

IAM CAPITAL MARKETS:

2024 Credit Outlook



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Bonding for Success: Patience to be rewarded in 2024

Key Points:

- Investors are focused on when central banks will cut interest rates
- We should see longer duration, high quality bonds perform
- Australian credit spreads should outperform US in a recessionary scenario
- Expect strong investor demand for private credit in 2024

Executive Summary

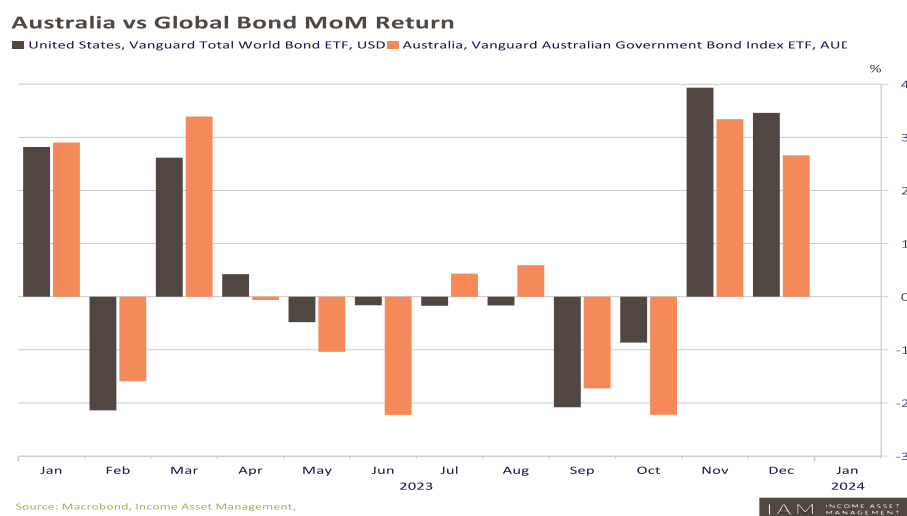
After challenging years in 2022 and 2023, fixed income investors should enjoy better returns during 2024. With inflation showing signs of falling, developed-market growth slowing, central banks pausing, and not much priced in in terms of interest rate cuts over the coming year, we see bonds offering value. Currently, credit spreads do not yet represent recessionary conditions, so we prefer bonds of low-risk or investment-grade.

However, considering where current yields are for investment grade and sub-investment-grade credit, we expect strong investor demand for private credit in 2024. To this end, we remain more discerning on warehouses with a portion of consumer-facing levered loans and private property debt.

To help explain why this is the case, it's worth reviewing the year that's passed.

Fixed income performance: The year that was...

Chart 1: Monthly Returns from Fixed Income Alternatives, Calendar Year 2023



Source: Macrobond January 2024

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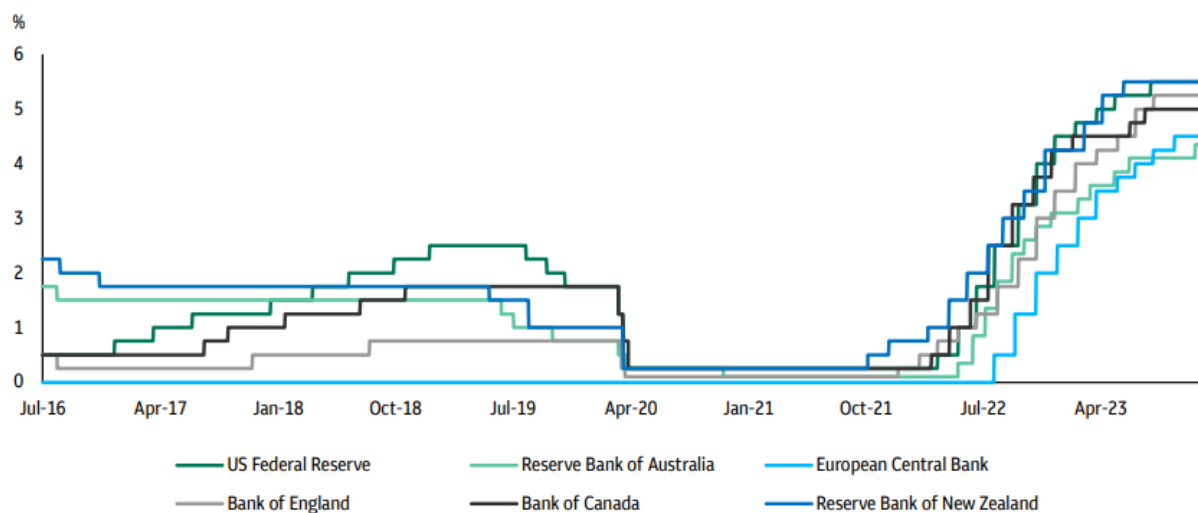
Global central banks have raised interest rates between 400-500bps over the past two years to combat rising inflation.

