Liquid Credit

Major Trends

Credit yields stabilised at higher levels in 2023, setting up for attractive income potential in 2024: After a sharp increase in yields in 2022, which marked the weakest year of performance for high yield indices since 2008, bond and loan yields stabilised in 2023 at levels higher than seen in recent years, due in large part to the effect of higher base rates. While volatility in spreads and interest rates weighed on performance in parts of the year, structurally higher yields and a strong Q4 rally helped deliver good full-year results. Looking forward to 2024, the potential for positive tailwinds from central bank easing is likely to be offset by potential stress on corporate balance sheets amid a higher interest rate environment. Given that credit spreads are now tighter than long-term averages, we do not expect pricing to move materially higher (spreads tighter) in high yield or leveraged loans, but high starting yields still offer the potential for attractive income generation.

Structured products lagged the rally in corporate credit in 2023, creating opportunities for security selection in 2024: While corporate CLO debt performed strongly in 2023, commercial mortgage-backed securities came under pressure due to poor fundamentals in some market segments, particularly office and retail. This has created an opportunity to identify restructuring opportunities in stressed credits and securities in stronger sub-segments trading at depressed levels. In US residential mortgage-backed securities, significant home price appreciation since the pandemic has created an attractive opportunity in seasoned loans, which benefit from enhanced downside protection.

Approaching maturity wall likely to lead to higher issuance activity: New issuance of leveraged credit was weaker in 2022 and 2023 as companies were reluctant to issue debt at higher interest rates. However, as maturities start to approach and with prospects improving for a soft landing, issuance is likely to increase in 2024 as corporate activity picks up and companies seek to refinance upcoming debt maturities.

Default rates likely to continue to rise: Default rates rose in 2023, finishing at c. 3% for both US high yield and leveraged loans. While this was at the lower end of the range for most analyst projections, it was slightly above long-term averages. Our expectation is for defaults to increase modestly from these levels, staying in a range of 3-5% amid a more prolonged but less severe cycle than seen in some prior recessions.

Attractive environment for opportunistic credit strategies: Refinancing pressure, rising default rates, and dispersion in both pricing and fundamentals are likely to create an attractive environment for opportunistic and event-driven credit strategies. Security selection will be key in taking advantage of restructuring and refinancing opportunities, as well as exploiting an increased volume of stressed and distressed activity.

Golden Rules

- Use a bottom-up approach to identify and position for relative value across sub-sectors over the economic cycle.
- Employ a dynamic approach to asset allocation, as sub-sector selection is a significant driver of returns and market pricing can change quickly.
- Partner with specialists with deep knowledge of a sub-sector's credit fundamentals, market technicals and legal documentation.
- Focus on niche, capacity constrained sub-sectors marked by complexity to uncover additional value
- Use custom vehicles where appropriate to maximise flexibility and allow for control of sub-sector exposures.

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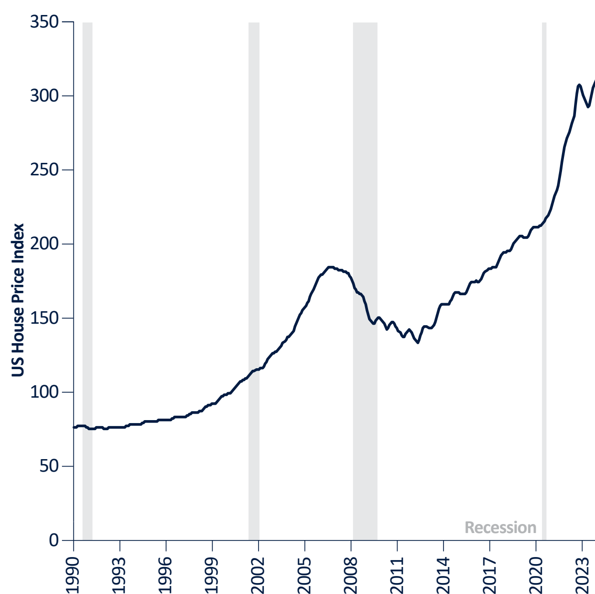
Sub-Strategy Attractiveness

- **Residential Mortgage Bonds:** Positive view. We remain focused on seasoned non-agency bonds in this sector. US home prices have rebounded from a decline in H2 2022 and are now back at all-time highs, 47% higher than in January 2020 prior to the pandemic (Exhibit 1). This provides a significant cushion for seasoned residential mortgage loans against further economic weakness. As mortgage rates potentially decline, we expect home sale volumes to rise, buoying the health of the underlying housing market.

Exhibit 1
House prices have increased 47% since January 2020



Note: *Shaded areas indicate US recession*
Source: *Federal Reserve Bank of St. Louis*

- **Opportunistic / Event Driven Credit:** Positive view. Distressed activity picked up in 2023 and is likely to continue to gradually increase in 2024. In addition to that, CCC bonds and loans have detached from the relatively strong performance of higher-rated issues, with CCC loans trading at an average dollar price of $80 while CCC high yield bonds are currently yielding 13.7%. Access to credit markets remains challenged for these companies, which creates a compelling opportunity for security selection as companies seek to refinance debt or modify their capital structures.
- **CLO Debt:** Positive view, albeit with less upside potential than in 2023. CLO debt was one of our favoured sub-asset classes heading into last year, and it benefited from a strong rally in 2023 with BB CLOs +24.5% and BBB CLOs +17.7% on the year. After this rally we still see attractive value, but it is largely driven by the high current yield relative to limited underlying credit risk, with less upside convexity remaining at current pricing. The BB CLO index currently has a yield-to-maturity of 12%, while BBB CLOs are yielding 8%[1], with structural subordination that significantly reduces the possibility of impairment.

