CAPITAL GROUP™

Investment Insights

Attractive opportunities remain across four key credit markets

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Marketing communication

Attractive opportunities remain across four key credit markets

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Key takeaways

- Despite high inflation and interest rate hikes weighing on fixed income markets, opportunities exist across four key credit sectors.
- The high-yield market appears healthier than it has been for years and valuations in investment grade credit offer a potentially attractive point to increase exposure.
- While elevated EM spreads might not be high enough given the challenging backdrop, compelling opportunities remain. In the US, strong consumer balance sheets are underpinning areas of the securitised market.
- The uncertain economic environment warrants caution, so a diversified approach is key. High-yield and emerging market debt can be balanced by higher quality investment grade credit and securitised sectors.

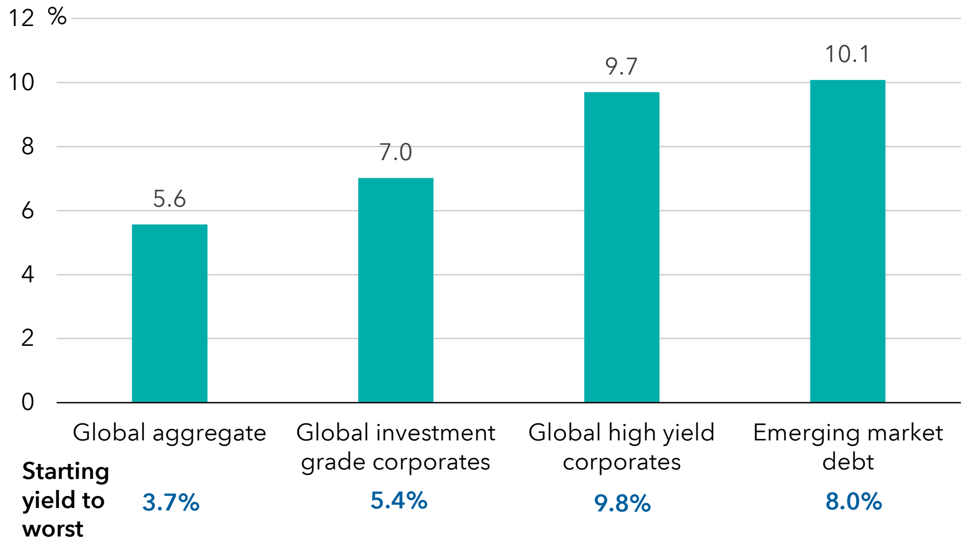
It has been a challenging year for fixed income markets in 2022 amid rising inflation and slowing global growth.

While uncertainty is likely to remain elevated, today's starting yields offer an attractive entry point for long-term investors. Yields across sectors are sharply higher compared with lows over the recent past. At current levels, history suggests higher total returns over the next few years.

This higher income can offer more of a cushion for total returns over time, even if price movements remain volatile. In fact, a greater portion of investors' income needs could potentially be met with traditional fixed income than would have been the case in recent years.

Historically, at current yields, longer term returns have been strong

Average five-year forward returns at recent yield levels (%)



Past results are not a guarantee of future results.

Yields and returns as of 30 September 2022. Sources: Capital Group, Bloomberg. Data goes back to 2000 for all sectors except for emerging markets, which goes back to 2003 and global high yield corporates, which goes back to March 2001. Based on average monthly returns for each sector when in a +/- 0.30% range of yield-to-worst. Sector yields above include Bloomberg Global Aggregate Index, Bloomberg Global Investment Grade Corporates Index, Bloomberg Global Corporate High Yield Index, 50% J.P. Morgan EMBI Global Diversified Index / 50% J.P. Morgan GBI-EM Global Diversified Index blend. Returns in USD terms.

The broad credit universe provides ample opportunities for investors to add value through bottom-up research and security selection in each of the four primary credit sectors – high yield, investment grade, emerging market and securitised debt. Keeping a long-term view and employing balance can help smooth the way.

