

# Let There Be Yield

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*Senior Investment Grade Strategist*

# Global Central Bank & Rates Market Expectations

## ECB Playing Catch Up

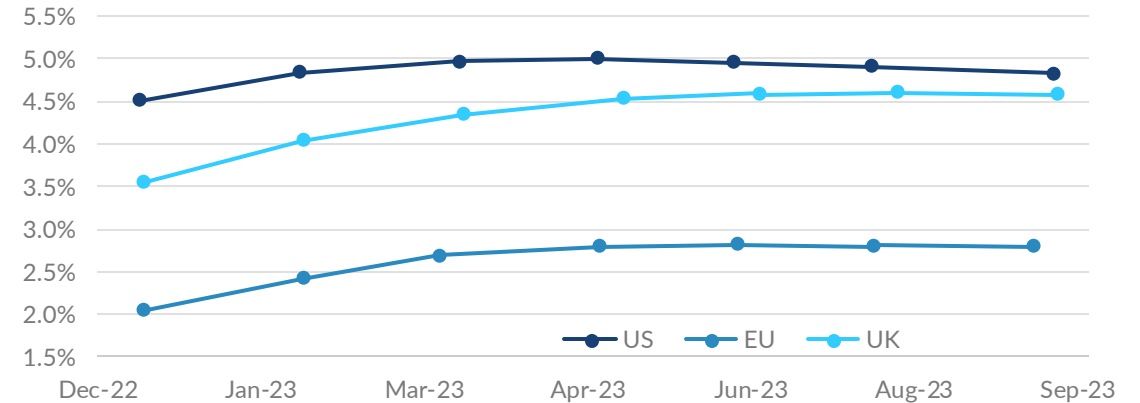
### European Central Bank

- We expect the ECB to hit a terminal rate of 3.0% by May and pause through the rest of the year
- Preliminary details around quantitative tightening are expected at the December meeting.
- Given the uncertainty in the Eurozone and preference to complete policy normalization ahead of QT, we anticipate a 2Q23 commencement and a gradual phase in of balance sheet normalization.

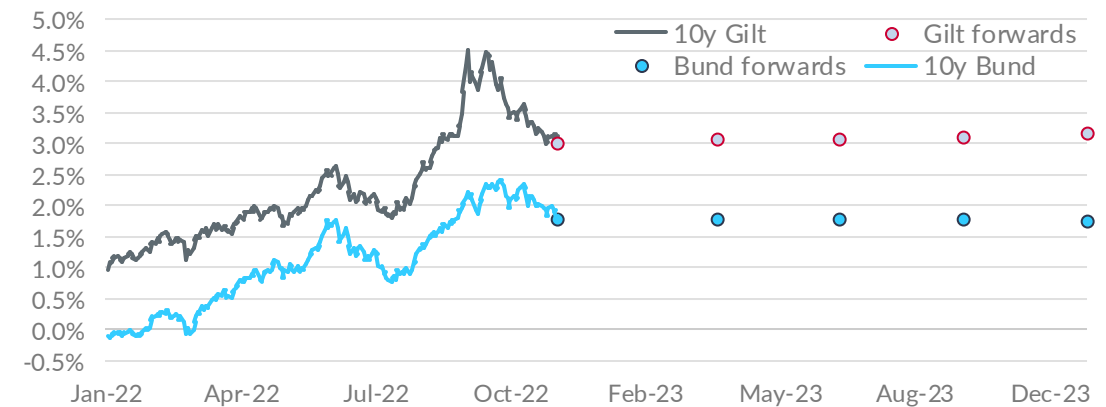
### Bank of England

- We expect the BoE to hike to a terminal rate of 4.25% by March and pause through the rest of the year.
- We expect Gilt sales to remain in place at least through the first half of 2023.
- The BoE could halt sales depending on the severity of the likely recession the economy is facing in 2023.

## Implied Forward Policy Rates



## 10y Bund and Gilt Yields and Implied Forwards

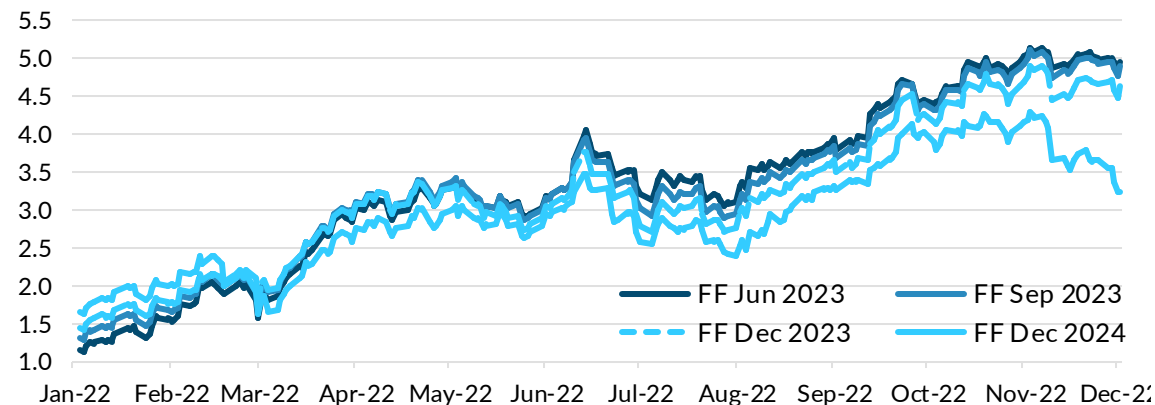


# U.S. Central Bank & Rates Market Expectations

## Too Much Tightening; Too Rapid Rate Cuts

- **We expect the Fed to hike to a terminal rate of 4.5%-4.75% by February and pause through 2023.**
- **QT to remain in place through the first half of the year.** The Fed may consider reducing the pace of QT around midyear as reserves fall back toward 2018-19 levels.
- **Treasury yields to remain elevated with the 10y rising back to 4%.**
- **Curve steepening likely in the second half of 2023.** The Fed will likely be contemplating bringing the policy rate back toward a more neutral level in 2024.

## Rates Implied by Fed Funds Futures



## 10y Treasury Yield and Implied Forwards



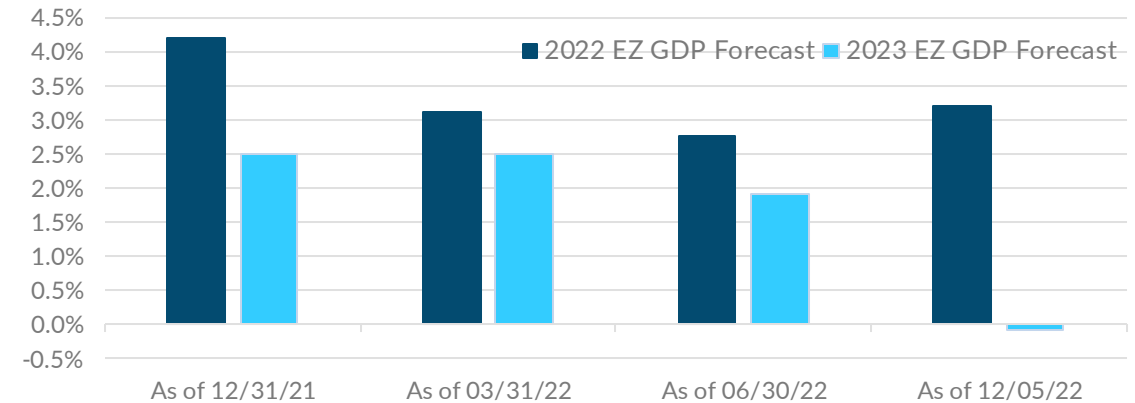


# Macro Views for 2023: Europe

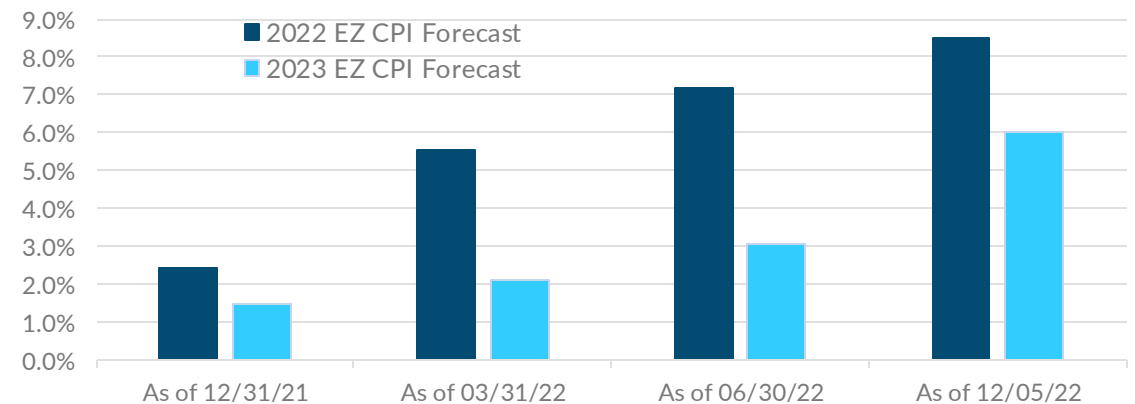
## Base Case: Shallow Recession

- GDP:
  - Modestly negative GDP growth
  - ECB to continue tightening amid elevated inflation but weak economic activity
  - Potential for worse energy crisis in second half of 2023
- CPI:
  - Remain elevated in 2023, causing the ECB to raise rates and enact QT program in Q2
  - November data showed encouraging signs, but still long way to go
- Labor Market:
  - Unemployment remains low at just 6.5%.
  - We expect it to rise as economic activity dips into negative territory, but the labor market is starting from a relatively strong point

