

Schroders



Schroders Credit Lens

Perspective of EUR investor

Q1 2022

Marketing material for professional investors or advisers only.

Important information

- **These do not represent the investment views of Schroders' credit teams**
- Marketing material for professional investors and advisors only
- Past performance is not a guide to future performance and may not be repeated
- Yields and returns are shown hedged to EUR unless stated otherwise
- All credit spreads are option-adjusted spreads (OAS) unless stated otherwise
- Spreads are quoted in basis points (bps) where 100 basis points = 1%
- Full list on indices on page 54

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[Emerging market debt \(EMD\)](#)

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Cross-credit summary

Summary

- **Credit indices ended 2021 on a high note as Omicron fears faded. Excess returns were positive across the board but total returns were negative in investment grade (IG) because of higher government bonds yields**
- Valuations have generally become unattractive again after a short-lived improvement in November
- Technicals are very strong with default rates in high yield (HY) credit at record lows. Rating agencies continue upgrading issuers. Rising stars, upgrades from HY to IG, have finally picked up as well
- Fundamentals improved throughout 2021. Strong earnings growth facilitated deleveraging and low bond yields have allowed companies to refinance higher-yielding debt
- Granted, there are some signs of late cycle behaviour. In HY, M&A/LBO related issuance exploded in 2021. This could start to put pressure on leverage. In IG, M&A related issuance also increased in 2021, but it is still lower than in the 2015-2018 period
- In hard currency EM debt (EMD), Omicron fears have hit some of the most vulnerable countries hard, with spread dispersion the highest since August 2020
- The real yield differential between EM and developed market (DM) bonds has increased to a post-financial crisis high. This implies significant value in local currency EM bonds and EM currencies

Summary table

Cross-credit overview

Date: 31 December 2021

	IG GBP non-gilts	IG GBP corporates	IG Euro	IG USD	HY GBP	HY Euro	HY USD	Hard EMD	Local EMD	Corp. EMD
Yield to worst	1.9%	2.1%	0.5%	2.4%	4.8%	2.9%	4.3%	5.3%	5.7%	4.1%
Yield to worst (hedged to EUR) ¹	0.9%	1.1%	0.5%	1.6%	3.9%	2.9%	3.6%	4.5%	-	3.3%
Spread (bps)	98	115	98	98	390	331	310	369	447	272
Spread (percentile) ²	25%	25%	38%	16%	30%	24%	13%	53%	50%	29%
Risk premium (bps) ³	48	59	41	41	202	104	46	224	371	143
Duration	8.0	8.6	5.4	8.4	4.0	4.1	5.3	8.0	5.2	4.7
MV (billion \$)	897	692	3,321	8,656	66	549	1,610	781	1,444	641
Rating	A2	A3	A3	A3	BB3	BB3	B1	BB1	BBB3	BBB3
Nr. of issues/countries	1,228	1,050	3,881	9,346	112	806	2,123	72	21	2,121

Since Jan 1997 or inception

Annualised return ⁴	4.8%	5.1%	4.4%	4.9%	7.9%	5.4%	5.7%	6.9%	5.4%	6.0%
Annualised volatility	5.2%	5.8%	3.5%	5.5%	10.5%	11.5%	8.9%	10.5%	9.0%	7.7%
Return/volatility	0.9	0.9	1.3	0.9	0.8	0.5	0.6	0.7	0.6	0.8
Max drawdown	-11.5%	-18.7%	-7.2%	-16.5%	-29.4%	-40.2%	-34.8%	-29.6%	-17.8%	-26.0%
Correlation with MSCI EMU	0.2	0.3	0.3	0.2	0.6	0.6	0.6	0.5	0.4	0.4
Correlation with MSCI World €	0.2	0.2	0.2	0.2	0.5	0.6	0.5	0.4	0.5	0.4
Correlation with Euro Gov	0.6	0.6	0.7	0.5	0.1	0.0	0.0	0.3	0.3	0.3

Past performance is not a guide to future performance and may not be repeated.

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 December 2021.

¹Local currency yield minus annualized 3-month hedging cost/return.

²Percentile shows where the current spread is relatively to the historical range of spreads, within a range of 0 to 100. The greater the percentile the higher the spread compared to history.

³Spread minus average historical default and downgrade losses (see slide 14).

⁴All returns EUR hedged returns, except EMD Local which is unhedged USD return in EUR.

Performance table

Cross-credit overview

Date: 31 December 2021

	IG GBP non-gilts	IG GBP corporates	IG Euro	IG USD	HY GBP	HY Euro	HY USD	Hard EMD	Local EMD	Corp. EMD
Return (local)¹										
1 month return	-1.2%	-1.3%	-0.1%	-0.2%	0.7%	0.9%	1.9%	1.4%	1.6%	0.4%
YTD return	-3.0%	-3.0%	-1.0%	-1.0%	3.8%	3.3%	5.4%	-1.8%	-8.7%	0.9%
1 year return	-3.0%	-3.0%	-1.0%	-1.0%	3.8%	3.3%	5.4%	-1.8%	-8.7%	0.9%
Return (EUR hedged)²										
1 month return	-1.3%	-1.4%	-0.1%	-0.3%	0.6%	0.9%	1.7%	1.2%	0.5%	0.3%
YTD return	-3.7%	-3.7%	-1.0%	-1.8%	1.0%	3.3%	4.5%	-2.8%	-1.8%	0.0%
1 year return	-3.7%	-3.7%	-1.0%	-1.8%	3.2%	3.3%	4.5%	-2.8%	-1.8%	0.0%
Spread										
1 month OAS change	-1	-2	-13	-5	-28	-40	-57	-23	-7	-20
YTD OAS change	-1	-2	5	-5	-73	-24	-76	17	60	2
1 year OAS change	-1	-2	5	-5	-73	-24	-76	17	60	2
Latest OAS	98	115	98	98	390	331	310	369	447	272

Past performance is not a guide to future performance and may not be repeated.

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 December 2021.

¹Local EMD is USD return.

²Local EMD is USD return in EUR.

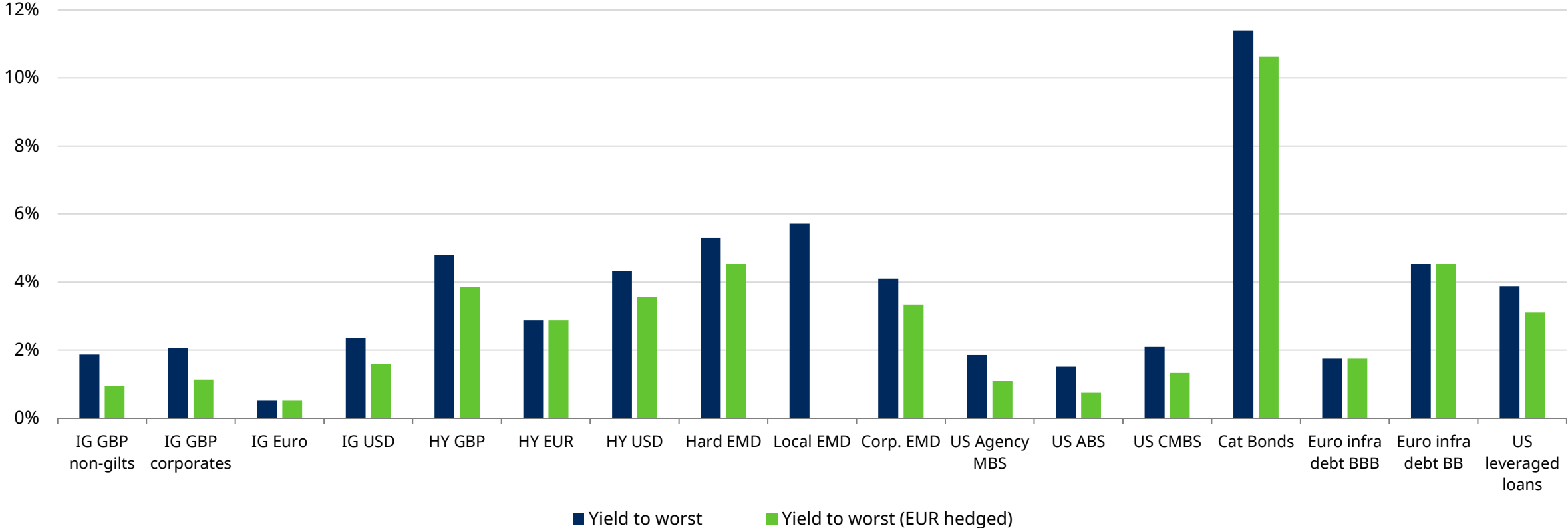
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Cross-credit analysis: key insights

Cross-credit yield

Yield to worst



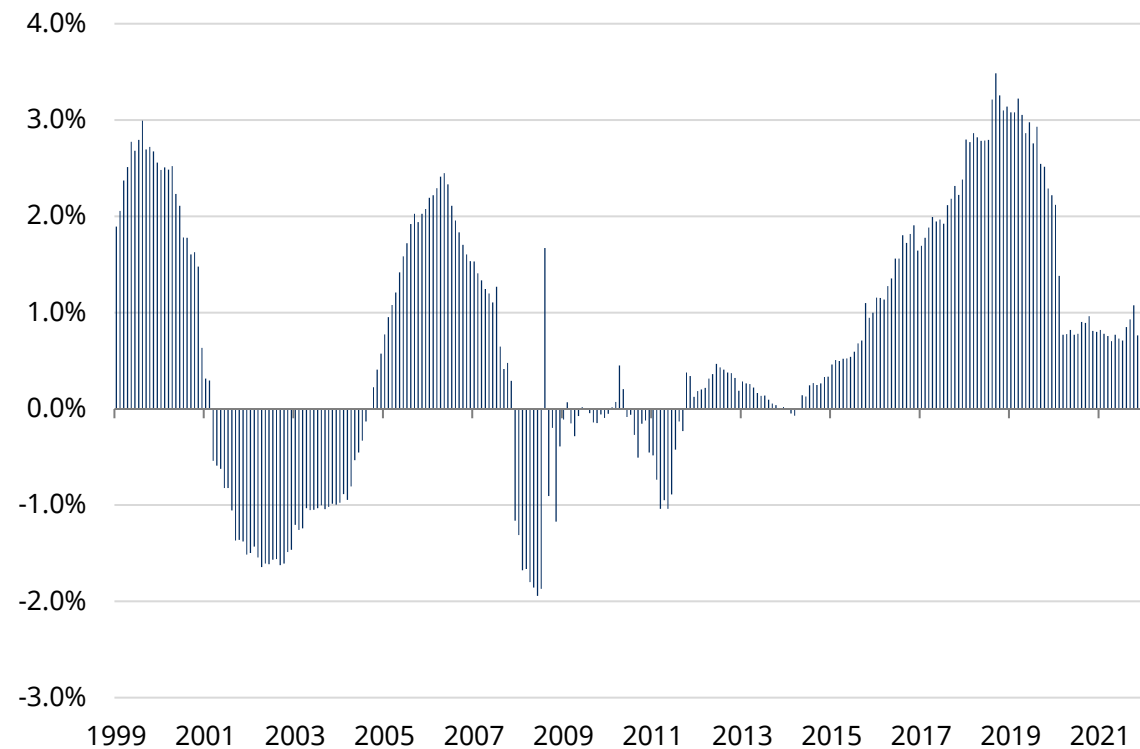
Currency-hedged GBP and USD corporates are very attractive for EUR investors

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan, Bloomberg. Data as at 31 December 2021. Hedged yield is local currency yield minus annualised 3-month FX hedging cost/return (see next slide).

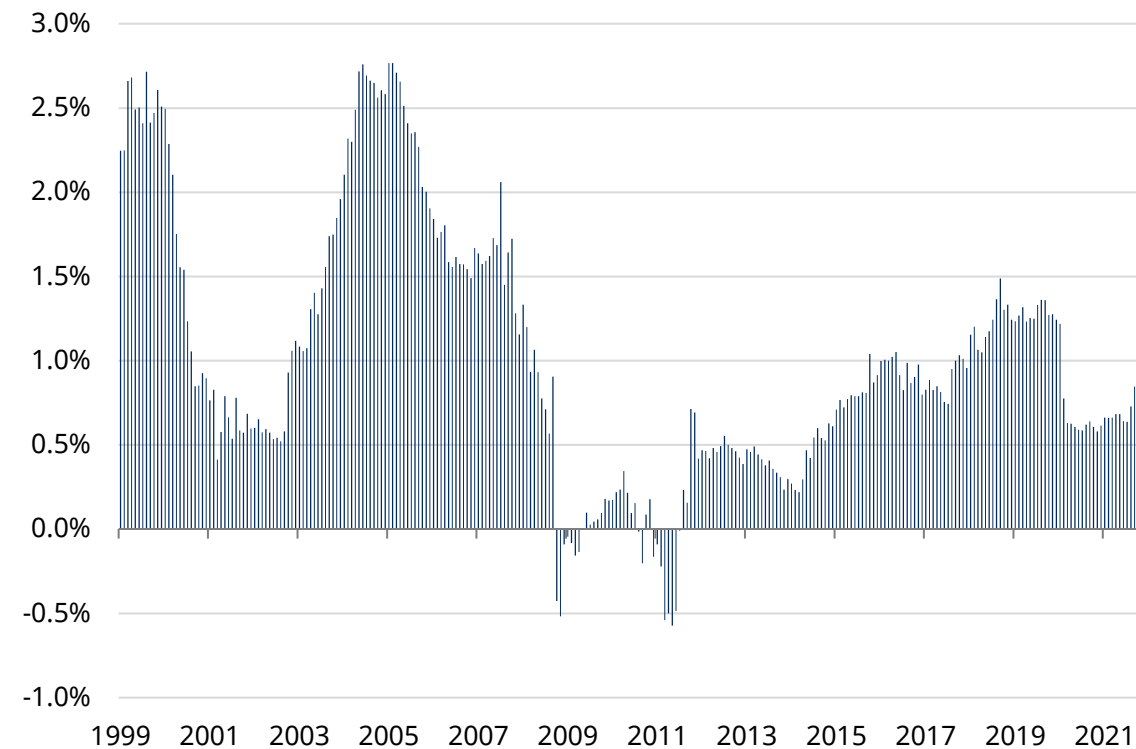
FX hedging cost or return

Using 3-month FX forwards

Annualised USD to EUR hedging cost (pos) or return (neg)



Annualised GBP to EUR hedging cost (pos) or return (neg)



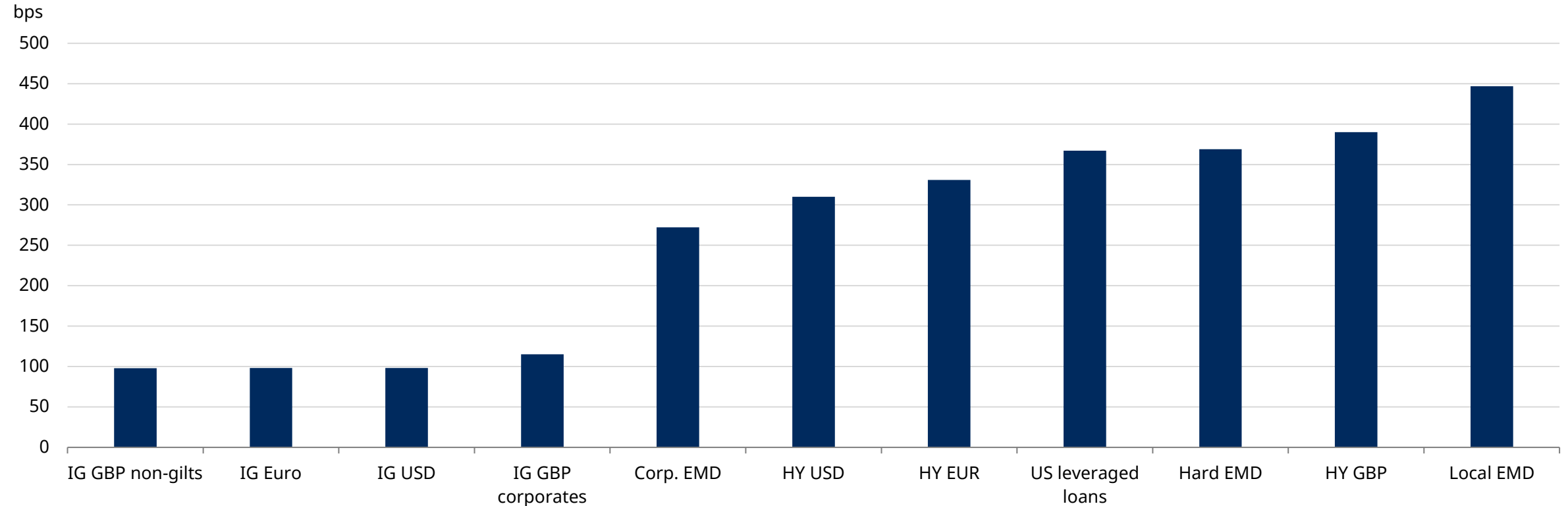
USD yields will be 0.8% lower in EUR once hedging taken account

GBP yields will be 1.0% lower in EUR once hedging taken account

Source: Refinitiv Datastream. Data as at 31 December 2021.

Cross-credit spread

Spread

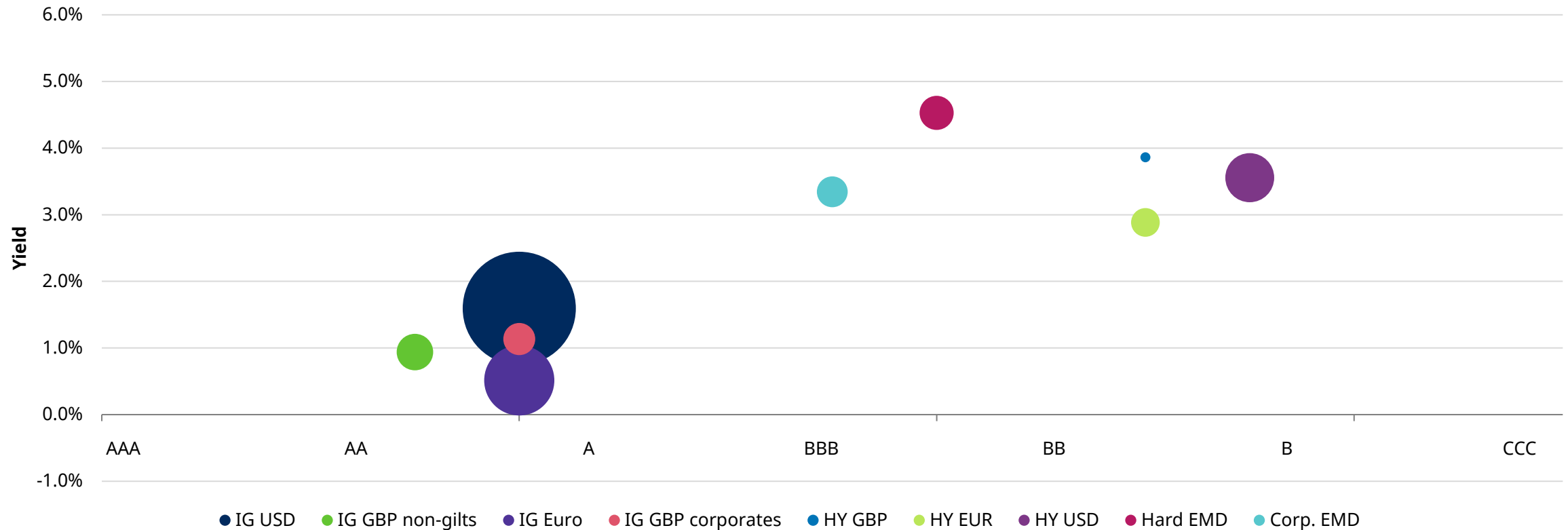


Source: Refinitiv Datastream, ICE Data Indices, J.P. Morgan, Bloomberg. Data as at 31 December 2021. Local EMD has been estimated as a spread over Treasuries of similar maturity.

Yield vs. credit rating vs. market size

The size of bubble is proportionate to the size of the market

Yield (EUR hedged) vs credit rating vs market size

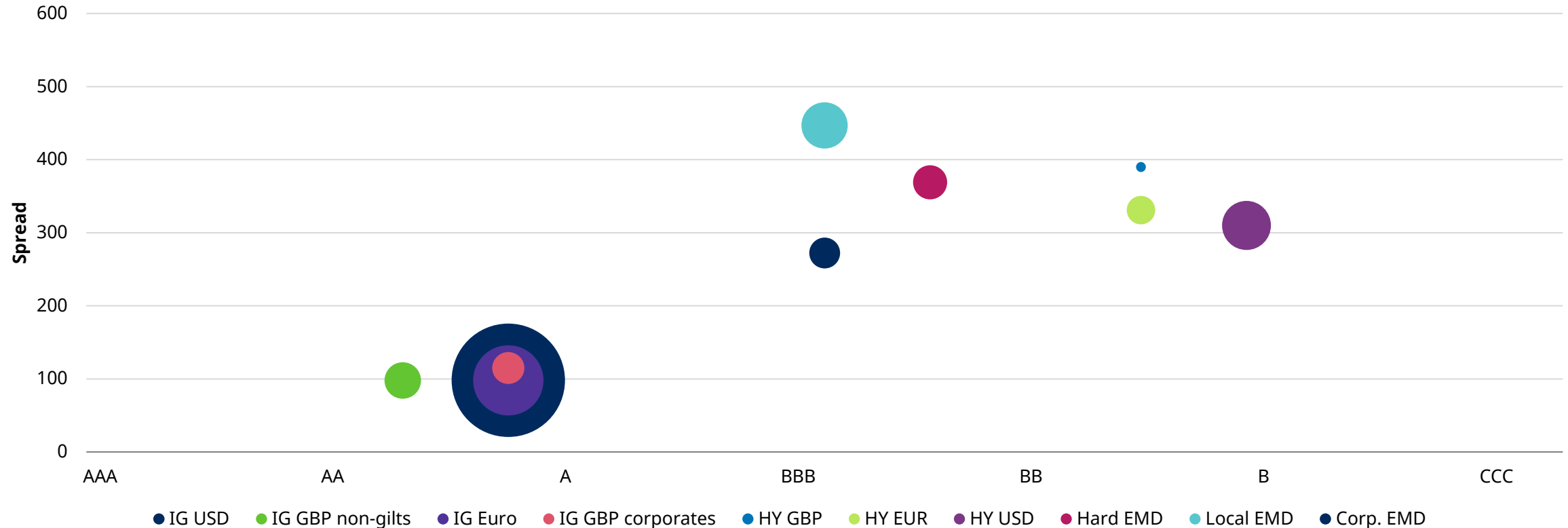


Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 December 2021.

Spread vs. credit rating vs. market size

The size of bubble is proportionate to the size of the market

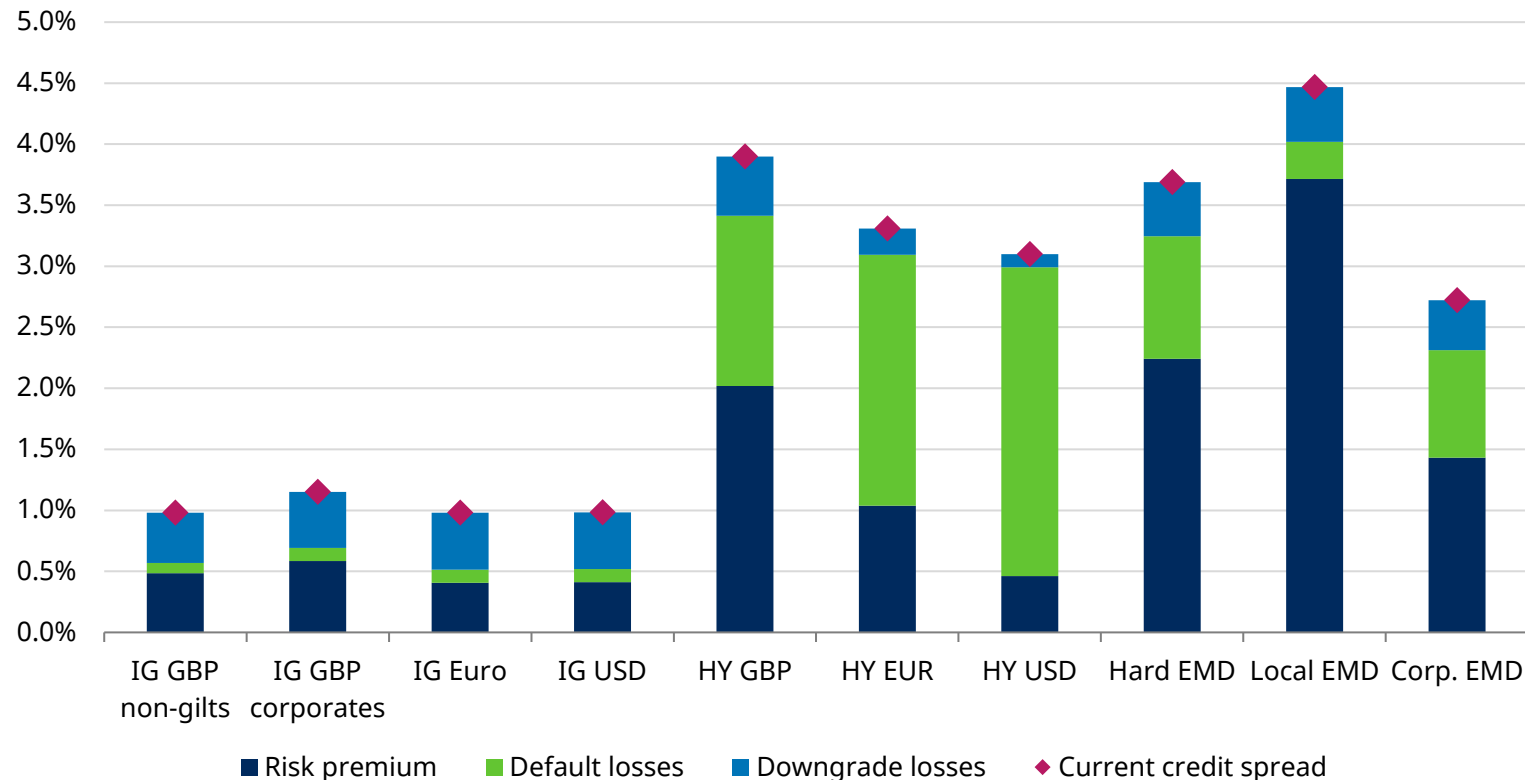
Spread vs credit rating vs market size



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 December 2021.

