Private Markets

July 25, 2024

Global Credit Weekly:

No summer slowdown

BlackRock

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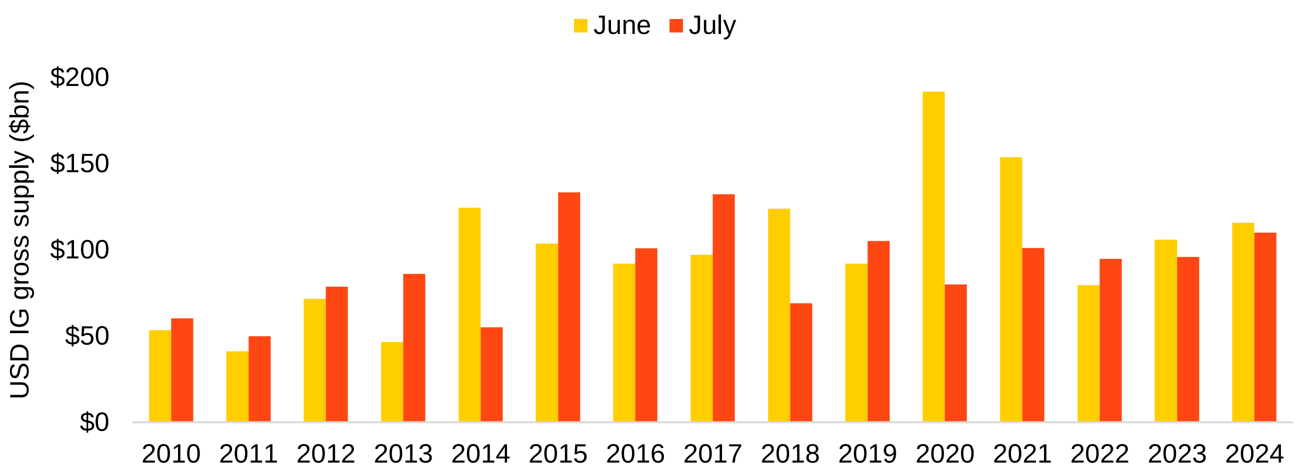
Key takeaways

- In our *3Q2024 Global Credit Outlook* (published in late June), we outlined our expectation for IG and HY corporate credit spreads to trade largely range-bound, with some potential for further spread tightening (from levels that were *already* at the tight end of the historical ranges) as corporate debt issuance moderated into the (typically) slow summer period. In the USD market, spreads have (so far) generally followed the path we anticipated and are largely consistent with an environment of "dispersion, but not widespread market disruption."
- That said, issuance has yet to slow. We believe the historically elevated USD primary market volumes reflect, to some extent, a "pull forward" of activity from 2H2024, as corporates proactively raise liquidity. This potential "pull forward" view was echoed by some large U.S. banks (with debt capital markets syndicate desks) in the recent 2Q2024 reporting season. Our review of deal level data also shows that M&A financing has played a role in keeping activity elevated.
- In the U.S., 1H2024 growth has clearly moderated from the 2H2023 pace, but has remained "supportive enough" in our view to allow HY credit to outperform its IG peer (on a total return basis). A trend pace of growth (or ideally, above trend) is likely a prerequisite for continued resilience in the credit market, as we do not expect material near-term relief in corporate borrowers' interest costs. Based on recent public commentary from Federal Reserve (Fed) officials, we do not expect a rate cut at the upcoming July 30th - 31st FOMC meeting. That said, we believe the Fed will guide towards a potential rate cut in September, based on the "two sided" risks to its dual mandate of price stability and maximum employment.
- In the Euro Area, the economic trend has been the opposite of the U.S. as growth improved in 1H2024 vs. the stagnant levels of 2H2023. That said, as ECB President Lagarde noted last week, the risks to economic growth in the Euro Area remain tilted to the downside (with a particular focus on risks related to global trade policy and exports). We see potential for more cuts (relative to market pricing), driven by downside risks to growth (as opposed to improved inflation).

Exhibit 1: July 2024 (month-to-date) USD IG supply is already the most active since 2017
USD IG gross supply by month



Source: Dealogic (ION Analytics), BlackRock. As of July 24, 2024.

Range-bound spreads

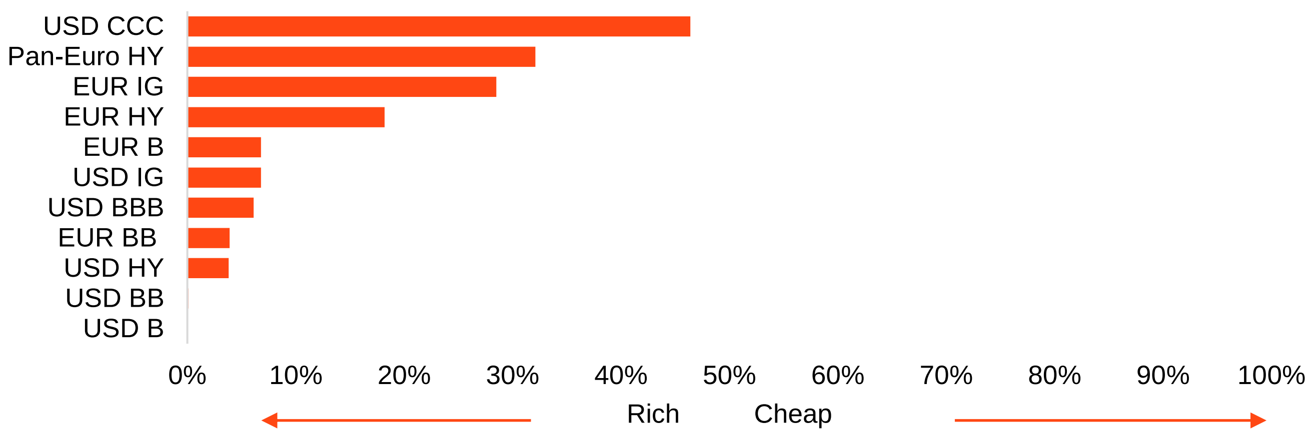
In our *3Q2024 Global Credit Outlook* (published in late June), we outlined our expectation for IG and HY corporate credit spreads to trade largely range-bound, with some potential for further spread tightening (from levels that were *already* at the tight end of the historical range) as corporate debt issuance moderated into the (typically) slow summer period.