While the past two years have proven difficult for fixed income investors, bond yields are now at their highest levels for some time. With inflation falling, developed-market growth slowing, and monetary policy in restrictive territory, central banks are slowing down or pausing on their interest rate hike cycles. In particular, this is illustrated within the Australian yield curve, with 3- and 10- year bonds pricing below the current cash rate. Concurrently, the impact of sharp monetary policy tightening has yet to hit growth while credit spreads are at the lower end of historical trading ranges.

Outside of the growth outlook, geopolitical issues remain a major risk for investors to monitor.

Chart 2: Developed World Policy Rates

DW policy rates - Significant global monetary policy tightening



Source: Macrobond (November 2023).

Source: Macrobond (November 2023)

The restrictiveness in monetary policy and potential tightening in financial conditions over 2024 does mean there is somewhat of a cloud regarding the global growth outlook. However, bond yields are at their highest levels for several decades, and this corresponds to a more constructive outlook for bonds. In addition to the attractive income (running yield) on hand, bond yields also provide good buffer against any potential credit spread widening.

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Investment Strategy Implications

With central banks either slowing down or nearing the end of their tightening cycles, we favour owing duration given the higher income (carry) environment and capital gain potential. With inflation coming off its multi-decade highs, and the prospect of modest rate cuts in the back half of 2024, we should see longer duration, high quality bonds perform.

This view of longer duration, high quality bonds performing is in line with the Swanger Series and 2024 Outlook:

Rates will fall faster than expected as the world comes to grips with globally slower economic growth and deflationary pressure exported from China.

It is really the combination of China and the gentle slowdown in the US and EU in 2024 that pushes rates down more sharply than expected by markets. Either by itself would allow a more gradual normalisation of rates, but the combination, and particularly the fact that markets seem to be ill-prepared for the slowdown in China, is what creates the opportunity and risks for Australian investors.

China's central government will be left with little choice but to try to push for higher export market share, but with the significant amount of excess capacity in the Chinese economy, this effectively results in the export of deflation to the rest of the world.

Beyond 2024, lower rates will be aided by central banks, now increasingly released from the fight against high inflation, looking to protect employment and re-engaging in the currency wars that pushed down rates in the 2010s.

We see 2024 as being a year where security selection will be rewarded, so it is still important to manage idiosyncratic risk. Over 2023, credit spreads were relatively resilient across many regions and are at the lower end of historical trading ranges. Australian credit spreads usually follow credit spreads in the US, but we believe they would outperform in a recessionary scenario.

The reasons are fourfold as follows:

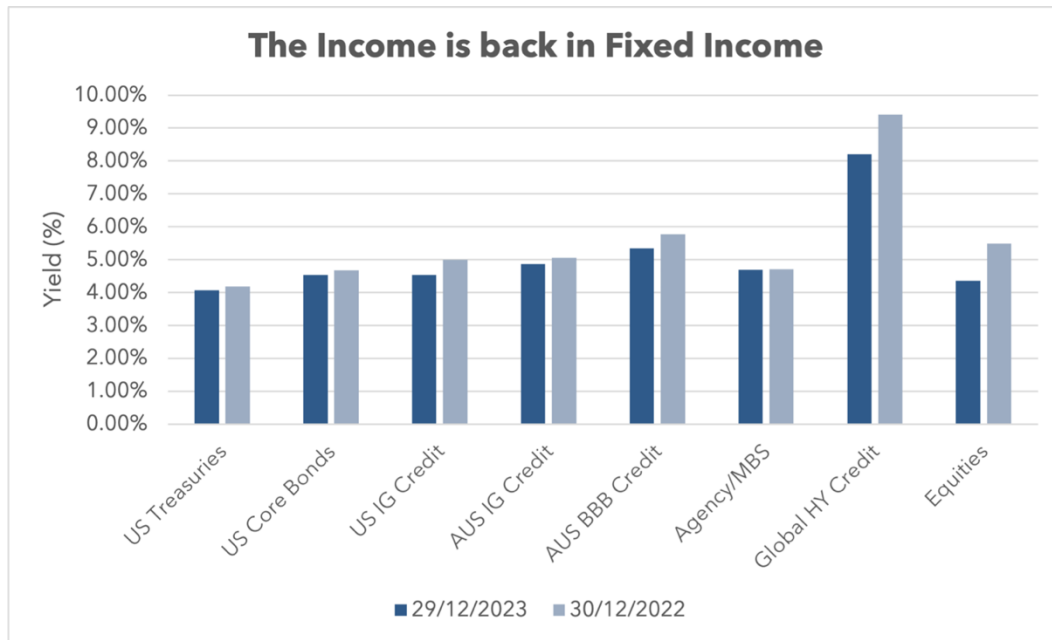
1. Australia's real GDP supports the credit environment;
2. Australian investment-grade credit has historical default rates close to 0%;
3. Australian Super funds have been increasing their exposure to fixed income; and
4. Australian BBB investment-grade credit spreads are wider than equivalent US investment-grade credit spreads.