Risk premium/net spread in credit

Decomposition of credit spread into expected losses and expected risk premium



- IG is more exposed to **downgrade losses** (value of a bond falling after a downgrade), while **default losses** have been negligible
- Major losses in HY come from defaults that mostly happen in recessions
- Historically, investors have received a **risk premium** for having exposure to credit, as the average default and downgrade losses have been less than the average spread

Source: Schroders, Moody's default and recovery study 2019, ICE Data Indices, J.P.Morgan. Data as at 31 December 2021.

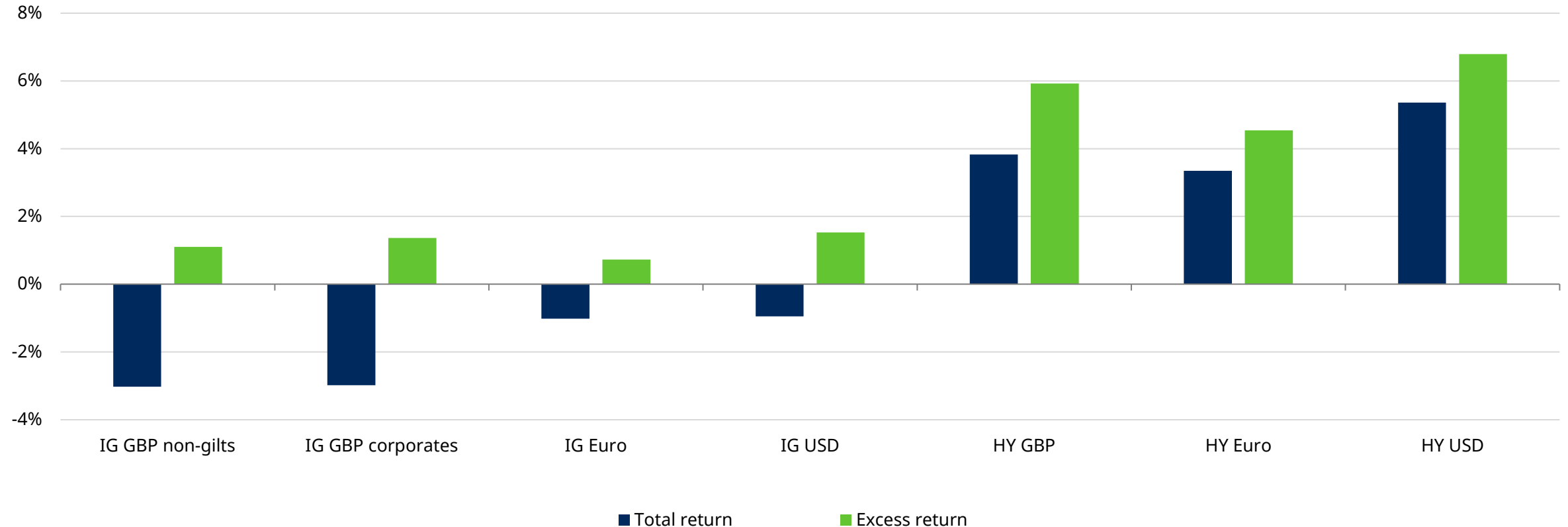
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Hot topics

All corporate credit indices posted positive excess returns¹ in 2021 but total returns were negative in IG

2021 corporate credit returns



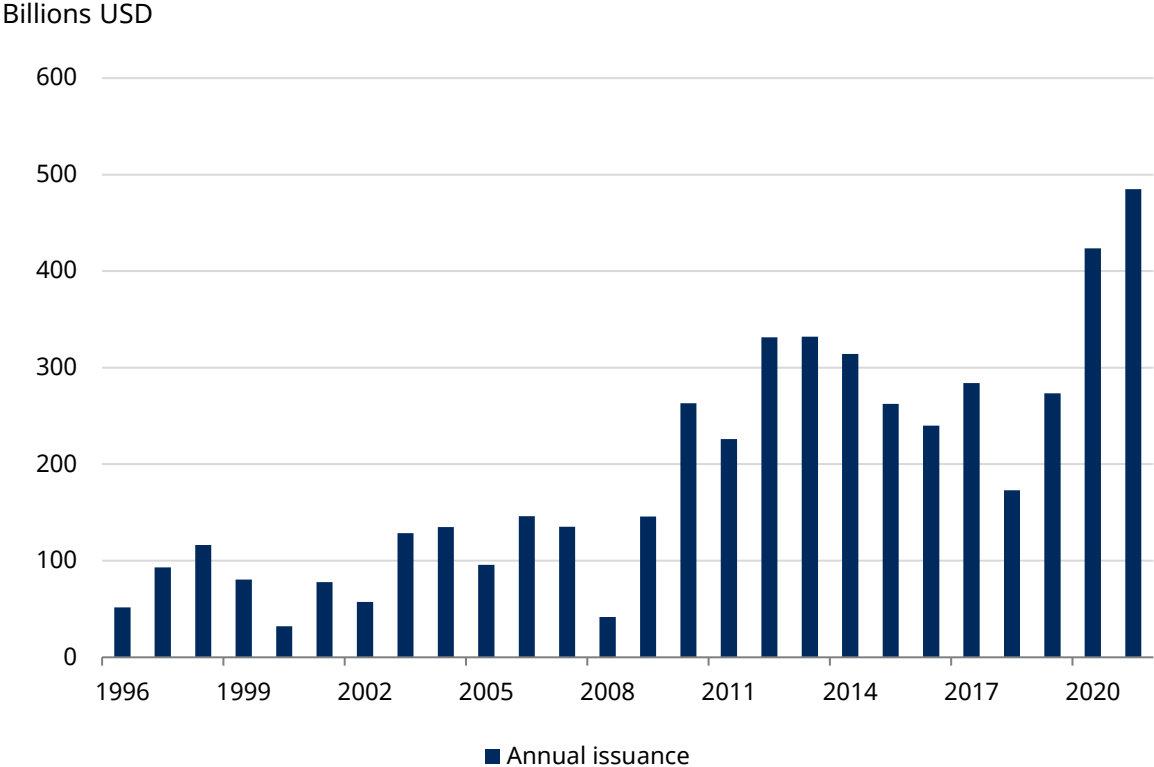
Higher duration of IG exposed it to rising bond yields

Past performance is not a guide to future performance and may not be repeated

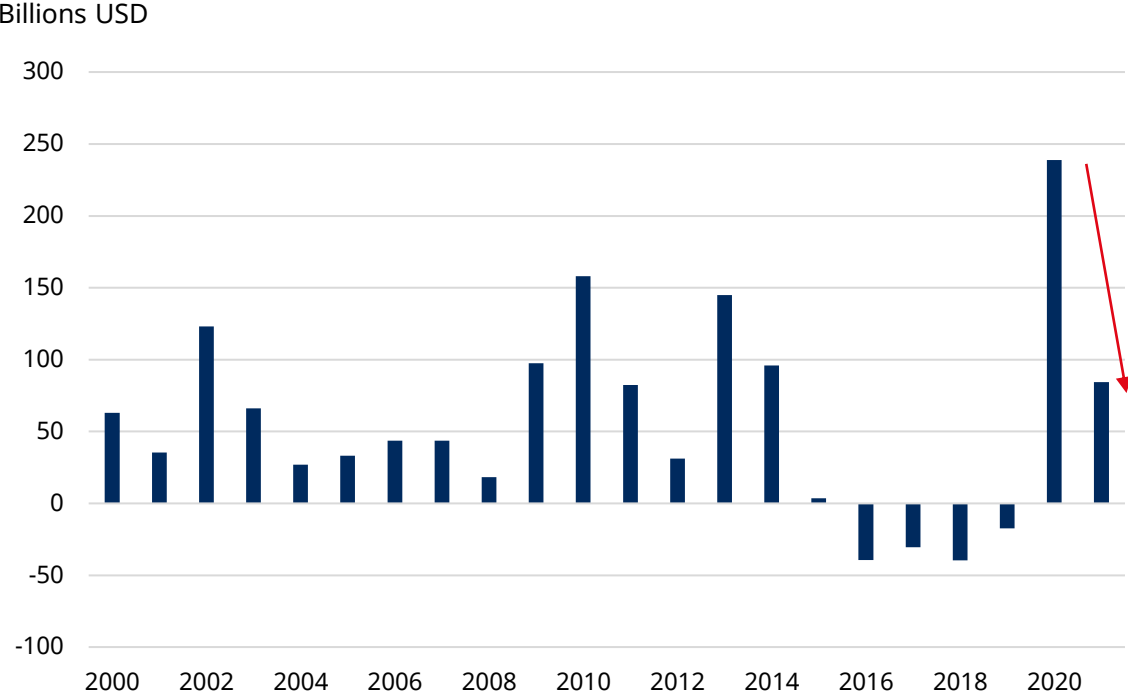
Source: Schroders, Refinitiv Datastream, ICE Data Indices. Data as at 31 December 2021. ¹Excess return is return over similar maturity government bond return.

Large volumes of bonds leaving US HY index partially offset record issuance

US HY gross issuance



US HY index annual change in face value



A large volume of calls and maturities and upgrades from HY to IG curtailed US HY index growth despite record gross issuance

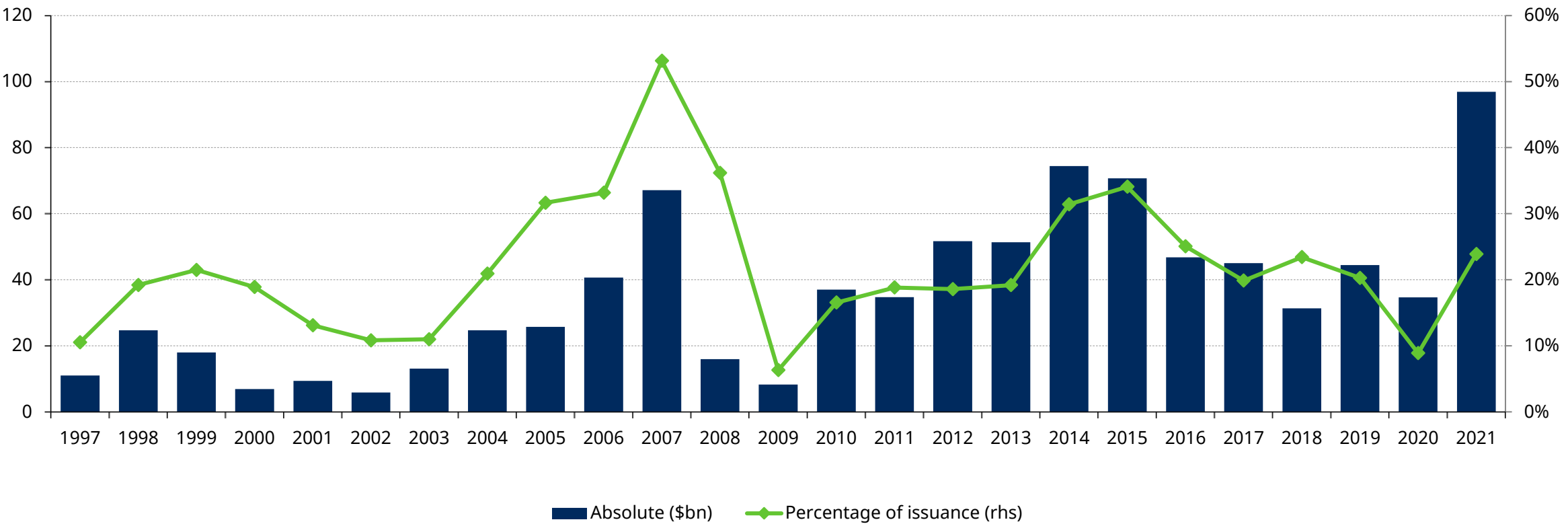
Source: Sifma, Refinitiv Datastream. Data as at 31 December 2021.

M&A/LBO related HY issuance exploded in 2021

More opportunistic issuance might start to put pressure on leverage

US HY LBO/M&A related issuance

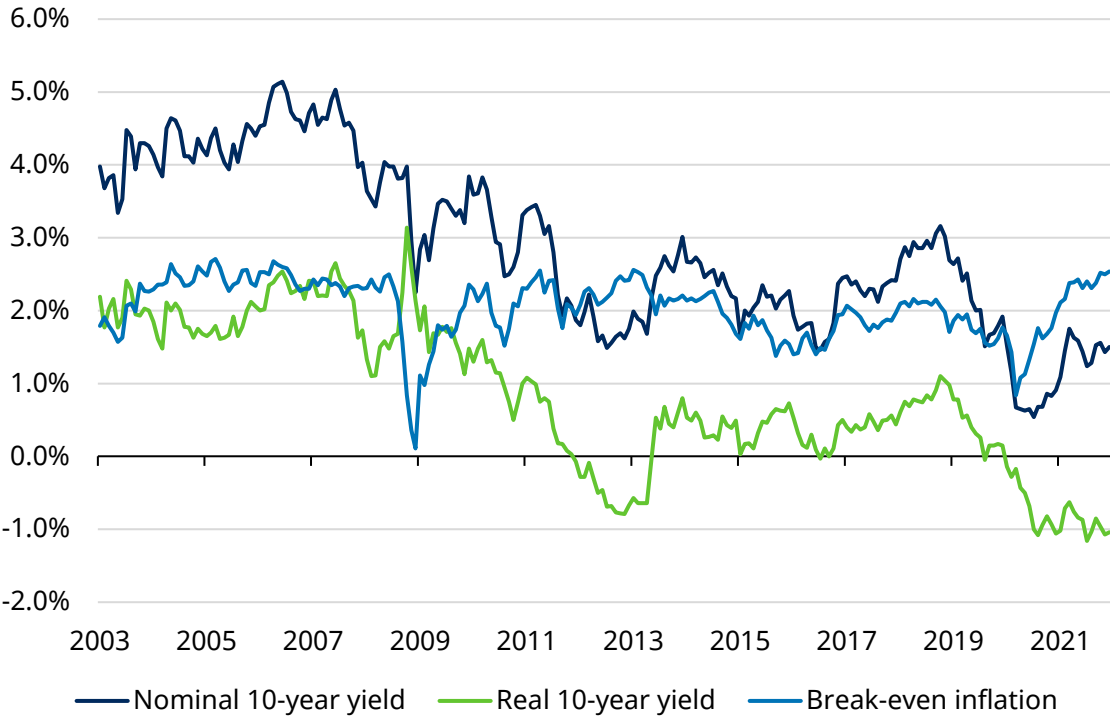
Billions USD



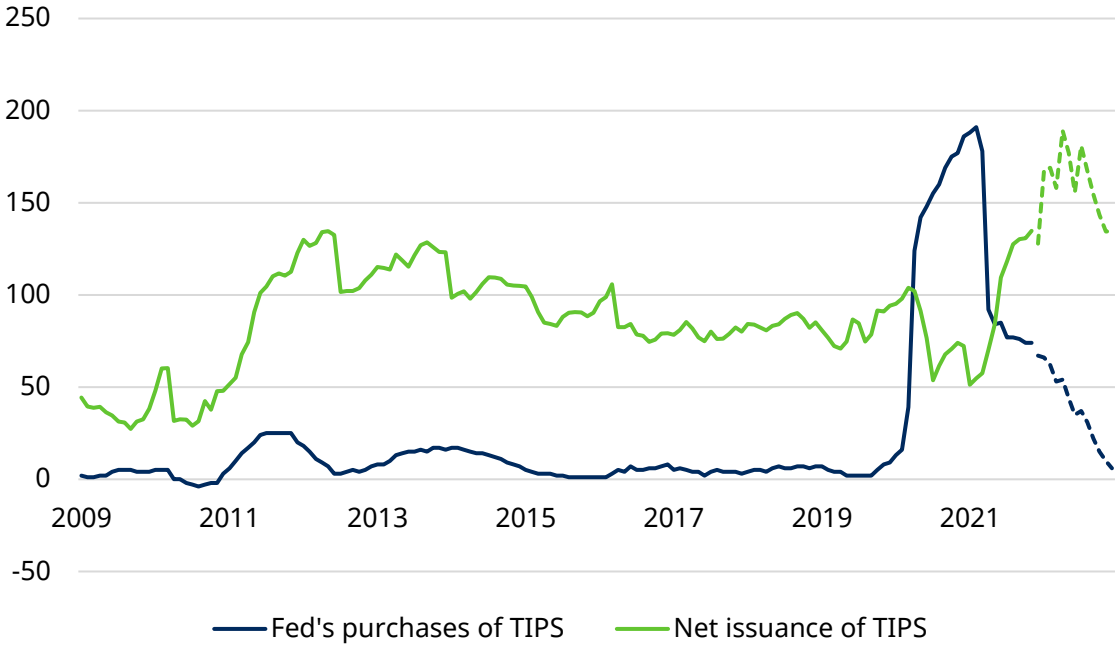
Source: BofA Global Research. Data as at 31 December 2021.

Higher real yields could become a headwind in 2022

US real yields have been hovering at record low levels



TIPS supply and Fed's purchases are moving in opposite directions in 2022 (billions \$)



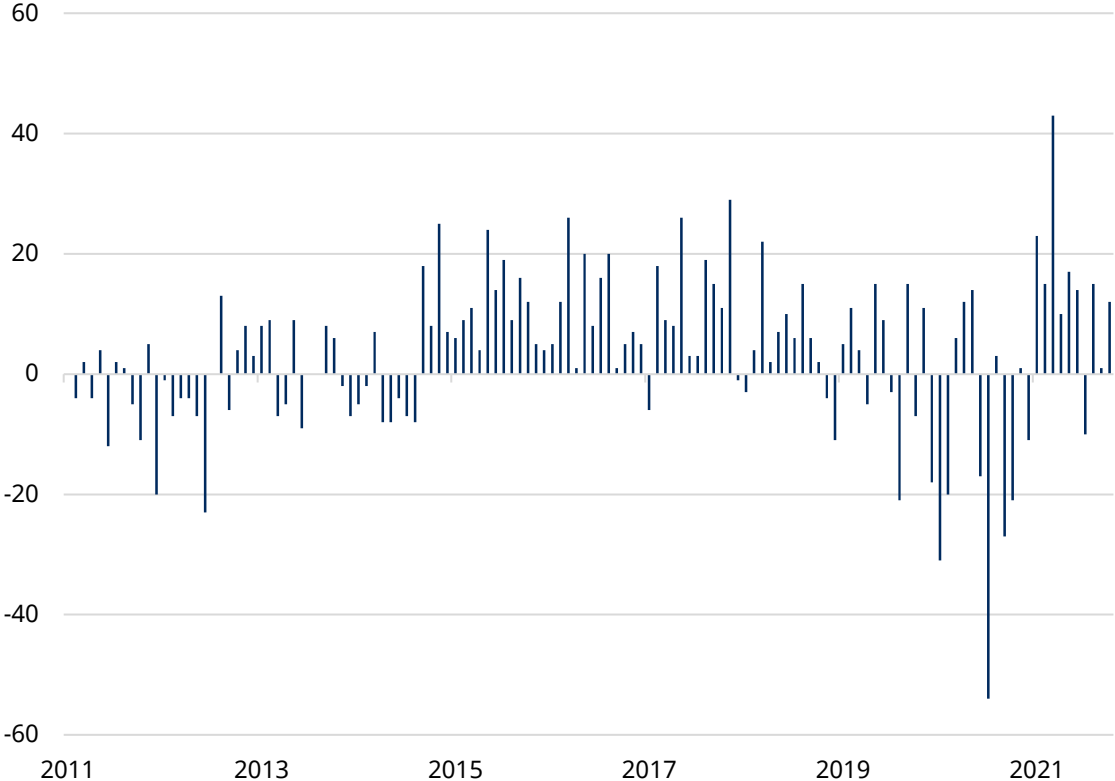
See more: [Why US real yields could rise in 2022](#)

Source: Schroders, Refinitiv Datastream. Left-hand figure data as at 31 December 2021. Break-even inflation is the difference between yields of nominal and inflation-protected US Treasury securities. Right-hand figure: actual data to 30 November 2021, assumptions thereafter. The Fed's monthly purchases assumed to decline to zero by April 2022. Monthly net TIPS issuance assumed to be \$11 billion, matching the average net issuance between December 2020 and November 2021.

Foreign demand for US credit remains stellar

Relatively high hedged yields are enticing European buyers

Foreign net purchases of US corporate bonds



Euro IG yield vs US IG yield hedged¹ to EUR

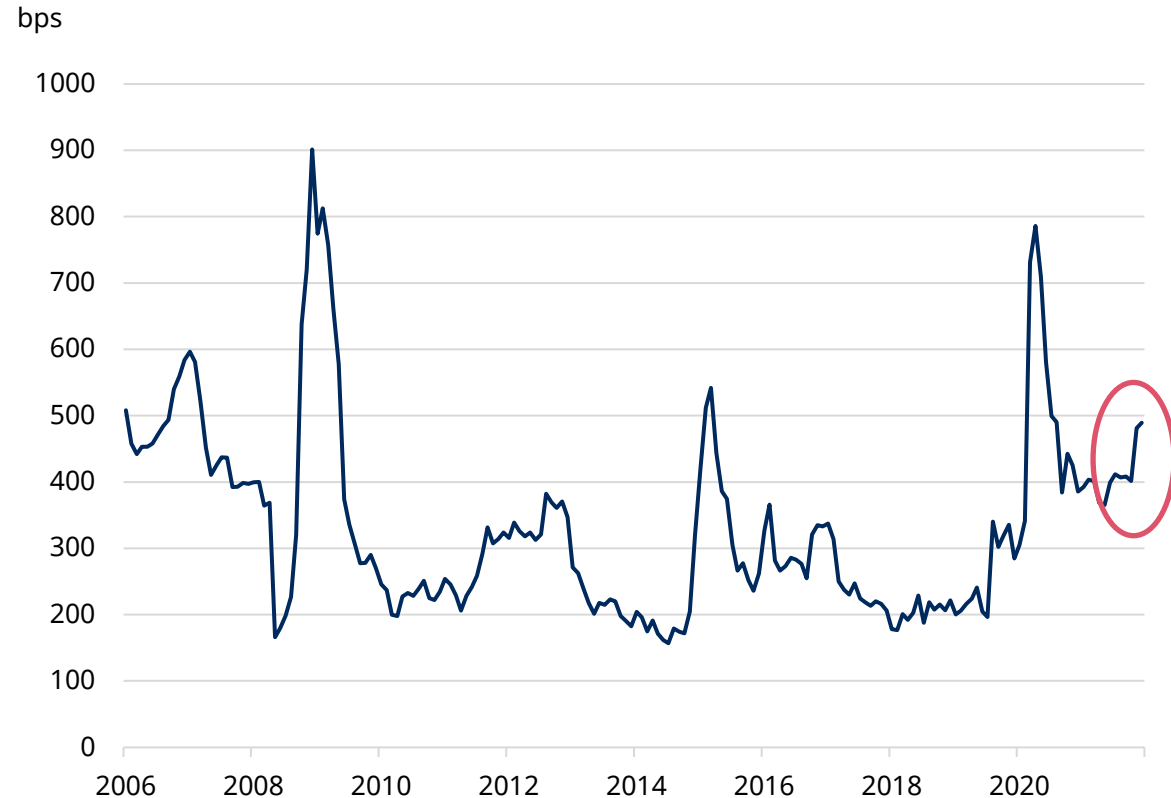


Hedged US IG yield provides 1.1% pick up over Euro IG yield for Euro investors

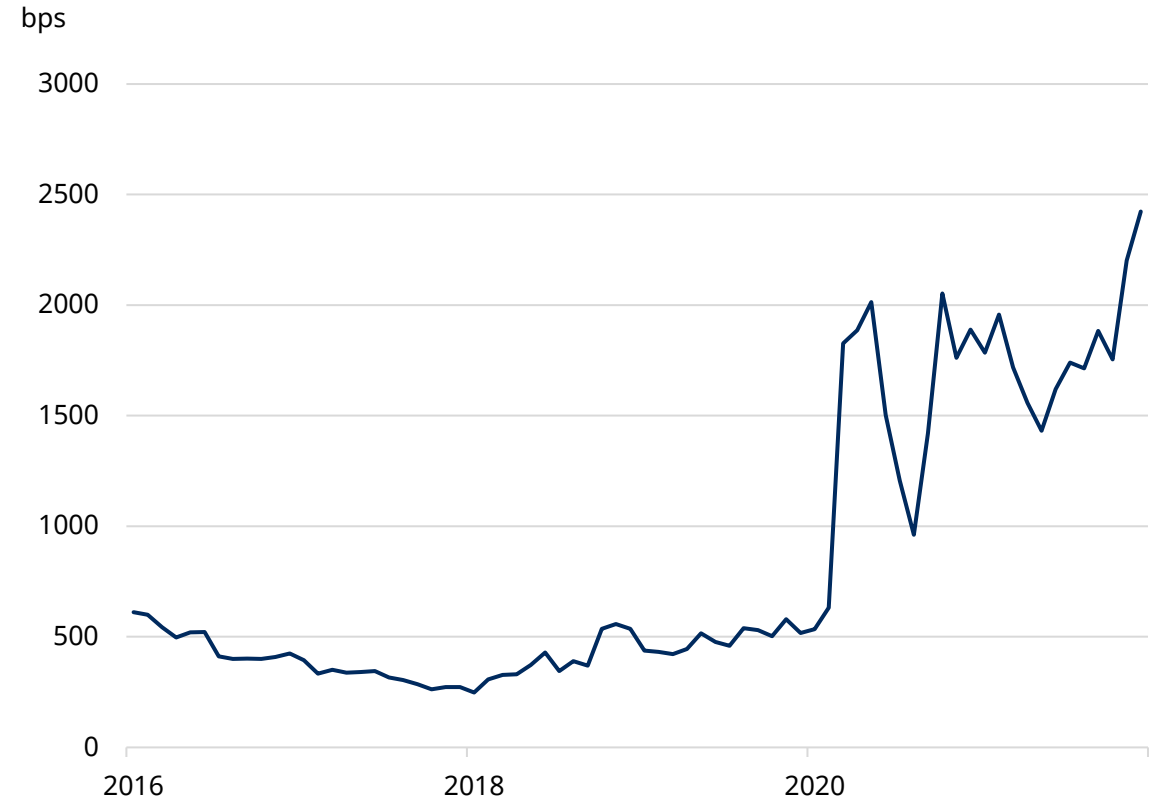
Source: Schroders, Refinitiv Datastream. Left-hand figure data as at 31 October 2021. Right-hand figure data as at 31 December 2021. ¹Hedged yield is local currency yield minus annualised 3-month FX hedging cost.

