

CREDIT RISK MONITOR



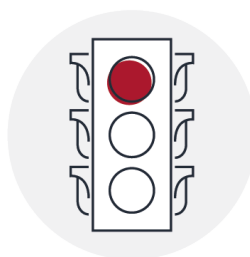
Jim Cielinski,
Global Head of
Fixed Income

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.

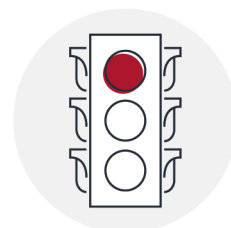


HIGH DEBT LOADS

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

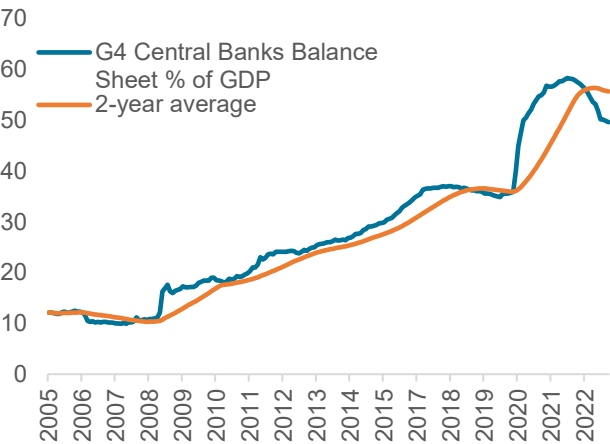
Prognosis: earnings growth set to weaken, energy / input costs impacting cashflow

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

Cycle indicators

Central bank liquidity (% GDP) falls

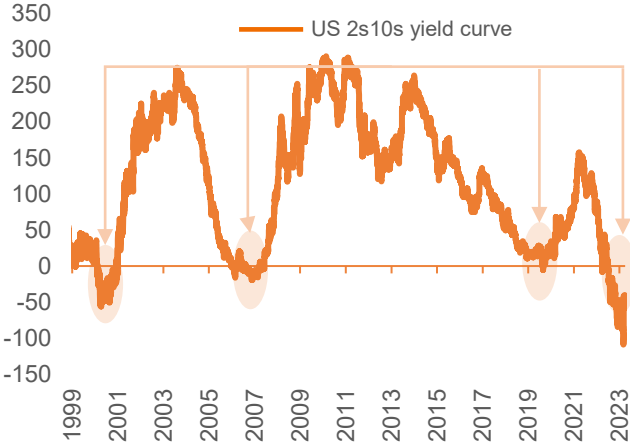
G4 central bank balance sheets fall below the 2-year average.



Source: Janus Henderson Investors as at 31 March 2023.

2s 10s yield curve slope flattens (bps)

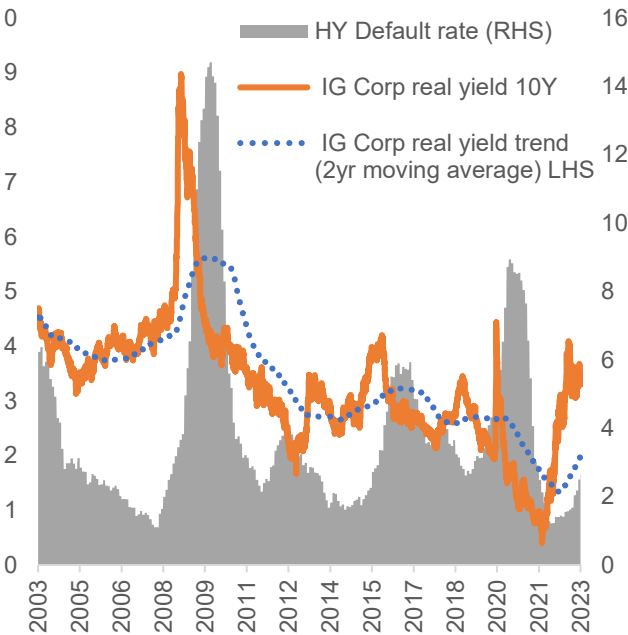
2-year rates rise relative to 10-year rates, and yield curve slope moves deeper into negative territory, indicating recession risk.



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

Real rates (%) spike higher

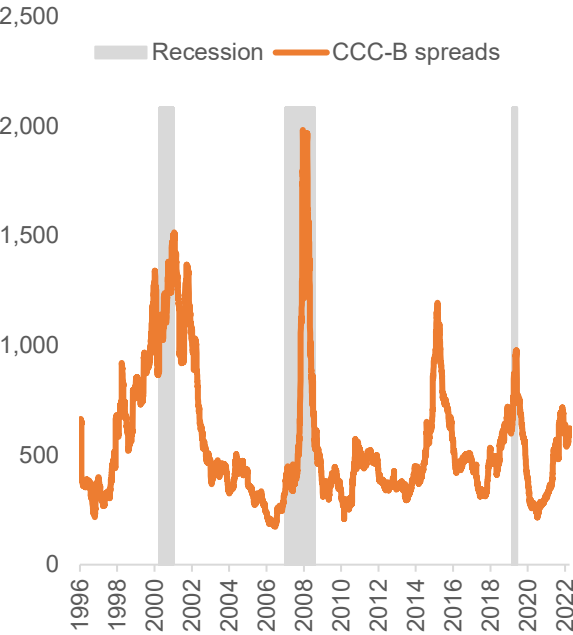
Sharp moves higher in real yields tend to lead a default cycle.



