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BlackRock

2021 global credit outlook

Stay nimble and carry on

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Introduction	Lessons of 2020	Delivering results in 2021	Theme 1	Theme 2	Theme 3	Summary

Stay nimble and carry on

Global credit in 2021

We begin a new year optimistic about growth, constructive on the economic recovery underway, yet vigilant to how that recovery is experienced across regions and sectors. The Covid-19 vaccine development and distribution is ramping up and will have a material impact on the path of economic growth. Credit markets are seeing greater demand globally in a low yield world, and investors are re-thinking portfolio design to incorporate higher allocations to both public and private credit. But we expect more dispersion going forward, and navigating these opportunities will be critical to delivering differentiated results.

Underlying the supportive demand backdrop is our view that the relative value of credit remains attractive compared to fixed income, with credit able to provide income and balance in a portfolio where interest rate duration may not act as a hedge to equity risk.

Corporate fundamentals are in reasonably good shape, albeit with a wider distribution of outcomes in sectors most heavily exposed to the negative economic impacts of the pandemic. Redesigning and right-sizing business models is an important focus this year across many sectors.

Although liquidity is sufficient to avoid significant near term defaults in our view, M&A is likely to pick up as business confidence rebounds, pandemic restrictions are lifted, and economic activity accelerates. As highlighted in the BlackRock Investment Institute 2021 Outlook, the shift in how economies and societies operate is creating a new investment order that is materially influencing businesses around the world.

Consumer and investor behaviors in response to the pandemic are accelerating structural changes which should contribute to significant credit dispersion this year. Beyond the direct impact of the pandemic, there is also greater consideration around sustainability and an increasing recognition of racial and social justice issues. These are critical issues to society and have a meaningful impact on the companies we invest in. Successfully navigating credit going forward will require a greater understanding of how these issues affect credit investments, and how they influence corporate behaviors.

We highlight three investment themes we believe are significant to credit investing in 2021 and beyond:

1 (Re)building portfolios for income

Insufficient yield in fixed income is forcing investors to re-think portfolio design while incorporating a greater allocation to credit.

2 Sustainability to the fore

Growing investor demand and increasing issuer transparency are driving environmental, social and governance (ESG) standards to the forefront of credit investing.

3 Opportunities in Asian credit

Opening up of the Chinese onshore markets and attractive yield profiles across the region are increasing opportunities in Asian credit.

Policy-driven credit expansion

Full year results across global credit markets last year masked the most significant and highly correlated selloff in recent history, followed by an impressive rebound from the March lows. Overall returns lagged longer term annual averages despite the recovery, while investment grade indices outperformed due to directly benefitting from monetary policy actions, up in quality investor demand and a longer duration profile.

The extreme deceleration of global economic activity early in the year tested businesses' ability to adapt to survive. Central bankers moved quickly to provide significant liquidity in order to maintain market functionality and issuers' access to capital. For example, the Federal Reserve's balance sheet expanded by more than US$3 trillion to US$7.3 trillion through asset purchases in just three months. Meanwhile, politicians overcame political hurdles to deliver over US$10 trillion of global fiscal policy support, and we anticipate additional fiscal spending until household income recovers. Although the full impact of the pandemic is still to be determined, the large scale and coordinated global policy actions were a key factor in the trajectory of credit performance last year.

Credit markets reacted to the policy response with spreads tightening sharply, and issuers took advantage of liquidity conditions to refinance debt, term out maturities, and fortify balance sheets. Approximately US$ 4 trillion of global corporate debt was issued in 2020 per BlackRock Capital Markets.

