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Schroders Credit Lens

Perspective of USD investor

Q2 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 49

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Cross-credit summary

Summary

- Credit spreads have held up well despite the significant increase in government bond yields. Valuations remain unattractive vs history, especially in investment grade (IG)
- As the recovery gathers pace, credit rating agencies are starting to upgrade issuers. Periods of net ratings upgrades have historically been associated with stable/tightening spreads
- Corporate fundamentals have started to improve across the board. Leverage fell in most markets in Q4 and interest coverage ticked higher. Higher yields should not hurt fundamentals too much in the near term
- Issuance has been surprisingly high so far in 2021, despite already large corporate cash balances. While part of this can be explained by companies refinancing their debt in anticipation of higher yields, M&A activity has also picked up recently
- At the same time, demand for credit has remained resilient, even for longer maturity bonds. This can be explained by pension funds purchasing long-term bonds, as funded statuses improve, buoyed by very strong equity markets
- In emerging market debt (EMD), sovereign bonds, both local and hard currency, have taken a hit from higher developed market (DM) yields. Hard currency EM corporates have held up relatively well

Summary table

Cross-credit overview

Date: 31 March 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	1.6%	1.9%	0.3%	2.3%	4.2%	2.6%	4.3%	5.3%	5.0%	3.8%
Yield to worst (hedged to USD) ¹	1.8%	2.0%	1.1%	2.3%	4.3%	3.4%	4.3%	5.3%	-	3.8%
Spread (bps)	96	115	91	97	379	314	336	354	408	258
Spread (percentile) ²	23%	24%	31%	10%	27%	19%	18%	48%	40%	22%
Risk premium (bps) ³	46	58	33	40	201	137	119	209	352	127
Duration	7.9	8.4	5.5	8.2	4.1	4.2	5.2	7.9	5.3	4.5
MV (billion \$)	904	702	3,340	8,259	61	521	1,554	728	1,373	594
Rating	A2	A3	A3	A3	BB3	BB3	B1	BB1	BBB3	BBB3
Nr. of issues/countries	1,223	1,051	3,679	8,962	106	727	2,049	74	19	1,937
Since Jan 1997 or inception										
Annualised return ⁴	5.8%	6.1%	5.4%	5.9%	9.1%	6.5%	6.8%	8.1%	6.2%	7.1%
Annualised volatility	5.2%	5.8%	3.5%	5.4%	10.6%	11.6%	8.9%	10.5%	11.8%	7.5%
Return/volatility	1.1	1.0	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 31 March 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 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	-0.3%	-0.3%	0.2%	-1.4%	0.2%	0.5%	0.2%	-1.0%	-3.1%	-0.6%
YTD return	-4.1%	-4.5%	-0.7%	-4.5%	1.6%	1.5%	0.9%	-4.5%	-6.7%	-0.8%
1 year return	7.0%	8.9%	8.5%	9.3%	22.9%	22.2%	23.3%	16.0%	13.0%	18.3%
Return (USD hedged)²										
1 month return	-0.2%	-0.3%	0.3%	-1.4%	0.2%	0.6%	0.2%	-1.0%	-3.1%	-0.6%
YTD return	-4.1%	-4.5%	-0.5%	-4.5%	1.6%	1.8%	0.9%	-4.5%	-6.7%	-0.8%
1 year return	7.5%	9.5%	9.6%	9.3%	23.7%	23.7%	23.3%	16.0%	13.0%	18.3%
Spread										
1 month OAS change	4	5	2	2	-15	-8	-16	-5	14	7
YTD OAS change	-3	-2	-2	-6	-84	-41	-50	2	20	-12
1 year OAS change	-116	-143	-147	-208	-614	-440	-541	-272	-92	-341
Latest OAS	96	115	91	97	379	314	336	354	408	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 31 March 2021.

¹Local EMD is USD return.

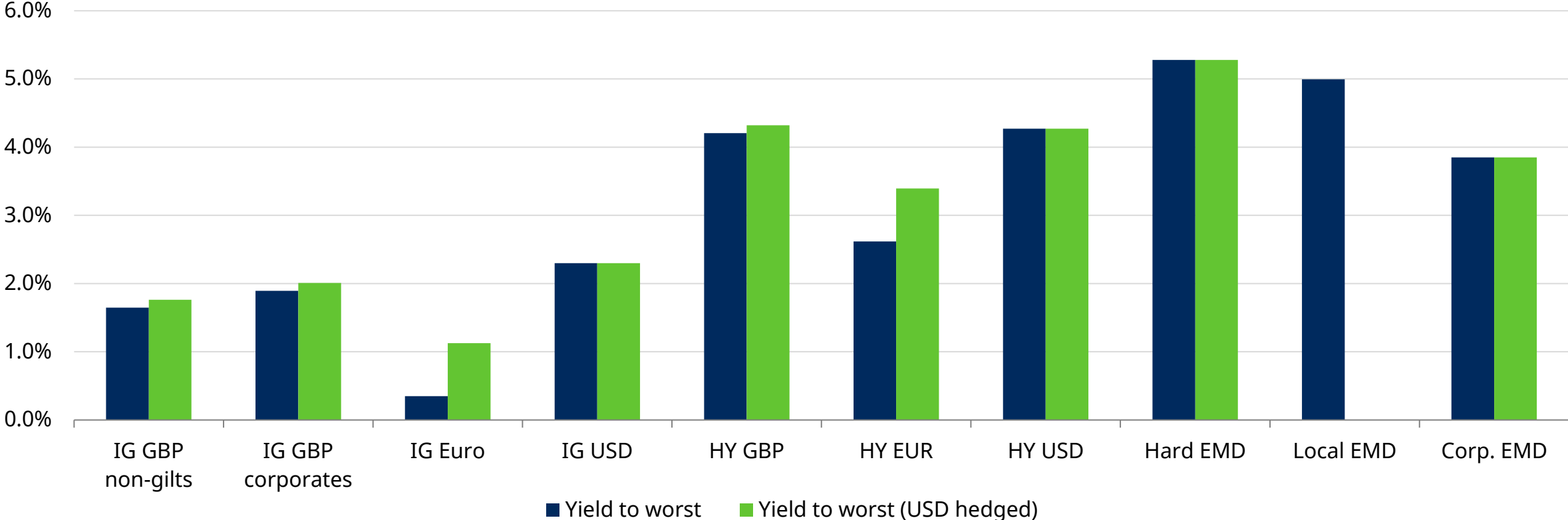
Schroders



Cross-credit analysis: key insights

Cross-credit yield

Yield to worst



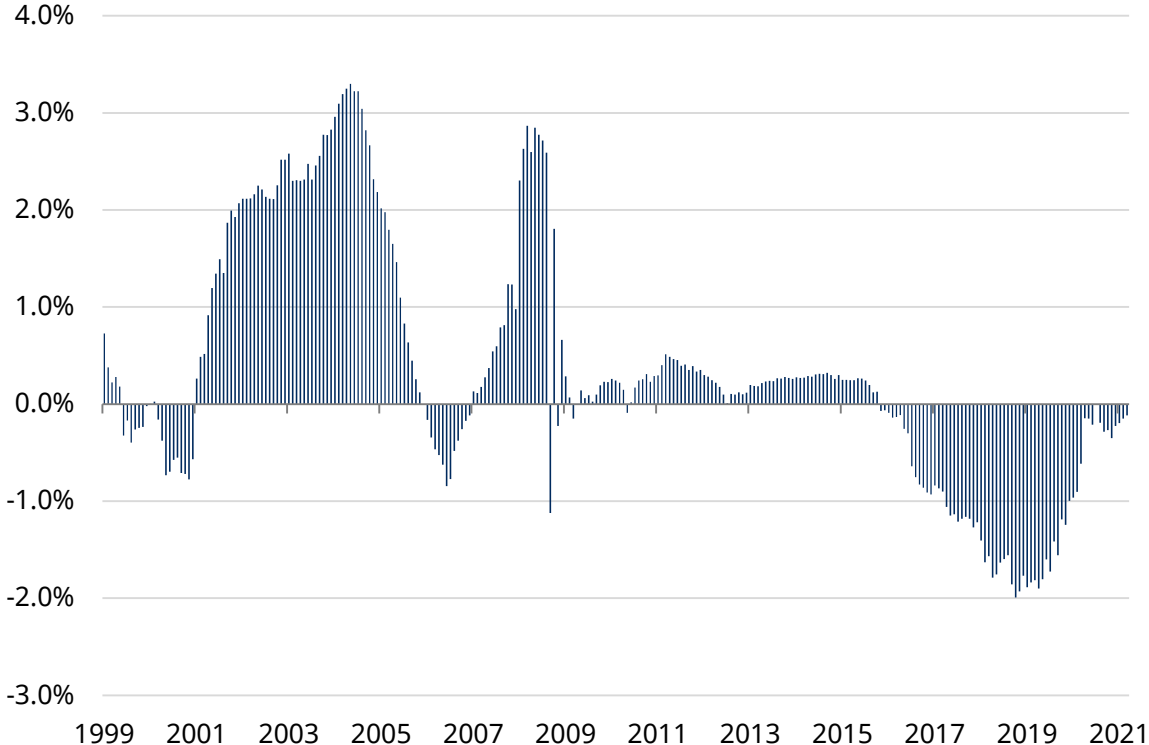
Currency-hedged EUR and GBP corporates do not provide a yield pick over USD corporates

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

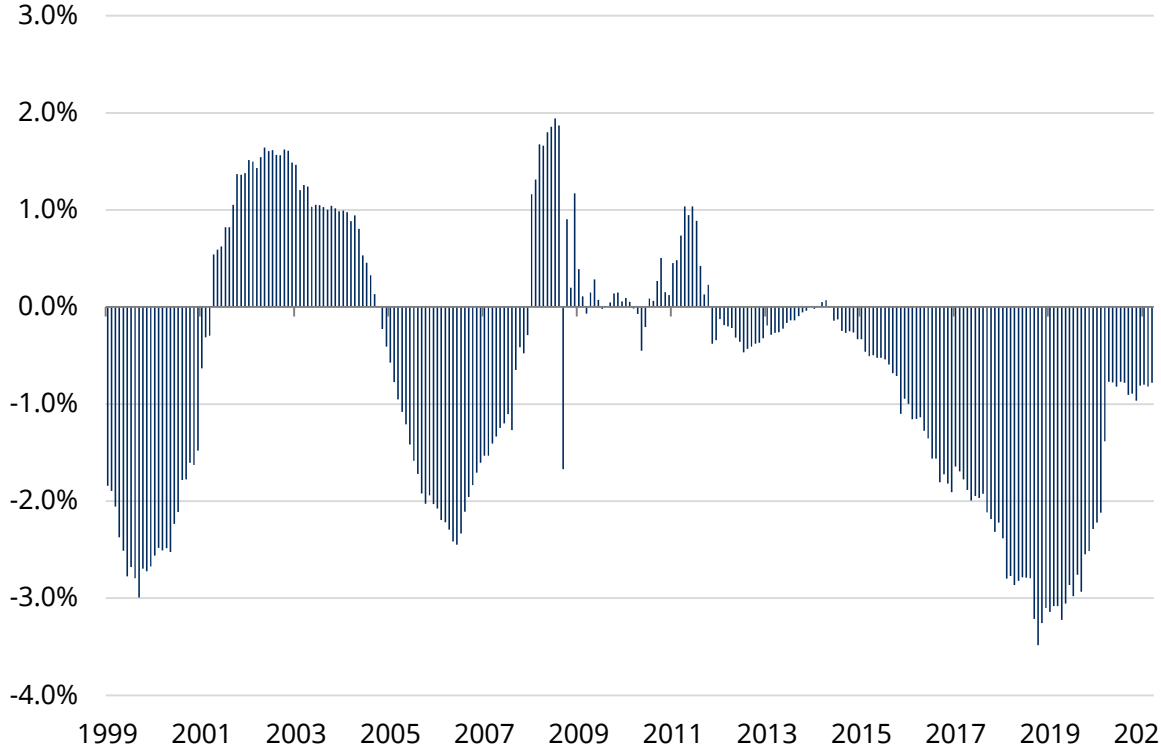
FX hedging cost or return

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

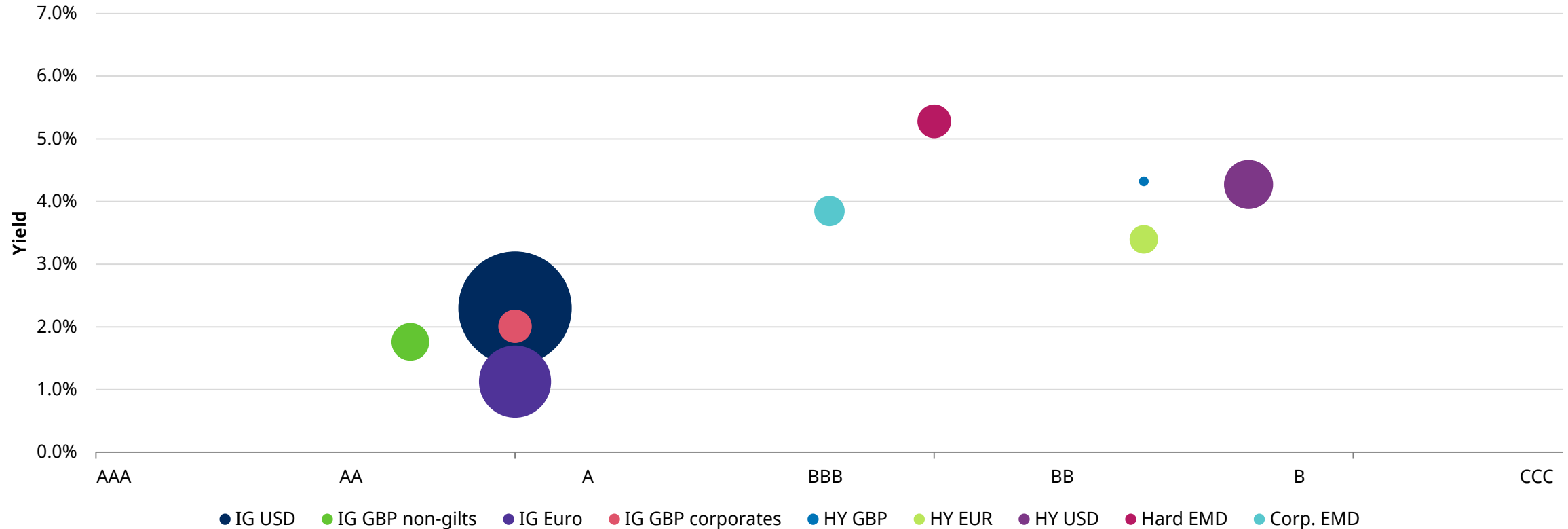
EUR yields will be 0.8% higher in USD once hedging taken account

Source: Refinitiv Datastream. Data as at 31 March 2021.

Yield vs. credit rating vs. market size

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

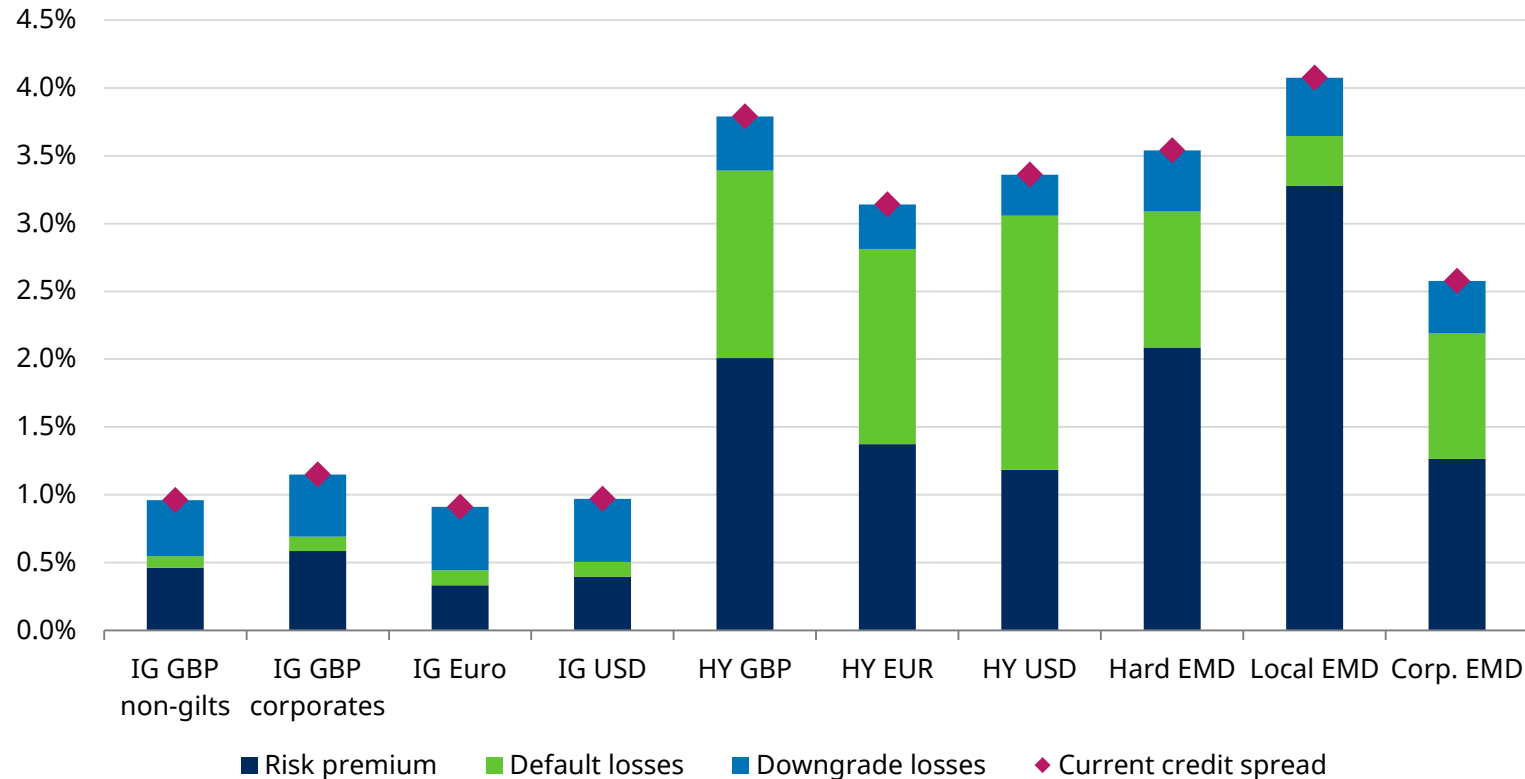
Yield (USD hedged) vs credit rating vs market size



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 March 2021.

Risk premium/net spread in credit

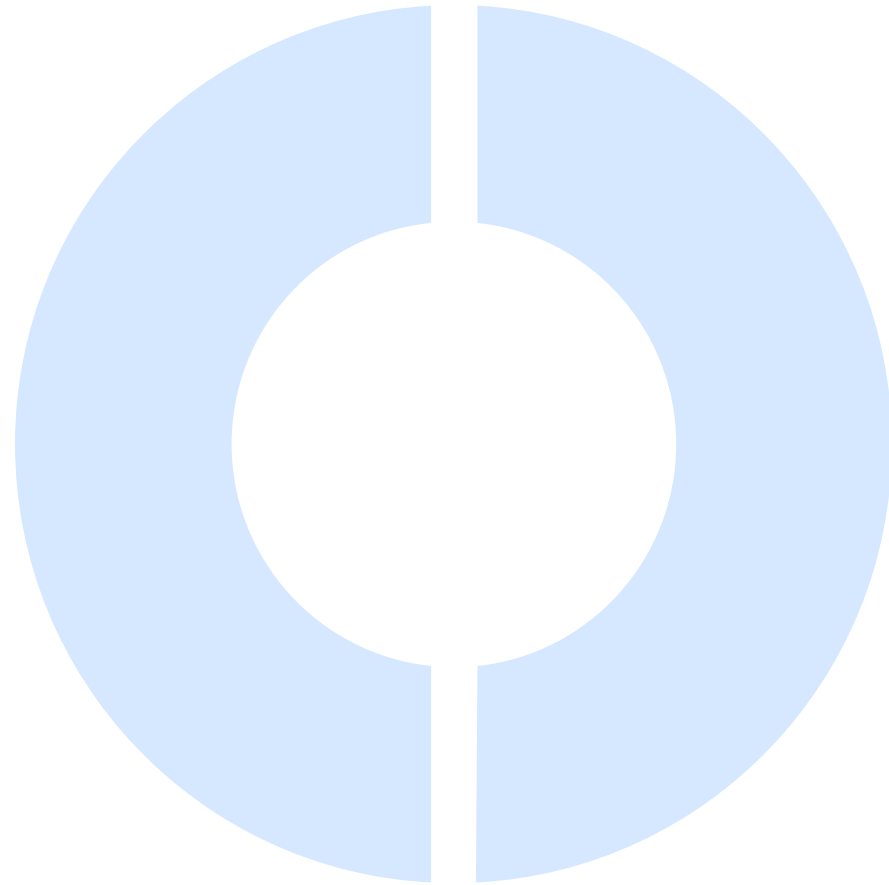
Decomposition of credit spread into expected losses and expected risk premium



- 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 31 March 2021.

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Hot topics

How much room is there for spreads to fall?