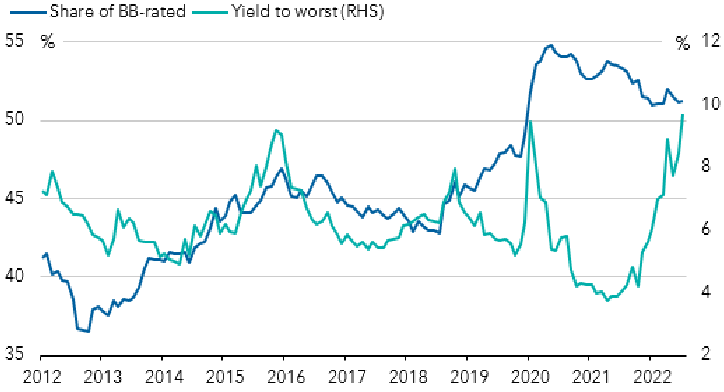
1. High yield is finally high yielding

With yields at 9.7%, the US high yield market is looking attractive again and could present a compelling opportunity to add to positions, should fundamentals continue to outperform expectations of slowing economic growth. With fundamentals in good shape, the asset class is healthier and more stable than it has been in many years. It is a larger and more diverse market, and the overall credit quality is higher than it has been during other periods of slowing growth. BB-rated credits make up over 50% of the market. (See charts on page following).

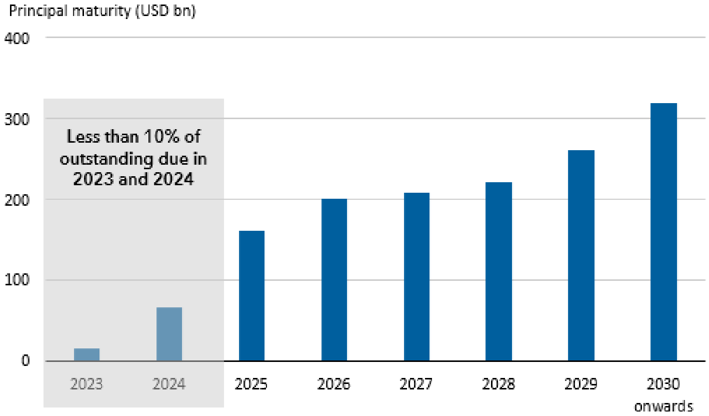
That said, we are cautious as high yield spread widening year-to-date has been limited relative to spreads in higher quality sectors. As such, a repricing of risk based upon negative changes in the economy could have an outsized impact on the sector. Should the US economy enter a recession, we would expect high yield to underperform investment grade and securitised sectors, thus we have recently reduced exposure. That said, there are many positive attributes of the sector which contribute to our current sizing of the sector.

The absence of near-term large-scale refinancing requirements is also supportive. Corporates tapped into the low-rate, favourable credit environment of the past few years, meaning that many do not need to issue at prevailing higher rates. The volume of issuance could therefore remain low for at least another year.

Improved credit quality and higher yield~



High yield bond market maturity profile†



Past results are not a guarantee of future results.

~ As at 30 September 2022, based on the Bloomberg US High Yield Corporates Index 2% Issuer Cap. Source: Bloomberg

† As at 30 September, based on the Bloomberg US High Yield Corporate Index. Source: Bloomberg

In terms of defaults, at 1.6%[1], the latest 12 months' default rate is low by historical standards. Looking forward, an early indicator of future defaults is distressed debt. Today, distressed debt as a percentage of the high-yield universe is in the mid-single digits. Based on this metric, while we do think the default rate will likely rise from low levels, we do not expect it to spike.

Another factor that we consider is debt that is rated triple-C or below. This too, is around historical lows at about 13% of the high-yield market, compared to 20% in December 2007.[2]

The combination of these three parameters presents a constructive view of the sector, which supports our current position.

Meanwhile, average duration of the US high-yield market is lower than that of US investment-grade credit.[3] A lower sensitivity to higher interest rates is attractive at a time when central banks are trying to tame inflation.