## Eurozone Consensus GDP Forecasts



## Eurozone Consensus CPI Forecasts

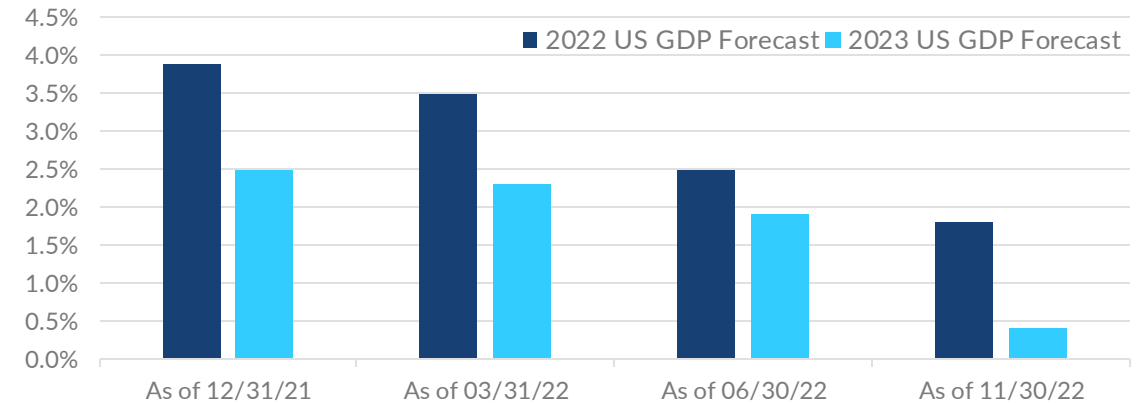


# Macro Views for 2023: US

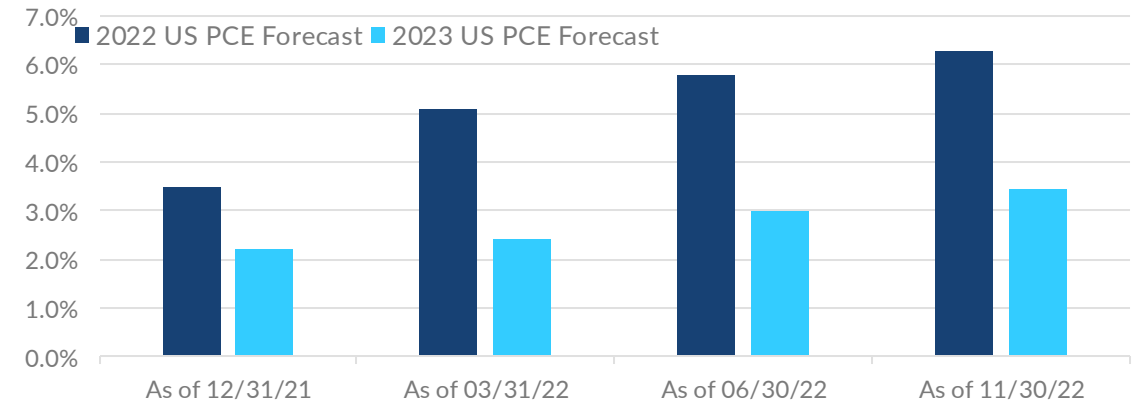
## Base Case: Bumpy Landing/Policy Just Right

- GDP:
  - 0-1% Run Rate
  - Well below potential
  - Consumer begins to pull back as excess savings are drawn; remains focused on services
- Core PCE:
  - 2.5% by YE 2023
  - Already seeing goods disinflation
  - Services and shelter lagging
- Labor Market:
  - Unemployment +50-100 bp
  - Participation a key driver of unemployment and average hourly earnings
- Fiscal impetus remains at bay

## US Consensus GDP Forecasts



## US Consensus PCE Forecasts



# Euro IG & HY Forecasts for 2023

## Euro Credit Strategy IG/HY Forecasts for 2023

	YE 2020	YE 2021	YTD 2022 as of 11/30	Year-End 2023 Forecast			
				Bull Case	Base Case: Stagflation Light	Bear 1: Severe Stagflation	Bear 2: Hard Landing
<b>Probability Weighting</b>				10%	40%	30%	20%
<b>EUR Policy Rate/Bund Yields</b>							
Euro Deposit Rate	-0.5%	-0.5%	1.5%	2.5%	3.0%	3.8%	2.8%
5-Yr Bund	-0.7%	-0.5%	1.9%	2.0%	2.5%	3.5%	1.3%
10-Yr Bund	-0.6%	-0.2%	1.9%	2.0%	2.5%	3.5%	1.3%
<b>Euro Investment Grade</b>							
OAS	93bp	98bp	179bp	125bp	175bp	225bp	275bp
FY Excess Return	1.6%	0.7%	-2.3%	4.5%	2.0%	-0.6%	-3.1%
YTW	0.2%	0.5%	3.8%	3.3%	4.3%	5.8%	4.0%
FY Total Return	2.6%	-1.0%	-12.5%	6.0%	1.3%	-5.8%	2.4%
Gross FY Supply (€bn)	570	454	313	425	375	300	300
<b>Euro High Yield</b>							
OAS	355bp	331bp	506bp	400bp	525bp	600bp	800bp
YTW	2.9%	2.9%	7.2%	6.2%	8.0%	9.7%	9.5%
FY Total Return	2.8%	-1.0%	-10.8%	10.4%	4.7%	-0.9%	-0.1%
Gross FY Supply (€bn)	96	127	23	100	50	40	40
HY Defaults (TTM % Issuers)	2.0%	0.3%	0.8%	2.0%	3.5%	4.5%	6.0%

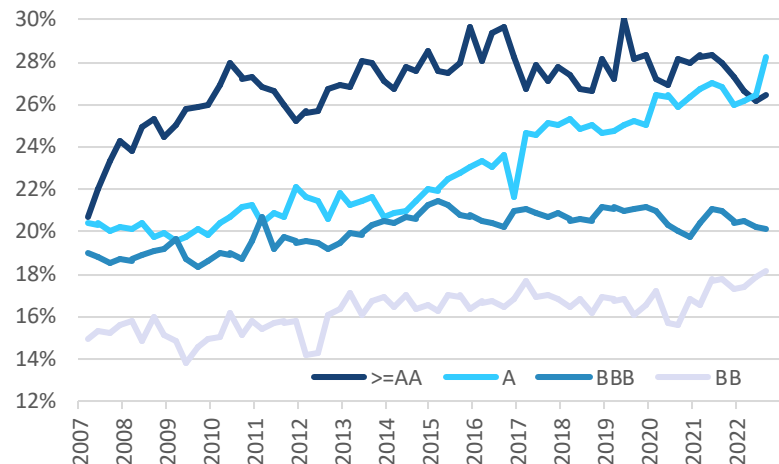
# US IG & HY Forecasts for 2023

## US Credit Strategy IG/HY Forecasts for 2023

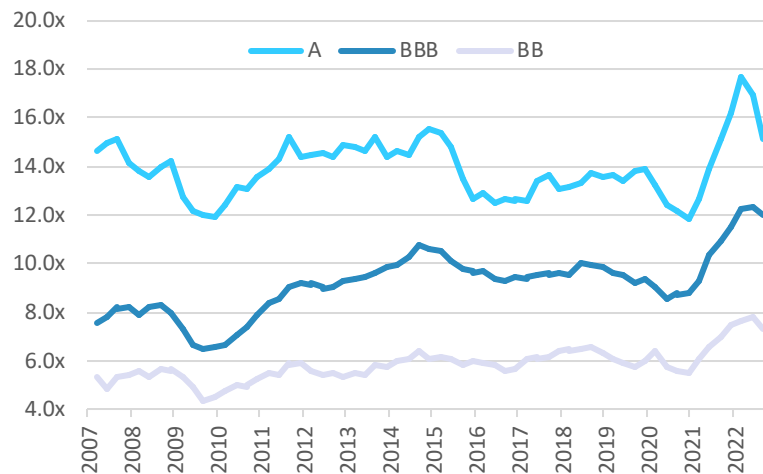
	YE 2020	YE 2021	YTD 2022 as of 11/30	Year-End 2023 Forecast			
				Bull Case	Base Case: Bumpy Landing	Bear 1: Stagflation	Bear 2: Hard Landing
<b>Probability Weighting</b>				15%	50%	12%	23%
<b>US Treasury Yields</b>							
Fed Funds Target (Mid)	0.1%	0.1%	3.9%	4.4%	4.6%	5.9%	2.9%
5-Yr UST	0.4%	1.3%	3.7%	3.3%	4.0%	5.0%	2.8%
10-Yr UST	0.9%	1.5%	3.6%	3.8%	4.0%	5.0%	2.3%
<b>US Investment Grade</b>							
OAS	103bp	98bp	142bp	110bp	120bp	200bp	300bp
Excess Return	0.5%	1.5%	-1.8%	3.7%	3.0%	-2.6%	-9.7%
YTW	1.8%	2.4%	5.4%	5.2%	5.6%	7.4%	5.6%
Total Return	9.8%	-1.0%	-15.3%	6.6%	4.2%	-8.3%	3.8%
Gross Supply (\$bn)	1,932	1,561	1,241	1,200	1,050	800	1,000
Net Supply (\$bn)	705	546	434	420	357	160	250
<b>US High Yield</b>							
OAS	386bp	310bp	455bp	350bp	400bp	700bp	900bp
YTW	4.2%	4.3%	8.6%	7.1%	8.3%	12.3%	12.1%
Total Return	6.2%	5.4%	-10.5%	15.3%	9.9%	-7.6%	-6.5%
Gross Supply (\$bn)	440	493	113	250	175	125	125
Net Supply (\$bn)	239	247	62	113	79	25	31
HY Defaults (TTM % Issuers)	7.5%	1.2%	1.3%	2.0%	3.0%	4.0%	7.5%