The hurdle changes after adjusting for shifts in credit quality

- Credit spreads are approaching levels last seen just before the global financial crisis in 2007
- However, a direct comparison of current spreads to 2007 levels might not be appropriate due to changes in credit quality
- In IG the quality has worsened, as the share of BBB bond has increased substantially (see next slide)
- In HY it is the opposite situation. Limited lower quality issuance and the inclusion of downgraded IG bonds means that the share of BB bonds is at a record high
- After adjusting for these changes, there is slightly less value in IG and slightly more value in HY
- For example, US IG spread is already tighter than the adjusted 2007 spread (97bps vs 103bps)
- In Euro HY, the effect is that the adjusted 2007 spread is 25bps lower

US IG OAS is already lower than in 2007 when adjusted for changes in credit quality

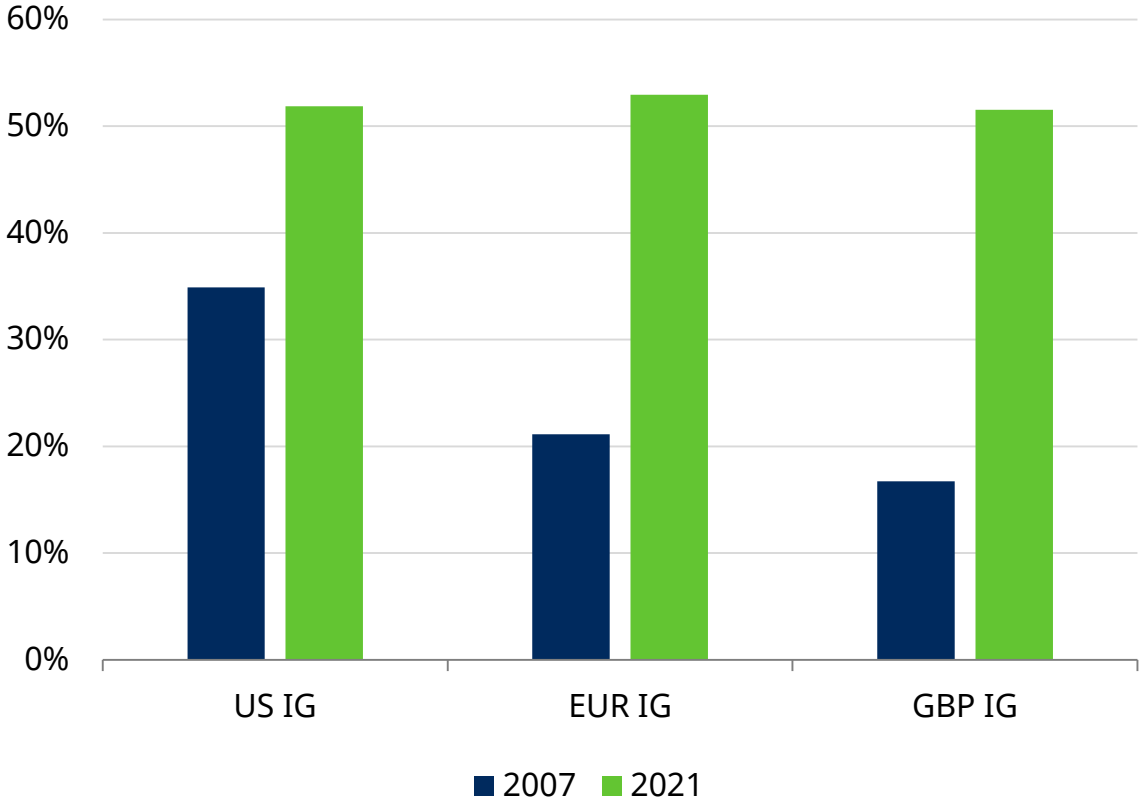
	March 2021	May 2007	May 2007 adjusted ¹
US IG	97	94	103
EUR IG	91	47	58
GBP IG	115	74	91
US HY	336	274	254
EUR HY	314	186	156
GBP HY	379	201	176

Source: Refinitiv Datastream. Data as at 31 March 2021. 1. Historical spreads reweighted using current credit quality distribution.

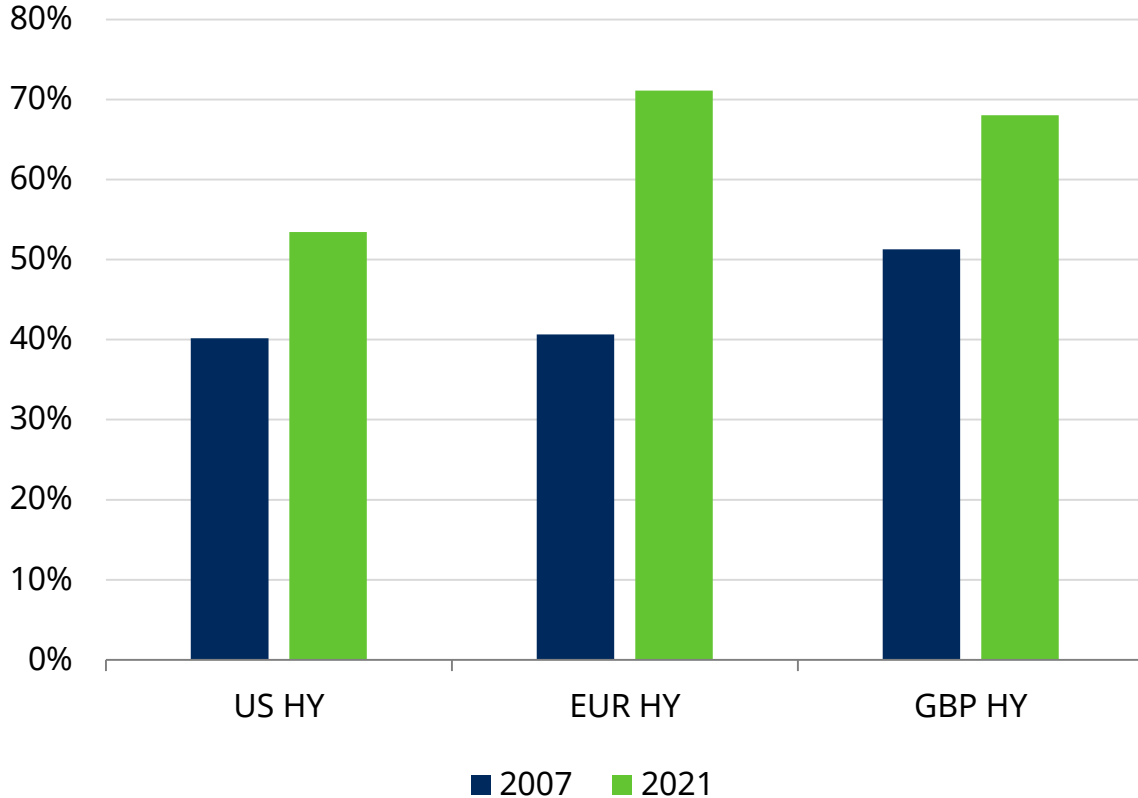
Major shifts in credit quality

Since 2007 the quality has worsened in IG but improved in HY

Share of BBB bonds in IG indices



Share of BB bonds in HY indices



Source: Refinitiv Datastream. Data as at 31 March 2021.

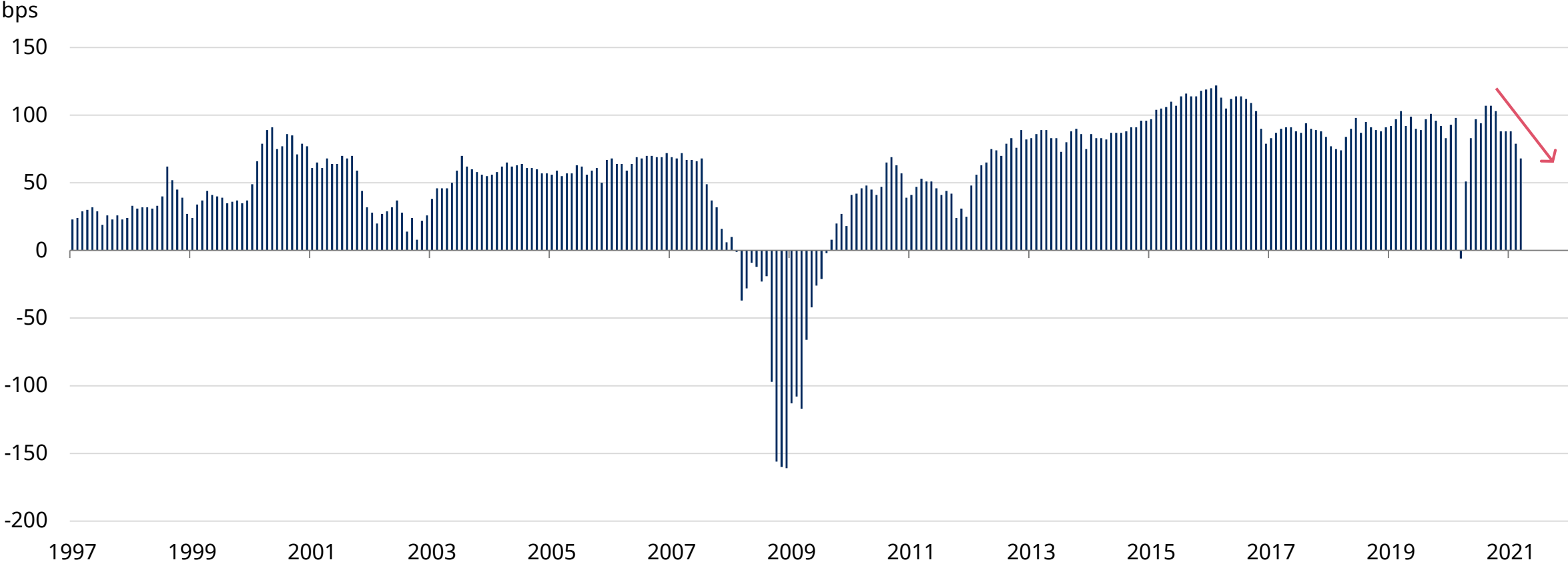
Demand for IG credit has remained resilient

- US IG saw a large negative total return in Q1 at -4.5% because of rising Treasury yields
- Despite that, the spread of the US IG index tightened 6bps over the quarter, so corporate bonds outperformed Treasuries
- Furthermore, demand for IG credit has held up well, highlighted by continuing inflows to IG credit funds
- US IG spread curve has actually flattened, with the spreads of bonds at longer maturities, that are most exposed to rising yields, tightening compared to spreads of bonds at the shorter end of the curve (see slide 34)
- The two major sources of demand for US IG bonds have been:
 - 1. US pensions funds:** rising equity markets have improved US pension fund funded status, leading pension funds to de-risk and purchase long-term bonds
 - 2. Foreign investors:** currency-hedged US bonds are very attractive for euro investors (see next slide)

US IG spread curve has flattened in 2021

Implying significant demand for longer-dated corporate bonds

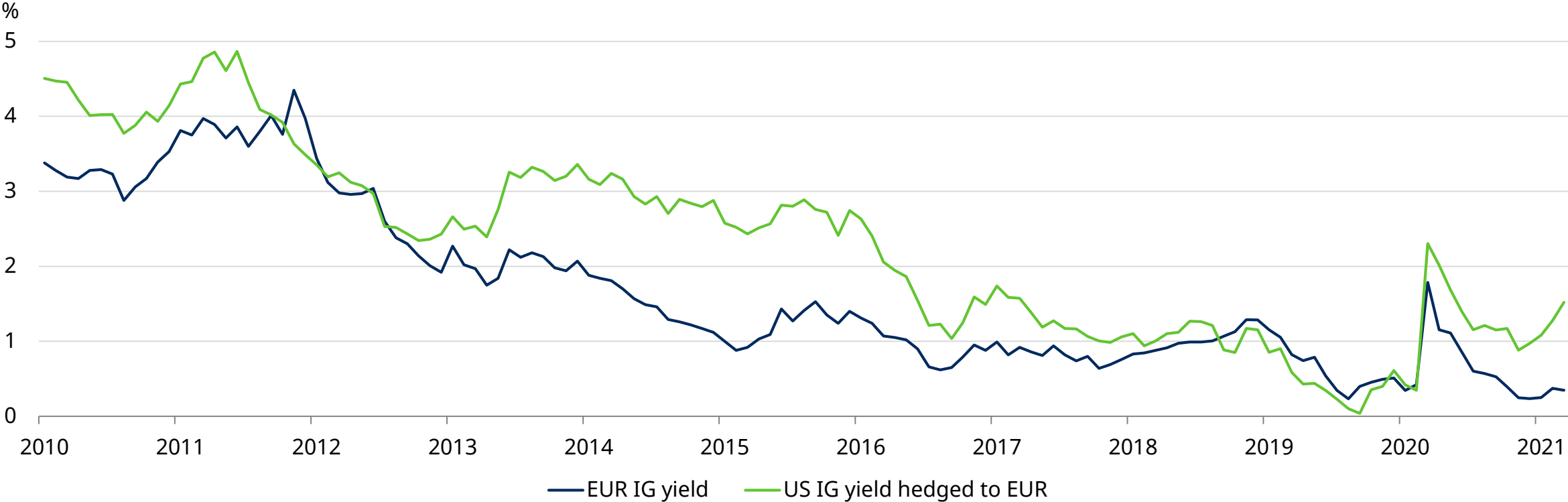
US IG long minus short index OAS



Source: Refinitiv Datastream. Data as at 31 March 2021. The long index is ICE BofAML 15+ Year US Corporate Index. The short index is ICE BofAML 1-5 Year US Corporate Index.

Hedged USD credit is very attractive for euro investors

IG yields for euro investors



Step US yield curve and abundant dollar liquidity mean that euro investors can purchase US IG bonds, hedge the currency exposure and receive more than 1% yield pick up over euro IG bonds

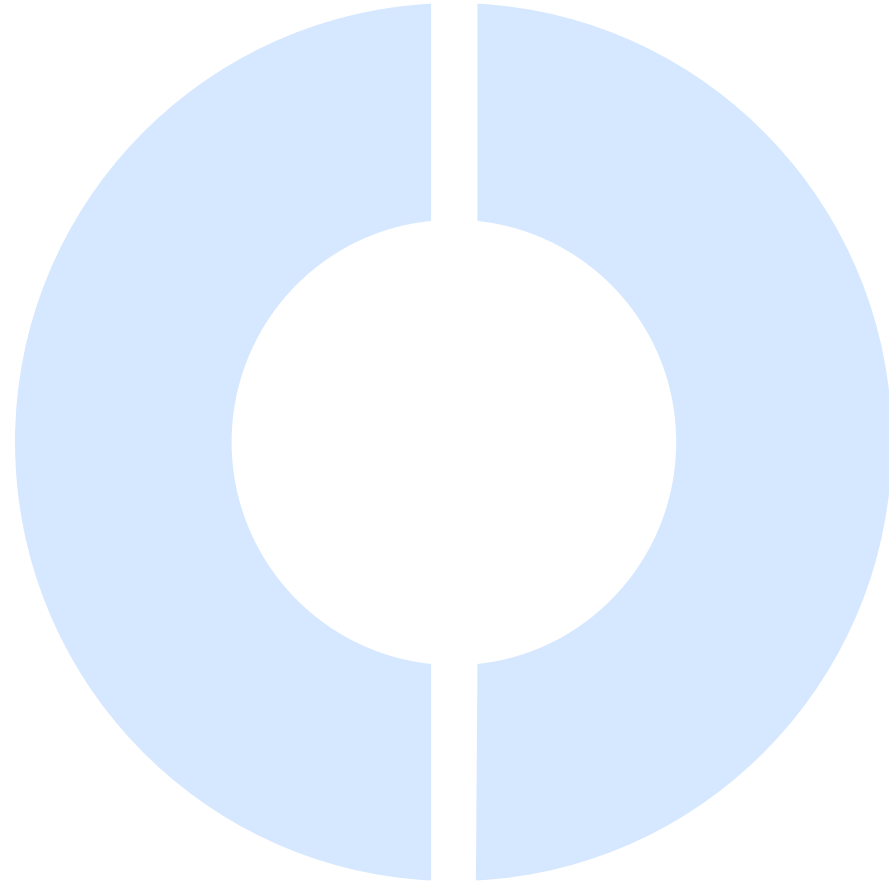
Source: Schroders, Refinitiv Datastream. Data as of 31 March 2021. Hedged yield is local currency yield minus annualised 3-month FX hedging cost/return (see page 10).

M&A trends turning more negative for credit investors

March saw record M&A related issuance

- The swift rebound of the economy has led to a record fast reversal in credit spreads
- But the growth revival also has a more sinister implication for credit investors
- Rising confidence means that merger and acquisition (M&A) activity has resumed much sooner than in the previous cycles
- This means that M&A related credit issuance is picking up. In March, M&A related issuance was \$52 billion, a new record
- The pipeline of M&A deals with potential IG funding implication stands at \$300 billion
- So far, the activity has been concentrated in sectors that were less affected by Covid, such as technology
- But this could spread to other sectors and short-circuit the deleveraging process, a worrying prospect given the record high leverage (see fundamentals section from page 34)
- Consequently, the failure to deleverage could result in an earlier-than-expected end of the credit cycle

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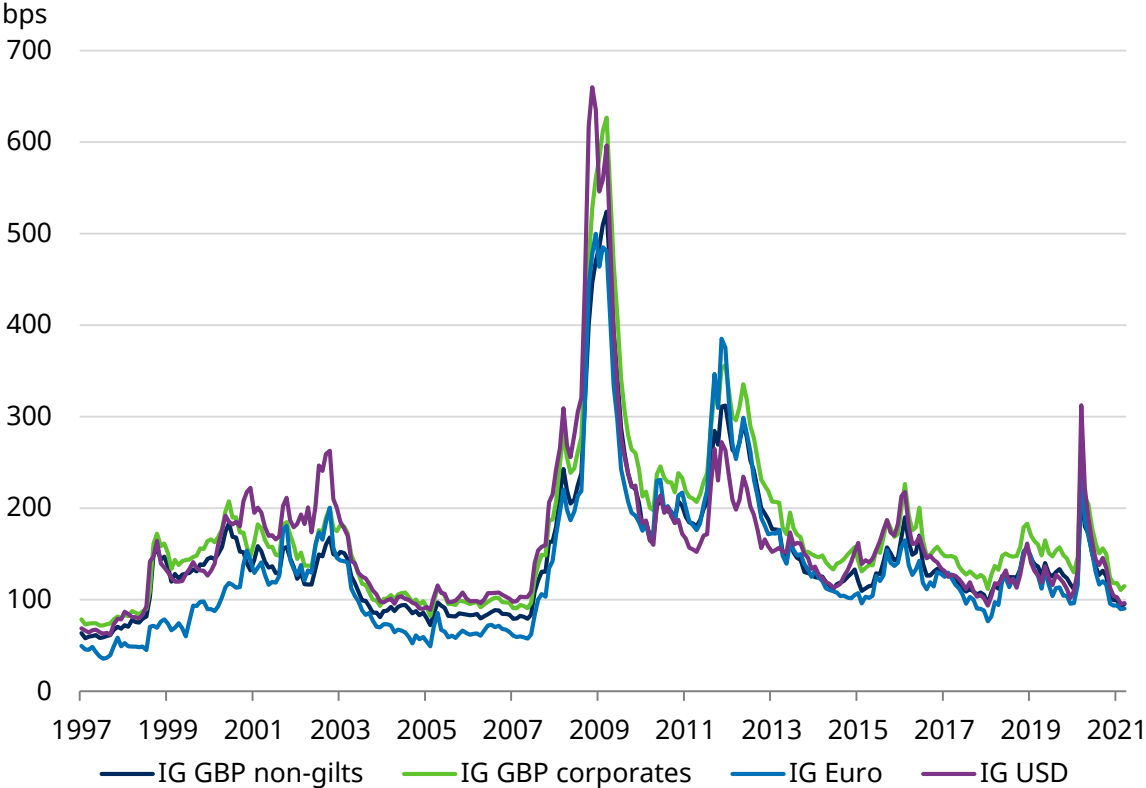