In the USD market, spreads have (so far) followed the path we anticipated, but issuance has yet to slow (as discussed on pages 6-7). For example, index level spreads for the Bloomberg USD IG index are roughly flat with their late-June level, while USD HY index spreads are slightly tighter.

The moves in the USD HY market have been especially notable and reflective of the backdrop of "dispersion but not widespread market disruption" we have been emphasizing over the past several months. For example, USD B and BB spreads have reached new lows for the post-financial crisis era, while CCC spreads have continued to lag (Exhibit 2).

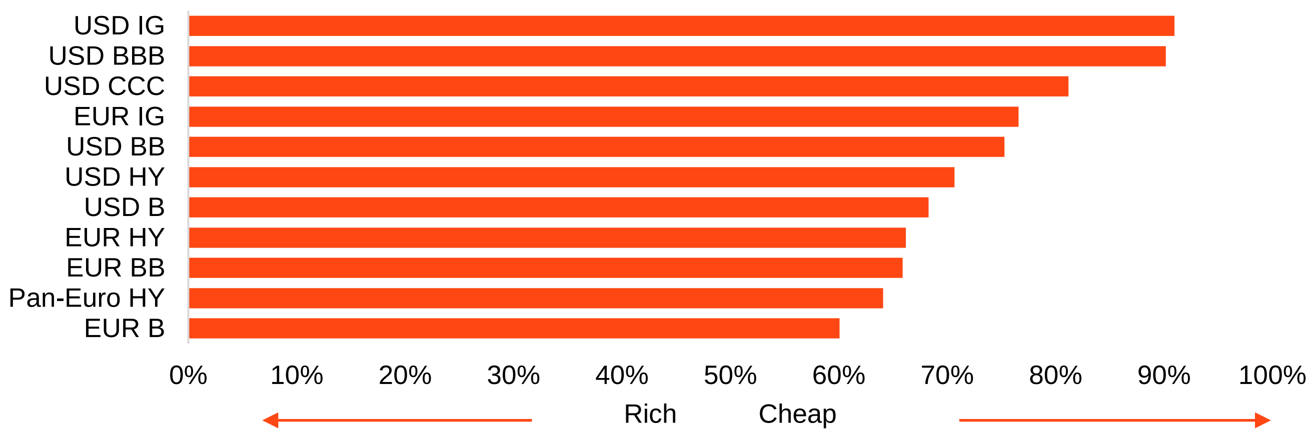
Despite historically tight spreads in many pockets of corporate credit, yield valuations remain attractive (Exhibit 3). In our view, such yield-based demand has been one factor – alongside moderating but still supportive growth – keeping credit spreads relatively anchored.

Exhibit 2: Subsets of USD HY spreads have reach new lows for this cycle, while CCCs lag
Percentile rank of daily index-level corporate bond spreads since January 1, 2010



Source: BlackRock, Bloomberg, ICE-BAML. Captures option adjusted spread data through July 23, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Exhibit 3: All-in yields still generally screen as attractive vs. history
Percentile rank of daily index-level corporate bond yields since January 1, 2010



Source: BlackRock, Bloomberg, ICE-BAML. Captures yield-to-worst data through July 23, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

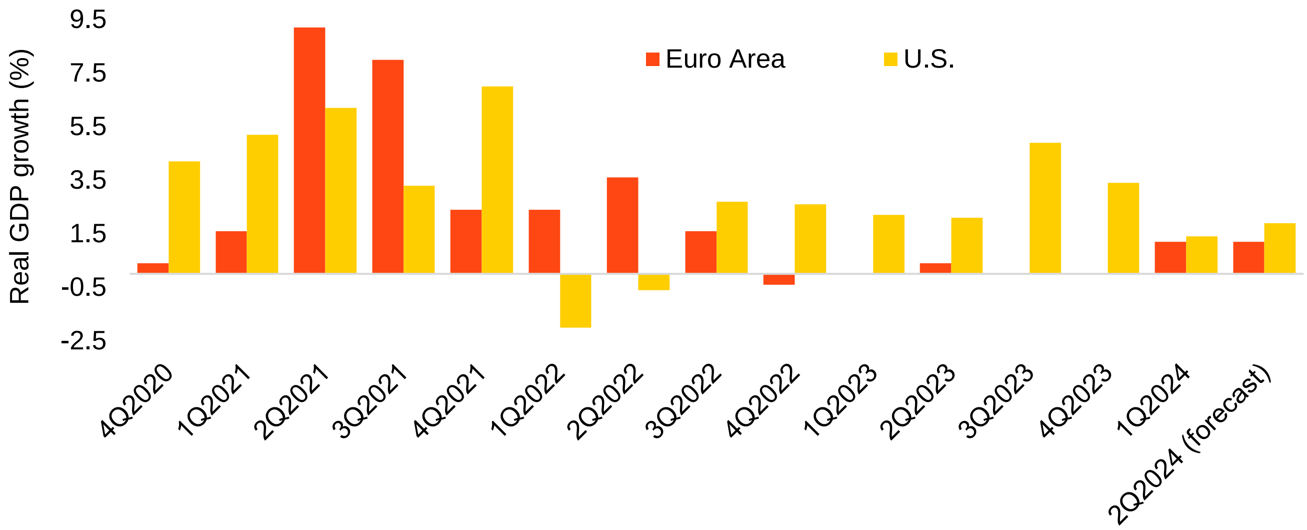
“Supportive enough” growth has allowed HY to outpace IG

As shown in Exhibit 4, growth in the U.S. has moderated vs. its 2H2023 pace. That said, Bloomberg consensus estimates place 2Q2024 real U.S. GDP growth at a still solid 1.9% pace. And the Atlanta Fed’s GDPNow tracker places the same measure at an above trend pace of 2.6%, as of July 24th.