# Credit Fundamentals: Sound Starting Point

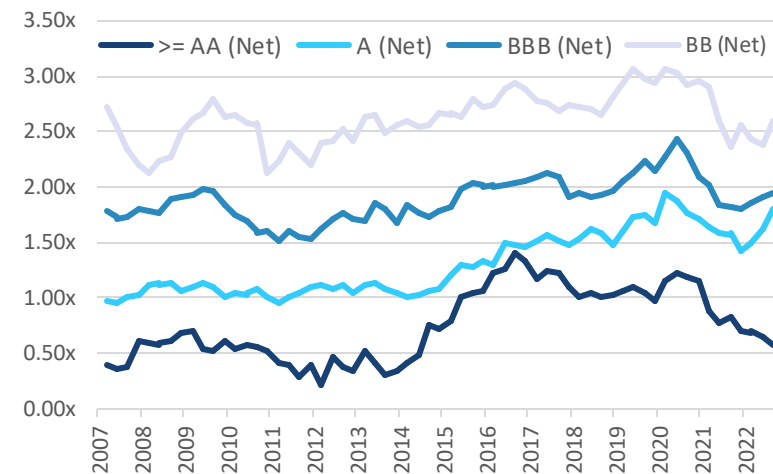
## US IG & BB EBITDA Margins



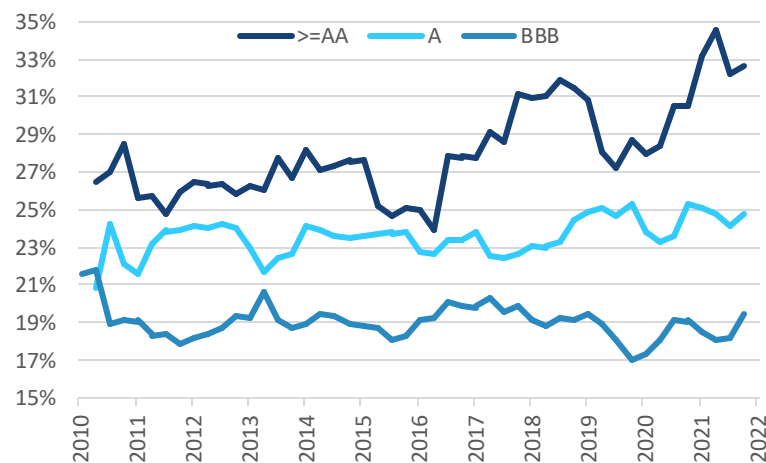
## US IG & BB Coverage



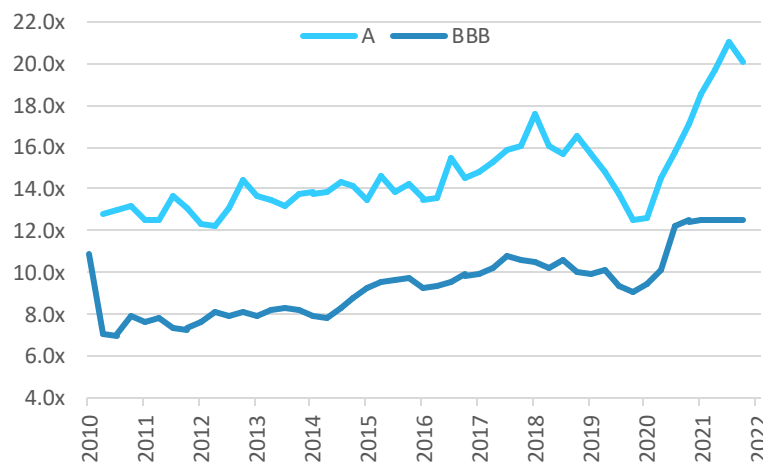
## US IG & BB Net Leverage



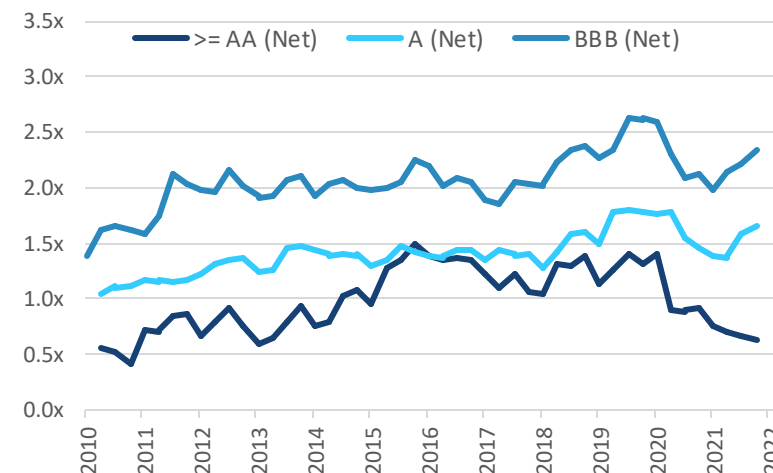
## Euro IG EBITDA Margins



## Euro IG Coverage



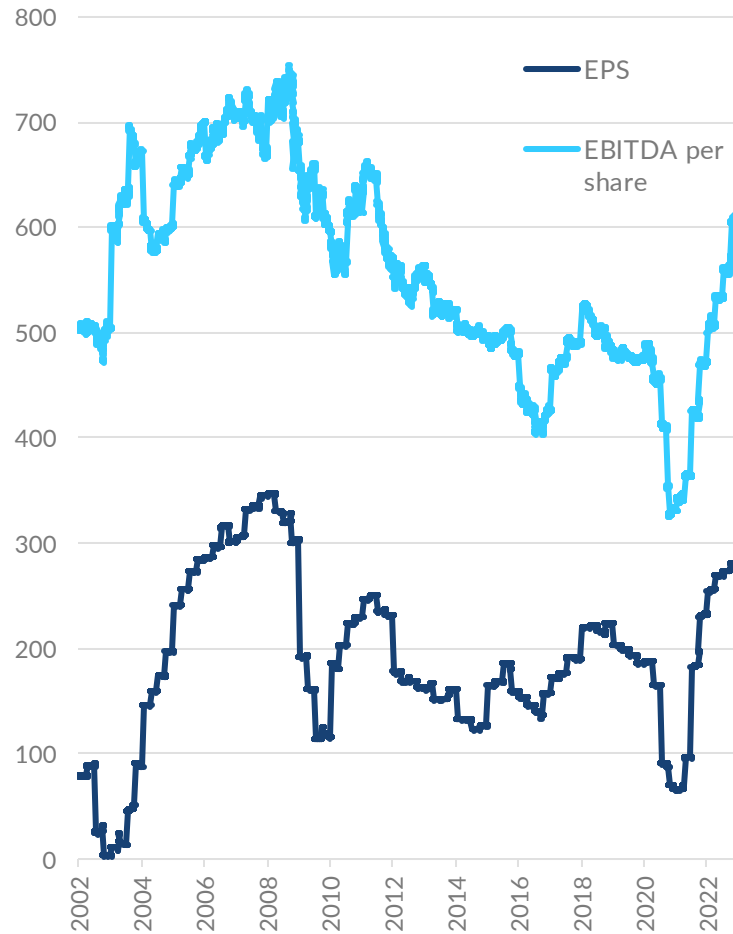
## Euro IG Net Leverage



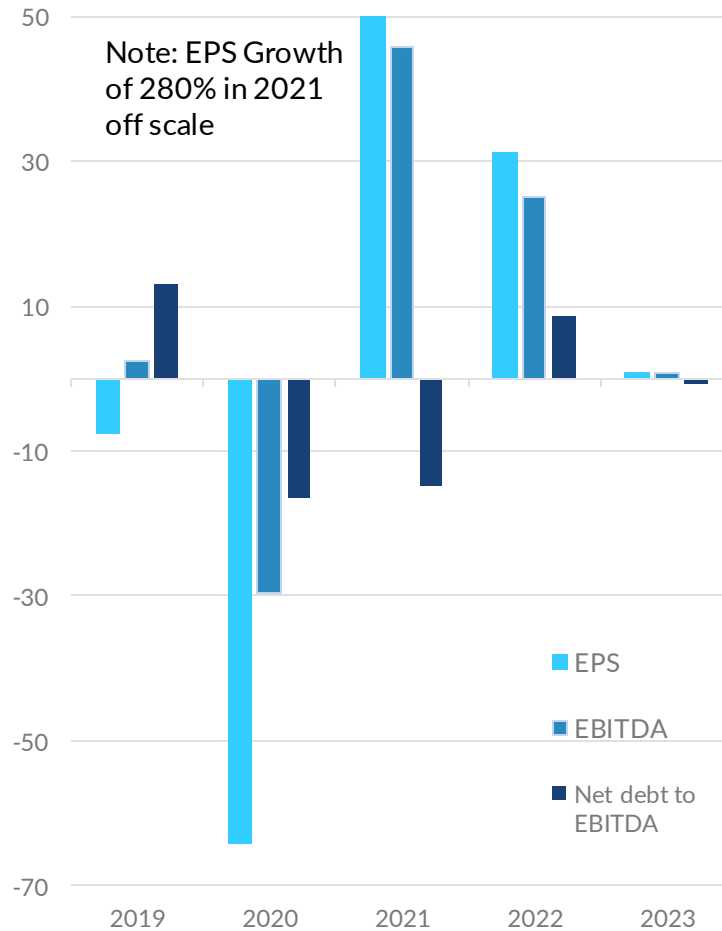


# Earnings Expectations Essentially Flat Amid Recession Concerns

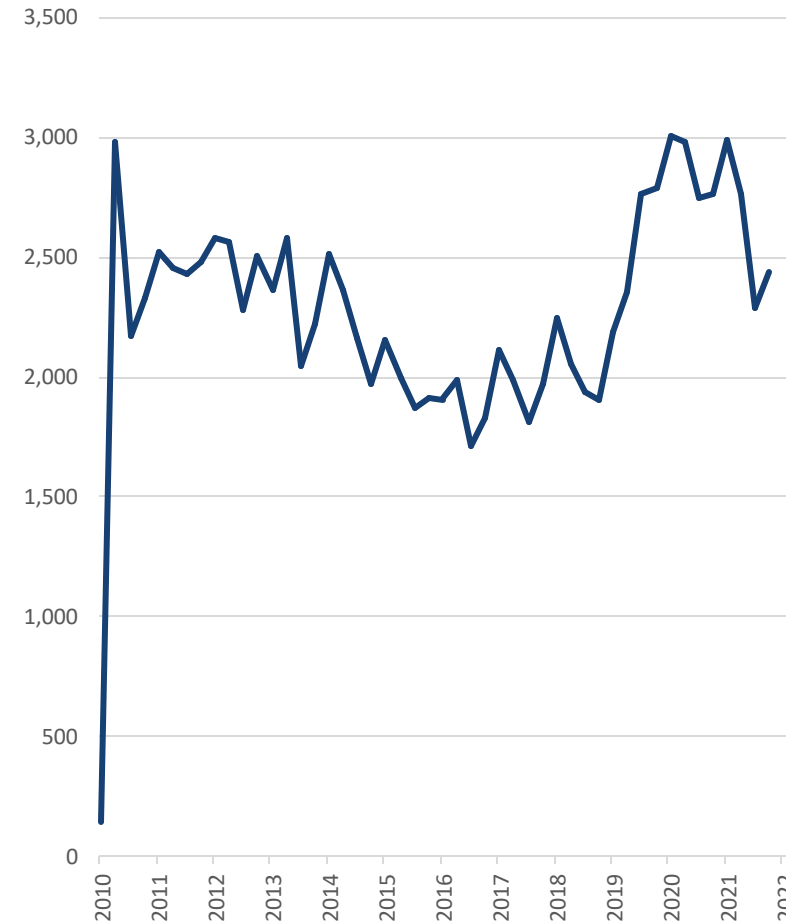
## Euro Stoxx EPS In Cycles



## Euro Stoxx 50 Expectations (YoY %)

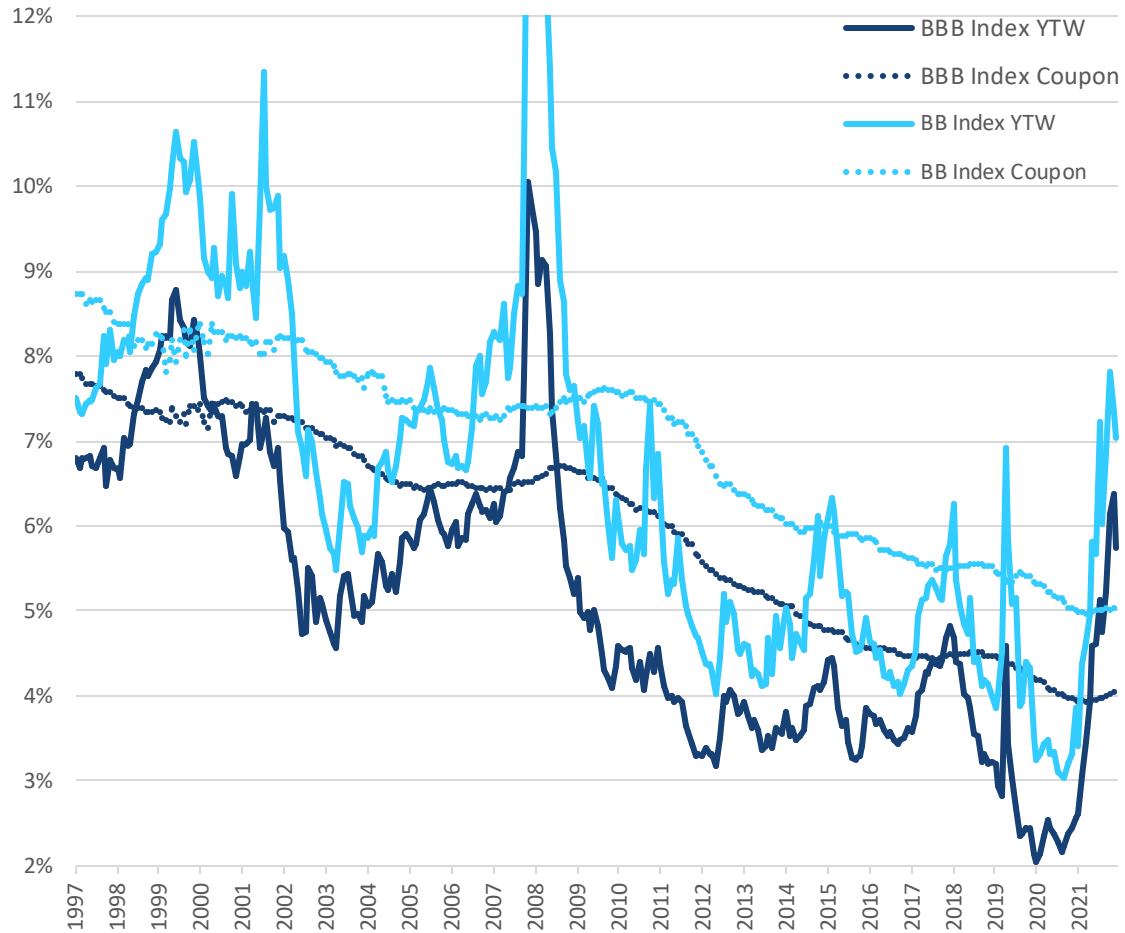


## Euro IG Median Cash Balance (€MM)

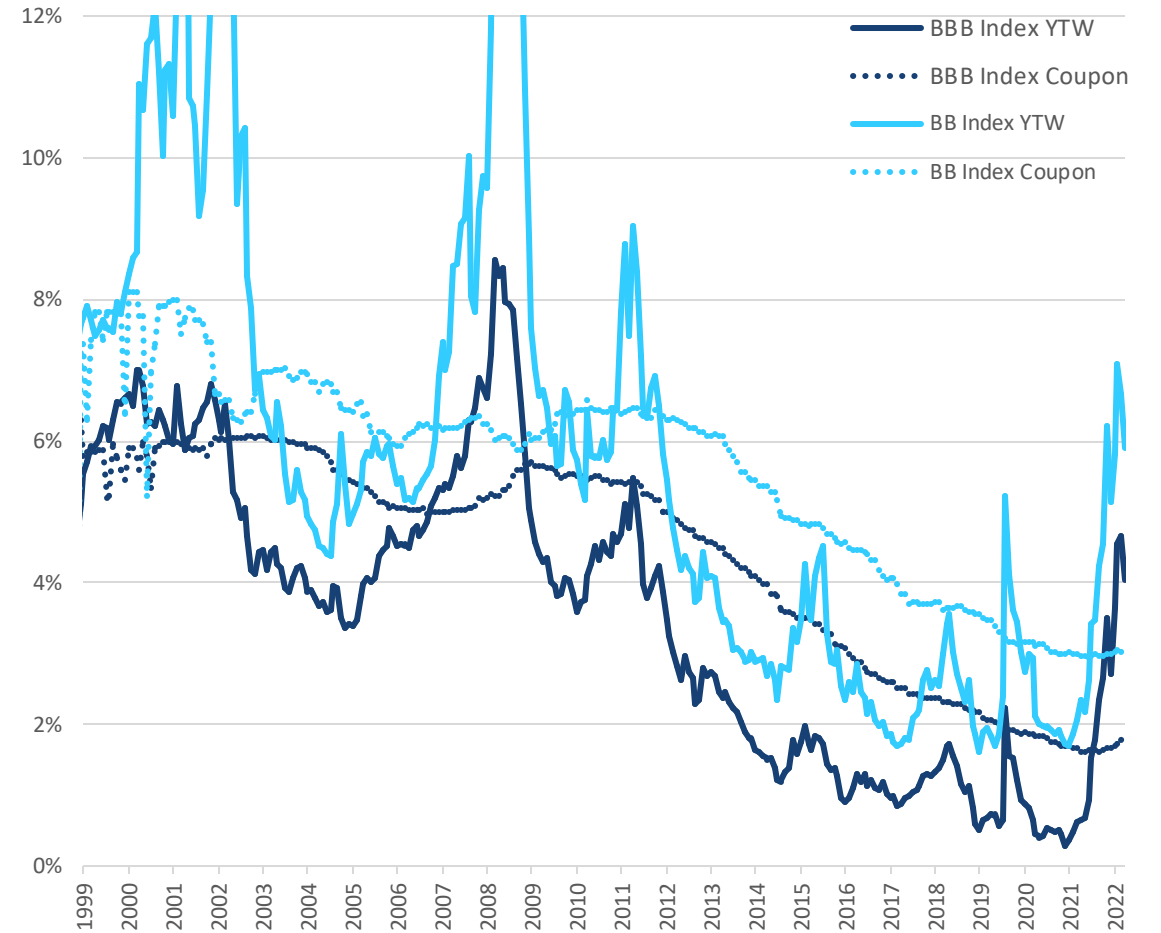