Corporate credit
Valuation

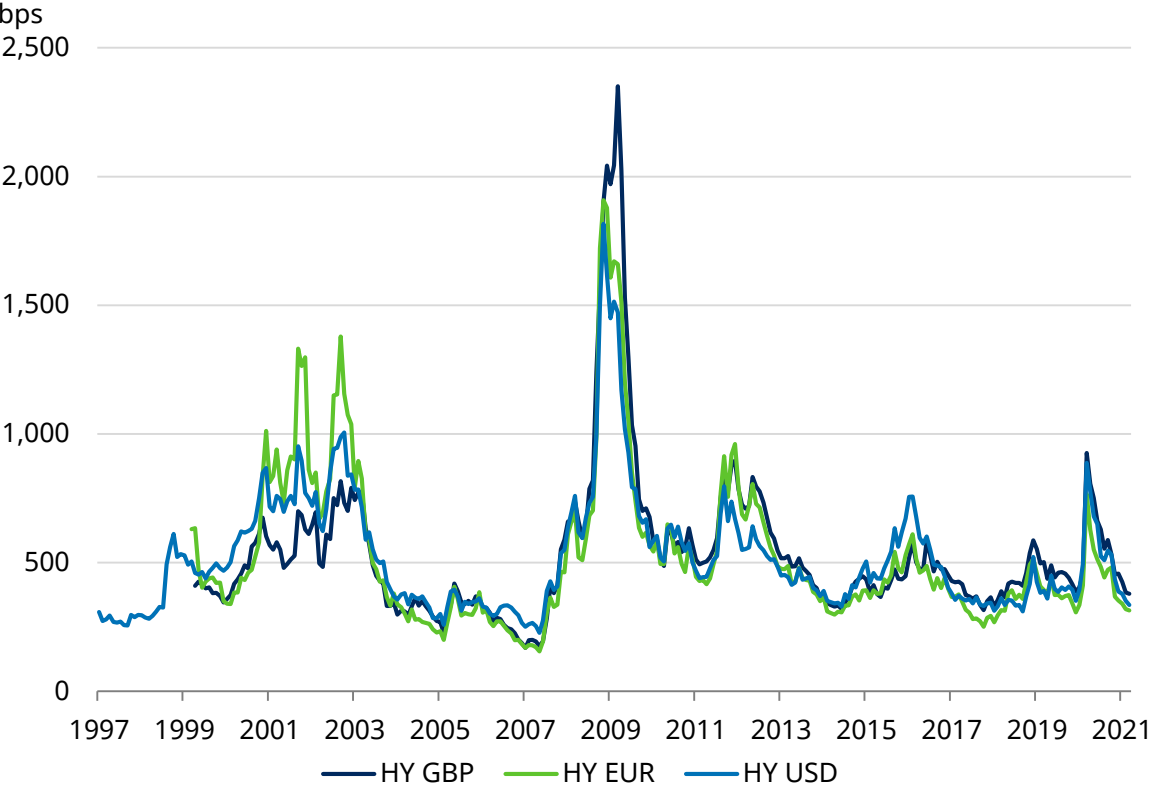
IG and HY valuation

Historical ratings-adjusted credit spreads

IG adjusted spreads



HY adjusted spreads

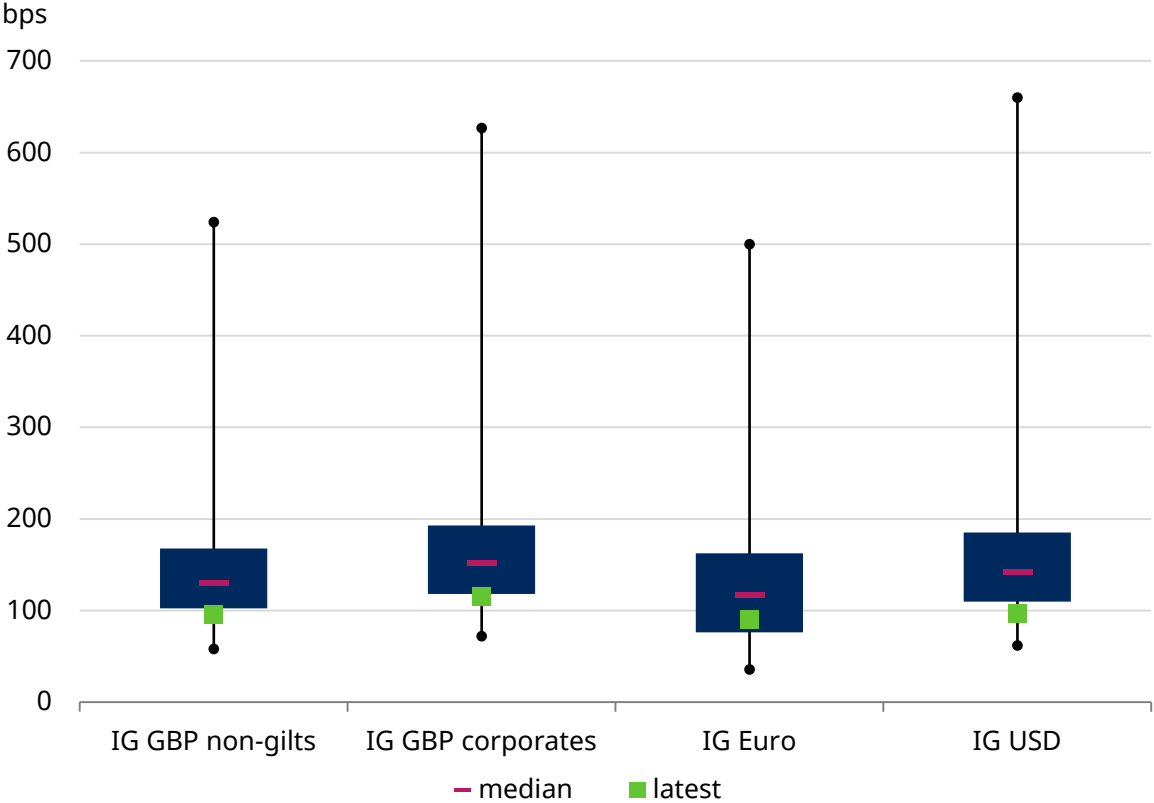


Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 March 2021. Spreads are adjusted for changes in the distribution of credit ratings within each index over time.

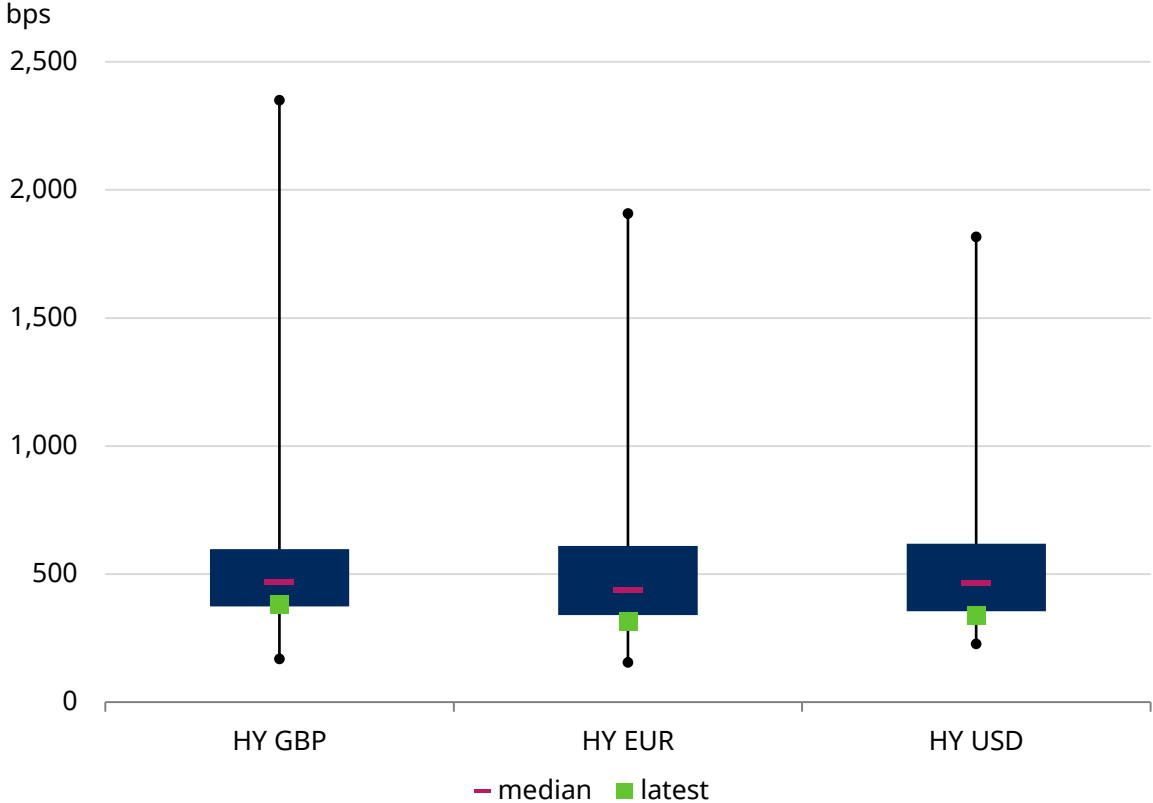
IG and HY valuation

Spread percentiles¹

IG adjusted spreads

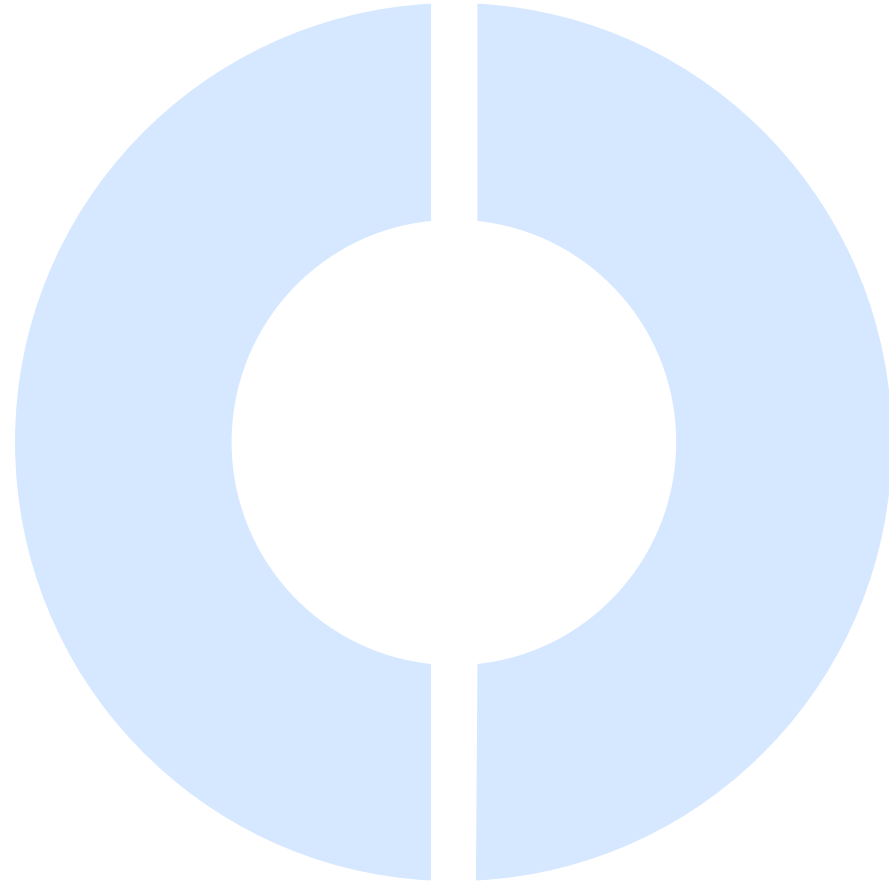


HY adjusted spreads



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 March 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.

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Corporate credit
Fundamentals

Corporate fundamentals summary

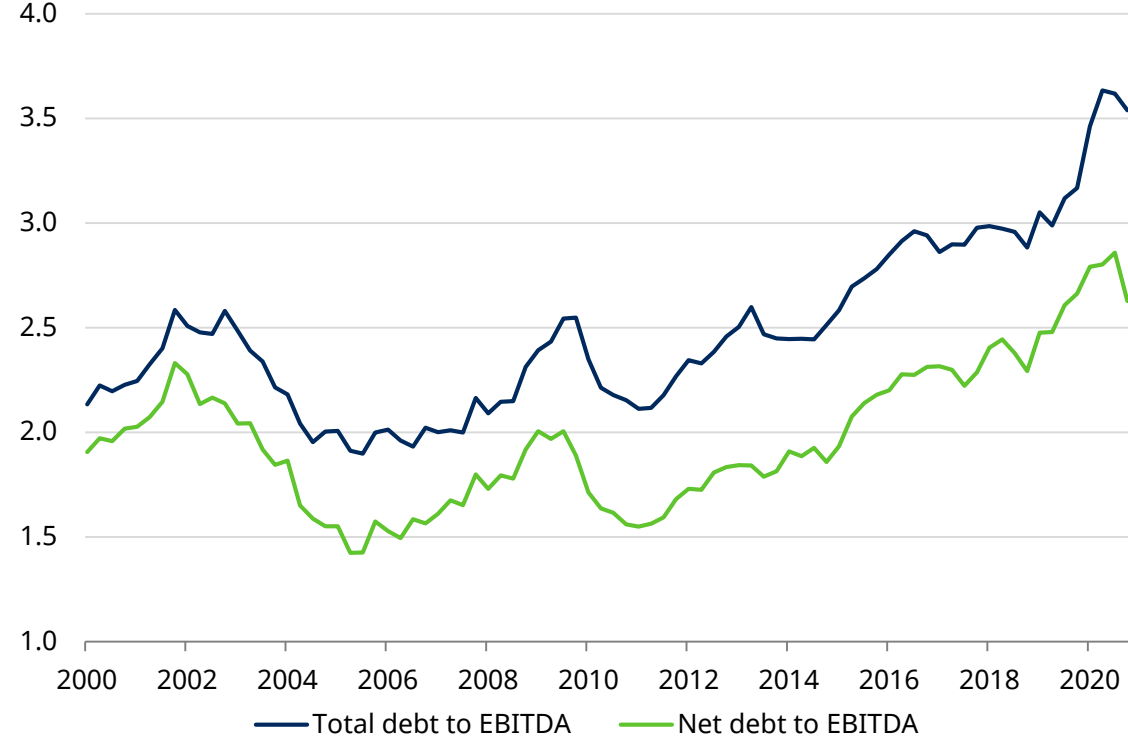
- **Credit fundamentals started to improve across the board in Q4. The tailwind should continue as the economy recovers. EBITDA¹ is also supported by the positive base effect because of the very weak Q1 2020**
- Corporate leverage is coming off from record levels. The gap between gross and net leverage continues to increase as companies maintain large cash balances
- Interest coverage has started to improve in most cases, aided by lower interest costs. Recovery in EBITDA should be a further tailwind
- Higher yields will not have a big impact in the near term, as issuance needs should be much lower in 2021. Long term debt sustainability questions remain
- Cash levels remained high or even increased in Q4, while payouts are depressed. This indicates that companies have taken a cautious approach in the recovery. The recent increase in M&A activity could lead to a decline in cash balances
- **See more: <https://www.schroders.com/en/uk/tp/markets2/markets/a-tug-of-war-in-credit-fundamentals-vs-valuations/>**

EBITDA is earnings before interest, tax, debt and amortisation

US IG leverage falling from very high level

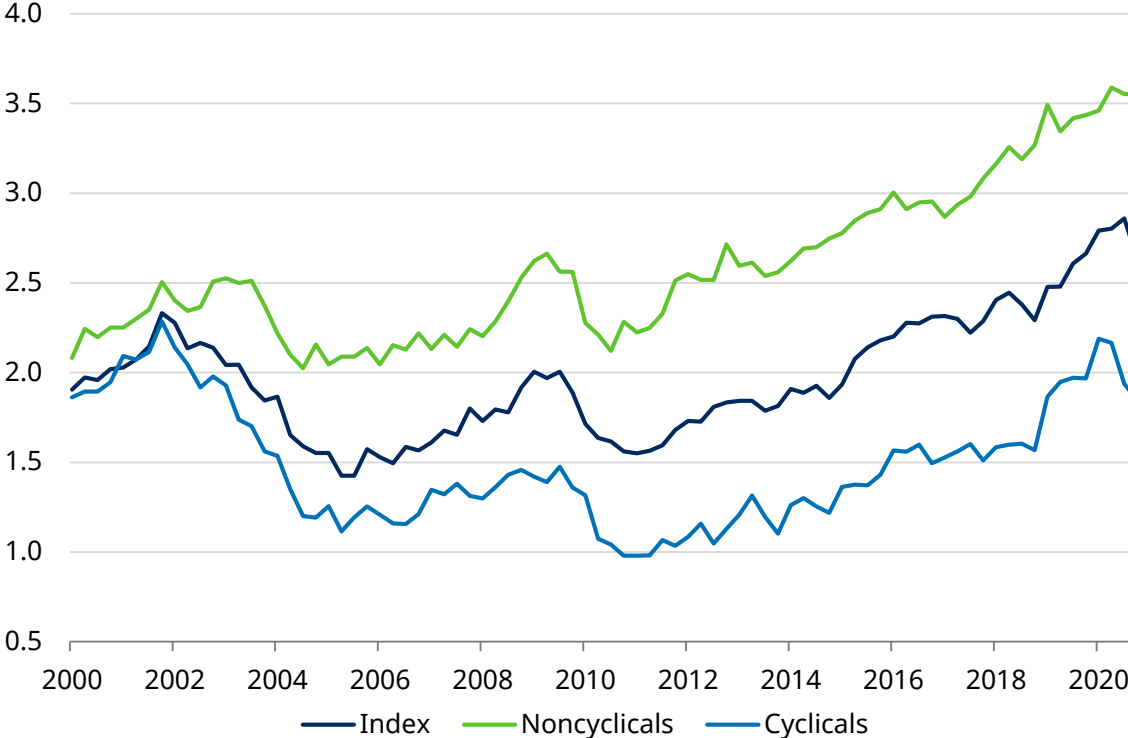
US IG leverage

Debt to last twelve month EBITDA



US IG net leverage

Debt to last twelve month EBITDA



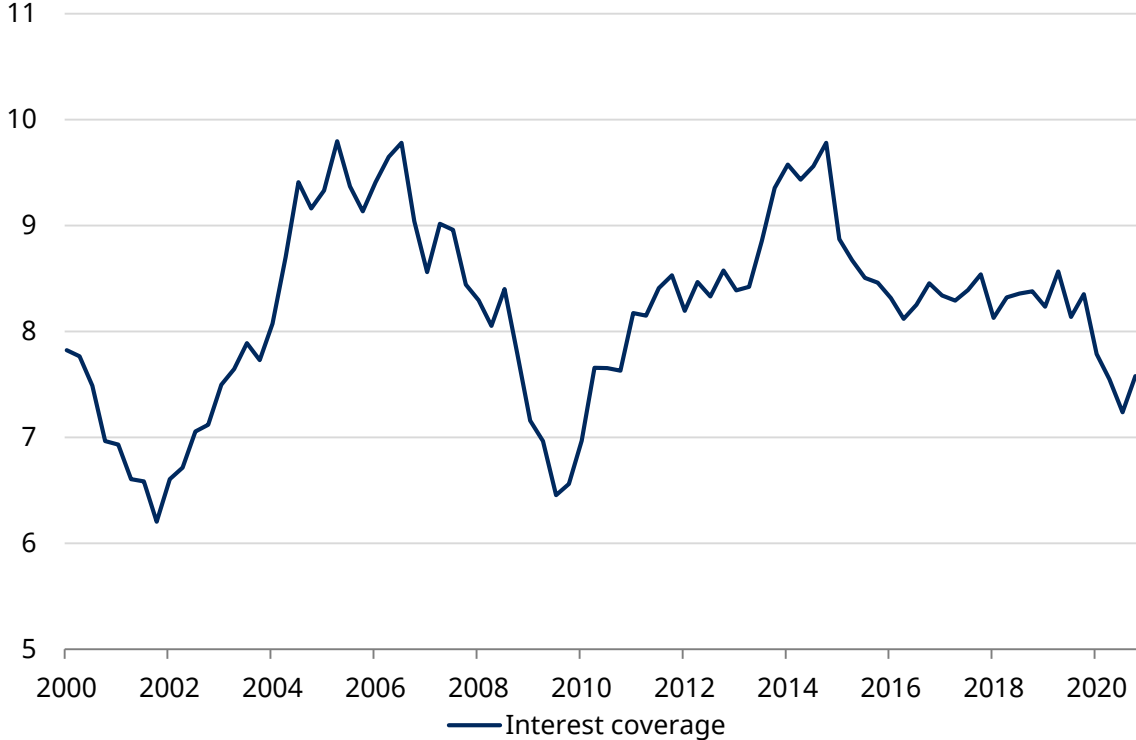
US IG leverage continued to tick lower in Q4 ; net leverage is falling faster than gross as cash balances remain high

Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q4 2020. Cyclical sectors: Basic Materials, Consumer Discretionary, Industrials, Technology. Noncyclical sectors: Communications, Consumer Staples, Utility, Health Care.

