Janus Henderson INVESTORS

CREDIT RISK MONITOR

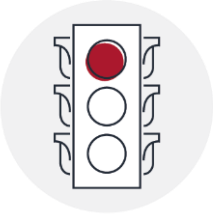
Pain delayed?

Jim Cielinski, CFA
Global Head of Fixed Income

Credit quality in aggregate has mostly held up due to the impact of high nominal growth and COVID-era consumer savings on corporate revenues, with default rates yet to show a meaningful rise this side of the debt maturity wall. Nonetheless, traditional indicators of a deteriorating credit cycle – an inverted yield curve, tighter lending standards, and elevated debt levels – remain. Notable in the third quarter was the sharp rise in real rates which, alongside a fresh tightening in financial conditions, is likely to weigh on credit.

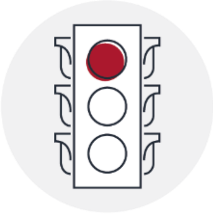
Longer term predictors still flashing red

Debt servicing costs have risen with higher yields and may remain elevated given the looming maturity wall and prospect of higher-for-longer policy rates.



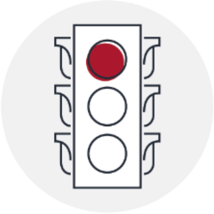
HIGH DEBT LOADS
Key metrics: interest cover, leverage
Prognosis: stock of debt high; refinancing costs higher

Stronger, larger companies can access capital, but at a higher price. Smaller companies reliant on bank lending are finding it tougher.



RESTRICTED CAPITAL ACCESS
Key metrics: liquidity cycle, real borrowing costs
Prognosis: liquidity withdrawal amid QT and tighter lending standards

The earnings rebound post COVID is now (with some exceptions) being challenged by weaker nominal growth and the incremental rise in financing costs.



EXOGENOUS SHOCK TO CASH FLOW
Key metrics: earnings, earnings revisions
Prognosis: earnings growth weakening

Note: Our traffic lights represent historically reliable predictors of credit cycles on a medium- to long-term basis. They indicate the direction of the cycle. They do not predict the precise timing, shape or magnitude of a turn in the cycle. Our Credit Risk Monitor is not designed around valuations and is not intended to be used as a market-timing tool.

Sharp rise in real yields as market dialogue shifts to supply-demand imbalances

- Rates rose sharply in the third quarter as investors focused on G7 budget deficits and supply-demand imbalances creeping into fixed income markets, driving term premia higher.
- A reset in policy rate expectations to a "higher for longer" mentality upended markets. Inflation has peaked (except in Japan), but targets of 2% are still a long way away.
- The staggering rise in real yields has helped push the real cost of borrowing higher than it has been for a decade. This is a negative for economic growth and credit creation.

Access to capital – a mixed picture

- Large companies still appear able to borrow with ease. Large cash balances prevented net interest payments climbing at first, but each refinancing comes at a premium. The rise in borrowing costs is set to be felt more heavily in the coming quarters. This could impair finances and credit quality quickly if revenue growth stumbles.
- Small and medium enterprises – those relying on the banking system – are more exposed to higher costs, particularly as more leveraged borrowers have been turning to floating rate loans.
- High yield issuers have been met with decent appetite for bonds, but this could rapidly fade if the 'soft landing' narrative falters, given a heavy refinancing calendar in coming quarters.

Issuer fundamentals – generally okay but areas of credit stress evident

- We expect default rates to climb but remain relatively low for the next 12 months. Issuers came into the slowdown with strong fundamentals and many companies have termed out their debt.
- That said, higher borrowing costs typically lead to defaults (with a lag) and areas of stress are emerging. Europe is experiencing a weaker economic environment, partially offset by a higher quality high yield market.