# Higher Borrowing Costs a New Reality

## US BBB & BB YTW vs. Index Coupon

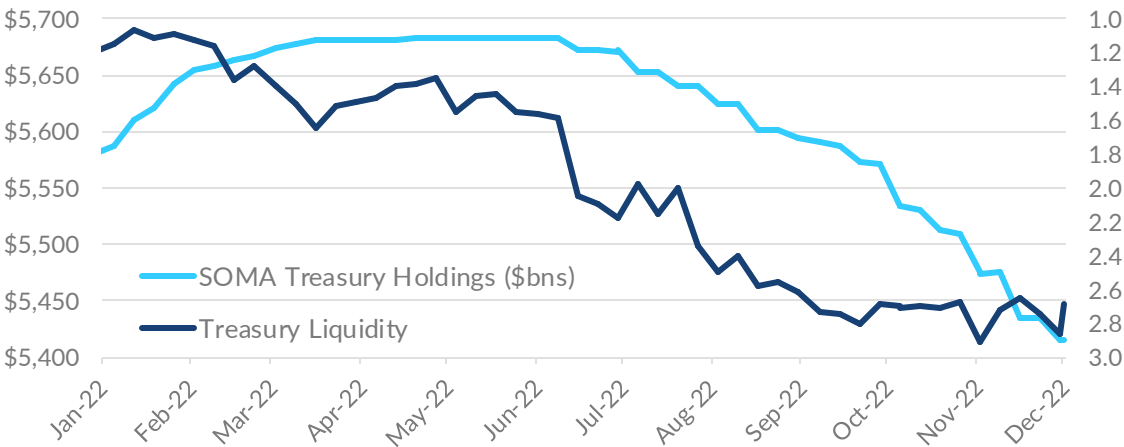


## Euro BBB & BB YTW vs. Index Coupon

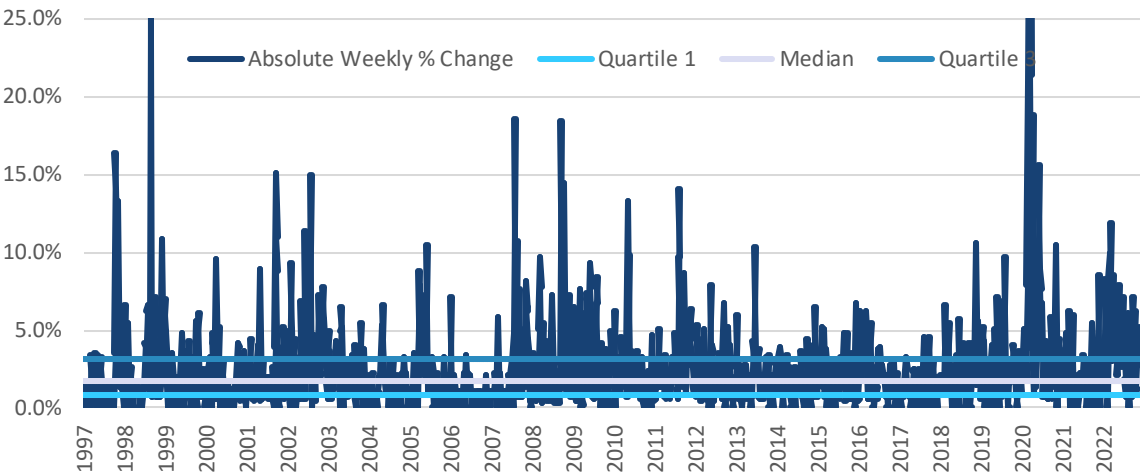


# Global Market Liquidity Eroding

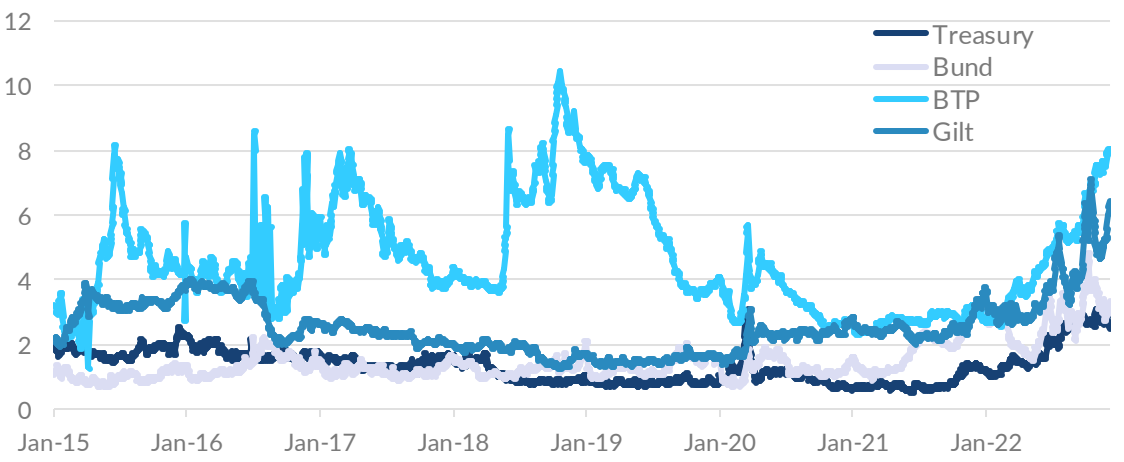
Treasury Liquidity and SOMA Holdings



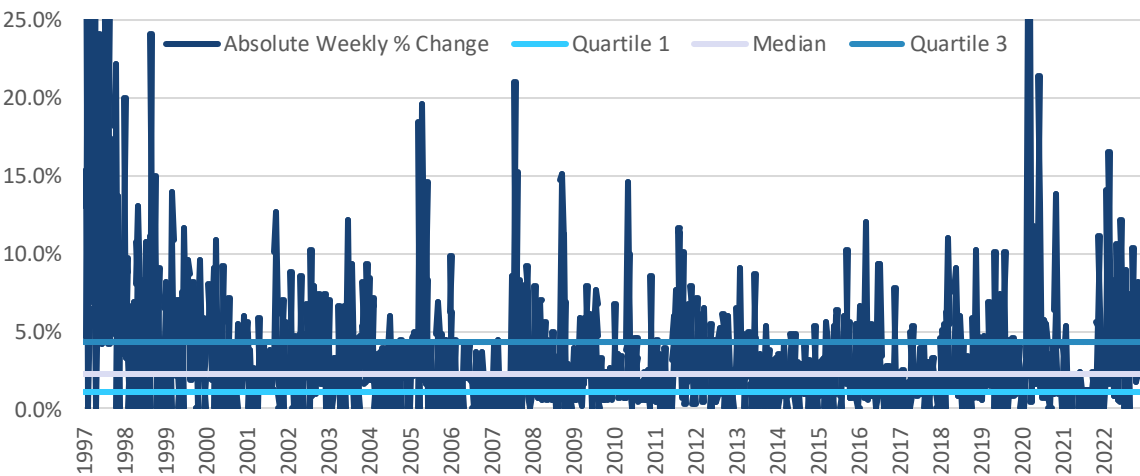
US IG Weekly % Change in Spreads (Absolute Values)



Euro and US Sovereign Market Liquidity



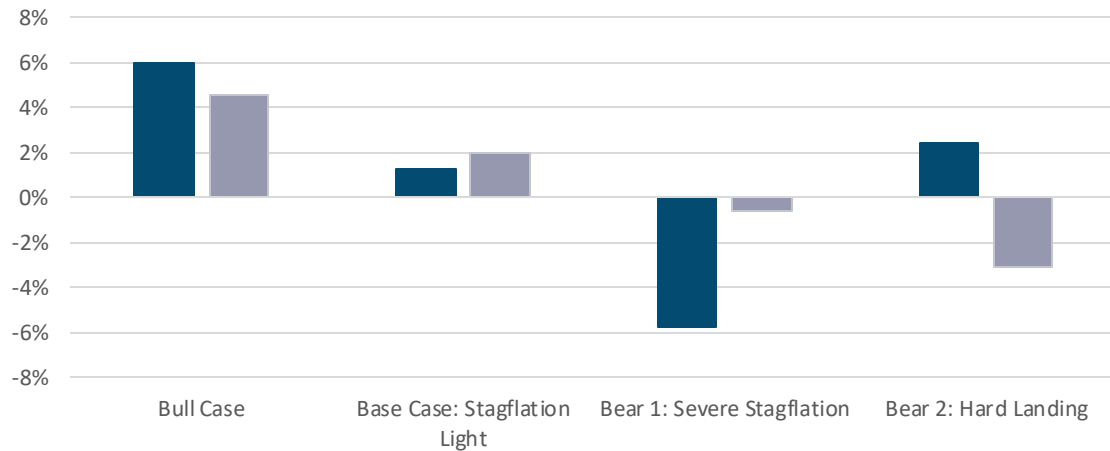
Euro IG Weekly % Change in Spreads (Absolute Values)



# Euro IG & HY 2023 Total Return Scenarios

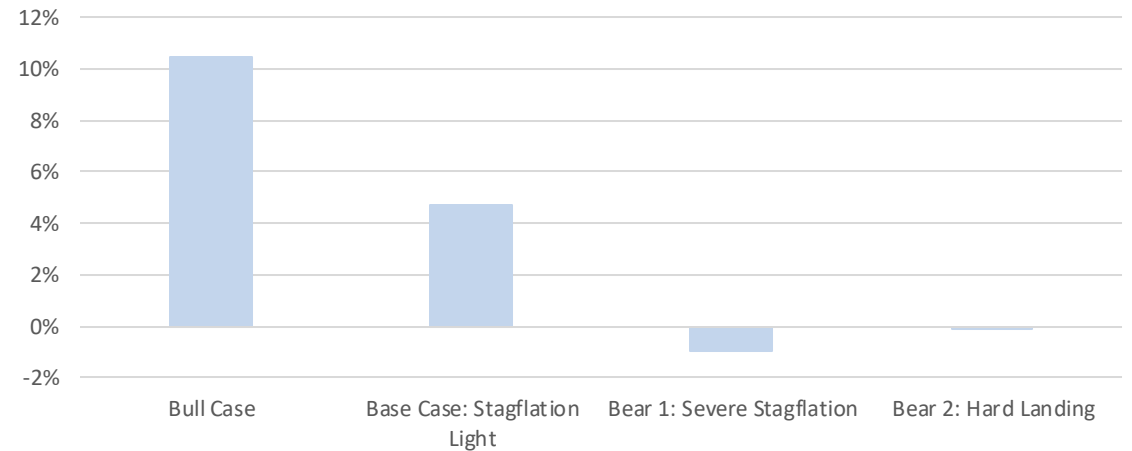
- At 3.8%, Euro IG has the **highest** starting yield since **2011/Euro Sovereign crisis**.
  - Even so, yields have fallen materially since setting a recent high of 4.4% in late October 2022, pulling forward some potential return gains.