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

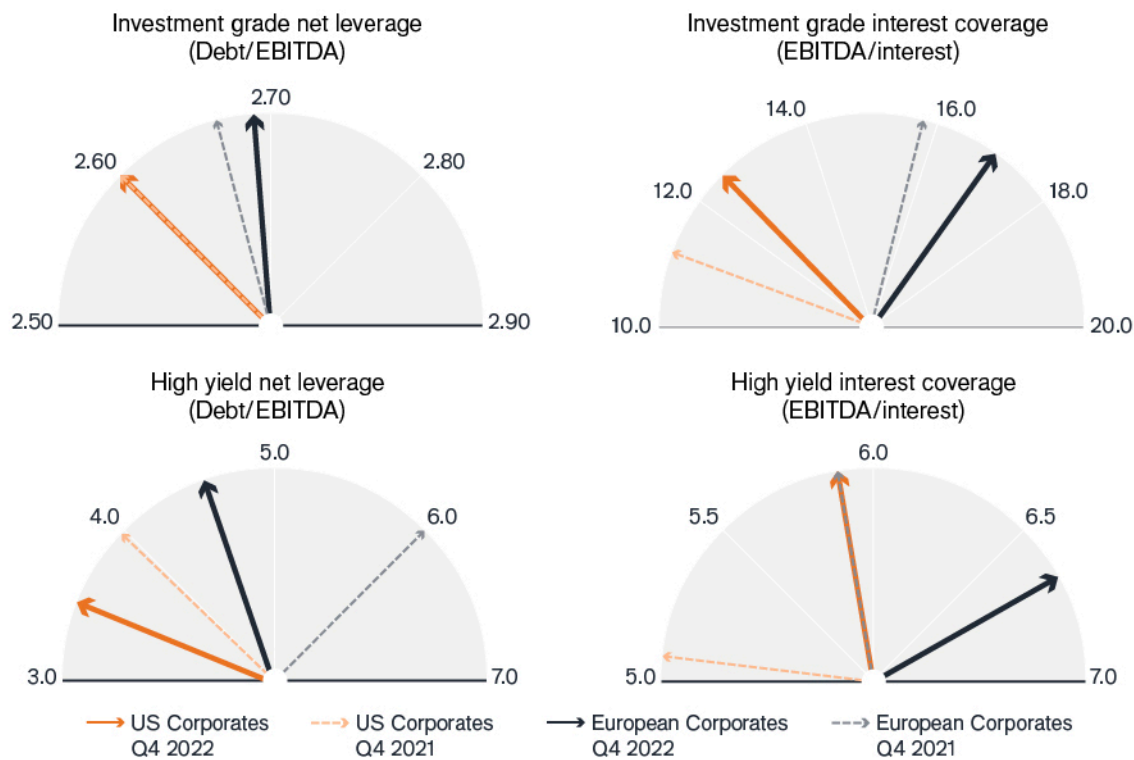
Weaker performance trends in lower quality (CCC) is a warning sign of credit stress – this is shown by periods when the orange line rises sharply from low levels as highlighted. This has started to be evident.



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

'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 medium recession would be enough to dent cashflows.
- Credit fundamental weakness 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.

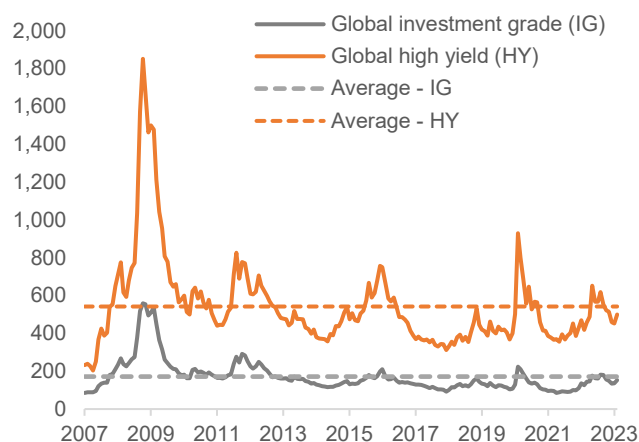
Dispersion to continue

- 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

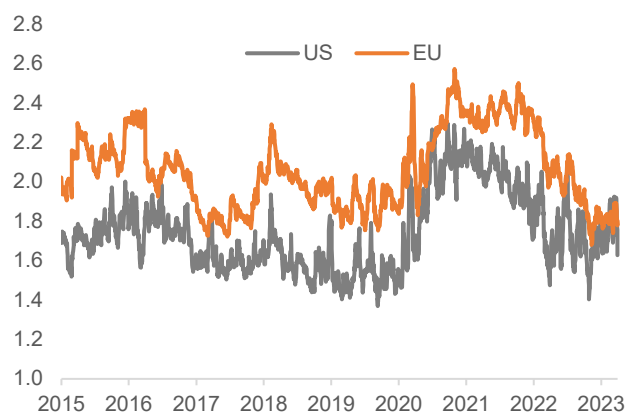
Credit spreads at or slightly above long-term averages on ratings-adjusted basis



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.