Some EM sovereigns are still under significant distress

Standard deviation of hard EMD spreads



EMBI Sri Lanka spread



Hard EMD spread dispersion is the highest since August 2020; the market thinks Sri Lanka could be heading for a default

Source: Schroders, Refinitiv Datastream. Data as at 31 December 2021.

Schroders

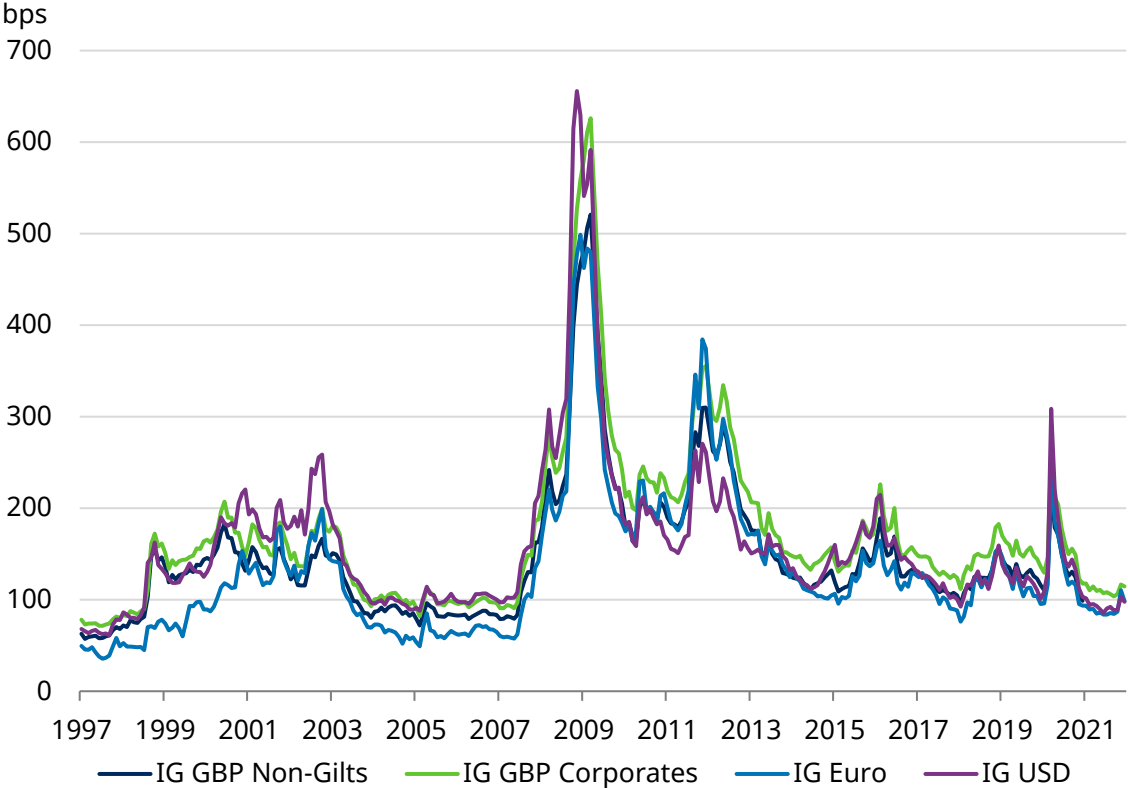


Corporate credit
Valuation

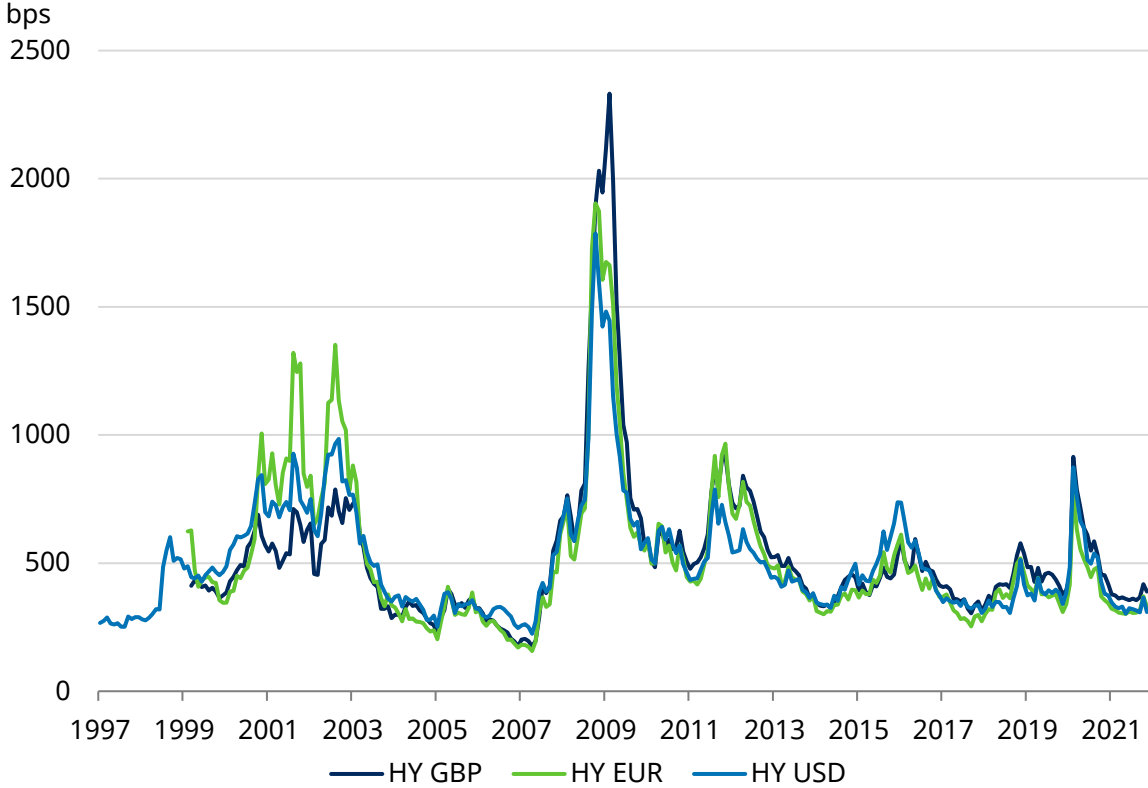
IG and HY valuation

Historical ratings-adjusted credit spreads

IG adjusted spreads



HY adjusted spreads

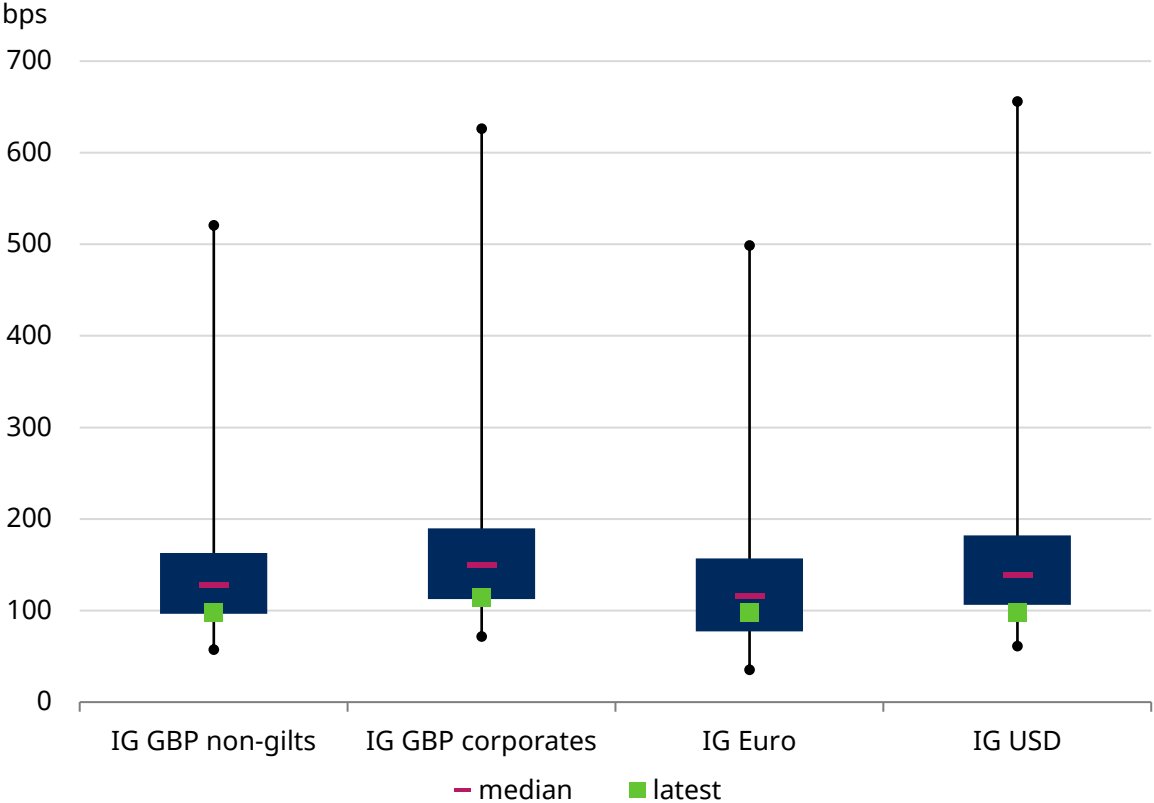


Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 December 2021. Spreads are adjusted for changes in the distribution of credit ratings within each index over time.

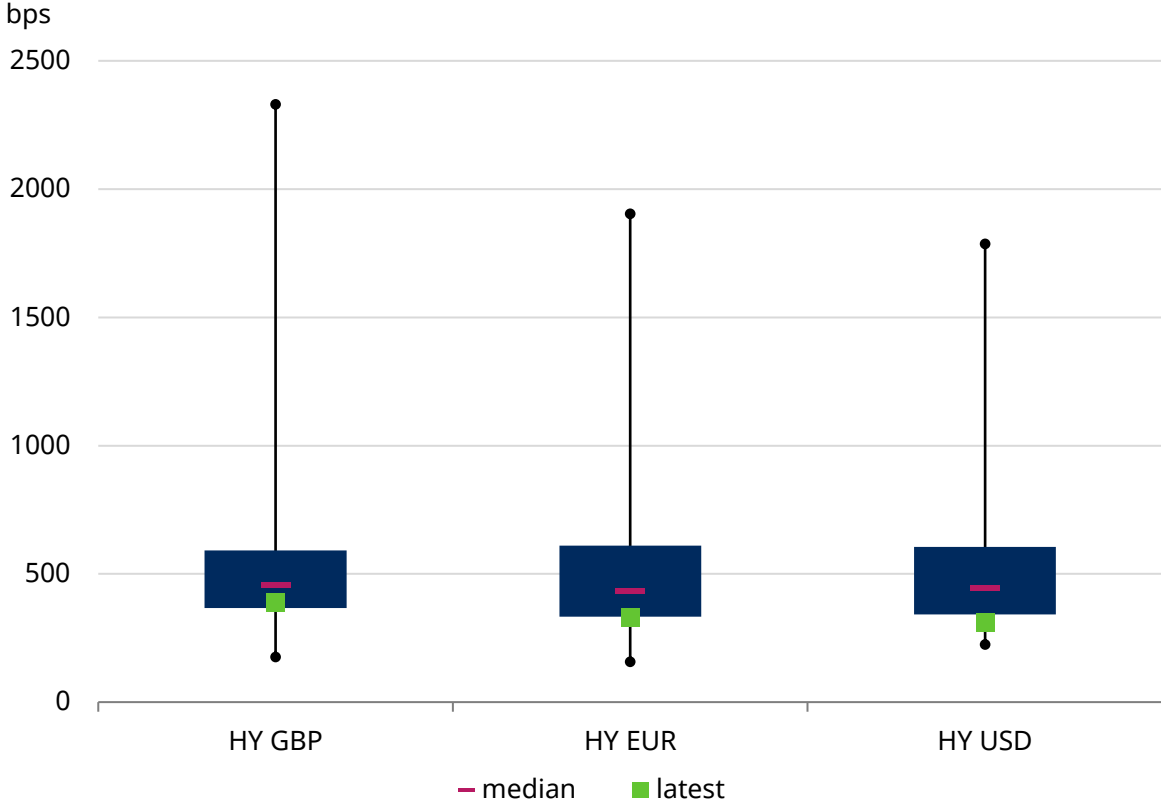
IG and HY valuation

Spread percentiles¹

IG adjusted spreads



HY adjusted spreads



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 December 2021. Spreads are adjusted for changes in the distribution of credit ratings within each index over time.
¹Percentiles shows where the current spread is relatively to the historical range of spreads, within a range of 0 to 100. The greater the percentile the higher the spread compared to history.

Schroders



Corporate credit
Fundamentals

Q3 corporate fundamentals summary

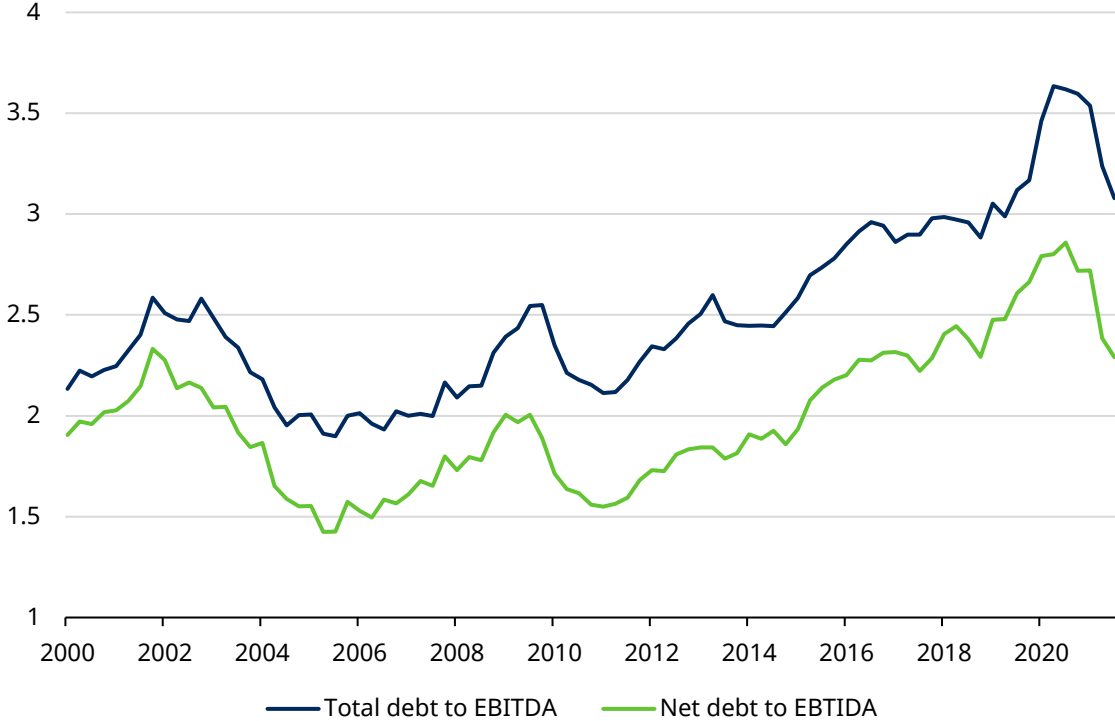
- **Corporate fundamentals improved in Q3, as strong earnings growth continues to facilitate deleveraging and low bond yields allow companies to refinance higher-yielding debt**
- Net leverage is now well below pre-Covid levels and even back to 2015 levels in some markets. Analysts expect earnings growth to remain solid in 2022 and beyond
- However, there are first signs that leverage could start to move higher again. In HY, record issuance seems to be cancelling out strong earnings growth in some sectors
- In IG, limited M&A related issuance has dampened the debt growth so far. Should M&A issuance increase in 2022, it will be harder to keep leverage on a downward path
- Cash levels are falling as companies are putting excess cash to work, either through capex or dividends/share buybacks. Corporate behaviour is likely to become more equity friendly in 2022
- Margins remain very strong. There are no signs yet that higher input costs are having a significant impact. Fading supply bottlenecks should be a positive

US IG leverage

Strong earnings growth continues to support deleveraging

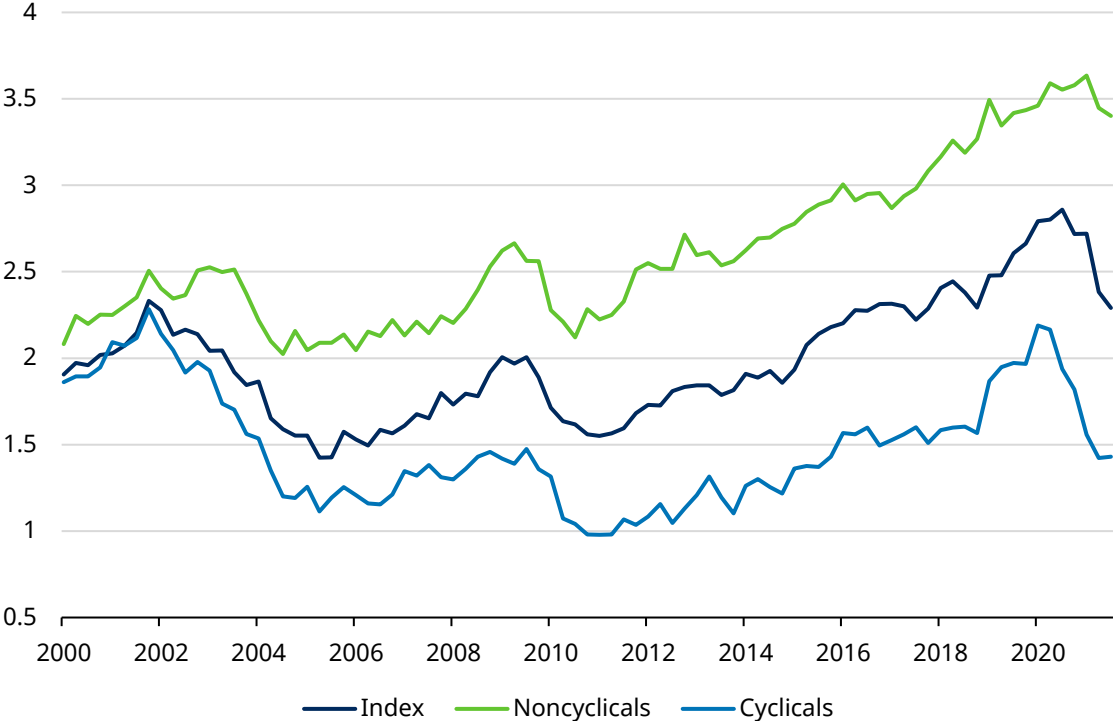
US IG leverage

Debt to last 12 months EBITDA



US IG net leverage

Net debt to last 12 months EBITDA



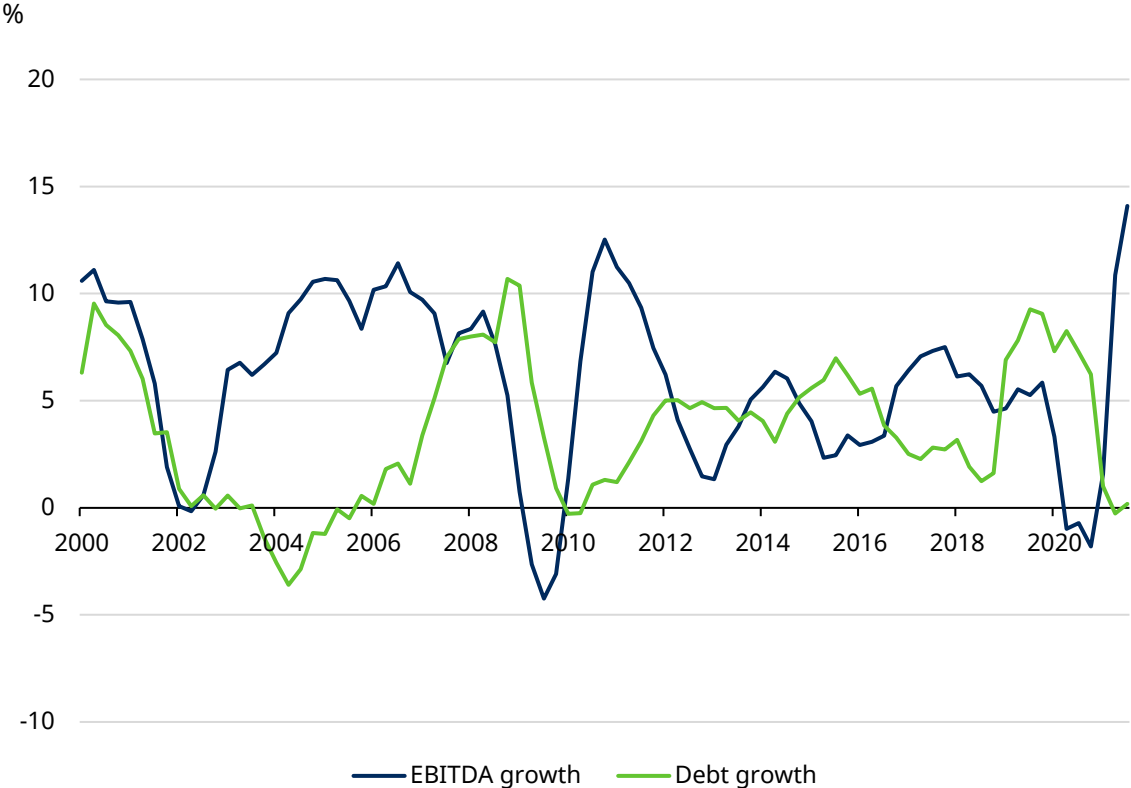
Noncyclical sectors have made less progress than cyclical sectors...

Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as of Q3 2021.

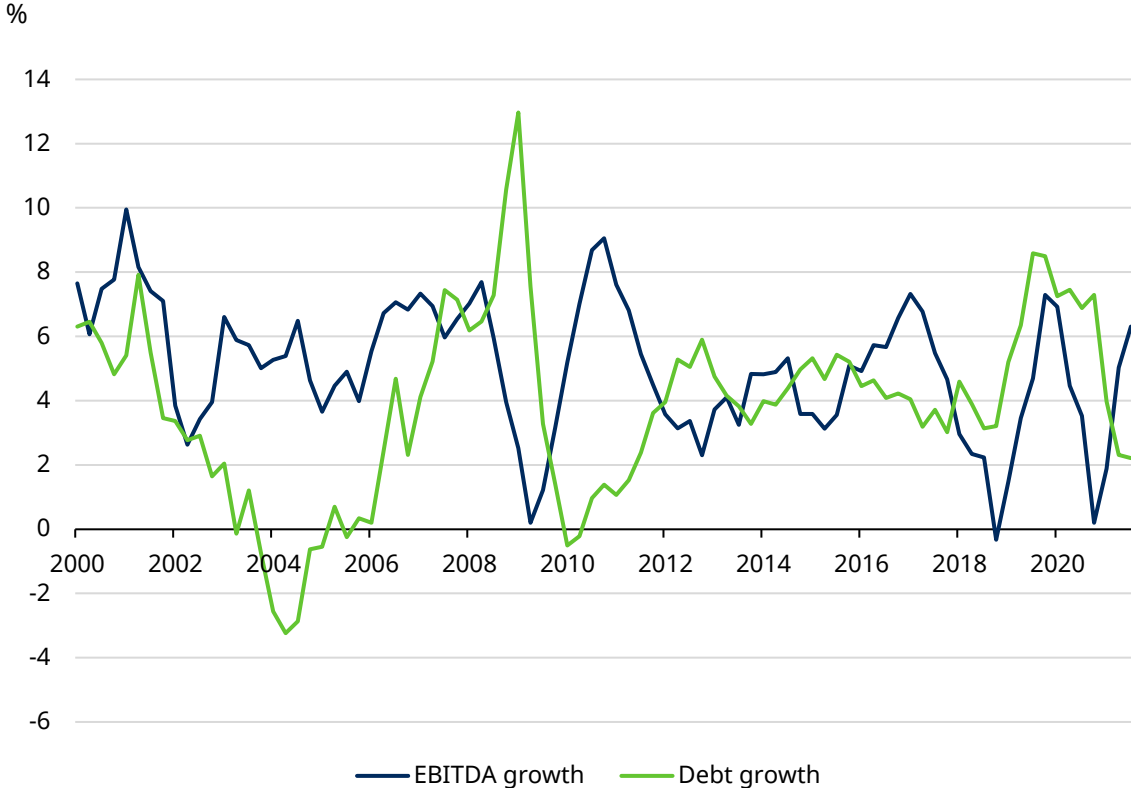
Cyclical sectors: Basic Materials, Consumer Discretionary, Industrials, Technology. **Noncyclical sectors:** Communications, Consumer Staples, Utility, Health Care.