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Chart 3: The Income is back in Fixed Income

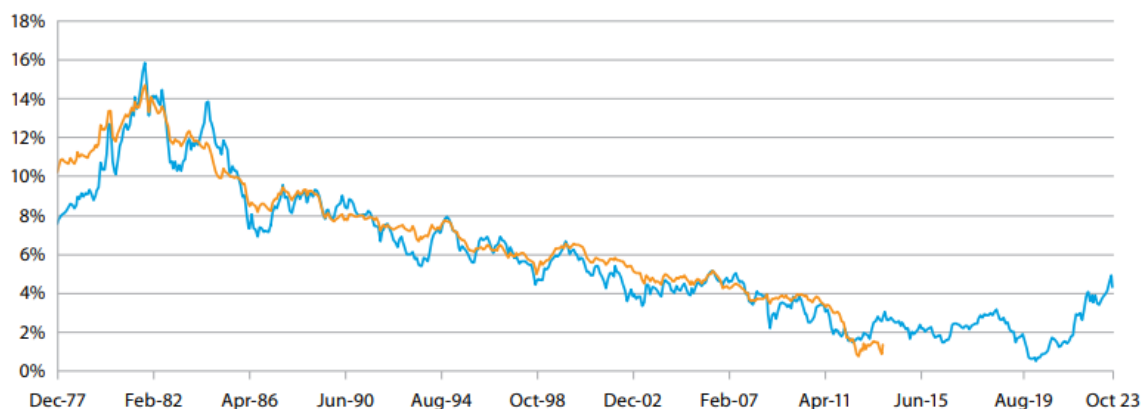


Source: Bloomberg as of 31st December 2023

To this end, we would hold short to mid-curve maturity credit since that is well protected against higher credit spreads. Current yields of around 5-7% in investment-grade credit combined with 3-4 years of spread duration, would require an unlikely GFC scenario to generate negative returns over a 1-year period. We also favour holding longer duration (10+ years) semi-government bonds as a defensive tool.

Modelling indicates that 10- year government bond yields are a strong precursor to longer-term bond returns. The yield on the US 10- year government bond yield hit a 16- year peak last year, and the Australian 10- year government bond yield reached their highest point in more than a decade.