  - In our Base Case, we forecast total returns of 2-3%.
- For the first time in our data series, Euro IG has posted two consecutive years of total return losses: 2021: -1.0%; YTD 2022: -12.4%.

## Euro IG Total & Excess Return Scenarios



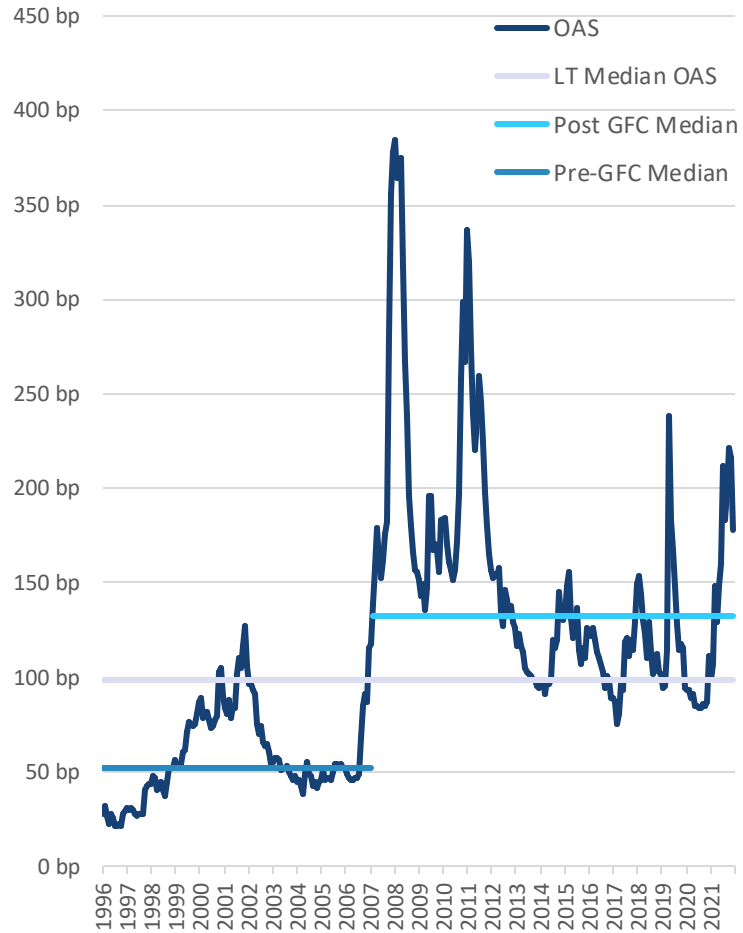
- At 7.2%, Euro HY has the **highest** starting yield since **2011** and is 2.5x than at YE 2020 and 2021.
  - Even so, yields have fallen materially since setting a recent high of 8.5% in mid-October 2022, pulling forward some potential return gains.
  - In our Base Case, we forecast total returns of 5.5-6.5%.
- Euro HY has posted annual return losses in only six of the past 26 years, though three of these years were back-to-back: 2000, 2001 and 2002.