US IG earnings and debt growth

US IG EBITDA and debt growth (last 12 months)



US IG EBITDA and debt growth of noncyclical sectors



...because of less stellar earnings growth

Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as of Q3 2021.

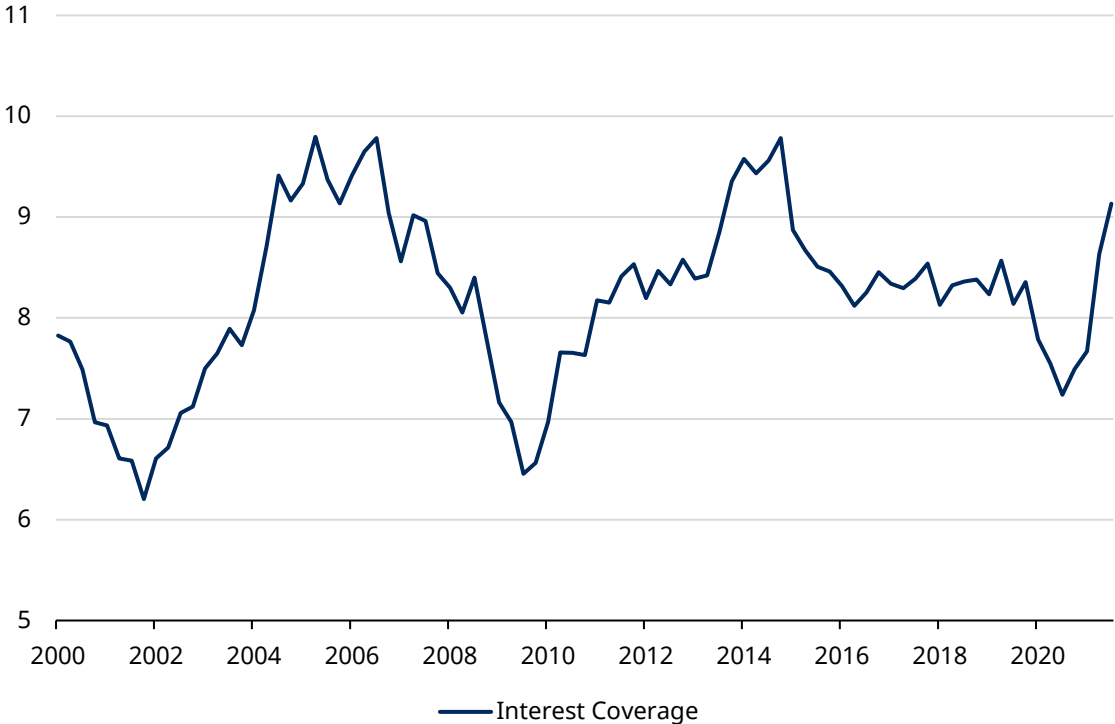
Cyclical sectors: Basic Materials, Consumer Discretionary, Industrials, Technology. **Noncyclical sectors:** Communications, Consumer Staples, Utility, Health Care

US IG interest coverage

Interest coverage well above the pre-Covid level

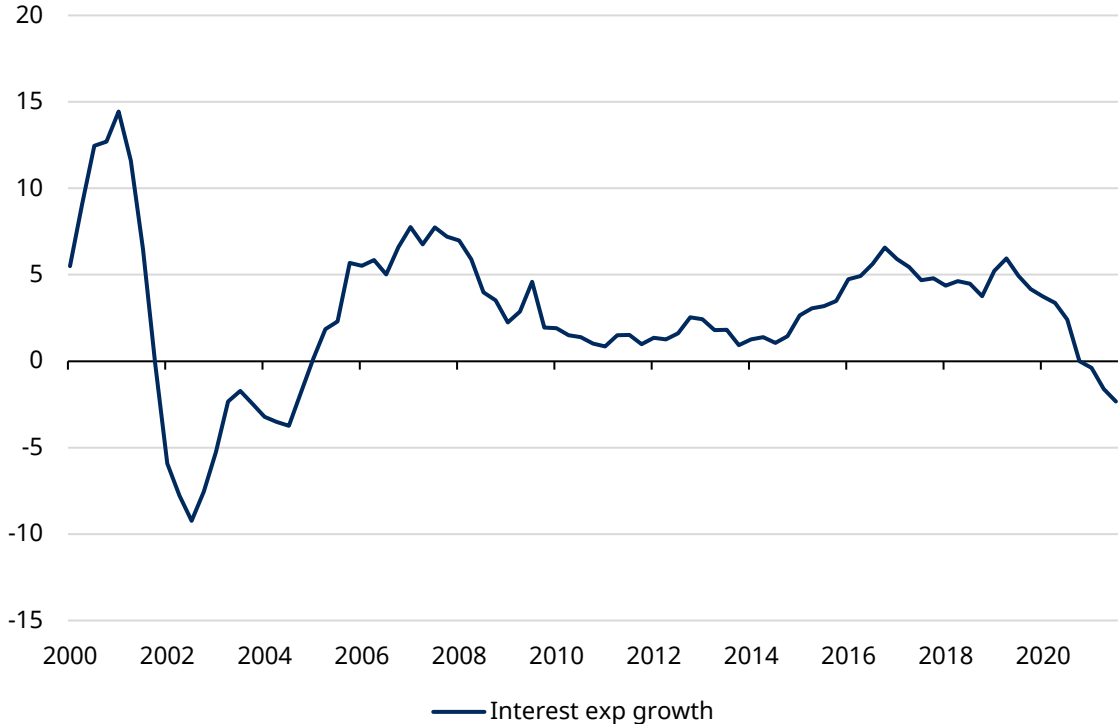
US IG interest coverage ratio

Last 12 months EBITDA to interest expense



US IG annual interest expense growth

%

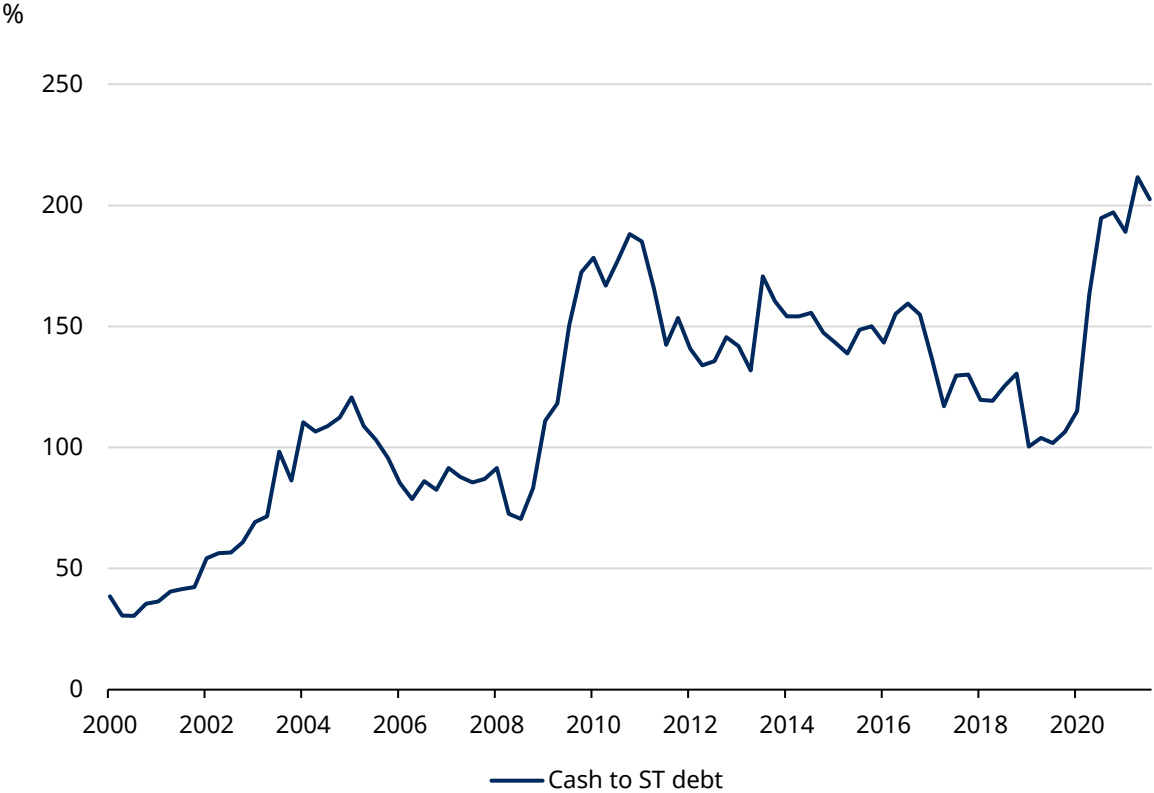


Refinancing is continues to drive interest costs lower

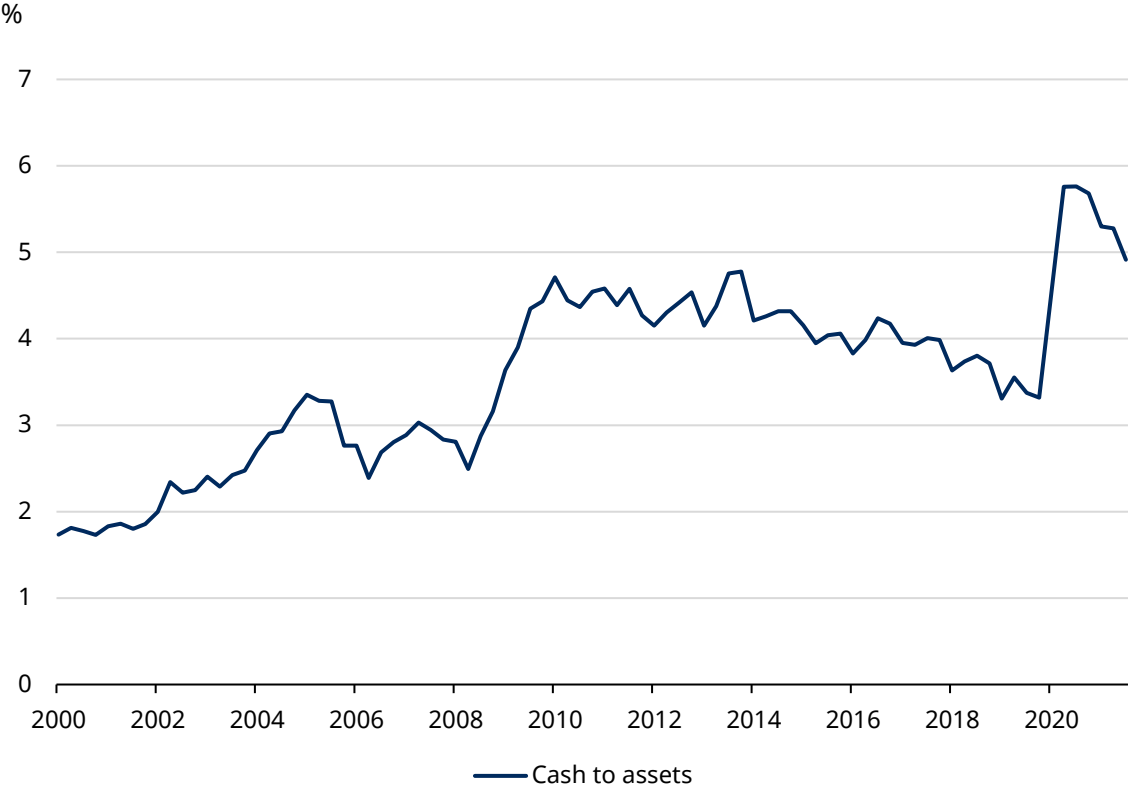
Source: Schrodgers, Bloomberg. Median issuer ex-Financials. Data as of Q3 2021.

US IG cash balances fell in Q3

US IG cash to short term debt



US IG cash to assets



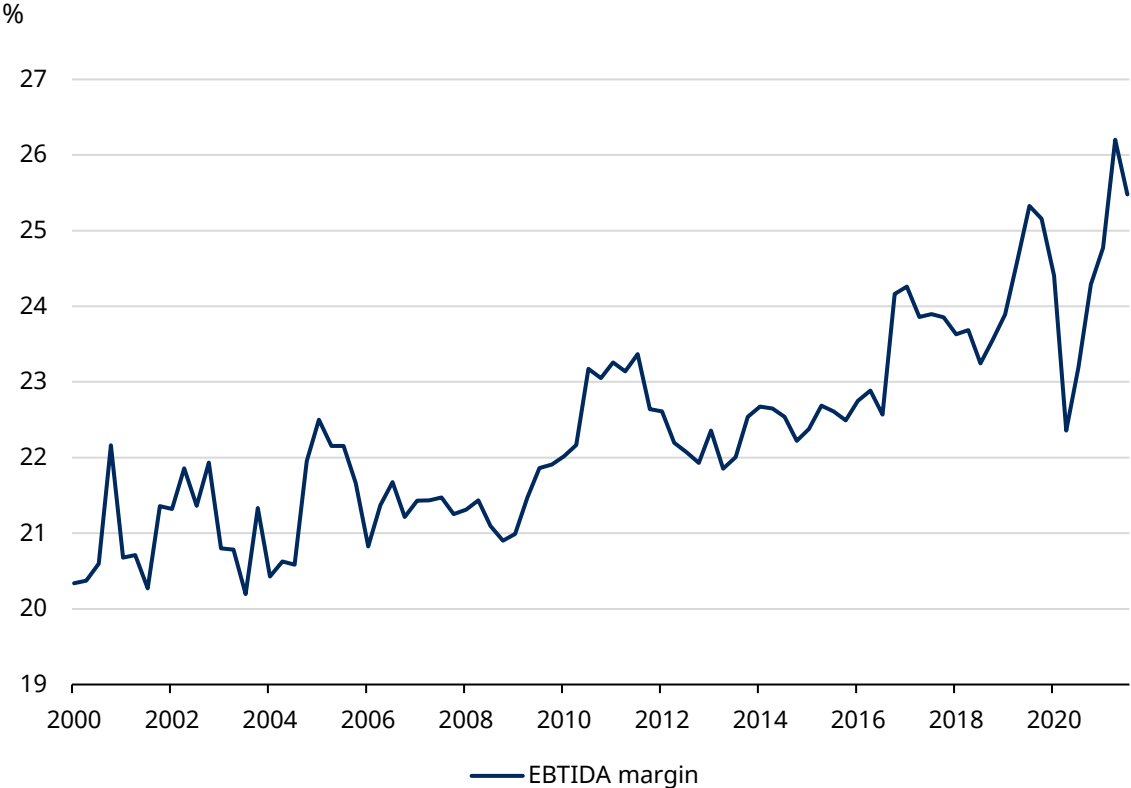
Despite lower cash levels, most companies continue to carry significant liquidity buffers

Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as of Q3 2021.

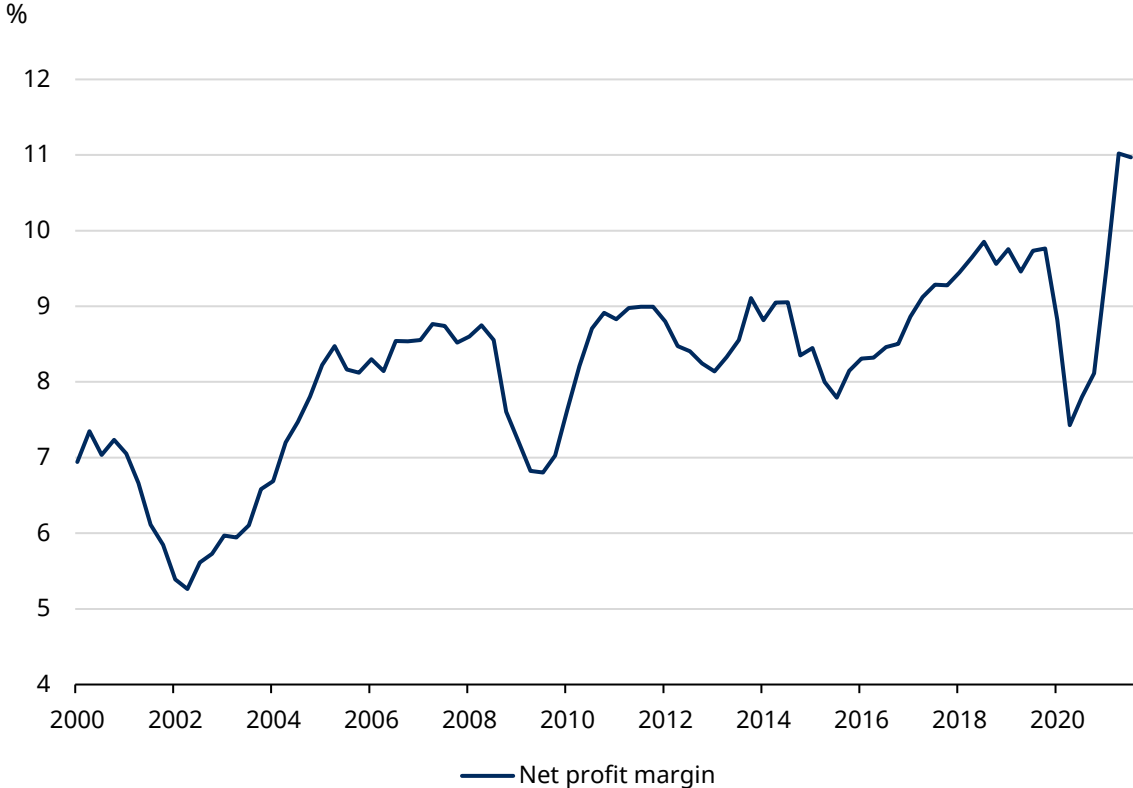
US IG corporate margins

Margins fell slightly in Q3 but remain very elevated compared to history

US IG EBITDA margin



US IG net profit margin

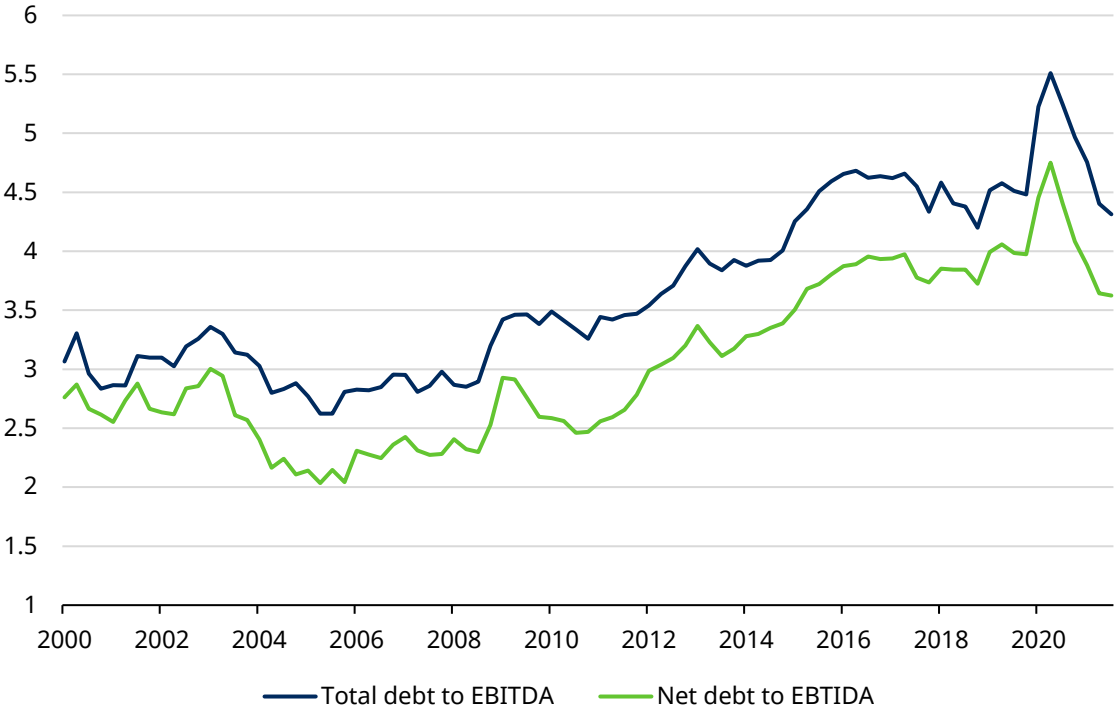


Source: Schrodgers, Bloomberg. Median issuer ex-Financials. Data as of Q3 2021.

US HY leverage

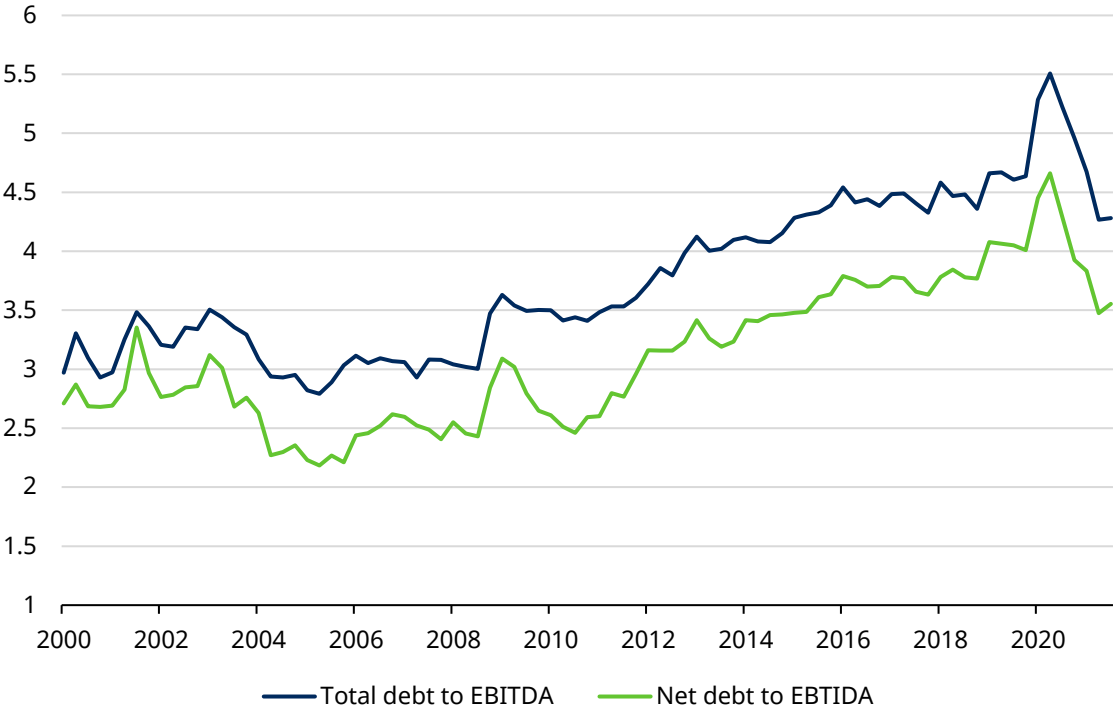
US HY leverage

Debt to last 12 months EBITDA



US HY ex-energy leverage

Debt to last 12 months EBITDA



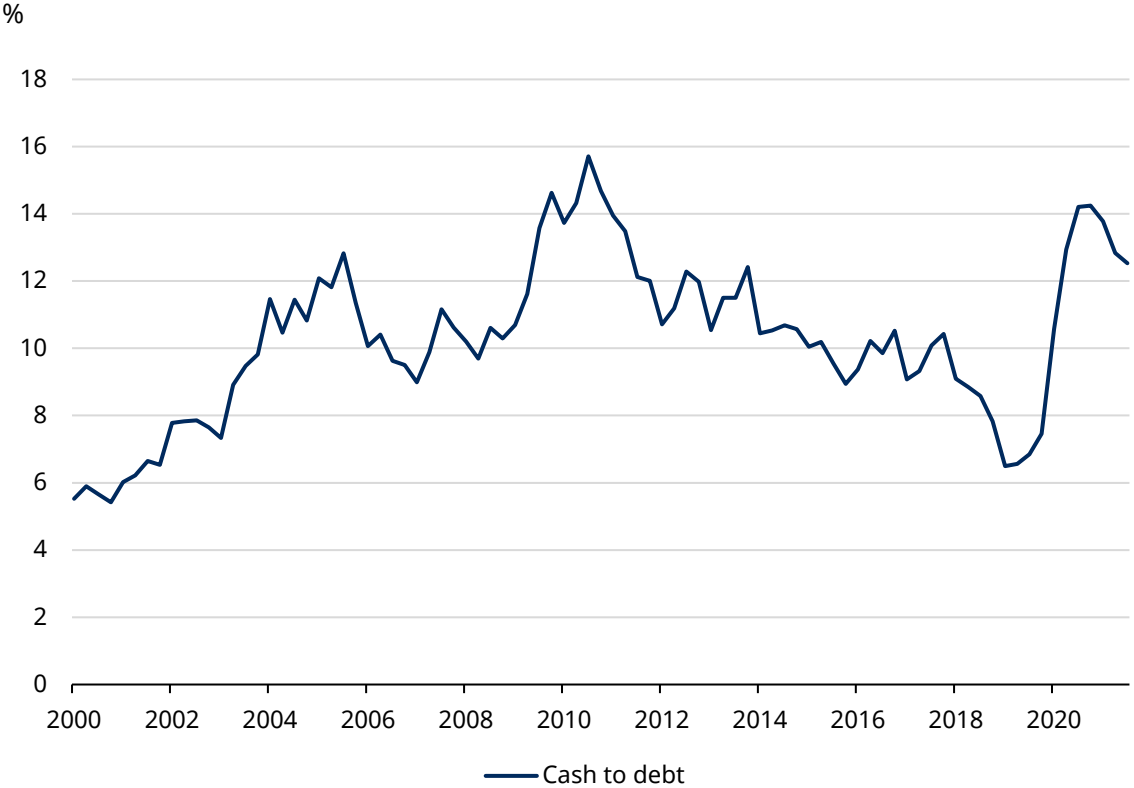
Ex-energy leverage increased fractionally in Q3, indicating that renewed debt growth could soon start to push leverage higher again

Source: Schrodgers, Bloomberg. Median issuer ex-Financials. Data as of Q3 2021.