In the Euro Area, the directional trend has been the opposite: after stagnant growth in 2H2023, activity has rebounded, driven in part by improving real wages and less of a drag from monetary policy tightening. That said, as European Central Bank (ECB) President Lagarde noted at last week’s ECB press conference (July 18th), the risks to economic growth in the region are tilted to the downside. She explicitly mentioned that a potential “escalation in trade tensions between major economies would weigh on Euro Area growth.”

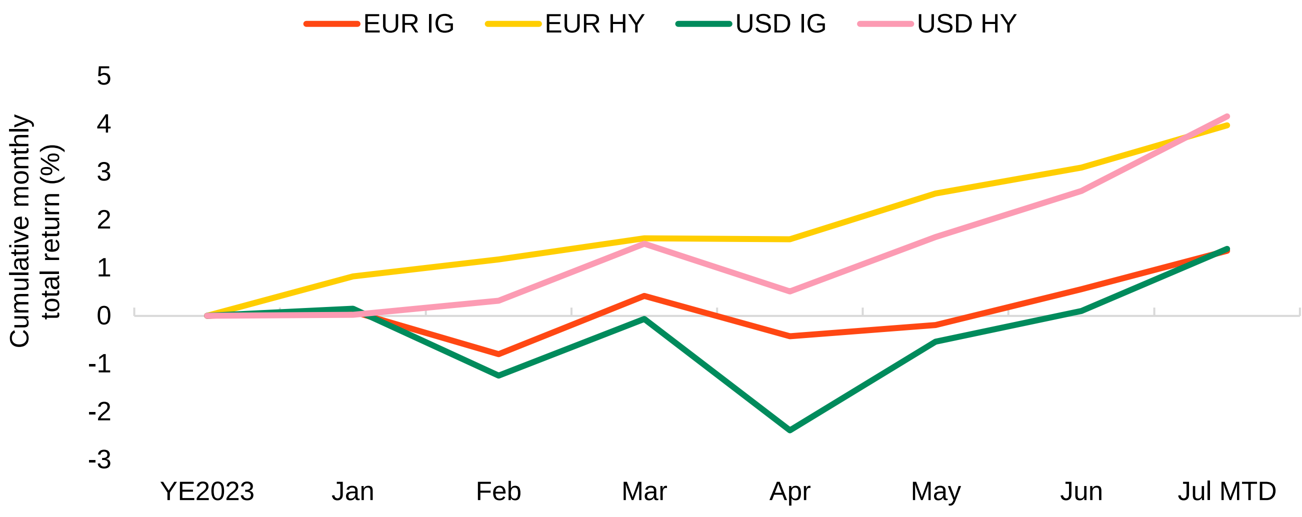
Taken together, these growth backdrops have been “supportive enough” for USD and EUR HY credit to outpace their IG peers from a total return perspective so far this year – even as many market participants remain concerned about a potential inflection point in the cycle.

Exhibit 4: U.S. growth has moderated vs. 2H2023, but is still supportive enough for spreads
Quarter-over-quarter real GDP growth (%), seasonally adjusted at an annualized rate



Source: BlackRock, Bureau of Economic Analysis, Eurostat. 2Q2024 forecast uses the Bloomberg Contributor Composite as of July 22, 2024. **There is no guarantee any forecasts may come to pass.**

Exhibit 5: Solid growth has allowed HY to outperform IG, in the USD and EUR markets
Cumulative monthly total returns for the ICE-BofA USD and EUR corporate bond indices (IG and HY)



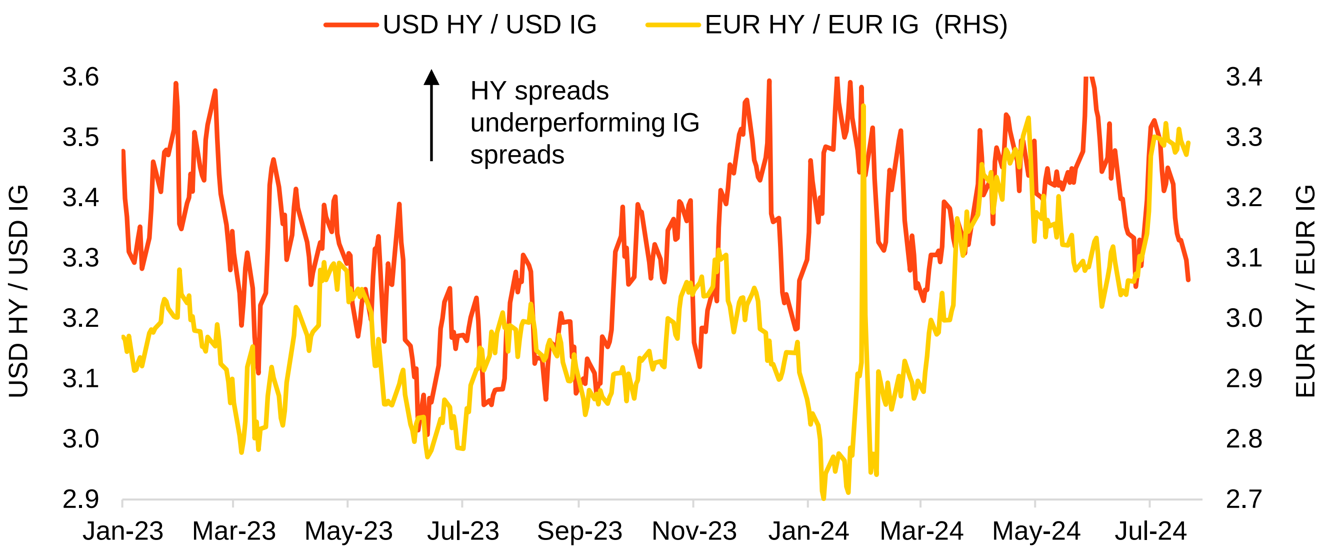
Source: Bloomberg, ICE-BofA, BlackRock. July month-to-date is as of July 22, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Isolating spread fluctuations – which are a true measure of "credit risk" and exclude the impact of interest rate movements – paints a relatively similar picture. Starting *within* regions, Exhibit 6 shows a USD HY/IG spread ratio that is towards the low end of the range of the past several months – which points to relative outperformance of HY. In our view, this reflects the supportive growth backdrop, as well as previously discussed technical tailwinds such as the minimal amount of "new money" issued in the HY market (given that the bulk of year-to-date supply has been earmarked for refinancing). And in the EUR market, while the HY/IG spread ratio is at the high end of its recent range, it is not outsized.

