CREDIT SUISSE

"Why we're bullish on investment grade bonds in 2023"

1. We really like the upside potential for simple investment-grade fixed income.
2. We really like the base case for investment-grade fixed income.
3. We really like the downside protection afforded by investment-grade fixed income.

Why is this uncomfortable for a Head of Fixed Income? Because in over two decades, we have rarely had a view that is so lacking in nuance and caveats and is so bullish.

There undoubtedly are other asset classes and even parts of the broader fixed-income universe with greater upside potential. Other asset classes may also offer greater protection during a deep recession or an extended period of moderate inflation. As an overall package, however, and even after having delivered great returns since we last wrote, boring, standard vanilla investment-grade corporate bonds look great.

The technicals are strong, the fundamentals are okay, and relative value has rarely been better than this.

Risks remain despite inflation having seemingly turned the corner

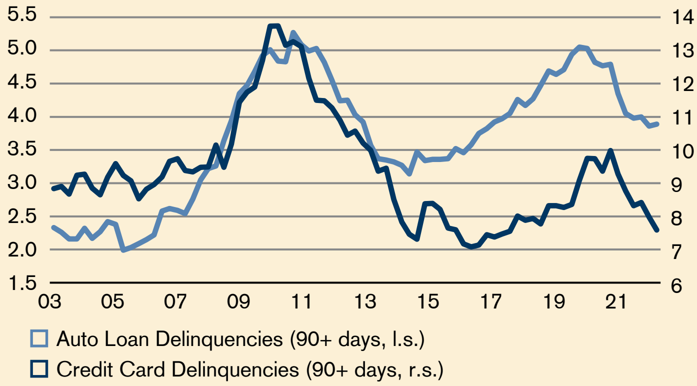
Since we last wrote in December, we have seen inflation take a significant, concerted, and coordinated turn for the better. Much of this is related to those input factors that moved first in lifting inflation and that have quickly reversed, such as those related to energy and supply-chain disruptions. Labor markets around the world remain very strong, and we are seeing early signs that wage-price inflation may be a rather pernicious laggard tending to keep inflation high. Central bankers around the world have needed to be firm both in word and deed to try to prevent markets from assuming that pivots are bound to occur. Part of this, of course, is to prevent inflation from becoming self-fulfilling, but part is surely also because they acted too little and too late when inflation first emerged. Moves by the Bank of Japan stand out among recent central-bank actions. We are watching developments at the Bank of Japan closely because theirs is a very difficult future path to predict. Our end-2022 report card for central banks reads "satisfactory." The first half of the year was rocky, but the second half saw improvements in both effort and achievement.

Our main risk concerns broadly fall into four categories:

- Credit cycle effects
- Overleveraged underlying corporates
- Consumer defaults
- Less liquid areas of fixed-income markets

US Commercial Banks

Auto Loan and Credit Credit Card Delinquencies, in %

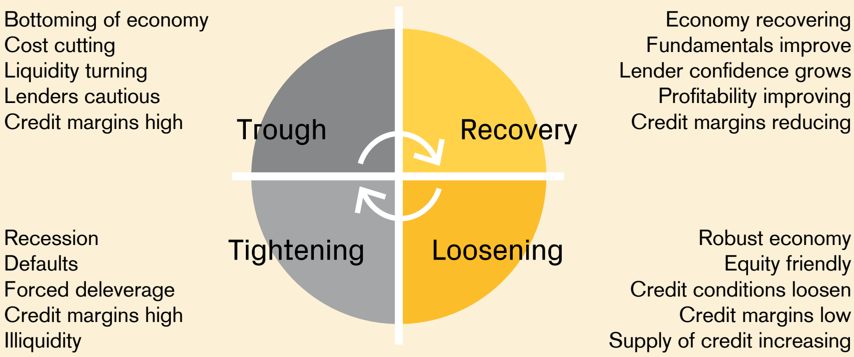


Source: Credit Suisse. Data as of 30.12.2022

The chart shows the development of US delinquency rates for auto and credit card loans over the past 20 years. The term delinquency refers to the state of being in arrears. When a borrower is delinquent, he or she is past due on their financial obligations such as a loan. Financial delinquency often leads to default if the arrears are not brought up to date. The delinquency rate typically goes up in times of weak or negative economic growth and rising unemployment, and vice versa. High delinquency rates are a problem for the profitability of a banking system, and individual banks typically respond to a worsening economic outlook by tightening their lending standards in order to keep potential loan losses contained.

Credit cycles come in all shapes and sizes, sometimes fast and focused, and occasionally slow-moving and all-consuming. One thing that is consistent about them, though, is that they cannot be avoided. They are a symptom of the behavioral element of finance. We expect to start to see those effects in Q1 2023 and will watch closely as they evolve. Defaults (even a small number of them) and delinquencies tend to be the first signs that tightening will accelerate. We mentioned this in our last note.
Being fixed-income investors ourselves, we often speak with

The credit cycle



We are only just entering the tightening phase of the credit cycle, much can go wrong from here.

