Flash Fixed Income

December 2024

TwentyFour
a boutique of Vontobel

Credit correction coming?

- Corporate bond spreads are comfortably tighter than 10-year averages (more so in the US), though above-average yields remain attractive in our view.
- Despite potential catalysts for volatility in 2025, healthy fundamentals and strong technical demand for corporate debt should help to maintain downward pressure on spreads.
- Spread widening into an environment of high overall yields should present opportunities for active investors.

With favourable conditions for credit having driven spreads in some sectors close to all-time tights heading into 2025, some market participants have begun to speak of late-cycle exuberance and a potential correction.

Below, we look at the factors that have supported credit in 2024 and which, if any, of those factors we think could change in the coming months.

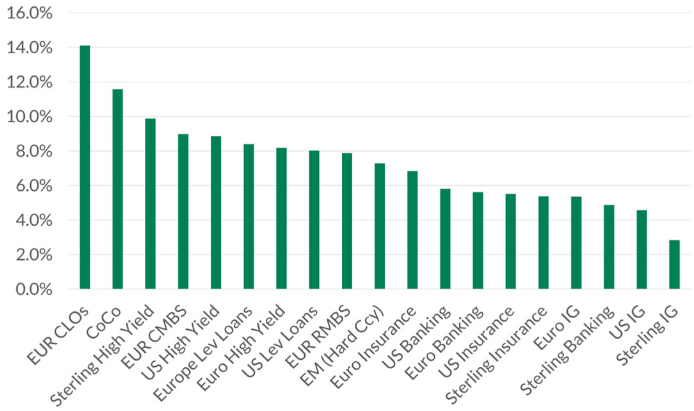
2024 a hard act to follow

Unsurprisingly, of the sectors we track it is the higher beta markets of collateralised loan obligations (CLOs) and bank Additional Tier 1 bonds (AT1s) that have led the way in 2024, posting double-digit returns year-to-date (see Exhibit 1). Investment grade (IG) non-financial GBP bonds have been a relative underperformer, returning just under 3% YTD, though this is primarily driven by the underperformance of Gilts against both US Treasuries (USTs) and Bunds.

This isn't far removed from what many expected from credit at the start of the year, given high all-in yields meant the income generated from coupons and pull-to-par alone offered solid return prospects (not unlike the outlook for 2025).

However, 2024's returns have been aided by spread tightening, which is why many are now questioning whether credit can repeat the trick in 2025. Besides a relatively benign macro environment, healthy corporate fundamentals and a strong technical bid for corporate debt have driven credit performance in 2024 – so in our view the key question is whether these two factors will weaken over the next 12 months.

Exhibit 1: Credit market performance 2024 YTD



Past performance is not a reliable indicator of current or future performance. It is not possible to invest directly into an index and they will not be actively managed. Source: TwentyFour, Bloomberg, ICE BofA Indices, data as at 9 December 2024

Credit market performance

	Total return YTD (%)	Total return last 30 days (%)	Yield (%)	Duration (yrs)
EUR IG	5.54	1.46	3.0	4.5
GBP IG	2.82	1.36	5.4	5.9
US IG	4.79	0.71	5.1	6.7
EUR HY	8.72	1.06	5.3	2.8
GBP HY	10.32	0.83	7.9	3.0
US HY	9.13	0.77	7.1	3.3
EM HY	12.95	0.48	7.7	3.9
Euro Senior Banks	5.69	1.22	2.9	3.6
CoCo	10.53	0.12	6.4	3.3

Past performance is not a reliable indicator of current or future results. Included for illustrative purposes only. Shown in local currency terms. It is not possible to invest directly into an index and they will not be actively managed. Source: Bloomberg, TwentyFour, 11 December 2024


