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INVESTMENT GRADE FIXED INCOME | OUTLOOK

2023 Investment Outlook: Investment Grade Credit

By: EV Forward | December 14, 2022

Capturing Elevated Yields Without Longer Duration or Lower Quality

KEY POINTS

1. We expect credit spreads to remain range-bound in 2023, limited by macro uncertainty, while the anticipated lack of economic destruction means spreads are unlikely to make new wides.
2. We believe investment grade credit yields are at levels that meet investor goals, without the need to extend duration or move down in credit quality.
3. Uncertainty is expected to decrease as central banks pivot to a more balanced policy mix focused on growth and inflation, and cost increases become less challenging for corporate planning.

What We Are Seeing

Four themes are dominating the credit debate:

- Geopolitical challenges — Ukraine conflict, deglobalization, sustainability — have triggered supply-side disruptions and higher inflation.
- Zero-COVID policies in China have led to lower global growth expectations.
- As central bank policies have shifted to fighting inflation with tightening financial conditions, markets are focused on a potential policy error.
- Corporate profitability is under pressure from cost increases, and aggregate demand is expected to fall, resulting in increased defaults.

Many recent trends look positive for credit, including signs of moderating U.S. inflation, supply-side relief in Europe and a potential reopening in China, with lower energy prices. As a result, valuations have moved to the tight end of our expected range — just above the long-run average — for investment grade credit.

Overall, we see companies entering 2023 with defensive business models, strong liquidity and optimized costs of production thanks to efficiencies implemented during the COVID era. We also see lower leverage that considers the risks to corporate profitability in 2023.

Markets are expecting a recession in 2023, as signaled by the inverted, risk-free yield curves. However, with employment remaining strong, nominal growth is expected to be positive. Moreover, with generally strong consumer balance sheets supported by the fiscal stimulus under COVID, we expect a "different" recession, where default rates do not spike.

What We Are Doing

We look to capture elevated investment grade credit yields, which we believe are at levels that can meet investor goals without the need to extend duration or move down in credit quality.

We expect credit spreads to remain range-bound in 2023 and are positioning accordingly. We see macro uncertainty limiting the upside of credit ranges beyond their long-run averages. Moreover, we think the lack of economic destruction in a different recession effectively restricts credit spreads in making new wides. We look to carry[1] as a driver of returns, with yields at attractive levels.

We are positioned to favor U.S. revenue streams from issuers with bonds denominated in euros. Growth looks more robust in the U.S. than in Europe, but wide swap spreads and attractive cross-currency hedging favor euros.

We expect the financials sector to outperform in 2023, as the weakness in 2022 created by heavy supply and recession concerns continues to abate.

What We Are Watching

Supply-side disruption. We expect economies to adapt to the "new order" with new energy supply sources, labor markets addressing shortages and technology advances limiting cost increases. These trends should result in lower inflation in 2023.

Central bank pivots and monetary policy. In an environment of lowering inflation, central banks are likely to pause their tightening cycles, while maintaining optionality for future moves. If this occurs, it should reduce the tail risk for markets — a positive for credit spreads.

China growth. Recent headlines announcing policy developments related to a 20-point plan to address the COVID reopening and a 16-point plan to support the housing sector signal the marginal news may be positive in 2023.

Corporate defaults. Markets are ending the year wondering whether expectations of a spike in default rates is too pessimistic. Looking forward, for credit to perform well, we don't need good news, just better-than-expected news.

Focusing on ESG could bifurcate between those measuring impact and those centered on financial returns, while still considering sustainability factors.

The market is sensitive to supply and demand expectations, which reportedly are conservative.

European spread underperformance in 2022 reflects the widening of swap spreads and weaker credit markets. Outperformance in 2023 should come from swap spread tightening as German government supply increases.

Richard Ford
Global Head of Investment Grade Credit
Portfolio Manager

[1] Carry refers to a strategy that involves two different positions, where the inputs end up being greater than the outputs.

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EV Forward

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