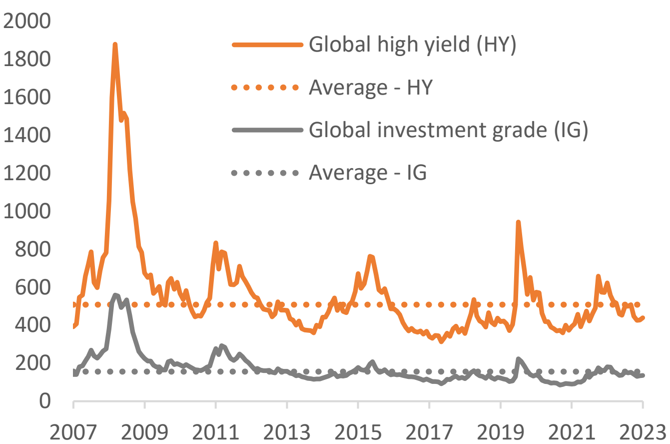
An unusual cycle – and why we remain cautious

- Leading indicators pointing to a recession (the Conference Board Leading Index, for example, indicates a recession should have already started) have been somewhat blindsided by consumer strength, the disconnect between nominal and real growth, and easy fiscal policy.
- Nonetheless, we think the market narrative could shift quite quickly given the sharply higher rates and the lagged effect of cumulative tightening means (two years on from initial tightening) we are entering a high-risk period. We continue to be cautious around security selection in portfolios.

Valuations

Quality-adjusted spreads (bps) tighten

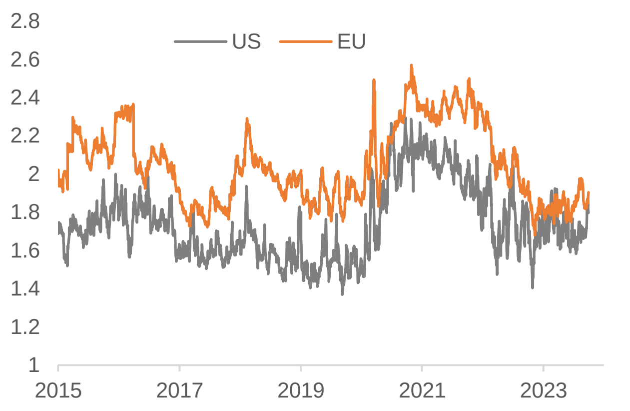
Credit spreads are below long-term averages on ratings-adjusted basis



Source: Bloomberg indices as at 30 September 2023. Option-adjusted spreads (OAS) shown. Average is over the last 20 years. 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 ratios ended the quarter slightly up.

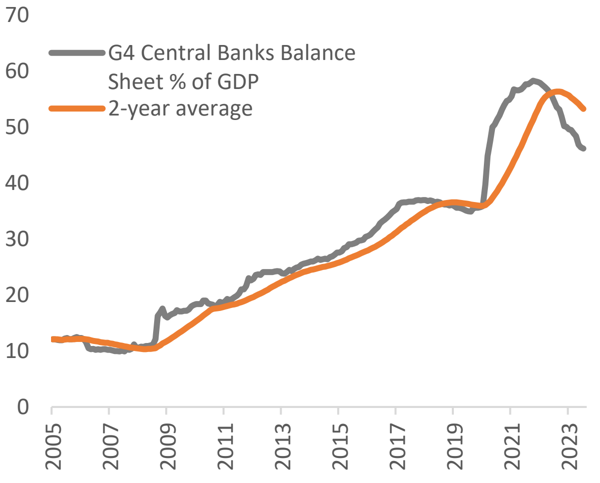


Source: ICE BofA corporate bond indices as at 30 September 2023. The spread ratio is calculated by dividing the BB spread by BBB spread. See Important Information for full information on underlying indices.

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 2023.