## Euro HY Total Return Scenarios

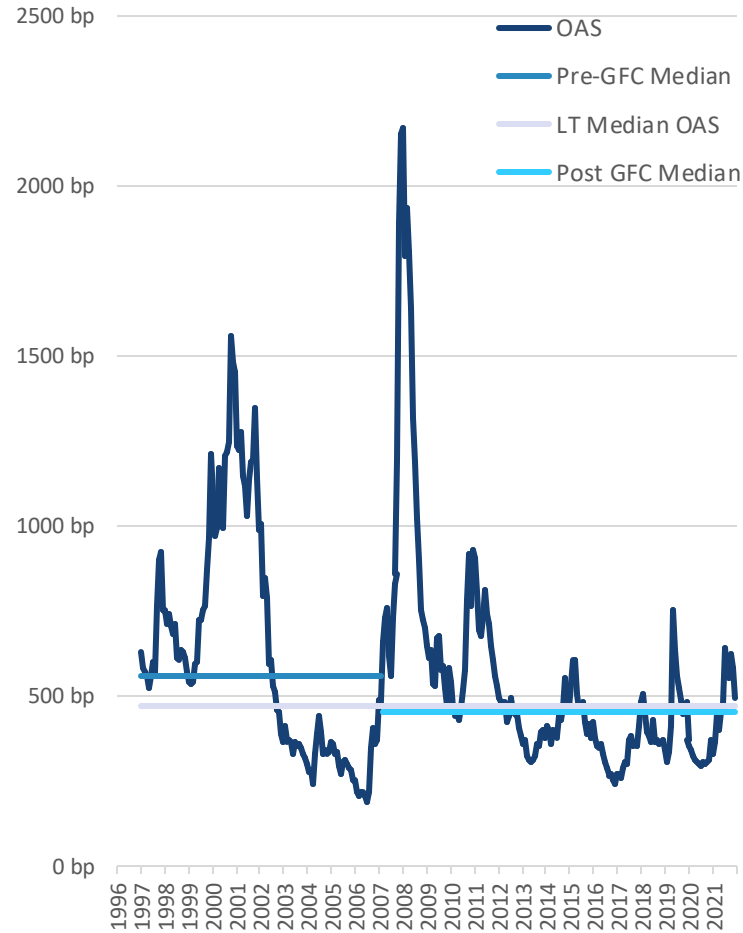


# Euro Credit: Market Weight Allocation to IG & HY

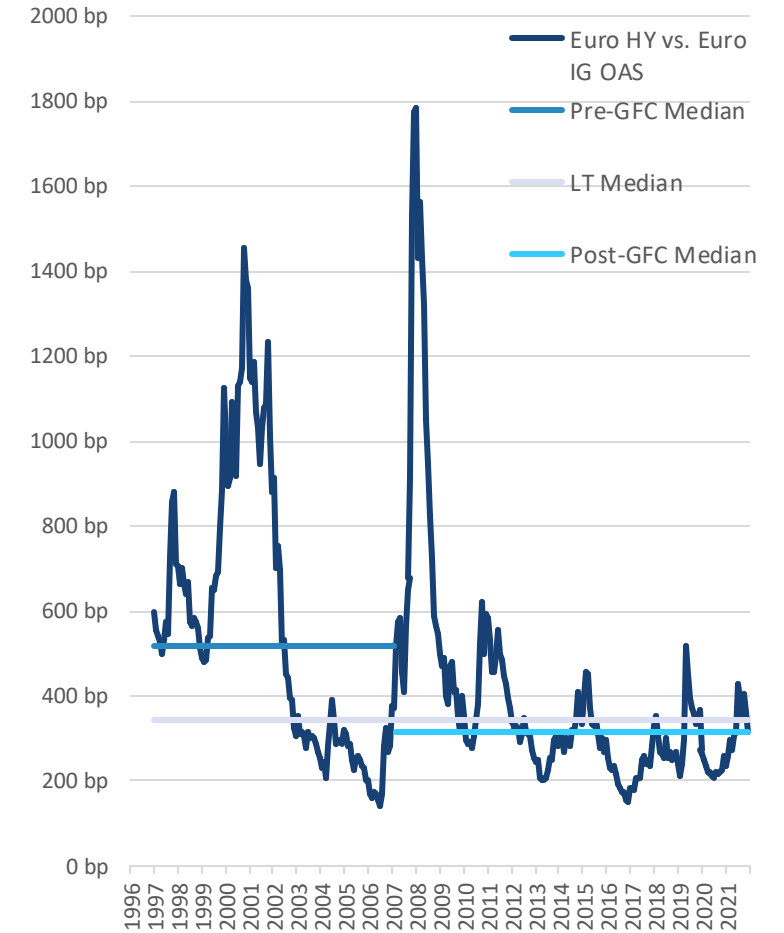
## Euro IG OAS History



## Euro HY OAS History



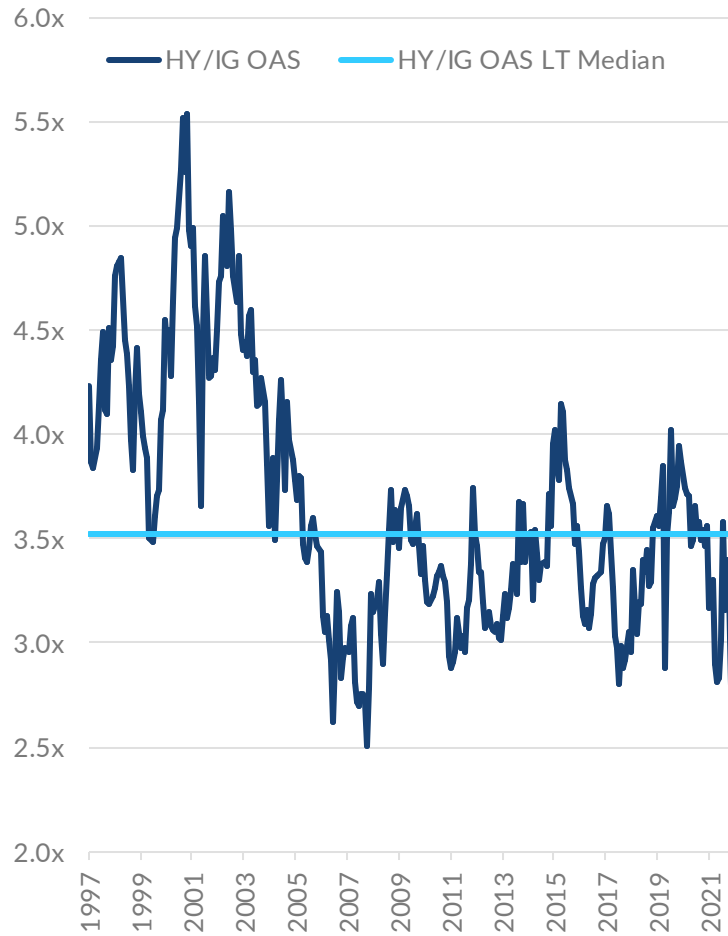
## Euro HY vs. IG OAS History



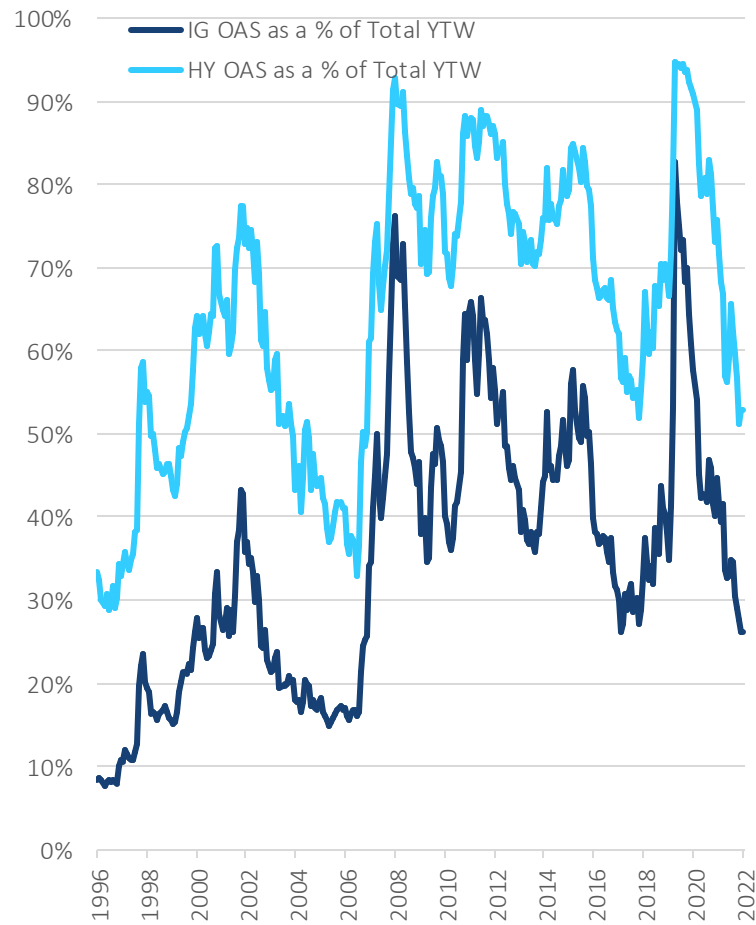


# US Credit: Overweight Allocation to IG & HY

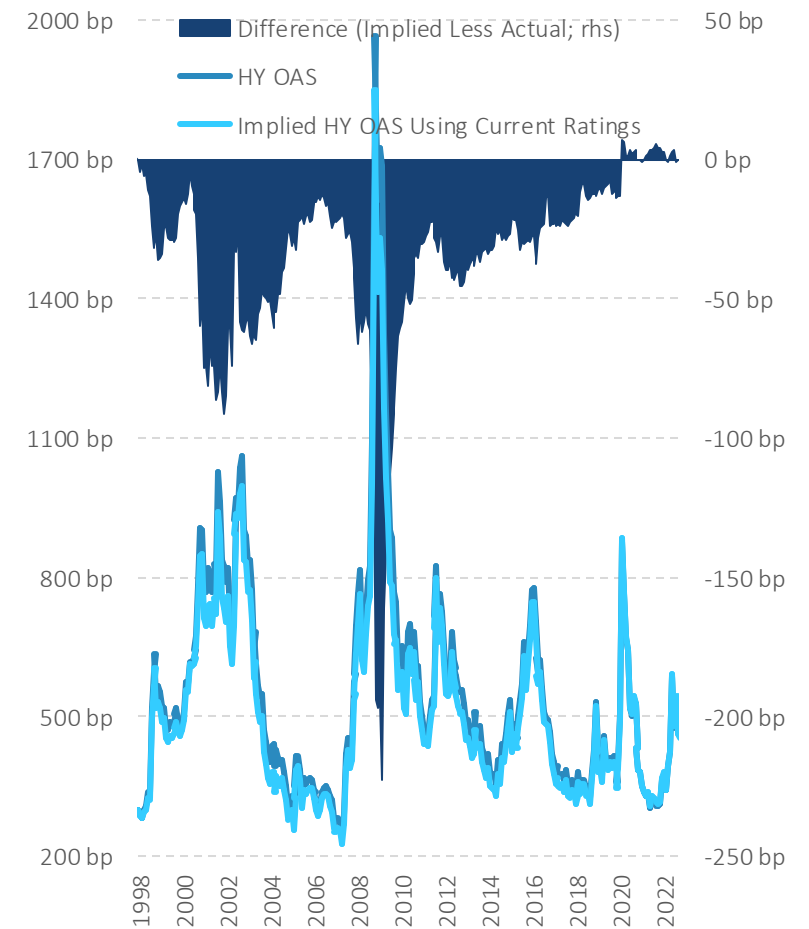
## US IG vs. HY: Spread Ratio



## US IG & HY: OAS as % of YTW

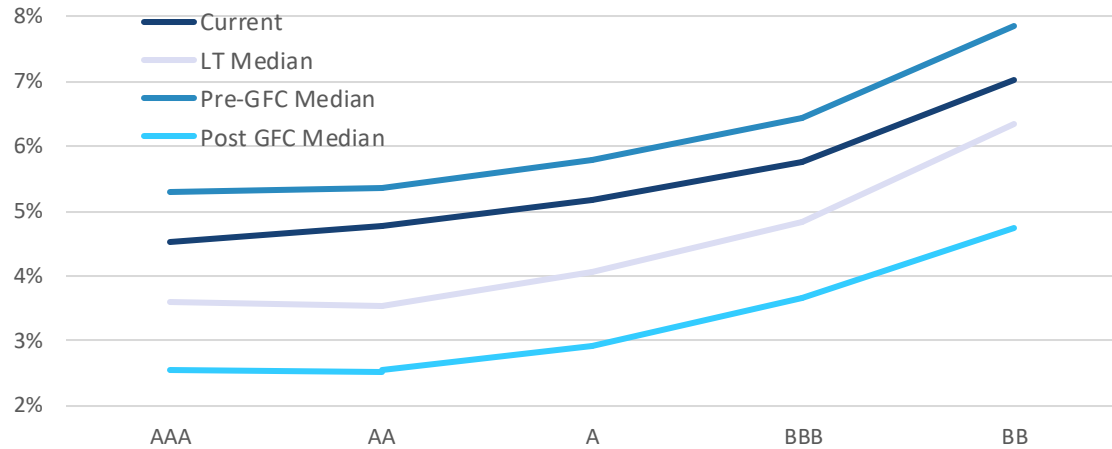


