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2023

Credit Outlook

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2022 has been a torrid year for risk assets where quite a few certainties have been more than challenged or simply written off. “Doubt is not a pleasant condition, but certainty is absurd” as cold-blooded Voltaire reminds us.

While recession is already/nearly here in the UK/Europe, it still seems premature in my opinion to extend into too much duration. You do not want to fight the Fed too early either. While I’m cognisant that the front end of the yield curve will keep bearing the pressure of any remaining hikes, the strong pick-up you can get in the short part of the curve justifies the risk. There are two ways to view the credit markets for next year, each with their own compelling arguments.

For those who see the glass half empty, the Budget in November has confirmed the astronomical level of Gilts to be issued by the UK government despite the various fiscal measures. You can also add the negative technical of quantitative tightening (QT), where the BoE keeps selling corporate bonds. The former pushing risk-free rates higher, the latter widening the spread. And a similar pattern can be defined for the ECB and various governments, where central bankers will gradually test the markets for QT.

If you see the glass half full, you will point out the current valuations reflecting the already higher rates and spreads represent a great opportunity to lock in impressive yields while reallocating your portfolio from riskier/uncertain assets. The flow dynamics will have to adjust to the new risk appetite given the now sizeable carry from bonds.

When focusing on fundamental research, it is important to assess the key features of a company and its potential resilience through this tough environment. Are any doubts justified or could the company even benefit from this market? Strong candidates will have a robust balance sheet and most importantly, multiple entry points in the value chain:

A diversified but also limited dependency to third-party suppliers are qualitative features that should not be overlooked. For companies that didn’t fix issues in previous years, the problems may build up. 2023 is expected to be a year of more normalised defaults given the perfect recipe of a recessionary environment and higher refinancing costs for companies.

At the sector level, I think that fundamentals for financials are very appealing. While I am comfortable with their capital strength and the tailwind of higher rates, this naturally raises questions on the ability of debtors to repay loans in a cost-of-living crisis. One key area where this could become an issue is the UK mortgage market. After relatively low fixed rate periods start to end, borrowers will be exposed to significantly higher floating rates. Recent and future rate hikes will impact a third of borrowers year after year on average. This raises legitimate doubts regarding available income to repay any debt. However, the UK’s decade of sluggish productivity growth may be the silver lining that keeps unemployment down over the next 18 months and keep incomes being paid. Real wages have stagnated (or fallen) and so human capital still remains relatively cheap for businesses.

Finally, financial rigor is the new motto and governments are not expected to be as interventionist as during the pandemic. Having said that, it would not be implausible for them to reconsider fiscal measures to protect consumers, borrowers, workers and companies in times of stress. To some extent, it has already started across the continent (nationalisation, mortgage aids, tax windshields, etc.) to smooth some of the recession on the horizon. So, while certainty is never certain, I remain positive that 2023 will present opportunities and unique investment ideas as we move through the year.



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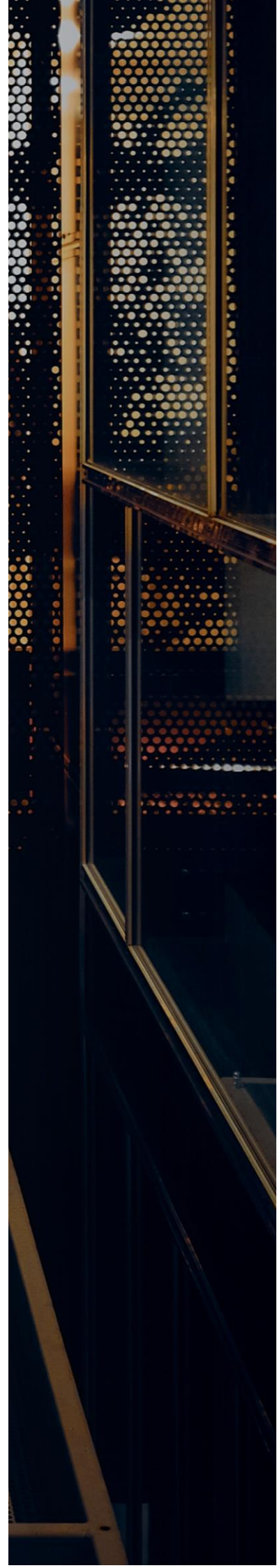
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