Gordon Shannon
Partner, Portfolio Management

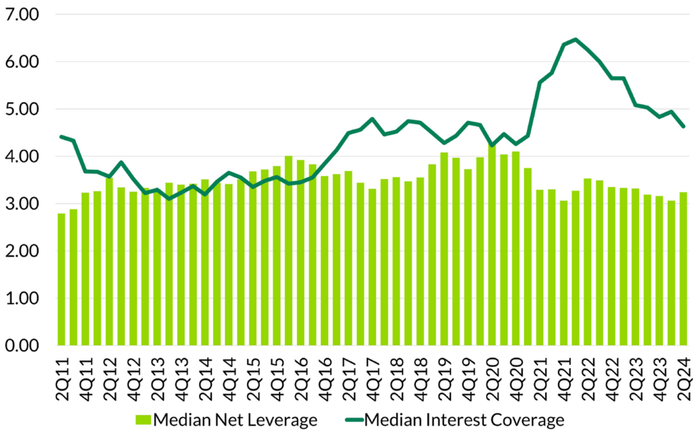

George Curtis
Portfolio Management

Companies showing rate rise resilience

Looking at corporate fundamentals, some businesses have no doubt suffered from rate rises but most have navigated the environment well, and solid earnings growth has generally supported credit metrics.

Net leverage in the high yield (HY) space, for example, is towards the bottom end of the 10-year range, and below where it was in Q4 2019 (see Exhibit 2). Interest coverage, while inevitably declining from the peaks of 2022, remains around its longer term average.

Exhibit 2: Net leverage and interest coverage in European HY (%)



Past performance is not a reliable indicator of current or future performance. Source: CreditSights, data as at Q2 2024.

In the IG space, net leverage is roughly in line with the five-year pre-Covid average, although interest coverage has fallen quickly from the highs of 2022 to settle slightly below the longer term average.

Profit margins in both IG and HY have been resilient, though it is fair to say there has been dispersion among sectors and ratings. Low margin, commoditised sectors such as industrial chemicals have seen pressure, for example, while higher rated businesses and those with significant pricing power have in some cases expanded margins materially.

HY default rates, while higher than the longer term average in Europe, remain subdued at below 3%. US default rates are even lower at just over 1%, well below the longer term average of 3.5%. Distressed ratios – the percentage of the index trading above 1,000 basis points (bp) in spread – are 7% and 4% below their post-crisis averages in the US and Europe index respectively. Defaults on a forward-looking basis should be relatively subdued given HY firms have successfully termed out a large percentage of short term debt.

We see similar fundamental strength in financials, where higher interest rates have been a profitability tailwind for European banks in particular; the sector's forecast 11.5% average return on equity for full-year 2024 is a world away from the 4-6% average seen during the negative rate era. Combined with impressive capital levels and the significant post-crisis improvement in loan book quality (average non-performing loans are around 2% now versus 8% 10 years ago), this has helped Western European financials to achieve the highest upgrade/downgrade ratio of any credit market over the past two years.

Low net supply holds down spreads

When it comes to the technical bid for corporate debt (i.e. a favourable balance of demand versus supply), one way to measure this is to compare fixed income fund flows to net bond issuance.

On the flow side, 2024 has seen a record year for inflows into European credit. While spreads are relatively tight, overall yields remain attractive and well above 10 and 20 year averages (IG bonds now offer yields that in 2021 could be achieved on CCC rated credits, for example). This underpins the cross-asset relative value of credit in our view, particularly compared to achievable dividend yields in equities. Leaving aside cross-asset flows, the coupon payments bondholders are due to receive next year will in some cases be larger than the expectation for net supply.

Gross supply across IG and HY markets increased in 2024 and is on course for a record year in US and European IG. The most important driver of the technical however is net supply, i.e. the amount of new bonds issued versus those maturing. Whilst elevated in IG, net supply has been much lower in US HY and negative in European HY, both as a result of limited organic issuance and a net migration of bonds being upgraded to IG. We expect HY net supply to pick up in 2025 but to remain below longer term averages.