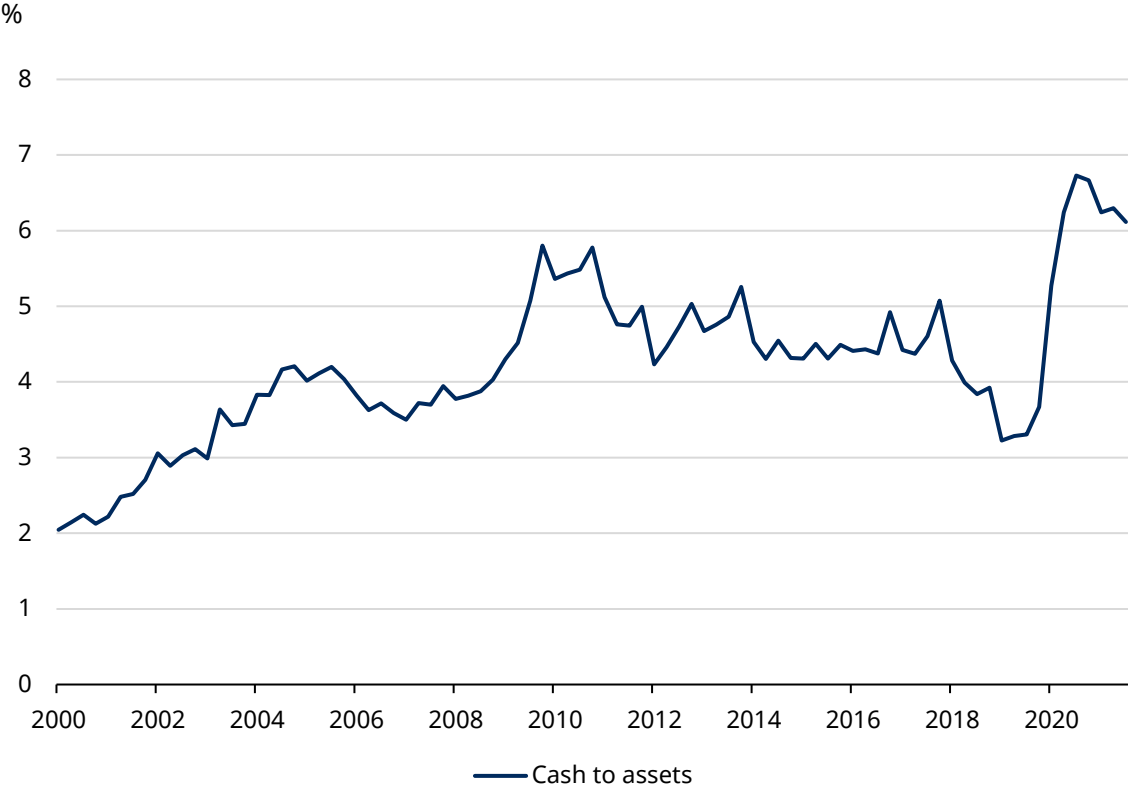
US HY cash levels

Cash balances have fallen slightly

US HY cash to debt



US IG cash to assets



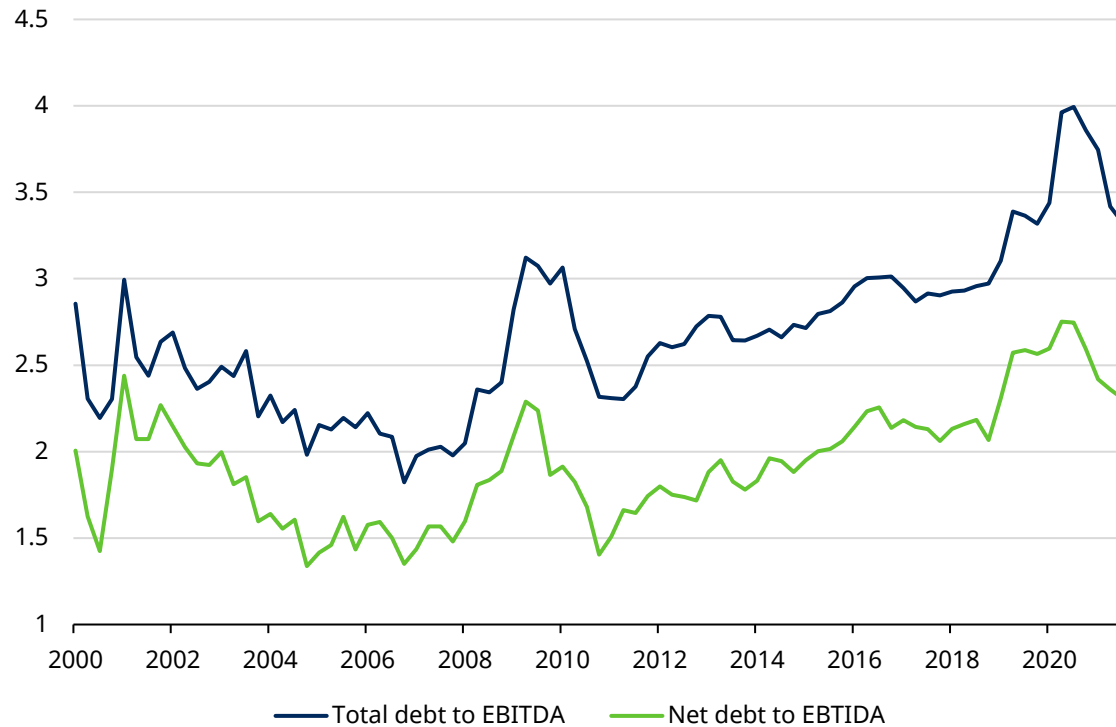
Source: Schroders, Bloomberg. Median issuer ex-Financials. Data as of Q3 2021.

Euro IG leverage

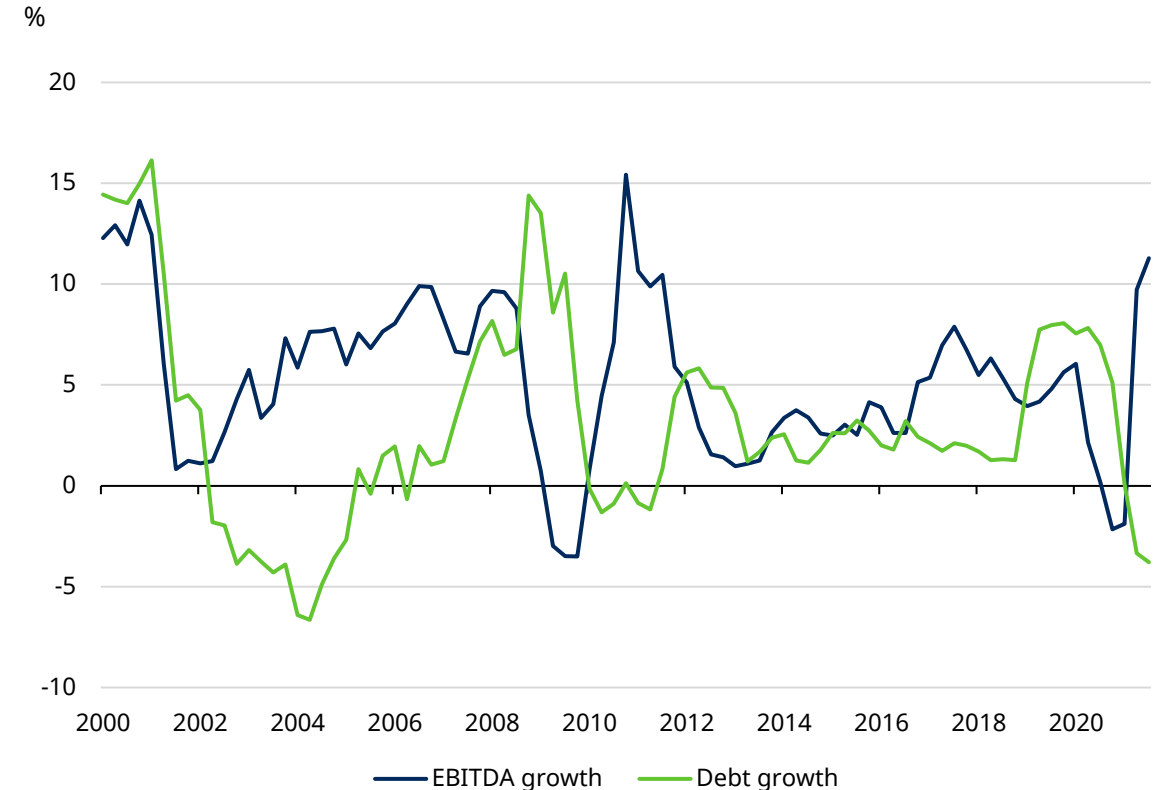
Leverage is falling but at a slightly slower pace than in US

Euro IG leverage

Debt to last 12 months EBITDA



Euro IG EBITDA and debt growth (last 12 months)



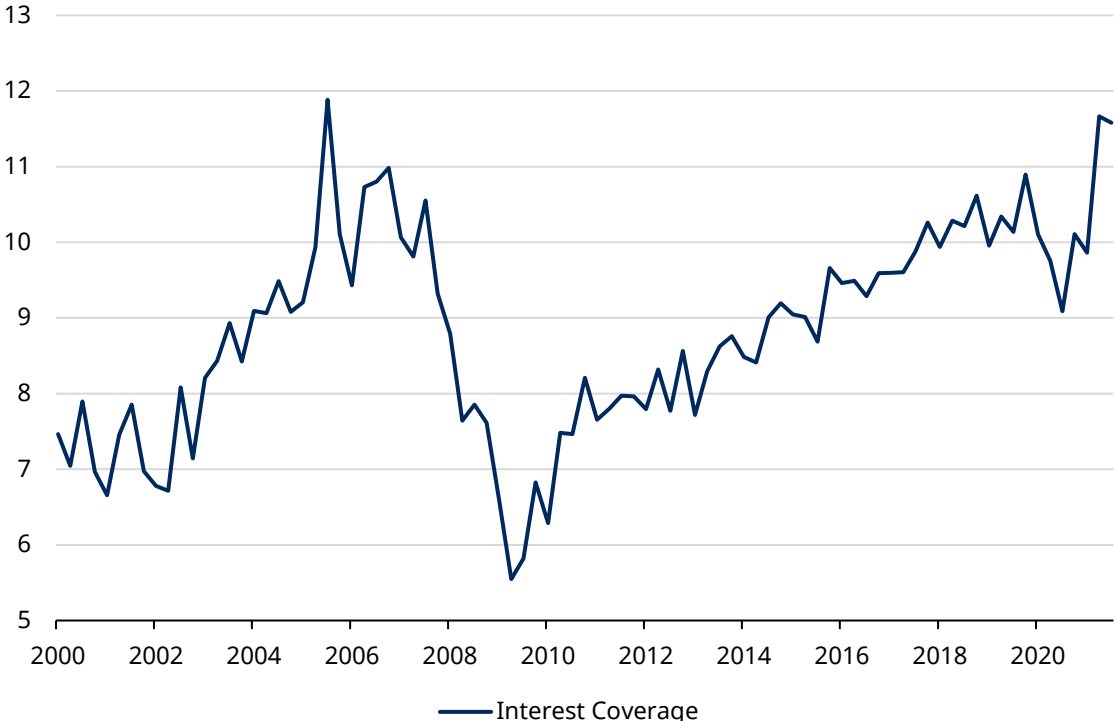
European companies have made up for slower EBITDA growth with more aggressive debt cutting

Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as of Q3 2021.

Euro IG interest coverage

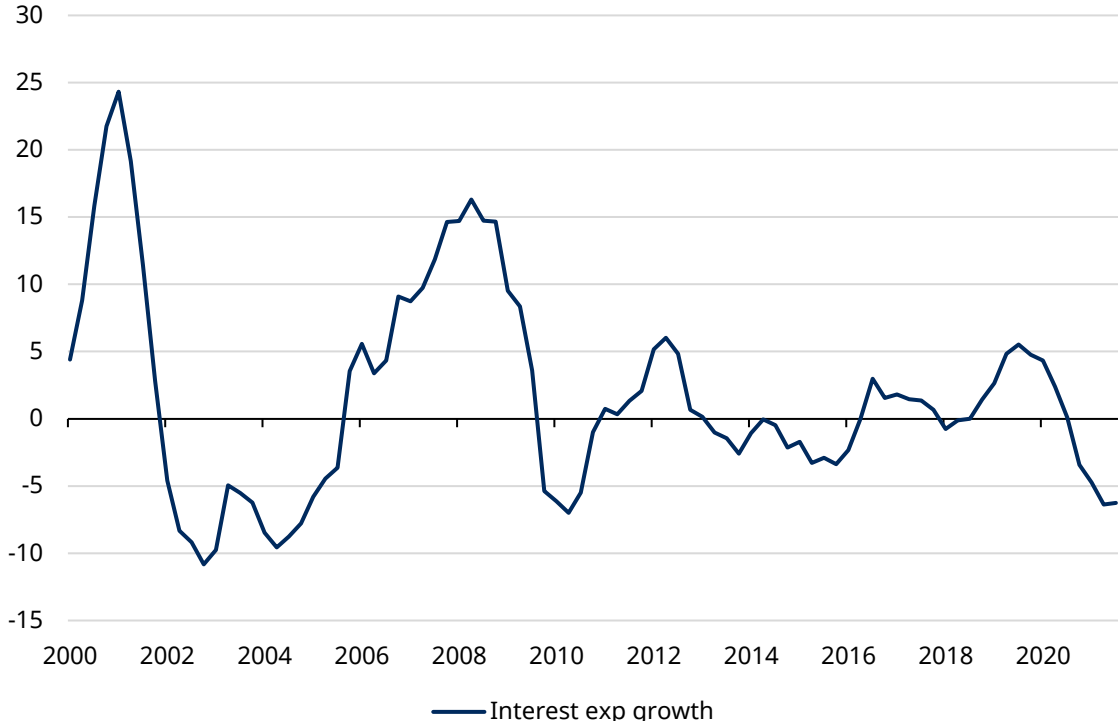
Euro IG interest coverage ratio

Last 12 months EBITDA to interest expense



Euro IG annual interest expense growth

%



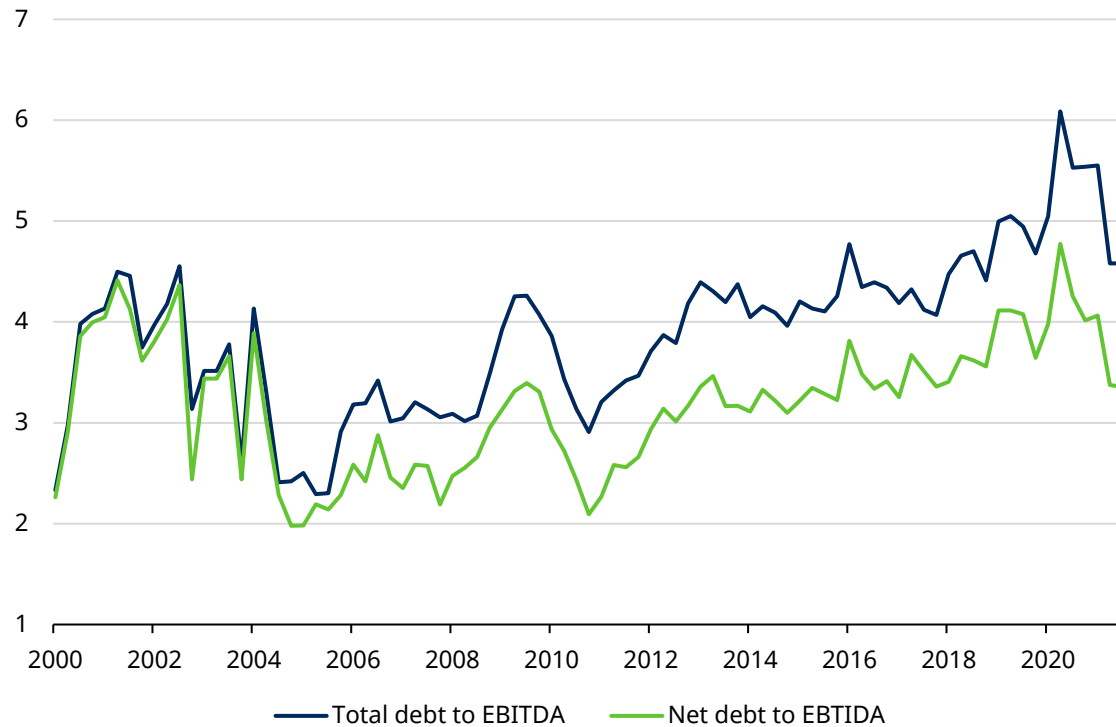
Source: Schroders, Bloomberg, Median issuer ex-Financials. Data as of Q3 2021.

Euro HY leverage

Leverage seems to be stabilising after a sharp drop

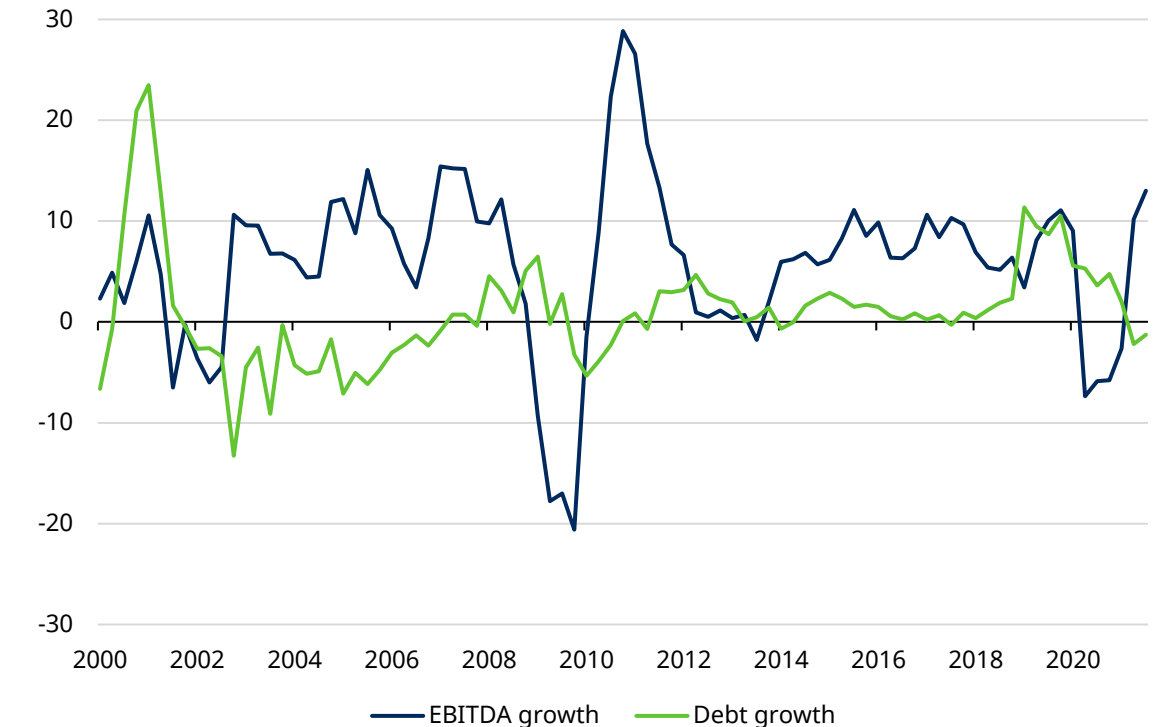
Euro HY leverage

Debt to last 12 months EBITDA



Euro HY EBITDA and debt growth (last 12 months)

%



Source: Schrodgers, Bloomberg. Median issuer ex-Financials. Data as of Q3 2021.

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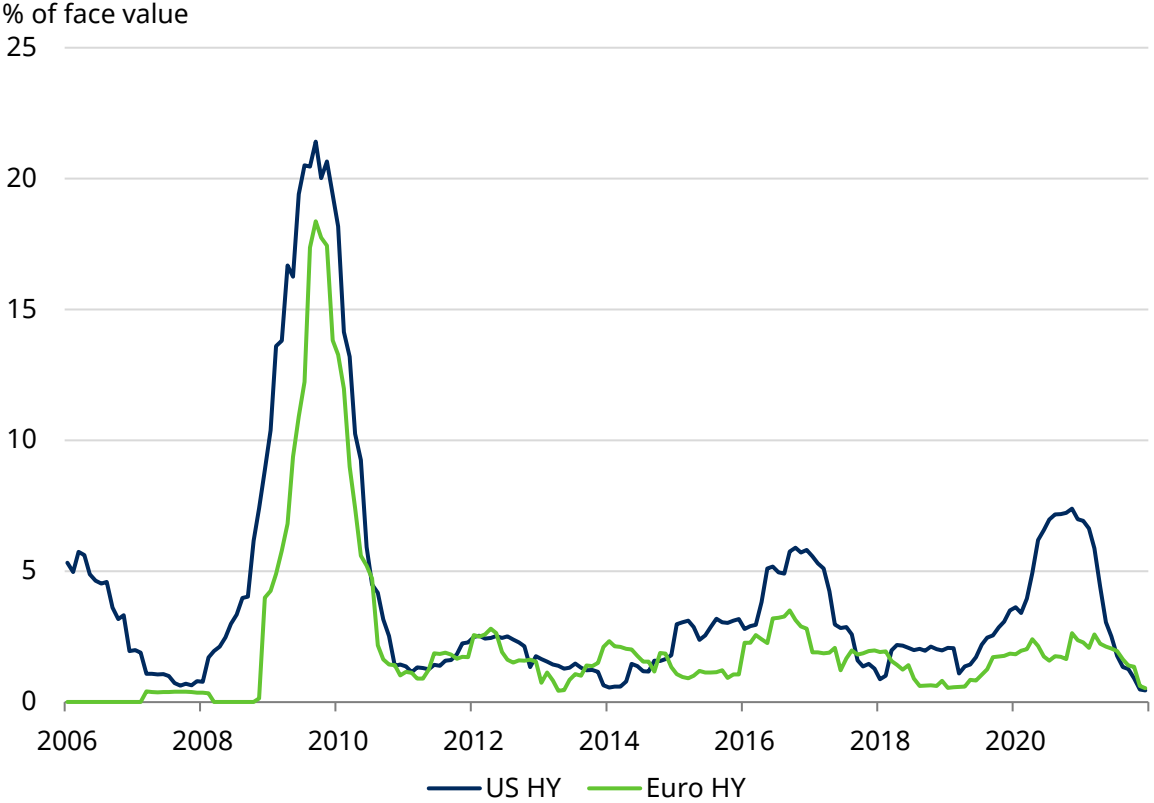


