Q1 2023

Janus Henderson INVESTORS

CREDIT RISK MONITOR

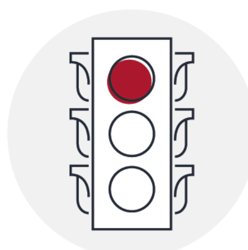
Jim Cielinski, Global Head of Fixed Income

While there were clear idiosyncratic reasons why certain banks ran into problems in Q1, there is no escaping the fact that tighter monetary policy catalysed inherent weaknesses. We are likely to see problems surface elsewhere as tighter credit conditions – exacerbated by the banking fallout – make themselves felt.

Credit spreads continue to dance around, however, buffeted by policy and economic expectations. Bad economic news can readily be interpreted as suggesting earlier rate cuts (bad news = good news) but eventually deteriorating fundamentals are likely to catch up (bad news = bad news). Volatility creates opportunities and as markets debate potential turning points in rates and the probability of recession, we are likely to see increased dispersion among rating quality, sectors and individual credits. A selective approach remains vitally important.

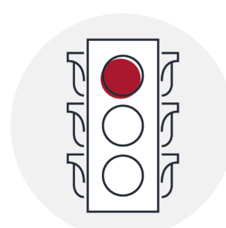
Why the cycle matters

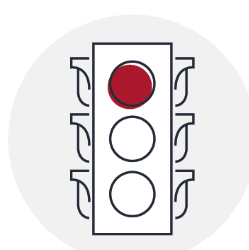
- Historically, corporate credit excess returns have been positive two-thirds of the time or more*, but investors must bear the asymmetry of credit markets where downside corrections can be severe.
- Monitoring the credit cycle and top-down risks is good risk management. The challenge for investors is that every cycle is different and requires a combination of data and judgement.
- No single indicator or dataset can be reliable in isolation, and the lags are uncertain. However, by considering the credit cycle within a framework and assessing the weight of evidence from the key metrics shown here, we can better understand the balance of risks and potential turning points.



HIGH DEBT LOADS
Key metrics: interest cover, leverage
Prognosis: debt is everywhere; interest costs remain controlled

RESTRICTED CAPITAL ACCESS
Key metrics: liquidity cycle, real borrowing costs
Prognosis: liquidity trends fading fast as ultra-accommodative policy is removed





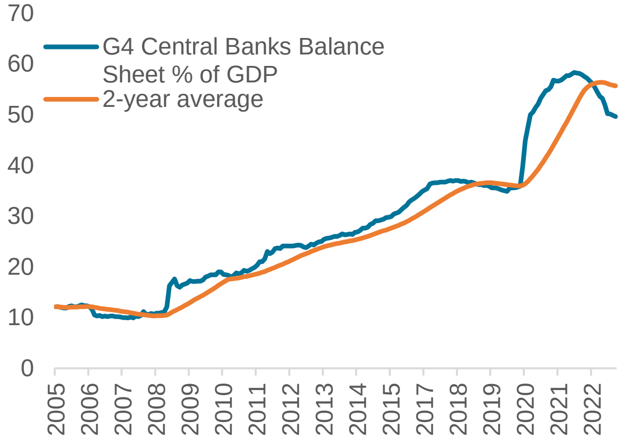
EXOGENOUS SHOCK TO CASH FLOW
Key metrics: earnings, earnings revisions
Prognosis: earnings growth set to weaken, energy / input costs impacting cashflow

**Based on quarterly excess returns on global investment grade and high yield indices since 1999.*

Cycle indicators

Central bank liquidity (% GDP) falls

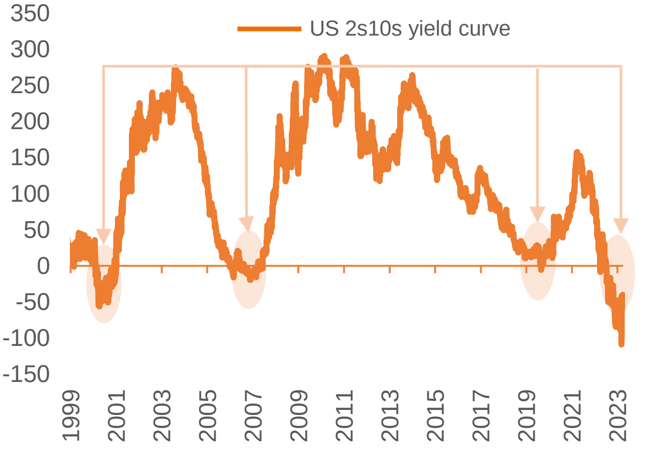
G4 central bank balance sheets fall below the 2-year average.



