CREDIT MARKET: IS REMUNERATION SUFFICIENT FOR THE RISK TAKEN, IN ANTICIPATION OF A RECESSION?

Stéphane Déo
Head of Market Strategy

DETERIORATION YES, BUT LIMITED

The deterioration of the economic environment has raised fears of a rise in corporate bankruptcies. However, our economic analysis shows that companies remain at high levels of profitability.

The inflation generalisation across a number of sectors is also leading to an increase in corporate revenues, as demonstrated by the latest earnings season, and therefore strong cash flows.

Our models suggest a deterioration in fundamentals, with the coming recession that seems inevitable, but to a limited extent as nominal growth will remain strong.

The default rate is expected to pick up over the coming year, as our models lead us to an expect high yield default rate exceeding 4% - above the long-term average of 3% to 3.5%.

However, we are still far from the 19% reached during the 2009-2011 crisis. The projected deterioration in fundamentals therefore remains very reasonable.

Conversely, markets are anticipating a much gloomier scenario, as we write, high yield CDS levels are above 600 bps, which would equate to a stratospheric default rate of more than 40% over five years. Consequently, in our view, there is a major disconnection between the degree of extreme market pessimism and the fundamentals that, if they deteriorate, lead us to expect a much less catastrophic trend.

Sanda Molotcov
Head of Credit Research

THE SUPPORT OF STRONG FUNDAMENTALS

With economic conditions set to deteriorate further, we expect credit fundamentals within corporate and financial institutions segment to continue to erode over the next period, but not fall off a cliff, thanks to a sound starting point.

Going further, European corporates are first in line to feel the pain from prevailing recessionary conditions and impact on demand. Key negative drivers include among others rapidly tightening monetary policies pushing up (re)financing costs, higher energy prices, $ strength.

As supply constrains ease and demand weakens, sectors exposed to discretionary spending such as retail and auto will suffer first, as well as energy hungry sectors and industries depending on discretionary end-markets.

Within the financial institutions, the banking segment will gradually see the revenue benefit from rising interest rates offset by weakening asset quality as corporate and consumer health weakens. Life insurance is probably the sector expected to benefit the most in the current environment (increasing rates), outside a jump in surrenders, while P&C and reinsurance face the structural shift from physical risks associated with climate change.

Overall, while in the short to midterm we remain confident a large portion of our credit universe will be able to face the headwinds, several structural risks are gathering pace.

Cyber threat increases systemic risk, whereas the energy crisis in Europe shows not only the economic, but even more, the political difficulty to manage sustainably high energy prices (which are also associated with the decarbonisation goals).

Philippe Berthelot
Head of Credit & Money Market

2022: ANNUS HORRIBILIS, 2023: ANNUS MIRABILIS?

With rates of return of 4.20% for investment grade and 8.11% for high yield, unseen for more than 10 years, credit in the eurozone seems very attractive. The same goes for the other side of the Atlantic, with yields of 5.75% and 9.27% for the eponymous categories.

Many bad news is already incorporating these valuations which seem to be cheap, given the fundamentals and flaws they infer. These levels should be placed in the context of a near recession (estimated around Q4 2022/Q1 2023), which is more of a soft landing than a hard landing of economic activity.

Of course, we cannot ignore the violent “repricing” witnessed with negative 2-digit performances rarely seen since 1994 on all bond asset classes. This is mainly due to high volatility on interest rates, linked to strong uncertainties on inflation levels that had not been seen in over 40 years. From now on, central banks are in a position to curb this risk by raising rates as they rarely do, both in velocity and magnitude. These multiple contingencies have led bonds integrating optional clauses such as contingent convertibles (Cocos), hybrid corporates and high yield to be valued at maturity and no longer at the first call date, in many cases this seems excessive.

2022: annus horribilis, 2023: annus mirabilis? The next vintage could prove particularly tasty for asset classes such as bonds in general and credit in particular.

ADDITIONAL NOTES

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