Corporate credit

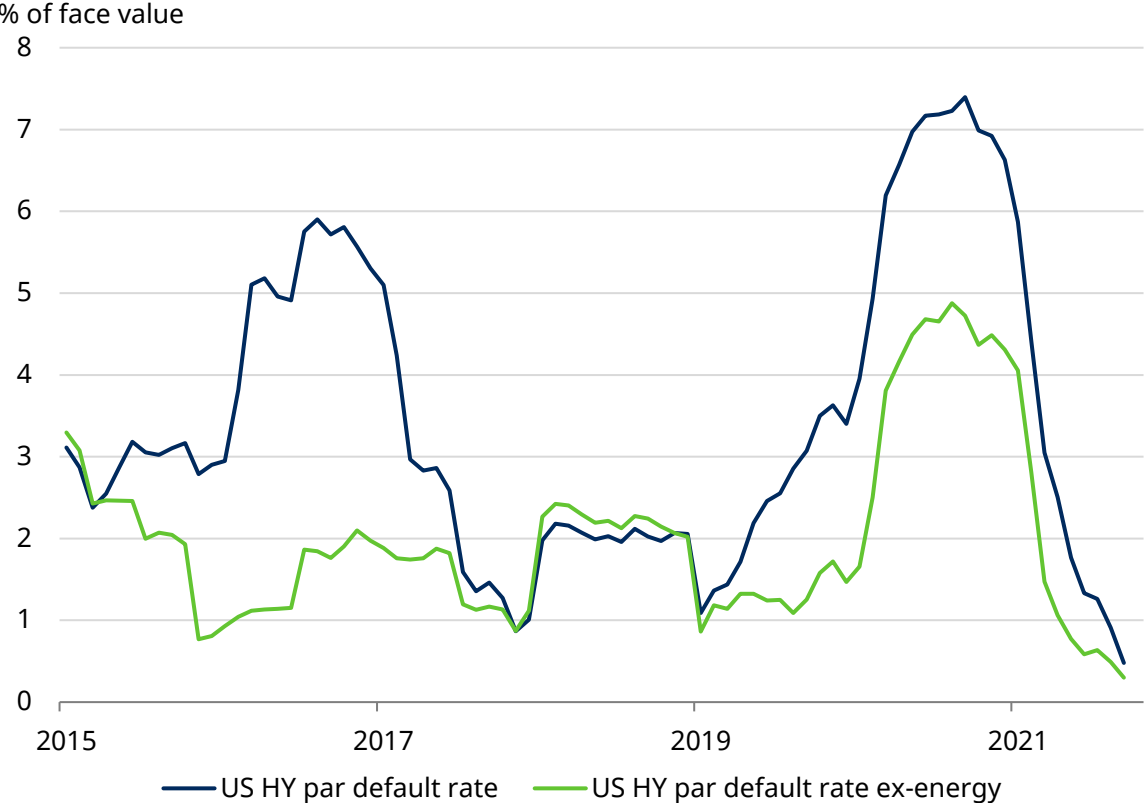
Technicals

HY default rates

HY par default rate (last twelve months)



US HY par default rate (last twelve months)



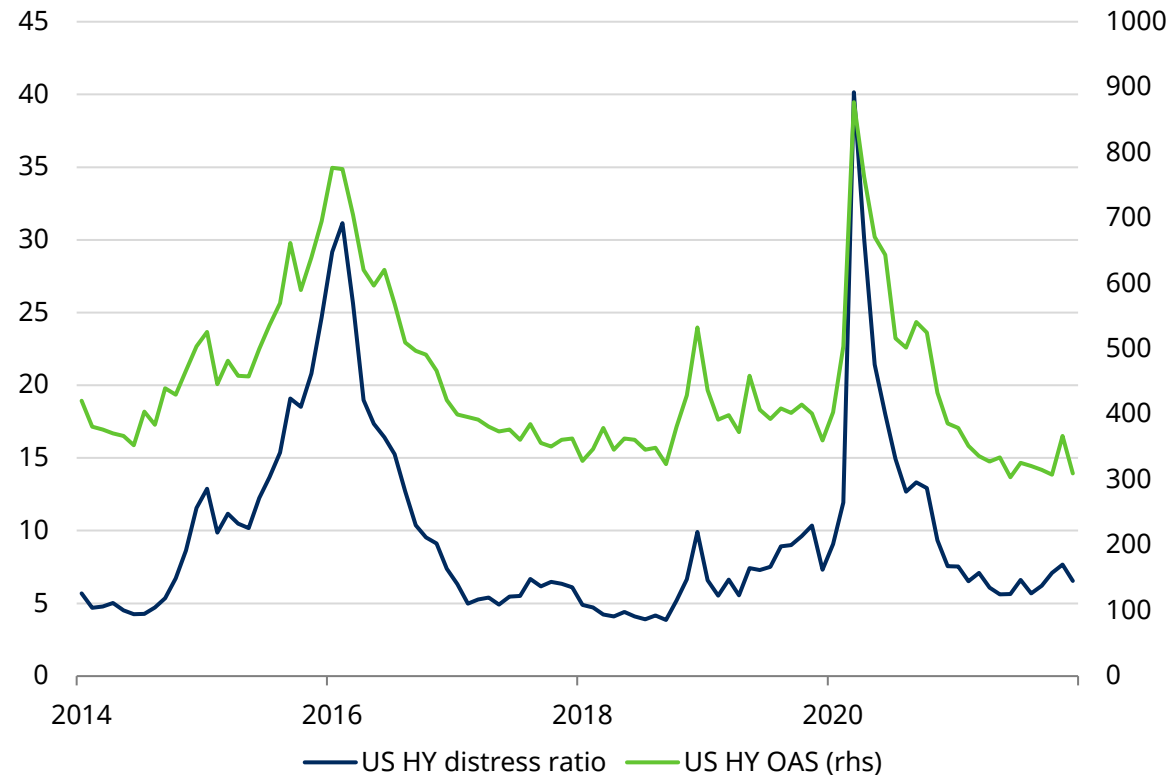
Default rates are at record lows in both US and Euro HY

Source: Schroders, BofA Global Research, Moody's. Data as at 31 December 2021.

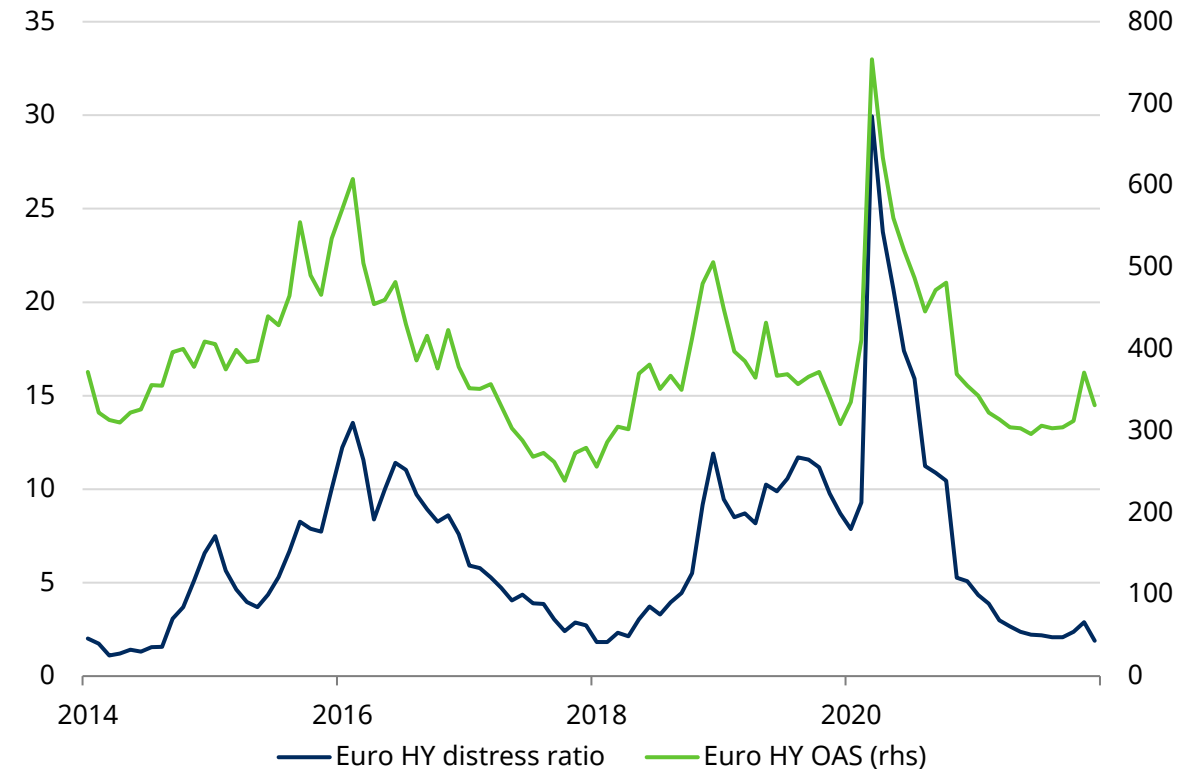
HY distress ratios

Harbinger of defaults

US HY distress ratio¹



Euro HY distress ratio¹



Distress ratios remain low despite some recent volatility in credit

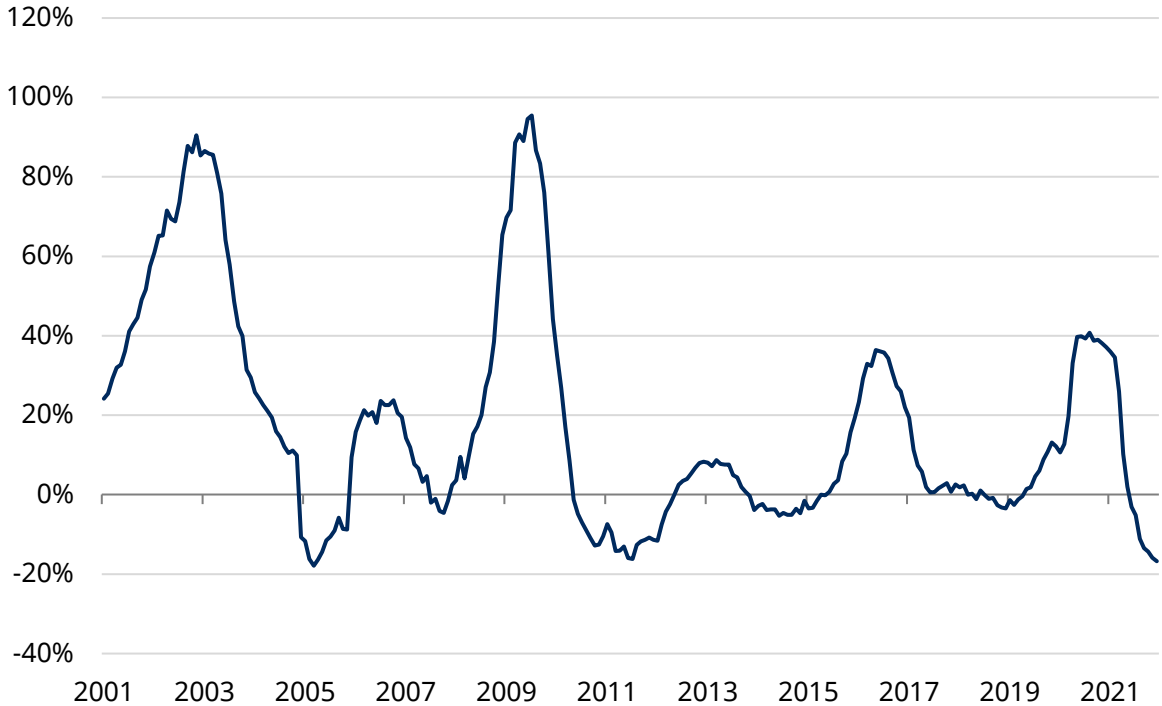
Source: Schroders, BofA Global Research, Moody's. Data as at 31 December 2021.
¹HY distress is defined as percentage of issues in the index trading with spreads > 1,000bp.

US HY ratings migration (net downgrades)

Indicator of changes in credit quality

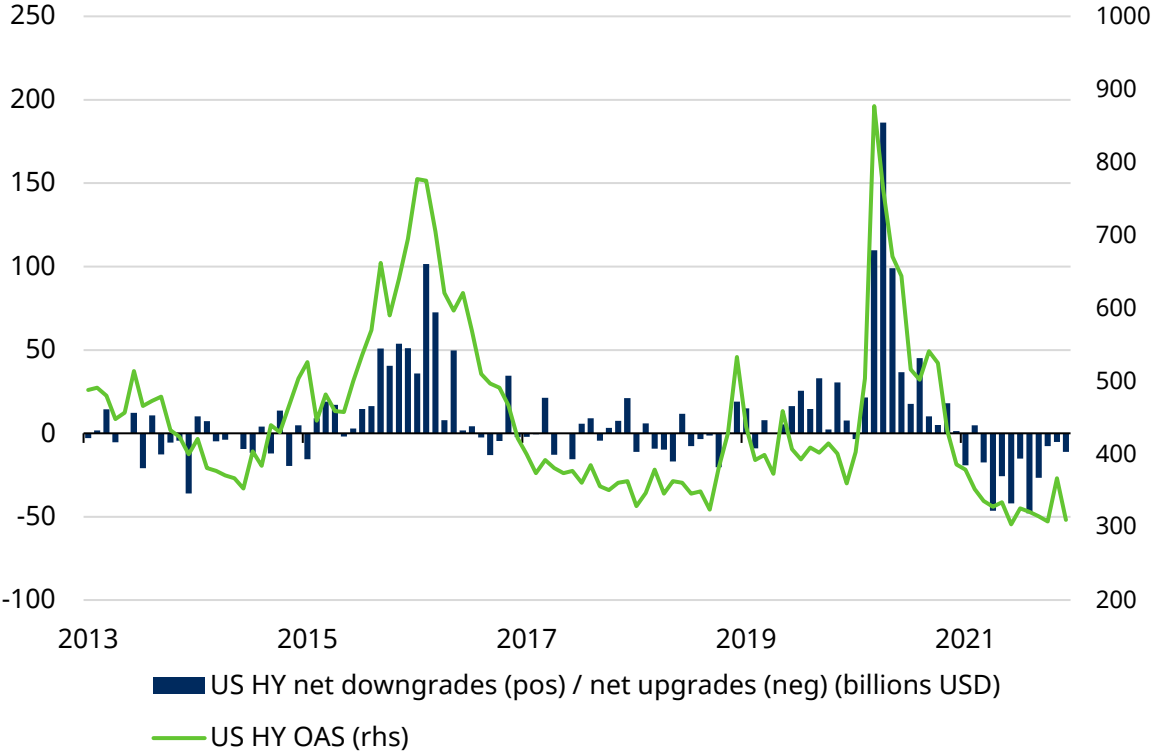
US HY net downgrades¹

Percentage of the HY index, last 12 months



US HY monthly net downgrades

Billions USD



HY upgrades have waned in recent months

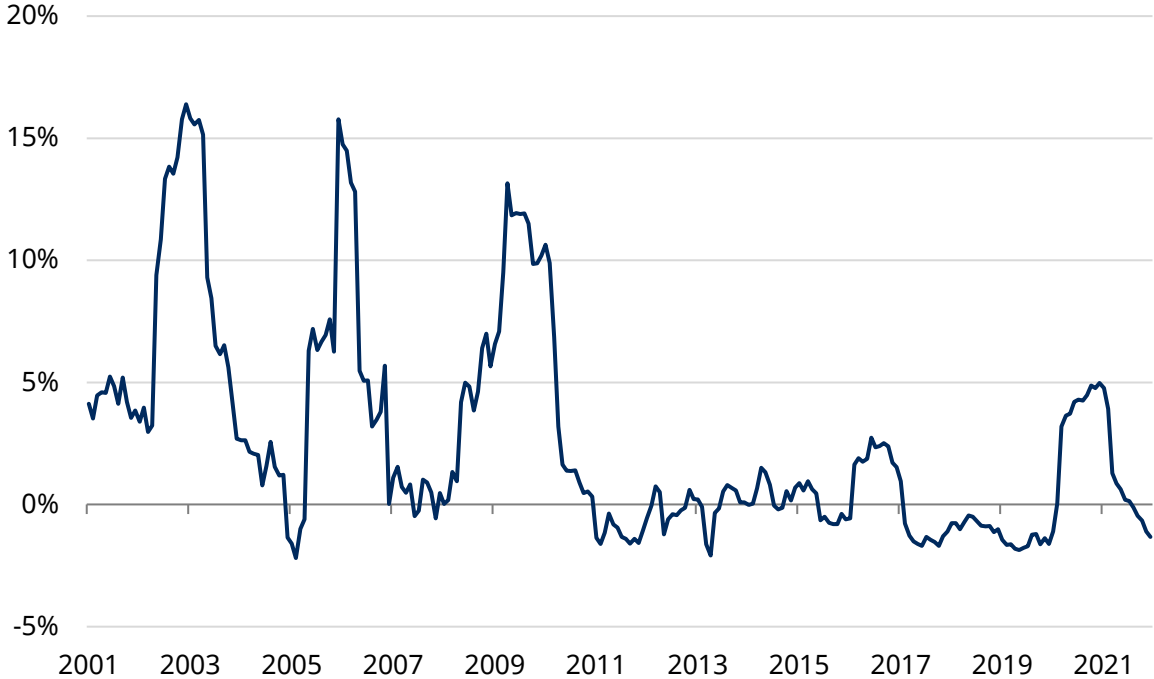
Source: BofA Global Research, Refinitiv Datastream. Data as at 31 December 2021. ¹Face value of downgraded bonds minus face value of upgraded bonds divided by face value of the index.

US IG fallen angels/rising stars

Bonds downgraded from IG to HY

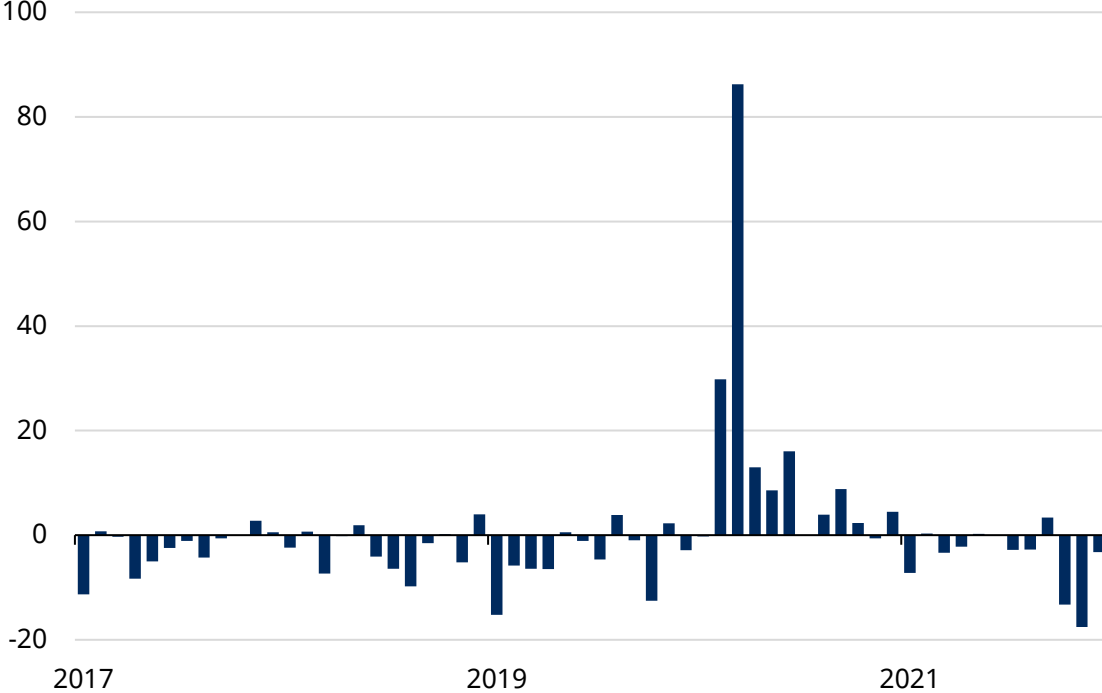
US IG net fallen angels

Percentage of the BBB index, last 12 months



US IG monthly net fallen angels

Billions USD

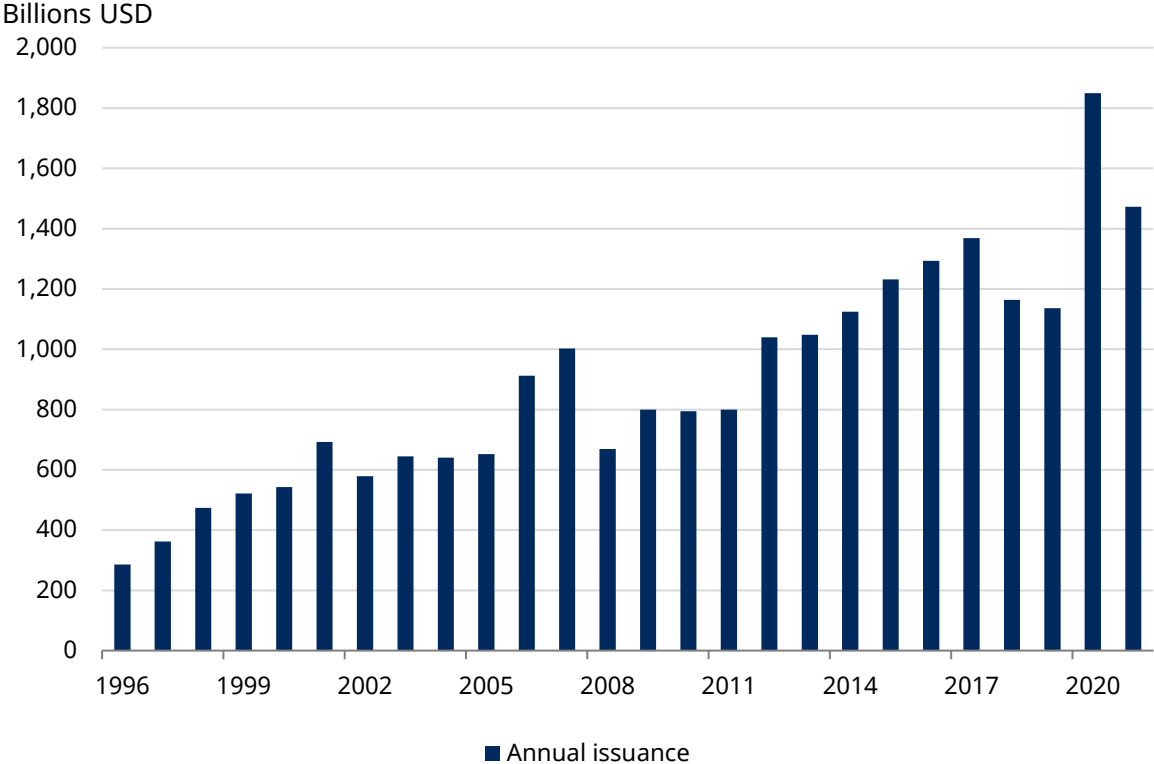


Upgrades from HY to IG finally picked at the end of 2021

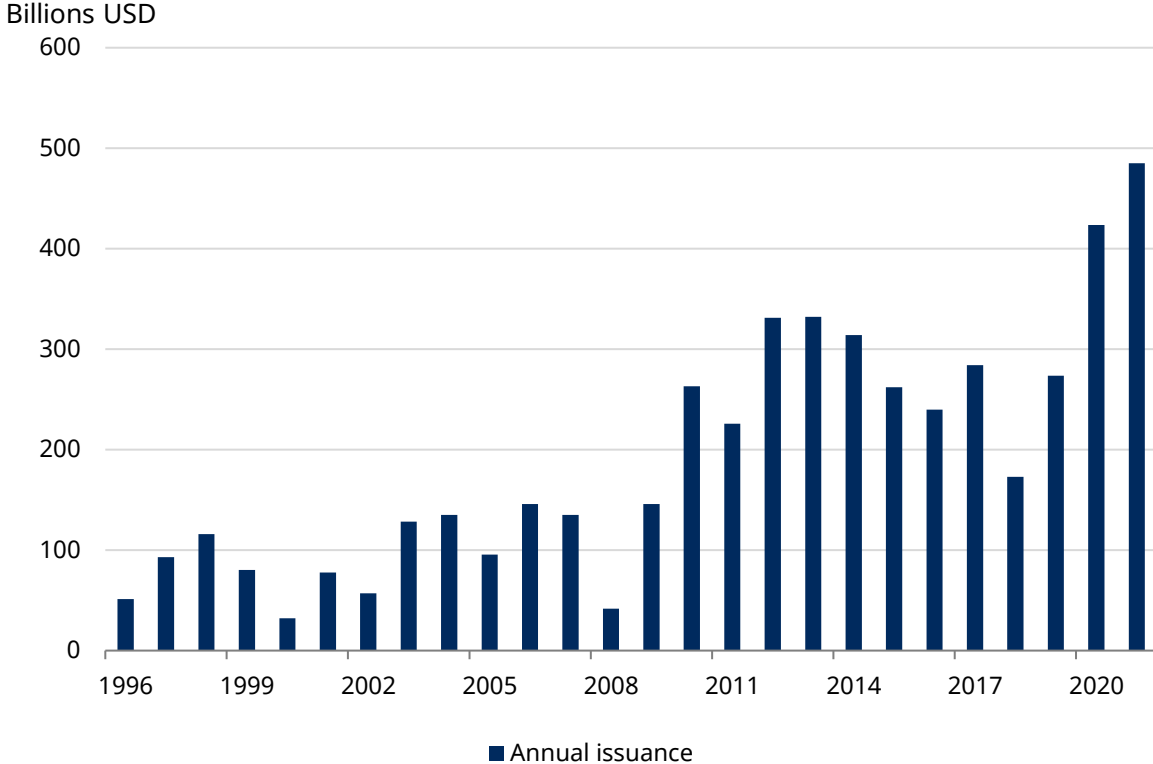
Source: BofA Global Research. Data as at 31 December 2021.