Source: Janus Henderson Investors as at 31 March 2023.

2s 10s yield curve slope flattens (bps)

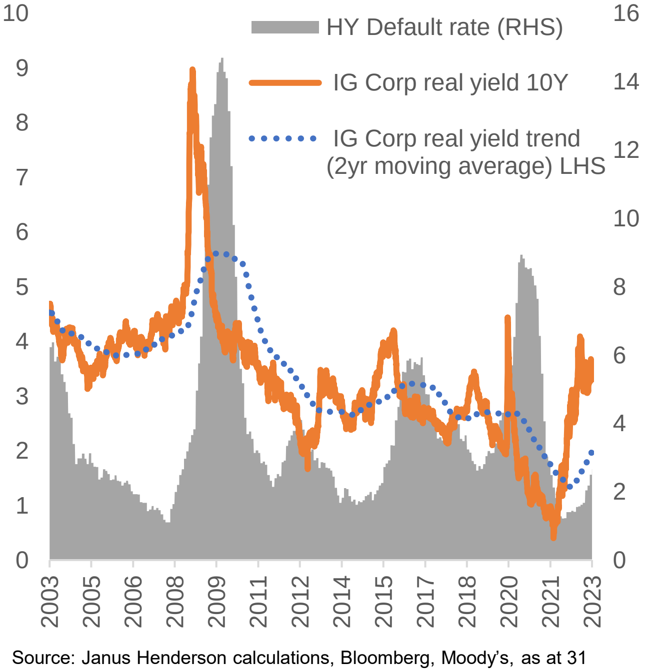
2-year rates rise relative to 10-year rates, and yield curve slope moves deeper into negative territory, indicating rising recession risk.



Source: Bloomberg 2-year and 10-year government bond yields to 31 March 2023.

Real rates (%) spike higher

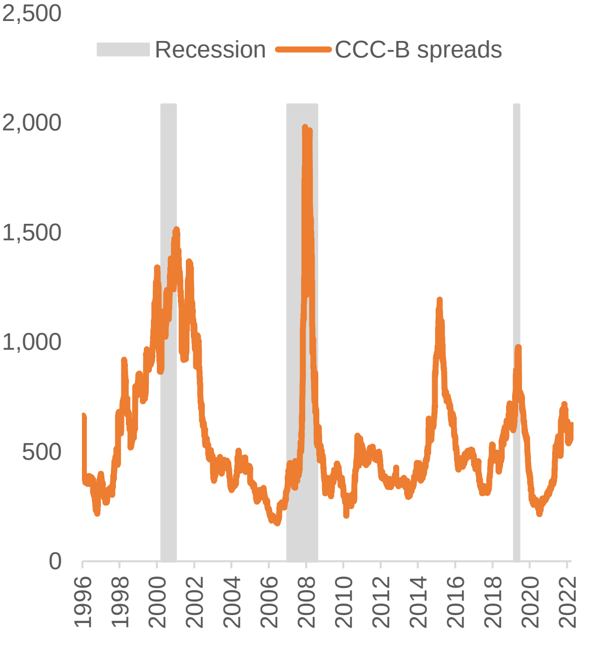
Sharp moves higher in real yields tend to lead a default cycle.



Source: Janus Henderson calculations, Bloomberg, Moody's, as at 31 March 2023. HY = high yield, IG = investment grade
Note: there is no guarantee that past trends will continue. See Important Information for full information on underlying indices.
Past performance does not predict future returns.