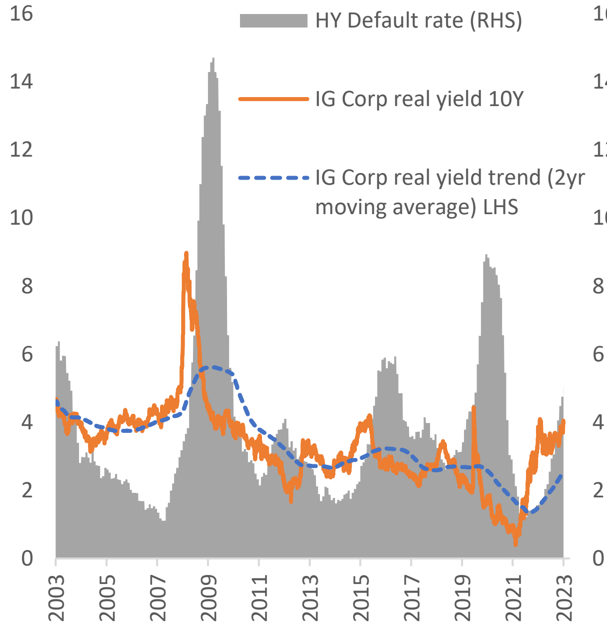
2s 10s yield curve slope flattens (bps)

The yield curve slope remains in negative territory, indicating ongoing recession risk.

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

Real rates (%) spike higher

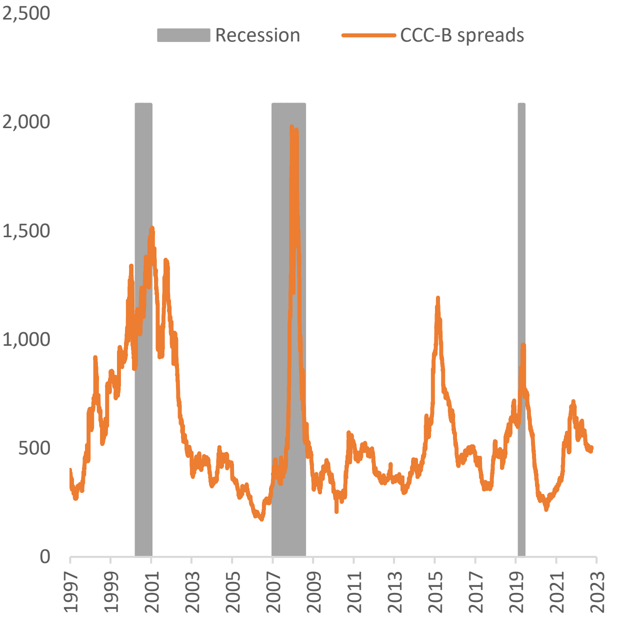
Sharp moves higher in real yields tend to lead a default cycle.



Source: Janus Henderson calculations, Bloomberg, Moody's, as at 30 September 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

