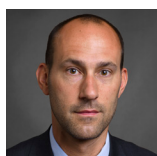
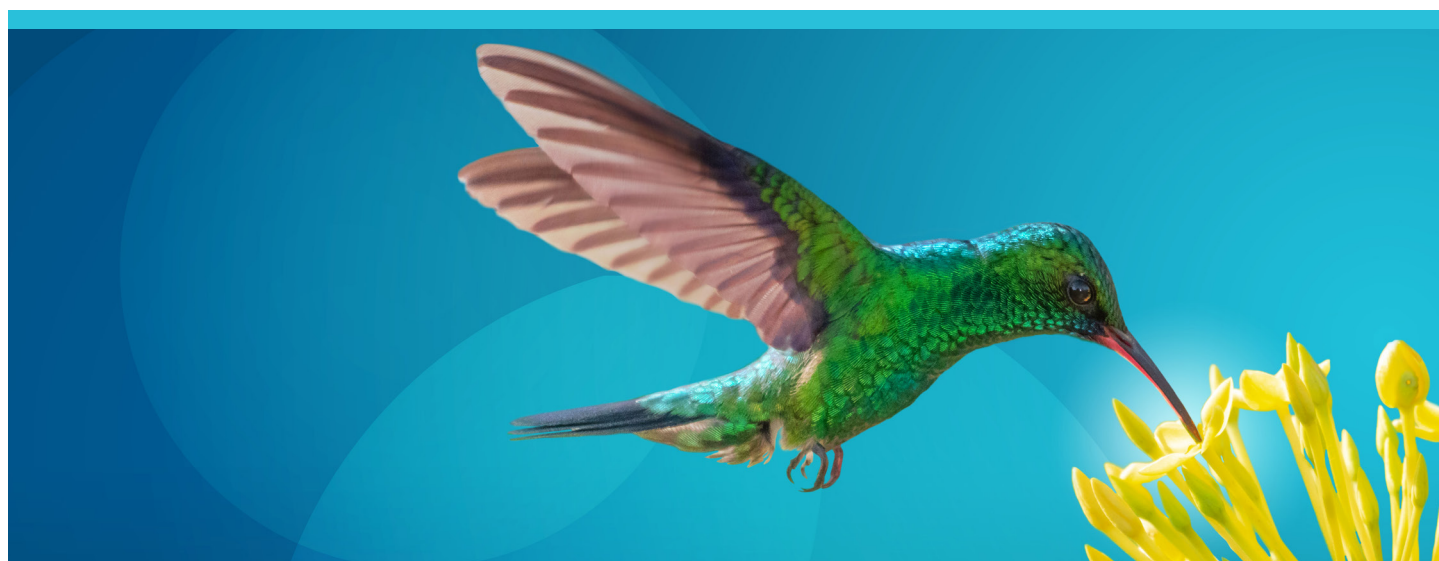




## Outlook

# Credit investing road map for 2022



**Justin Gerbereux**  
Director of Fixed Income  
Credit Research



**Carolyn Chu**  
Director of Fixed Income  
Credit Research



**Michael Lambe**  
Investment Grade Team  
Leader

## Key Points

- Credit fundamentals across high yield and investment grade corporates are generally robust, in both emerging and developed markets.
- On aggregate, we are broadly positive on high yield, neutral on investment grade and somewhat negative on emerging markets.
- Within high yield, we see particular value in the leveraged loan market, and in areas such as mandatory convertibles and second lien loans.
- In high yield, we expect to see a trend of rising stars migrating into investment-grade space, so the name of the game in 2022 will be predicting the upgrades.
- In investment grade, amid inflation concerns, rising yields and the prospect of central bank tapering, the proportion of sub-zero debt is smaller than it was this time last year. The question is whether that will alter investor behaviour.
- For investment grade investors, a key theme is semiconductor supply chain issues, especially in the auto sector. We think challenges will persist in 2022, but we think the bigger challenge to credit quality will be the transition to electric vehicles.
- While emerging market (EM) corporate fundamentals are generally healthy, tight valuations and numerous headwinds keep us broadly neutral on the asset class. In Asia credit, Evergrande's woes have hit sentiment towards Chinese high yield, but the investment grade sector has remained resilient. Elsewhere in EM, political and policy uncertainties continue to weigh in the Central and Eastern Europe, Middle East and Africa (CEEMEA) and Latin American regions.