CCC v B spreads differential (bps) rises

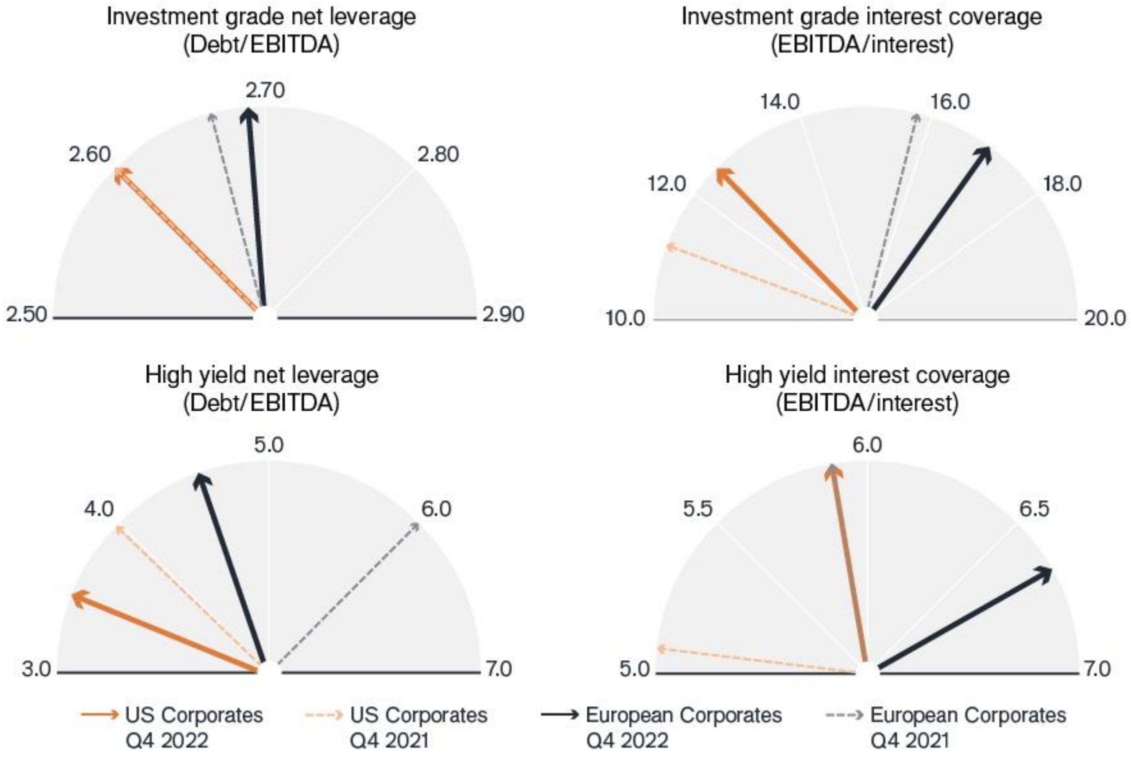
Weaker performance trends in lower quality (CCC) is a warning sign of credit stress – this is shown by periods when the orange line rises sharply from low levels as highlighted. This has started to be evident.



Source ICE BofA US High Yield CCC and ICE BofA US High Yield B spread-to-worst shown. Data as at 31 March 2023.

Issuer fundamentals remain resilient

Net leverage and interest coverage have broadly improved compared with the previous year, but some deterioration is emerging in pockets.



Source: JPMorgan. Net leverage and interest coverage is as at Q4 2022, except for European high yield which reflects Q3 2022 data, the latest available complete data at 31 March 2023. Data is subject to change.

Earnings growth (%) weakness expected to broaden

Year-on-year earnings per share growth revisions turn more negative in the most recent quarter with all regions except the Eurozone being marked down.

Region	22F	23F	24F	Revisions on '23 forecasts since last Quarter
Global	**9**	**0**	**11**	↓
Developed	*10*	*0*	*10*	↓
US	6	0	12	↓
Eurozone	20	2	8	—
UK	27	-8	3	↓
Japan	6	7	8	↓
Emerging	*5*	*-1*	*17*	↓
China	2	19	14	↓

Source: Refinitiv Datastream data, 31 March 2023.
2022, 2023 and 2024 data are estimates, and there is no guarantee that past trends will continue.
Past performance does not predict future returns.