The high yield sector is instrumental to a multi-sector credit strategy as over time it typically generates the highest level of income, which is the key contributor to total return over a full market cycle. The size and diversity of the sector allows for

1. As at 30 September 2022. Trailing 12-month results. Source: JPMorgan
2. As at 30 September. Index used is the Bloomberg US High Yield Corporates 2% Issuer Cap Index. Source: Blomberg
3. As at 30 September 2022, as measured by the modified duration for the Bloomberg US High Yield Corporates 2% Issuer Cap Index and Bloomberg US Corporate Index. Source: Bloomberg

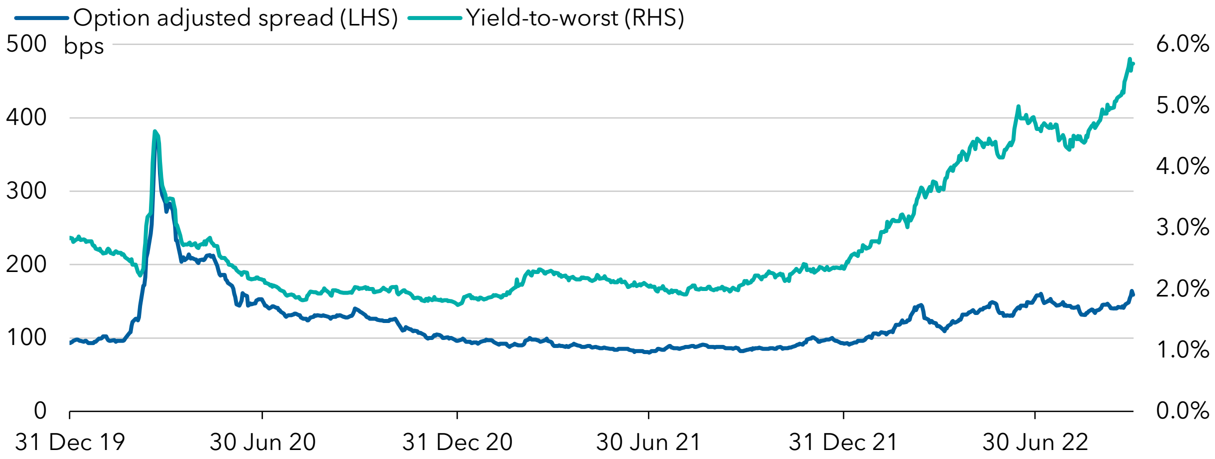
ample opportunity to add value through fundamental research and appropriate risk allocation across quality and industry.

2. Investment grade corporates: higher quality but more sensitive to rates

Along with other fixed income asset classes, investment grade corporate bonds have repriced significantly this year, returning -18.7% year-to-date.[4] Once again, however, valuations have improved significantly as a result and, with a yield of 5.7%[5], which has contributed to a recent decision to increase the sector's weight.

Caution is warranted, however, as the risk of recession, or at least a material slowdown in growth, is rising and spreads could widen further, though not as wide as lower quality corporate debt. That said, with spreads having widened from recent tights, there is less downside risk to further spread widening than there had been during previous periods of declining economic growth.

US investment grade spreads and yields



Past results are not a guarantee of future results.
Data as at 30 September 2022 based on daily data. Index used is the Bloomberg US Corporate Index. bps: basis points. Source: Bloomberg, Capital Group

Although credit fundamentals and consumer spending are currently in good shape, both could deteriorate. Slowing growth and inflation pose risks and call into question the sustainability of corporate profit margins. That said, a deep recession is not currently our base case given still strong balance sheets for both financial and non-financial issuers.

With the current macroeconomic environment highly volatile, however, careful selection in companies and sectors remains key. Nonetheless periods of volatility can present compelling opportunities, particularly where a bottom-up and fundamentally driven research approach is used to add value.

Furthermore, investment grade credit could play a vital role in terms of adding balance and resilience to a portfolio. Investment grade credit can help limit the downside during market volatility, particularly in the contraction phase of the business cycle. As duration of the asset class has extended, interest rates have become a larger component of total returns. Should a mild recession transpire, and interest rates begin to fall, the longer duration profile of investment grade bonds could offer a degree of resilience. In addition, investment grade spreads

4. As at 30 September 2022. Data in US dollar terms, for the Bloomberg US Corporate Index. Sources: Bloomberg, Barclays
5. As at 30 September 2022. Index used is the Bloomberg US Corporate Index. Source: Bloomberg

tend to widen much less relative to high yield when the economy slows and fundamentals weaken due to its higher credit quality.

