



# Precision insights: Credit

September 2024

## Highlights

- **With most developed market (DM) central banks having kicked off their rate cutting cycles, high yield (HY) and Investment grade (IG) credit spreads have remained remarkably stable.**<sup>1</sup> Activity levels and liquidity remained strong in Q2, bolstered by interest in relative value trading and resilient demand in the credit default swap (CDS) index market as a high yielding cash alternative and volatility hedge.<sup>2</sup> We expect these factors to continue to sustain volumes – barring \$HY – in H2.
- **Minimal carry erosion supports our view of a slow grind tighter for spreads across the board, though some relative value opportunities persist, in our view.** We continue to prefer € exposures over \$, particularly €HY and the BBB-BB bucket within IG.

We outline our current views on broad developed market credit exposures, updated to reflect the latest macro and microeconomic developments.

**Click through to explore our precision credit views in detail.**

Exposure	View	Outlook
<b>€IG</b>		Despite tougher valuations, we expect carry-driven returns to persist for €IG, continuing the trend of the last two quarters. Our preference for € high grade credit is reinforced by strong demand technicals and widespread derisking by investors to mitigate the seasonal effects of August and September. <sup>3</sup>
<b>€HY</b>		€HY continues to offer attractive yield, at 5.6%, with the highest yield cushion across exposures, given its shorter duration profile. <sup>4</sup> Although relative value vs. \$HY has been eroded, €HY's option-adjusted spread (OAS) ratio to €IG remains elevated and above its 1Y average, boosting its attractiveness. <sup>5</sup>
<b>\$IG</b>		While a possible move lower in yields driven by US growth concerns would weigh on sentiment and push spreads wider, a soft landing in the US remains our base case. The carry on offer from \$IG (5.3%) screens as attractive, given solid fundamentals. <sup>6</sup>
<b>\$HY</b>		We stay underweight \$HY, waiting for macro fundamentals to improve. The near-term CCC-rated maturity wall still looks challenging, weighing on the broader exposure. <sup>7</sup>

Note: \$ denotes US dollar, unless stated otherwise.

**1** Source: Bloomberg, as of 18 July 2024. **2, 3** Source: Barclays, as of 26 July 2024. **4** Source: GS Marquee Custom Basket, as of 2 August 2024. **5, 6** Source: Bloomberg and BlackRock, as of 31 July 2024. **7** Source: Goldman Sachs Research, as of 12 July 2024.

## €IG

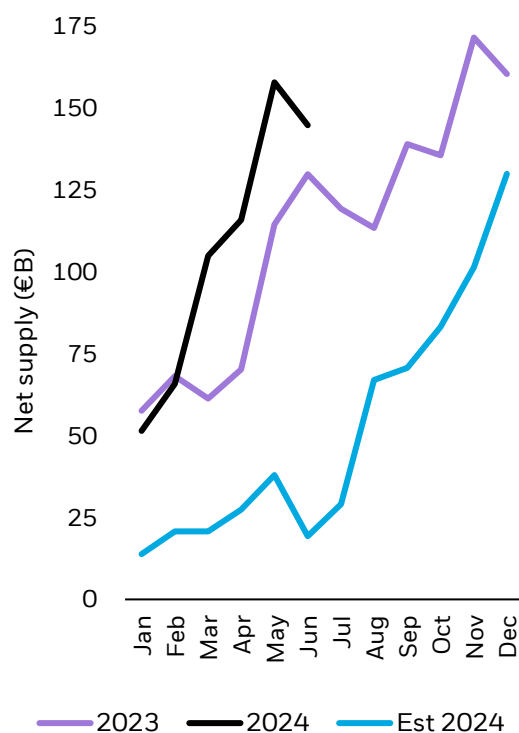
We stay overweight €IG even as relative value against \$IG has fallen below the 1Y and 3Y averages<sup>8</sup> on stronger macro fundamentals and healthy technicals. The € corporate bond market has remained remarkably robust in the face of macro challenges, with both €IG and HY markets having outperformed their \$ counterparts YTD.<sup>9</sup>

The euro area continues to benefit from a domestic rebound driven by increased real incomes and public spending, resulting in slightly higher-than-expected GDP growth in Q2 (0.3%).<sup>10</sup> Although the eurozone services PMI dipped from 53.2 to 52.8 in July, with manufacturing activity remaining entrenched in contractionary territory at 45.8,<sup>11</sup> we think €IG markets can withstand near-term macro headwinds with a cyclical recovery underway, albeit slow. The iTraxx Crossover index has not encountered a single default in this cycle, evidencing the lower sensitivity of € credit markets to growth fluctuations.<sup>12</sup>

Year-to-date, €IG has seen significant net issuance totalling €157B (€457B gross issuance), which has been consistently oversubscribed, resulting in unprecedented spread tightening.<sup>13</sup> However, we expect a slow grind tighter in Q3 as international investors – including in emerging markets – increasingly look to European credit over US exposures, given potential US election volatility, strong credit fundamentals, European Central Bank (ECB) rate cuts and corporate leverage declining from its peak.<sup>14</sup>

It is worth noting that iTraxx Main CDS index is tight to both Euro STOXX 600 and €IG cash as expectations of heavy IG cash bond supply in September and upcoming roll in iTraxx drove up sentiment.<sup>15</sup> We view this as supportive for €IG ETFs by driving more IG cash spread tightening vs. Main, in our view.

