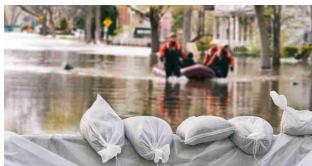


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Will Rising Rates Sink Global Corporate Credit?

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The Federal Reserve is in the midst of accelerated tapering and, if market expectations are to be believed, tightening may not be far behind. Some developed market central banks, including the Bank of England, have already introduced rate hikes while the Reserve Bank of Australia is adhering to its tapering plans. Given that credit spreads are at or near historical tights, will rising rates put an end to corporate bonds' strong run?

Certainly, spreads are tight. However, there are several factors that remain supportive of corporate credit going forward. While selectivity remains of utmost importance, we continue to see opportunities in global credit markets.

Different Environment, Different Starting Point

Today's environment is very different from when the Federal Reserve (Fed) last tightened rates. An argument can be made that the business cycle is currently "mid-cycle" rather than "late cycle" given the challenges the economy faces stemming from the pandemic. As the economy reopens, corporate profits should remain robust in certain sectors as increasing operating costs are pushed through to the consumer. In contrast, the last Fed tightening cycle was "late cycle" when policymakers were looking to squeeze excesses out of the market.

Defaults Expected to Remain Low

Furthermore, defaults sit at historical lows and are expected to remain minimal. Accommodative monetary policy provided many companies with broad access to capital markets and favorable financing—and management teams did not rest. Not only did this enhanced liquidity sustain businesses during the pandemic, but companies have also been able to extend their debt maturity profiles. Apart from certain sectors that remain under stress, like retail, hospitality, and entertainment, other industries and companies are in solid financial positions and well situated to resume more normal operations at the same time that economic conditions are improving.

Tailwinds Supporting Corporate Credit

While it is unlikely that corporate profits will surpass the record-breaking levels seen in 2021, we expect company earnings to continue to surprise to the upside. There are two strong tailwinds working in their favor and supporting the market. First, supply constraints may have peaked, which should relieve cost pressures across multiple sectors. Second, companies continue to exhibit a high degree of pricing power due to strong demand from consumers. Additionally, an enormous amount of consumer savings should continue to support demand as the economy progresses toward renormalization.

Navigating Global Credit Markets amid Rising

Rates

As the unprecedented monetary and fiscal policies begin transitioning to the next stages, reverting to more “normal” or conventional policy, we still see opportunities for a cyclical recovery and for corporate credit. Fiscal policy, while not at the levels seen over the past few years, should remain expansionary in the near term, although we acknowledge that on a year-over-year basis, growth will be decelerating. Additionally, the Fed has emphasized its commitment to tapering first before embarking on tightening interest rates. This order of operations will allow time for supply chain dislocations to correct and for Fed policymakers to assess market conditions before moving to raise the federal funds rate. An abatement in supply constraints and easing of inflationary pressures may even allow the Fed to delay rate hikes.

Nonetheless, these expected tightening conditions should arrest the spread tightening that we have seen in corporate credit over the past year and a half. However, we do not see that as the last act for corporate bonds. After some initial spread widening, we believe spreads could again retrace that widening as economic conditions remain supportive. Furthermore, even with potential spread widening, we see pockets of opportunity across corporate credit markets.

Cyclical Tilt to Opportunities

Therefore, we remain constructive on risk assets, although on a selective basis. We do believe the days of broad outperformance across corporate credit are behind us, so we are deploying a very nuanced allocation to select credit instruments. Central to expressing our views across credit markets is rigorous fundamental analysis utilizing our strong, proprietary underwriting model. Our focus continues to be on basic industries, capital goods, energy, and other cyclical sectors in both developed and emerging markets. We favor those industries that have a more cyclical tilt, like autos and mining, which should see marked improvement as the economy rebounds from the lockdowns. We are emphasizing companies with strong balance sheets and manageable leverage. We are also looking for indications that companies in certain industries, like commodity producers and basic materials, will maintain access to capital markets, given that margins may follow commodity prices lower. Lastly, broadcasters are an area that we will potentially revisit as the sector reconstitutes itself in an ever-changing world of viewers and content.

We continue to be very mindful to the risks we discussed above around tightening monetary and fiscal conditions. That said, we believe higher-quality assets offer the best risk/return profile and should remain supported even if there is risk around monetary policy. However, we are generally avoiding both ends of the credit-quality spectrum, with high quality offering limited total return potential. At the other end, we remain cautious on global high yield; lower-quality bonds are still susceptible to hiccups in the global economic recovery and to tightening financial conditions.

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