Credit on the comeback trail in 2023

Fixed income | January 2023

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- **Last year was tough for all investors, with credit offering little respite**
- **In a world without quantitative easing and artificially low rates, investors will have to seek higher credit quality**
- **We do this through intense 'bottom-up' fundamental credit analysis with a focus on issuer and security selection**

All global financial markets were rattled in 2022. We saw an aggressive policy pivot from multiple major central banks to address an inflationary environment that was much more persistent than hoped or expected. Assets sensitive to rising real and nominal rates, such as government bonds, performed woefully. In addition, the lower quality bonds of the high yield space also underperformed badly. As such, fixed income investors could have lost just as much money in treasuries as they did in high yield bonds.

There is agreement on what it will take to stop the carnage: clarity on an end to central bank rate rises. The US Federal Reserve recognises this, but chair Jay Powell has made it clear that the Fed wants to see "compelling evidence of inflation easing" before it shifts policy[1]. The difficulty it and other central banks face is that monetary policy impacts the real economy with a lag: it can take around six months for changes in interest rates to be seen. As such it is hard to judge what effect policy makers are having. The risk is that, not seeing sufficient signs of inflation easing, they push rates too high; if they don't go high enough inflation continues for longer. But it does appear the US is seeing evidence that its policy is starting to work.

Into 2023

As the year progresses we expect to see a dramatic slowing in economic growth, Although this won't be comparable to the global financial crisis of 2008 or the effects of Covid-19, we expect recession in the UK and Europe, as well as in the US – although the slowdown in the latter should be less stark than on this side of the Atlantic.

[1] FT.com, Jay Powell faces test of Fed's 'unconditional' resolve to tame inflation, 22 June 2022

This means that companies and consumers with too much leverage, and sovereigns not well positioned to deal with elevated levels of currency volatility, will come under increased pressure. We are also now in a world where policy-based shock absorbers such as quantitative easing or artificially low rates have gone. Instead investors will have to seek higher credit quality: companies with strong fundamentals, a healthy cash flow and lower leverage.

Here is how we're looking at the credit market for 2023:

Credit triggers – outlook for corporate credit spreads

Key Indicators	Current Flag	Notes
Policy conditions	Red	Central banks took interest rates beyond neutral in 2022. Expectations are for them to remain in restrictive territory in the coming year(s).
Economic outlook	Amber	Economic growth to be around 0% in 2023 – weakest in the UK and strongest in the US. A modest rebound is expected in 2024.
Valuations/spreads	Amber	Spreads to be well above short-term averages and modestly higher than long-run averages. Europe/UK look cheapest, US more neutral.
Corporate health	Green	From a strong starting point, we expect credit fundamentals to improve in the US, but modest deterioration in Europe. High-yield defaults will increase throughout the year but remain low.
Abnormally low but rising volatility	Amber	After increased volatility and challenging liquidity in Q2/Q3 2022, volatility has fallen and liquidity has improved

How we manage credit

At Columbia Threadneedle Investments we have always sought to deliver attractive relative and risk-adjusted relative returns through the cycle. And in what is an asymmetrical risk-return asset class – one which has most of the downside (when things go wrong) and not much of the upside (when things go well) – that has never been more important.

In order to find higher credit quality we have intense "bottom-up" fundamental credit analysis, with a focus on issuer and security selection. Downside risk management is embedded in portfolio construction and in our research, and the chief focus for our team of analysts is default and downgrade risk. Put simply, we want to find the best companies out there.

We believe this is not a time to stay on the side-lines. There are very compelling total return opportunities in high-quality assets. Yes, there are risks, but investors are being well-compensated, and a focus on quality and credit selection will be critical to setting the stage of successful fixed income investment outcomes.