# Global Credit

## Q3 Outlook 2024

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### In brief

- Global investment grade (IG) company fundamentals are healthy, particularly in the US, where we see an improvement in current and expected earnings.
- Our base case for macroeconomic growth reflects a 70% probability of Sub Trend Growth and a soft landing, which should continue to support IG fundamentals.
- The technical backdrop has been hot, with robust European demand absorbing elevated US supply. Spreads remain tight on a historical basis, while all-in yields are still elevated.
- We continue to like non-financial hybrids and thematic opportunities in companies that benefit from fiscal programmes and artificial intelligence. Valuations are stretched in banks but there are still pockets of value in some European capital structures and select Additional Tier 1 (AT1) exposures.

### Growth outlook remains supportive

Expectations for rate cuts have dramatically eased this year, with the higher for longer narrative taking centre stage. Evidence of a soft landing continues to intensify and economic data is pointing to the global economy getting back to trend growth and 2% inflation. Against this macro backdrop, our Global Fixed Income, Currency and Commodities team holds a 70% probability of Sub-Trend Growth, with a balance in tail risks to Above Trend Growth (15%) versus Recession (10%) and Crisis (5%).

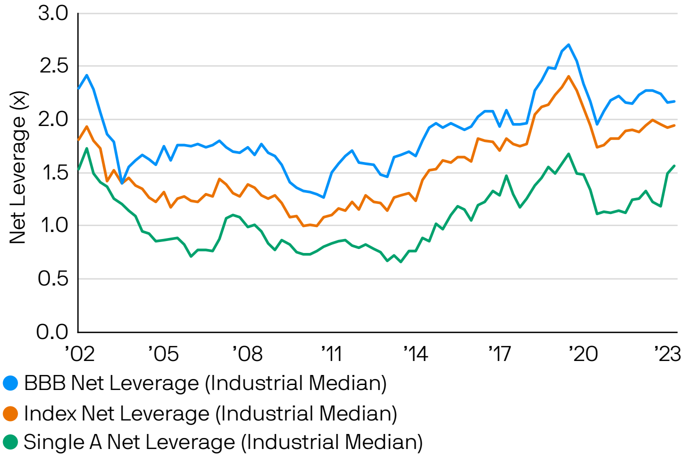
This type of environment is typically constructive for credit risk, although spread levels have tightened further Year-to-date to price this in. However, a shift in recessionary or higher inflationary expectations would introduce volatility into what has been a carry-like expected return environment.

### IG fundamentals are healthy

Bottom-up fundamental estimates show that IG companies have managed through a period of significantly higher funding costs and should be able to manage through a period of higher for longer rates. The trough in corporate earnings growth looks to have been firmly placed in Q2 2023 and growth projections are improving and remain in positive territory through the end of 2024 for US companies.

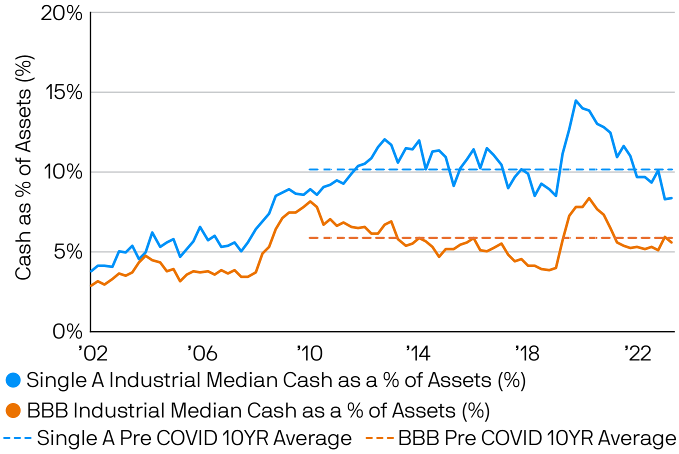
In the industrials sector, interest coverage levels for the median company have reduced, but are in line with the pre-Covid average. Industrial leverage has been stable at an index level, though higher quality companies have seen pronounced releveraging and higher cash spend as they prioritise shareholder returns and capital expenditure versus the BBB cohort.