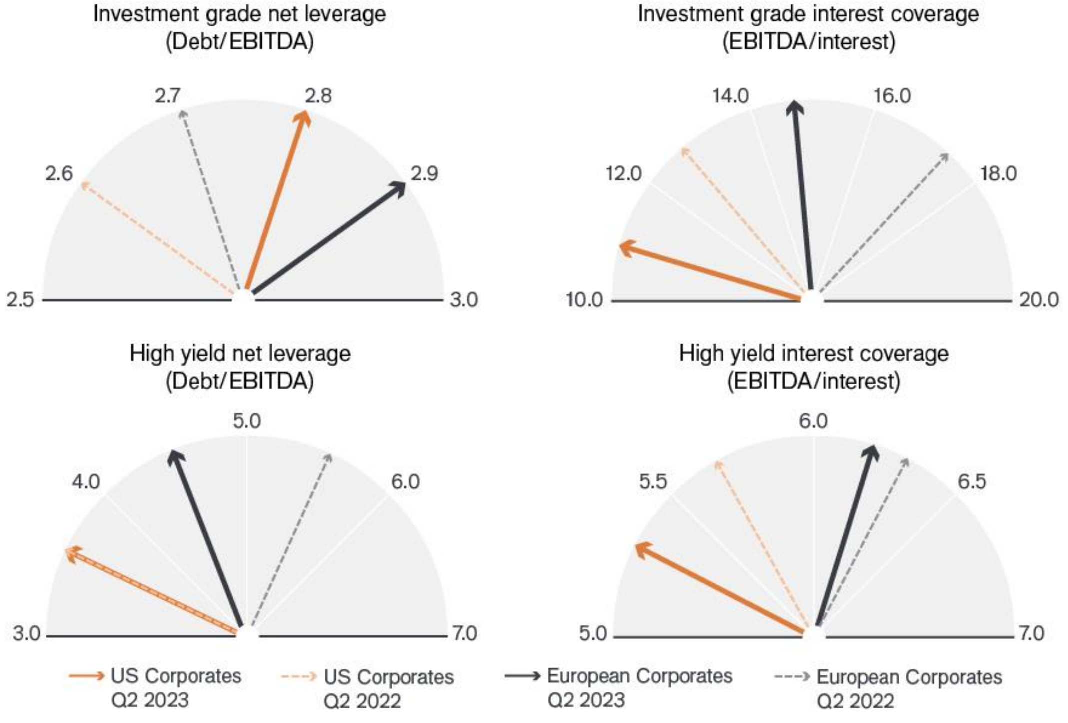
Weaker performance trends in lower quality (CCC) is a warning sign of stress – this is shown by periods where the orange line rises sharply from low levels. The recent fall in the US slowed in Q3.



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

Issuer fundamentals show mild weakening

Median interest coverage has edged lower across the board (US and Europe; IG and HY). Notably, interest cover in the US CCC-rated segment has declined to 2.15x as at Q2 2023 from 2.87x in Q2 2022. Meanwhile, Moody's data, as at 31 August 2023, shows the global corporate trailing 12-month (TTM) default rates for speculative grade issuers has risen in aggregate to 4.3% from 3.8% a year earlier.



Source: JPMorgan. Net leverage and interest coverage is as at Q2 2023, except for European HY which reflects Q4 2022, the latest available complete data at 30 September 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	**10**	**0**	**11**	↓
Developed	10	1	10	↓
US	6	2	12	↑
Eurozone	20	4	7	↑
UK	29	-12	5	↓
Japan	3	13	7	↑
Emerging	*6*	*-4*	*19*	↓
China	2	16	16	↓

Source: Refinitiv Datastream data, 30 September 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.

"Each cycle is different, but when you have a lot of debt, when you have companies losing access to capital at a reasonable price, and when you then get some type of exogenous shock on top of that – that tells you that a credit cycle is likely to unfold in a negative way."

Jim Cielinski
Global Head of Fixed Income

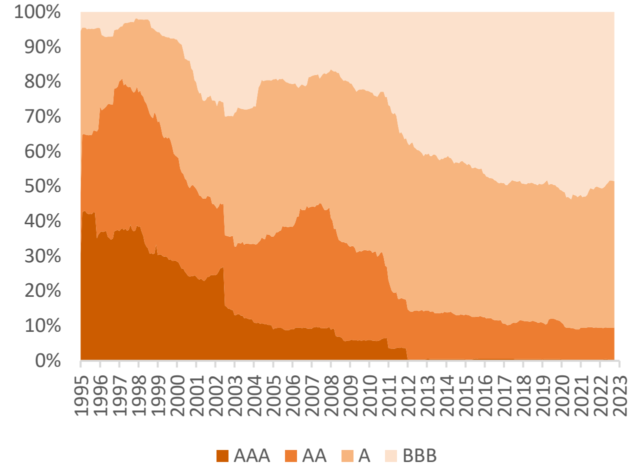
Euro Investment Grade market snapshot

	30/09/2023	YTD change
Market size €mm	2,731,906	+5.2%
No. of issuers	800	+12
Yield	4.44%	+29bps
Credit spread (OAS)	151bps	-14bps

By maturity	2-year	5-year	10-year
Bund yield	3.20%	2.77%	2.86%
Swap yield	3.80%	3.41%	3.39%

Source: ICE BofA indices and Bloomberg. Data as 30 September 2023. See Important Information for full information on underlying indices.

