Sterling credit: it's all about the yield

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Sometimes, investing can be quite simple when it is stripped back to basics. When we look at the outlook for the next 12 months, we can see the prospects for issuance, the strength of corporate balance sheets and the potential for central bank action, but in my view, the starting point for next year is a very attractive 'all-in' yield.

It is very easy to focus more on credit spreads – after all, this is an essential premium we want to receive for the credit risk we take – but while these have not really moved a great deal over the past few years, the underlying gilt reference yield has increased dramatically. It is helpful to look at this in a historical context – Figure 1 shows that the yield on the iBoxx Sterling Non-Gilt index is back above 6% for the first time since the global financial crisis in 2008/9.

Market risks

Obviously, a higher headline index yield is not enough in itself: credit risk – which usually manifests through downgrades rather than defaults in the investment grade world – is real. At an aggregate level, we still believe that credit spreads more than compensate for that credit risk, but events in 2023, notably the collapse of Credit Suisse, reminded investors that this is not just a theoretical risk.

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We are expecting an economic slowdown in 2024. That may be a mild recession, or just flat-lining growth. The economy has been resilient to this point but I think that most investors expect the monetary policy tightening of the past two years to start to show up more in the real economy.

As a backdrop, that would normally be bad for corporates. But many have used the past few years sensibly, retiring higher paying debt, and taking advantage of ultra-low rates to issue debt at advantageous levels. That phase has now come to a close, but the extent of activity in recent years means that many companies have more breathing space when it comes to needing to go back to the market for financing.

Credit markets remain resilient

The collapse of Credit Suisse had a clear impact on the market, with the complete wipe-out of AT1 bond holders (while equity holders achieved some modest recovery), effectively stopping new AT1 issuance. But as we near the end of 2023, that pause has already come to an end. Banks issuing in this area are having to pay a high price to do so, but it was noteworthy that UBS, which of course took over Credit Suisse, was able to raise some $3.5 billion with the issue over-subscribed by around ten times.

Sterling credit remains a small component of global investment grade markets, with US and euro markets significantly bigger. As a result, it's easy to overlook the opportunities in the sterling market, especially with the drive to achieve higher global diversity in portfolios, but ignoring or removing exposure to this market means that an investor is missing out on a potentially attractive source of returns. For instance, at present our sterling credit all-maturities strategies typically yield around 1% more than the iBoxx index – meaning an all-in yield of around 7%.

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There are always concerns...

For any fixed income manager, there are ever-present concerns, most of which stem from the inherent nature of fixed income, namely we want to ensure that the coupons and principal of the bonds we buy will be paid. And obviously changes in interest rates and expectations can lead to volatility in the current price of those bonds. If we look at central bank interest rates, we think that further material increases would only occur if inflation not only remains at current levels, but arguably spikes higher once more. That is not our core expectation.

On the health of the corporate sector and its ability to service existing debt, an economic slowdown obviously impacts corporate profitability. But as mentioned earlier, the corporate world has been pretty sensible in how it has managed balance sheets following the pandemic.

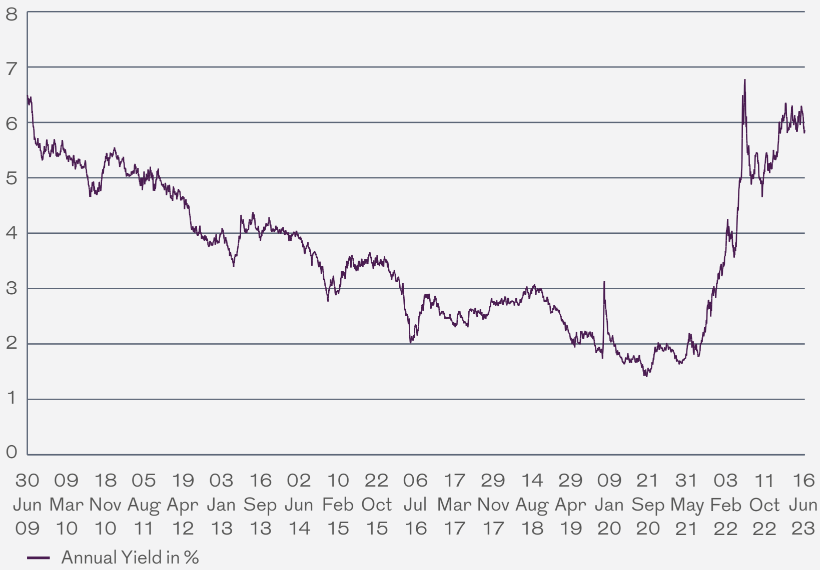
...and ways to mitigate them

Investors familiar with our sterling credit strategies will know that we like to mitigate risk by favouring diversification and security, the former because it reduces the impact of any negative event, and the latter because we continue to think that we are over-compensated for risk when compared with unsecured debt. In our view, the main attraction of this approach is that it has historically been less reliant on the economic cycle, which always feels a better place to be when forecasters are on the fence around growth and recession prospects in the year ahead.

So to bring this back to our starting point, although there are some potential pitfalls out there for sterling credit markets, for the first time in a decade we can go into a year looking at a headline yield that we think is attractive and sustainable, and some supportive underlying factors, including the fact that interest rates appear to have peaked and inflation is falling. For a fixed income investor, that is a decent starting point for any year.

Figure 1: Sterling credit yields have rebounded significantly

Sterling Credit Index duration and yield



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