## HY Ratings Adjusted OAS

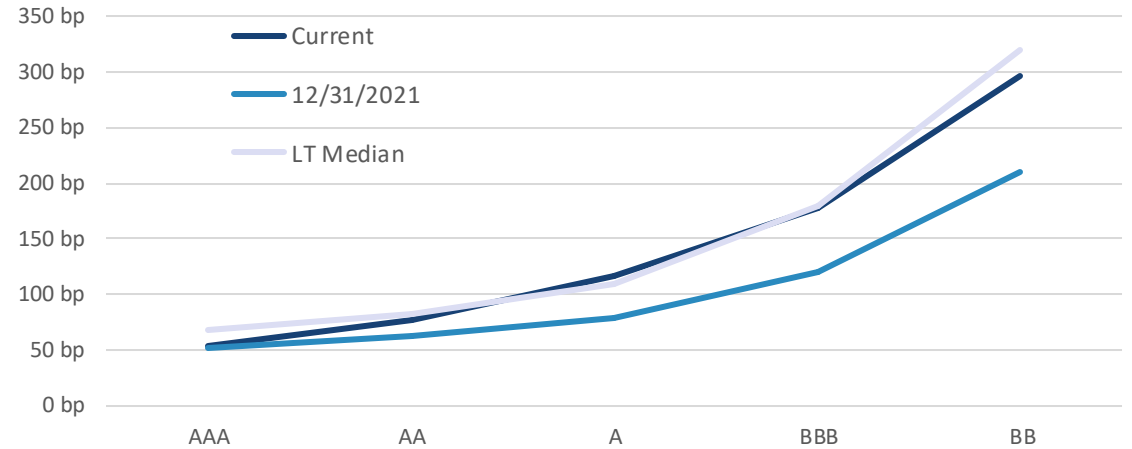


# Ratings: Yield and Spread Curves Across US & Europe

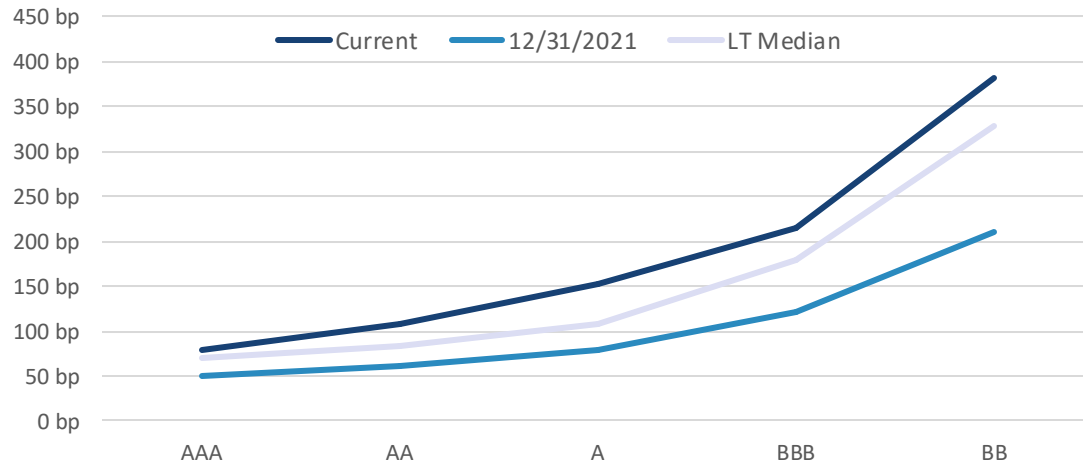
## US IG & BB Yield Curve



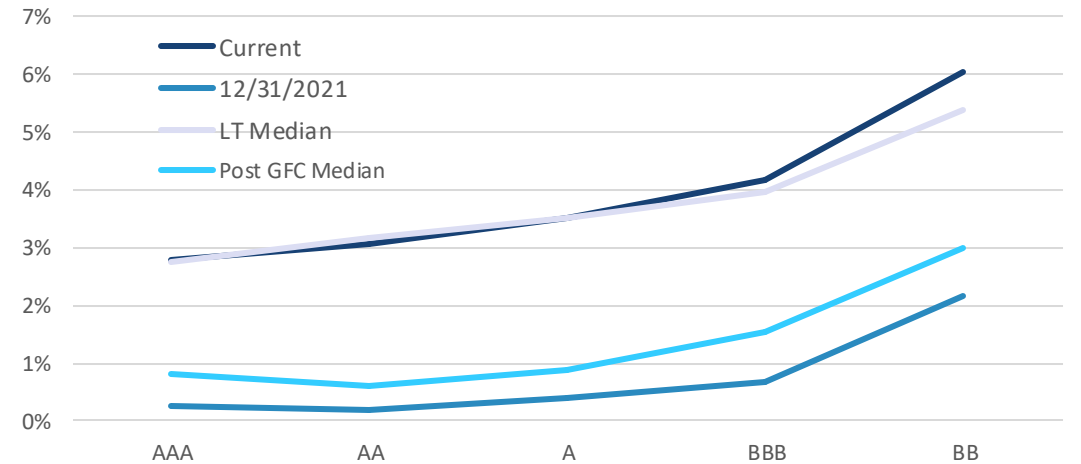
## US IG & BB Spread Curve



## Euro IG & BB Yield Curve

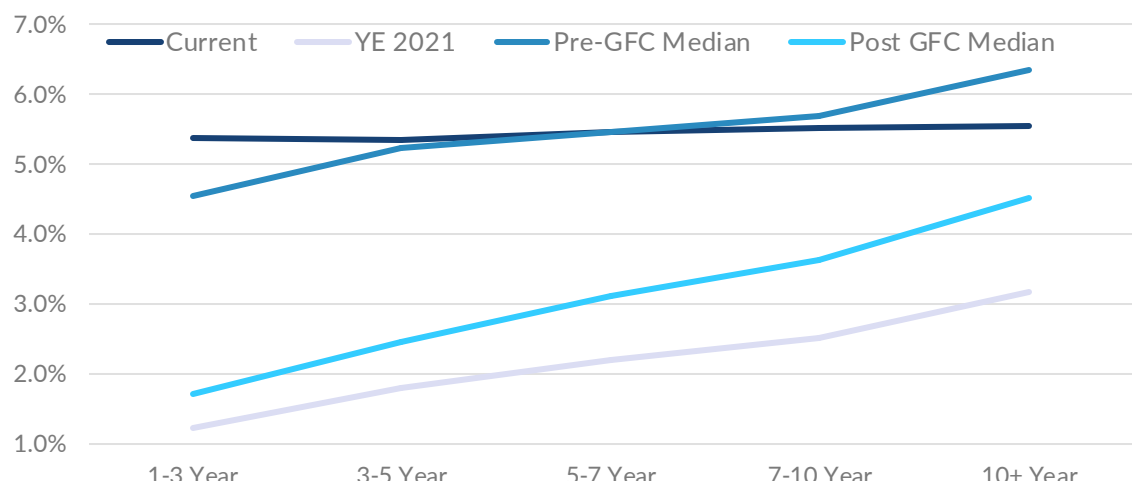


## Euro IG & BB Spread Curve

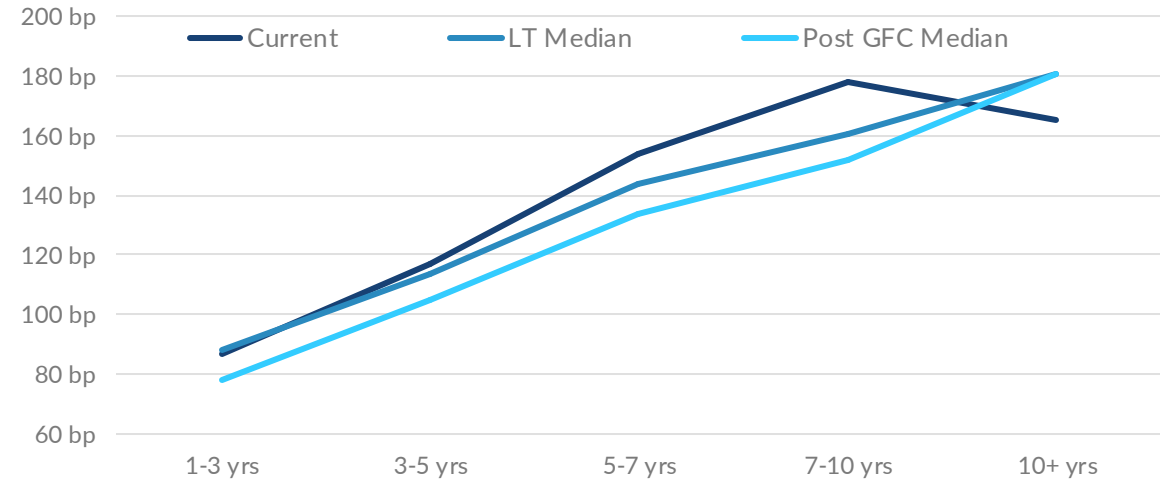


# Curve Positioning: Yield and Spread Curves in US & Europe

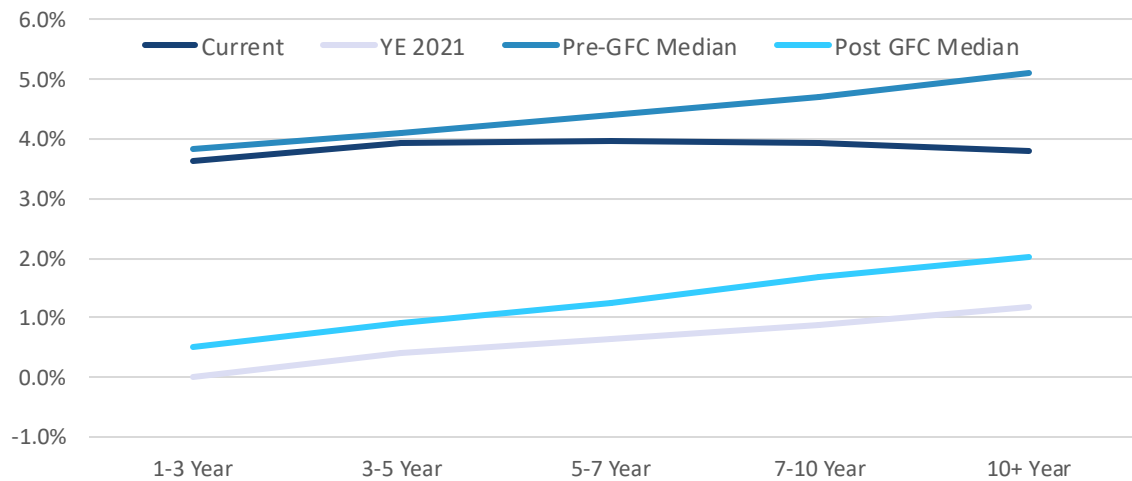
## US IG Yield Curve: Flat, But Elevated



