Q2 2023

Janus Henderson INVESTORS

CREDIT RISK MONITOR

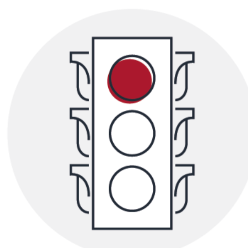
Jim Cielinski, Global Head of Fixed Income

Over the second quarter, markets took the view that a recession had been averted rather than delayed. Data showed growth holding up, the banking sector recovering from prior volatility and inflation moderating, although impatience with the speed of moderation saw developed market central banks hiking rates further, spurring rises in government bond yields. Credit spreads tightened over the quarter.

On the flip side, the credit cycle continued to deteriorate. Tighter financial conditions alongside weak manufacturing PMIs contributed to earnings downgrades for some industrials. Recent bankruptcy filings for small businesses may spread more broadly into capital markets. Seasonal technicals may support credit markets near term but we anticipate credit quality dispersion to become more material later in the year as companies address the 2025 maturity wall. A selective, nimble investment approach is paramount.

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

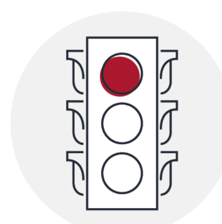
Key metrics: interest cover, leverage

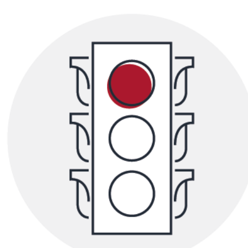
Prognosis: stock of debt high; refinancing costs higher

RESTRICTED CAPITAL ACCESS

Key metrics: liquidity cycle, real borrowing costs

Prognosis: liquidity withdrawal amid QT and tighter lending standards





EXOGENOUS SHOCK TO CASH FLOW

Key metrics: earnings, earnings revisions

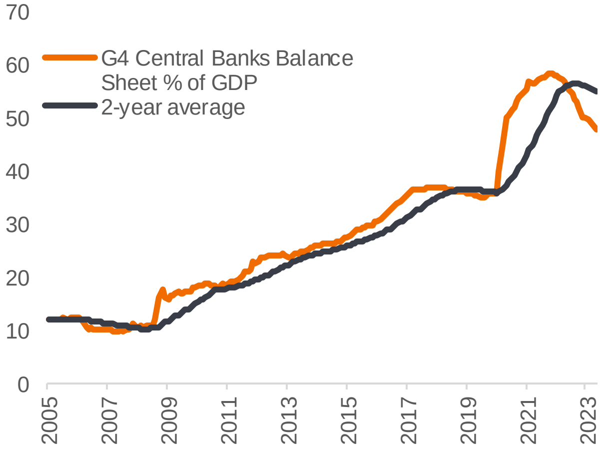
Prognosis: earnings growth weakening

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

Cycle indicators

Central bank liquidity (% GDP) falls

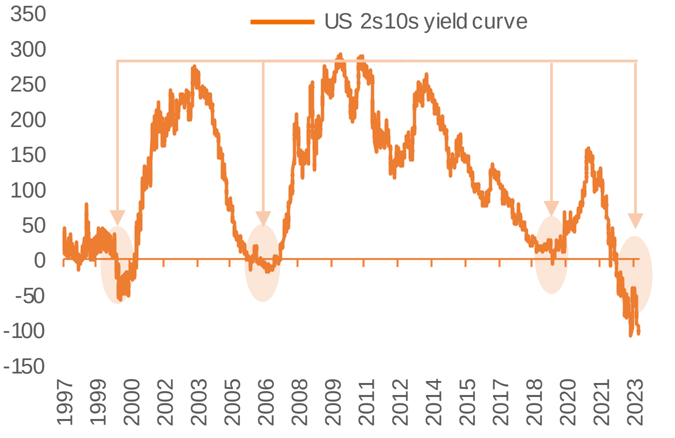
G4 central bank balance sheets fall below the 2-year average.



Source: Janus Henderson Investors as at 30 June 2023.