> "Lending standards had been tightening long before the banking turmoil in March. Growth impacts are not spread evenly across the economy, however, so interest rate sensitive sectors will feel more pain but ongoing nominal growth could help limit defaults."
>
> **Jim Cielinski**
> Global Head of Fixed Income

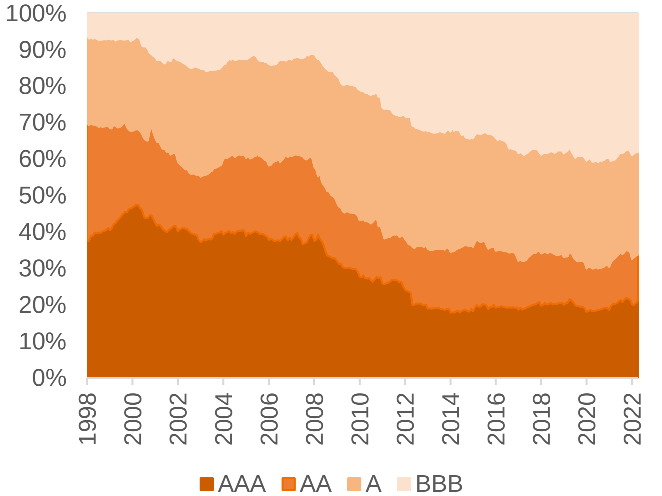
Sterling market snapshot

	31/03/2023	YTD change
Market size £mm	565,191	4.7%
No. of issuers	462	+3
Yield	5.19%	-0.16%
Credit spread (OAS) bps	159	-7

By maturity	2-year	5-year	10-year	30-year
Gilt yield	3.44%	3.36%	3.49%	3.84%
Swap yield	4.28%	3.78%	3.43%	3.20%
Credit spread (OAS)	124	138	200	189

Source: ICE BofA indices and Bloomberg. Data as at 31 March 2023.
*Credit spread data based on BofA Sterling Non-Gilt index using maturity bands with similar duration to the 2,5,10 and 30-year gilts. See Important Information for full information on underlying indices.

Sterling Non Gilt Index - ratings breakdown (%)

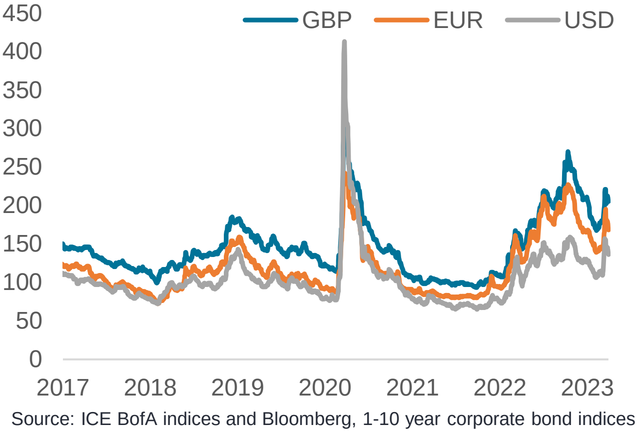


Source: ICE BofA indices. Data as at 31 March 2023. See Important Information for full information on underlying indices.

Spreads (bps)	10-year Average	Current	Last Q-end	Last Q-end chg
Non-Gilt index	124	**159**	166	-7bps
Non-Gilt 15+ index	134	**152**	153	-1bp
A Financials	142	**185**	184	+1bp
A Industrials	114	**130**	139	-9bps
A Utilities	133	**146**	143	+3bps
BBB Financial	234	**284**	285	-1bp
BBB Industrials	173	**217**	228	-11bps
BBB Utilities	152	**185**	183	+2bps

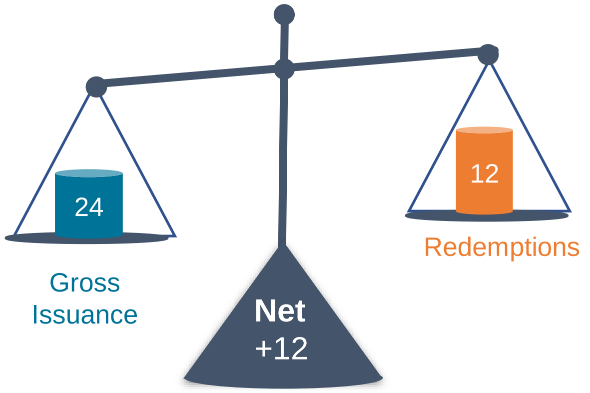
Source: ICE BofA indices and Bloomberg. Data as at 31 March 2023. See Important Information for full information on underlying indices.