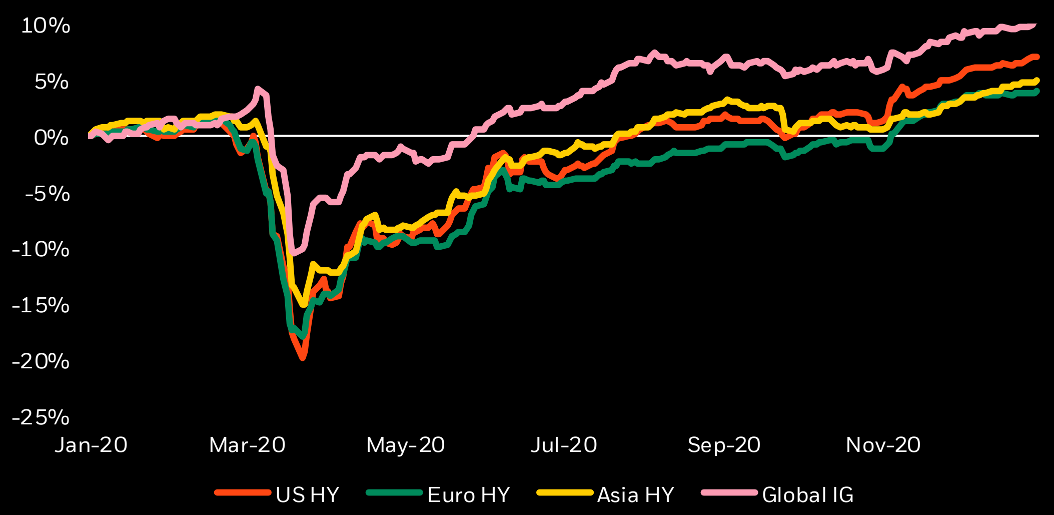
Regionally, Asian credit benefitted from a first in, first out position as the pandemic lockdowns and re-openings occurred earlier there than in Europe or the US. By rating, investment grade markets were more significantly direct beneficiaries of monetary policy which limited the depth and length of the drawdown.

Although many companies and individuals are still struggling with restrictions on business activities, the pandemic massively accelerated technology adoption and generally benefitted companies with more flexible business models and management teams willing to adapt quickly despite market uncertainty. M&A transaction volume was down 16% year over year at the lowest annual level since 2014 per Bloomberg, but is poised to accelerate this year on the back of rebounding business sentiment coupled with a growing urgency to adapt to a post-pandemic environment.

While 2020 was not a business cycle in the traditional sense, the speed of change accelerated in many industries will result in both winners and losers. In the year ahead we expect to see the outperformers increase scale, while those unable to adapt look for alternative solutions which may include bankruptcy restructuring. Idiosyncratic opportunities become more critical investment drivers in this environment, and our focus will remain on deep fundamental analysis to drive credit selection.

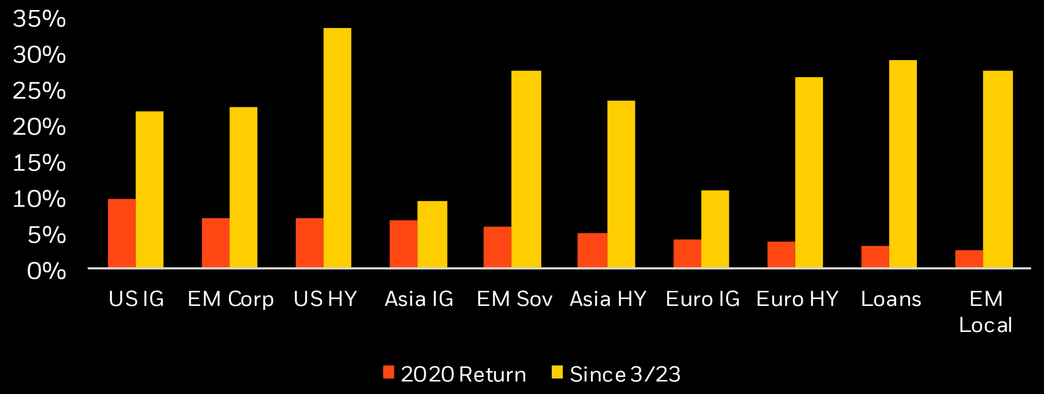
Modest full year returns obscure the wild ride