Euro IG Index - ratings breakdown (%)

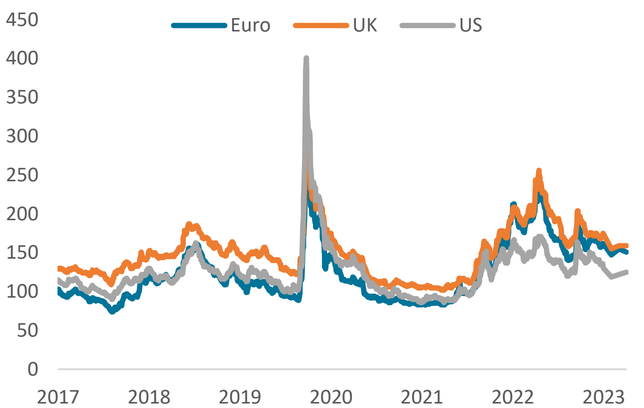


Source: ICE BofA indices. Data as at 30 September 2023. See Important Information for full information on underlying indices.

Spreads (bps)	10-year Average	Current	Last Q-end	Last Q-end chg
Euro Corp	121	**151**	161	-10
Euro Corp 10Yr+	139	**149**	160	-11
A Financials	112	**156**	170	-14
A Industrials	91	**112**	115	-3
A Utilities	96	**96**	111	-15
BBB Financial	184	**208**	222	-14
BBB Industrials	141	**171**	184	-13
BBB Utilities	126	**148**	147	1

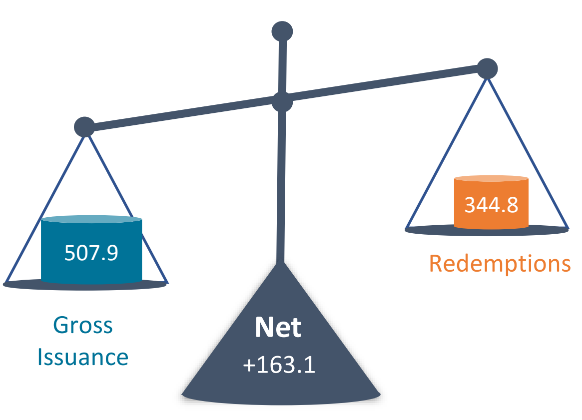
Source: ICE BofA indices. Data as at 30 September 2023. See Important Information for full information on underlying indices.

Euro IG spreads versus other markets (bps)

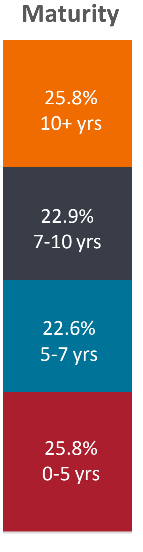


Source: ICE BofA indices and Bloomberg, 1-10 year corporate bond indices in GBP, USD and EUR. Data as at 30 September 2023. See Important Information for full information on underlying indices.

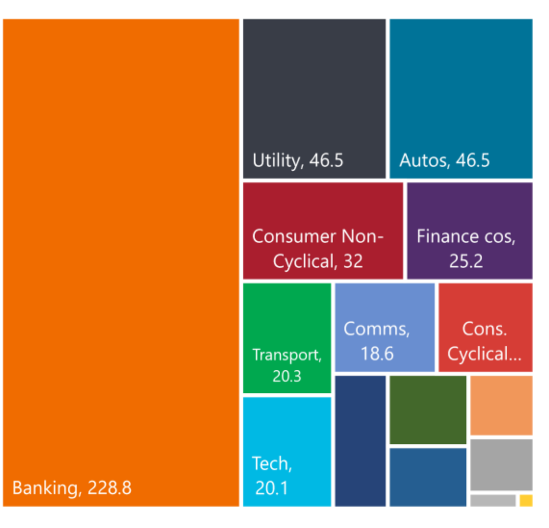
Corporate Issuance, 2023 YTD €bn



Maturity



Sector breakdown



Source: Barclays Credit Research. Data as at 30 September 2023.