## The big picture

As 2021 draws to a close, we believe credit fundamentals across high yield and investment grade corporates are generally robust, in both the emerging and developed markets.

### High yield

In recent months our Sector Strategy Advisory Group has upgraded its tactical view on global high yield from neutral to positive. Although spreads remain well below historical averages, fundamentals are generally strong. Issuer leverage has fallen as profits have rebounded; the number of BB rated credits has significantly increased; and issuers are benefiting from easy access to capital in debt and equity markets.

From a technical perspective, investor demand for yield should persist amid low rates, and a potential wave of upgrades to investment grade could shrink the supply of high yield debt.

We remain positive on loans given their relatively attractive spreads, negligible interest-rate risk, and lower volatility profiles than comparable high yield bonds.

Technical support for the sector persists, as the prospect of rising interest rates is making floating rate debt more interesting. In the US, we've been seeing collateralised loan obligations (CLOs) being put together at a record pace.

The loan default rate has continued to fall, recently hitting 0.35% according to S&P/LSTA. While an increase is inevitable, we believe a meaningful rise is unlikely in the near term, with the distressed loan percentage under 1% and upgrade/downgrade ratios skewed in favour of upgrades.

### Investment grade

We have a neutral view on the global investment grade sector on aggregate, but within that there is some variation. Although valuations are broadly not compelling, technicals remain robust, with issuance

expected to slow into year-end and US credit offering attractive hedged yields for foreign buyers. Fundamental improvement is slowing, but balance sheets are stronger, and ratings momentum remains positive.

In general, the corporate bond team sees the most attractive yield opportunities around the intermediate section of the credit curve and likes the greater liquidity available in the banking and communications sectors.

### Emerging markets

As of late 2021, the tactical view on emerging markets credit generally remains neutral, with tight valuations offsetting strong credit fundamentals. Corporate fundamentals remain healthy as most companies have focused on preserving liquidity and managing their balance sheets prudently. With the exception of China high yield, we think the corporate default rate should remain low by historical standards as many companies have opportunistically termed out their debt amid excess global liquidity over the past 12 to 18 months. Within Asia high yield, we see pockets of value, as weak market sentiment has resulted in what we view to be excessive spread in some credits. However, the persistently weak technical backdrop is likely to drive continued price volatility across the board.

Asian high yield spreads have widened meaningfully as concerns, first sparked by the Evergrande default and then followed by more payment challenges by other peers, caused a sector-wide sell-off across China property bonds. Against a backdrop of already tight onshore liquidity, weak investor sentiment has exacerbated concerns around cashflows and refinancing risks across China high yield more broadly. The extreme volatility we have witnessed, with bonds gapping up or down with little or no change in fundamentals, reflects a breakdown in the market structure, exacerbated by investors and intermediaries unwilling to take down more risk, particularly as we approach year end. While this technical backdrop remains a headwind to bond price performance, we believe that financial stress will be managed

and that the indiscriminate selling we've seen has created attractive entry points for discerning investors.

Elsewhere in EM, political and policy uncertainty in the CEEMEA and LATAM regions have also caused heightened bond price volatility. These evolving situations remain fluid, and our preference is to stick to high quality credits rather than be tactical and reach down the credit quality spectrum. Within EM sovereign credit, the same bifurcation between higher quality and higher beta assets has also been evident, with single Bs generally underperforming BBs. External credit metrics generally have remained relatively solid while domestic public debt levels are leveling off, as countries undergo fiscal consolidation and growth returns.