US IG and HY gross issuance

US IG issuance



US HY issuance

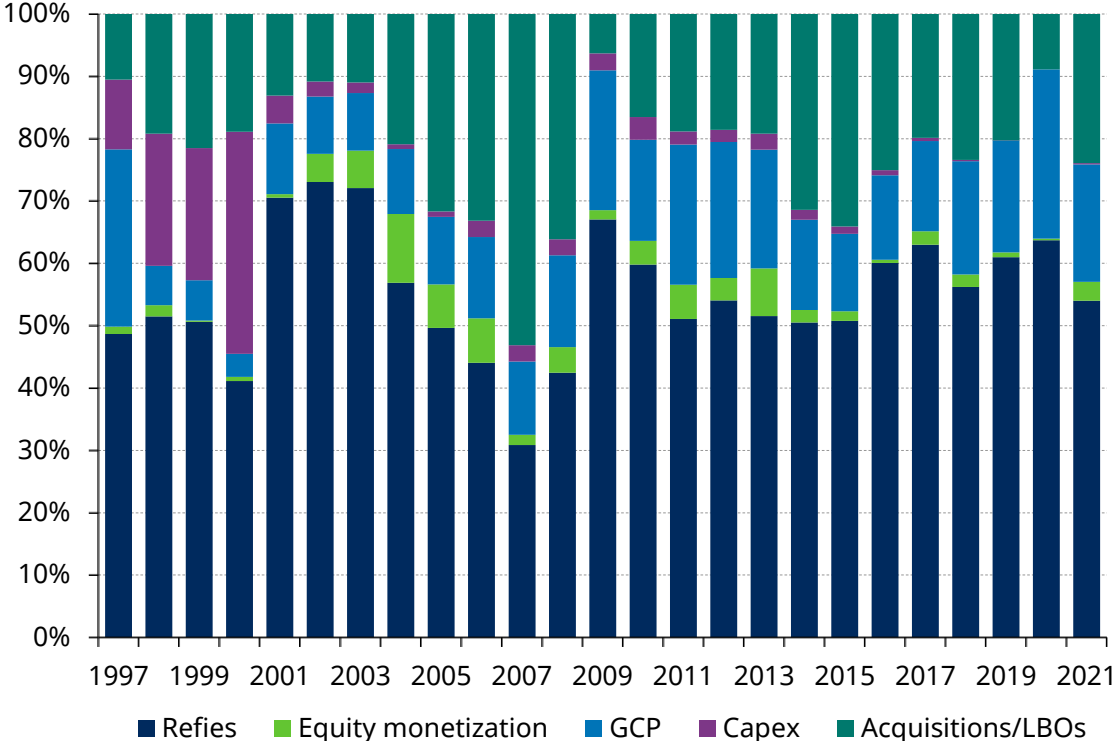


US IG issuance was almost \$400 billion lower compared to 2020; US HY issuance was just shy of \$500 billion in 2021

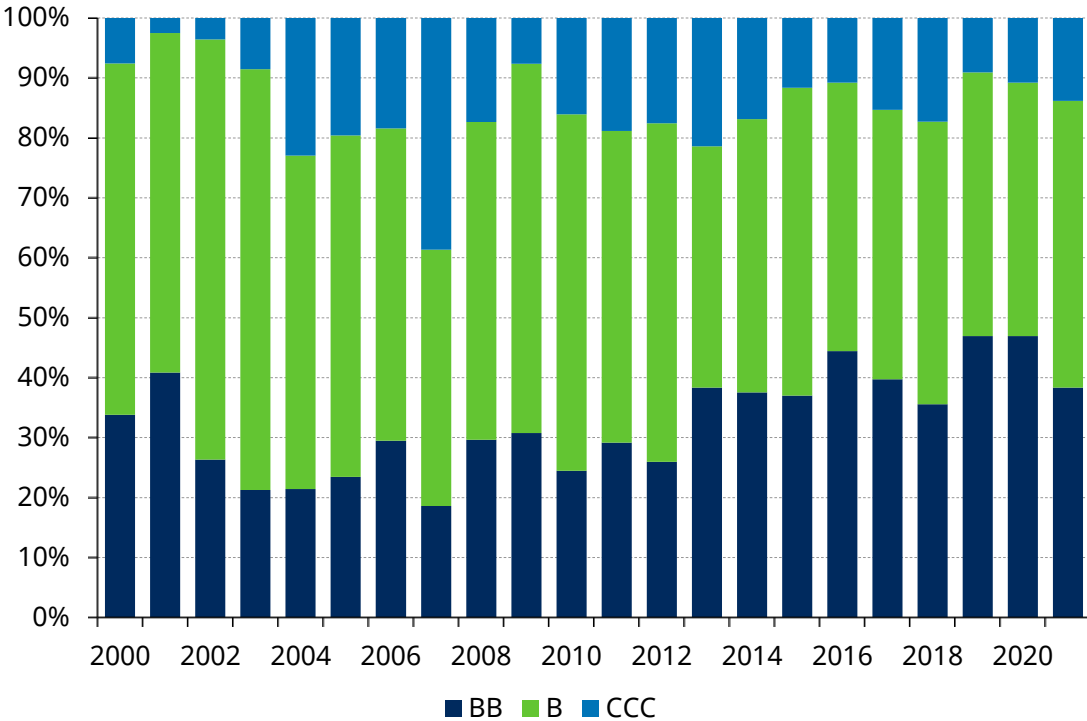
Source: Sifma. Data as at 31 December 2021.

US HY issuance details

Use of proceeds (percentage of issuance)



Issuance by rating (percentage of issuance)



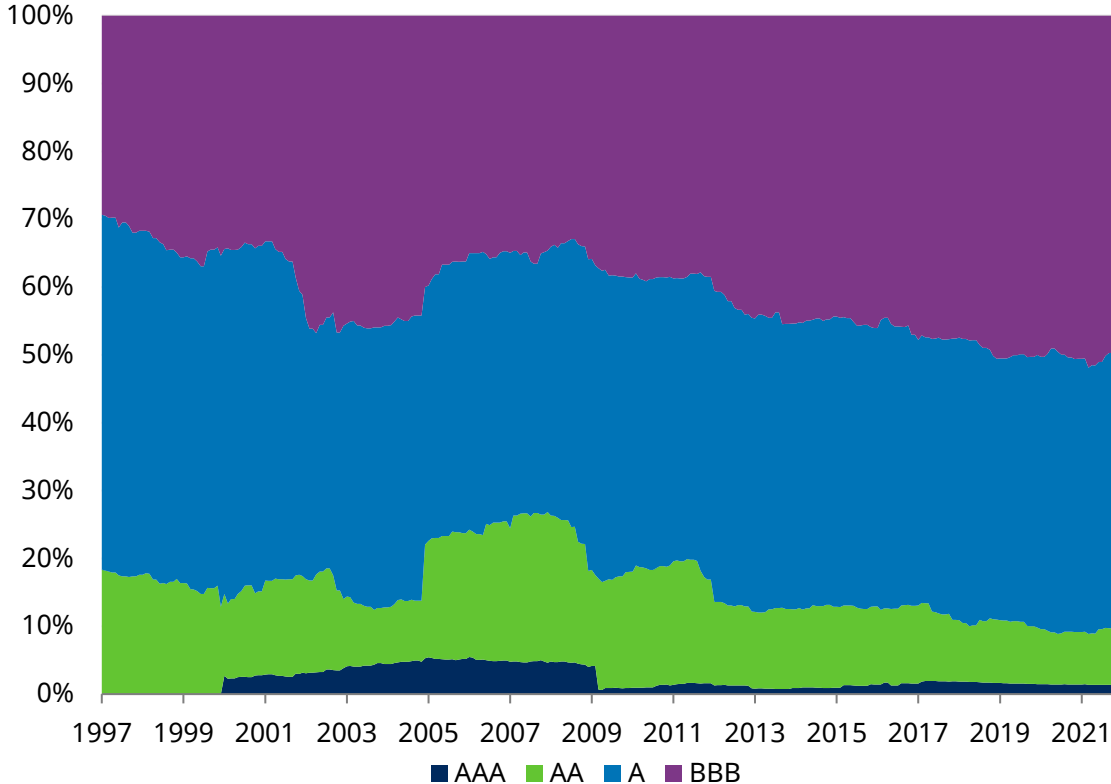
Issuance quality has worsened with higher acquisition/buyout and CCC issuance

Source: Schrodgers, BofA Global Research, Moody's. Data as at 31 December 2021. GCP is general corporate purposes, Refies is refinancings, Equity monetization is replacing equity capital with debt

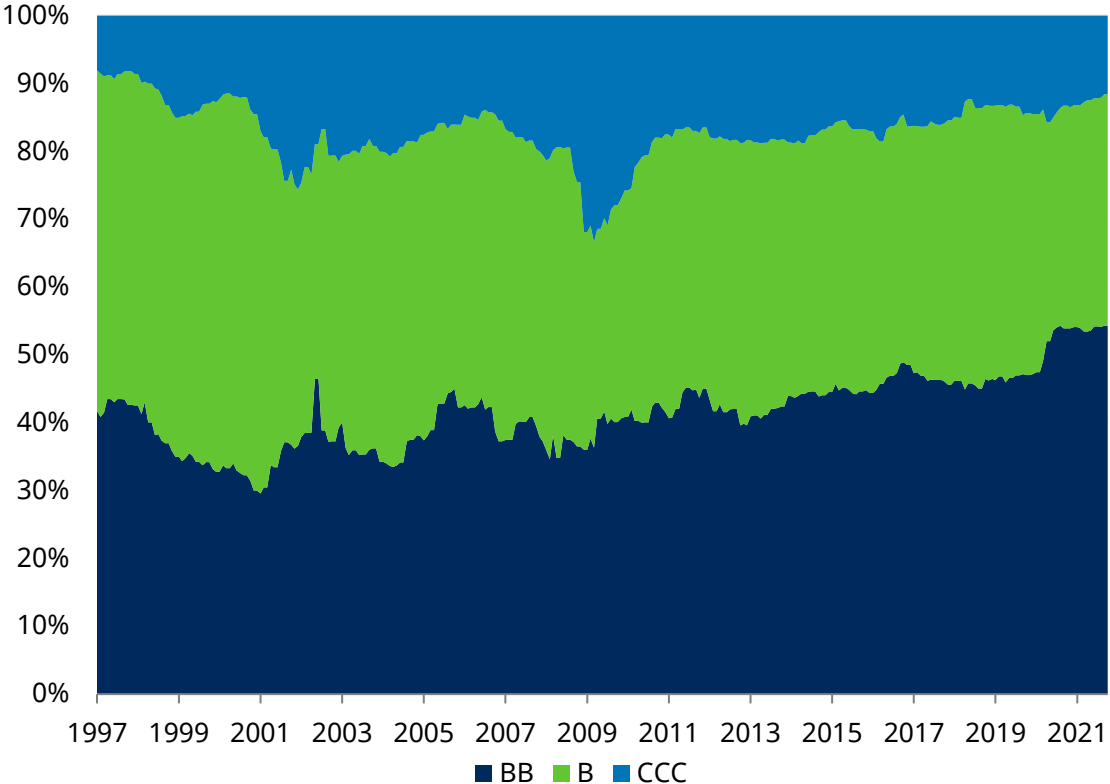
US dollar credit historical ratings split

Significant changes in credit quality over time

US IG ratings split



US HY ratings split



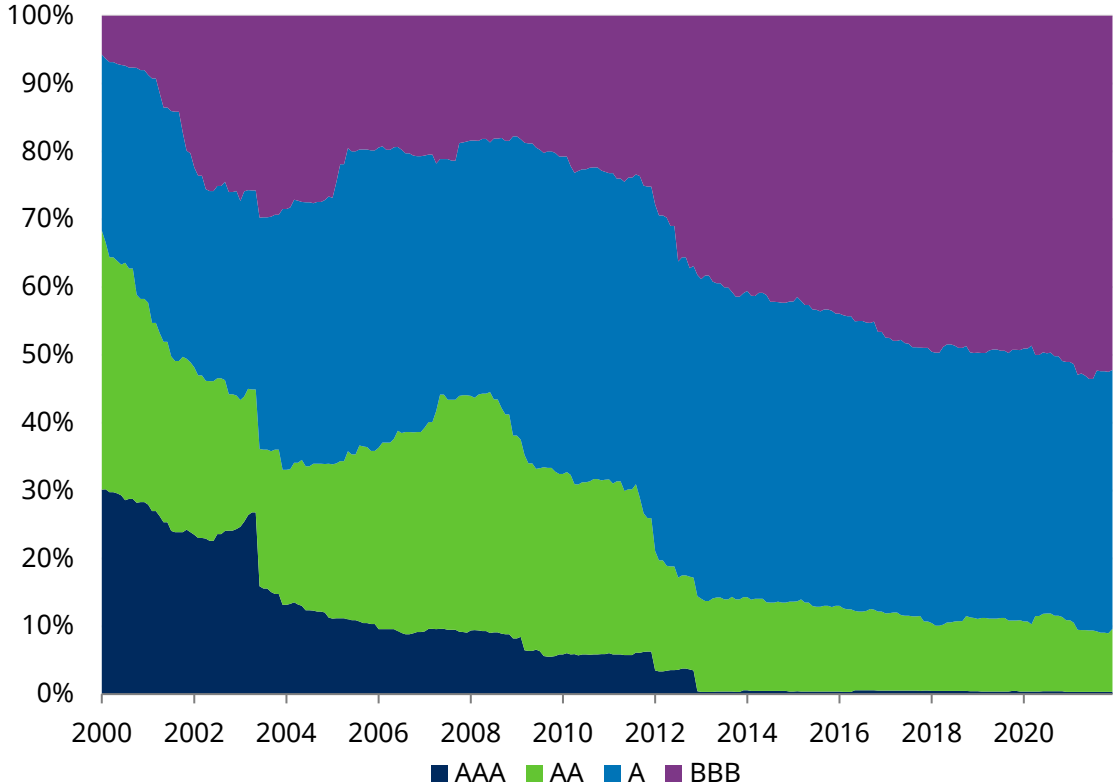
HY credit quality has improved since 2020 because of the inclusion of downgraded IG bonds and ratings upgrades

Source: Schroders, ICE Data Indices. Data as at 31 December 2021.

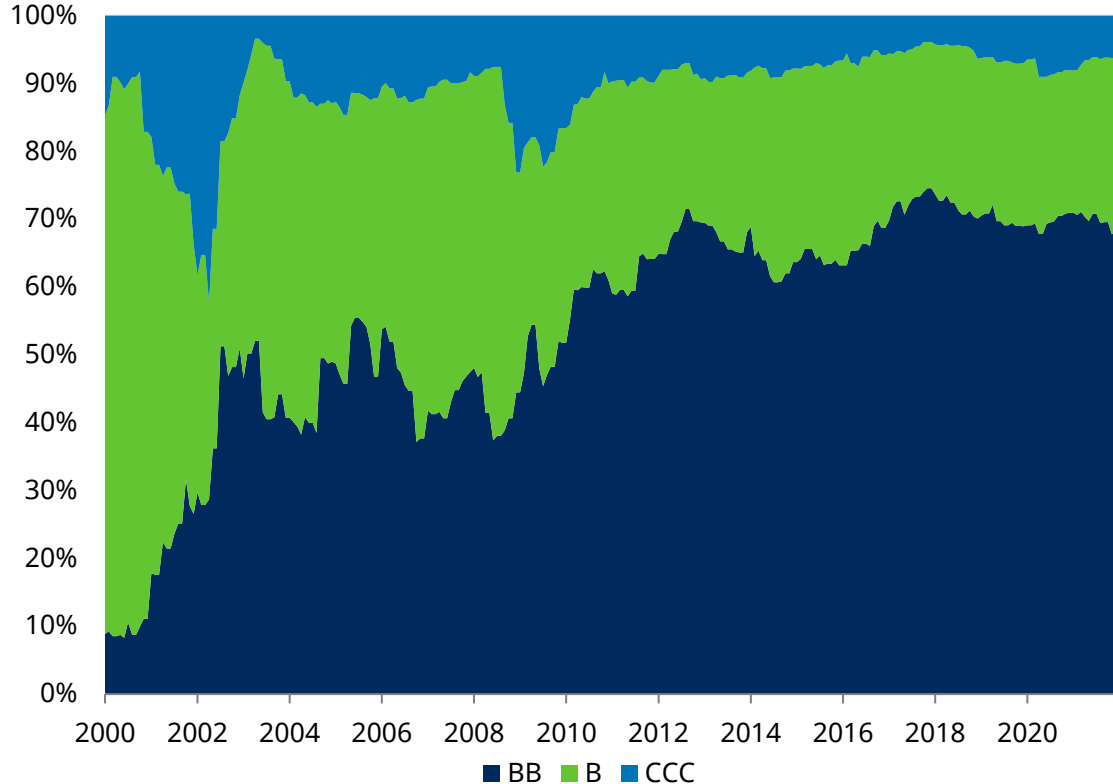
Euro credit historical ratings split

Significant changes in credit quality over time

Euro IG ratings split



Euro HY ratings split



IG credit quality has worsened in the pandemic

Source: Schroders, ICE Data Indices. Data as at 31 December 2021.

Schroders

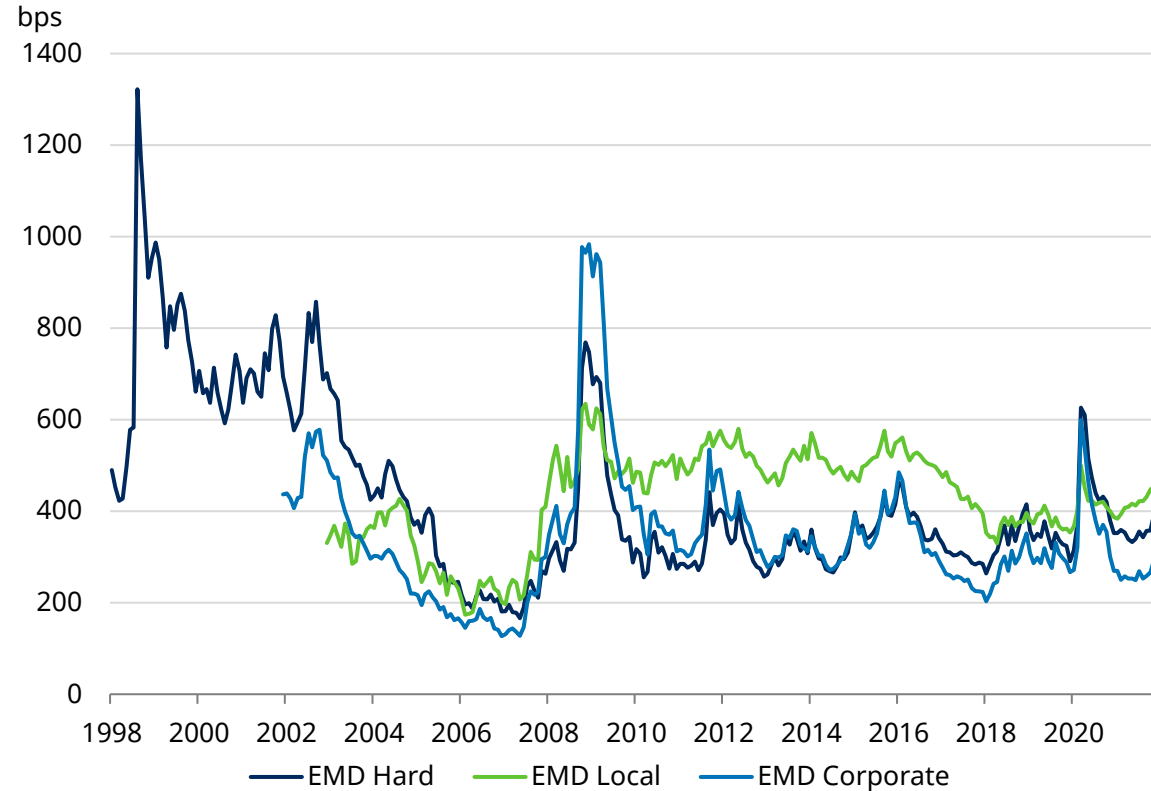


Emerging Market Debt

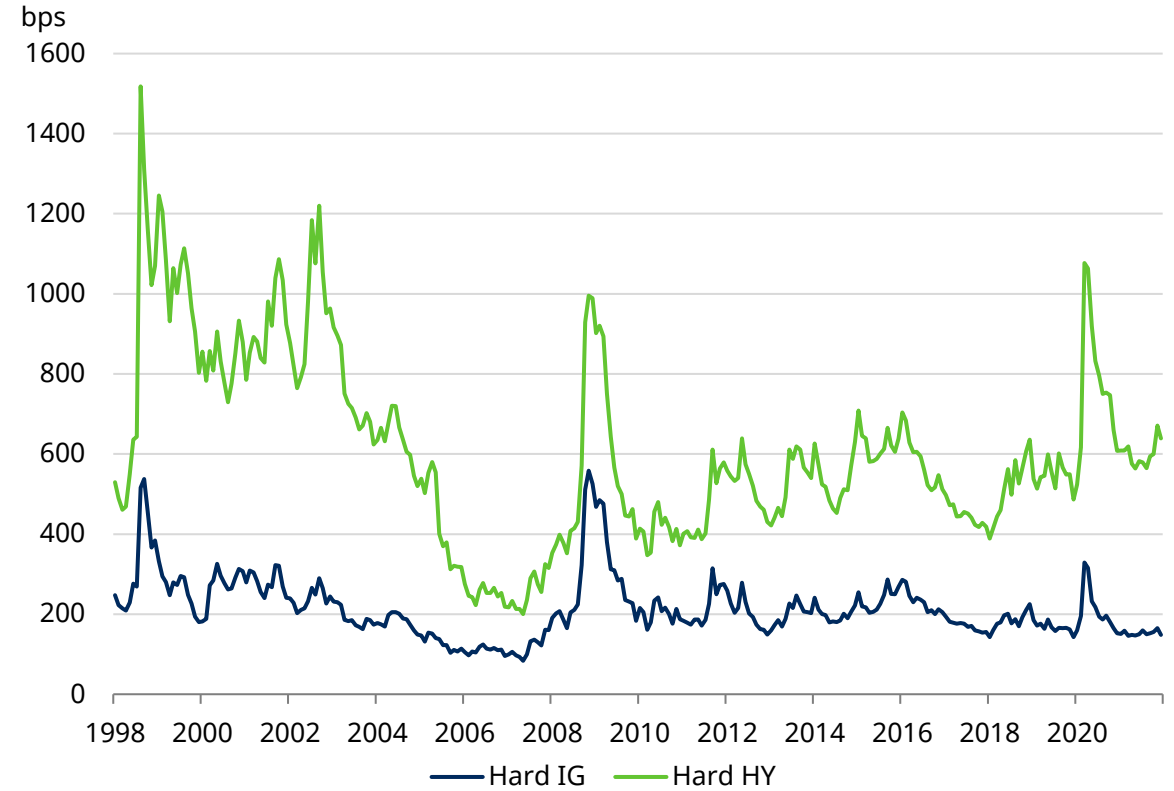
Valuation EMD

Historical spreads

EMD spreads



EMD Hard IG and HY spreads



Source: Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 December 2021.

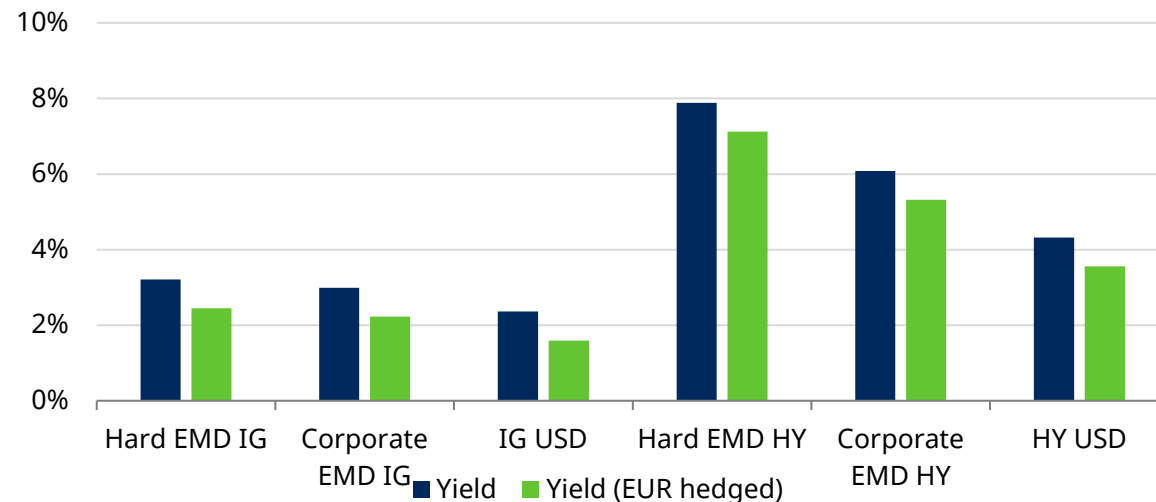
EMD Local is not a spread product, the spread is manually calculated relative to treasuries of approximately equivalent duration.