GBP corporate bond spreads versus other markets (bps)



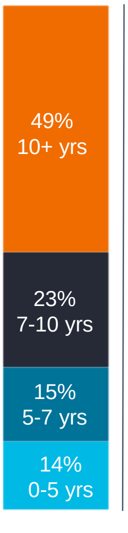
Source: ICE BofA indices and Bloomberg, 1-10 year corporate bond indices in GBP, USD and EUR. Data as at 31 March 2023. See Important Information for full information on underlying indices.

Sterling Corporate Issuance, 2023 YTD £bn

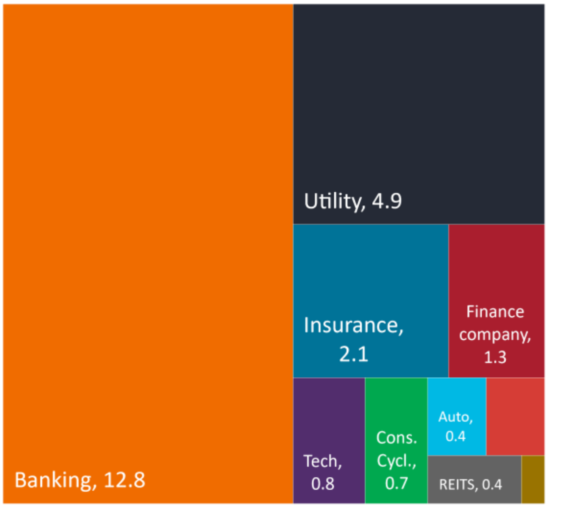


Source: Barclays Credit Research. Data as at 31 March 2023.

Maturity



Sector breakdown



'Brick on elastic' gives way in banking

As we have said before, the US Federal Reserve will continue to tighten until something breaks. The lagged effect of policy means that it may take a long time for it to take effect – like pulling a brick with elastic – but when it does it moves quickly. This 'brick on elastic' gave way in banking. Nevertheless, corporate credit excess returns were positive over the quarter despite the end of quarter volatility. Overall spreads tightened in high yield and traded sideways in investment grade.

Recession more likely

- Banking turmoil has exacerbated the trend towards tighter credit. It could push GDP down by maybe 0.3-0.4% and brings forward the likely recession as lead economic indicators all point toward this.
- However, spreads did not widen as much as expected in March and are still pricing in a soft landing with defaults expected to peak over the next six months and then roll over.

The credit cycle has moved lower

- Access to capital is tightening, particularly for small to medium-sized enterprises and high yield.
- Earnings continued to be revised down, with no or negative earnings growth expected in 2023 across developed and emerging economies except for the eurozone, China and Japan. A moderate recession would be enough to dent cashflows.
- Credit fundamental weakness is only appearing in pockets – but there is a lagged effect. A deterioration in credit ratios is likely to show up more obviously as we progress through 2023.

An inflection point is nigh

- Policy has done a lot of work already – a key inflection point is nigh and so investors should keep an eye on policy function.
- For us, signposts to become more bullish are for core inflation to be meaningfully below 4-5%, broad money to start to bottom and pick up, and China and EM easing, providing a tailwind for global growth.
- However, cascading risk tends to be underestimated in every cycle – another sector could give way and a hard or soft landing will determine the ultimate default path.

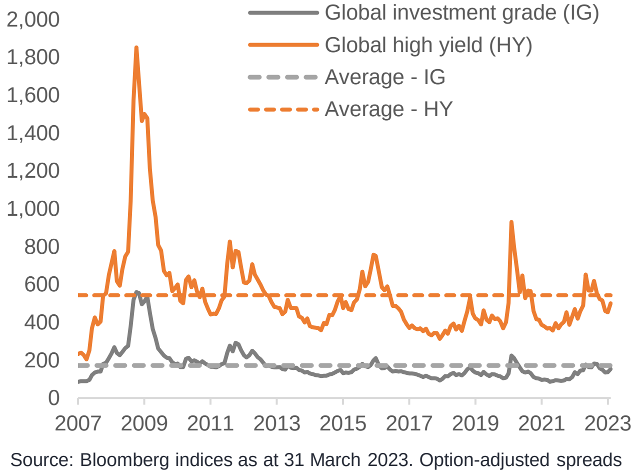
Dispersion to continue

- Regional differences will emerge in central bank policy paths, as will different sensitivities to rising interest rates across economies.
- Growth impacts in recessions tend to be uneven. Interest rate sensitive sectors – banks, real estate and durable goods – are feeling the pain, while the rest of the corporate markets appear more insulated.
- Flexibility is key to dial up and down risk, but we are still cautious on spreads until we see confirmation the cycle has turned.
- Near-term opportunities will emerge with strong technicals (low issuance) – security selection will be key.