More broadly, the EM macroeconomic backdrop remains challenging. A strong US dollar has been negative for EM currencies as an asset class more generally; inflation continues to be a focus for EM central banks, many of which have already begun rate hikes earlier this year (well ahead of developed markets); and China growth indicators have continued to lose momentum over the course of 2021 as a focus on de-leveraging has compounded the slowdown in domestic growth.

In China, the leadership's focus on "Common Prosperity" as a guiding principle for the coming years also has implications for the parts of the economy that are likely to be impacted, either curtailed or supported. Global growth is also likely to slow from elevated levels as fiscal stimulus put in place during the pandemic will be reduced or withdrawn given lack of fiscal space in most EMs. Corporate profits are likely to come under pressure as companies find it difficult to pass on input/logistics price increases to the end consumer against weak domestic demand, though we expect corporate profiles to remain manageable. Last but not least, renewed concerns of the rapid spread of Covid variants and the risk of potential lockdowns compound the uncertainty, though we would argue that the risk of renewed lockdowns (and drag on growth) is greater in developed economies than in EM countries.

## Outlook: global high yield

High yield returns, as we know, are not what they used to be. For context: at the end of 2006 a quarter of the J.P. Morgan Global High Yield Index paid coupons of more than 9%, and 91% of the market paid coupons of 6% or higher. By 30 September 2021, less than a tenth of the index paid coupons over 9%, and less than 40% paid coupons of 6% or more. In valuation terms, 2021 saw significant spread compression as the markets rallied after Covid. So where can investors look to find value, especially in a potentially rising interest rate environment?

One place to look is relative value within issuers' capital structure. One example where we're seeing value is mandatory convertible bonds issued by investment grade companies, notably in the utilities sector—in other words “lower quality” because they are less senior in the capital structure. These tend to offer attractive coupons with relatively short durations. Another example is second lien (junior, or subordinated,) loans, which tend to offer a better risk-return trade off.

A second route to gaining some yield, in our view, is loans in general. They benefit from the same trends as the broader high yield sector—strong fundamentals, low default outlook, supportive investment flows, an upward trend in credit upgrades—but their floating rate payments mean they have little or no interest rate exposure (duration). And demand is strong: as mentioned earlier, we've been seeing CLOs being put together at a record pace, particularly in the US.

### Potential for rising stars

2020 was a record year in fallen angel volume, with well over \$US200 billion in downgrades to high yield, compared with around US\$150 billion in 2009 at the time of the global financial crisis (GFC). That increased the BB segment of the high yield universe to more than 60%, compared with less than 40% before the GFC. As we predicted, high yield default rates fell in 2021, with upgrades outnumbering downgrades. And this means that the new big investment

theme is going to be to spot the rising stars.

We see plenty of opportunities over the coming two years. As Mike Connelly pointed out in a recent article '[High Valuations Balance Healthy Credit in Global High Yield](#)', 9.5% of the Bloomberg US High Yield Index was one rating upgrade away from investment grade as of August 31 2021, versus 7.0% at the end of 2019. A remarkable 23% of the US index was two or fewer rating moves from investment grade, compared with 15% on December 31, 2019.

This trend, which stems from both credit rating upgrades and fallen angels entering the market, illustrates how much the overall credit quality of the sector has improved. Mike argues that this should also provide technical support for global high yield by removing a large volume of bonds from the market as they receive upgrades and gain investment-grade ratings.

Of the potential rising stars, perhaps the most obvious high yield candidate is the automaker Ford. Two other likely candidates, in our view, are Netflix and Occidental Petroleum.

### Netflix: building on Covid outperformance

Netflix was a high-profile beneficiary of the COVID lockdown and is almost singlehandedly disrupting the traditional linear pay television ecosystem. Up to now, Netflix has been a better equity story than credit story due to persistent debt issuance to fund cash flow. But free cash flow appears to be turning around.