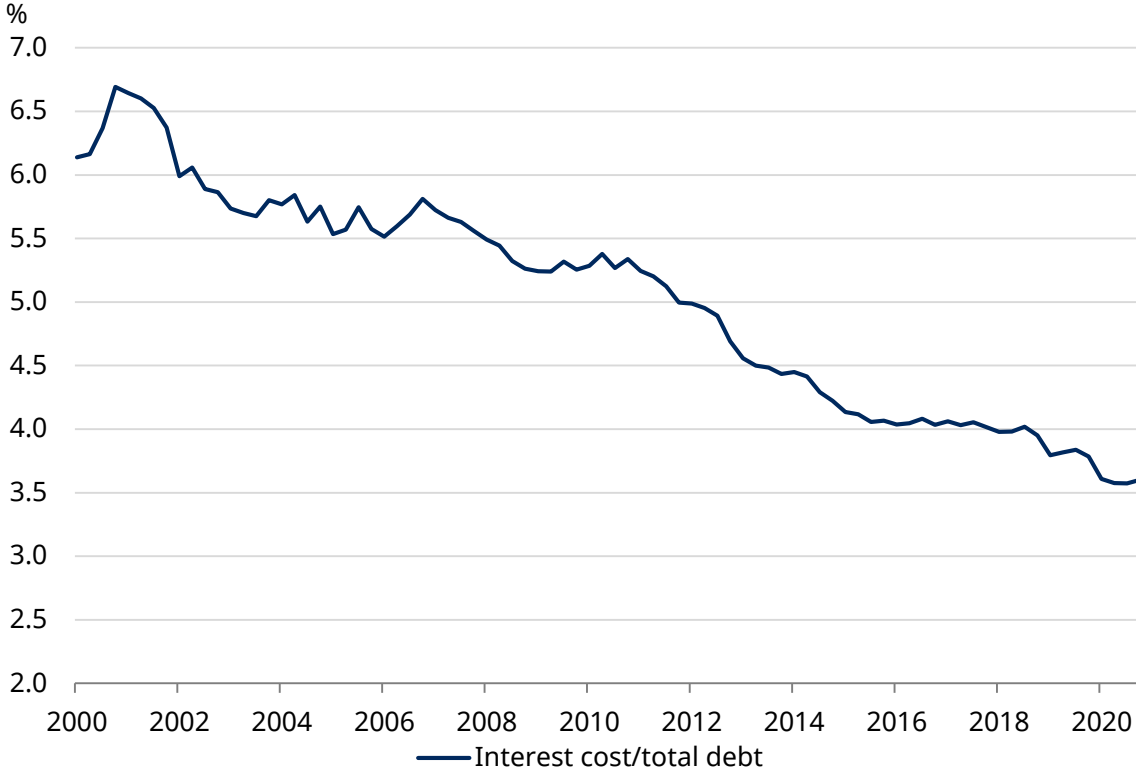
US IG interest coverage ratio

US IG interest coverage ratio¹

Last twelve month EBITDA to interest expense



US IG cost of debt



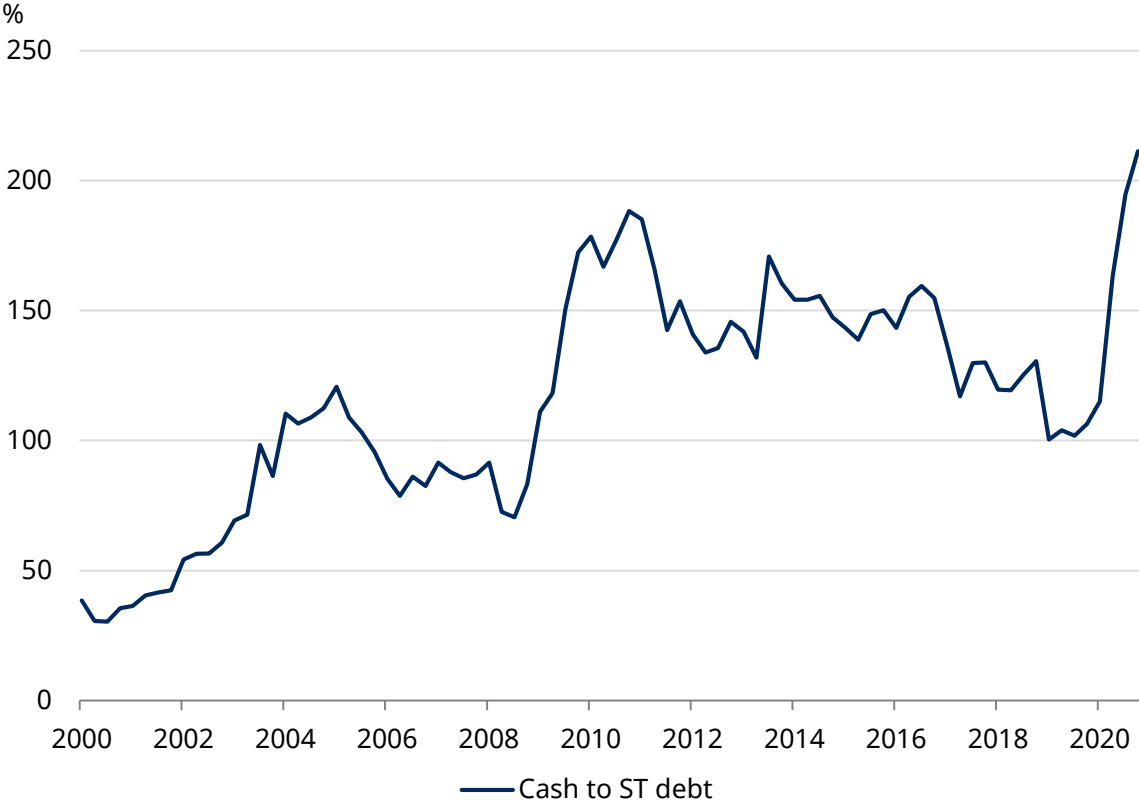
Interest coverage has started to improve as EBITDA is bottoming and cost of debt remains very low

Source: Schroders, Bloomberg, J.P. Morgan. Median issuer ex-Financials. Data as at Q4 2020. ¹Calculated as last twelve month EBITDA divided by interest expense on the income statement

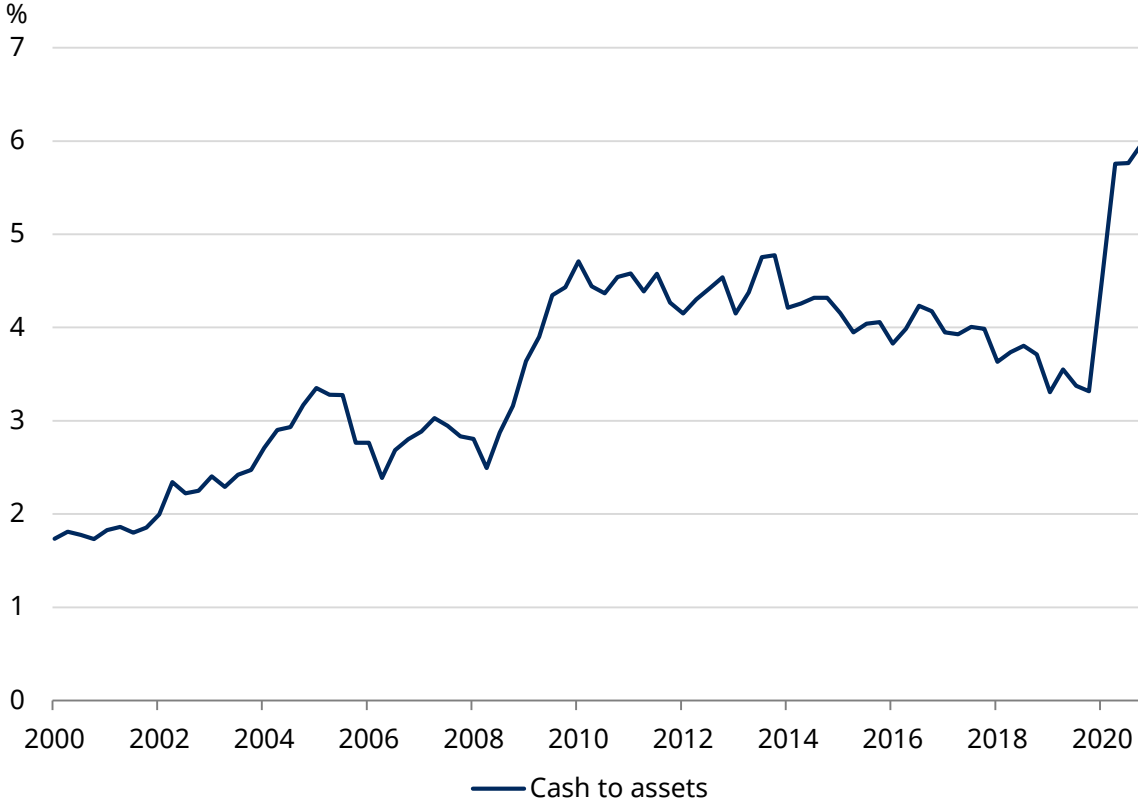
Cash on balance sheets increased further in Q4

Cash to assets at a record level

US IG cash to short term debt



US IG cash to assets



It is possible that companies will continue to hold significant cash balances even as the situation normalises

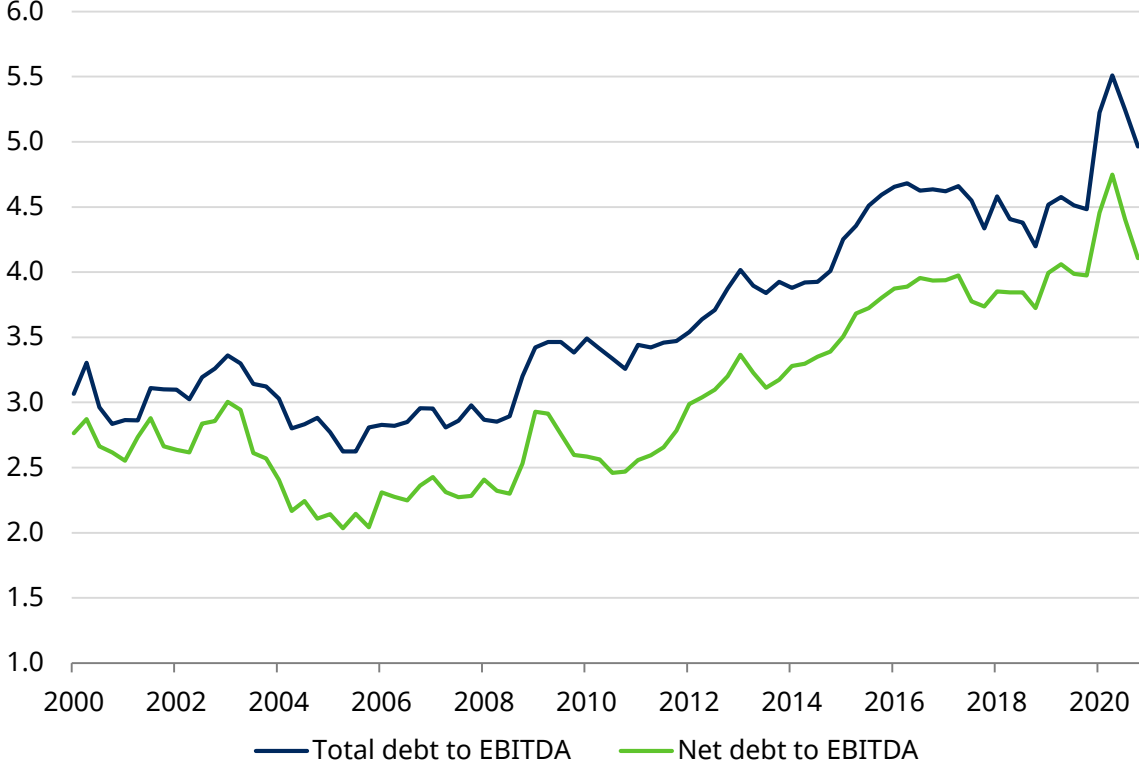
Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q4 2020.

US HY leverage

High but falling

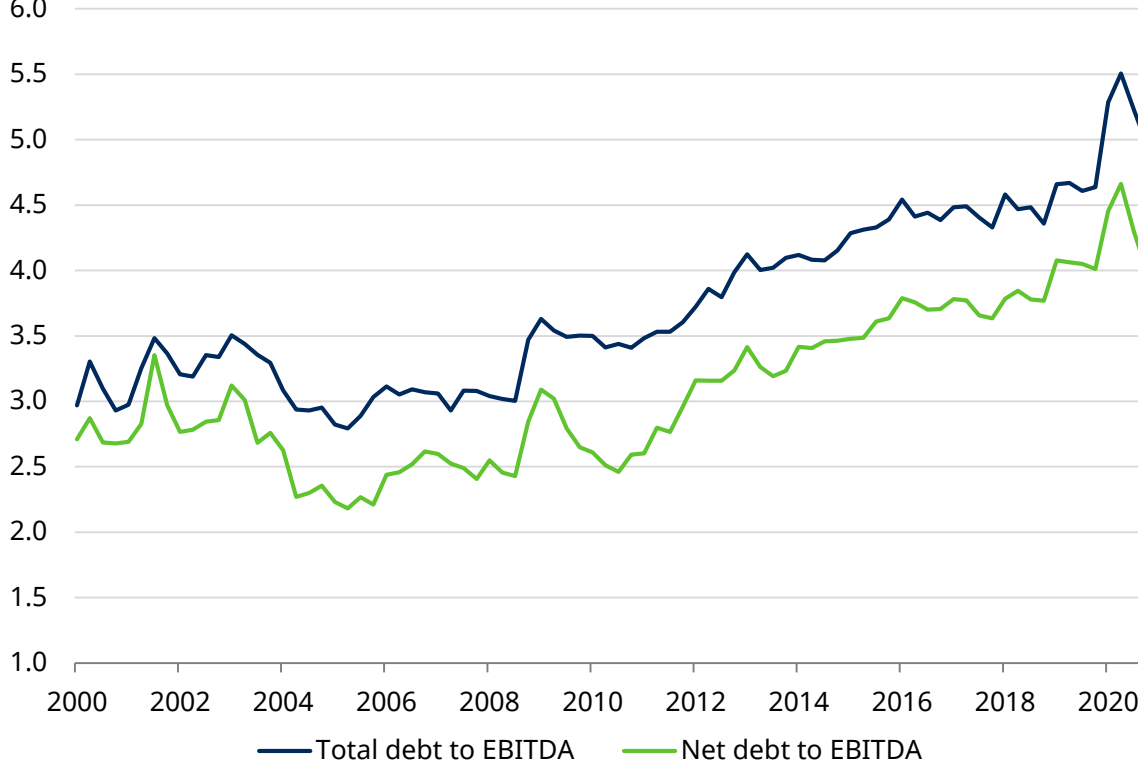
US HY leverage

Debt to last twelve months EBITDA



US HY ex-energy leverage

Debt to last twelve months EBITDA



HY leverage, especially net, has come down fast in the last two quarters

Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q4 2020.

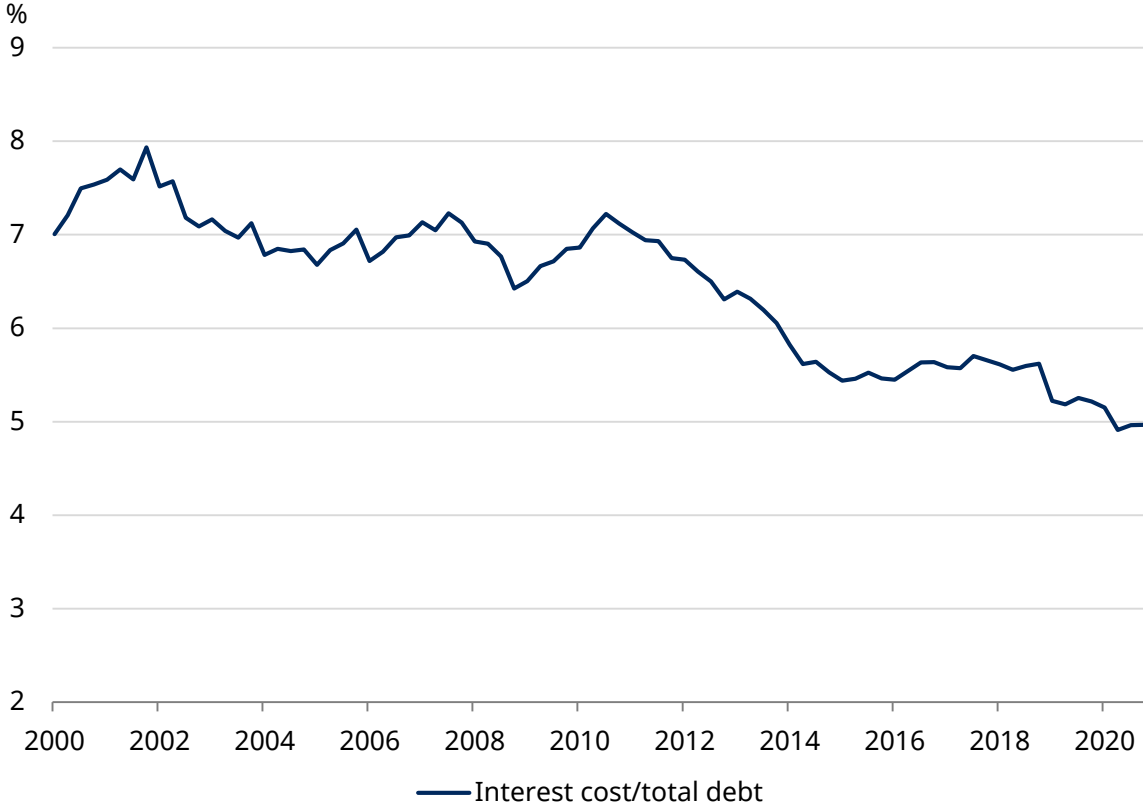
US HY interest coverage ratio

US HY interest coverage ratio

Last twelve months EBITDA to interest expense



US HY cost of debt

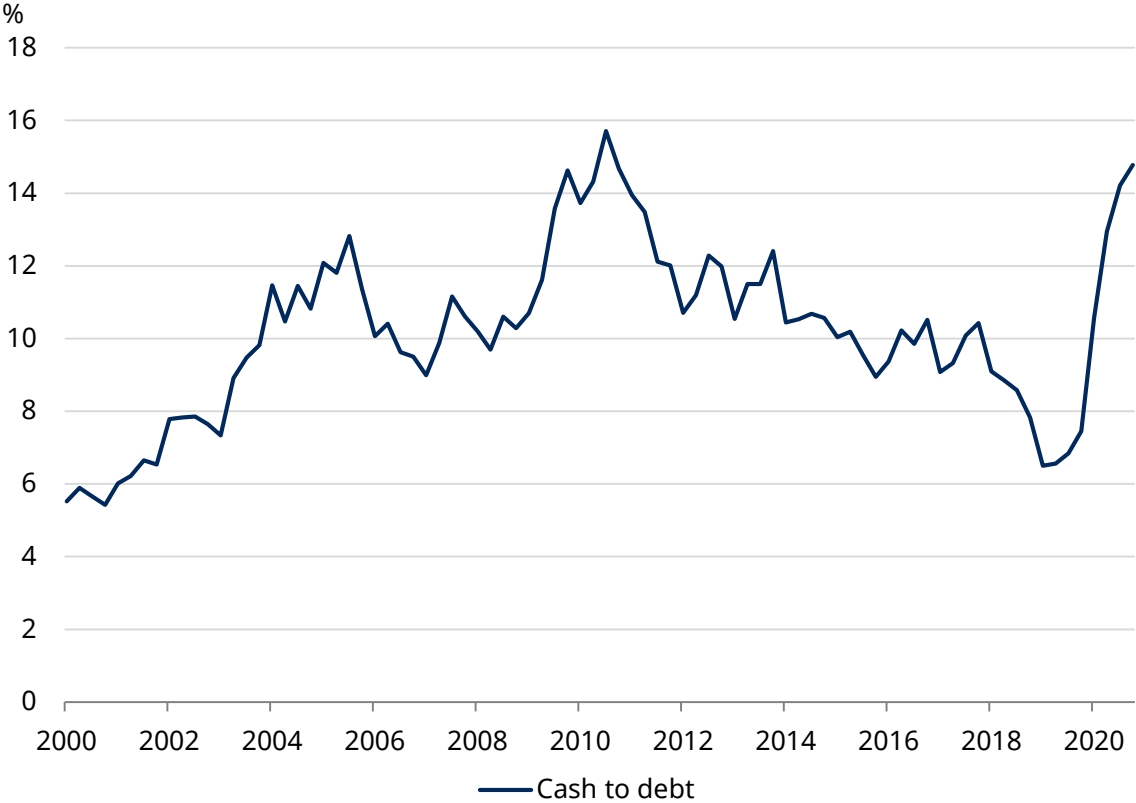


Interest coverage has started to improve; rebounding EBITDA should become a tailwind from Q1

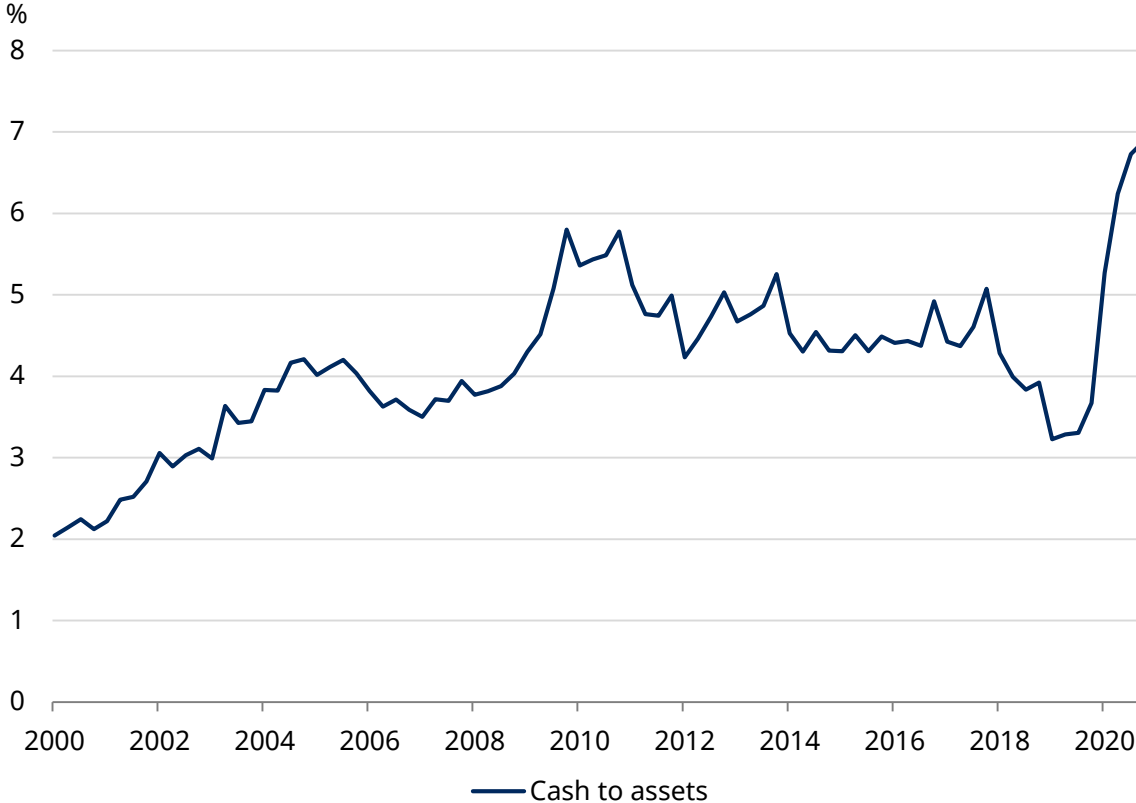
Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q4 2020.

