

Is the worst over in the credit market?

It depends on the time horizon, but things are looking up.



Mark Dowding, Chief Investment Officer of the BlueBay Fixed Income Team, recently sat down with Institutional Investor to share his insights into the issues that are moving and shaking today's global markets.

After some tough sledding in markets in 2022, it's natural to wonder if we've seen the worst of things. Is it safe to get back in the water?

The answer depends in part on the time horizon of your choosing.

"By this time next year, I'd like to think inflation will be less of a problem than it currently is," says the inimitable Mark Dowding, CIO, BlueBay Fixed Income Team. "It may well be that Fed rate hikes have given way to rate cuts, and perhaps war in Europe will be behind us."

In the nearer term, however, Dowding says the investment landscape remains plenty challenging. "We're certainly not out the woods yet," he says, "but over a longer-term view things are starting to appear discernibly better."

Here are the highlights of Dowding's 2023 outlook for credit markets.

The U.S.

"We haven't seen the full effect of some of the existing rate hikes, so we'll likely see the economy continuing to slow on a forward-looking basis," says Dowding.

The question the Fed must ask itself repeatedly is: Can we afford to stop hiking rates?

"Inflation at an absolute level remains far too high for the Fed to feel at all comfortable," Dowding says. "We are going to see further monetary tightening over the course of the next few months."

For the Fed to put on the brakes, Dowding is looking for a consumer price index CPI below 4% and personal consumption expenditures PCE inflation below 3%.

"We might see that around the end of March," he says. "As things stand, we probably have another 100 basis points to go before peak rates in this cycle."

In the first half of next year, Dowding anticipates negative GDP prints and perhaps mild recession – but in the context of the full year, he thinks the U.S. economy will be "above the zero line" despite a slow pace of growth and rising unemployment rates.

"We don't think there will be a dramatic, ugly recession in the U.S.," says Dowding.

Anxiety lingers, however, in part because of a very tight labor market. The longer inflation stays above the Fed's target of 2%, wages could start to creep up, breathing life into inflation.

"That's why Fed guidance is not just to look at the price data, but also to focus on the jobs market," says Dowding. "Broadly speaking, we do think there's currently enough data to be analyzed to indicate inflation coming under control. It's a question of how quickly."

Dowding points to goods-related inflation slowing, along with elements service inflation, such as healthcare. In addition, rents are likely to drop following moves in the housing market.

"We see better news coming in the U.S. When we look at the U.S. treasury market today, we don't think we're a long way away from fair value," he says.

Europe

In Europe policymakers are downbeat and feel powerless against inflation, yet have no choice but to push rates higher in a recessionary economy in the midst of war.

"We think GDP will likely contract in the eurozone, maybe down 1% on the year," says Dowding. "But the number could be worse if a severe winter triggers gas rationing, which in turn could open up more downside risk."

Inflation is yet to peak in Europe, and Dowding suspects it won't until next spring.

"The ECB will need to remain fairly hawkish for now," he says. "That will probably take eurozone rates up to 3%, at which point if the Fed is in a position where it's ending its rate hikes, the ECB may hope to do the same. If that's the case, as in the U.S., we don't think that yields are currently a long way away from fair value."

Dowding notes investors should keep an eye on the possibility that some stress inducing scenarios could re-emerge. For example, In Italy, the sovereign spread has moved tighter as the new populist government says all the things so the EU will follow through on next generation funds earmarked for the country. However, “if growth is still a struggle next year, we could see a more populist agenda comes back into play and renewed stress in the periphery of the eurozone.”

The UK

The same problems faced by Europe are a drag on the UK – but due to a few additional elements the outlook is even less optimistic.

Much of the country’s young and productive workforce came from beyond the island nation, and in the wake of Brexit vote and the Covid pandemic has returned home.

