Janus Henderson INVESTORS

CREDIT RISK MONITOR

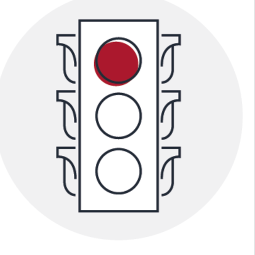
Jim Cielinski, Global Head of Fixed Income

The risk of a policy error has increased further as central banks continue battling high inflation. Inflation is winning the game, leaving policymakers with no good choices and making a global recession increasingly likely. The first stage of the deteriorating credit cycle was liquidity driven. The next stage will be driven by deteriorating credit fundamentals, but this is from a very strong starting point.

Spreads have widened and so are more reflective of recession risk, but further volatility could emerge as liquidity remains challenging. Getting close to the precipice in a central bank's balancing act between inflation and growth – albeit unnerving – highlights scope for a dovish retreat. In our view, this would be a signal for investors to add risk in portfolios. As fundamentals worsen, dispersion between industries and sectors is set to increase, leaving opportunities for active investors.

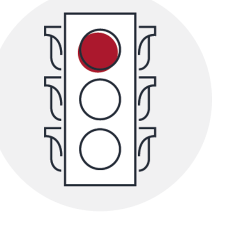
Why the cycle matters

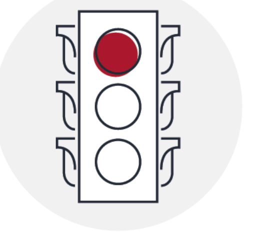
- Historically, corporate credit excess returns have been positive two-thirds of the time or more*, but investors must bear the asymmetry of credit markets where downside corrections can be severe.
- Monitoring the credit cycle and top-down risks is good risk management. The challenge for investors is 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





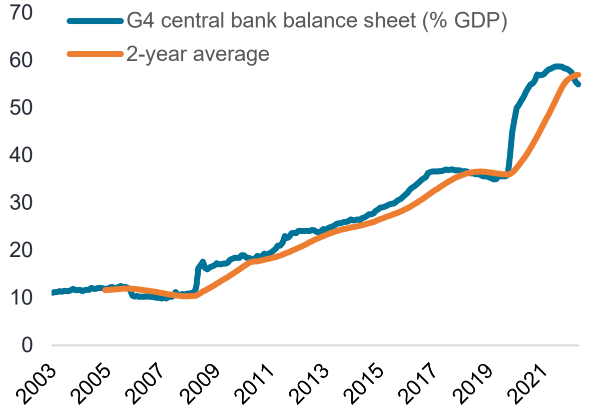
EXOGENOUS SHOCK TO CASH FLOW
Key metrics: earnings, earnings revisions
Prognosis: earnings growth set to weaken, energy / input costs impacting cashflow

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

Cycle indicators

Central bank liquidity (% GDP) falls

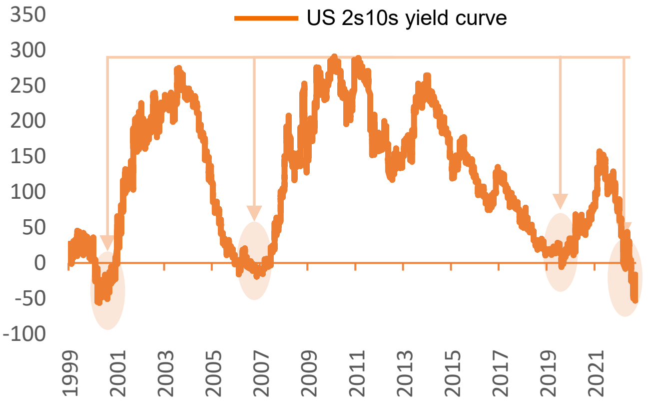
G4 central bank balance sheets fall below the 2-year average



Source: Janus Henderson Investors as at 30 September 2022.