And *across* regions, Exhibit 7 shows that USD HY spreads have outperformed their EUR HY peers on a relative basis. Meanwhile, USD IG spreads have modestly underperformed EUR IG since mid-June.

Exhibit 6: The HY/IG spread ratio is somewhat tighter in the USD market

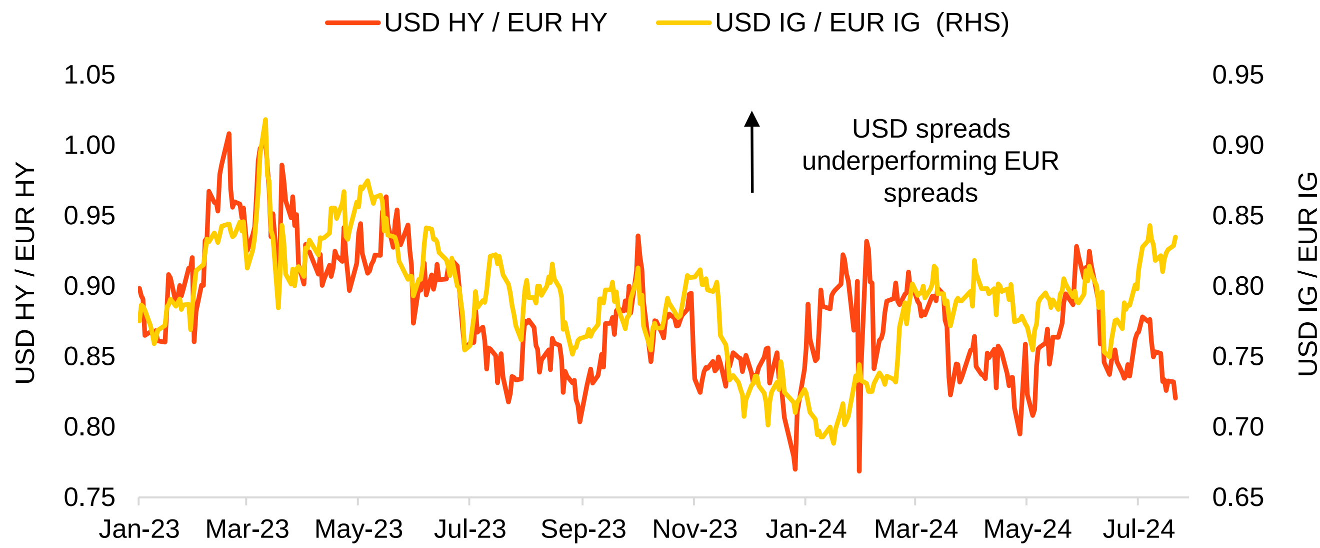
Option adjusted spread ratios using the Bloomberg Corporate indices: USD HY / USD IG and EUR HY / EUR IG (RHS)



Source: Bloomberg, BlackRock. As of July 24, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Exhibit 7: In the HY market, USD spreads have recently outperformed their EUR peers

Option adjusted spread ratios using the Bloomberg Corporate indices: USD HY / EUR HY and USD IG / EUR IG (RHS)



Source: Bloomberg, BlackRock. As of July 24, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

USD IG and HY supply: Defying the (typical) seasonal summer slowdown

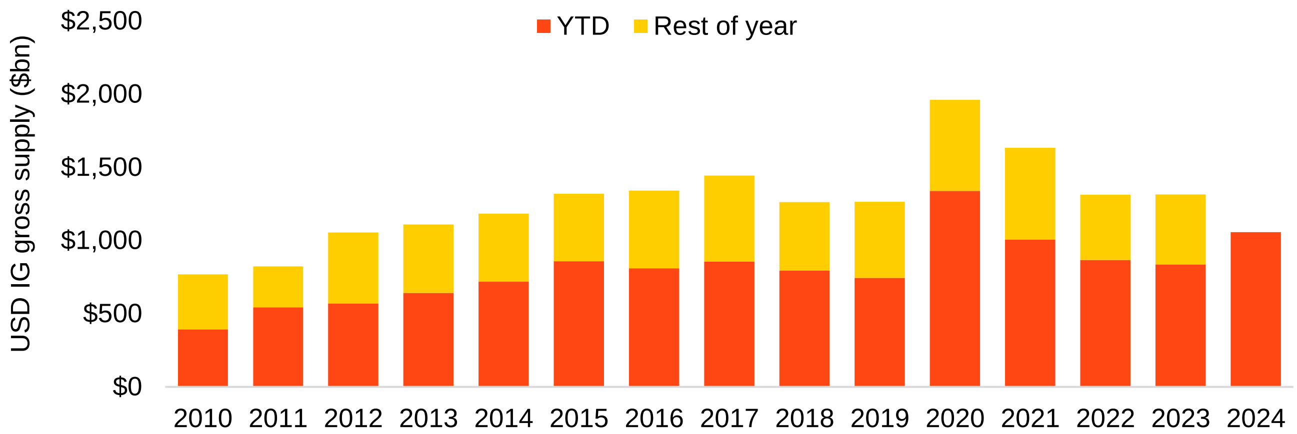
The USD IG primary market has, so far, defied the typical summer lull. With $110 billion priced as of July 24th (per data from Dealogic), the USD IG new issue market has already generated its most active July since 2017.