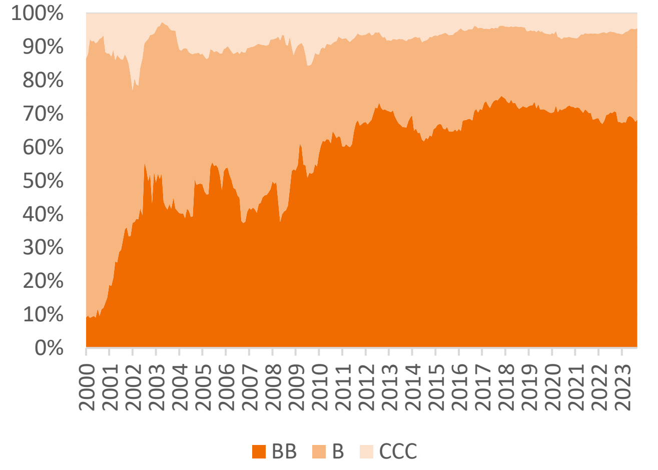
Euro High Yield market snapshot

	30/09/2023	YTD change
Market size €mm	369,388	-3%
No. of issuers	354	-16
Yield	7.38%	-13bps
Credit spread (OAS)	445bps	-53bps

By maturity	2-year	5-year	10-year
Bund yield	3.20%	2.77%	2.86%
Swap yield	3.80%	3.41%	3.39%

Source: ICE BofA indices and Bloomberg. Data as at 30 September 2023. Important Information for full information on underlying indices.

Euro HY Index - ratings breakdown (%)

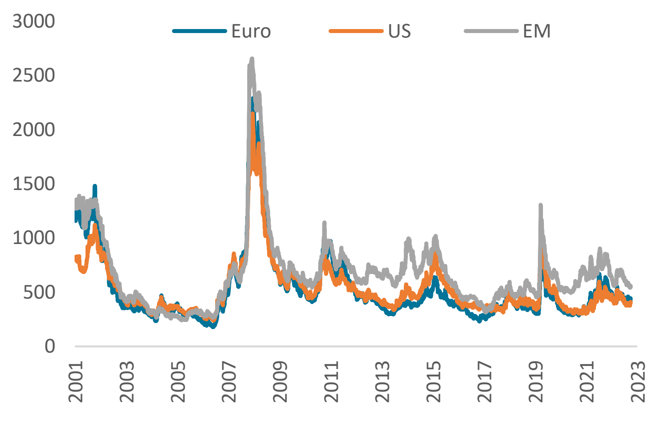


Source: ICE BofA indices. Data as at 30 September 2023. See Important Information for full information on underlying indices.

Spreads (bps)	10-year Average	Current	Last Q-end	Last Q-end chg
Euro HY all	403	**445**	446	-1
Euro HY 1-3	339	**404**	401	3
Euro HY Financials	380	**379**	401	-22
Euro HY Non-Financials	408	**459**	455	4
Euro Fallen Angels	328	**417**	381	36
BB	301	**337**	341	-4
B	532	**506**	529	-23
CCC	1093	**1712**	1568	144
iTraxx Crossover	320	**428**	400	28

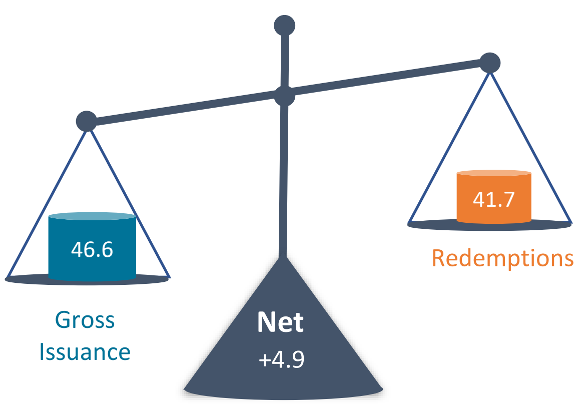
Source: ICE BofA indices and Bloomberg. Data as at 30 September 2023. 10-year average. See Important Information for full information on underlying indices.