Valuations

Quality-adjusted spreads (bps) move wider

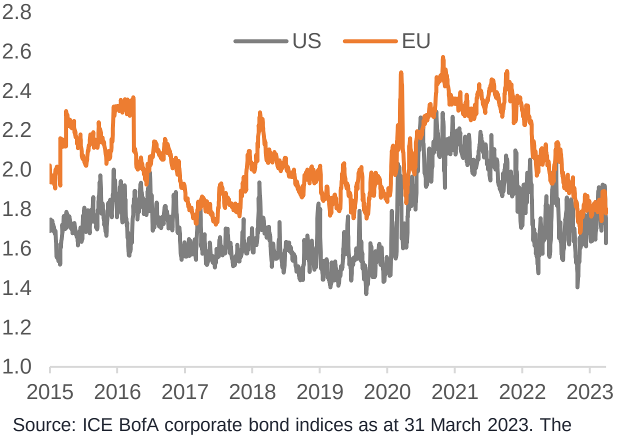
Credit spreads at or slightly above long-term averages on ratings-adjusted basis



Source: Bloomberg indices as at 31 March 2023. Option-adjusted spreads (OAS) shown. See Important Information for full information on underlying indices.

High yield vs investment grade (spread ratio) falls

A lower BB/BBB ratio could indicate worse value in BB-rated bonds compared to BBB-rated bonds. The ratio fell as investors look to quality assets.



Source: ICE BofA corporate bond indices as at 31 March 2023. The spread ratio is calculated by dividing the BB spread by BBB spread. See Important Information for full information on underlying indices.

Important information

Page	Data sources (supplementary information)
2	Bloomberg: G4 Balance sheet as a % of GDP (BSPGCPG4 Index)
	Bloomberg: 10- year minus 2-year US government bond yields
	Bloomberg: US 10-year generic real yield and 7-10yr BBB Corporate spread
	ICE BofA Single-B US High Yield Index and ICE BofA CCC & Lower US High Yield Index
3	Earnings growth (%)
	Global earnings = MSCI AC World Index
	Developed earnings = MSCI World Index
	US earnings = The MSCI USA Index
	Eurozone earnings = The MSCI EMU Index (European Economic and Monetary Union)
	UK earnings = MSCI United Kingdom Index
	Japan earnings = TOPIX Index
	China earnings = MSCI China Index
4	Quality-adjusted spreads (%):
	Global IG = ICE BofA Global Corporate Index data used
	Global HY = ICE BofA Global High Yield Index data used
	High yield vs investment grade (spread ratio)
	US ratio : ICE BofA BB US High Yield Index / ICE BofA BBB US Corporate Index
	Euro ratio: ICE BofA BB Euro High Yield Index / ICE BofA BBB Euro Corporate Index
5	**GBP Corporate bond spreads vs other markets:**
	GBP Corp = ICE BofA 1-10 Year Sterling Corporate Index OAS
	USD Corp = ICE BofA 1-10 Year US Corporate Index OAS
	EUR Corp = ICE BofA 1-10 Year Euro Corporate Index OAS
	Table: Sterling corporate bond market data:
	ICE BofA Sterling Non-Gilt Index
	Data for 2,5,10 and 30-year spreads based on weighted OAS of bonds in that maturity bucket, calculated using ICE Sterling Non-Gilt Index constituents
	ICE BofA Single-A Sterling Financials Index
	ICE BofA Single-A Sterling Industrials Index
	ICE BofA Single-A Sterling Utilities Index
	ICE BofA BBB Sterling Financial Index
	ICE BofA BBB Sterling Industrials Index
	ICE BofA BBB Sterling Utilities Index
	ICE BofA Sterling Non-Gilt 15+ Index

Important information

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