3. Emerging markets debt offers diversified sources of income and return

Persistent inflation, slowing global growth, tightening US monetary policy, a soaring US dollar, and geopolitical tensions, including the Russia – Ukraine conflict and China – Taiwan tensions are all currently weighing on emerging market debt. That said, cheap valuations in pockets of higher yielding sovereign and corporate sectors make us constructive on the sector.

The breadth and diversity of the sector is attractive, though there are fewer issuers than corporate sectors. The quality range is diverse which offers opportunities to move up and down the credit quality spectrum to manage the risk and return characteristics of the sector without changing the overall market value weighting within portfolios.

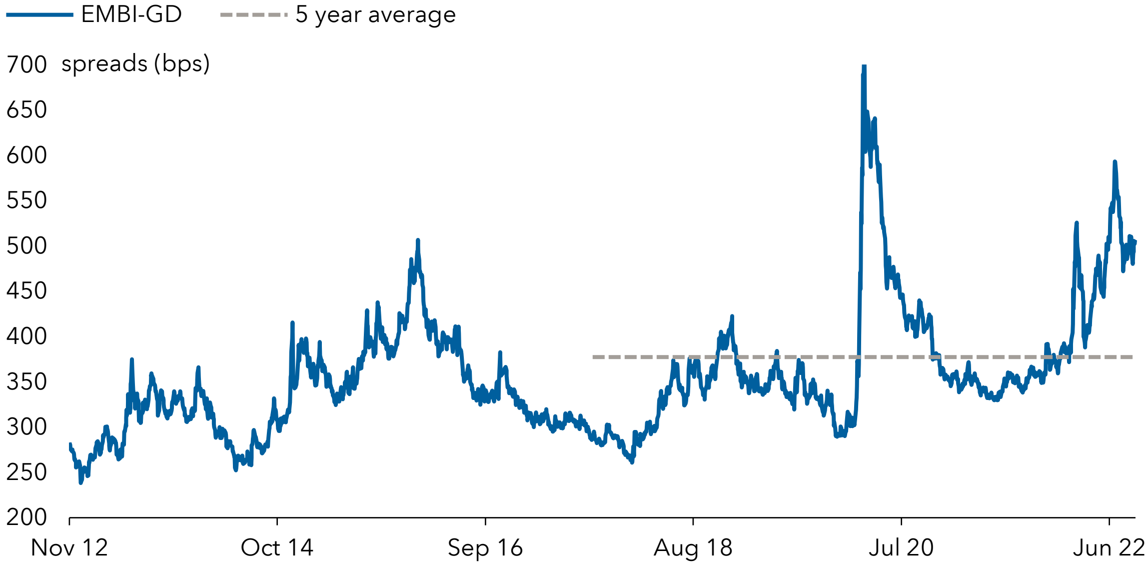
Inflation and cost of living concerns are putting pressure on fiscal deficits, which are high compared to previous EM peaks. While many EM central banks are in the last phase of their tightening cycle, others are struggling with credibility concerns amid high inflation and weak currencies. External balances have generally improved across many EM countries thanks to pandemic-related restrictions and undervalued exchange rates, but pressure on EM currencies has led to some erosion of FX reserves.

EM spreads are elevated on a historical basis (although some of this is skewed by distressed credits), but they might not be wide enough given the challenging backdrop. That said, we continue to find compelling opportunities within the asset class. Examples include some of the investment grade parts of the universe such as Mexico and Panama, which do not have near-term external funding needs, and some high yield EM credits with access to external funding such as Egypt.

We are also finding selective opportunities in the higher yielding part of the universe with a focus on the safer higher-yielding credits whose spreads have widened in sympathy with the rest of the asset class, such as the Dominican Republic and Senegal.

Looking ahead, the end of the zero COVID policy in China, although not certain, could provide a boost to EM growth, but it is unlikely to support commodity prices enough given the increasing limitations of its growth model and geopolitical pressures for de-globalisation. A resolution to the Russia/Ukraine conflict would be the main positive catalyst, but this looks unlikely for the time being. Overall, the combination of relatively weak global growth and high inflation remains a challenging backdrop for EM debt hard currency, especially with a front-loaded Fed hiking cycle, underscoring the need to be selective.