We see a few drivers behind this elevated activity. First and foremost, we believe it reflects a "pull forward" of some potential issuance needs from 2H2024 into 1H2024, as corporates may be looking to proactively raise liquidity and avoid potential volatility around certain events later this year (such as the U.S. election). Indeed, 18% of the year-to-date gross USD IG issuance has been earmarked for refinancing or debt repayment, according to Dealogic – a level towards the higher end of the historical range (Exhibit 9). This potential "pull forward" view was also underscored in public commentary from some large U.S. banks (with debt capital markets syndicate desks) during 2Q2024 earnings season.

The second driver is strategic M&A financing. As we have discussed recently, deal making among corporates has rebounded notably over the past few quarters, with a portion of this activity utilizing debt financing. 10% of the year-to-date gross USD IG issuance has been earmarked for M&A financing – a level that is moderately above the 2021-2022 pace (again, Exhibit 9). (Note: as for the "remainder" of the USD IG issuance, the bulk of it is generally issued under the category of "general corporate purposes").

Exhibit 8: USD IG gross supply is tracking 26% above the 2023 level

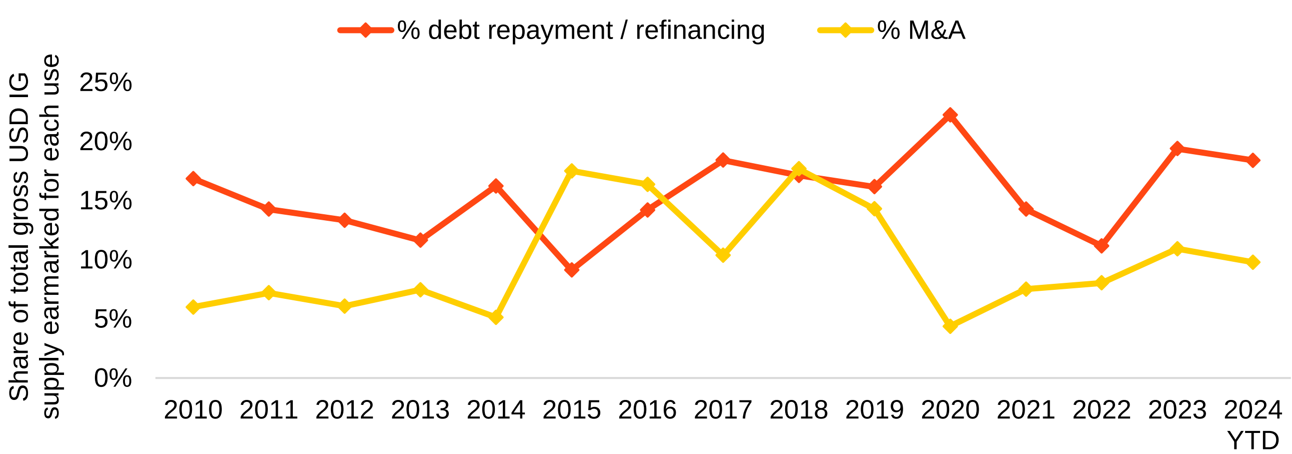
USD IG gross supply by year-to-date period (as of July 24) and rest of year



Source: Dealogic (ION Analytics), BlackRock. As of July 24, 2024.

Exhibit 9: The share of debt issued for upcoming maturities and M&A is below the recent peaks, but still meaningful

Share of total USD IG gross issuance earmarked for debt repayment / refinancing, and M&A, as captured by Dealogic's "primary use of proceeds"



Source: Dealogic (ION Analytics), BlackRock. As of July 24, 2024.

So far, this elevated USD IG supply has been well absorbed. According to data compiled by Bloomberg, year-to-date new issue concessions have averaged just 3.5bp – this compares to 8.5bp for full-year 2023. Additionally, USD IG order books (on average) have been 3.7x oversubscribed (vs. 3.5x in 2023).

A similar pattern can be seen in the USD HY market, as shown in Exhibits 10 and 11. With $176 billion issued so far this year, USD HY gross issuance is tracking 79% above last year's pace, with meaningful contributions from June and July. Here too, we believe management teams have been focused on upcoming maturities – even those as far away as late 2025 and early 2026, based on our review of deal level data compiled by Dealogic.