Dollar debt: EMD vs. US Corporates

Combination of IG and HY

	Hard EMD IG	Corporate EMD IG	IG USD	Hard EMD HY	Corporate EMD HY	HY USD
Yield	3.2%	3.0%	2.4%	7.9%	6.1%	4.3%
Yield (hedged to EUR)	2.4%	2.2%	1.6%	7.1%	5.3%	3.6%
Spread (bps)	149	150	98	639	484	310
Duration	9.5	5.6	8.4	6.3	3.5	5.3
Rating	A3	A3	A3	B1	B1	B1
Percentage of EMD index	51%	56%	-	49%	44%	-

Yield (%)

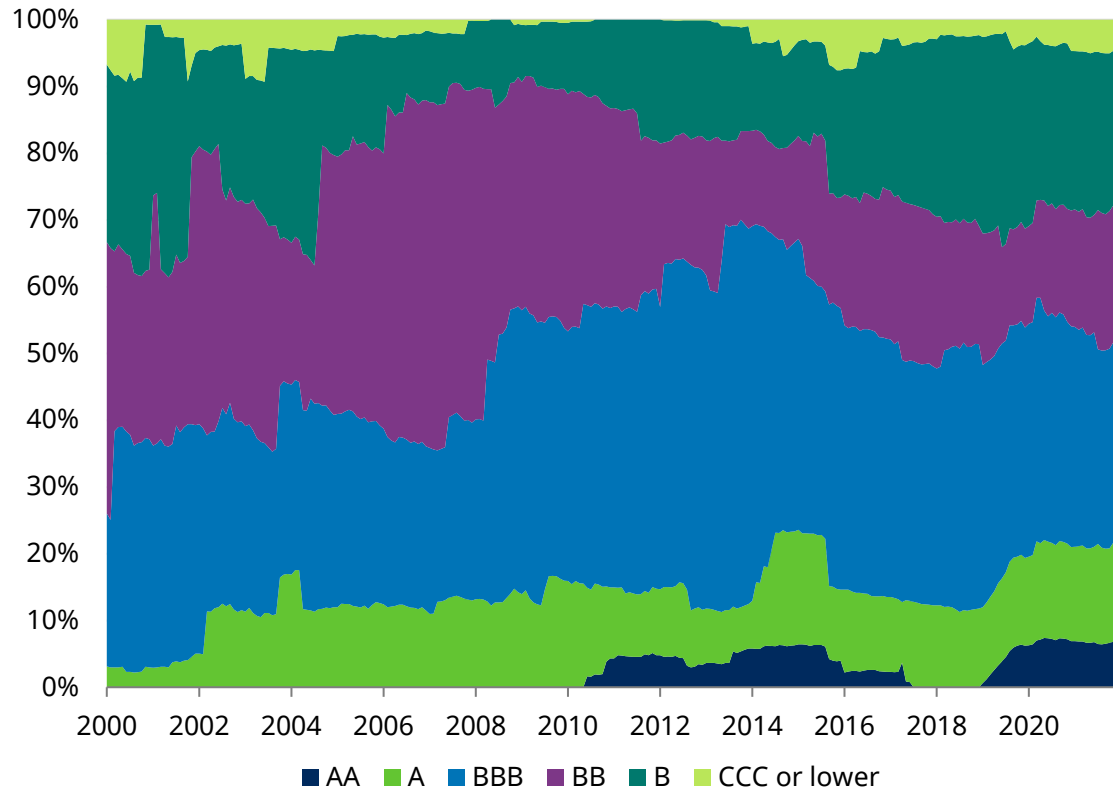


- Allocation to hard-currency EMD is a combination of IG and HY allocations
- Corporate EMD IG rating is one notch below US IG, EMD Hard IG rating is on par with US IG
- Hard EMD HY and Corporate EMD HY ratings are on par with US HY
- **Besides valuations, the decision between EMD (dollar-denominated) and US corporates should consider the credit cycle, issuance and ratings migration**

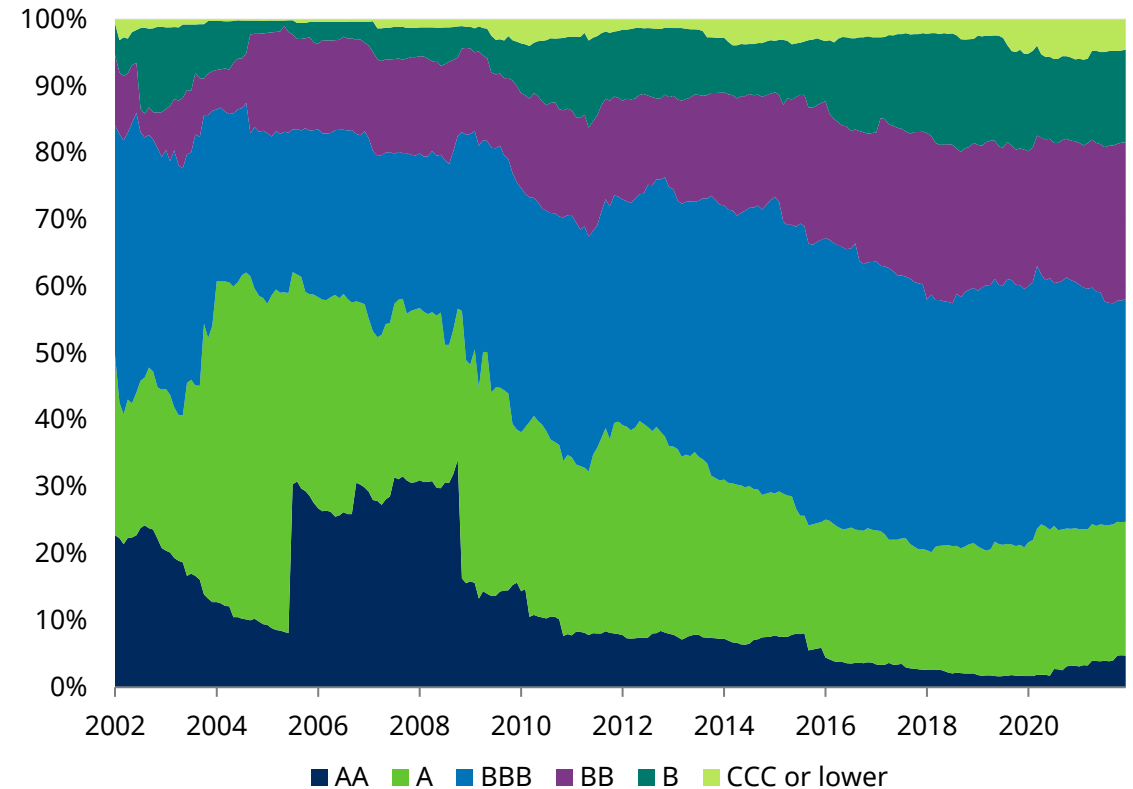
Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 December 2021.

EMD historical ratings split

Hard EMD (JPM EMBI Global Diversified Index)



Corporate EMD (JPM CEMBI Broad Diversified Index)

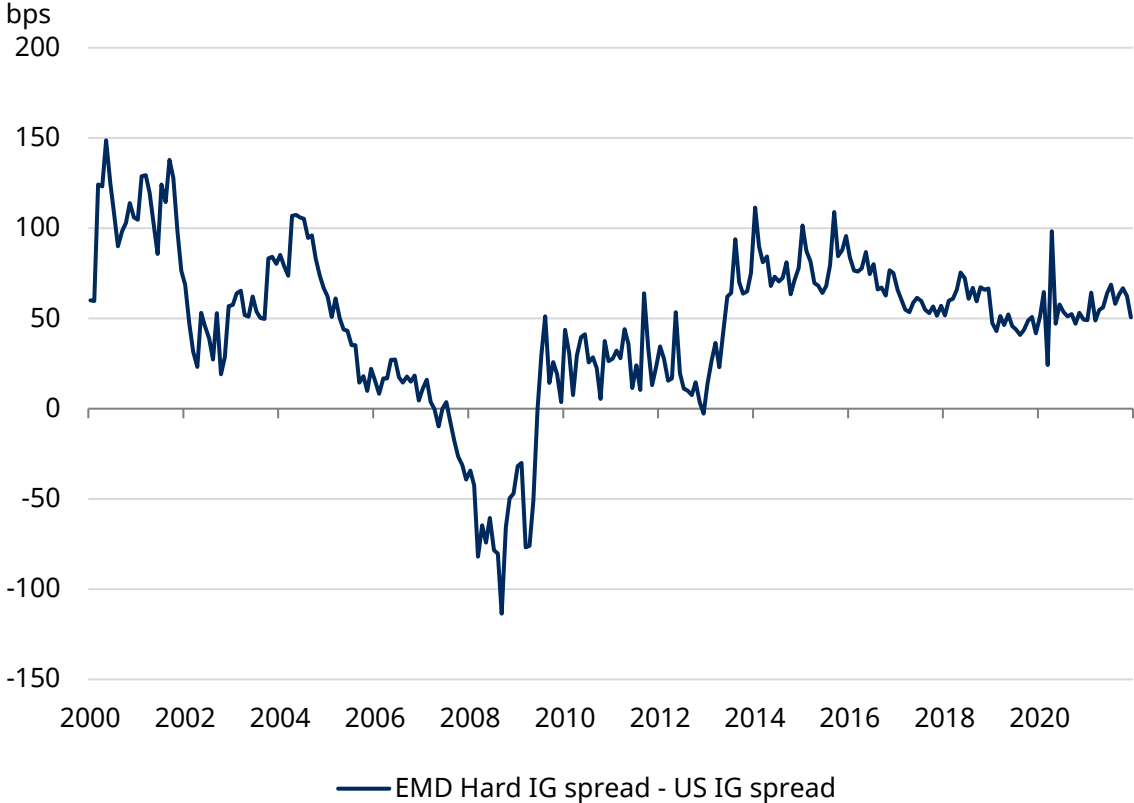


The share of IG bonds has been falling since mid-2020 in both hard and corporate index

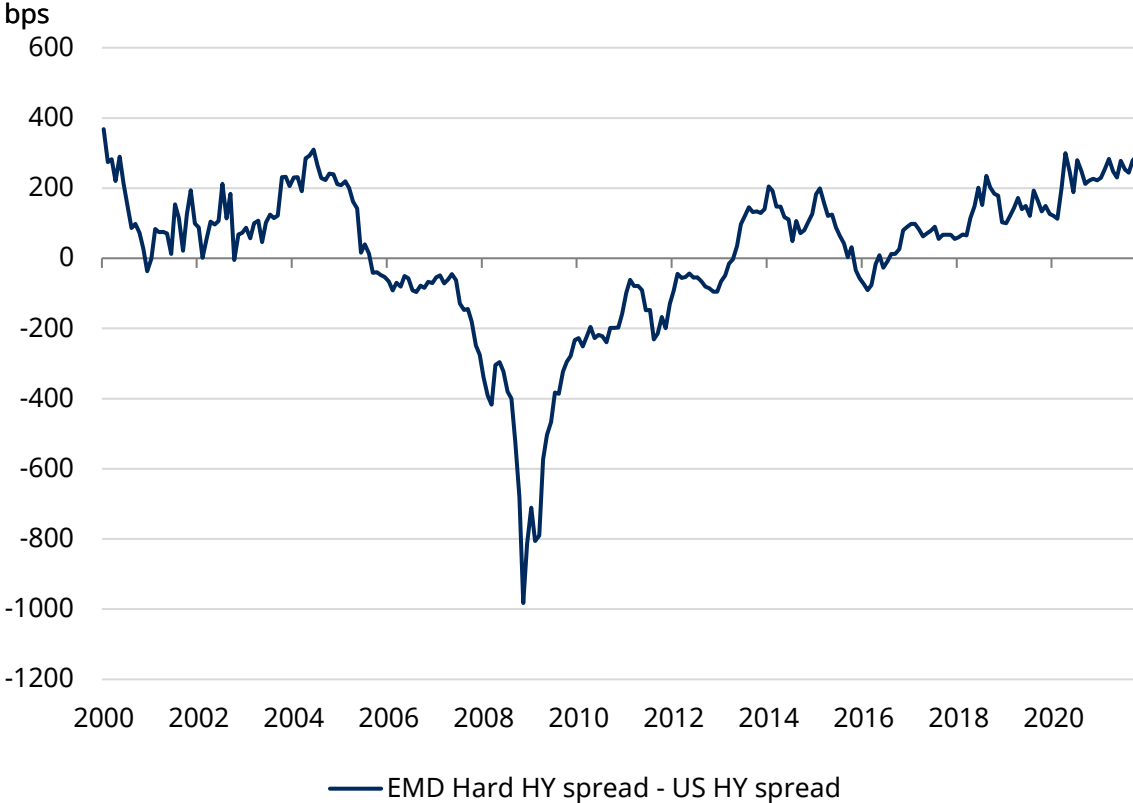
Source: Schroders, J.P. Morgan. Data as at 31 December 2021.

Dollar debt: EMD Hard vs. US Corporates

EMD Hard IG spread minus US IG spread



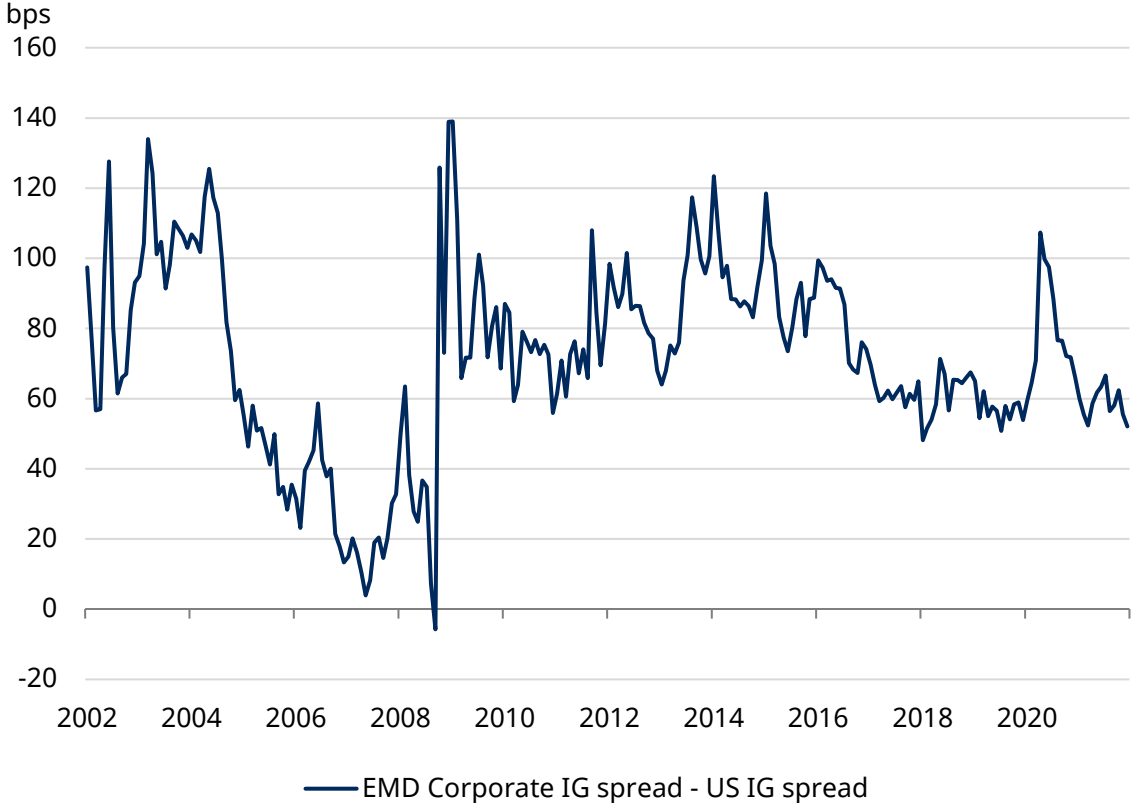
EMD Hard HY spread minus US HY spread



Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 December 2021.

Dollar debt: EMD Corporates vs. US Corporates

EMD Corporate IG spread minus US IG spread



EMD Corporate HY spread minus US HY spread

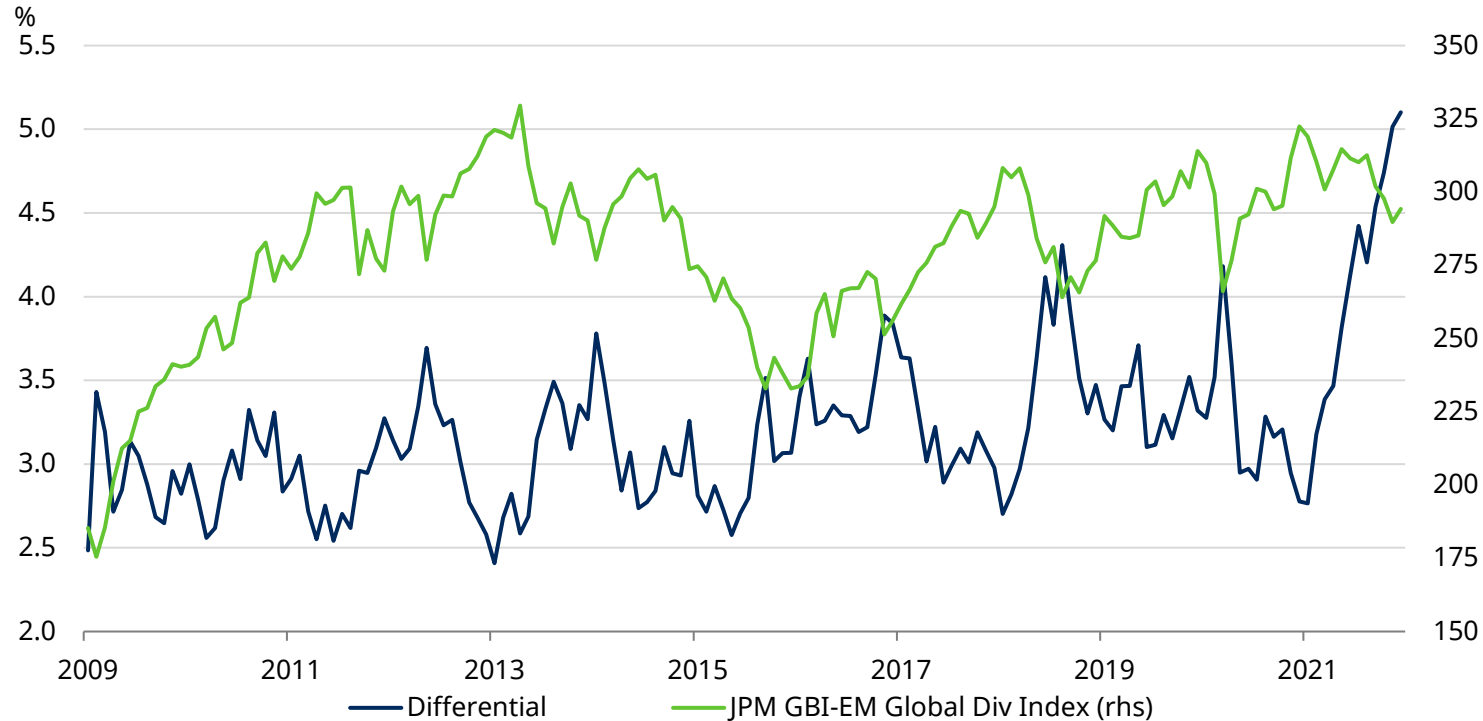


Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 December 2021.

EMD Local valuation – real yield differential

Valuation of local yields

EM-DM real yield differential



- EMD Local index constituents have historically had higher real yields than DM countries
- A higher real yield is necessary to compensate for the risk of unexpected inflation
- Falling real yield differential is normally associated with positive returns

Real yield differential implies significant premium for local currency EM bonds. Historically, this has been supportive for local currency EM bond returns

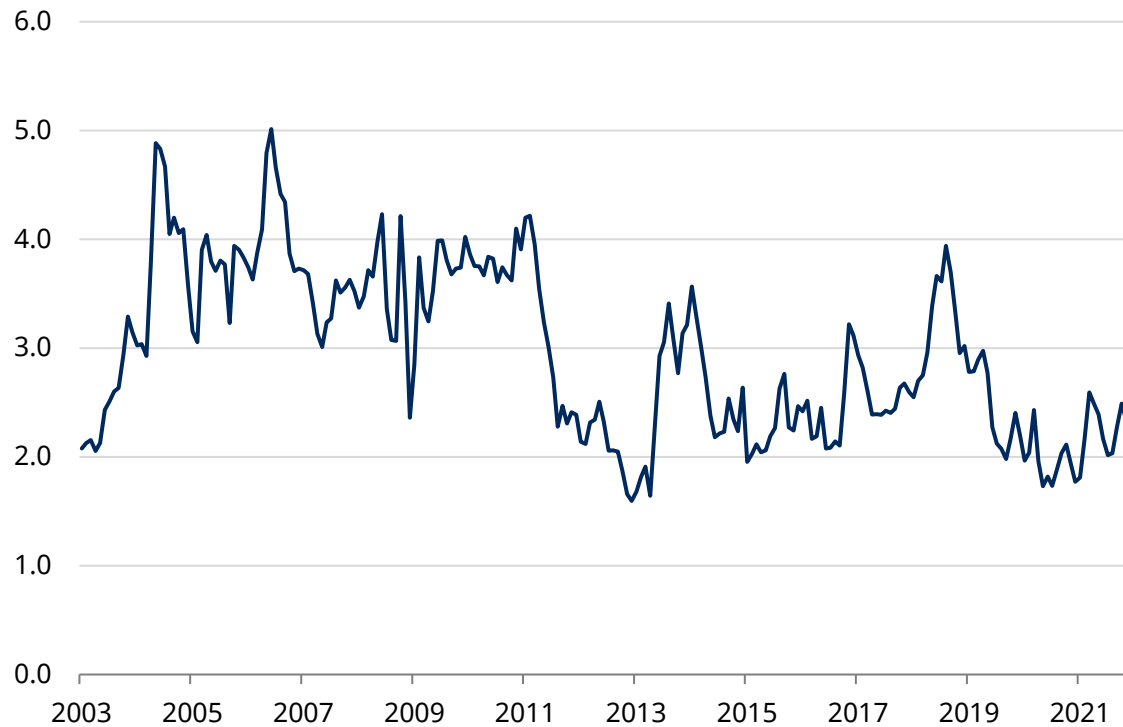
Past performance is not a guide to future performance and may not be repeated.

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 December 2021. EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by core inflation. DM real yield is 5Y government bond yields of US, UK, Euro zone, Japan deflated by core inflation, weighted by the size of individual government bond market.

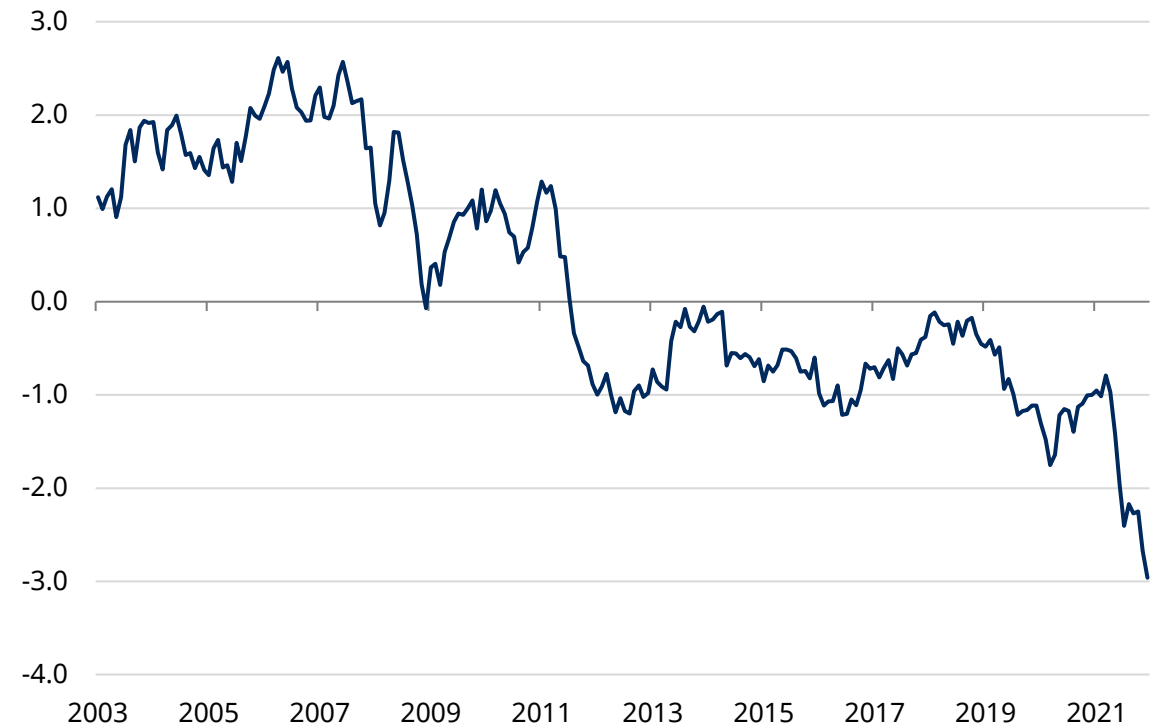
EM/DM real yields

Individual drivers of the real yield differential

EM real yield (%)



DM real yield



DM real yield has fallen sharply as US core inflation has accelerated

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 31 December 2021. EM real yield is weighted average of individual JPM GBI-EM index nominal yields deflated by core inflation. DM real yield is 5Y government bond yields of US, UK, Euro zone, Japan deflated by core inflation, weighted by the GDP PPP of each country.

List of indices

- **IG GBP non-gilts** - The ICE Data Indices Sterling Non-Gilt Index
- **IG GBP corporates** - The ICE Data Indices Sterling Corporate & Collateralized Index
- **IG Euro** - The ICE Data Indices Euro Corporate Index
- **IG USD** - The ICE Data Indices US Corporate Index
-
- **HY GBP** - The ICE Data Indices Sterling High Yield Index
- **HY Euro** - The ICE Data Indices Euro High Yield Index
- **HY USD** - The ICE Data Indices US High Yield Index
-
- **Hard EMD** - JPM EMBI Global Diversified Composite Index
- **Local EMD** - JPM GBI-EM Global Diversified Index
- **Corporate EMD** - JPM CEMBI Broad Diversified Index

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