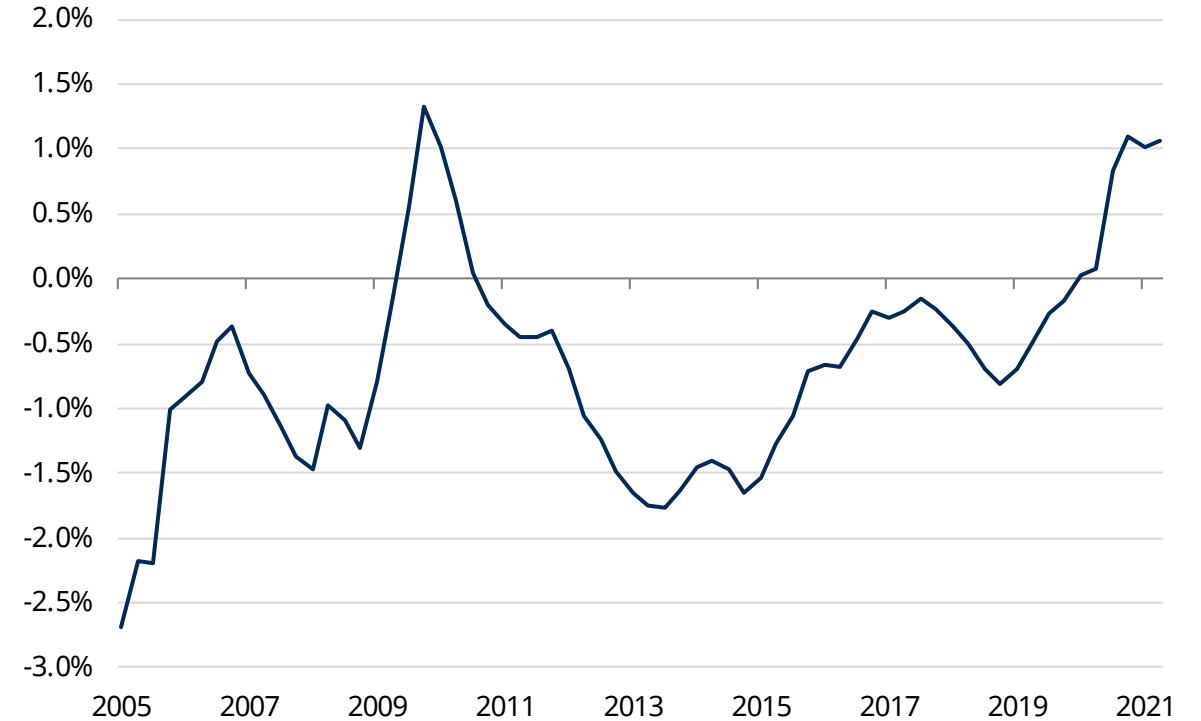
Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2021. EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by core inflation. DM real yield is 5Y government bond yields of US, UK, Euro zone, Japan deflated by core inflation,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

# EMD Local fundamentals

## EM real effective exchange rate<sup>1</sup>



## EMD Local current account balance (%GDP)<sup>1</sup>



**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 Q2 2021.

<sup>1</sup>Calculated 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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