Credit Quarterly Outlook

Death by a thousand cuts

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Fifth edition

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Fundamentals - *Economics*

Before the Iran conflict erupted, the US economy was gradually improving, carried by resilient consumer spending and tech-related capex. US inflation was stickier than headline CPI suggested. GDP deflators told the real story: services inflation stubbornly elevated, AI-driven energy demand quietly pushing up utility costs. Europe was struggling instead. Inflation drifted lower, but for the wrong reasons. European growth remained tepid under de-industrialisation and fiscal constraints. China, struggling too, kept exporting its overcapacity in several sectors driven by an overbuild situation. It was unable to escape its deflated property bubble. All in all though, there was no catalyst to derail this global economic situation.

AI is a bubble in the making, but it is 1997, not 2001. Hyperscaler capex has surged to roughly 1% of US GDP. Funding models are increasingly questionable: vendor financing, special purpose vehicles (SPVs), significant debt issuance. Tech firms lending to each other to buy each other's products - that should concern anyone. Yet, profits hold up and leverage remains contained. There is no evidence that AI is meaningfully boosting productivity yet. The late 1990s analogy feels apt: exuberance is building, financial engineering is back, but the reckoning is not imminent. At Osmosis, we are benefiting by boosting our research process with AI support. Many more companies will follow.

Geopolitical shocks are usually temporary. The Russia-Ukraine war taught us that again recently. What matters more than the shock itself is timing and context. How stretched are imbalances? How much room do policymakers have? Against what cyclical backdrop does it land? And, importantly, how unexpected was it? Can Iran be the unexpected catalyst to make a few dominos fall?

The Iran war is first and foremost an energy story, but the market is focused on the wrong chapter. Oil prices rose a lot, adding 50 to 100 basis points to headline inflation, depending on the region. That seems manageable. But the closure of the Strait of Hormuz is unleashing second-order effects that dwarf the crude oil narrative. Fertiliser prices are spiking, hitting global food costs. Sulphur supply, critical for semiconductor manufacturing, is under pressure. The Gulf's role in container shipping is felt through surging freight rates and lengthening delivery times.

Look at diesel, kerosene, aluminium, sulphur, fertilisers and shipping fees - the headline oil price move is a story of secondary importance. Central banks face an uncomfortable reality. Burned by the 'transitory' narrative in 2021-2022, they will not make that mistake again.

Quick Read

Geopolitical shocks like the Iran war are usually temporary. What matters more than the shock itself is timing and economic context.

How stretched are imbalances? How much room do policymakers have? Where is the leverage?

Every credit cycle ends the same way: weak underwriting, excessive leverage, regulatory arbitrage and often the Fed to intervene with rate hikes that bite. This time around it may not be that different…

Investment-grade corporates are in solid shape. Balance sheets are healthy. There is no leverage cycle in public credit unlike private credit.

Sovereigns are a different story. The real leverage cycle sits on government balance sheets.

Tight spreads are riskier than wide spreads. Risk/reward is insufficient, hence neutral beta.

Rate cuts are off the table. Rate hikes are back on, it seems. This was unexpected for the global economic situation we were in. Rate hikes could be the unexpected catalyst ending the business cycle. Historically, these often have been. The question is whether there are enough imbalances to push over? Certainly not corporate leverage in the public market.

Fundamentals - *Corporates*

Every credit cycle ends the same way: weak underwriting, excessive leverage, regulatory arbitrage and often the Fed to intervene with rate hikes that bite. Only the sector differs. In the 1990s it was telecom. In 2007-2008 housing and structured finance. In the European crisis, sovereign and bank balance sheets. The pattern is always the same, the address only changes.

So where is the leverage today? We intend to ask this in every Credit Quarterly Outlook, because identifying where excesses are building is the single most important exercise in credit investing. We need to understand the Global Macro Cycle, one of our investment principles. The answer is both reassuring and concerning, depending on where you look.

Investment-grade corporates are in solid shape. Non-financial debt-to-GDP ratios kept falling since the pandemic. Balance sheets are healthy, IG issuance relative to GDP remains contained. There is no leverage cycle in public credit. These companies weathered tariffs, supply chain disruptions and policy uncertainty without materially leveraging up. US corporates lead on profitability and discipline; European IG, though weaker, faces no existential stress.

Sovereigns are a different story. The real leverage cycle sits on government balance sheets. The US, France, the UK, Italy, Japan and, arguably, Spain and Canada, all face elevated debt-to-GDP ratios with persistent deficits and zero political appetite for consolidation. Italy's growth cannot service its debt trajectory. France is in a similar position. Defense spending adds pressure. Yield curves have steepened as term premia rise, confirming the Yield Era thesis from our first quarterly. This is important since sovereign debt sustainability has not been a market theme yet. This is likely to change. We believe it will be on Bloomberg TOP stories soon.

Private credit is where parallels to previous cycle excesses are most striking. The market has grown from roughly $1 trillion in 2015 to $2.5 trillion today. North American direct lending AUM increased sevenfold in a decade. As capital flooded in, underwriting deteriorated - a pattern we see in every late-cycle expansion. BDCs now trade at their largest discount to book since the post-COVID recovery. PIK loans in BDC portfolios have risen near post-COVID highs: borrowers are struggling to service debt in cash.