Cumulative daily total returns



2020 performance by market

Total returns full year and since pandemic crisis market peak



Source:. Bloomberg, JP Morgan, S&P LCD., December, 31 2020 US IG = Bloomberg Barclays U.S. Corporate Index, Asia IG = JP Morgan Asia Credit Investment Grade Index, EM Corp = JP Morgan Corporate EM Bond Index, EU IG = Bloomberg Barclays European Corporate Index (USD-hedged), Asia HY = JP Morgan Asia Credit Non-Investment Grade Index, EM Sov = JP Morgan Emerging Market Bond Index, US HY = Bloomberg Barclays U.S. High Yield Index, U.S. Loans = S&P LCD Leveraged Loan Index, EU HY = Bloomberg Barclays Pan-European High Yield Index (USD hedged), EM Local = JP Morgan GBI-EM Global Diversified Index (USD hedged). Global IG = Bloomberg Barclays Global Corporate Index. The figures shown relate to past performance. **Past performance is not a reliable indicator of current or future results.**

Delivering results in 2021

Uneven recovery, increasing dispersion

Our conviction in credit this year is supported by expectations for continued accommodative monetary and fiscal policies, the positive trajectory of vaccine development and deployment, an improving consumer and corporate sector that is able to drive growth, and a multi-year earnings recovery that we believe is underway. However, starting valuations for both yields and credit spreads are near historic lows, and some deteriorating terms (covenants) and transaction quality (second liens, dividend recaps) are important to monitor and reinforce our greater focus on credit selection this year.

We are intensely aware of the ‘K-shaped’ nature of the recovery with many lower income workers facing greater economic hardship. This will influence public policy as well as corporate behavior this year. The uneven recovery across regions and sectors will contribute to greater dispersion, particularly in sectors which have lagged in the recovery and where business restructurings and balance sheet recapitalization may be needed. Covid-sensitive sectors such as airlines, leisure, lodging, retailers and energy all offer significant idiosyncratic potential.

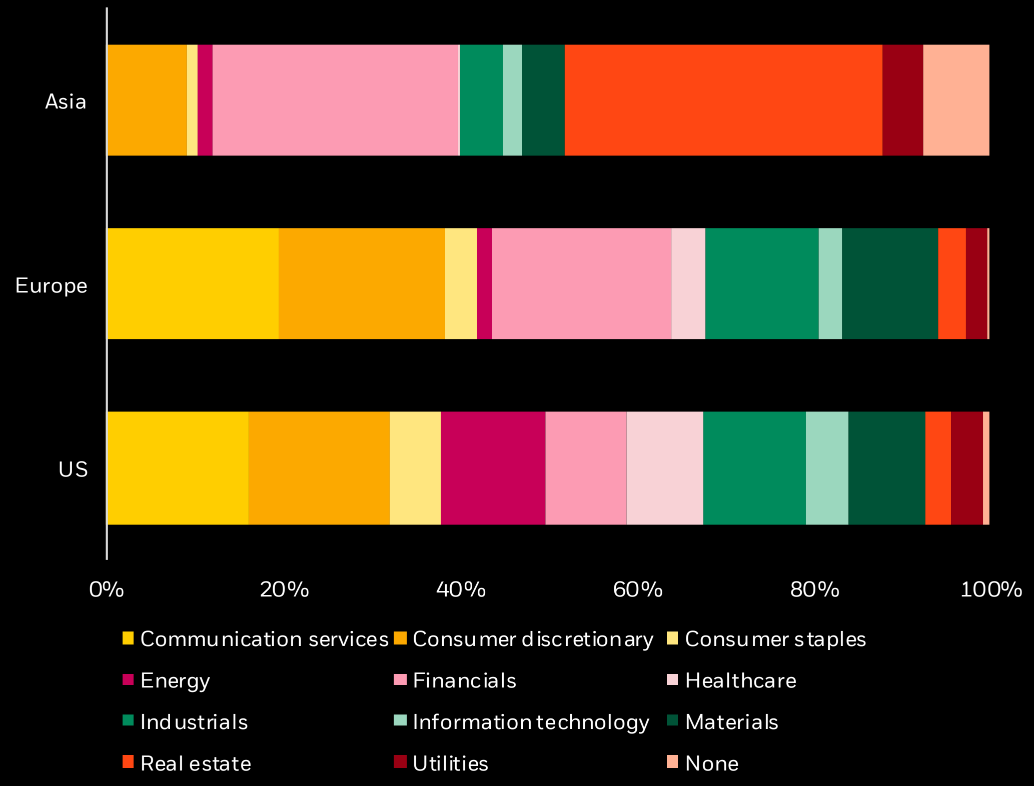
Inflation risk is higher for the first time in awhile, driven by a combination of factors including deglobalization, supply side disruptions, and the effects of greater stimulus boosting asset prices. This may put upward pressure on interest rates and produce a steeper yield curve which would benefit equities over credit. However, consumers today carry relatively low household debt which should provide greater flexibility and outweigh the risks of modestly higher inflation.