2s 10s yield curve slope flattens (bps)

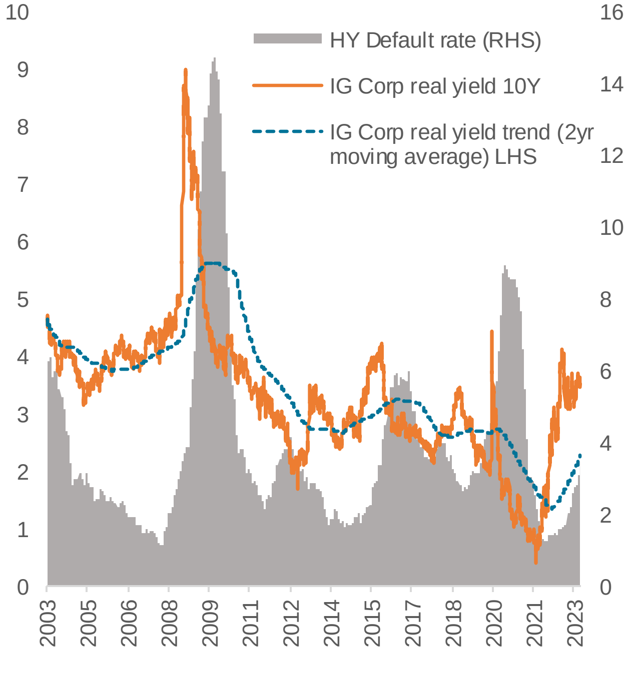
2-year rates rise relative to 10-year rates, and yield curve slope moves deeper into negative territory, indicating rising recession risk.



Source: Bloomberg 2-year and 10-year government bond yields to 30 June 2023.

Real rates (%) spike higher

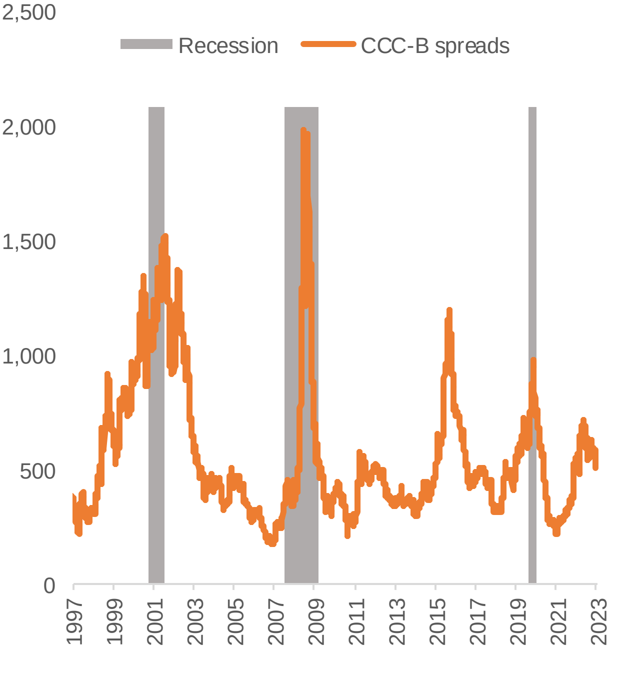
Sharp moves higher in real yields tend to lead a default cycle.



Source: Janus Henderson calculations, Bloomberg, Moody's, as at 30 June 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) falls