Netflix's cash deficits have largely been the result of content investment and international expansion. One acquisition, reportedly for about US\$680 million in the second quarter of 2021, was Roald Dahl's literary catalogue—a smart move, in our view.

*“The success of Squid Game highlights a couple of Netflix's competitive advantages”*

The global success of the South Korean “Squid Game” highlights a couple of Netflix's competitive advantages—a local content ground game that took years to build and is currently unmatched by any other global subscription video on demand (SVOD) player, as well as the foresight to make a multiyear investment in high-quality dubbing. The popularity of “Squid Game” builds on other successful local language programming including “Lupin” in France and “Money Heist/Casa de Papel” in Spain.

### Occidental Petroleum: recovering from self-inflicted injury

In our view, Occidental Petroleum Corp (OXY) is essentially a good company with a solid and diverse asset base that has ended up with a bad balance sheet as a result of a self-inflicted wound. The company's aggressive pursuit of the acquisition of US-based oil and gas exploration and production company Anadarko in 2019 blew up the balance sheet and landed what was once an A-rated company in high yield space.

But the breadth, size and quality of OXY's assets are unparalleled in high yield energy. Given the deterioration in its credit profile and the 2020 crash in oil prices, management is now firmly focused on debt reduction through a combination of asset sales, free cash flow generation and refinancing. The company also has the potential support of two deep pocketed investors—Warren Buffet and Carl Icahn—although it is unlikely to be needed. We think the outlook for free cash flow is very strong given the rebound in commodity prices, and we expect OXY's credit metrics to improve over time.

The Anadarko deal took OXY's leverage from less than 1 times earnings to more than 4 times. But the company has a lot of options at its disposal. Steps already taken to start addressing the debt include slashing the dividend by 99%, halving 2020 capex and pushing out the company's existing debt maturities. Last year OXY shifted roughly US\$3.5 billion of its debt out beyond 2030.

## Outlook: investment grade credit

Until November 2021, spreads had been recovering consistently in line with our expectations this time last year, with the “Covid recovery” sectors such as retail, real estate and airlines outperforming. One area that surprised us was the strength of the rebound in M&A activity. We’d expected the focus to remain more on balance sheet consolidation. But that said, the M&A we have seen has been largely “credit aware” and neutral for bondholders. But the November volatility—driven primarily, but not entirely, by the fears surrounding the Omicron variant—serve as a timely reminder that the market is not yet free of virus concerns, which will continue to be a near term driver of market risk appetite.

In spite of the higher volatility and spread weakness, valuations remain expensive. Yield, however, is not as scarce as it was this time last year. At the end of November 2020, more than a third of the Bloomberg Global Aggregate Index was yielding less than zero, with ultra-low government bond yields and stimulus-related central bank buying driving investors down the ratings spectrum in search of yield. By the same time in 2021, rising yields and the prospect of central bank tapering had taken the proportion of negative-yielding debt back below 20%. Going forward, one might expect higher government bond yields to trigger a migration back up the ratings spectrum but, so far, demand for corporate credit in the primary market has remained strong, providing a continued positive technical to spreads.

### Key themes in 2022

Two key fundamental themes that will follow through into 2022 are the growing emphasis on inflation and (a related issue) continued logistical and supply chain constraints, both of which have the potential to weigh on market volatility and corporate fundamentals through the year.

Inflation is a risk to raw material costs, input costs and profit margins. But the flipside of the inflation picture is strong pent-up demand

and low inventory levels, which are helping companies defend their margins. Third-quarter financial results in many cases beat expectations, showing resilient business performance and pricing power.

While supply chain challenges will persist, and there may be increases in capex as companies try to negotiate the near-term challenges, we don’t expect this to impact credit quality too severely. We think we are likely to see logistical pressures easing in 2022, notably in the auto industry, which has been hit particularly hard by the semiconductor shortages supporting our view that in spite of tight valuations, we believe credit fundamentals are generally solid across global investment grade.