US HY cash levels continued to increase in Q4

US HY cash to debt



US HY cash to assets



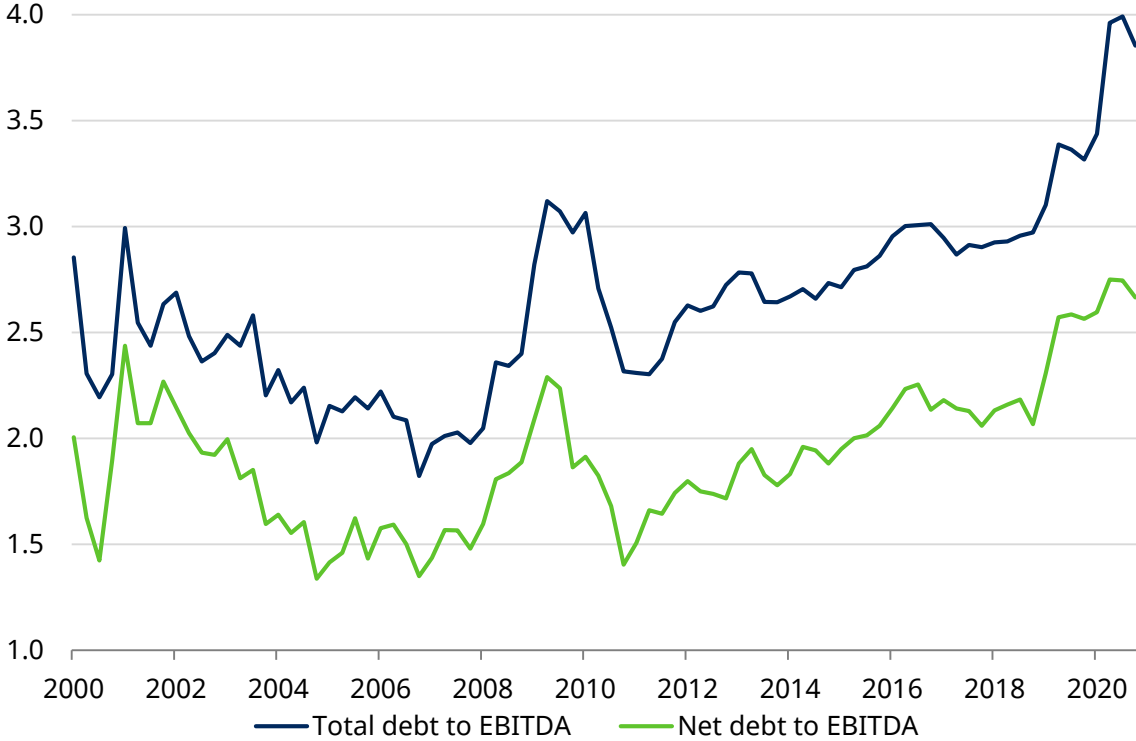
Comfortable cash position somewhat alleviates the worries on structurally weak US HY fundamentals

Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q4 2020.

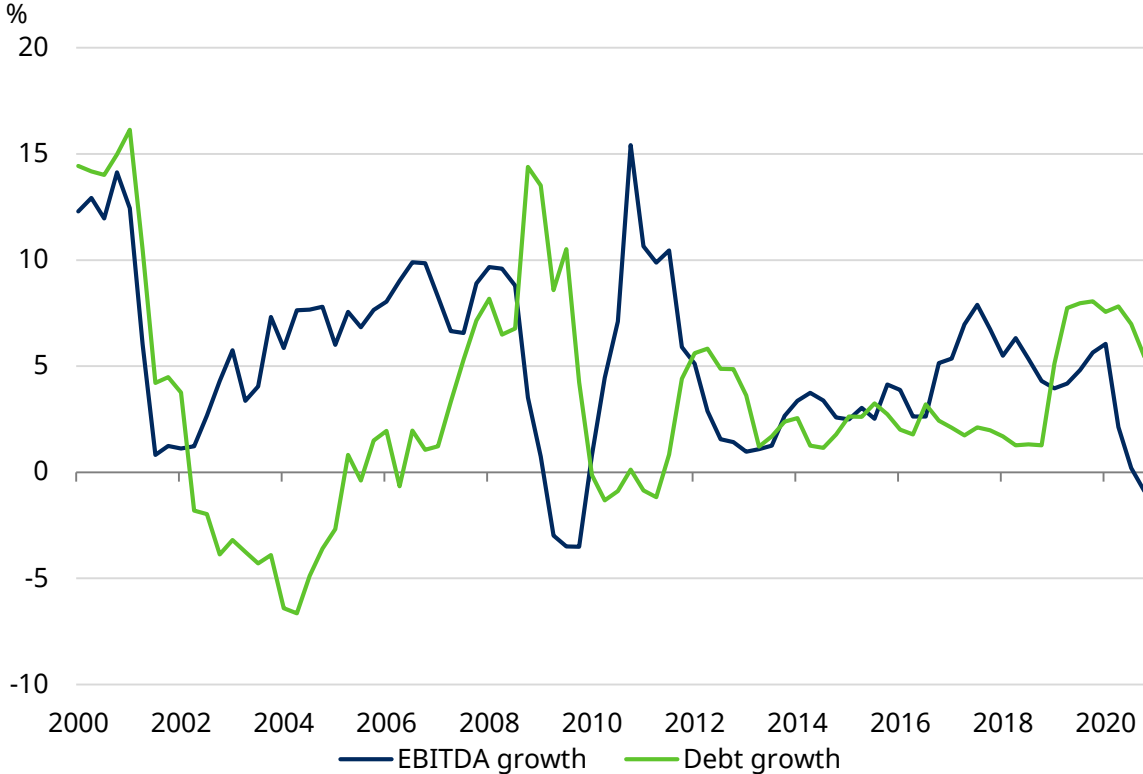
Euro IG leverage starting to tick lower

Euro IG leverage

Debt to last twelve months EBITDA



Euro IG EBITDA and debt growth (last twelve months)



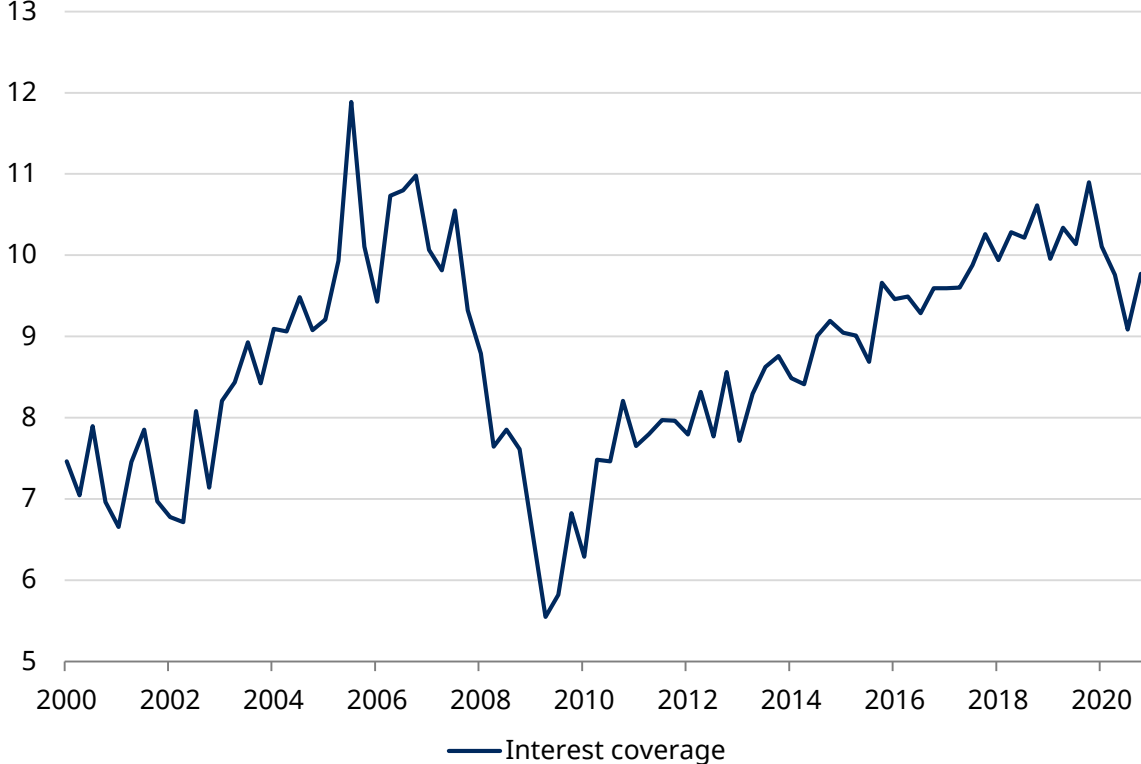
**Net leverage has increased much less,
implying that companies have not spent most of the emergency borrowing**

Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as at Q4 2020.

Euro IG interest coverage has started to rebound

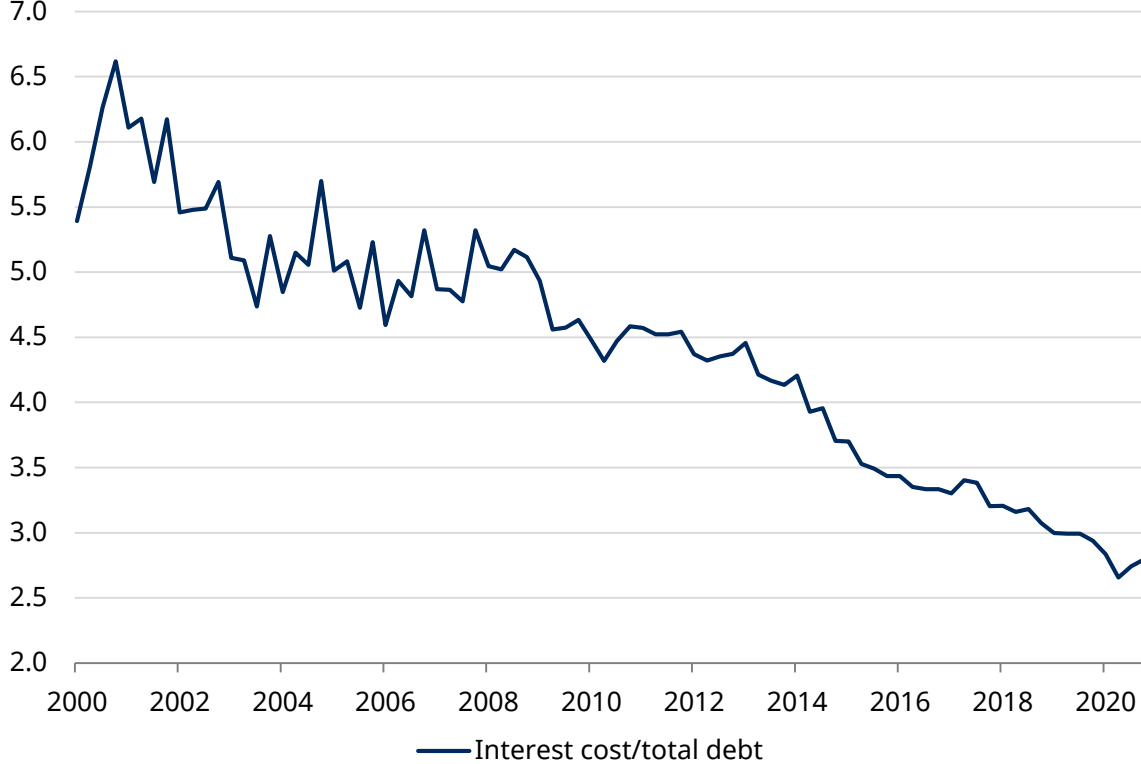
Euro IG interest coverage ratio¹

last twelve months EBITDA to interest expense



Euro IG cost of debt

%



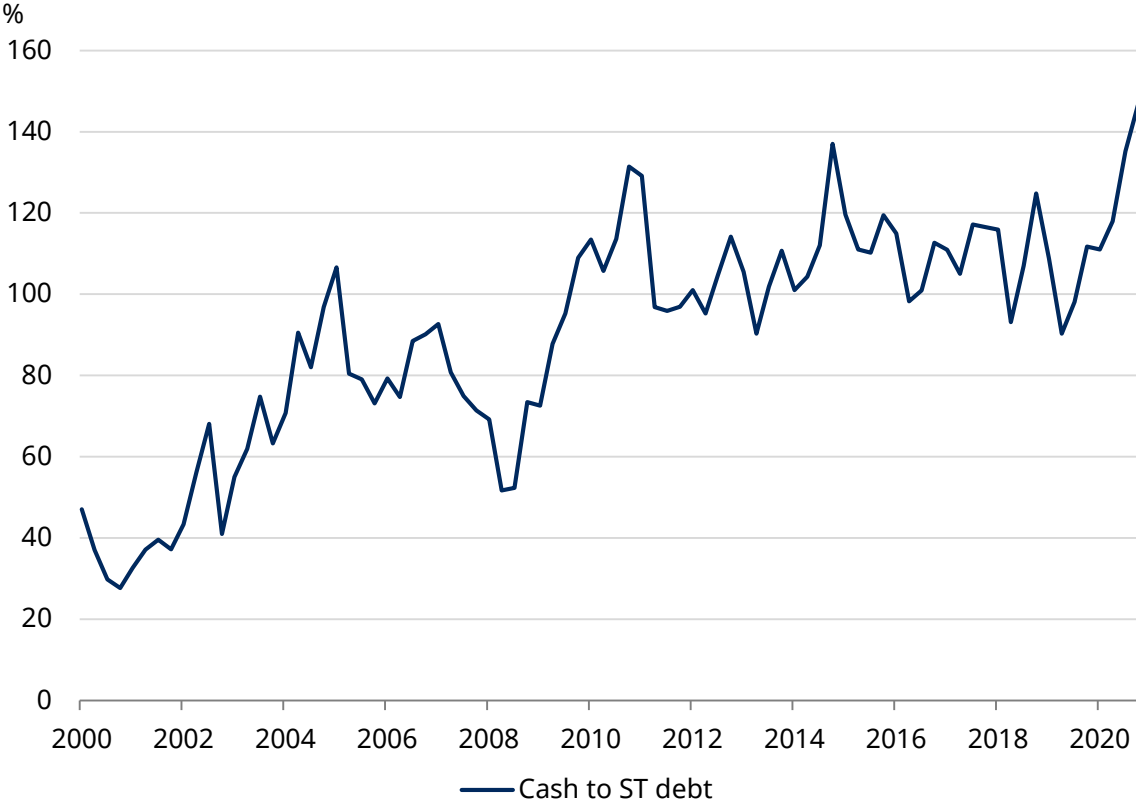
Interest coverage is significantly higher than in US, driven by lower cost of debt in the euro area

Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as at Q4 2020. ¹Calculated as last twelve month EBITDA divided by interest expense on the income statement

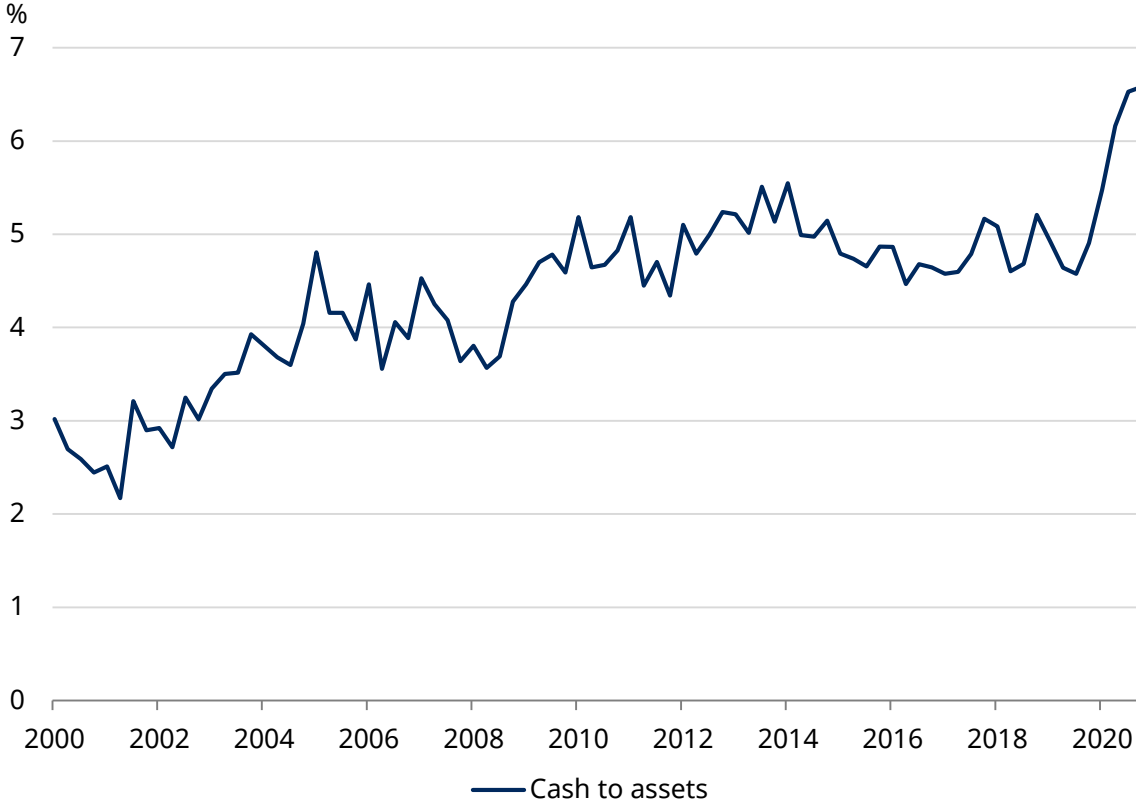
Cash levels have increased similarly to US IG

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 Q4 2020.