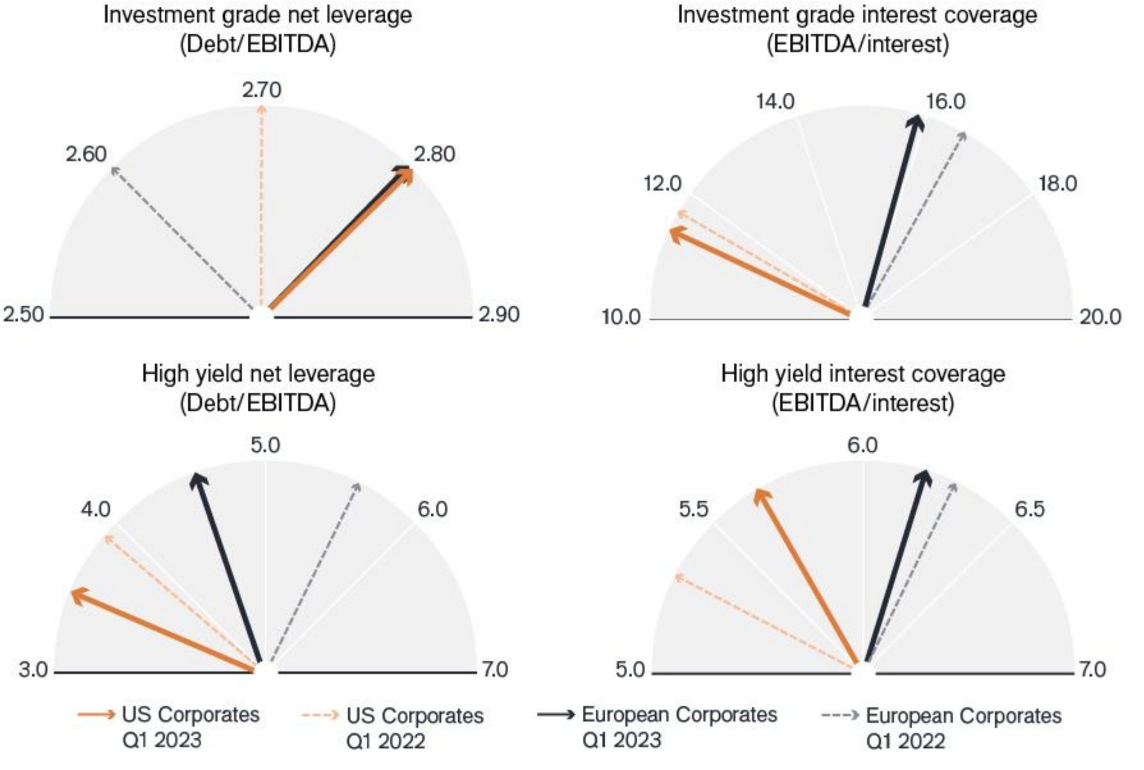
Weaker performance trends in lower quality (CCC) is a warning sign of stress – this is shown by periods where the orange line rises sharply from low levels. This recently fell in the US chart below but rose in Europe.



Source ICE BofA US High Yield CCC and ICE BofA US High Yield B spread-to-worst shown. Data as at 30 June 2023.

Issuer fundamentals starting to deteriorate

Net leverage and interest coverage have mildly deteriorated compared with the previous year; high yield is still showing some improvement year-on-year but has weakened in the last three months.



Source: JPMorgan. Net leverage and interest coverage is as at Q1 2023, except for European HY which reflects Q4 2022, the latest available complete data at 30 June 2023. Data is subject to change.

Earnings growth (%) weakness expected to broaden

Year-on-year earnings per share growth revisions were mixed in developed markets, with the UK the laggard, while emerging markets were generally weaker.

Region	22F	23F	24F	Revisions on '23 forecasts since last Quarter
Global	**9**	**0**	**11**	↓
Developed	*10*	*1*	*9*	↑
US	6	1	11	–
Eurozone	20	3	8	↑
UK	28	-9	4	↓
Japan	3	10	8	–
Emerging	*5*	*-2*	*18*	↓
China	-1	22	14	↓

Source: Refinitiv Datastream data, 30 June 2023.
2022, 2023 and 2024 data are estimates, and there is no guarantee that past trends will continue or forecasts will be realised. **Past performance does not predict future returns.**

"Credit quality in aggregate has mostly held up as nominal growth and revenues have held up. However, it is damage to the weakest 10-15% of companies that often causes the credit cycle to unravel. That's what we think we are seeing now."

Jim Cielinski
Global Head of Fixed Income

Something for everyone

Data in the second quarter offered something for everyone. Bears could point to weakness in lead economic indicators, stubborn core inflation and credit metrics deteriorating. Bulls could counter with strong labour markets, declining headline inflation and a robust consumer. The resolution of the US debt ceiling impasse removed a key market risk. With recession fears scaled back, markets have been pricing in a more muted credit default cycle. Our view is more circumspect. We expect more “trouble credits” to emerge as the lagged impact of tighter policy takes effect.