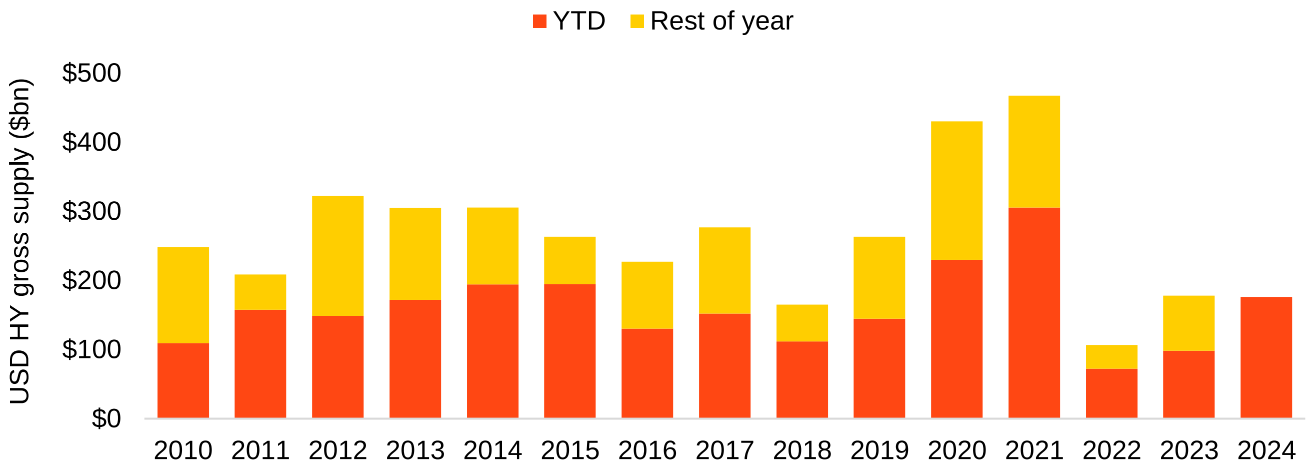
In fact, 75% of the year-to-date USD HY gross issuance has been earmarked toward debt repayment or refinancing, according to Dealogic. This compares to 63% in 2023 and is the highest share of post-financial crisis era issuance (using year-to-date periods). The second-highest share was 2017's 65%.

M&A financing has also played a role in some of the recent activity, again based on our review of deal level "use of proceeds" information for a wide variety of USD HY transactions.

Given the sensitivity of speculative rated issuers to the growth backdrop, we view a proactive approach to liquidity raising and pre-funding as a positive for overall credit quality. Moreover, a receptive and open debt capital markets backdrop is a key ingredient to a resilient corporate credit market, in our view.

Exhibit 10: USD HY gross supply is tracking 79% above the 2023 pace, but has been largely skewed towards refinancing activity

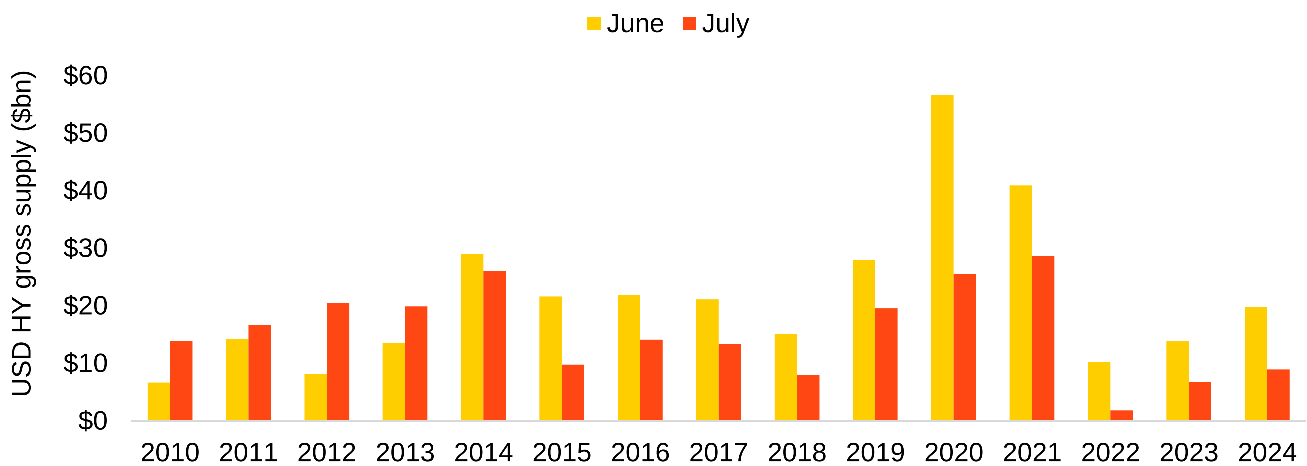
USD HY gross supply by year-to-date period (as of July 24) and rest of year



Source: Dealogic (ION Analytics), BlackRock. As of July 24, 2024.

Exhibit 11: June and July (month-to-date) USD HY supply is elevated vs. the past two years

USD HY gross supply by month



Source: Dealogic (ION Analytics), BlackRock. As of July 24, 2024.

ECB takeaways: A pause for July, but September is "wide open"

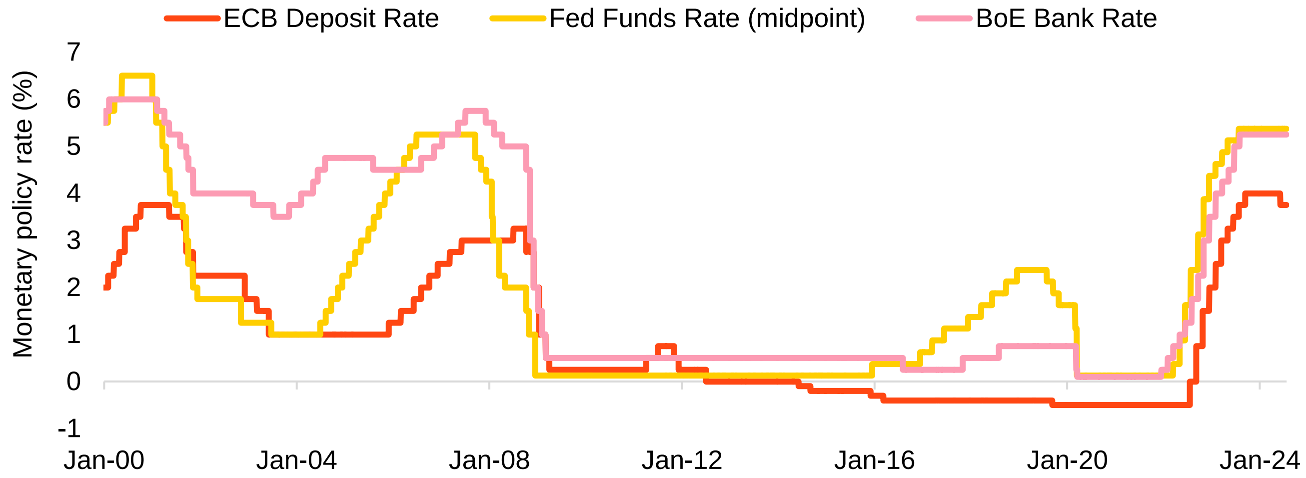
As was widely expected by consensus estimates, the ECB kept rates unchanged at last week's monetary policy meeting – taking a pause from the 25bp cut in June, which represented the first cut of this cycle (Exhibit 12). That said, during the Q&A of the press conference, President Lagarde said the question of what to do at the September meeting was "wide open."