Default expectations last March peaked with cumulative five-year implied defaults on US high yield above 50%. Today they are approximately 15%, and we expect realized defaults will come in under 10% as companies aggressively raise capital and term out maturities. Implied defaults in other regions followed a similar course. Sectors unable to refinance and under continued economic pressure will create new distressed and restructuring opportunities as the longer term durability of pandemic trends such as working from home and reduced travel challenges some existing businesses while enhancing others. (See our recent paper, A different kind of distressed credit cycle).

As vaccine distribution promotes a resurgence in economic activity, inventory restocking and capital investment should follow. Companies are expected to spend more time on supply chain resilience and adapting to different consumption patterns in order to incorporate lessons from the pandemic and enhance growth.

Regional market differences offer diversification potential

Industry sectors by % of market value in regional high yield markets



Sources: BlackRock, 12/31/20. U.S. = BBG Barclays US High Yield Index, Europe = BBG Barclays Pan-European High Yield Index, Asia = JP Morgan JACI High Yield Index. Composition breakdown using GICS sector methodology.

A constructive demand backdrop supports credit, while the uneven economic recovery will produce wider dispersion among winners and losers

Theme 1

(Re)building portfolios for income

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(Re)building portfolios for income

Fixed income yields are near historic lows with the Bloomberg Barclays Global Aggregate Index now yielding 0.83% and US$18 trillion in negative yielding debt outstanding as of December 31, 2020. With traditional fixed income markets no longer providing sufficient income, investors are actively re-evaluating portfolio design.

As we highlighted in a recent paper (“**Flexible global credit investments**”), we believe the expanding global universe of credit will be critical to delivering income and helping investors meet their investment objectives. The issue goes to the core asset allocation assumptions driving portfolio construction. After 30 years of declining interest rates and with broad fixed income yields approaching zero, fixed income becomes more asymmetric with limited room for rates to rally. This may change the relationship between fixed income and equities going forward and prompt investors to consider portfolio construction among more highly correlated assets.

Credit assets generate a larger portion of their expected return through coupon income, which has become increasingly valuable as fixed income yields declined. As a hybrid asset class with characteristics of both fixed income and equities, credit can provide both the enhanced income and a source of diversification from equity risk. Given the wider universe of credit available and the greater expected dispersion discussed earlier, accessing opportunities via dedicated local resources or combining them via a multi asset credit approach can offer efficient investment solutions to capture spread volatility and dispersion.

The income theme applies in private credit markets as well. Demand in direct lending strategies continues to grow as investors are looking to capture illiquidity premiums with a focus on higher underwriting standards, established due diligence capabilities, and robust sourcing networks to see a wide range of deals and remain selective on participation.