In financials we expect a similar story, with net supply from European banks expected to be close to zero across most of the capital structure, including senior, Tier 2 and AT1 bonds. This longer term technical tailwind (banks only have a set amount of capital as a percentage of assets they need to issue)

Rates dashboard

			Change (bp)		
		Current (%)	1 w	1 m	YTD
US Treasury	2yr	4.14	-4	-20	-11
	10yr	4.23	0	-20	35
	30yr	4.42	2	-15	39
UK Gilt	2yr	4.28	5	-22	29
	10yr	4.32	8	-18	79
	30yr	4.88	1	-4	74
German Bund	2yr	1.96	2	-17	-44
	10yr	2.12	7	-24	10
	30yr	2.35	8	-22	9

			Change (bp)		
	Market projection	Current (%)	1w	1 m	YTD
Base rate 4.75%	end-2024	4.38	-2	-6	65
	end-2025	3.78	5	-12	71
Base rate 4.75%	end-2024	4.63	1	3	101
	end-2025	3.90	3	-14	88
Base rate 3.25%	end-2024	2.83	0	3	53
	end-2025	1.77	-6	-10	-14

Past performance is not a reliable indicator of current or future results. Included for illustrative purposes only. Shown in local currency terms. It is not possible to invest directly into an index and they will not be actively managed. Source: Bloomberg, TwentyFour, 11 December 2024 should continue to support spreads in the sector.

US valuations look more stretched

When it comes to valuations, fixed income investors will be looking at today's tight spreads in the context of still-high overall yields.

There would appear to be a tension between these two facts, but it makes sense given the macro environment; central banks hiked rates aggressively but are cutting more gradually (hence yields remain high), yet growth still remains robust and consumer and corporate balance sheets look solid (hence tight spreads).

Euro HY and IG spreads are around 80bp and 20bp tighter than their 10-year averages respectively, but in yield terms they are 100bp and 140bp higher than their 10-year averages.

While the picture is similar in the US, valuations do appear more stretched; HY and IG spreads are around 160bp and 45bp inside their 10-year averages, respectively, though again in yield terms they are 35bp and 140bp above their 10-year averages.

Yields allay fears over spread widening

Ultimately, we don't expect to see a sustained credit spread widening in 2025 as long as the fundamental and technical tailwinds remain in place, which they seem likely to do.

To be clear, with considerable uncertainty surrounding the trade policy of the incoming US administration and a troubling geopolitical backdrop, there are numerous potential catalysts for volatility and spreads could certainly spend periods of 2025 wider than they are now. However, we don't expect to see a level of weakness that could be termed a "correction" in credit.

High yields offer fixed income investors some protection against spread volatility, and central banks have "dry powder" to increase the pace of rate cuts if the macro environment weakens. As a result, we think credit spread widening will most likely provide opportunities for the active investor.

Important information:

The views expressed represent the opinions of TwentyFour as at 11 December 2024, they may change, and may also not be shared by other members of the Vontobel Group. The analysis is based on publicly available information as of the date above and is for informational purposes only and should not be construed as investment advice or a personal recommendation.

Any projections, forecasts or estimates contained herein are based on a variety of estimates and assumptions. Market expectations and forward-looking statements are opinion, they are not guaranteed and are subject to change. There can be no assurance that estimates or assumptions regarding future financial performance of countries, markets and/or investments will prove accurate, and actual results may differ materially. The inclusion of projections or forecasts should not be regarded as an indication that TwentyFour or Vontobel considers the projections or forecasts to be reliable predictors of future events, and they should not be relied upon as such. We reserve the right to make changes and corrections to the information and opinions expressed herein at any time, without notice.

Past performance is not a guarantee of future results. Investing involves risk, including possible loss of principal. Value and income received are not guaranteed and one may get back less than originally invested. TwentyFour, its affiliates and the individuals associated therewith may (in various capacities) have positions or deal in securities (or related derivatives) identical or similar to those described herein.

The index data referenced herein is the property of Merrill Lynch, Pierce, Fenner & Smith Incorporated (BofAML) and/or its licensors and has been licensed for use by Vontobel. BofAML and its licensors accept no liability in connection with its use. Index comparisons are provided for informational purposes only and should not be used as the basis for making an investment decision. It is not possible to invest directly in an index and they are not actively managed.

Source: Bloomberg. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). Bloomberg does not approve or endorse this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith. This marketing document was produced and approved by TwentyFour Asset Management LLP ("TwentyFour"), a company of the Vontobel Group (collectively "Vontobel") for professional/institutional investors only.

