Euro Credit Quarterly Update

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What has been happening in your market?

Despite the interest rate volatility in the past year, credit markets have performed very well in 2023, with both investment grade and high yield assets returning impressive return of 8 and 12% respectively.

What is your outlook?

Looking forward to 2024, we anticipate another positive year for credit markets. While spreads are not particularly wide from a historical standpoint, we think that the all-in yield of the credit markets is attractive from a total return perspective and even outpacing the dividend yield. The level of yield that you can receive on the euro credit investment grade and high yield markets is still above the historical average of the past 10 years, around 4% and 6% respectively.

Central bank pauses have often been followed by a period of declining rates volatility and positive return for the asset class. Therefore, central bank rate cuts should provide an additional tailwind for corporate bonds in 2024.

So valuations of the asset class are indeed attractive, and apart from valuation, fundamentals are another argument for the asset class. Fundamentals have been extremely resilient and we believe that the asset class is well placed. We have seen some deceleration in trends in the third quarter. This deceleration continued in Q4 earning and we think that it will probably continue in the coming quarter. Having said that, for 2024, we expect a normalisation of trends rather than a massive decline in corporate earnings. Most investment grade and high yield companies have started off on a strong foot with regards to leverage and liquidity. Indeed, following the pandemic, companies were able to take advantage of favourable financial conditions to bolster their balance sheet and prepare themselves for this new rate environment.

For high yield, even though 2023 was a year challenged by concern on the economic backdrop, the impact on default rates was actually fairly limited. It is also interesting to see that the number of rising stars have exceeded that of fallen angels in 2023.

For 2024, default rates is expected to increase to a 3 to 4% range, which is still in line with the historical average. So valuations are attractive and fundamentals are fairly resilient. On top of that, the yield attractiveness of the asset class has been a strong support for credit markets, resulting in significant inflows and the easy absorption of primary issuance.

2024 started on a positive footing as inflows have actually accelerated in both high grade and high yield, showing the attractiveness of credit markets over risk free or low risk products. We expect this positive trend to continue, while supply should be below 2023 figures.

For high yield, issuance should also be fairly modest compared to 2023.

Why do you believe investors might be interested in the asset class?

In summary, we remain optimistic about the credit asset class in 2024. Satisfactory growth, declining inflation and easing policy will support risk appetite.

A mild recession combined with the expectation of potential central bank cuts, will probably be favourable for risky assets this year. Hence, credit strategies remain attractive in 2024 for both investment grade and high yield, thanks to appealing coupon-based return and expected capital gains this year.

For investors, active strategies could be considered to generate alpha. Today, we have a preference for unconstrained total return strategies within Euro credit as they offer flexibility to adapt to changing market environments and to adjust the level of risk accordingly.

Source : AXA IM, as of February 2024