Concentration risk is acute. Technology, software, and healthcare dominate private credit portfolios of BDC holdings. This is overwhelmingly a US story, driven by PE sponsors who are, in our view, better at optimising fees than at underwriting credit risk. We believe these funds carry 10-15% PIK exposure and conceal at least a significant percentage in restructured loans, despite not reporting them. When roughly 25% of a loan book is impaired or, in banking terms, in stage two or three, the implications can be significant. A serious default cycle may be underway. Underwriting standards in private credit, leveraged loans and certain HY segments are poor, but that is typical late-cycle. We saw it in CLOs before 2008, European leveraged loans before the sovereign crisis, energy HY before 2015-2016. Every cycle produces its own vintage of badly underwritten debt.

This one is produced by ex-bankers and PE firms with all kinds of intercompany relationships between the different business units. These all share a classic mistake; funding illiquid assets with (partly) short term debt. Again, on its own maybe not a bubble big enough to derail markets, but it adds to imbalances.

Many of these companies will seek alternative funding. Banks, now cautious and tightening underwriting standards, will not step in. The public high-yield market becomes the logical destination, increasing tech concentration in HY indices and dragging the private credit problem into the public domain. It could create a large supply overhang which might be ‘priced to sell’ with much better covenants and hence effectively repricing the public high yield market. Another technical which could contribute to a rollover of the credit cycle.

Valuation

Our golden rule: valuations matter most. Tight spreads are riskier than wide spreads. Obvious? Perhaps. But easily forgotten when carry is king and markets are calm. Credit spreads across the board still sit within the 25th percentile of their historical range, except for CCCs. Current spreads represent roughly 71% and 75% of historical medians.

Subordinated structures tell a similar story. Some widening since the Iran war, but still well below historical medians and within the 25th percentiles. Some relative value versus senior IG, but these are not yet bargain levels.

Sovereign spreads tell a similar story. Since the Iran war, Italy, France, Spain and Portugal widened versus Bunds. The 10-year Italy-Germany spread trades around 90bps, up from 60bps four weeks ago. Sounds like a move? It is nowhere near Liberation Day peaks (130bps) or peak central bank hikes in 2022 (250bps). European sovereign spreads are not properly discounting debt sustainability risks. For the UK and US, bond market dynamics differ: significant repricing of rates and term premia, but not close to UK LDI crisis levels or the bond market stress of the 1960s and 1970s.

Bottom line: public credit spreads are tight, sovereign risk premia has not been repriced enough yet. Compensation for running these risks is simply too low. We know where the leverage sits, but risk premia are not near buying territory.

Technicals

Leverage is concentrated in two areas: private credit and sovereign balance sheets. The technical dynamics around both deserve attention, they contain the potential triggers for broader repricing.

In private credit, the trigger is straightforward. BDCs and semi-liquid funds face redemption risk. When investors lose confidence in stale valuations and rising PIK exposure, outflows accelerate. Funds gating redemptions in recent weeks are early evidence. Write-downs on BDC net asset values could trigger further selling, creating a negative feedback loop. Opacity in valuation processes, rating processes and fire sale of assets potential are reminiscent of 2008, albeit smaller in scale. Global credit markets can absorb the total amount. But the repricing will create volatility and opportunity.

On the sovereign side, warning signals are equally visible. Spreads for fiscally challenged nations are widening. G10 currency weakness reflects eroding confidence in fiscal trajectories. Term premia rise, yield curves steepen, long-end bonds sell off even as growth slows, unusual in a traditional cycle but perfectly logical in the Yield Era. For Italy and France, the arithmetic is unforgiving: nominal growth cannot stabilise debt ratios at current rates. Watch the long bond yields. At a certain moment long duration stocks (Technology) and sovereigns might get hurt.

IG corporate issuance continues to lag nominal GDP, corporates are deleveraging, not releveraging. This scarcity of corporate debt versus surging government issuance supports the structural bid for investment-grade credit. Investors increasingly prefer high-grade corporate balance sheets over sovereigns, a trend building for several quarters.

If a wider repricing occurs driven by stress in the most important mechanism in a debt driven Yield Era, we do believe spreads might peak at a lower level than a full-blown recession level. Corporate leverage is just not big enough.

Positioning

For our Global Credit (GLC) strategy, we are moderately underweight banking and finance, and exposures is almost exclusively taken via senior and senior preferred exposure. The strategy currently has no exposure in subordinated instruments of banks like AT1, CoCo’s, etc. We are neutral in technology but with a quality up bias and only limited exposure in Hyperscalers. Relevant to note is the absence of exposure to BDC's. GLC is also overweight consumer non-cyclicals, covered bonds and communications. The overall mix of underweights in banks and BDC's while overweight covered bonds, consumer non-cyclicals, and communications results in a credit beta of 1, which should do well in situations of spread decompression.