**Exhibit 1: Median net leverage for single-A rated companies has increased 33% since Q3 2023**




Source: J.P. Morgan Asset Management, Fact Set, Bloomberg, as of 31 March 2024. Based on the median US industrial company.

**Exhibit 2: Cash levels for higher quality companies have fallen below their 10 year pre-Covid average**

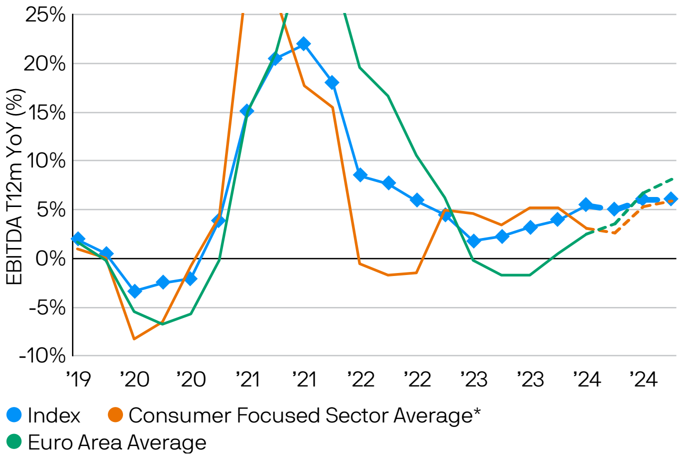



Source: J.P. Morgan Asset Management, Fact Set, Bloomberg, as of 31 March 2024. Based on the median US industrial company.

Support from various fiscal programmes have underpinned medium-term expectations for several industries. Secular themes such as artificial intelligence (AI) are driving strength in the technology sector, where we see companies moving from net layoffs to net hiring.

Retailers have enjoyed an unprecedented period of pricing power during and post-pandemic. However consumers today are more price sensitive due to inflation and higher cost of living. Companies focused on value proposition are leading, but many are using price cuts to drive volumes. We still expect consumer-facing companies within the IG universe to see reasonably positive EBITDA (earnings before interest, taxes, depreciation and amortization) growth into 2025.

**Exhibit 3: Despite challenges for the consumer focused sectors, we still expect positive EBITDA growth**




Source: J.P. Morgan Asset Management, Bloomberg, as of 31 March 2024. Based on the median US industrial company. Bottom up fundamental JPM analyst estimates as of Q2 2024, Q3 2024, Q1 2025. Consumer focused sectors are autos, consumer, media, retail. Other industrial sectors are basics, cap goods, energy, healthcare, tech, telecom, transports.

In financials, US regional banks are moving beyond last year's concerns around deposit outflows as NII (net interest income) has stabilised, resulting in decent earnings power which can support additional reserves for commercial real estate or capital build as needed. Fundamentals of the big six banks continue to be superior to regional banks, which supports their tighter valuations.

Europe looks close to a trough in EBITDA growth, following a broadly similar path as the US but with a lag. The same challenges are facing consumer focused companies. One difference with the US is in the auto sector, where European manufacturers seem to be experiencing greater headwinds from a shift in profit mix, higher exposure to electric vehicles, and a greater exposure to China. Chemical producers are indicating a likely end to destocking, and capital goods companies are benefitting from demand from data centres and grid expansion. European banks continue to benefit from strong profitability and high CET1 (Common Equity Tier 1) ratios which gives flexibility to return capital to shareholders.

In the UK, headwinds from mixed volumes in non-financials are cushioned by disciplined capital allocation, strong liquidity and ratings stability. Increased share buybacks have so far been neutral for credit, and leverage remains relatively low. The UK water sector is an outlier with wider spreads year to date reflecting regulatory uncertainty.