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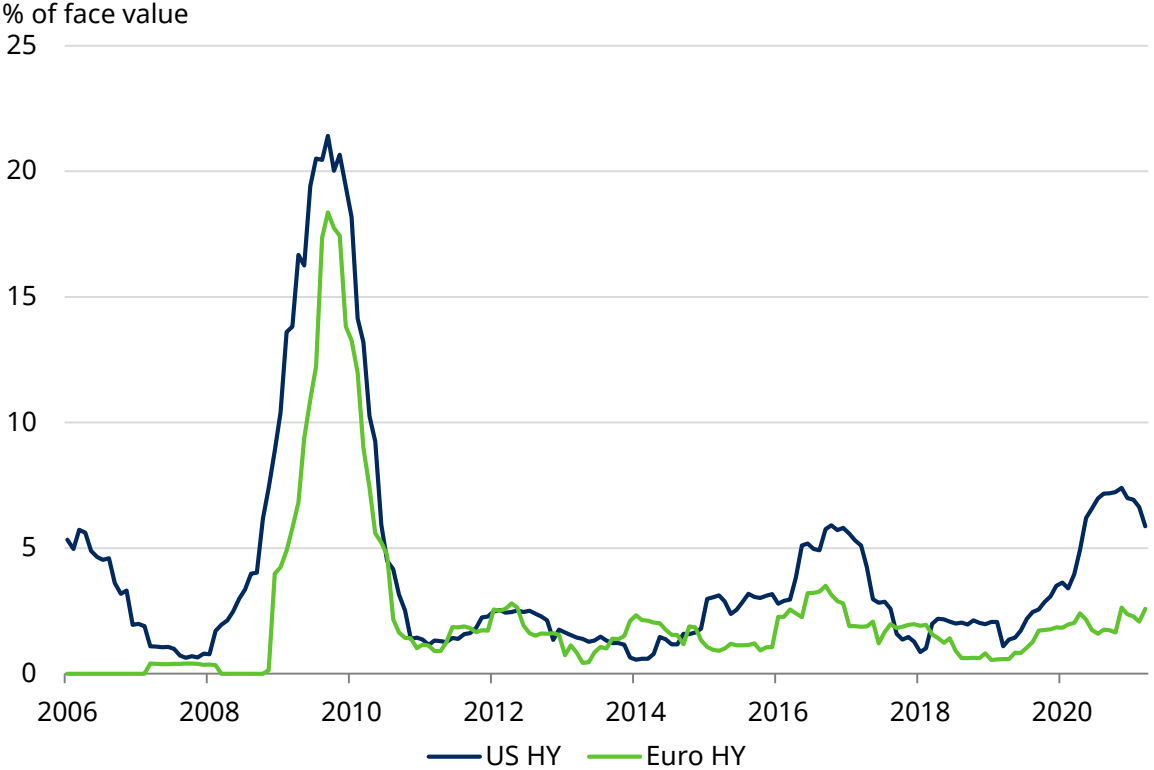


Corporate credit

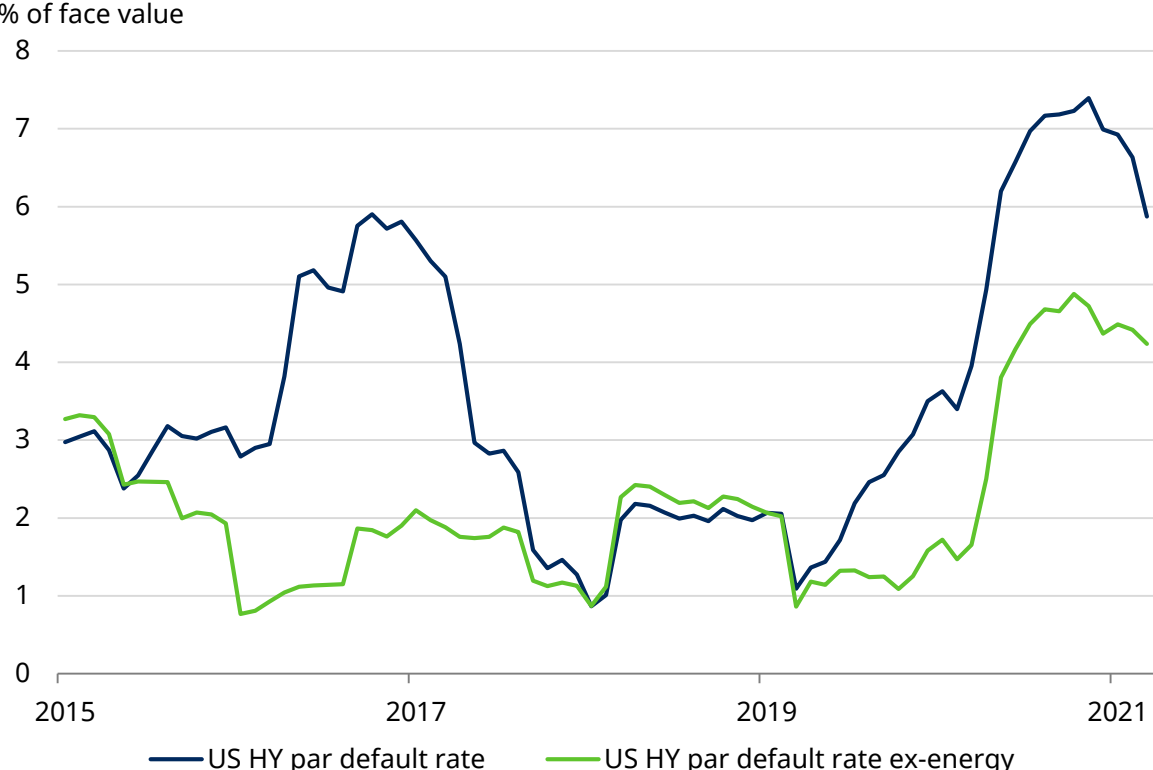
Technicals

HY default rates

HY par default rate (last twelve months)



US HY par default rate (last twelve months)



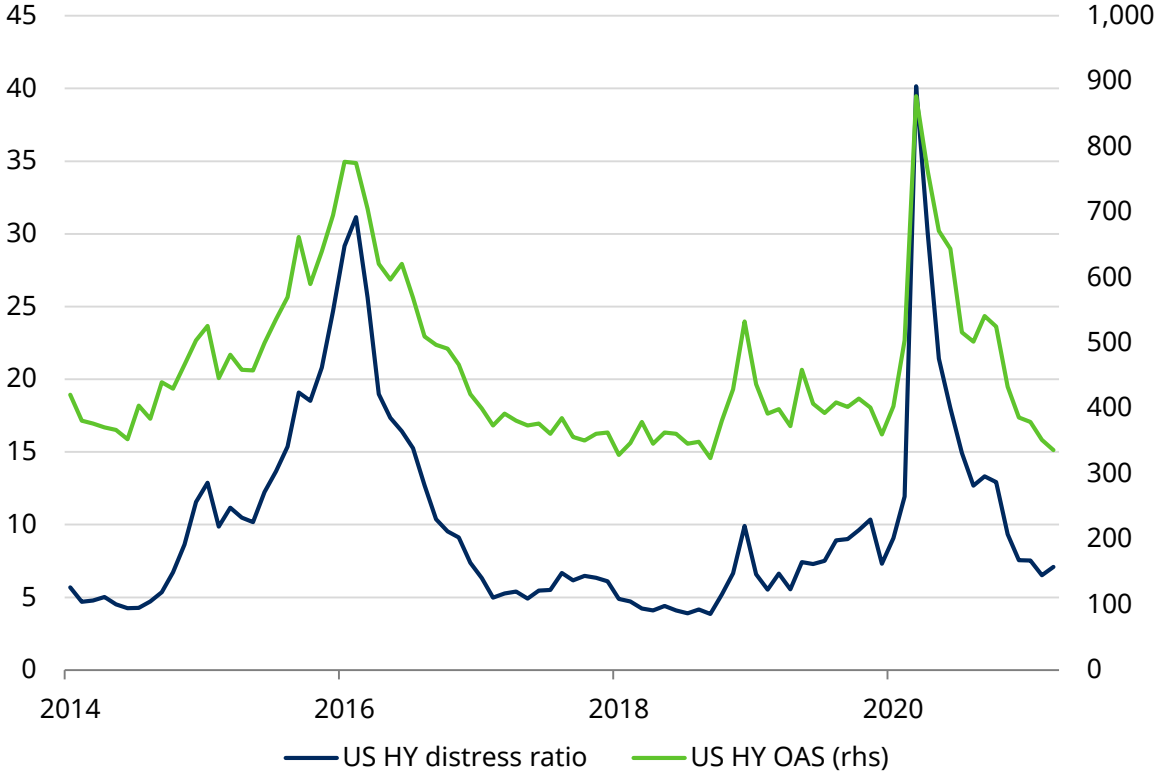
US HY default rate is falling; EUR HY default rate remains muted

Source: Schroders, BofA Merrill Lynch, Moody's. Data as at 31 March 2021.

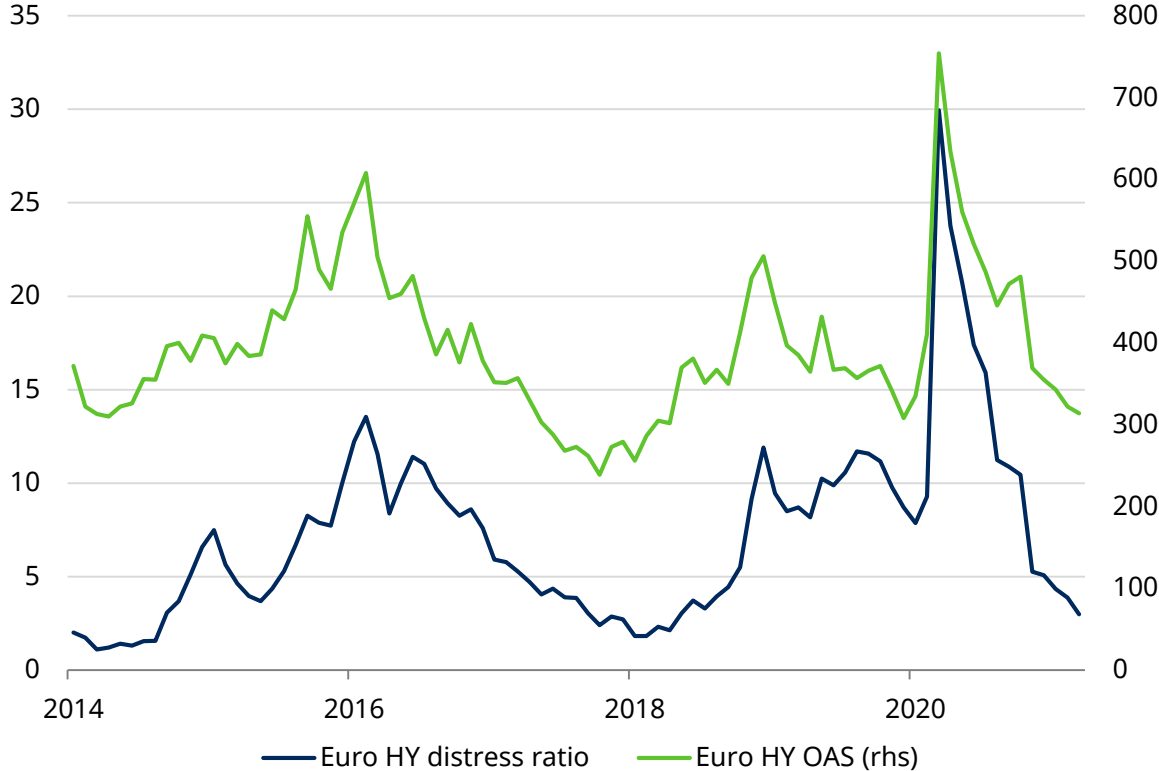
HY distress ratios

Harbinger of defaults

US HY distress ratio¹



Euro HY distress ratio¹

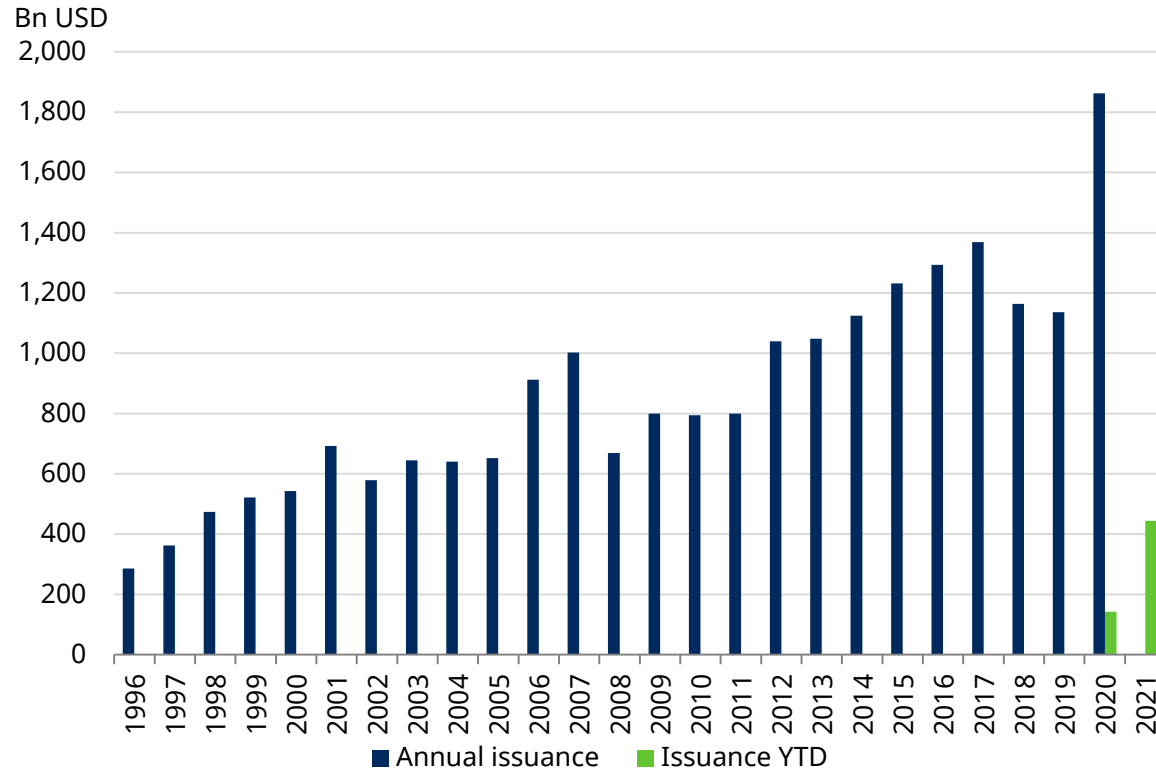


HY distress ratios the lowest in two years

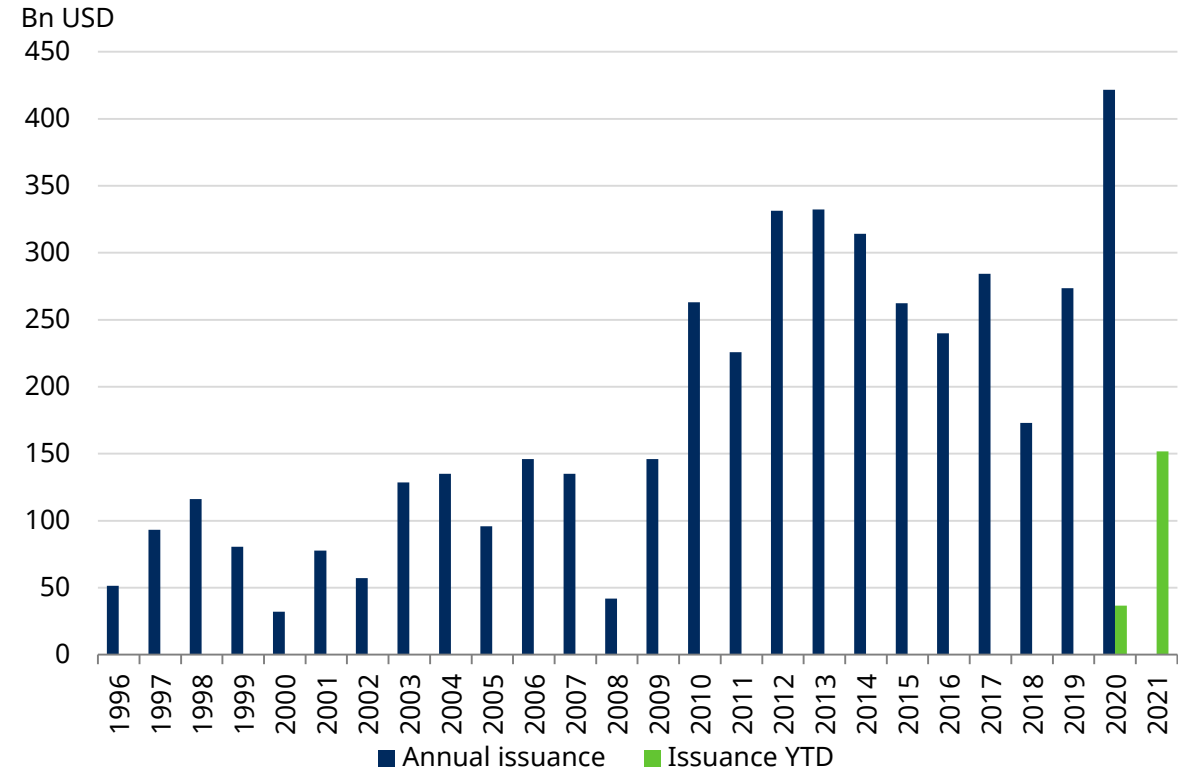
Source: Schrodgers, BofA Merrill Lynch, Moody's. Data to 31 March 2021.
¹HY distress is defined as percentage of issues in the index trading with spreads > 1,000bp.

US IG and HY gross issuance

US IG issuance



US HY issuance

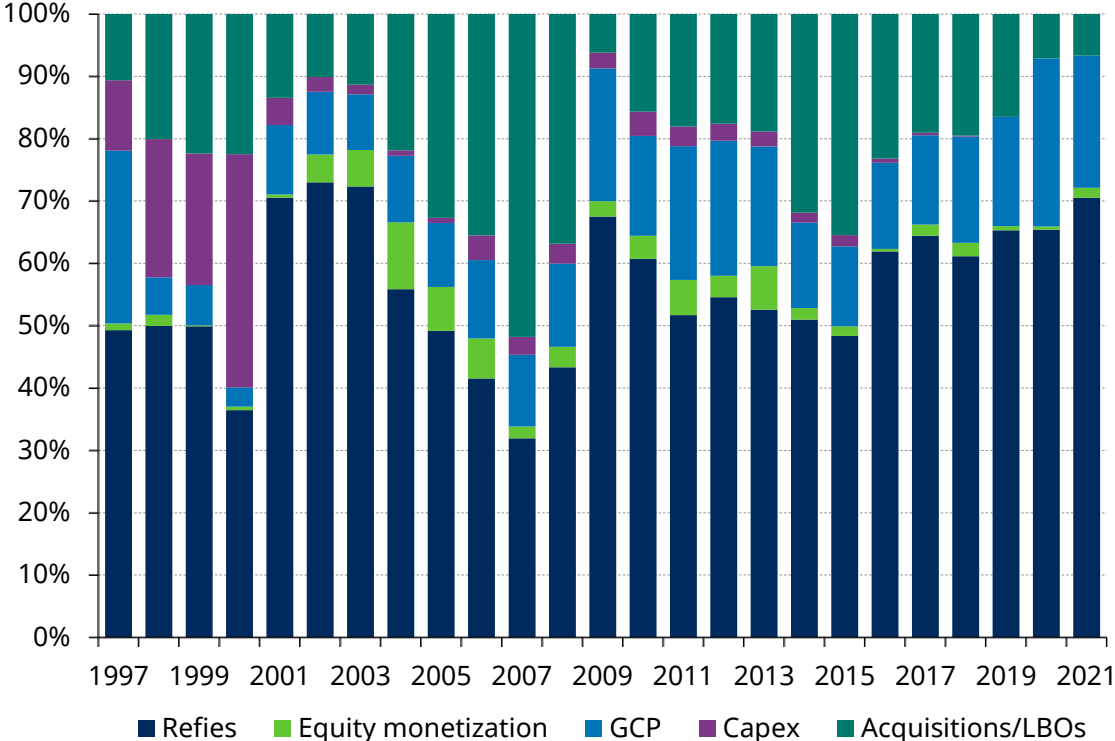


US HY starting 2021 with a bang with issuance coming in at \$150 billion in the first three months

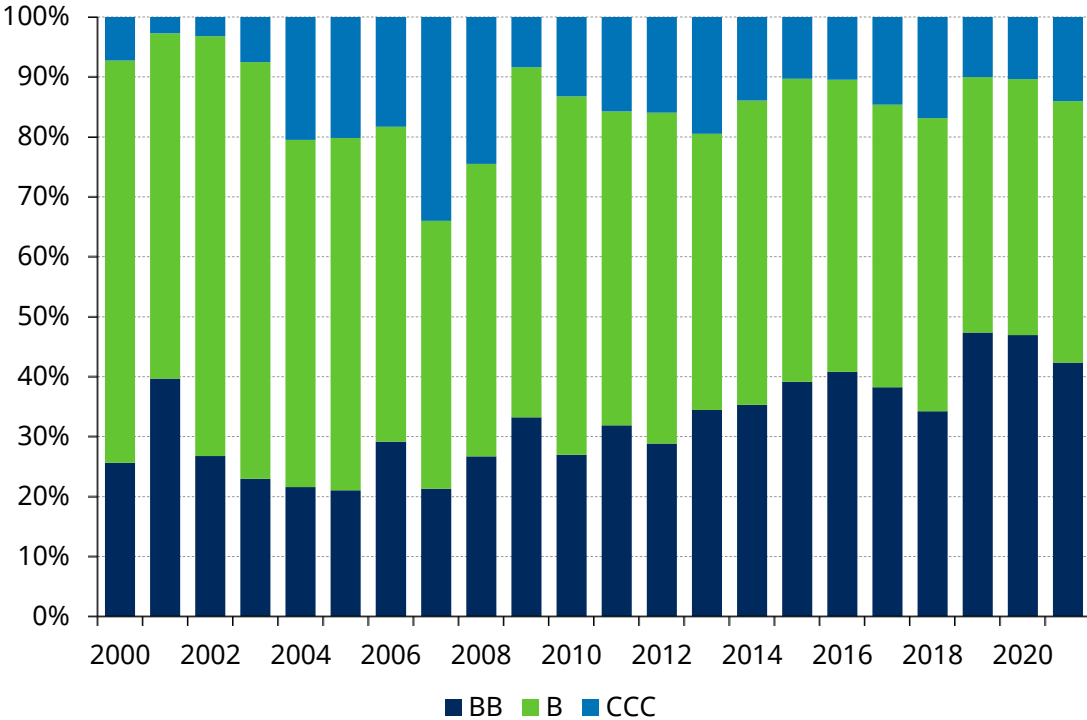
Source: Sifma. Data as at 31 March 2021.