Chart 4: Yields hold a Strong Correlation with Long-Term Bond Returns



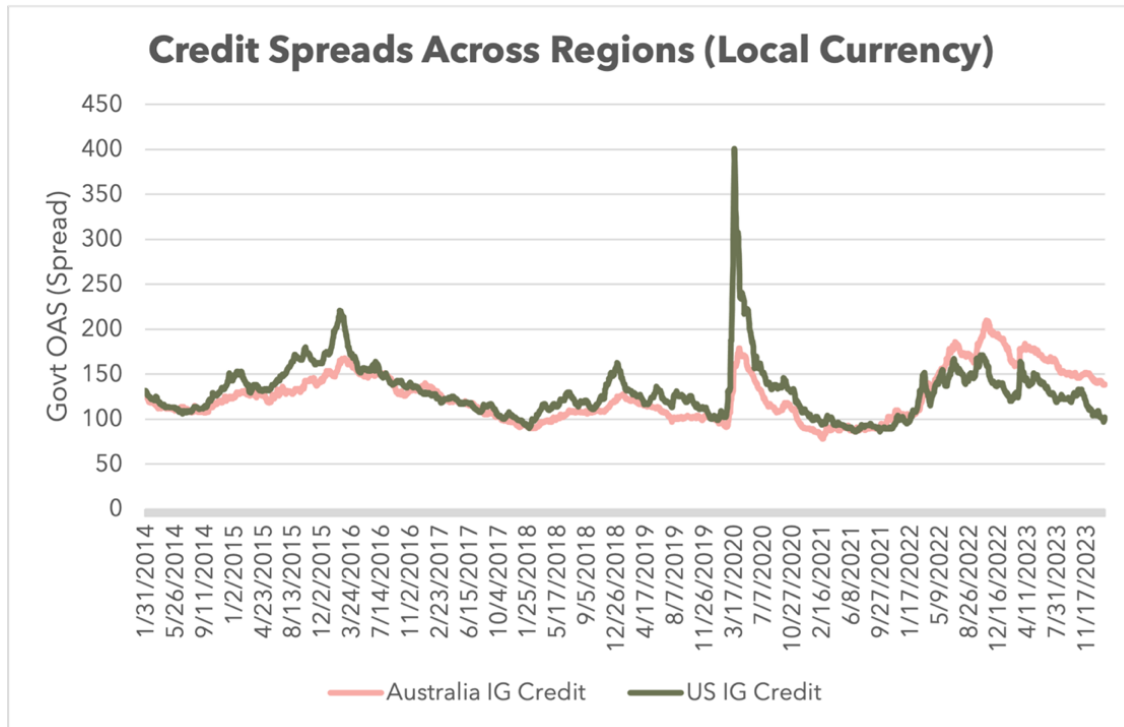
Source: Bloomberg as of 31st December 2023

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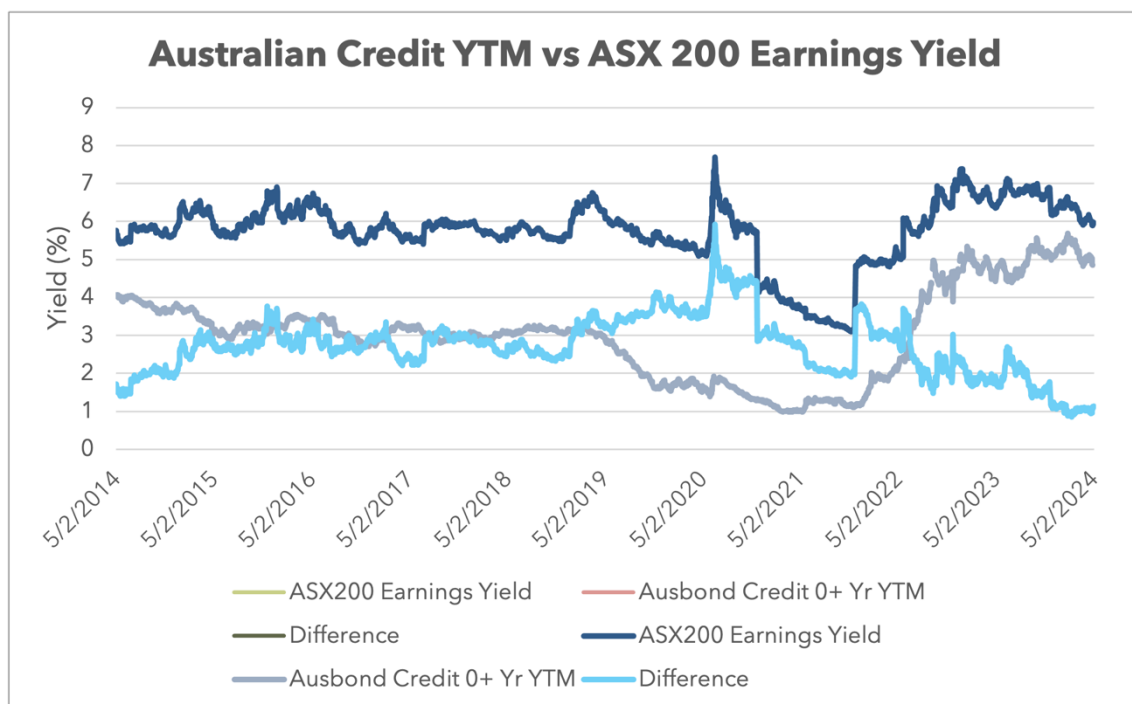
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Chart 5: Credit Spreads across regions



Source: Bloomberg as of 5th February 2024

Chart 6: Australian Credit YTM vs ASX 200 Earnings Yield



Source: Bloomberg as of 5th February 2024

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Our favoured sectors in 2024

Tier 2 bank and insurance securities continue to offer outsized risk-adjusted returns and should continue to sustain income (carry) and generate capital growth as spreads normalise. For instance, the recent BBB+ rated NAB 10nc15 Tier 2 issued at an attractive 6% (+195bps credit spread).