Distressed and special situations strategies are seeing greater interest as well where structure and capital requirements don’t align with traditional public or direct lending strategies.

Adding income to a portfolio isn’t necessarily at the expense of fixed income, however. The risk characteristics may well continue to support a capital efficient allocation to high quality fixed income, while balancing risk factor exposures among equities and credit diversified by region, sector and liquidity. While no two solutions may look alike, we believe they all begin with the greater need for income.

Higher correlations may prompt portfolio redesign

Total and excess return correlations

	Total returns			Excess returns		
Correlations	Fixed income	Equities	Credit	Fixed income	Equities	Credit
Fixed Income	1.00			1.00		
Equities	-0.29	1.00		0.50	1.00	
Credit	0.01	0.38	1.00	0.72	0.50	1.00
Return	3.90%	16.10%	5.20%	0.60%	8.30%	3.90%
Risk	3.40%	17.40%	2.80%	1.00%	26.70%	3.50%
Return/ Risk	1.15	0.93	1.86	0.60	0.31	1.11

Source: Bloomberg as of December 31, 2020 based on 10 years of daily returns. Fixed Income = Bloomberg Barclays U.S. Aggregate Bond Index, Equities = S&P 500 Total Return Index, Credit = 50% U.S. High Yield Index/50% S&P Leveraged Loan Index. Excess return methodology follows Bloomberg Barclays index methodology. Equity excess returns calculated using the blended 2y forward earnings expectations for the S&P 500 index to calculate earnings yield, then converting the output to an implied duration using the perpetual bond duration methodology (1+Yield)/Yield The excess return is then calculated by subtracting from the S&P total return the duration-implied return using the 30y Treasury carry and yield changes. No adjustments were made for bank loan returns as they do not have duration. **Past performance is not indicative of future results.** You cannot invest directly in an unmanaged index.

The investment landscape is changing rapidly, but the need to generate results persists. Global credit offers a wide range of possible exposures to increase income and portfolio diversification.

Theme 2

Sustainability to the fore

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Sustainability to the fore

Although environmental, social and governance (ESG) issues have long been important for credit investors, this may be the year that integration of sustainable investment practices becomes a truly global mandate. ESG has always been at the heart of fundamental credit analysis and investment selection, with credit investors focusing on the potential risks that ESG factors could play on the long-term sustainability of a borrower's business model. More recently, there has been a greater awareness and appreciation of sustainability and a willingness by investors to direct capital to those companies that are actively engaging in the transition to a more sustainable economy in the expectation that these companies will outperform over the longer term.