For illustrative purposes only

members of our clients' teams who focus on fixed income. The challenge they most often pose to our core view is that they hear that "all is well in high-yield" from other managers. We simply do not agree with that view. We see signs of looser covenants, potential for lower recoveries and, most importantly, leverage creeping higher. Of all the fundamentals we monitor, this is the most important one. As the new issuance market reopens, we expect to see this tested. More on this next month.

In the past, if one wished to see the first signs of stress and distress in economies, one needed to watch banks and their reporting on provisions. The emergence of securitization enabled us to monitor consumer behavior more carefully (for those of you who have seen The Big Short, we are referring to remittance data). Credit-card debt and car loans are normally the canary in the coal mine. Everything looks disturbingly good there now. We will provide you with an analysis of Q4 2022 bank reporting in the next edition.

This is of greatest concern. Not only have we barely seen any writedowns in this sector, there in fact has been little or no repricing of the credit risk premium within the less well-established pockets. This is one area where our concern is growing.

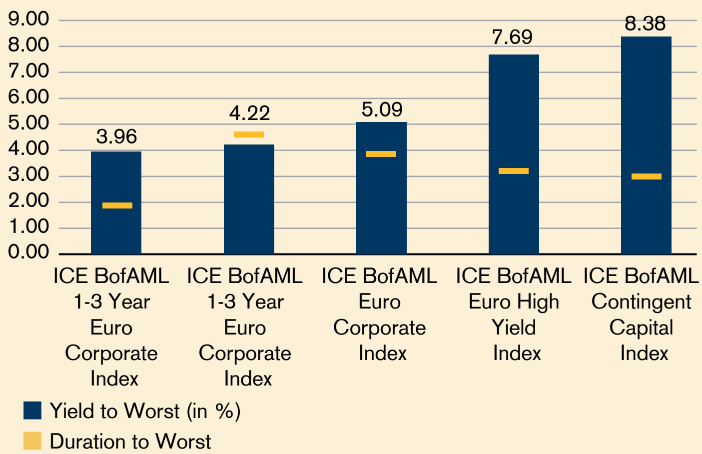
Dispersion and the sector to avoid

If and when we see a credit cycle take hold, we would expect to see it bite disproportionately in one or a small number of sectors. European banks are much talked about in this respect, but our view is that despite their history of problems, volatility, and the effect of a recession on European economies, the banks themselves appear robust. An increase in dispersion would be a welcome sign, and we have little doubt that volatility will persist in 2023, so this will help to shake the dispersion tree. If banks are not the sector to avoid, they will be one of the sub-asset classes to hold. For those building a barbell portfolio of fixed-income assets, you could do worse than to include an allocation to European AT1s from blue-chip banks[1].

Attractive yield pickup compared to other credit classes

- The yield on contingent capital compares favorably with European high-yield corporate bonds.
- The interest rate risk associated with CoCos, measured by duration, is lower than the risk inherent in a broad corporate benchmark.

Comparison of yield and duration of credit classes



Sources: BofA Merrill Lynch, Credit Suisse. Data as of 31.12.2022
The shown yield to worst is calculated as of December 31, 2022, and does not take into account costs, changes in the portfolio, market fluctuations, and potential defaults. The yield to worst is an indication only and is subject to change.

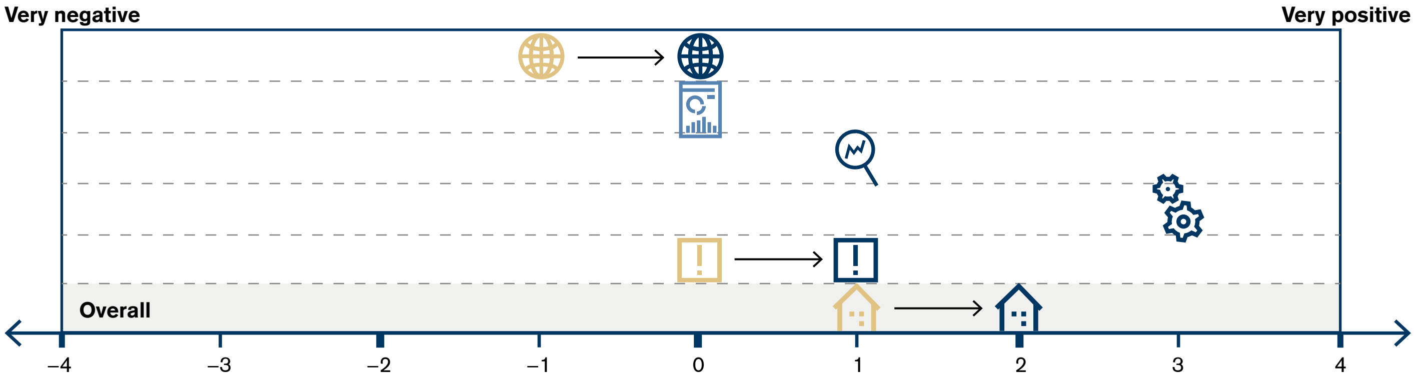
Other potential candidates for that risky (or unloved) piece of the barbell include corporate hybrids and some of the more volatile areas of EM[2]. The key is not to find something that is a consensus long, but rather to find something where the fundamentals are better than the current market perception. We will cover both of these next month as we articulate our idealized portfolio for 2023 and beyond.