Credit cycle continues to deteriorate

- Quarter-on-most-recent-quarter metrics show a broad, albeit shallow deterioration.
- Worrisome trends include weakening in the industrial side of the economy (e.g., weakening in manufacturing and raw materials pricing and volumes), often a lead indicator for the broader economy.
- A few sectors showed improvement, with interest cover higher and net leverage lower among transportation (recovery in travel) and gaming (as new regulations open up the market in US).
- A seasonal lull in primary issuance could support markets near term but we believe that tighter lending standards, higher refinancing costs and a slowing economy will gradually take their toll on credit quality.

Not a typical credit cycle

- A unique feature of this cycle is the high disparity between nominal growth and real growth, with high inflation allowing nominal earnings at companies to stay robust.
- For now, markets have viewed falling inflation as a positive; allowing central banks to be less restrictive.
- A negative reading of falling inflation is that it highlights weakening demand. Later in the year, we believe markets will focus more on the demand side of softer inflation.
- With inflation declining and rates remaining high, real rates are going up, pressuring companies with heavy refinancing needs.

Attractive yields – but is it enough?

- All-in yields look attractive relative to recent years because policy rates have moved up.
- However, spreads have tightened further, particularly in the higher yielding segments. Unless a soft landing materialises, yields on some sub-investment grade bonds may not offer a sufficient cushion for slowly rising default risk and liquidity declines.

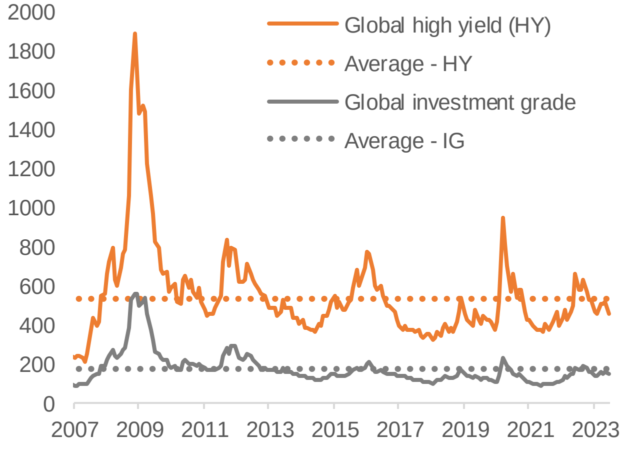
Dispersion pronounced – credit selection is key

- Nimbleness and careful credit selection remains key. Deterioration in credit quality will affect some sectors and economies more than others. It is often in the tails – the weakest 10-15% of companies – that a credit cycle unravels.

Valuations

Quality-adjusted spreads (bps) tighten

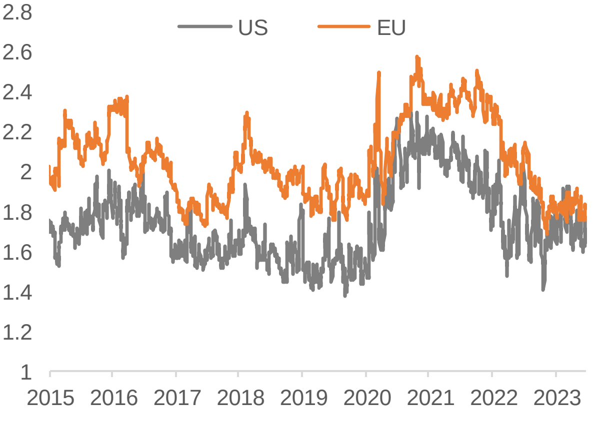
Credit spreads move below long-term averages on ratings-adjusted basis



Source: Bloomberg indices as at 30 June 2023. Option-adjusted spreads (OAS) shown. See Important Information for full information on underlying indices.

High yield vs investment grade (spread ratio) rangebound

A lower BB/BBB ratio could indicate worse value in BB-rated bonds compared to BBB-rated bonds. The ratio ended the quarter barely changed.



Source: ICE BofA corporate bond indices as at 30 June 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

Glossary

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.
Volatility	The rate and extent at which the price of a portfolio, security or index, moves up and down. If the price swings up and down with large movements, it has high volatility. If the price moves more slowly and to a lesser extent, it has lower volatility. Higher volatility means the higher the risk of the investment.

Important information

Janus Henderson INVESTORS

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

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.

A yield curve plots the yields (interest rate) of bonds with equal credit quality but differing maturity dates. Typically bonds with longer maturities have higher yields.

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