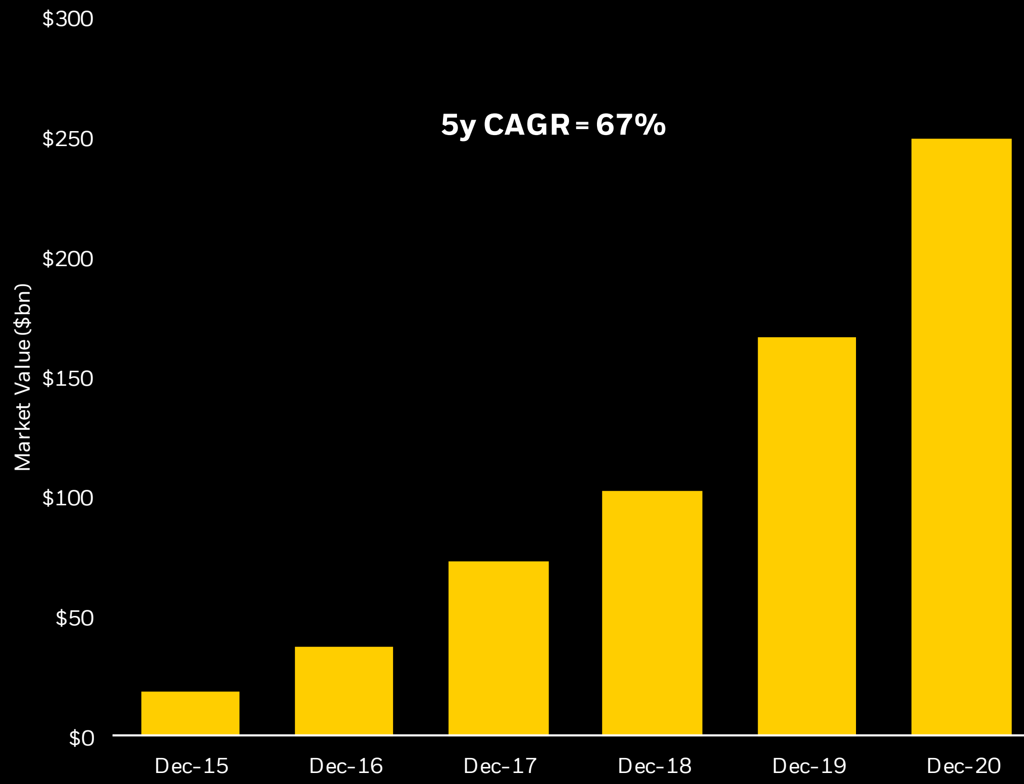
The events of 2020 have reinforced the importance of considering material ESG risks in credit selection and, in particular, social and environmental factors. The pandemic highlighted the vulnerability of supply chains, particularly in labor markets, and a path to complete economic recovery will need to take full account of the 'S' for social impact. There will be opportunities to provide capital to companies that are seeking to create quality jobs and more local supply chains. As natural disasters become more frequent and intense as a result of climate change, it will continue to be a significant area of focus with investors increasingly seeking to allocate capital to companies that are actively pursuing low or zero carbon emissions policies.

Credit investors will play a wider role in supporting companies with the integration of sustainability within their business models this year. Historically, management and shareholders have led the sustainability agenda within portfolio companies, however, credit providers have a significant role to play. Lenders will look to influence behaviors through the terms of their capital, for example, reducing margins for companies with strong ESG credentials or setting specific ESG covenants targeting reductions in carbon emissions or water consumption. They will also seek to partner with companies to develop enhanced ESG reporting to better inform their credit selection processes and to provide capital for new sustainable initiatives.

The sustainability agenda will require engagement and a collective approach encompassing all stakeholders, and credit providers will play their part.

BlackRock's commitment to Sustainable investing is a holistic approach across markets and asset classes. See Sustainability at BlackRock for more information.

ESG corporate debt growth is accelerating
Market value of JPM Corporate Green Bond Index



Source: JP Morgan as of December 31, 2020. Shows market value of the JPM GENIE Corporate Index. CAGR = Compound Annual Growth Rate. Additional social and sustainability debt estimated at $100bn not included in index data.

Fundamental credit investing has a long history of incorporating ESG considerations when making investment decisions. Greater awareness of these risk factors improves transparency and increases accountability among issuers and investors.

Theme 3

Opportunities in Asian credit

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Opportunities in Asian credit

As investors look beyond developed credit markets for income and diversification, we believe the opportunities in Asian credit broadly and China specifically should be explored. The opening of the Chinese onshore markets is coinciding with an extreme surge in global liquidity, and a growing shortfall of assets that can meet investors' need for yield. China’s relatively high growth rate, more advanced stage of recovery from the pandemic, and deleveraging efforts made before the pandemic are providing a supportive investment backdrop for the market.

However, China is not the sole reason for our constructive view on Asian credit. We see potential opportunities in India, Indonesia and Southeast Asia as well. Local markets appear more attractive where nominal and real rates are higher, and currencies are well positioned in a stable to weaker USD environment. Although the tense geopolitical climate is a persistent headwind for markets, we believe the risk premia will come down under a less contentious U.S. administration combined with effective vaccine deployment.