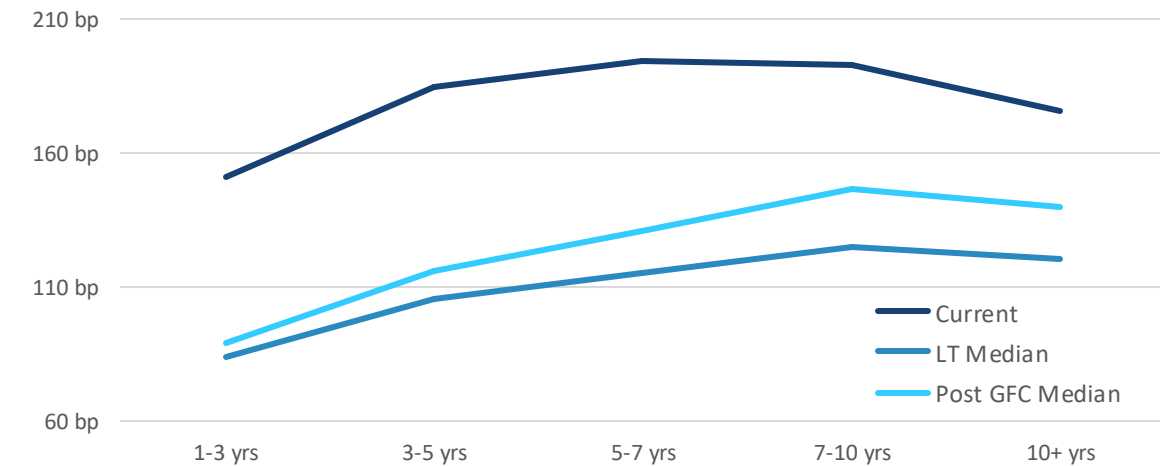
## US IG Spread Curve: Steep In Belly



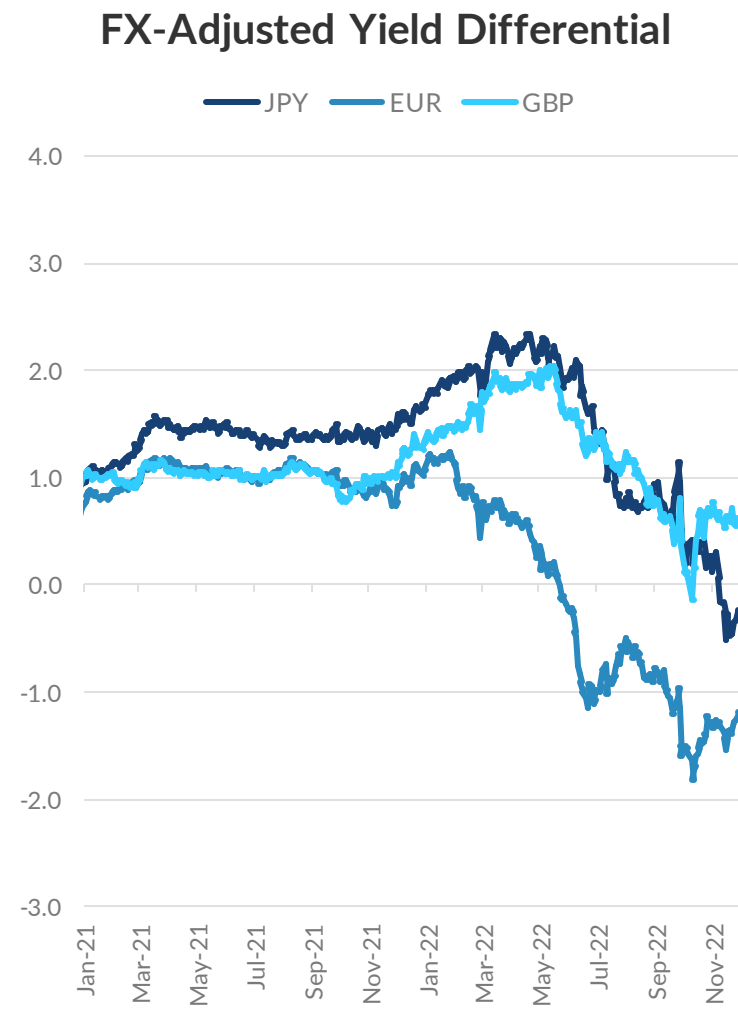
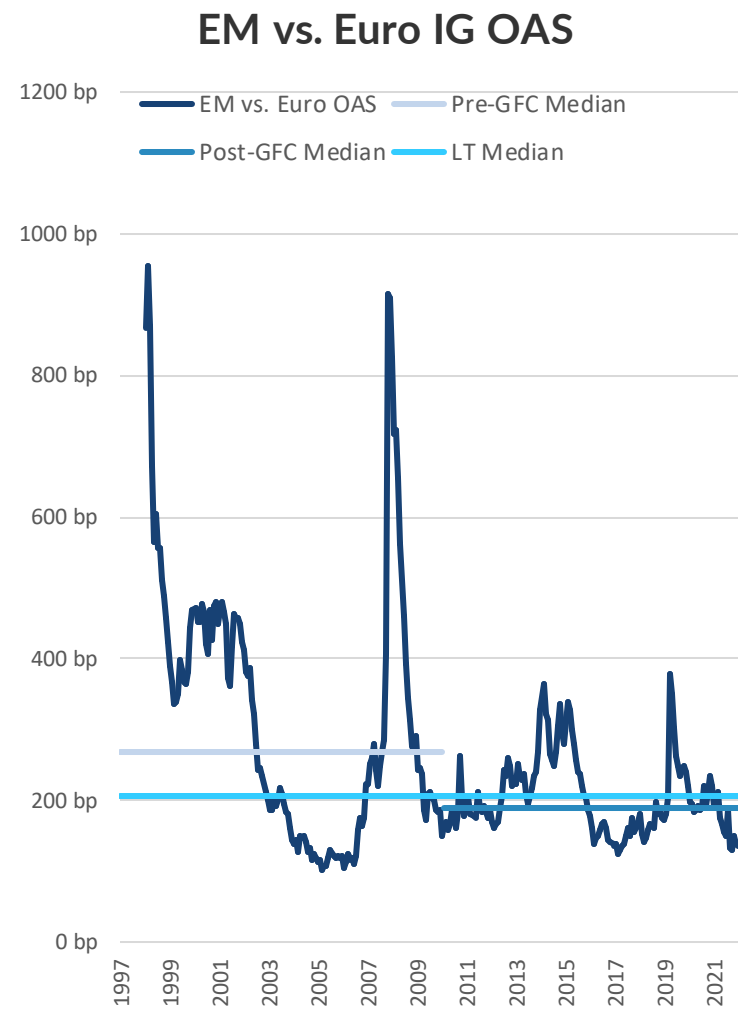
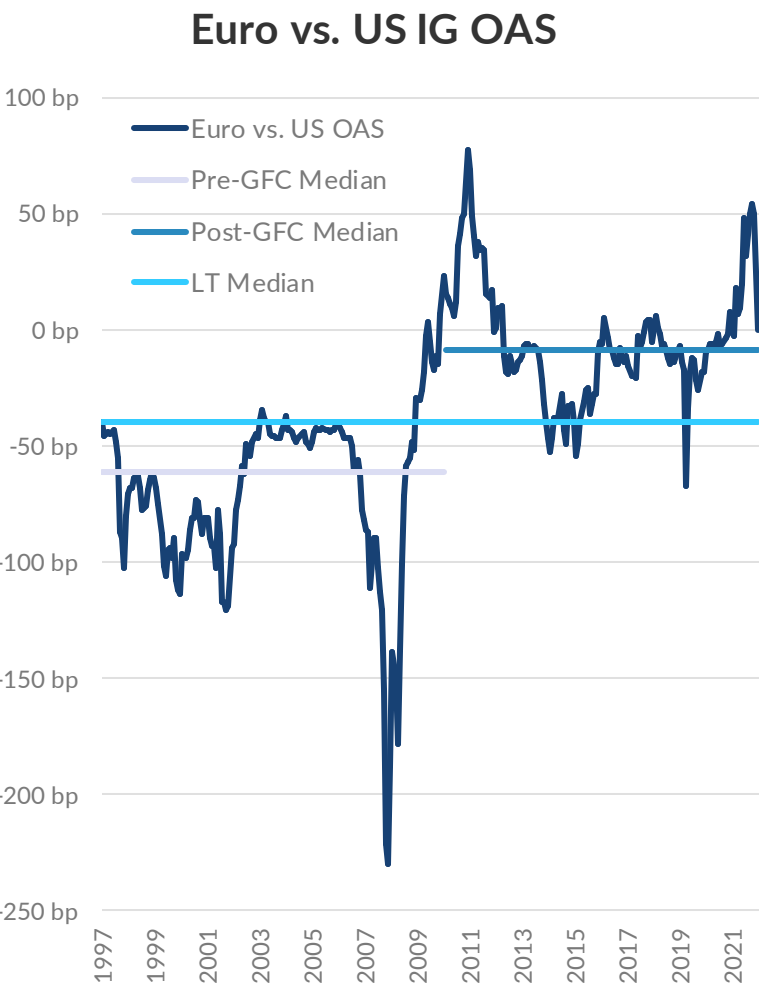
## Euro IG Yield Curve: Current vs. Historical



## Euro IG OAS Curve: Current vs. Historical



# Global Credit Relative Value: FX-Driven



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