Be it autos, TMTs[3], homebuilders, financials, or energy in 2020, there is almost always one sector that gets hammered and fundamentally reprices through a credit cycle. This sector sees higher defaults and lower recoveries, and subsequently carries scar tissue into the next cycle. This is a natural result of banks and other lenders having to focus on restructuring, recoveries, and turning off lending to those in-focus sectors for a period. Scanning across our portfolios, no single candidate currently jumps out at us. For that reason, we are maintaining a very disciplined portfolio management approach, avoiding anything that raises even a small concern. Now is not the time for irrational exuberance or hope.

[1] A "blue chip" is a recognized, well-established and financially sound company that is publicly traded. Blue chips sell widely accepted products and services.
[2] Emerging Markets; [3] TMT stands for Technology, Media, and Telecommunications.

CSAM Fixed Income Investment Strategy

Risk appetite – Investment Grade



Economic outlook (from -1 to 0) – Recession fears and high inflation coupled with potential energy stress over winter continue to provide for uncertain economic backdrop, but mild weather has eased concerns based on the latter.

Credit fundamentals (unchgd) – Generally, fundamentals have started to deteriorate and are expected to weaken going forward as reflected by worsening credit metrics in earnings reports. For now, IG still looks solid, while concerns are mainly centered around HY and weaker credits.

Valuation (unchgd) – Most credit markets are pricing in a recession. While IG valuations continue to look highly attractive with yields trading at multi-year highs, HY look increasingly challenged given comparably tighter relative spreads.

Sentiment / technicals (unchgd) – Flows have turned positive and investor surveys show overweight positioning in bonds for first time since 2009. Volatility remains elevated and liquidity below average.

Tail risks (from 0 to 1) – Risk of a CB overtightening remains, but has been reduced by inflation prints surprising to downside of late. Immediate effect of energy crisis has been softened by mild weather recently.

Source: Credit Suisse. As of 6.1.2023
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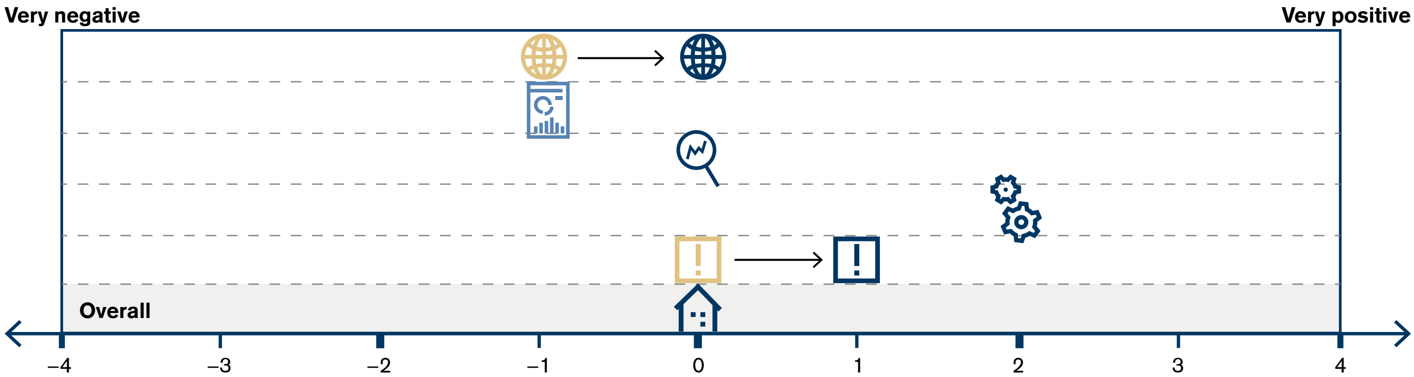
CSAM Fixed Income Investment Strategy

Risk appetite – High Yield



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We feel much more comfortable now having listed all of those caveats. We are even starting to feel that we need to restate our main takeaways:

- Interest-rate duration is worth owning.
- Technicals are very supportive for vanilla investment-grade fixed income.
- Fundamentals look positive, but there are things to watch.
- More volatility will come.
- Investment-grade bonds issued by boring, safe corporates show very positive payoffs in all but the worst possible scenarios.

In summary, against the backdrop of the inflation data and the recent positive market moves, we find ourselves maintaining a strongly bullish medium-term view on fixed income, but with a growing bias toward simplicity and liquidity.

We feel very uncomfortable stating such constructive views and fully expect to be able to give a much more nuanced and balanced view next month.

Source: Credit Suisse, unless otherwise specified.
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[1] Legal entity, from which the full offering documentation, the key investor information document (KIID), the fund rules, as well as the annual and bi-annual reports, if any, may be obtained free of charge.

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