As shown in Exhibit 13. market pricing reflects a 90% probability for a 25bp rate cut at that meeting, with a total of four 25bp cuts priced through June 2025.

Most notable from the press conference, in our view, was the confidence that President Lagarde expressed related to the ECB's expected improvement in wage inflation in 2025 and 2026 (Exhibit 15). This has important implications for an eventual improvement in broader services inflation, which has (so far) proved sticky (Exhibit 14).

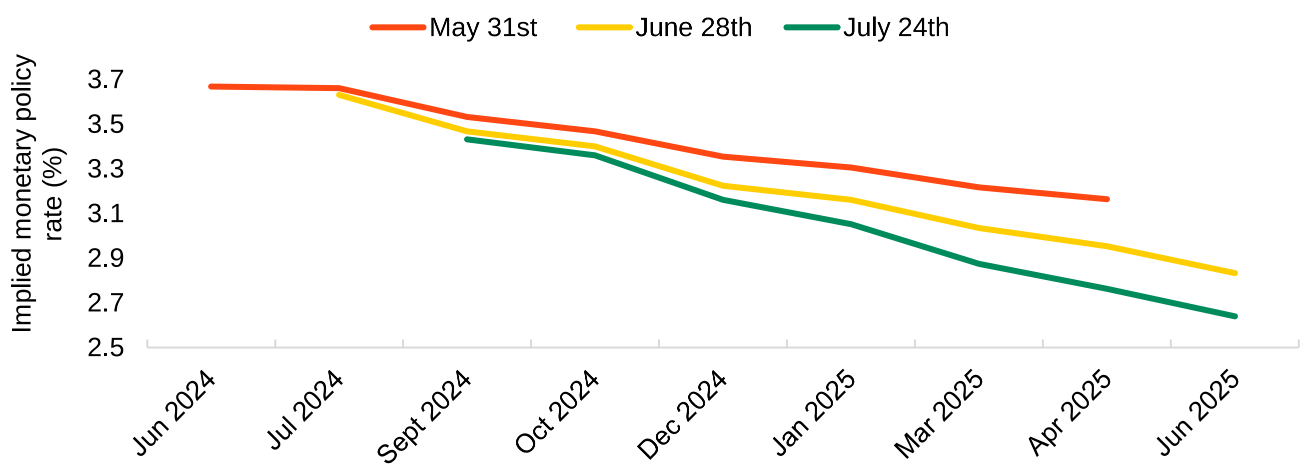
Also important, in our view, was President Lagarde's characterization that growth risks are tilted to the downside – with global trade (exports) a key component of any economic recovery. Uncertainty related to trade policy will be important to watch, in our view, given the 2018-2019 experience (discussed later). On net, we see potential for more cuts relative to market pricing, given the downside risks to growth.

Exhibit 12: The ECB cut rates in June 2024, but kept them on hold at the July meeting
Monetary policy rates for the European Central Bank, Federal Reserve, and Bank of England



Source: Bloomberg, European Central Bank, Federal Reserve, Bank of England, BlackRock. As of July 23, 2024.

Exhibit 13: Market pricing reflects a 90% probability of a cut in September
Monetary policy rates for the European Central Bank, Federal Reserve, and Bank of England

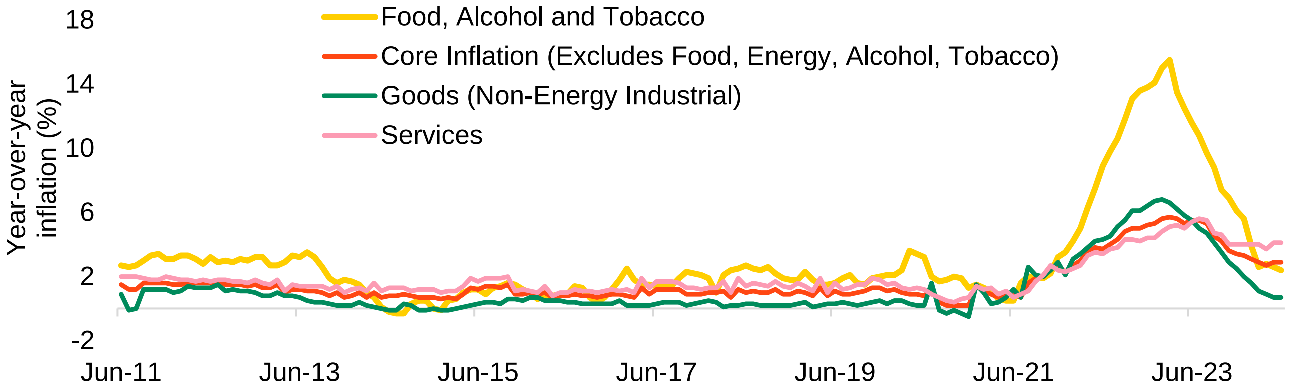


Source: Bloomberg, BlackRock. As of July 24, 2024, June 28, 2024, and May 31, 2024. There is no guarantee any forecasts may come to pass.