“Even though the UK economy is weak, and the labor market is tight, we are seeing more wage inflation, which in turn is a driver of second round inflation effects,” says Dowding. “That is problematic in what is effectively a floating rate mortgage society – inflation is killing the consumer and the housing market, making it difficult for the Bank of England to hike rates as much as it would like for fear of economic collapse. We think that the Bank of England will be forced make smaller rate hikes than the U.S. or Europe, and that means inflation in the UK stays higher for longer – and the pound probably continues to trade on the weaker.”

China

The ability to control what’s going on in society is becoming “quite an addictive thing” for the government and Chairman X, according to Dowding, as witnessed by the way in which adherence to a zero covid policy has played out.

“The idea of controlling everything from the center has decimated the rate of growth you might expect in the Chinese economy,” says Dowding.

The result is that, from a cyclical point of view, China is easing into a housing crash that is continuing to unfold, and could resemble what happened in the U.S. in 2008.

“There’s no constructive growth outlook for China. It’s more about mitigating the downside,” says Dowding. “Even when Covid restrictions are eased, society likely won’t rebound as it has in the West. The trajectory of a turnaround in growth as easing or restrictions moves forward won’t be the same as in the U.S. and Europe – and if cases spike some restrictions will be reinstated. It’s not going to be a smooth journey along a straight line.”

Japan

“Slowly but surely inflation is creeping upward, and the yield curve control policy is becoming unsustainable,” says Dowding. “We think the Bank of Japan is going to change that policy before [BOJ head] Kuroda ends his term in March. When they do back out it could send shockwaves that lead yields around the globe to push higher for a time, potentially creating a buying opportunity.”

At the same time, Dowding notes, the yen – which has been one of the cheapest currencies in the world – could become one of the strongest.

“FX hasn’t moved much for 30 years in Japan,” he says. “But it’s showing signs, and that’s going to be interesting.”

Emerging markets

It is difficult to form a view of emerging markets composed of different countries with different dynamics.

As a baseline, however, Dowding and his team like “countries that are exporting energy and food.” The news isn’t good for countries that are importing both.

In addition, “North Africa looks to be in a mess, Egypt maybe the next Argentina, and Turkey has a dreadful policy mix,” he says.

On the positive side, keep an eye on Mexico, South Africa, even Brazil – notwithstanding some of the politics. “Rates are relatively cheap in Brazil because inflation is coming down,” says Dowding.

Credit market outlook

It may seem a bit out of place given the state of the global economy, but Dowding likes banks. “Typically, banks struggle in a slowdown,” he says. “This time around rates are going up – interest rate margins are improving.”

Further, says Dowding, banks are far more conservative than they used to be. As a result, “we don’t see a lot of credit impairment and loss on balance sheets, and they have large capital buffers. Subordinated bank debt is what we like best in the credit market at the moment.”

On the flip side, Dowding is not a fan of private assets.

“There was a bit of a gold rush in private credit and private equity, and for a period there was no value in public market fixed income,” he says. “With all flows going into private markets, a lot of financing came cheap. But now a lot of these entities aren’t generating free cash flow, and as a result I think we’ll see some pretty eye-watering markdowns in private equity, with knock-on effects in private credit.”

The dearth of genuine high yield, which was one driver of the private markets' gold rush, has dissipated, and in "parts of the credit market today you can see equity-like returns from fixed income at much lower levels of volatility," says Dowding.

Investors should expect some pickup in defaults, Dowding says, but that trend will be less prevalent in the high yield bond market compared to parts of the bank loan market and private credit more generally.

"In terms of sequencing, we believe that when inflation peaks, treasury marks and treasury yields find their peak – and we may be in the middle of that sort of process at the moment," says Dowding. "Only after that occurs do we think it's time to buy investment grade credit, and then at a later juncture high yield and emerging markets. Equities will probably be the last asset class to turn, because in 2023 they will be dealing with elevated discount rates on long date cash flows – which is effectively what an equity is. At the same time, earnings momentum is could stall, and we may see a contraction in earnings in some sectors. Those are strong headwinds for the asset class."

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