US HY issuance details

Use of proceeds (percentage of issuance)



Issuance by rating (percentage of issuance)



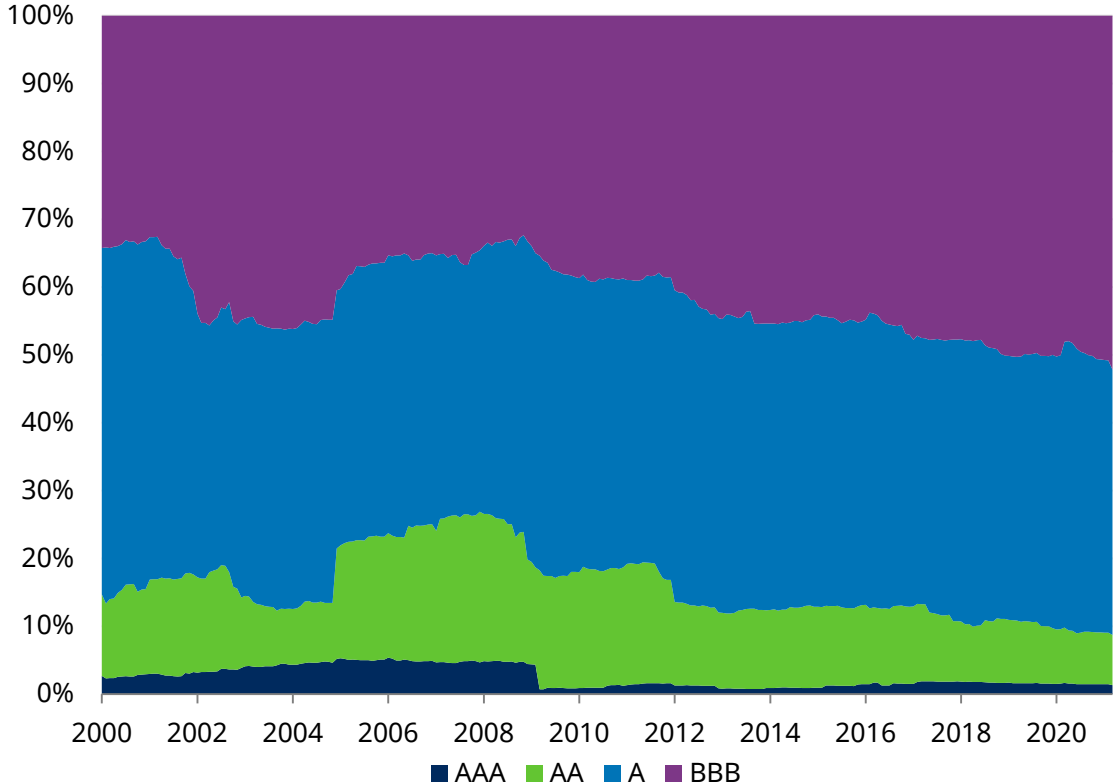
Very little of HY issuance has been used for acquisitions and buyouts with majority going for refinancing

Source: Schroders, BofA Merrill Lynch, Moody's. Data as at 31 March 2021. GCP is general corporate purposes, Refies is refinancings, Equity monetization is replacing equity capital with debt

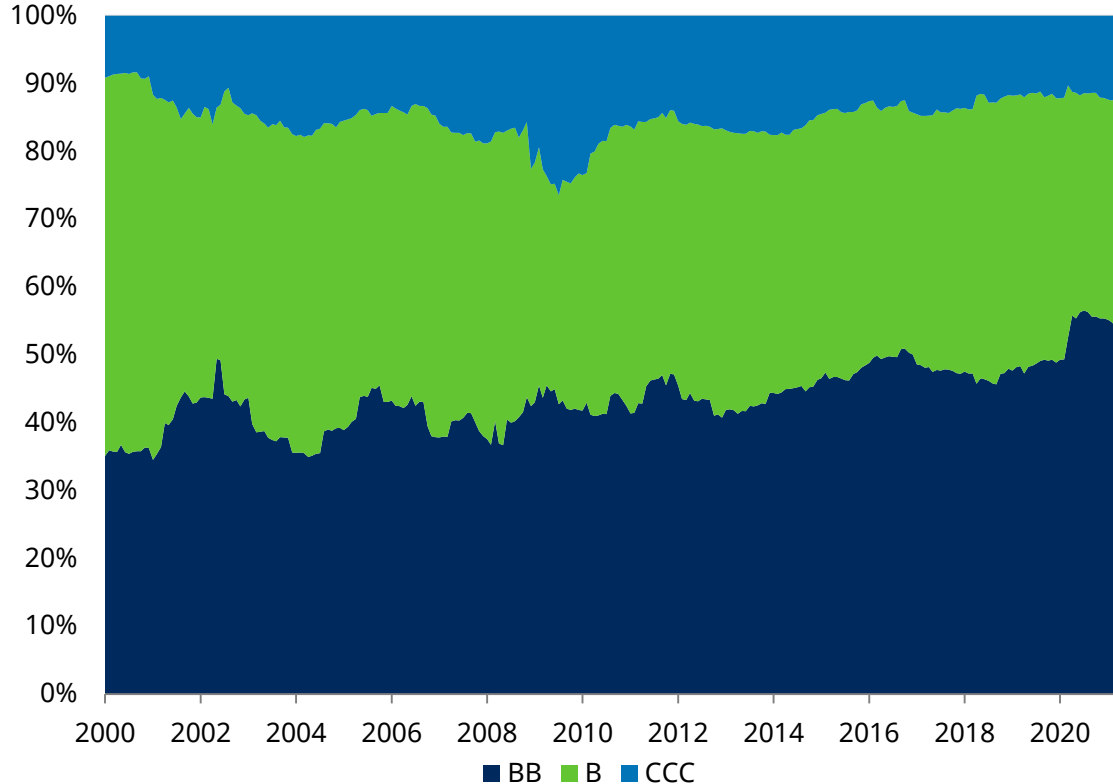
USD credit historical ratings split

IG has been deteriorating in quality but HY improving

US IG ratings split



US HY ratings split



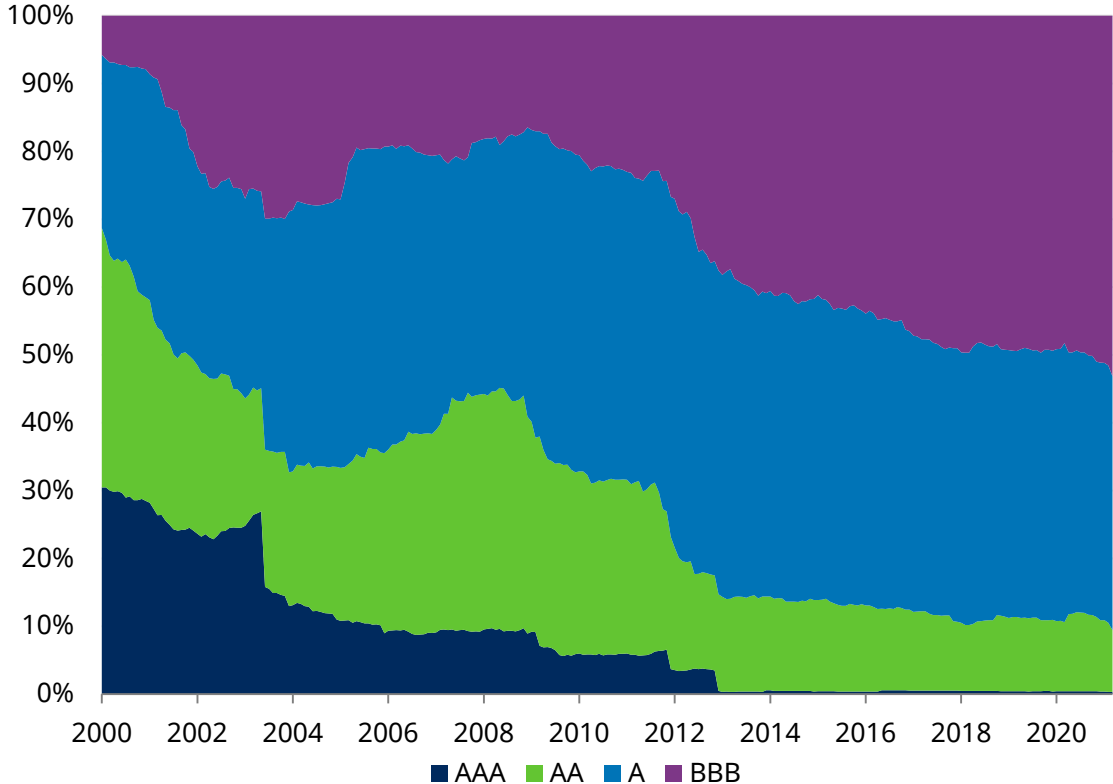
Credit quality improved in HY in 2020 because of the inclusion of downgraded IG bonds

Source: Schroders, ICE Data Indices. Data as at 31 March 2021.

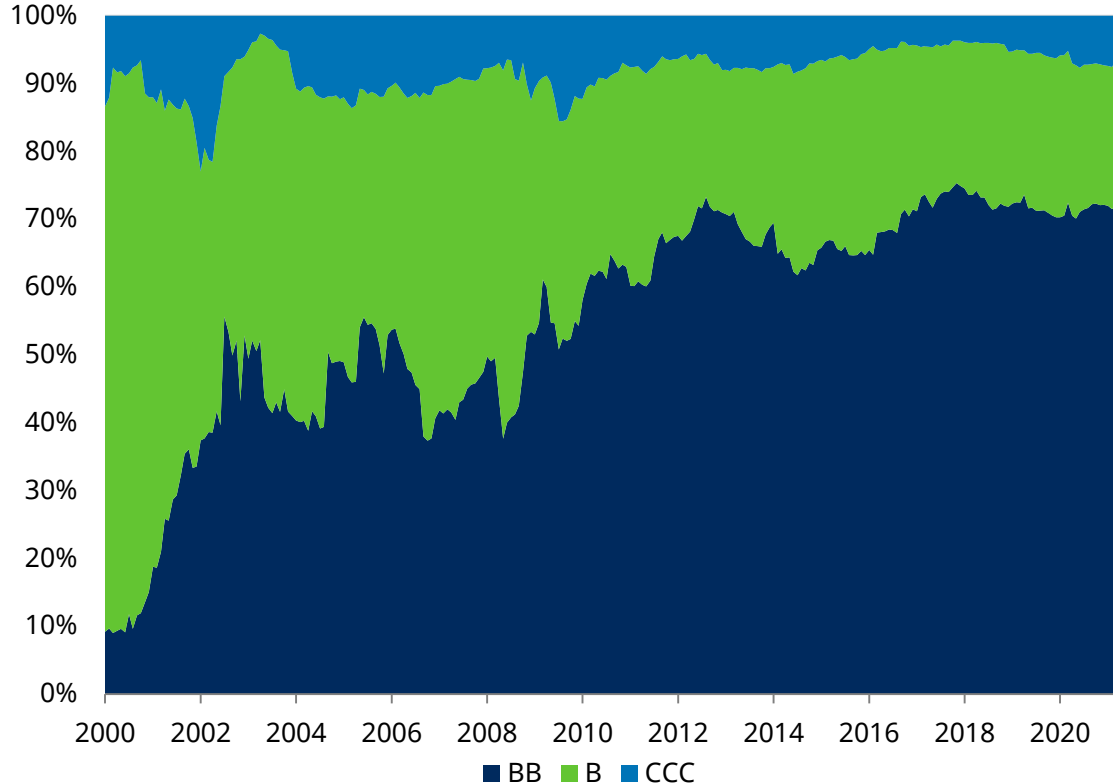
Euro credit historical ratings split

IG has been deteriorating in quality but HY improving

Euro IG ratings split



Euro HY ratings split



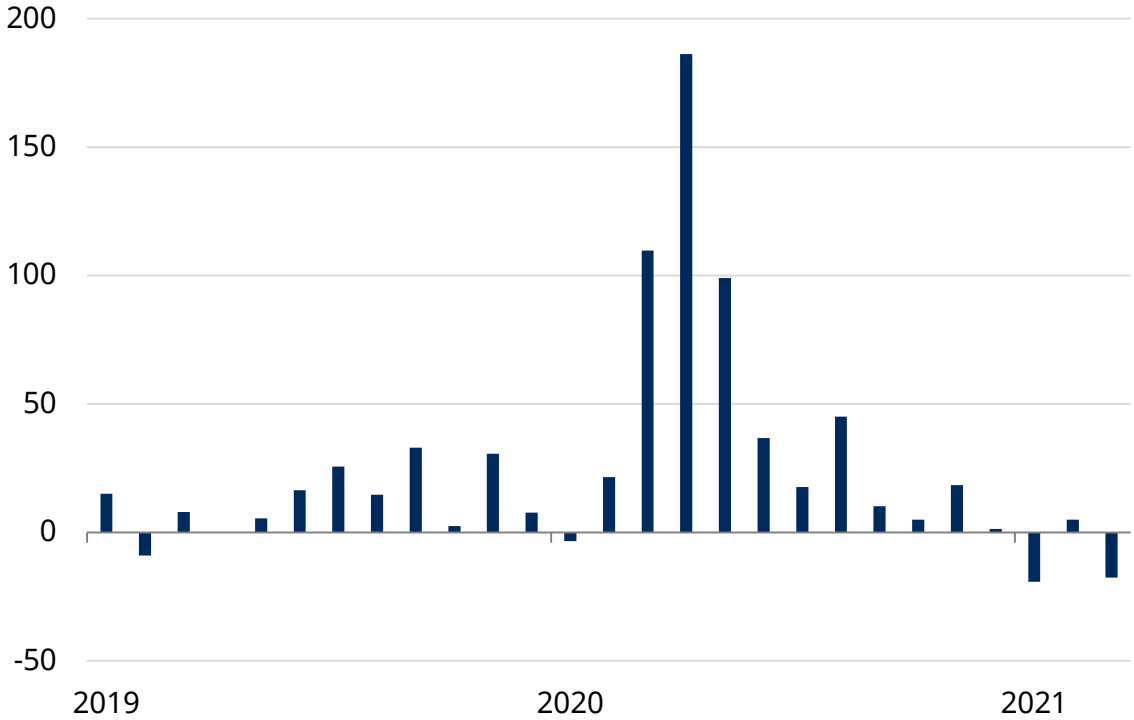
Euro IG credit quality has worsened in the Covid-19 crisis

Source: Schroders, ICE Data Indices. Data as at 31 March 2021.

US IG fallen angels

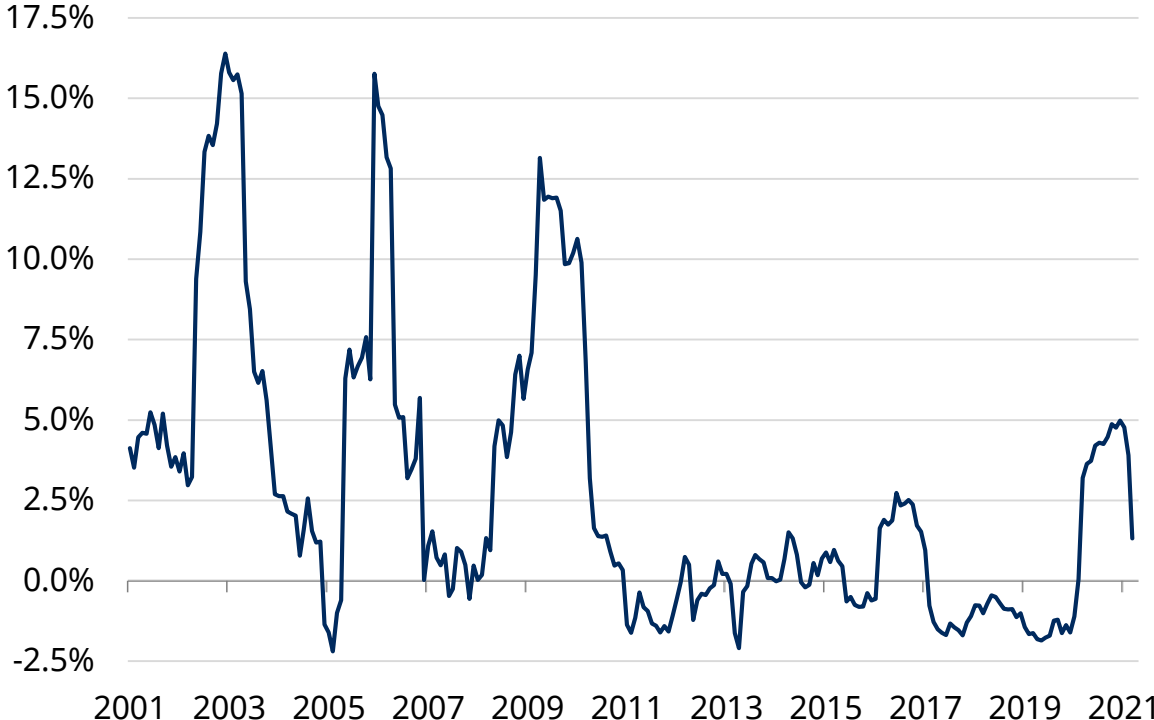
US IG net fallen angels

Monthly, billions USD



US IG net fallen angels

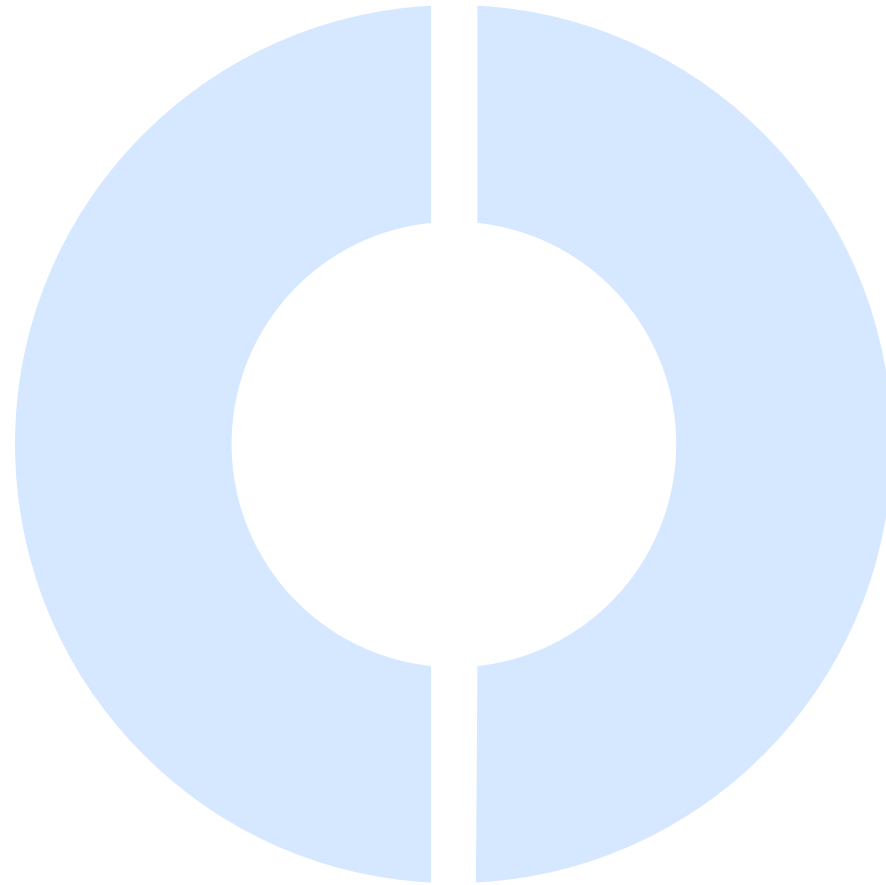
Last 12 months, percentage of BBB index



Rising stars (upgrades from HY to IG) have outpaced fallen angels (downgrades from IG to HY) so far in 2021

Source: BofA Merrill Lynch, Moody's. Data as at 31 March 2021.