Emerging market debt spreads are high relative to history



Past results are not a guarantee of future results.
Data as at 21 September 2022. Source: JP Morgan, Bloomberg

4. Securitised credit: a differentiated view of the US consumer provides potential opportunities

In terms of US securitised credit, we consider ABS, CMBS, non-agency RMBS, and CLOs [6]. In an environment of tightening financial conditions and rising rates, our portfolio managers have a preference for ABS. This is based on a differentiated view of the US consumer. High employment and savings accumulated from pandemic fiscal stimulus packages are supporting the personal finances of the US consumer. The run-off of these strong balance sheets could take a few years, providing a modicum of support to consumers in the impending economic downturn. Given where we are in the financial cycle and how much liquidity has been built up, portfolio managers have shown a preference for slightly greater credit risk than adding to duration exposure.

Within ABS assets, auto loans and student loans have shorter duration and more consumer credit risk. As such, they can be good diversifiers, particularly for income-seeking portfolios that include corporate bonds. Credit risk on private student loans has improved as a result of President Biden's plan to provide debt relief to borrowers, though the programme is being challenged in court. Private student loans are not being forgiven, but students often have federal and private loans and this plan should reduce the average debt load. Should the programme receive approval to go ahead, it would likely provide a further catalyst for the sector.

Compared with ABS, CMBS is more cyclical and is exposed to the economic slowdown. It also has longer duration given the typical maturity of commercial loans. Our portfolio managers favour the senior part of the capital structure and avoid mezzanine tranches of these securities, given the slowing economy.

Other corners of the CMBS market our managers find attractive include warehouses, data centres and industrial buildings. These tend to have better

6. ABS: Asset-backed securities, CMBS: Commercial mortgage-backed securities, RMBS: Residential mortgage-backed securities, CLO: Collateralised Loan Obligations.

profiles than office buildings and retail, where there is more uncertainty associated with an economic slowdown.

Non-agency RMBS exposure is mainly to credit risk transfer securities, which are government-originated loans that have been offloaded to the private sector. Portfolio managers believe the biggest potential headwind in this market is extension risk. With rising interest rates, we are likely to see borrowers extend their mortgages. Borrowers who secured loans or refinanced their existing mortgage during the pandemic when rates were below 3% are unlikely to prepay any time soon. Therefore, duration risk in the mortgage market is something we are analysing closely.

CLOs represent an area where opportunities are rising although a selective and opportunistic approach is crucial when investing in these securities. There are currently some technical headwinds as a result of the UK pension turmoil, which is causing selling of higher quality tranches. We expect CLO supply is going to be elevated which may bring some spread volatility. In addition, some US and Asian banks may pump the brakes on buying amid the market volatility. We continue to monitor this segment as valuations would likely become gradually more attractive.

We believe a key benefit of including securitised credit in a diversified fixed income portfolio is its lower correlation with corporate credit. Many of the fundamental drivers of this sector are distinct from corporate and sovereign credit. The result is the potential to generate similar returns while achieving healthy diversification. The securitised sector is smaller and less liquid than investment grade corporates and has a narrower quality spectrum. It is a short duration sector with good credit quality that offers attractive yield and defensiveness over time. The sector is also under-researched by many market participants, enabling our team of securitised credit analysts to identify numerous mispriced investment opportunities.

The bottom line

All four sectors of the credit universe play an important role in providing consistent and durable income streams in bond portfolios. The high income of the high-yield and emerging markets debt sectors can be balanced by the defensiveness of the higher-quality investment grade corporates and securitised sectors. The shorter duration of high-yield and securitised credit also tempers the higher interest rate sensitivity of investment grade and EMD. Overall, credit spread correlations are reduced by the inclusion of securitised and sovereign credit. These sectors offer fundamental drivers that can be distinct from the corporate credit drivers in high-yield and investment grade corporates.

Given the uncertain economic environment, we believe taking a diversified, balanced approach to credit is more important than ever.

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