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TALKING HEADS PODCAST

By **Andrew Craig,** Co-head Investment Insights Centre I **Victoria Whitehead,** Senior Portfolio Manager

BONDS ARE BACK! INVESTMENT-GRADE CREDIT OFFERS YIELD

Andrew Craig: Hello and welcome to the BNP Paribas Asset Management Talking Heads podcast. Every week, Talking Heads will bring you in-depth insights and analysis through the lens of sustainability on the topics that really matter to investors. This week, we'll be discussing developments in investment-grade credit, that's to say, in corporate debt markets. I'm Andy Craig, and I'm delighted to be joined by Victoria Whitehead, who is a senior portfolio manager for investment-grade credit in our fixed income team. Welcome back, Victoria.

Victoria Whitehead: Thanks very much, Andrew. It's great to be back.

Andrew Craig: Since the beginning of 2022, we have seen a very sharp correction in the market for investment-grade corporate bonds. This is due to the negative impact of steeply rising government bond yields and much wider credit spreads. Is there much further to go, in your view, or have valuations now reached levels that could justify building or expanding overweight positions?

Victoria Whitehead: The short answer is there is an awful lot of bad news priced into investment-grade markets at these current levels. Spreads are trading not far off where we were back in March 2020 when we were living through the Covid crisis, with all the uncertainty that brought about for the economy. We are also a long way from the highs that we saw in 2007 and in 2019. So we still have the possibility to trade tighter next year, given the fact that we will see more stability in the rates markets.

Andrew Craig: Obviously, investors are worried about high inflation and recession risk. So far, corporate earnings have held up well in Europe. Do you think this can last and what does it mean for company fundamentals such as cash balances, debt levels and earnings potential? Should we be expecting a wave of defaults and bankruptcies in 2023?

Victoria Whitehead: I think it's unlikely for investment-grade credit – the companies that are of the highest quality. It's much more likely that default ratios will tick up in the high-yield markets. But we are starting from a very, very low level. It is inevitable that we will see earnings deteriorate from here because most of the corporates that we cover in our universe have had very good earnings year-to-date. The credit ratings are still very strong and we have seen a number of upgrades throughout the year, regardless of the fact that credit markets are going through a difficult phase. So what we can say is that investment-grade corporates are going into this crisis in a very solid position compared to previous downturns and to previous recessions.

Andrew Craig: So what do you see then as the main risks for the corporate bond market at this point?

Victoria Whitehead: The main risk is probably going to be inflation that remains stubbornly high and that the central banks are unable to bring down to levels far lower than what we are seeing today. If we get stubbornly high inflation, that could mean that the economic downturn is worse than expected. For me, that is the biggest tail risk right now.

Andrew Craig: And how are you positioning your portfolio for 2023? Will you be maintaining an overweight in financials, say, in bank bonds and in sectors that are less sensitive to the economic cycle?

Victoria Whitehead: Yes, we are still overweight banks and we do still like banks as our favoured sector pick. If we look at how banks are currently positioned, they will benefit from the rise in interest rates, which will help their profitability. Some of this will be moderated by the fact that it is inevitable that we will see non-performing loans tick up. But banks have done an enormous amount of work in terms of shoring up their balance sheets since the financial crisis in 2008. Regulators have been very keen to ensure that banks have much higher capital ratios and are in a much better position to weather downturns than was previously in the case. So they are a better investment proposal than some of the more cyclical sectors. And furthermore, financial spreads are still very cheap compared to non-financial bonds because we have seen a lot of new supply coming into the investment-grade markets issued by banks this year, at very cheap levels. And that has been a good opportunity to buy.

Andrew Craig: Victoria, thank you very much for joining us.

Victoria Whitehead: Thanks very much.