PUBLIC CREDIT

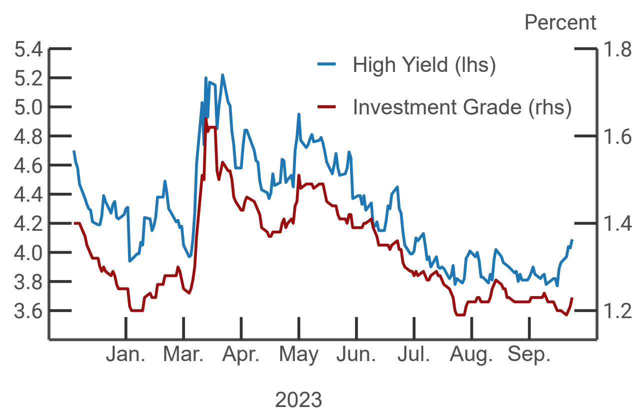
The third quarter marked a shift in credit markets over the summer from the continued trend of past performance and trends for the future. On the one hand, we witnessed continued robust performance in the lower-risk segments of the bond market, driven by factors such as peaking inflation expectations, healthy corporate cash reserves, and ongoing consumer strength. The Bloomberg Distressed Index saw gains of 1.4% in Q3 and is up 9.4% YTD. This trend extended upwards through the credit quality spectrum, with High Yield (HY) Index eking out gains of 0.5% in Q3, although the Investment Grade (IG) bonds lagged, losing 2.2% over the quarter.

As economic data began to take a notable turn during Q3, bond defaults once again started to concern investors. The S&P reported a provisional June default rate of 3.24%, a significant upswing from the low 0.5% seen in 2021, a peak default rate of 4.25% by 2024 Q2. Meanwhile, Fitch projects the HY default rate to reach 4.5% by the end of 2023, the single highest rate since the onset of the pandemic. Concerns also emerged regarding consumers, as US credit card debt crossed the trillion-dollar mark in Q3, and credit card delinquencies returned to a pre-pandemic rate of 2.8%. With student loan repayments looming in October, apprehensions about consumer stability are likely to persist and impact the markets.

The primary driver behind bond markets in this period was more technical than fundamental. Since the end of the COVID pandemic, credit markets have undergone a transformation. New issuances have remained low, as many corporations refinanced their debt during the low-rate environment of 2020 and 2021. They are now hesitant to issue bonds at higher interest rates and fixed coupons. Additionally, the rise of private credit has provided an alternative avenue for financing, with many corporations opting for short-term deals with floating rate coupons. This

approach is attractive in the current market climate, and many companies see it as a bridge to a later bond offering.

Figure 10. Credit spreads widened amid rising rates



Source: RockCreek; ICE BofA, retrieved via FRED.

For those remaining in the public markets, there continue to be strong inflows into the asset class. As of July 2023, US Bond Mutual Funds have seen inflows exceeding $41 billion. This is a significant shift from 2022, when investors withdrew over $540 billion. In the HY sector, inflows are particularly focused on a smaller pool of bonds, due to lack of issuance and more upgrades to IG than fallen angels in 2023. This trend is exerting downward pressure on credit spreads, even if somewhat artificially (Figure 10). However, investors continue to seem willing to secure a higher absolute rate of return despite narrower spreads compared to historical averages.

Finally, collateralized loan obligation (CLO) instruments have rebounded in 2023 after a challenging 2022. In Q3, CLOs posted gains of 5.30%, bringing their gains to 12.83% through the first nine months of 2023. Two characteristics make this market particularly attractive. First, their floating rate structure, tied to leveraged loans, provides strong price convexity compared to traditional bond funds. While bond prices have been under pressure due to low coupons and longer durations, CLOs – with their shorter duration and floating rates – are less affected. Additionally, the ability to invest in a diversified portfolio of assets rather than individual loans offers downside protection.