The information contained in this document is not intended for distribution to or use by any person or legal entity in any jurisdiction or country in which such distribution or use would violate any valid law or regulation or would require Vontobel or its affiliates to register within that jurisdiction or country. Vontobel makes no assurances that the information contained in this document is suitable for use at all locations or by all viewers.

This document does not in any jurisdiction constitute, directly or indirectly, a recommendation, offer or solicitation to the public or anyone else to subscribe to, purchase, hold or sell a financial instrument and is not to be construed accordingly.

This document is a general communication. It is not independent and was prepared exclusively for informational and educational purposes. The information and opinions contained in this document (jointly "information") are not to be taken as forecasts, research, recommendations or investment advice, are not intended to predict actual results and no assurances are given with respect thereto. Certain information herein is based upon forward-looking statements, information and opinions, including descriptions of anticipated market changes and expectations of future activity of countries, markets and/or investments. We believe such statements, information, and opinions are based upon reasonable estimates and assumptions. Actual events or results may differ materially and, as such, undue reliance should not be placed on such forward-looking information. All forecasts, forward-looking statements and estimates contained in this document are speculative. Various risks and uncertainties mean that it cannot be guaranteed that the estimates or assumptions made will prove to be correct and actual events and results may differ significantly from those presented or expected in this document. The opinions expressed in this document may change as a result of market, economic and other conditions. Information in this document should not be interpreted as a recommendation but as an illustration of general economic issues. Please note that past performance is not a reliable indicator of current or future performance and that forecasts are essentially limited and must not be used as an indicator for future performance.

All information in this document is provided on the basis of knowledge and/or the evaluation of the market at the time of preparing the document or at the time stated in the document without making any express or implicit representations or warranties of any kind. However such information can become void or change as a result of subsequent political or market events or for other reasons. Vontobel reserves the right to make changes and corrections to the information and opinions expressed herein at any time, without notice, but is under no obligation to do so. Viewers bear sole responsibility for decisions made on the basis of information in this document. They must not rely on information in this document when making an investment decision or any other decision.

This document was not prepared on the basis of individual investor relations. Nothing in this document constitutes advice regarding taxes, accounting, regulation, law, insurance, investments or any other form of advice regarding subscribing to, purchasing, holding or selling securities or other financial instruments, making transactions or following particular investment strategies.

Vontobel is not liable for any direct or indirect losses or damage that result from the information available in this document, including but not limited to loss of earnings, or for any losses or damage incurred as a direct or indirect result of the use of information contained in the document.

Vontobel releases itself, insofar as is possible under the applicable law, from any liability for direct or indirect damage or losses resulting from the information provided here or from the absence of information. Although Vontobel believes that the information in this document was compiled with all due care, Vontobel makes no express or implicit guarantee of the accuracy or completeness or the information, text, figures or other elements included in this document. The document should not be used as a reliable basis for decisions. Vontobel accepts no liability in this regard.

The information included in this document does not constitute a contractual relationship between the provider of this information and the viewers of this document and is not to be interpreted as such.

Vontobel, members of the management team or employees may have invested in the past or currently invest in financial instruments about which information or opinions are included in this document, or they may invest in these instruments in future. Vontobel may also have provided services in the past, may currently provide services or may provide services in the future for issuers of these financial instruments, including for example. corporate finance or market making services. It is also possible that employees or members of the management team at Vontobel have in the past exercised certain functions for the issuers of these financial issuers (e.g. work as member of the management team), or that they exercise these currently or will do so in future. Vontobel, employees or members of the management team could therefore have a personal interest in the future performance of financial instruments.

US: Distribution to U.S. persons (as defined in Regulation S under the Securities Act of 1933) by TwentyFour Asset Management (US) LP ("TwentyFour US"), Vontobel Asset Management, Inc. (VAMUS), TwentyFour US, and VAMUS are registered as investment advisers with the U.S. Securities and Exchange Commission (SEC) in accordance with the current version of the 1940 U.S. Investment Advisers Act. Registration as an investment adviser with the SEC does not presuppose a particular level of skills or expertise. TwentyFour US is a wholly-owned subsidiary of TwentyFour Asset Management LLP. VAMUS is a wholly-owned subsidiary of Vontobel Holding AG, Zurich, Switzerland.