2s 10s yield curve slope flattens (bps)

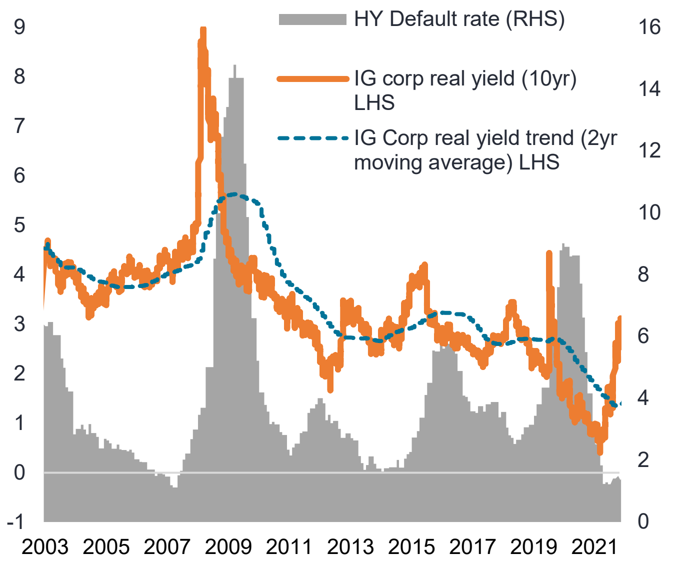
2-year rates rise relative to 10-year rates, and yield curve slope moves deeper into negative territory, indicating rising recession risk.



Source: Bloomberg 2-year and 10-year government bond yields to 30 September 2022. 2s 10s represents the difference between the 2-year and 10-year U.S. Treasury yields.

Real rates (%) spike higher

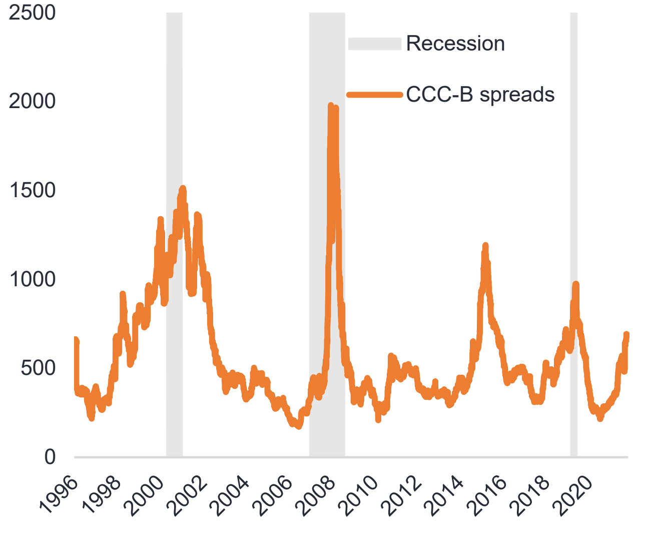
Sharp moves higher in real yields tend to lead a default cycle.



Source: Janus Henderson calculations, Bloomberg, Moody's, as at 30 September 2022.
Note: there is no guarantee that past trends will continue. See Important Information for full information on underlying indices.
Real rates refer to a real interest rate is one that has been adjusted for inflation.
Past performance is not a guide to future performance.