Chart 1: €IG net cumulative supply



Source: BlackRock and Barclays estimates, as of 2 July 2024.

## €HY

We remain constructive on €HY, despite mixed signals from macro data and corporate earnings, as spreads remain attractive compared to €IG: the OAS ratio to €IG is 3.28x, close to the April highs and above the 1Y and 3Y averages.<sup>15</sup> Although relative value vs. \$HY has largely been eroded, US macro uncertainty underscores our preference for € credit.

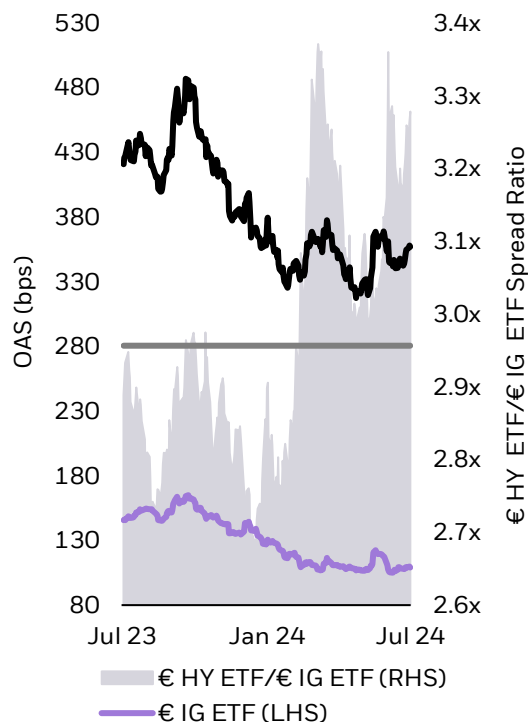
At the index level, €HY spreads have been range-bound in the low 300bps. However, idiosyncratic moves have become more pronounced during earnings season, leading to larger single-name shifts.<sup>16</sup> This heightened focus on cyclical risk, spurred by profit warnings and earnings misses, underscores the importance of sector-specific analysis. Weaker earnings showed reduced consumer demand, predominantly in the autos, airlines and retail sectors. However, this does not appear to be a structural challenge, based on our analysis, with many cyclical sectors, such as chemicals, having largely met expectations.<sup>17</sup>

The number of European issuers with ratings of CCC+ or lower fell to 46 in June 2024, compared to 48 a month prior and 52 one year prior, on improved leverage and cash flows. Upcoming maturities over 2024-2025 continue to screen as reasonable, in our view, with current default rates for € credit at 2.6%.<sup>18</sup> We project that this will remain below the 3% threshold by year-end and well below the full-year 2023 default level of 3.8%.

Our analysis shows that EMEA investor portfolios have a heavy skew towards €IG exposures, at 8% on average, compared to 0.4% in €HY and 1.3% in global HY, highlighting an underallocation compared to our strategic model portfolios.<sup>19</sup>

However, risks remain, with tight valuations as well as August and September seasonality weighing on excess returns as trading volumes dip in the back half of summer.<sup>20</sup>

Chart 2: Relative value of €HY against €IG



Source: Bloomberg and BlackRock, as of 31 July 2024.

**8**, Source: BlackRock and Bloomberg, as of 31 July 2024. **9, 10, 11** Source: Bloomberg, as of 31 July 2024. **12, 13, 14** Source: Goldman Sachs, as of 2 August 2024. **15** Source: Barclays, as of 30 August 2024. **16, 17, 20** Source: Barclays, as of 2 August 2024. **18** Source: S&P Global, as of 26 July 2024. **19** Source: BlackRock Portfolio Consulting EMEA, BlackRock Aladdin, Morningstar. Portfolio average allocation based on 291 moderate risk multi-asset EMEA domiciled portfolios collected between 30/04/2024 – 28/06/2024.