For our Global High Yield (GHY) strategy, we are underweight consumer cyclical, technology, and energy sectors while basic industry and communications are overweight. This is driven by bottom-up idiosyncratic stock picks. Especially in chemicals we believe a large part of the China (dumping) risk is priced. For GHY it is also important to look at ratings positioning, and this strategy is underweight CCC and B versus overweight BB. With respect to this quality bias we are comfortably below the maximum 5% weight in CCCs. In a decompression market, and with a benchmark weight of 10%, this should do well going forward and limit/reduce capital losses.

With respect to our positioning in special situations, these create uncorrelated upside potential and are increasingly available. There are currently seven special situation cases in our portfolio with two examples being the restructuring of Altice, the French cable company, and Mobico, the Spanish transportation company. The largest position in GHY is the Paramount and Warner Brothers case, which is not so risky in credit terms but given the strategy holds the long bonds of both issuers there is a large potential return in the next two years (long bonds have an upside potential of around 20 points). Both the Mobico and the Paramount positions in the Global High Yield strategy are shared with Global Credit. We consider Mobico a rising star (formerly investment grade rated). Paramount just started its trajectory to investment grade again too.

Transition

GLC owns a lot of low positive Transition stories like cable companies or utilities that are on the right trajectory, such as Enexis or Edison California. The carbon footprint based on EVIC is just under the benchmark level. The weaker scoring companies are long dated bonds of US utilities like Southern or Duke, companies we have for decompression beta positioning. In the GHY we are just over the 66% neutral or positive transition stories as per our internal guidelines. The main positions outside these are low negative scoring companies in utilities and packaging corporations. A good example here is the neutral position in the large Venture Global complex. This company exports LNG from the US, which obviously is doing very well now. Also, we are about 10% below the benchmark in carbon intensity terms based on EVIC.

Conclusion

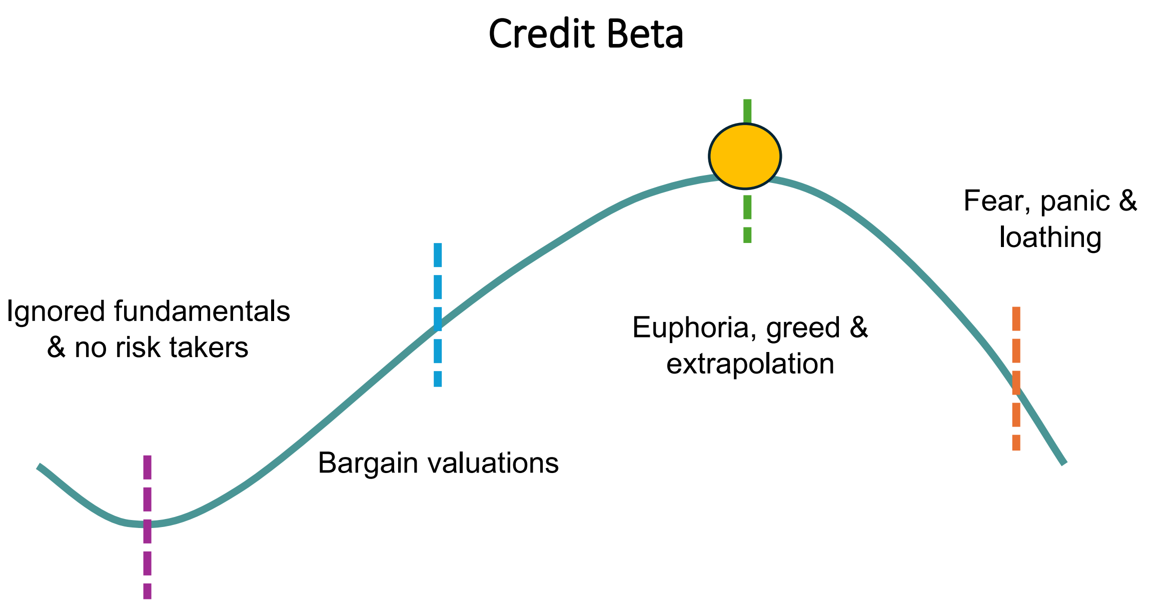
We titled this quarterly 'Death by a Thousand Cuts' because no single risk factor derails credit markets on its own. AI is not enough. The Iran war is not enough. Private credit stress is not enough. Sovereign debt concerns are not enough. But combined, the accumulated weight creates conditions for meaningful repricing. The Iran war may be one shock too many for an economy already battered by disruptions since 2022.

When will the repricing come? We never know. Only unexpected events move markets. But every cycle ends with weak underwriting and regulatory arbitrage, and we see both in abundance. The leverage sits in governments and private markets. Underwriting is poor. Valuations are tight.

We hold neutral beta across credit strategies. The risk reward does not favor adding risk. Spreads do not compensate enough. Instead, we focus on what we control: avoiding defaults, identifying selective opportunities with large safety margins, and positioning for repricing.

In practice: overweights in AAA-rated covered bonds and utilities, underweights in CCC and long-dated credit, quality-first selection in both IG and HY, leverage through duration or subordination rather than business risk. If the market turns, it will not be a single blow but a death by a thousand cuts. We are ready. We wait. And when opportunity arrives, we act on research and safety margin, not on hope.

Credit Quarterly Outlook: Where are we in the Cycle



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