CCC v B spreads differential (bps) rises

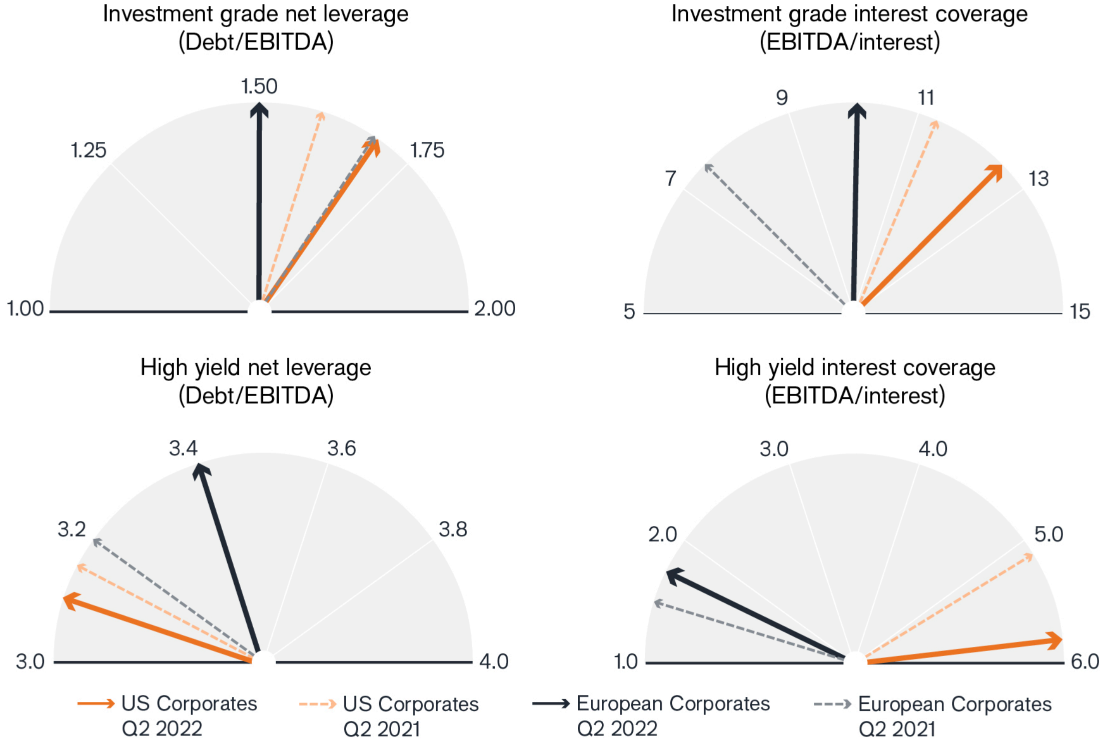
Weaker performance trends in lower quality (CCC) is a warning sign of credit stress – this is shown by periods when the orange line rises sharply from low levels as highlighted. This has started to be evident.



Source ICE BofA US High Yield CCC and ICE BofA US High Yield spread-to-worst shown. Data as at 30 September 2022.

Issuer fundamentals remain resilient

Net leverage stable or slightly up across investment grade and high yield while interest coverage, or companies' ability to pay the interest on outstanding debt, has climbed compared to the previous year.



Source: Morgan Stanley, Bloomberg, MCSI, IBES, Factset. Net leverage for US and Europe as at 30 September 2022. Note: MS use consensus GICS sector EBITDA growth estimates and zero debt growth to estimate median net leverage and interest coverage ratios based on a sample of US and European IG and HY corporates.

Earnings growth (%) weakness expected to broaden

Year-on-year earnings per share growth revisions turn more negative with the US joining the camp of downward revisions on 2023 earnings.

Region	22F	23F	24F	Revisions on '23 forecasts since last Quarter
Global	**11**	**6**	**8**	↓
Developed	*11*	*6*	*8*	↓
US	8	8	9	↓
Eurozone	17	3	8	↑
UK	23	-1	1	↑
Japan	13	4	4	↑
Emerging	*10*	*5*	*5*	↓
China	10	15	15	↓

Source: Reuters-Eikon-Datastream Data, 6 October 2022.
2022, 2023 and 2024 data are estimates, and there is no guarantee that past trends will continue.

> "The central bank put – where they ride to the rescue of markets or the economy – is no longer with us, but signs of their retreat from the relentless pursuit of tightening could be a sign to add risk in portfolios."
>
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> Global Head of Fixed Income

EBITDA refers to earnings before interest, taxes, depreciation and amortization.

Fundamentals in focus

Significant volatility in credit markets made for a challenging third quarter, as hope for a peak in inflation was eclipsed by higher service and housing cost pressures. Leading economic indicators are deteriorating rapidly, while central banks continue to be laser-focused on inflation. Markets have prepared for a likely policy mistake, reflected in spreads widening to levels reflecting a high probability of a global recession.

Approaching the peak

- Inflation rates could climb higher before they peak, igniting fears about sticky inflation that is on the rise, but in US, for example, base effects should start to wash through from October.
- Rate volatility remains the driver of credit spread volatility rather than corporate stress, but this could change as the market focus shifts to fundamentals.

Earnings weakness to broaden

- Lower earnings revisions were focused in specific sectors, but this is now broadening out across more industries and we expect earnings to be revised meaningfully lower over the next two quarters.
- A liquidity-induced downturn in the cycle is set to morph into a fundamental downturn, as the inventory overhang could lead earnings growth to fall off sharply in the next six to 12 months.