In terms of the opportunity set, we do still see value in financials given a potential rising rate environment. But, in general, we think 2022 will be less about sector themes than idiosyncratic factors. One notable source of ideas here is the sizeable group of rising stars potentially coming up from BB into BBB-. Some of the credit improvement has already been priced in, but in cases such as Netflix and some of the energy names, we believe there is still value.

### The auto sector: is the semiconductor squeeze over?

We’ve been looking closely at the potential impact of the semiconductor shortages on auto production, and we think the third quarter of 2021 may have marked the tightest point in terms of constraints. That said, supply issues are likely to persist through 2022 and possibly into 2023. We’ve heard mixed messages during the current earnings season. Toyota, for example, suggested production should soon return to more normal levels while others believe disruptions won’t start to ease until the second half of 2022. (Toyota’s confidence may reflect better access to chips, closer ties with Tier 1 suppliers and more direct negotiations with semiconductor makers.)

A fact that often gets overlooked is that the semiconductor challenge is both a supply and a demand issue.

The industry was already facing a structural problem before Covid. The auto sector uses a lot of trailing edge, older chips. The legacy node manufacturing for these was running near full capacity pre-pandemic and was not an area of focus for the key players like Taiwan Semiconductor Manufacturing Company. Their focus was on building out new capacity in higher margin, leading-edge chips. Back then, while light vehicle production was not really growing, the semiconductor content in vehicles was expanding—in some cases by 2 to 3 times in US dollar terms—notably for those vehicles incorporating additional tech such as advanced driving assistance systems and infotainment.

When Covid hit, auto makers cut their chip orders, and then when the v-shaped recovery happened they found themselves at the back of the queue. In addition, this year we’ve seen a set of one-off hits that have weighed on supply: the fire at Renesas (a major Japanese supplier of automotive semiconductors), storms in Texas, and Covid in southeast Asia. Availability also depends on competing demand for semiconductors from non-auto applications such as consumer electronics which, anecdotally, does appear to be easing but is hard to predict.

Our base case is in line with industry estimates for ongoing gradual improvement, but there are a lot of moving parts to the outlook and the risks are elevated. The supply chain is very fragile, and any small bottleneck can have outsized disruptive effects.

While supply chain tightness is going to be a key theme to watch it may not be the biggest challenge faced by the sector. In our view, the most significant risk to credit quality remains the costs and margin headwinds associated with transitioning to the new EV (and autonomous vehicle) future. Covid has accelerated this shift and exposes the industry to elevated credit risks. The sector is still undergoing a significant transition to EV, which requires high-quality execution and massive investment, also relying on customer adoption in order to enable the scale to make EV operations profitable.

## Emerging markets credit: focus on Asia

Credit investors globally are focusing more closely on inflation than they were this time last year, and that's particularly true of emerging markets, where the data prints have generally surprised to the upside—in some cases stubbornly so—and EM central banks have been the first to start the rate hiking cycle. A key question credit investors are grappling with is whether the inflation trend is temporary or structural. This will certainly impact the US Federal Reserve's decision and timing of monetary tightening.

Another important issue is how much of a drag China could be on the Asian region and the global economy in 2022. In this case, the year-on-year data may be less instructive than the sequential data. GDP growth in the first half of 2021 was strong, but the third quarter was weak, and we think it's likely that the fourth quarter will also disappoint. These considerations will influence the outlook for monetary tightening in China.

The government embarked on a deleveraging campaign a few years ago, with the goal of more effective capital allocation and redirecting economic growth away from fixed asset investment—driven activities to rely more on domestic consumption and services. This has had the result of continued tightening of onshore liquidity, with certain sectors (notably property) being the most directly impacted.