Canada: Information herein is provided for use with permitted clients / institutional investors only. Vontobel operates in Canada in connection with our investment and business activity pursuant to the following: Vontobel Asset Management Inc. relies on the International Adviser Exemption in the provinces of Alberta, British Columbia, Saskatchewan, Ontario and Quebec and the Investment Fund Manager Exemption in Ontario and Quebec. Vontobel Asset Management AG relies on the Investment Fund Manager Exemption in the provinces of Ontario and Quebec.

TwentyFour relies on the International Adviser, International Dealer and Investment Fund Manager Exemptions in the province of Ontario.

For US Offshore and LatAm: Information herein prepared and approved for institutional / professional investors and approved for use in certain jurisdictions only. Vontobel offers a variety of products and services intended solely for qualified investors from certain countries or regions. Your country of legal residence will determine the products or services that are available to you. Information herein should not be considered a solicitation or offering for the sale of any investment product or service to any person in any jurisdiction where such solicitation or offer would be unlawful or prohibited. Furthermore, this information is not intended for use in any jurisdiction which would subject Vontobel and/or TwentyFour to any registration, licensing or other authorization requirement within such jurisdiction or country. It is the responsibility of the recipient to inform themselves and observe applicable regulations and restrictions for their respective jurisdiction(s). Information herein is not intended for retail investors and/or distribution to the general public in any jurisdiction.

In Mexico: None of the funds managed by TwentyFour have been, and are not expected to be, registered in the National Registry of Securities maintained by the National Banking and Securities Commission ("CNBV"), and therefore may not be offered or sold publicly in Mexico. The funds managed by TwentyFour may only be offered or sold to qualified and institutional investors in Mexico, pursuant to the private placement exemption set forth under Article 8 of the Mexican Securities Market Law as part of a private offer.

Australia & New Zealand: Vontobel is represented in Australia by Vontobel Asset Management Australia Pty Limited (ABN 80 167 015 698), which is the holder of Australian Financial Services Licence number 453140 ("Vontobel Australia"). Vontobel and Vontobel Australia are also an Overseas Financial Adviser in the meaning of the Financial Advisers Act 2008 of New Zealand ("FAA"). Neither Vontobel Australia nor any other member of the Vontobel Group has a presence in New Zealand.

Hong Kong: The content of this document was not reviewed or approved by any regulatory body in Hong Kong, including the Securities and Futures Commission in Hong Kong. This document has been approved for use in Hong Kong by Vontobel (Hong Kong) Limited, a corporation licensed by the Securities and Futures Commission. You are therefore advised to exercise caution and, in the event of doubt regarding the contents, to seek independent professional advice.

Singapore: This document has not been reviewed by the Monetary Authority of Singapore. This document should not be considered as a solicitation to the general public or a member of the general public in Singapore to subscribe to or purchase financial instruments, either directly or indirectly.

Japan: this material has been approved and is distributed by Vontobel Asset Management Pte. Ltd. (Financial Instruments Business Operator conducting Investment Advisory and Agency Business) (Director of Kanto Local Finance Bureau (Kinsho) No. 3214) in order to provide general information only, and is not intended as a solicitation for the purchase or sale of any financial instruments, or as a solicitation for an investment management or investment advisory relationship. This document is to be used solely by your company for the purpose of research and informational purposes, and may not be copied, reproduced, used for unrelated purposes or provided outside your company without our company's consent. Although this document has been prepared based on information that we believe to be reliable, we do not warrant its accuracy or reliability. The information and data presented here are as of the date of preparation of this document. The historical performance and wording of this material do not warrant or imply any future operating results. Past performance is not a predictor of future performance or results. All rights and obligations relating to the information in this material belong to the information provider, and the content may be varied or modified without notice for any reason determined by the information provider. Any investment or other judgment based on the information in this material shall be made at the sole responsibility of the reader, and neither Vontobel Asset Management Pte. Ltd. nor any other information provider shall be held liable in any way for any loss caused by the information in this material.