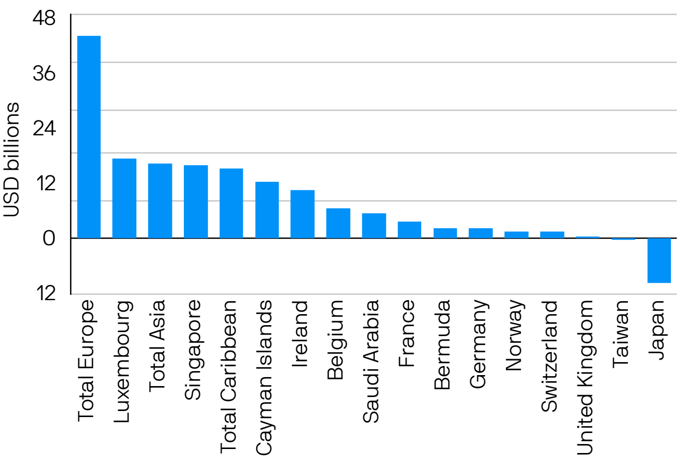
## Robust European demand is meeting front-loaded US supply

While fundamentals are 'goldilocks-like', not too hot and not too cold, demand has been heated for much of the year. Foreign flows have driven a lot of this demand, with Europe emerging as the important buyer of US IG credit (**Exhibit 4**), replacing the typical purchasing we see from Japan and Taiwan.

Attractive yields and more manageable hedging costs for European investors have supported this trend, though recent data suggests this flow may have waned. With the delay in scope and expectations for Federal Reserve rate cuts, this hedged spread differential between Europe and the US has compressed. Absent an offsetting pick-up in Asian demand, the technical picture could become less constructive for the US, though we recognise the demand for European credit may expand.

**Exhibit 4: Europe has been a big buyer of US investment grade credit through Q1 2024**

Through Q124, Europe has been a big buyer of US IG

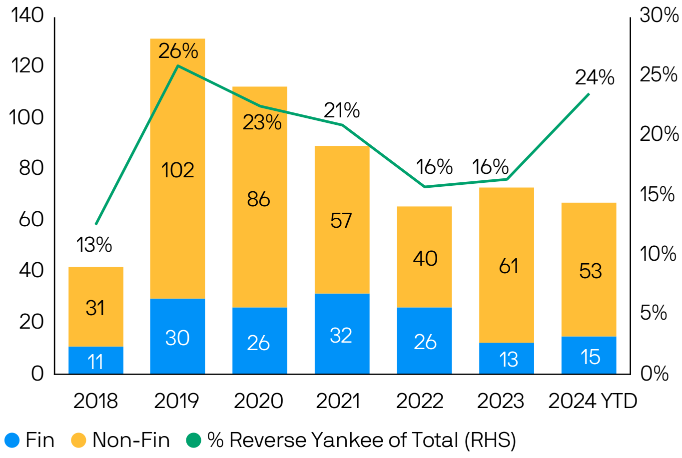



Source: Bloomberg, EPFR, J.P. Morgan Asset Management. Data as of 31 March 2024.

Fortunately, the supply picture is shifting and helping to mitigate these demand dynamics in the two markets. In the US, our analysts' full year bottom-up estimates for supply ($1.2 trillion gross and $375 billion net) continue to be much lower than 2023. Given the significant amount of supply Year-to-date and seasonally lower issuance in the second half of the year, we expect a meaningful decline in net supply. By contrast, the supply outlook continues to expand for Europe given the favourable terms for reverse Yankees (US companies issuing outside the US) and growing maturities from corporate purchasing programmes that are being refinanced.

**Exhibit 5: Reverse Yankee supply has increased as a proportion of financial supply**

Reverse Yankee Fins vs. Non Fins Gross Supply, EUR bn




Source: Bloomberg, J.P. Morgan Asset Management. Data as of 4 June 2024.

## Spread valuations improve into quarter-end

Spreads continued to tighten into the end of May but we saw some reprieve in June after higher than expected supply, a slight easing in buyer demand and some risk premium for election uncertainty in France and the US.