This has exposed the property sector to greater market discipline, with onshore investors getting more accustomed to defaults, where weaker companies succumb to natural selection. Onshore defaults rose significantly in 2021. The danger—and one that has acted as a drag on progress with China's deleveraging plans—is the risk of overdoing it to the point that even good companies get squeezed out and the sector becomes destabilised, triggering a tidal wave of defaults and restructurings and impacting both upstream and downstream sectors, as well as the Chinese banks.

The seismic shock from the meltdown of Chinese real estate developer Evergrande, as well as subsequent payment challenges by other developers caused turmoil in China real estate, but the impact has been remarkably localised, not just in the global context but even within China.

In China investment grade credit, for example, issuers have been able to raise financing at attractive costs. SF Holdings, a large third-party logistics service provider, recently issued a new bond without needing to pay any new issue premium. While a solid credit, SF Holdings is in an expansionary, high capex phase, and will need to walk a fine line with the rating agencies in the next few years, particularly in view of its split single A/triple B credit rating. The favorable pricing (for the issuer) achieved on the deal is one indication of how much cash there currently is to be deployed in the market, as well as broader risk aversion and preference for investment grade credits.

## General Risks

**Capital risk** – the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

**ESG and Sustainability risk** – May result in a material negative impact on the value of an investment and performance of the portfolio.

**Counterparty risk** – an entity with which the portfolio transacts may not meet its obligations to the portfolio.

**Geographic concentration risk** – to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

**Hedging risk** – a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

**Investment portfolio risk** – investing in portfolios involves certain risks an investor would not face if investing in markets directly.

**Management risk** – the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

**Operational risk** – operational failures could lead to disruptions of portfolio operations or financial losses.

## Additional disclosures

### Credit Suisse

© 2021 CREDIT SUISSE GROUP AG and/or its affiliates. All rights reserved.

ICE Data Indices, LLC ("ICE DATA"), is used with permission. ICE DATA, ITS AFFILIATES AND THEIR RESPECTIVE THIRD-PARTY SUPPLIERS DISCLAIM ANY AND ALL WARRANTIES AND REPRESENTATIONS, EXPRESS AND/OR IMPLIED, INCLUDING ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, INCLUDING THE INDICES, INDEX DATA AND ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM. NEITHER ICE DATA, ITS AFFILIATES NOR THEIR RESPECTIVE THIRD-PARTY SUPPLIERS SHALL BE SUBJECT TO ANY DAMAGES OR LIABILITY WITH RESPECT TO THE ADEQUACY, ACCURACY, TIMELINESS OR COMPLETENESS OF THE INDICES OR THE INDEX DATA OR ANY COMPONENT THEREOF, AND THE INDICES AND INDEX DATA AND ALL COMPONENTS THEREOF ARE PROVIDED ON AN "AS IS" BASIS AND YOUR USE IS AT YOUR OWN RISK. ICE DATA, ITS AFFILIATES AND THEIR RESPECTIVE THIRD-PARTY SUPPLIERS DO NOT SPONSOR, ENDORSE, OR RECOMMEND T. ROWE PRICE OR ANY OF ITS PRODUCTS OR SERVICES.

### J.P. Morgan Chase

Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright © 2021, J.P. Morgan Chase & Co. All rights reserved.

### MSCI

MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI.

## Important information

The specific securities identified and described are for informational purposes only and do not represent recommendations.

**This material is being furnished for general informational and/or marketing purposes only.** The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date noted

on the material and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

**Australia**—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

**DIFC**—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

**EEA**—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

**Hong Kong**—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

**Switzerland**—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

**New Zealand**—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

**Singapore**—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

**Switzerland**—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

**UK**—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

© 2021 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the bighorn sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.

CCON0100786 | 202112-1915572

For more information on T. Rowe Price and our investment capabilities, please visit our website:  
[troweprice.com](https://troweprice.com)

**T. Rowe Price**<sup>®</sup>  
INVEST WITH CONFIDENCE