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A WORD ON THE CREDIT MARKET

# SEEKING OUT RETURNS ON THE CREDIT MARKET

## Geoffroy Lenoir, Co-Head of Fund Management at Ofi Invest Asset Management, details the opportunities and risks of investing in various euro credit market segments.

### What is the outlook for the euro credit market?

Generally speaking, the euro bond asset class as a whole has benefited from hikes in the main key rates, which have put yield back on the table. This is obviously the case for money-market funds, whose yields, after six years of negative rates, have at last moved far back into positive territory. The corporate bond market is also riding this favourable environment, in both investment grade(1), i.e., the category of bonds from issuers rated above high yield(1), i.e., issuers that are rated lower but also offer higher returns.

We believe that carry opportunities(2) now remunerate the risk incurred. Moreover, in our view, the mechanisms for offsetting interest rates and spreads(3) are still working, thus making the asset class less volatile(4) during stressful market phases.

### What about investment grade in particular?

Investment grade is currently yielding an average of 4.40%/4.50% on maturities of around six to seven years. Because of the current inversion of the yield curve – something that happens very seldom – yields are almost the same on longer maturities of one to three years as on longer maturities, and offer a far shorter duration(5). To cite one example, as of end-September, the Investment Grade ICE BofA 1-3 years Euro Corporate Index, with an average maturity of 1.9 years, yielded about 4.4%, with two and a half times less sensitivity than the ICE BofA Euro Corporate All Maturities. This same 1-3-year investment grade index offers yields close to money-market yields but on a longer period of time, which looks like an attractive strategy at limited risk.

### Doesn’t longer-dated investment grade have some things going for it?

Assuming that monetary tightening has now peaked and that a phase of decline of central bank rates is now in sight – which assumes, further, that inflation will move back towards normal and that the economy will slow – it could be worth investing in all-maturities investment grade. It is worth investing in products having high sensitivity. Keep in mind, however, that, from an economic point of view, this scenario is not certain but does have some credibility. So, devoting a portion of the allocation to all-maturities investment grade makes it possible to invest at a 4.3% yield for a period of more than six years, barring defaults.

### What is your outlook for the high-yield credit market?

There are several reasons why we have been bullish on the high-yield credit market since the start of 2023. First of all, the spread(6) between high yield and sovereign debt is 460 basis points(7). This spread is higher than its historical average of about 410 bps over the past 10 years(8). In other words, the yield on offer to remunerate risk is about 7.7%, vs. just 3.0% in recent years, when government bond yields were negative or close to zero.

Moreover, we believe that much of the bad news on highly leveraged companies that could default has already been priced in. In fact, current spreads correspond to default levels of about 8.0%, whereas ratings agencies forecast only 3.8%. In other words, the markets are anticipating far more defaults than the ratings agencies. This is why we believe that the bad news is already priced in.

*(1) Investment grade / High yield: Investment grade (IG) bonds are issued by borrowers that are rated the highest by ratings agencies. Based on the classification of Standard & Poor’s and Fitch, these ratings range from AAA to BBB-. High yield bonds are rated lower than investment grade bonds (from BB+ to D, according to Standard & Poor’s and Fitch), due to their issuers’ weaker financial standing, according to the ratings agencies. They are therefore regarded as riskier by ratings agencies and, in exchange, offer higher yields.*
*(2) The carry trade consists of holding bonds in a portfolio in order to exploit their yields, possibly until maturity.*
*(3) The credit spread is the difference in interest rate between a government bond and a same-dated benchmark bond, which is regarded as the least risky (the benchmark sovereign yield).*
*(4) Volatility: the amplitudes of price shifts of a financial asset. The higher the volatility, the more the investment is considered risky.*
*(5) Duration: the weighted average life of a bond or a portfolio of bonds, expressed in years.*
*(6) The credit spread is the difference in interest rate between a corporate bond and the same-dated benchmark bond regarded as the least risky (the benchmark sovereign yield).*
*(7) On the ICE BofA Euro Non-Financial High Yield, all maturities combined, as of the end of September 2023.*
*(8) The 10-year average of daily data of the ICE BofA Euro Non-Financial High Yield, all maturities combined, as of the end of September 2023.*

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One last factor in potential support: mutual funds are not yet truly positioned on this theme, which suggests that inflows are coming, if investors begin to take an interest in this asset class.

## Has the high yield market matured?

In volume terms, this asset class has expanded 10-fold in the past 15 years and now has almost 400 issuers, up from 150, 10 years ago. The market is thus more liquid than it used to be[9]. The vast majority of sectors and geographical regions are now represented, making it even more worth looking into.

## An yet risks are greater on this segment…

High yield's average yield looks especially attractive for the carry trade and can provide protection against potential upturns in interest rates or spreads. At current levels as of the end of September, spreads would have to widen by 275 basis points in this asset class to erase this yield on one year. And this doesn't currently look likely. If it did, that would mean that the economy has slipped into a deep recession, which would affect all markets.
Likewise, some investors are concerned that recent rate hikes could place some overleveraged companies at risk of defaulting. But, given that high yield bonds are currently around 8%, carry, in our view, offers investors some valuable protection. In a well-diversified portfolio, one issuer's default can be offset by the high yields of the asset class in general. Of course, this doesn't keep us from being highly selective, something that is key in a risk environment featuring a gradual increase in the default rate.

## But isn't there the risk that the most heavily leveraged companies will be hit hard by high interest rates?

The economy is indeed sending out broad-based signals of a gradual slowdown. So, naturally, credit spreads are likely to begin widening to price in the fact that we are entering into a riskier environment. And yet, paradoxically, this is not happening, and we have even seen that when one issuer is shaken, this does not spill over into other issuers, in particular in the riskiest segment, high yield, in which the average default rate is still at historic lows, according to the ratings agencies. In our view, this means that investors are, for the moment, not fearing a systemic crisis.

## Does investing in a target-date fund in this asset class make sense?

A target-date fund buys bonds whose maturities are aligned with the fund's own maturity and to hold them until maturity, regardless of market fluctuations.
Barring default by portfolio issuers, a target-date fund is able to maintain its initial target return. Market fluctuations will therefore have little impact on an investor who stays with the fund until maturity.
Accordingly, the two main characteristics to monitor for this type of product are the annualised target yield and the ability of the chosen issuers to repay their debt.
This type of fund is nonetheless meant for investors having a certain amount of risk appetite, as invested capital is not guaranteed in the event, for example, of default by several issuers in the portfolio.
The choice of maturity, selection of issues and portfolio construction are therefore paramount in this type of investment.


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[9] *Liquidity: a financial asset (shares, bonds, etc.) is said to be liquid when it can be bought or sold with no major impacts on its price.*



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