2024 Outlook: Investment Grade Credit

By: Richard Ford | December 6, 2023

Investment Grade Credit Can Offer Attractive Income and Capital Preservation in Uncertain Times

KEY POINTS
1. We expect risk of recession and capital preservation to dominate the investment debate in 2024. Investment grade credit offers potential risk mitigation for when central banks move rates lower.
2. We believe corporates enter 2024 with conservative business models, having cut costs and raised liquidity in recent times. This makes high quality Fixed Income an attractive asset in uncertain times.
3. A global regime change characterized by de-globalization, higher structural inflation, quantitative tightening, increased geo-political risk and higher government debt, suggests 2024 is the start of a new era for investing.

What We Are Seeing

Heading into 2024, there is heightened uncertainty. There is greater difficulty in calling between the "Bull" and "Bear" cases for risk assets.

The "Bull Case" remains our base case, with key markets supported by strong employment, robust household balance sheets, and historically easy fiscal policy. We view the "Bear Case" as less likely. Although the business cycle remains valid, and a slowdown is probable, timing is key and the first half of 2024 looks early for a downturn.

Following the rise in 2023, investment grade (IG) credit offers attractive absolute yields and the potential to benefit if, and when, central banks look to normalize monetary policy by lowering rates. The relationship between risk-free rates and credit spreads has been positively correlated for much of 2022 and 2023, driven by central banks tightening monetary policy to combat inflation. Looking ahead, we expect the relationship to reverse and become inversely correlated. As a result, owning interest rate risk through high quality credit should help to mitigate risk in an economic downturn where risk asset valuations become challenged.

Asset price volatility is rising, as central bank policy becomes less supportive for markets. We expect this trend to continue into 2024, where large government debts and the cost of interest payments impacts the policy options available to support the economy.

What We Are Doing

We are moving up in quality in our portfolios through shortening maturities and favoring regulated and less cyclical industries to mitigate risk within the strategy in what we see as uncertain times.

We favor companies with earnings in the U.S. over Europe, given the more favorable economic conditions in the U.S. supported by the low unemployment maintaining consumer spending and fiscal stimulus incentivizing onshore activity.

We are retaining an overweight in subordinated Financials with fixed maturities (Tier 2), where we view the valuation as attractive relative to non-Financials. In Europe, we see issuers that were purchased by the ECB under the QE umbrella as less attractive on valuation reflecting the impact of the scale of purchases made (i.e., the "stock" effect).

We are adding duration risk to the strategy, as we view interest rates as having likely peaked and the correlation between credit and rates likely to "inverse" in 2024, meaning duration provides capital protection for a credit portfolio.

What We Are Watching

Inflation. We view inflation returning to target as key to central bank flexibility to lower rates and ease financial conditions. We see risks that inflation is sticky due to continued supply side disruption, higher costs from the transition to renewables and de-globalization increasing costs.

China growth policy. Increased global trade is necessary to support growth. We look to China as the marginal swing factor, and a key signal for corporate confidence to invest.

Geo-politics. Increased global tension following the impact of Covid has led to higher market volatility to reflect uncertainty in the future. A move lower in interest rate and equity volatility would be supportive for IG credit.

Corporate performance. 2023 was marked by limited M&A and CAPEX, as uncertainty over the outlook drove a conservative strategy. Any change in company risk appetite has potential implications for 2024, depending on market conditions and the success of implementation. Quarterly reporting will be, as always, closely watched for any change of direction.

Sustainability. Meeting all stakeholder goals will be a continued challenge in 2024, as the trade-offs between higher costs and "doing the right thing" remain a key corporate objective.

Technical. The shifting balance between new supply to fund financing needs, and demand in the higher yield environment, will drive the directionality of IG Credit spreads.

Valuation. 2023 has seen spreads tighten as the macroeconomy remains robust, while central banks move closer to terminal rates. With spreads around long-term averages, valuations increasingly price out the "Bear Case." We see tighter credit spreads as an opportunity to reduce risk.

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"High quality credit has many defensive qualities appropriate to provide income while helping to preserve capital, against an uncertain economic backdrop in 2024."

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