All signals turn to red

- All three of our indicators are red, indicating that the credit cycle is weakening, but also flags to investors to keep an eye on an inflection point in policy, earnings or economic growth.
- Spreads will peak before defaults as the latter are a lagging indicator and while spreads reflect a lot of risk already, they could widen further with a weakening in credit fundamentals and thus credit quality.

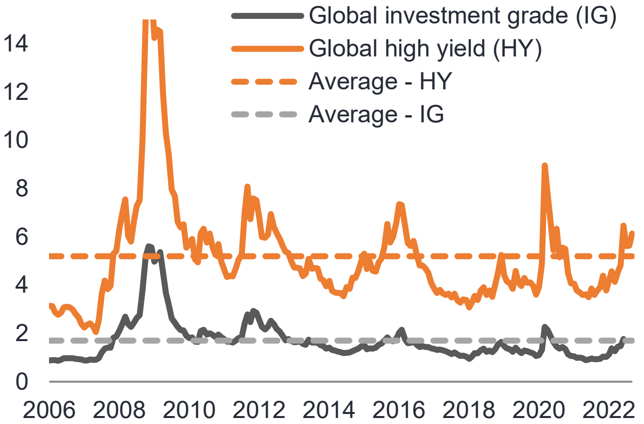
Volatility ahead

- Post the pandemic, companies have refinanced debt, pushing out maturities well into the future. This should reduce stress in the system, and lead to a shallower default cycle than seen historically.
- The central bank put – where they ride to the rescue of markets or the economy – is no longer with us, but signs of their retreat from the relentless pursuit of tightening could be a sign to add risk in portfolios.
- Episodes of volatility could offer better entry points as greater dispersion between sectors or inefficiencies across markets rises and so a nimble approach – alongside caution in adding credit risk – feels warranted.

Valuations

Quality-adjusted spreads (%) move wider

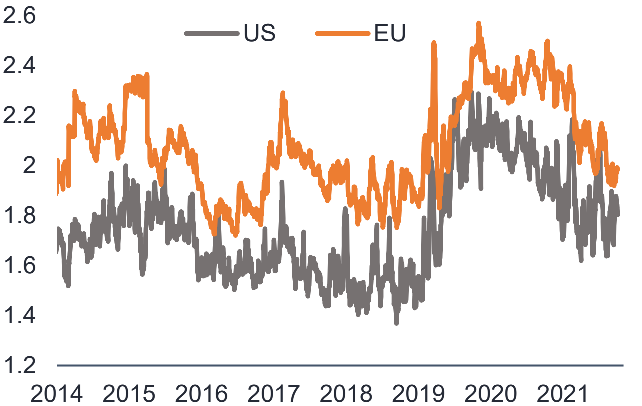
Credit spreads at or slightly above long-term averages on ratings-adjusted basis



Source: Bloomberg indices as at 30 June 2022. Option-adjusted spreads 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 30 September 2022. 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
2	Bloomberg: G4 Balance sheet as a % of GDP (BSPGCPG4 Index)
	Bloomberg: 2-year and 10-year US government bond yields
	ICE BofA Single-B US High Yield Index and ICE BofA CCC & Lower US High Yield Index
	Bloomberg: US 10-year generic real yield and 7-10yr BBB Corporate spread
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
	Emerging earnings = MSCI Emerging Markets 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

Basis point (bp) equals 1/100 of a percentage point. 1 bp = 0.01%, 100 bps = 1%.

Credit Spread is the difference in yield between securities with similar maturity but different credit quality. Widening spreads generally indicate deteriorating creditworthiness of corporate borrowers, and narrowing indicate improving.

Credit quality ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).

Fixed income securities are subject to interest rate, inflation, credit and default risk. As interest rates rise, bond prices usually fall, and vice versa. **High-yield bonds, or "junk" bonds**, involve a greater risk of default and price volatility. **Foreign securities**, including sovereign debt, are subject to currency fluctuations, political and economic uncertainty and increased volatility and lower liquidity, all of which are magnified in emerging markets.

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