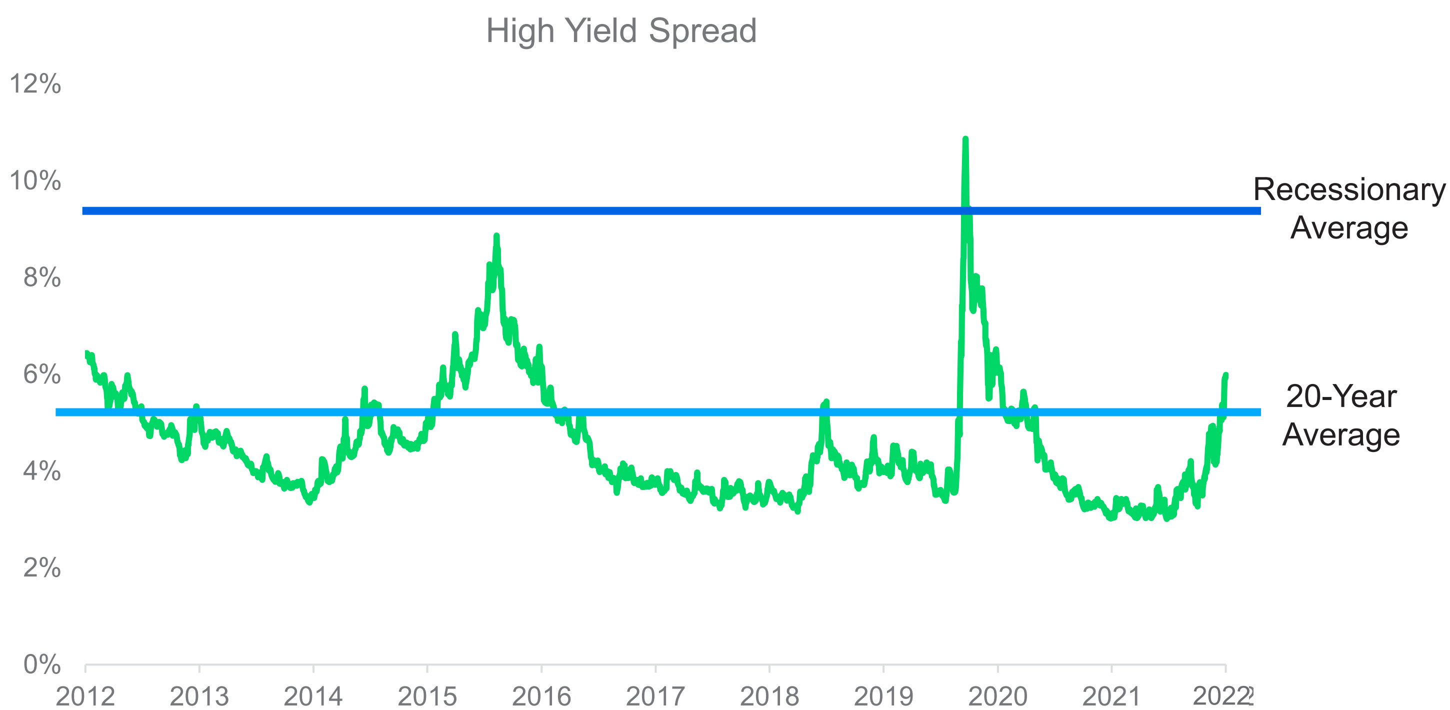
# Public Credit

**In a divergence from Q1, when duration largely drove returns, Q2 was marked by a sharp pickup in credit concerns, evidenced by widening spreads – finishing the quarter at 620 basis points, with June's widening of 150 basis points being the largest single month move since 2008.**

**Spreads are now above the long-run (20-year) average of 575 basis points and up sharply from the 420 basis point levels coming into the quarter.**

High yield bonds finished Q2 with a loss of 10%, with June driving the weakness at -6.8%. This brings high yield year-to-date performance to -14%. Yield spreads in the high yield bond market widened by more than 260 basis points in the first half of the year reaching almost 600 basis points, reflecting investors' increasing pessimism about the economic outlook.

Significant downside risk remains. The recessionary spread average of 970 basis points still leaves potential widening of 350 basis points. Given heightened expectations of a recession, minimal capital market activity, and falling earnings (and margins), credit markets still seem, at best, fairly valued.




Source: Federal Reserve Bank of St. Louis

Leveraged loans have fared better than their bond counterparts when it comes to returns, with the market down only 5.8% year to date, but the rising debt servicing costs are likely to be felt much sooner for these borrowers compared to those with a bias more towards having more fixed rate debt outstanding. Much of the losses in the leveraged loan asset class have been since May, reflecting mounting concerns about how a slowing economy could affect junk-rated borrowers' finances. This sentiment has resulted in loan mutual funds and loan ETFs recording outflows in May and June, following 17 consecutive months of inflows. Outflows for Q2 totaled more than $3.1 billion.

The nearly $1 trillion in refinancing activity over the past 20 months has helped shore up balance sheets and push out maturities and therefore near-term defaults are expected to remain low. However, worsening financial conditions can have an impact, even if corporate borrowers don't default. The biggest buyers of leveraged loans are CLOs and if credit-rating firms downgrade a large number of leveraged loans, as was the case during the early stages of the pandemic, it would cut into CLOs' demand for such loans pushing prices lower. In fact, this sentiment is pushing through in the weakest segments of the debt market such as CCC bonds now trading at spreads well over 1,200 basis points.

Given that default rates are unlikely to materially rise, a full-blown distressed cycle is unlikely to be in the cards for the foreseeable future. However, the investment opportunity set has improved meaningfully as dispersion has increased both across and within sectors, debt is more attractively priced on a relative basis, and the abrupt exit of fair-weather 'tourist' investors in the space has led to significant mispricing opportunities.

## Emerging Market Debt

Emerging market sovereign debt returned -10.55% in the second quarter, bringing year-to-date losses to 18.8%. The asset class is suffering one of its worst drawdowns since the 2008 Global Financial Crisis (GFC). Some of that of course stems from big losses in underlying rate markets, but credit deterioration has been a major driver for the most distressed countries. With the Russia-Ukraine war keeping pressure on commodity prices, global interest rates rising, and the continued strengthing of the US dollar, the financial burden for many emerging market nations is becoming strenuous at best. According to Bloomberg, there is $237 billion due to foreign bondholders in notes that are currently trading in distressed levels. That adds up to almost a fifth – or about 17% – of the $1.4 trillion emerging-market sovereigns that have outstanding external denominated debt.

This year, we have already seen Sri Lanka and Russia default on their debt and now all eyes turn to El Salvador, Ghana, Egypt, Tunisia, and Pakistan who could be next in line. Given increased political turmoil arising from soaring food and energy prices, an increasing concern to investors is whether these countries would begin to shift capital earmarked for external debt payments to providing access to food and energy for its citizens.