- **Asset-Backed Securities:** Mixed view. We are positive on the outlook for aviation securities, which we expect to recover as travel activity continues to rebound. We are more cautious elsewhere across asset-backed securities, particularly in areas with direct consumer exposure.
- **Commercial Real Estate Credit:** Selectively positive. Commercial real estate came under pressure in 2023, and for good reason due to deteriorating fundamentals in some market segments – most notably office and retail. While we are not bullish on the asset class across the board, this has created an attractive security selection opportunity to identify stressed credits and invest in sectors with more favourable backdrops such as multi-family.

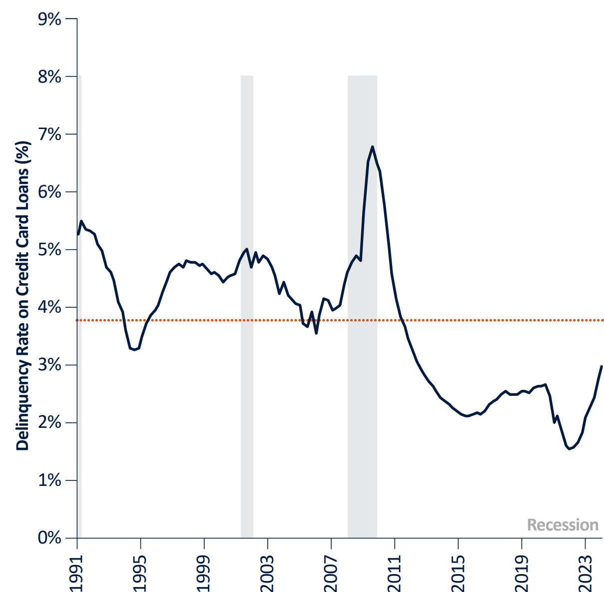
1 JPM CLOIE BB and BBB (2023 performance and yield as of 12/29/2023).

- **Leveraged Loans:** Neutral view. We were previously positioned overweight in floating rate leveraged loans going into 2022, which insulated our portfolios from the rise in rates. We shifted to neutral last year and maintain that stance currently. Elevated starting yields may look attractive, but we think these represent fair value given the weaker fundamentals of the loan market. The higher cost of floating rate debt and covenant-lite debt could lead to higher loss rates than in prior cycles.
- **Short Duration High Yield:** Neutral view. While the spread tightening in Q4 leaves us cautious regarding high yield at the start of 2024 (see below), shorter duration yield-to-call paper is typically less sensitive to spread widening and offers an attractive cash-plus return in the high single digits.
- **High Yield:** Neutral to negative view, based on valuation and duration. After a strong rally in Q4, US Corporate High Yield ended the year trading at a spread of only 322 bps, more than 100 bps less than the long-term average. The total yield-to-maturity remains healthy at 7.6%[2], but there is a higher chance of spread widening than tightening from those levels. We continue to use certain vehicles to get cash-efficient exposure to high yield beta in client portfolios but are modestly underweight relative to target as of this writing.
- **Emerging Market Debt:** Neutral view overall, though we continue to look for potential opportunistic areas of focus within emerging markets. We evaluated and passed on an opportunistic investment in Chinese real estate debt but remain open to other thematic investments within the asset class.

- **Consumer Credit:** Negative view. We are bearish on direct consumer credit exposure, which has begun to come under pressure with rising costs and a potentially fragile economy. Credit card delinquencies have been rising since the start of 2022 (Exhibit 2) and are likely to continue to increase. While certain structures may be better positioned, in general we are trying to limit our exposure to consumer credit.

Exhibit 2

Credit card delinquency rates have started to increase



Note: *Shaded areas indicate US recession*

Source: *Federal Reserve Bank of St. Louis, includes data for all commercial banks*

2 Barclays US Corporate High Yield Index as of 12/29/2023.

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2024 Strategic Priorities

- **Position in higher-quality assets:** Our current preference is for securities with structural credit enhancement, avoiding subordinate or first-loss exposures. Where no structural credit enhancement is available, we focus on higher-quality fundamental profiles that we believe are resilient to weakness in corporate credit markets. To shape our exposures, we utilise customised fund-of-one vehicles that allow us to directly influence allocations across credit sectors.
- **Exploit opportunity set in structured credit:** With the exception of CLOs, other areas of structured credit (including mortgage credit) lagged the strong rally in high yield in 2023. We see what we believe are attractive yields relative to the fundamental risk in certain areas within structured credit, and the opportunity to add value in a fertile security selection landscape through our strategic asset manager partnerships.
- **Prepare for upcoming stressed and distressed opportunity**: The opportunity set for distressed investing has been limited over the past five years, with the exception of a brief spike in defaults related to Covid. While our base case is not for a severe recession, we expect defaults to remain modestly above average and are preparing to increase our exposure to stressed and distressed credit if the opportunity presents itself.
- **Continued focus on emerging managers and opportunistic investments:** We actively seek out early-stage managers where we can negotiate terms, structure customised vehicles with increased control and transparency, and access niche or capacity constrained strategies. In 2023 we invested in multiple early-stage credit long/short funds and also partnered with a previously approved niche lending fund on a co-investment.

Long-Term Expected Return

Exhibit 3

Based on our 10 year forecasts, we target the following long-term expected returns for Liquid Credit

	Liquid Credit
Risk-free Rate	4.0%
Risk Premium	2.0%
Illiquidity Premium	—
Manager Alpha	1.0%
Total Return	**7.0%**

The beta return of 6.0% for Liquid Credit represents coupon income of c. 8.7% p.a. on average over the next 10 years, spread reverts to mean and detracts -0.6% p.a. and defaults net of recoveries detract -2.1%.

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.