S&P changed the outlook on Australia's BICRA to positive in Apr 2021, an upgrade of which would result in an upgrade to major bank Tier 2s from BBB+ to A-. Moody's recent methodology change also implies 1 notch uplift for major bank Tier 2s from Baa1 to A3 (expected in early 2024). **Thus, major bank Tier 2s have the potential to be rated single A by all three agencies next year.**

Australian banks remain well capitalised, with very high Common Equity Tier 1 capital ratios. The most positive development has been that Australian mortgage delinquencies have not really risen significantly despite central bank tightening. Nonetheless, Australian banks are well positioned for any downside in the economic outlook.

RMBS remains another favoured sector, where credit spreads had effectively doubled in 2022 and are only now starting to normalise across senior and mezzanine tranches. From our perspective, buying AA-BBB rated RMBS tranches at yields of 7-9% with strong collateral protection remains very attractive.

We are constructive on most sectors within the Australian corporate market (Infrastructure, Utilities, Retail, and Mining & Metals) especially as issuance will remain muted in 2024. Additionally, Australian corporates are running net leverage and interest coverage ratios in line with historical averages to have capacity to absorb an economic shock.

One sector we are cautious on is the A-REITs. We view significant potential for volatility during 2024 as the devaluation cycle plays out for Office and Retail sectors specifically.

2024 promises to be a year of clear winners and losers where security selection will be rewarded. We expect to see some high yield defaults impact the market and for the strength of investment-grade credit vs. high yield be re-established. However, we would selectively be adding significantly mispriced higher beta bonds where applicable.

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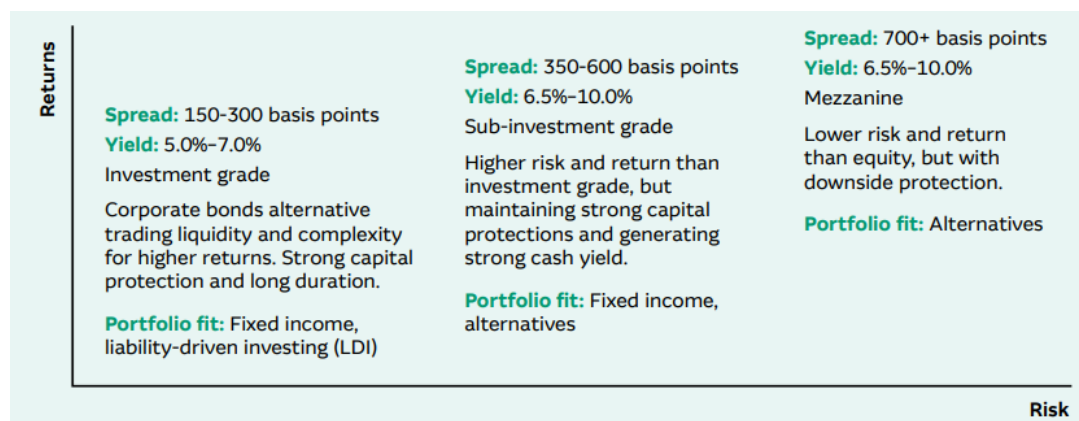
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Private credit: Strong yields plus capital seniority

Private credit, particular in the investment-grade spectrum, has historically been seen as an asset class calculated by its illiquidity premia over the public bond market. Nonetheless, in the higher yield environment, investors are looking at the merits of private credit as an alternative to equity. With current yields of around 5-7% in investment-grade credit and 6.5-10% for sub-investment-grade credit, complemented by high-certainty cash yield and capital seniority, we expect strong investment demand for private credit in 2024.

It's a similar story in private credit warehousing, with margins on senior and mezzanine credit facilities at very attractive levels. Both segments are expected to be important drivers of outperformance in 2024, with population growth putting a floor under house prices and underpinning credit quality for these warehouses. We remain more discerning on warehouses with a portion of consumer-facing levered loans and private property debt which are likely to become impaired in the year ahead.

Chart 7: Private Credit risk-return spectrum



Source: Macquarie Outlook 2024

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