本書は、投資助言・代理業の登録を受けた金融商品取引業者であるVontobel Asset Management Pte. Ltd.（関東財務局長（金商）第3214号）が、様々な投資戦略に関する需要調査の一環として、資産運用会社の概要や投資戦略などに関する情報提供の目的で作成したものであり、金融商品の取引の勧誘を意図するものでは[なく、また、投資一任契約や投資顧問契約の勧誘を意図するものでも]ありません。本書は、専ら貴社による調査及び情報収集の目的のために交付されるものであり、当社の同意なく本書を複製又は第三者に開示すること、また、当該目的以外の目的で本書を使用することは禁止されます。本書に記載された過去の業績やその他の情報は、将来の結果を保証するものではありません。また、過去の業績は、将来の業績や結果を予想するものでもありません。本書に記載された情報に関する一切の権利及び義務は情報の提供者に帰属し、その内容は、情報提供者の判断により事前の予告なく変更される可能性があります。本書に記載された情報に基づいて行われる投資その他の判断は、すべて貴社の責任において行われるものであり、Vontobel Asset Management Pte. Ltd. 及びその他の情報の提供者は、本書に記載された情報に起因して生じた損害について一切の責任を負いません。

Austria, Finland, Ireland, Luxembourg, Liechtenstein, Norway, Portugal, Sweden & The Netherlands: This document has been approved by Vontobel Asset Management SA, registered office 18 rue Erasme, L-1468 Luxembourg. Details on the extent of regulation can be obtained upon request at the same.

France: This document has been approved by Vontobel Asset Management SA, registered office 10, Place Vendôme, 75001 Paris. Details on the extent of regulation can be obtained upon request at the same.

Germany: This document has been approved by Vontobel Asset Management SA, Munich Branch, registered office Leopoldstrasse 8-10, 80802 Munich and regulated by the Commission de Surveillance du Secteur Financier (CSSF) and is subject to limited regulation by the German Federal Financial Supervisory Authority (BaFin). Details on the extent of regulation can be obtained upon request at Vontobel Asset Management SA, Munich Branch.

Italy: This document has been approved by Vontobel Asset Management SA, Milan Branch, registered office Piazza degli Affari 3, I-20123 Milan, Italy (telephone: 026 367 344). Vontobel Asset Management SA, Milan Branch, is authorized by the Commission de Surveillance du Secteur Financier (CSSF) and is subject to limited regulation by the Italian National Bank and the CONSOB. Details on the extent of regulation by the Italian National Bank and the CONSOB can be obtained upon request at Vontobel Asset Management SA, Milan Branch. The content of this document has not been reviewed or approved by any regulatory body, including the Italian National Bank or the CONSOB. This document should not be considered as an offer to the general public or a member of the general public in Italy to subscribe to or purchase financial instruments, either directly or indirectly.

Spain: This document has been approved by Vontobel Asset Management SA, registered office Paseo de la Castellana, 95, Planta 18, 28046 Madrid. Details on the extent of regulation can be obtained upon request at the same.

Switzerland: This document has been approved by Vontobel Asset Management AG, registered office Genferstrasse 43, 8002 Zurich. Details on the extent of regulation can be obtained upon request at the same.

United Kingdom: TwentyFour Asset Management LLP is registered in England No. OC335015 and is authorised and regulated by the UK Financial Conduct Authority, FRN No. 481888. Registered Office: 8th Floor, The Monument Building, 11 Monument Street, London, EC3R 8AF. For your protection telephone calls are usually recorded. This document has been approved by Vontobel Asset Management S.A., registered office at Third Floor, 22 Sackville Street, London W1S 3DN. Vontobel Asset Management S.A. is authorised by the Commission de Surveillance du Secteur Financier (CSSF) and is subject to limited regulation by the Financial Conduct Authority (FCA). Details on the extent of FCA regulation can be obtained upon request at Vontobel Asset Management S.A.

www.twentyfouram.com

TwentyFour
a boutique of Vontobel