Data source and glossary

Page	Data sources and glossary (supplementary information)
1	<p>Monetary policy - The policies of a central bank, aimed at influencing the level of inflation and growth in an economy. It includes controlling interest rates and the supply of money. Monetary stimulus refers to a central bank increasing the supply of money and lowering borrowing costs. Monetary tightening refers to central bank activity aimed at curbing inflation and slowing down growth in the economy by raising interest rates and reducing the supply of money.</p> <p>Spreads – Difference or gap between two prices, rates or yields.</p>
2	<p>Bloomberg: G4 Balance sheet as a % of GDP (BSPGCPG4 Index)</p> <p>Bloomberg: 10- year minus 2-year US government bond yields</p> <p>Bloomberg: US 10-year generic real yield and 7-10yr BBB Corporate spread</p> <p>ICE BofA Single-B US High Yield Index and ICE BofA CCC & Lower US High Yield Index</p> <p>Balance sheet - A financial statement that summarises a company's assets, liabilities and shareholders' equity at a particular point in time. Each segment gives investors an idea as to what the company owns and owes, as well as the amount invested by shareholders. It is called a balance sheet because of the accounting equation: assets = liabilities + shareholders' equity.</p> <p>Yield curve - A graph that plots the yields of similar quality bonds against their maturities. In a normal/upward sloping yield curve, longer maturity bond yields are higher than short-term bond yields. A yield curve can signal market expectations about a country's economic direction.</p>
3	<p>Earnings growth (%)</p> <p>Global earnings = MSCI AC World Index</p> <p>Developed earnings = MSCI World Index</p> <p>US earnings = The MSCI USA Index</p> <p>Eurozone earnings = The MSCI EMU Index (European Economic and Monetary Union)</p> <p>UK earnings = MSCI United Kingdom Index</p> <p>Japan earnings = TOPIX Index</p> <p>China earnings = MSCI China Index</p> <p>Leverage - Leverage has multiple meanings:</p> <ol style="list-style-type: none"> 1. An interchangeable term for gearing: the ratio of a company's loan capital (debt) to the value of its ordinary shares (equity); it can also be expressed in other ways such as net debt as a multiple of earnings, typically net debt/EBITDA (earnings before interest, tax, depreciation and amortisation). Higher leverage equates to higher debt levels. 2. The use of borrowing to increase exposure to an asset/market. This can be done by borrowing cash and using it to buy an asset, or by using financial instruments such as derivatives to simulate the effect of borrowing for further investment in assets. <p>EBITDA - Earnings before interest, tax, depreciation and amortisation is a metric used to measure a company's operating performance that excludes how the company's capital is structured (in terms of debt financing, depreciation, and taxes).</p>
4	<p>Quality-adjusted spreads (%):</p> <p>Global IG = ICE BofA Global Corporate Index data used</p> <p>Global HY = ICE BofA Global High Yield Index data used</p> <p>High yield vs investment grade (spread ratio)</p> <p>US ratio : ICE BofA BB US High Yield Index / ICE BofA BBB US Corporate Index</p> <p>Euro ratio: ICE BofA BB Euro High Yield Index / ICE BofA BBB Euro Corporate Index</p>

The opinions and views expressed are as of the date published and are subject to change. They are for information purposes only and should not be used or construed as an offer to sell, a solicitation of an offer to buy, or a recommendation to buy, sell or hold any security, investment strategy or market sector. No forecasts can be guaranteed. Opinions and examples are meant as an illustration of broader themes, are not an indication of trading intent and may not reflect the views of others in the organization. It is not intended to indicate or imply that any illustration/example mentioned is now or was ever held in any portfolio. Janus Henderson Group plc through its subsidiaries may manage investment products with a financial interest in securities mentioned herein and any comments should not be construed as a reflection on the past or future profitability. There is no guarantee that the information supplied is accurate, complete, or timely, nor are there any warranties with regards to the results obtained from its use. **Past performance is no guarantee of future results. Investing involves risk, including the possible loss of principal and fluctuation of value.**

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility, lower liquidity and differing financial and information reporting standards, all of which are magnified in emerging markets.

High-yield or "junk" bonds involve a greater risk of default and price volatility and can experience sudden and sharp price swings.

Janus Henderson, Knowledge Shared and Knowledge Labs are trademarks of Janus Henderson Group plc or one of its subsidiaries. © Janus Henderson Group plc.

This document is intended for the use of investment consultants and other institutional/professional investors only and is not directed at private individuals.