Euro HY spreads versus other markets (bps)



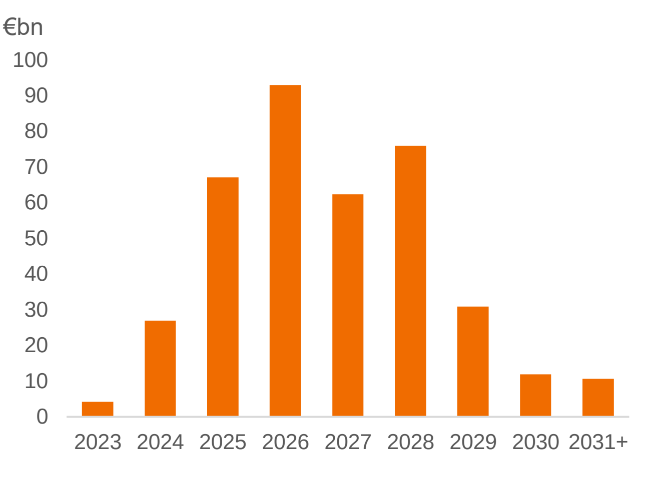
Source: ICE BofA indices and Bloomberg, Euro, US and Emerging Market HY OAS (bps). Data as at 30 September 2023. See Important Information for full information on underlying indices.

European Currency HY Issuance, 2023 YTD €bn



Source: J.P. Morgan. Data as at 30 September 2023..

European HY currency maturity wall (€ bonds)



Source: J.P. Morgan. Data as at 30 September 2023. Maturity pipeline will vary over time.

Important information

Page	Data sources (supplementary information)
2	**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
3	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
4	**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
5	**Euro corporate bond spreads vs other markets:**
	Euro = ICE BofA Euro Corporate Index OAS
	GBP = ICE BofA Sterling Corporate Index OAS
	USD = ICE BofA US Corporate Index OAS
	Table: Euro corporate bond market data:
	ICE BofA Euro Corporate Index
	Data for 2,5, and 10-year bund yields based on Bloomberg generic German bund yields and swaps on generic euro swap yields
	ICE BofA 10+ Euro Corporate Index
	ICE BofA Single-A Euro Financial Index
	ICE BofA Single-A Euro Industrial Index
	ICE BofA Single-A Euro Utility Index
	ICE BofA BBB Euro Financial Index
	ICE BofA BBB Euro Industrial Index
	ICE BofA BBB Euro Utility Index
6	**Euro high yield bond spreads vs other markets:**
	Euro = ICE BofA Euro High Yield Index OAS
	US = ICE BofA US High Yield Index OAS
	EM = ICE BofA High Yield Emerging Markets Corporate Plus Index OAS
	Table: Euro high yield bond market data:
	ICE BofA Euro High Yield Bond Index
	Data for 2,5, and 10-year bund yields based on Bloomberg generic German bund yields and swaps on generic euro swap yields
	ICE BofA BB-CCC 1-3 Year Euro Developed Markets Index
	ICE BofA Euro Financial High Yield Index

Important information

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6 cont.	ICE BofA Euro Non-Financial High Yield Index
	ICE BofA Euro Fallen Angel High Yield Index
	ICE BofA BB Euro High Yield Index
	ICE BofA Single-B Euro High Yield Index
	ICE BofA CCC & Lower Euro High Yield Index
	iTraxx Crossover