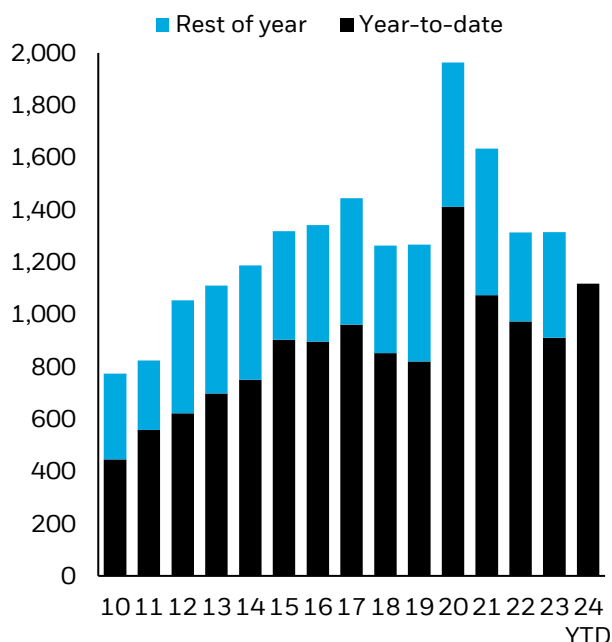
## \$IG

A succession of disappointing data releases, including the July payrolls report, has shifted attention back to the possibility of a potential 'hard landing' scenario for the US economy, resulting in front-end led curve steepening in treasury markets.<sup>21</sup> This introduces increased spread widening risk to US credit, underscoring our neutral view. However, we see the recent selloff as intensified by tech sector earnings misses and the late-July factor rotation, and expect \$IG spread sensitivity to future data surprises to be controlled.

Despite record net issuance of \$452B (\$1,084B gross issuance) in \$IG credit this year, the market has largely absorbed supply.<sup>22</sup> We expect this strong demand to continue, as yield-focused investors prioritise the 5.3% income on offer over spread positioning.<sup>23</sup> The extensive depth and breadth of the US credit markets, combined with the lack of credible alternatives, will likely limit outflows, in our view – even among international investors who seek liquidity in \$IG at a time of elevated volatility in DM rates markets.<sup>24</sup>

We expect a 25bp rate cut from the US Federal Reserve (Fed) in September and see this easing growth concerns and spread decompression risk. We also see the upcoming US election as a potential catalyst for sector dispersion in \$IG, supporting an active approach.

**Chart 3: US IG gross issuance, \$B, 2010-2024 YTD**



Source: Dealogic, Goldman Sachs, as of 8 August 2024

## \$HY

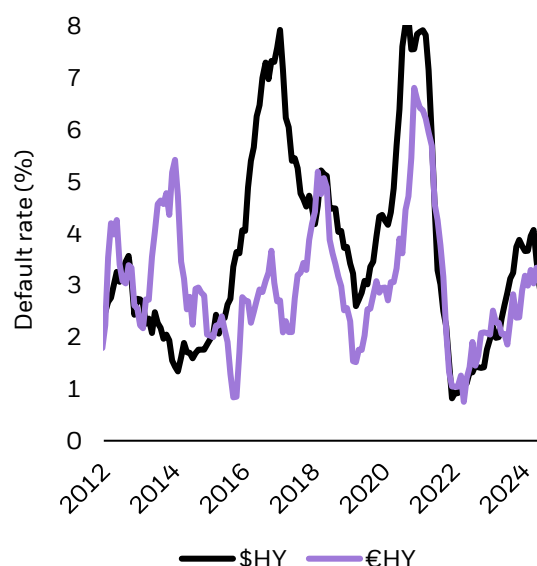
We maintain a cautious stance on \$HY, as the only market which experienced a decline in activity across all credit default swaps (CDX), ETFs and total return swaps (TRS) in Q2 2024. Also, CCC-rated bonds continue to trade at their steepest discount to the broader HY index in nearly 25 years, and we see little in the way of catalysts for this valuation gap to close.<sup>25</sup>

The growth outlook is a risk to spreads, in our view. The US job market has been softening, particularly in manufacturing, with significant moderation in hiring intentions and weak construction spending – although the impact on overall payrolls is expected to be minimal. Though not our base case, we see \$HY as unlikely to withstand a potential growth slowdown, particularly ahead of a Fed rate cut.

Investors also see 'demanding' maturity walls as a concern for refinancing in 2025 and 2026, with \$63B of \$HY bonds set to mature.<sup>26</sup> Although we see this as manageable given US companies' earnings growth,<sup>27</sup> consequent jitters introduce the risk of further spread widening. Net ratings migrations within \$HY have also been bifurcated, as the B bucket experiences a trend of upgrades surpassing downgrades, but the CCC bucket remains dominated by downgrades.<sup>28</sup>

Analysis has shown little correlation with US election polling in corporate credit markets thus far, particularly when compared with equity markets, reflecting likely sensitivity to downside risk.<sup>29</sup> We also look to derisk in Q3 ahead of August and September seasonality, underscoring our underweight view.

**Chart 4: 12-month trailing issuer weighted default rate for \$ and €HY**



Source: Moody's, Goldman Sachs, as of 8 August 2024

**21, 24, 27** Source: Bloomberg, as of 1 August 2024. **22, 23** Source: Goldman Sachs, as of 2 August 2024. **25, 26** Source: Barclays, as of 26 July 2024. **27, 28** Source: Goldman Sachs, as of 24 July 2024. **29** Source: Goldman Sachs, as of 16 July 2024.

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