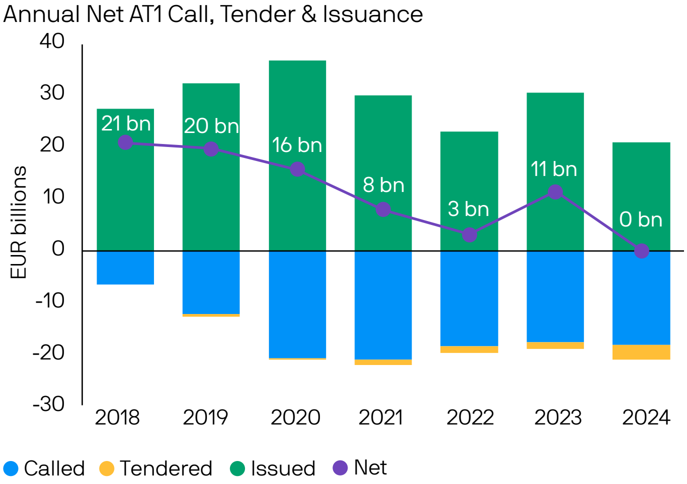
At end Q2 2024, global IG spreads are 104 basis points (bps), tightening from 115bps YTD. US IG spreads widened from 85bps at end of May (also their YTD tights) and ended the quarter at 94bps, settling 5bps tighter on the year. European and sterling IG corporates closed at 120bps and 123bps respectively, outperforming the US market by tightening 18bps and 16bps this year.

While index level spreads remain tight versus longer term comparisons, we like opportunities where spreads are similar to BB-rated bonds within the IG universe. Utility and energy hybrids are an attractive alternative here, though part of their additional spread is compensation for potential negative convexity (which can be mitigated through company and security selection) and liquidity. We believe the latter will improve for the US with the growth in issuance of utility hybrids.

We also continue to like banks, both in the US and Europe. There may be room for additional spread compression in selective US mid-sized regionals and lower tier European bank paper, which look attractive versus typical BBB- and BB industrials.

AT1 issuance picked up this year as issuers tendered existing bonds prior to call date at a premium, and issued new bonds with longer call dates. When investing in AT1s, we are focused on vintages with better convexity profiles (such as 2023) and more seasoned bonds with higher average resets.

**Exhibit 6: Annual AT1 issuance is close to flat for net supply, with higher gross issuance offset by call activity**




Source: Bloomberg, J.P. Morgan Asset Management. Data is as of 8 July 2024.

From a curve perspective, 7-10 year corporate exposure looks reasonably attractive when viewed from the perspective of carry and roll. We are also being selective in longer-dated exposures given a steepening in high quality 10s30s curves YTD, driven by slowing European demand and lack of flow from other high quality foreign buyers. In the UK, continued improvements in funding levels allowed more defined benefit pension plans to transfer their assets and liabilities to life insurance companies last year. With the first Bank of England rate cut priced in late 2024, we expect funding ratios to remain elevated which drives persistent demand for longer dated GBP-denominated paper.

## What does this mean for fixed income investors?

Valuations for IG corporates are at the narrower side of history and will be vulnerable to shifting views on the economy. Based on our analysts' bottom-up work, the environment for large IG companies is adequate. Companies have managed through a period of significantly higher funding costs and should be able to manage through a period of higher for longer rates. However, a shift in recessionary or higher inflationary expectations would introduce volatility into what has been a carry-focused expected return environment.

From a fundamental perspective, we are concentrating on companies that benefit from fiscal programmes such as the Inflation Reduction Act (IRA) and thematic opportunities such as data centre buildouts associated with AI. Exposure to these issuers will provide balance in the event of an administration change in the upcoming US election. Overall, we like sectors such as utilities, capital goods, energy and tech.

Utility and energy hybrids continue to provide an opportunity to earn additional spread for IG-rated companies, but security selection is key. Certain US mid-sized regional banks and lower tier European banks also looks attractive compared to typical BBB- and BB industrials valuations. In AT1s, we are focused on vintages that have produced better convexity profiles.

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