



## Opportunity among the rubble

Sifting out potential in the credit landscape

*Head of U.S. Fixed Income, Andrzej Skiba, and Tim Leary, Senior Portfolio Manager from the BlueBay Fixed Income Team, recently sat down with Institutional Investor to reflect on the carnage that they've have seen so far this year and discuss how best to navigate this challenging environment through 2022 and into 2023*

Institutional investors are well-versed in why fixed income is a tough arena at the moment, but many are required by investment guidelines to stick with it – and others feel there is opportunity waiting to be uncovered.

“With yields in excess of 9%, we have a slight preference for U.S. high yield assets, but we see opportunities in the high-grade space, too,” says Andrzej Skiba, Head of U.S. Fixed Income, RBC Global Asset Management.

A misconception about high yield and leveraged finance broadly is that inflation is a net negative. One of the most surprising aspects of the last 12 months has been how well margins have held up for corporates on an earnings basis.

“We’re at all-time highs for EBITDA margin at an index level, with five consecutive quarters of de-leveraging through growth as companies push through prices onto their consumers and are generating more cash flow,” says Tim Leary, Senior Portfolio Manager, Leveraged Finance, BlueBay Fixed Income Team. “That puts high yield in the best leverage position it has seen in over 10 years. Corporate balance sheets are in a very good position, and they’ve also locked in their cost of capital as they’ve refinanced so much of their debt stack into fixed rate bonds. The amount of cash flow relative to annual interest expense is at all-time highs. If we are entering into a meaningful recession, high yield is well-positioned to weather the storm.”

With so much uncertainty anticipated, however, many institutions might prefer to focus on higher quality assets before dipping a toe in high yield. That strikes Skiba as perfectly reasonable.

“If the pain caused by the higher government bond yields is almost at an end, the total returns on a go-forward basis should be positive because the carry will offset any incremental pain,” says Skiba. “Even if spreads widen

in response to weaker forward earnings, that should be captured and offset by the carry.”

A few areas of the quality credit space stand out to Skiba, specifically short duration high grade bonds in the U.S., where the market has a high degree of comfort that companies will pay the bills over the next years with that space yielding over 5%. “We’re seeing greater engagement in those types of bonds because clients want to take advantage of inverted yield curves, where they’re buying shorter duration but actually getting paid more because of the steepness of the treasury yields,” Skiba says.

### Don’t overlook commercial mortgages

Right now, investors in the commercial mortgage-backed securities (CMBS) space can gain exposure to trophy assets such as great hotels – opportunistic allocations that compared to their reference rates offer spreads of over nearly 350 bps in the AA space and 200 bps in AAA.

“By historical standards that is interesting,” says Skiba. “And a lot of those securities are quite short in maturity. Things have to get really ugly before you start losing money, given the carry that you are getting paid.”

After being down on the agency MBS space for some time because the market was complacent about the impact of the Fed potentially selling some MBS securities further down the line, Skiba is relenting now that agency MBS spreads well in excess of 150bp.

“We’re starting to look favorably at the agency MBS space, especially when you look at specified pools,” says Skiba. “Rather than generic securities, those pools that have exposure to parts of the U.S. with some favorable dynamics, either in terms of prepayment rates or in terms of the type of the borrowers. That was not the case a few months ago.”

Casting an eye for opportunity outside the U.S, Skiba thinks perhaps the doom-and-gloom prospects for Europe might be a bit overdone.

“Newly announced fiscal handouts – some straight from government coffers – will help offset effects of higher energy prices and increase debt of the issuing countries,” says Skiba. “Some of them are a function of windfall taxes

from energy companies that are greatly benefitting from power prices in Europe. What it all means is that if recession in Europe is inevitable, which it is in our view, the depth of that recession likely be less acute than otherwise would have been the case.”

Even with that support, Skiba believes U.S. assets should outperform on a going forward basis, reflecting the strength of the underlying economy.

“With uncertainty as high as it is, when we speak to investors across the world they feel much more comfortable holding U.S. assets rather than betting on Europe or China at this stage,” he says.

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