

Credit market outlook 2023

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Attractive entry point for selective parts of the credit markets

Total returns should be robust: Returns were abysmal for credit in 2022, with the rate moves the largest factor.

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Starting levels are much more attractive from a yield standpoint and provide room for error, whether it is spread widening in a recession or a rise in downgrades and defaults

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Expect higher frequency of defaults and idiosyncratic risks in Corporate Bonds and Leveraged Finance

Allianz Trade anticipates 36% increase in insolvencies in Italy in 2023, followed by France (29%), Germany (17%) and the UK (10%). In China, the company expects 15% more insolvencies on the back of lower growth and a limited impact from monetary and fiscal easing. In the US, it anticipates an increase of 38% on the back of tighter monetary and financial conditions. It gives three main reasons for the expected increase in insolvencies: 1. The major profitability shock for European firms due to the energy crisis, 2. The interest rate shock and higher wage bill due to a sharp increase in inflation, and 3. Only limited intervention expected from governments.

For US High Yield amid a challenging macro environment, risk assets will face further pressure next year, though spreads should peak in the first half and recover somewhat by year-end resulting in total returns of 4.0-5.0%.

Default rates in high yield and loans to end 2023 at 5.0-6.0% on an issuer-weighted basis. Though they have remained near historically low levels post-COVID, there are many factors pointing to higher default rates next year.

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Impact of 2022 Central Bank rate increases to be felt across Private Equity, Private Credit and Real Estate valuations

Corporate fundamentals will be challenged by slowing growth globally, with a recession in the developed economies. This will create a tough operating environment for corporates. Furthermore, US non-financial revenue growth is more correlated to European GDP now than pre-GFC. We believe that corporate fundamentals will continue to deteriorate in an adverse operating environment.

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Remain invested in high quality, investment grade companies which can sell assets, reduce headcount, and raise equity long before asking bondholders to share losses.

Pick up additional yield by investing down the capital structure into Tier 1 / Tier 2 Bank and Insurance Hybrid Capital

US, EU and UK Bank and Insurance company balance sheets will come under some pressure as asset quality and values deteriorate but current excess capital and robust risk management offer a substantial cushion. With insolvencies set to increase next year in a potential recession, European banks are likely to experience an increase in impairments.

Higher impairments should be broadly manageable for most banks, provided the unemployment rate does not spike up dramatically. This is due to banks having decent starting capital positions, strong asset quality metrics and some existing impairment overlays put in place for the COVID pandemic.

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Source: All charts supplied by Barclays Credit Research, December 2022.

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