Key takeaways from the July ECB press conference:

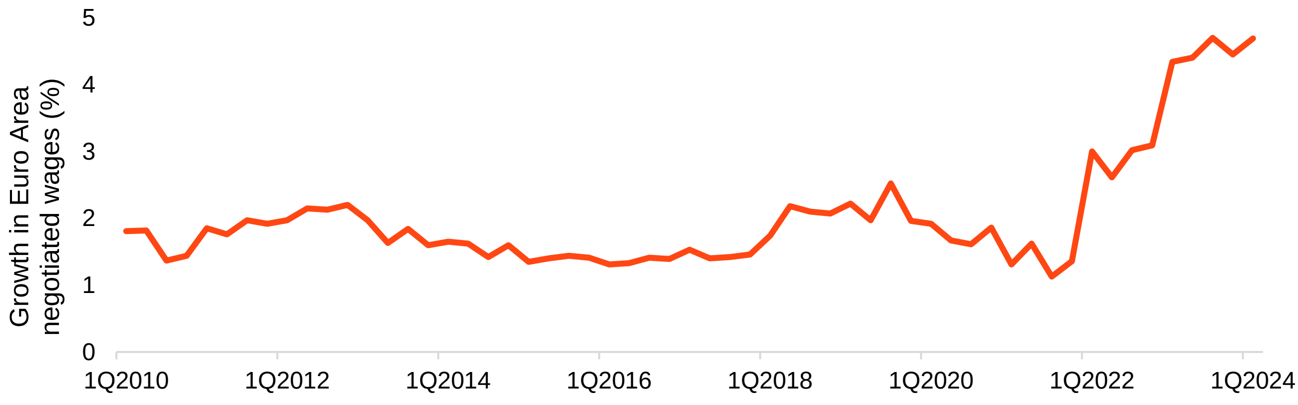
- **Services is key to the recovery.** While growth in the Euro Area improved in 1H2024 (Exhibit 4), the ECB expects "muted growth" through year-end, given weak business investment, tight financing conditions, and lagging manufacturing activity. An eventual recovery is expected to be led by the services sector, which accounts for around 75% of the European Union's GDP. President Lagarde acknowledged the "virtuous circle" between higher employment of services and consumption of services, which should ultimately support an economic recovery – especially in sectors with exposure to consumer and services spending.
- **Wage costs should peak in 2024.** While the ECB expects wage inflation to remain elevated in 2024, President Lagarde noted the pace of increases is expected to "decline significantly in the course of 2025 and even more so 2026." As we've discussed previously, collective wage bargaining in the Euro Area covers approximately 80% of total employees, according to the ECB. Labor contracts are often negotiated on a recurring cadence, with many contracts spanning multiple years. President Lagarde said the "staggered nature of wage adjustments and the large contribution of one-off payments" will likely keep growth in labor costs elevated over the near term as wages "catch up" to previous inflation.
- **The interplay between wages, profits and productivity.** Corporate profits have begun to absorb some of the elevated wage costs, "helping to offset the inflationary effects of higher unit labor costs." Additionally, President Lagarde cited "a little bit of progress" on productivity measures, but "certainly not what we would like to see." A rise in consumer demand is expected to increase labor productivity, as "hoarded employees" will be asked to respond to greater demand.

Exhibit 14: Services inflation has been sticky, due to elevated wage costs
Year-over-year inflation (not seasonally adjusted) for the Euro Area, by category



Source: BlackRock, Eurostat, European Central Bank, Bloomberg. Captures inflation data through June 2024 (latest available).

Exhibit 15: Wage growth is expected to peak in 2024, according to the ECB
Year-over-year percentage change in Euro Area negotiated wages



Source: European Central Bank, BlackRock, Bloomberg. As of 1Q2024 (most recent). Note: Developments in negotiated wages can be monitored by the ECB's indicator of Euro Area negotiated wage growth, which has been compiled since 2001 and is based on data from nine countries: Belgium, Germany, Spain, France, Italy, Netherlands, Austria, Portugal, and Finland. The indicator is published on a quarterly basis and includes structural wage increases as well as one-off payments.

Key takeaways from the July ECB press conference (continued):

- **Inflation is on track to reach the 2% target, but not in the near-term.** The Euro Area's Harmonised Index of Consumer Prices (HICP), showed continued moderation in June, declining to 2.5%, from 2.6% in May. President Lagarde acknowledged that most measures of inflation were either "stable or edged down" in June, making (gradual) progress toward the ECB's 2% medium-term target. President Lagarde expects inflation to "fluctuate around current levels" for the remainder of the year and decline toward 2% in 2H2025. She noted the ECB will keep policy rates "sufficiently restrictive" for as long as necessary to accomplish this.
- **Potential trade policy changes.** When asked about risks associated with tariffs and the U.S. election, Lagarde noted that the ECB "will be attentive to whatever political decisions are made," and that trade policy is "particularly important given that export is one of the engines of the [economic] recovery." Beyond the U.S., President Lagarde noted that the region's competitive position relative to China will also be monitored (related to trade and export activity). As we highlighted previously, a recent Goldman Sachs economic research analysis showed that trade *uncertainty* from the 2018-2019 trade tensions weighed on Euro Area industrial production over that timeframe. This suggests the *uncertainty* should be closely watched in the near-term, alongside any *formal policy changes* over the medium/long term.
- **The ECB represents the *whole* Euro Area.** During the press conference, some questions were directed toward the larger deficits of some member countries, and whether those posed any challenges to further inflation progress (or, financial stability risks). President Lagarde reinforced that the Euro Area is a "monetary union" with 20 different fiscal jurisdictions which inevitably have dispersion in economic conditions, and necessarily, the ECB makes decisions for the whole Euro Area, not in the interest of any single country. She guided member states to abide by the European Commission's new economic governance framework to strengthen fiscal sustainability.

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