Schroders



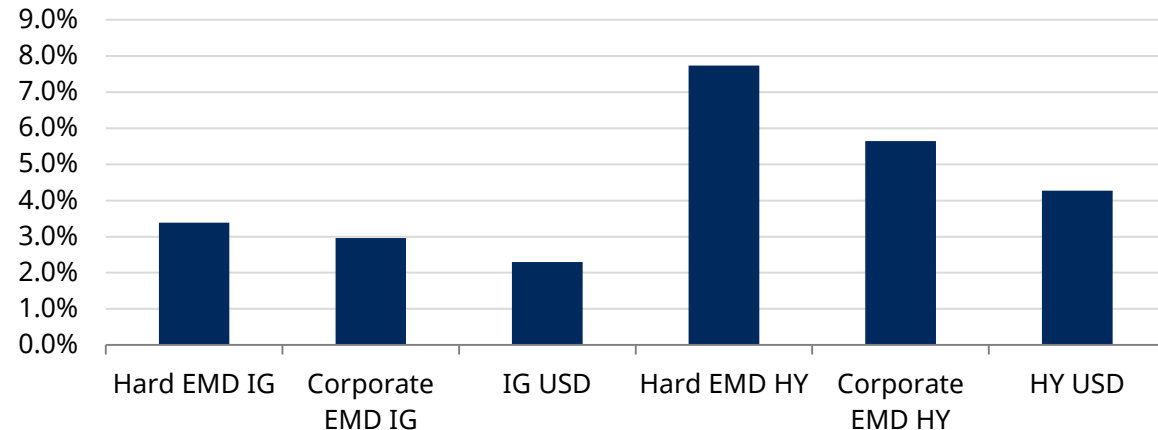
Emerging Market Debt

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	3.4%	3.0%	2.3%	7.7%	5.6%	4.3%
Spread (bps)	146	149	97	619	470	336
Duration	9.1	5.5	8.2	6.4	3.3	5.2
Rating	A3	BBB1	A3	B1	B1	B1
Percentage of EMD index	54%	57%	-	46%	43%	-

Yield



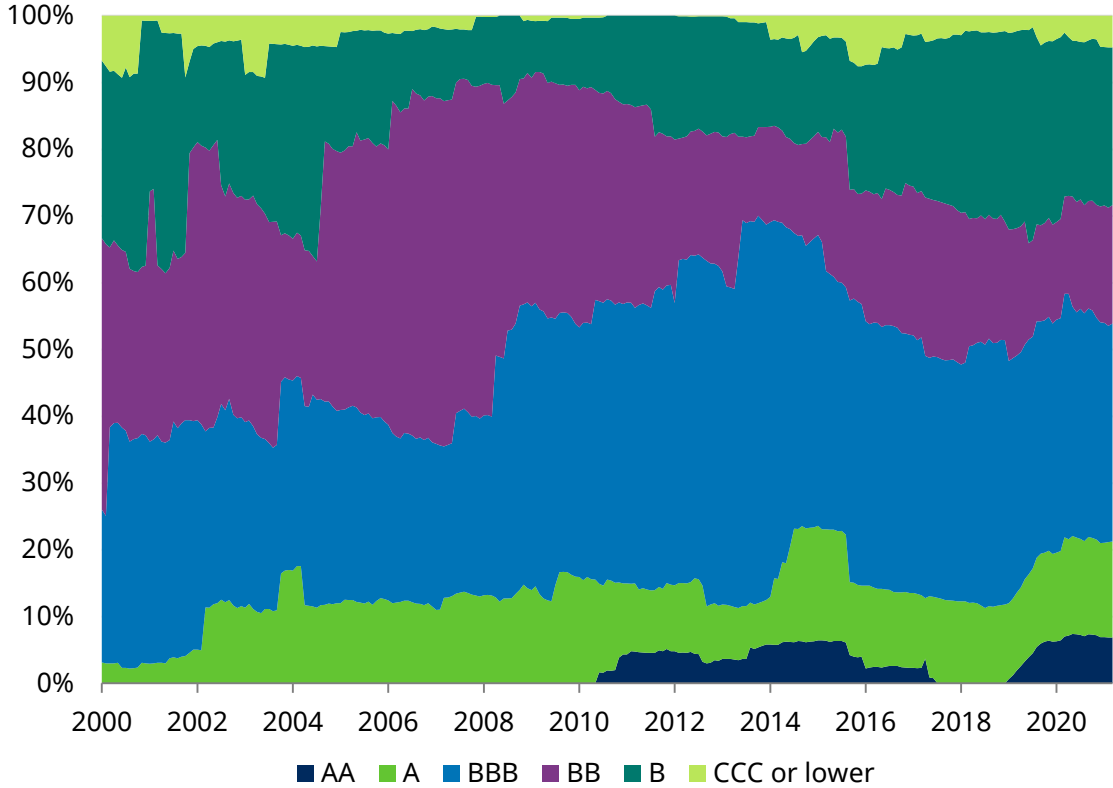
- Allocation to hard-currency EMD is a combination of IG and HY allocations
- Corporate EMD IG rating is one notch below US IG, EMD Hard IG rating is on par with US IG
- Hard EMD HY and Corporate EMD HY ratings are on par with US HY
- **Besides valuations, the decision between EMD \$ and US corporates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

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 March 2021.

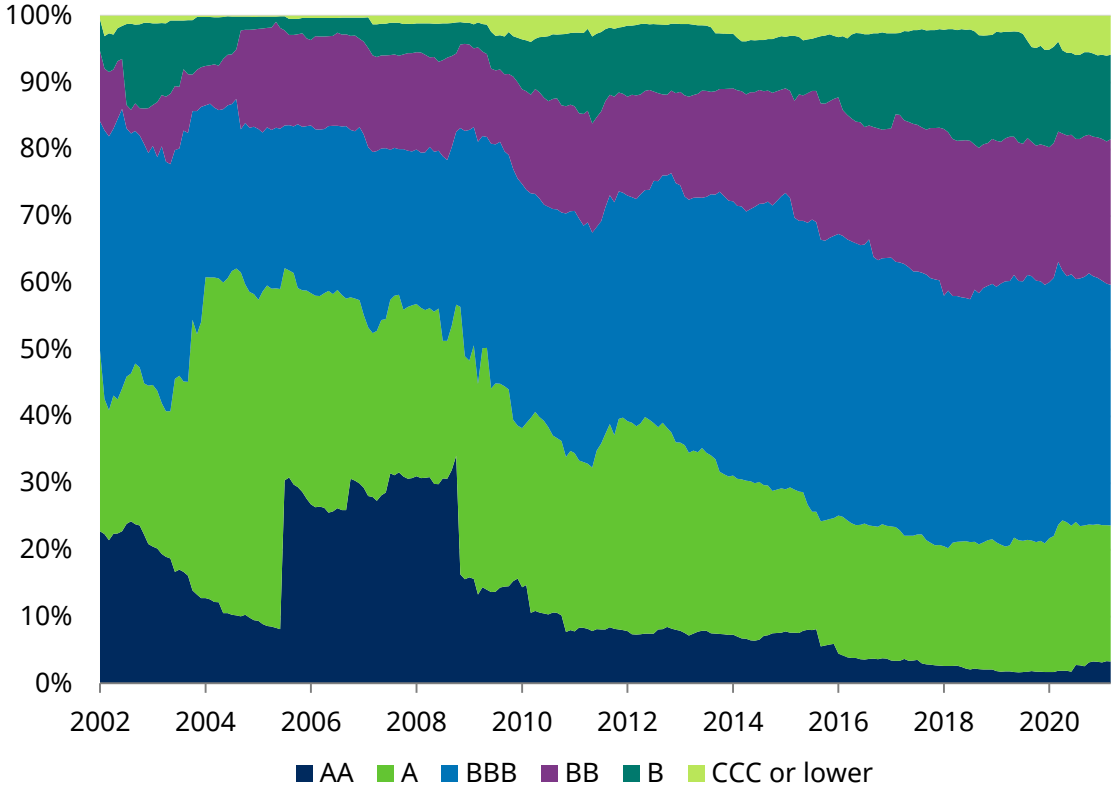
EMD historical ratings split

Credit quality has worsened since 2015

Hard EMD (JPM EMBI Global Diversified Index)



Corporate EMD (JPM CEMBI Broad Diversified Index)

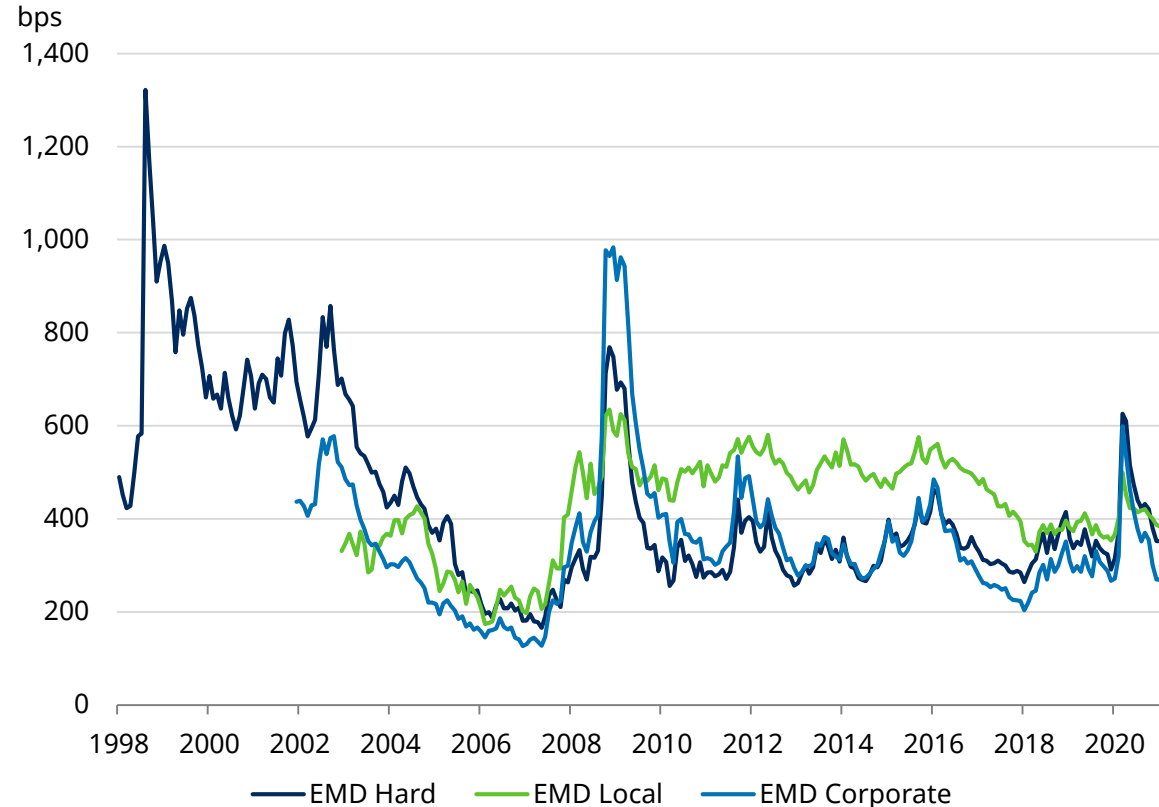


Source: Schroders, J.P. Morgan. Data as at 31 March 2021.

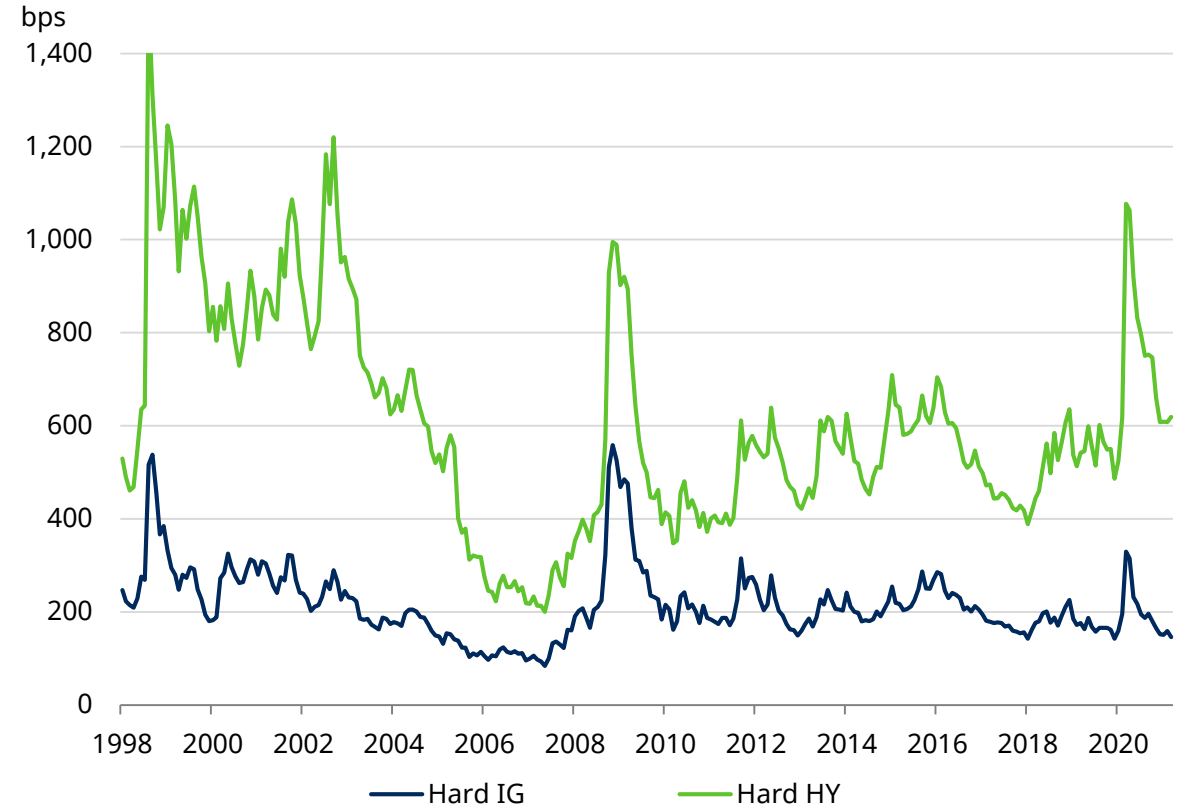
Valuation EMD

Historical spreads

EMD spreads



EMD Hard IG and HY spreads



EMD Hard IG spread has retraced all widening of 2020, HY around two-thirds

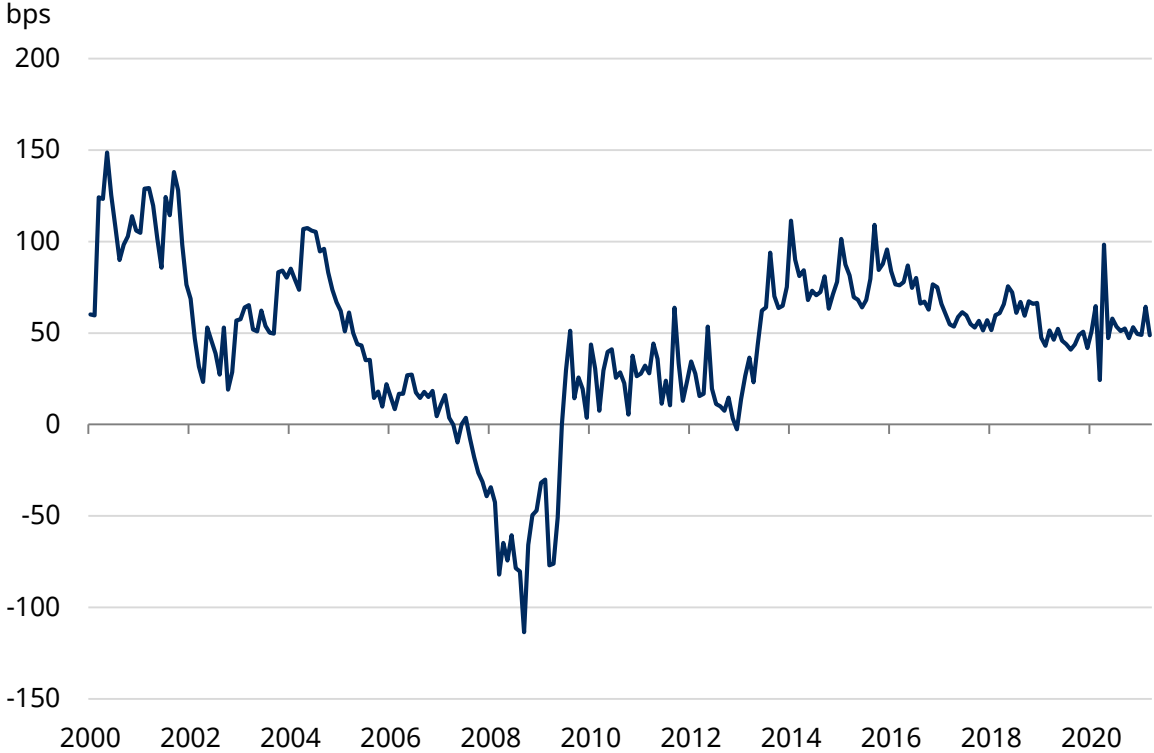
Source: Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 March 2021.

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 HY spread over US HY remains elevated

EMD Hard IG spread minus US IG spread



EMD Hard HY spread minus US HY spread

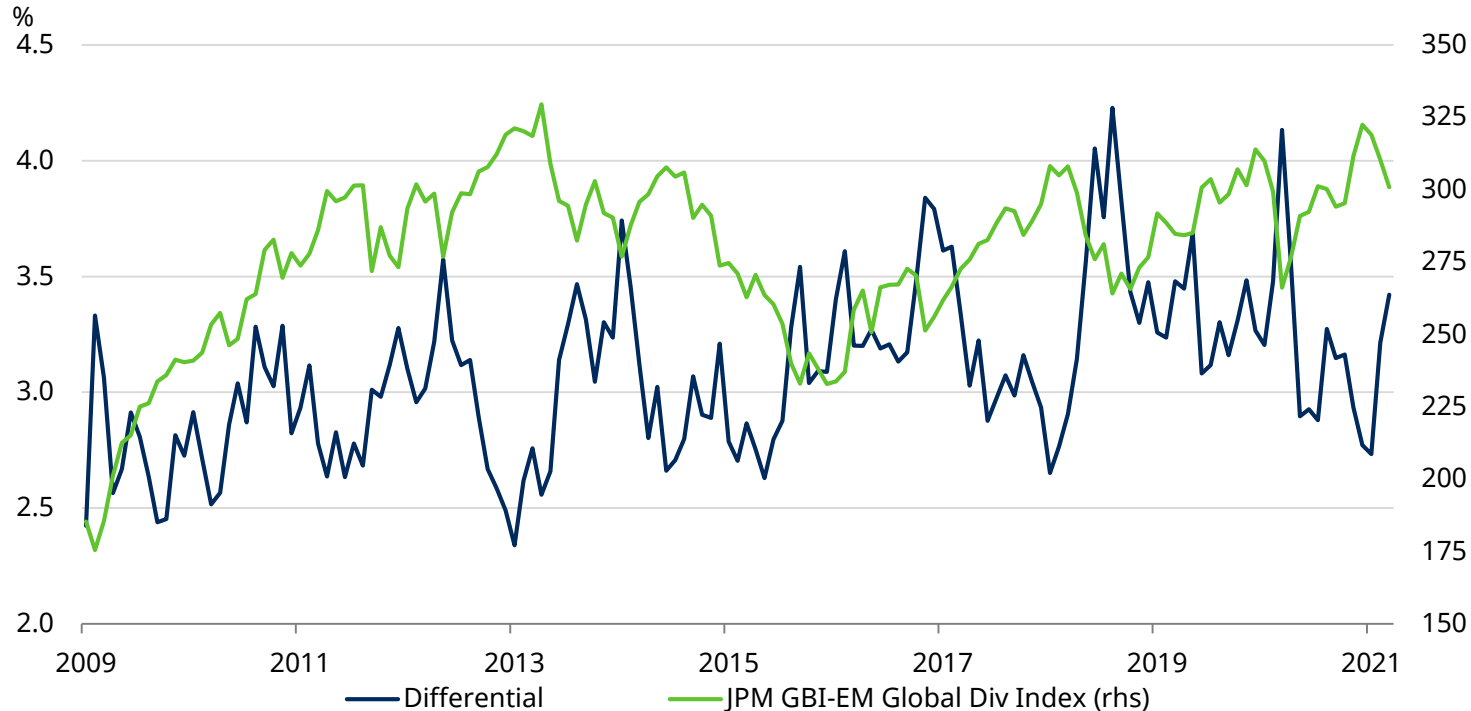


Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 March 2021.

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

The real yield differential has increased in 2021, implying better value in local bond yields

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 31 March 2021.

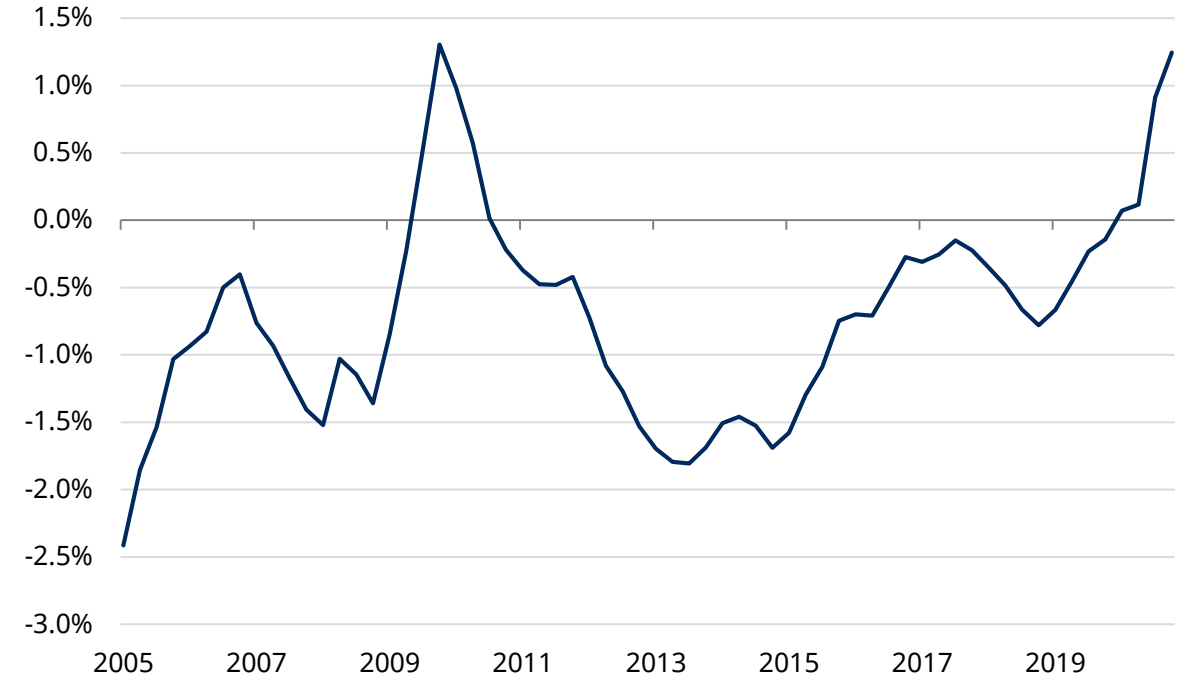
EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by core inflation. DM real yield is 5Y government bond yields of US, UK, Euro zone, Japan deflated by core inflation, weighted by the size of individual government bond market.

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 sharply positive

Source: Schroders, Refinitiv Datastream, J.P. Morgan. Exchange rate data as at 31 March 2021. Current account data as at Q4 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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