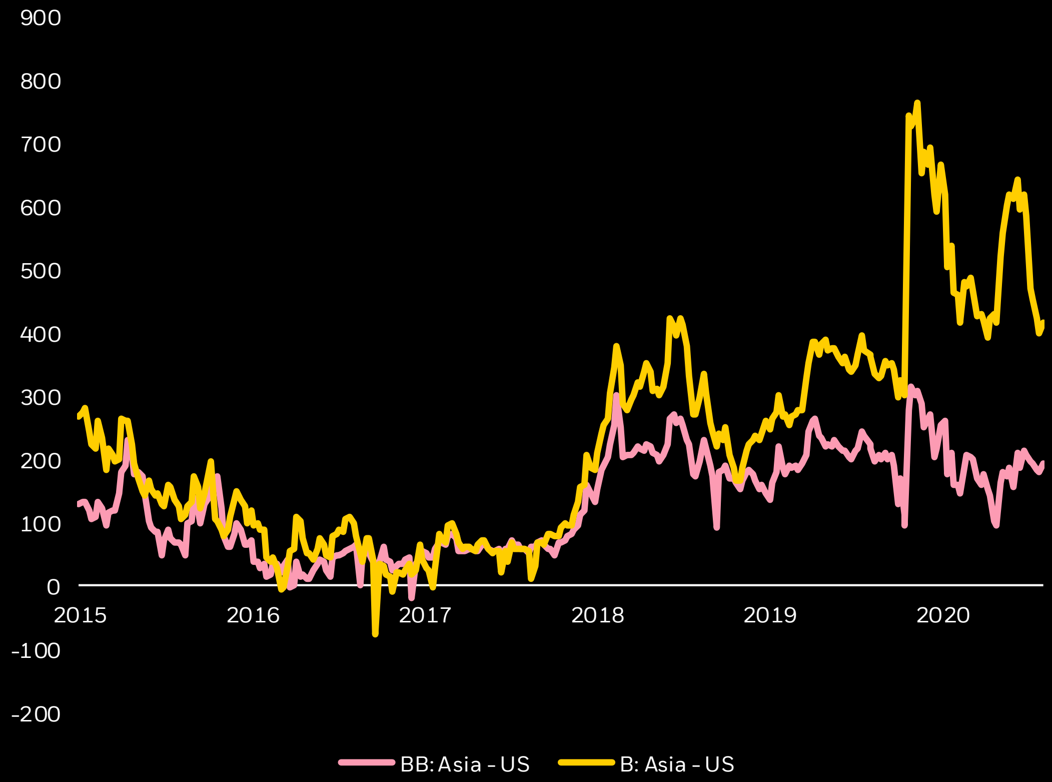
India has been hit hard by the pandemic, but we are seeing signs of a recovery with a sharp turnaround in purchasing manager index data recently. With a population of 1.4 billion, India is expected to be the single biggest beneficiary globally to a Covid-19 vaccine amidst a rebalancing of supply chains, which is structurally beneficial for the nation with its large, young and well-educated population.

We see opportunities for diversification in onshore Renminbi credit with the sector’s low correlation to USD Chinese credit and to the rest of the world. Asian high yield also looks attractive given the asset class’ historically low default rates, relatively short duration and spread premium. Asian corporates have not gone on a debt raising spree like many developed market peers, resulting in upgrade/downgrade ratios stabilizing and default rates remaining around the 3% level. Net issuance in Asia in 2020 remained considerably lower than 2018-2019, a sharp contrast to increased issuance in developed markets. We are cognizant of recent defaults among state owned enterprises and spread volatility in sectors such as Chinese property recently, which reinforces our view that credit selection is critical to navigate these market opportunities.

With Asia as one of the key growth engines of the world and with the significant gap in the demand and supply of credit, along with improving insolvency regimes, Asian private credit offers an attractive and increasingly scalable opportunity for investors. Deals in the region have a higher risk premium and loans are structured with a greater margin of safety driven by lower competition amongst lenders.

Attractive relative valuations of Asian high yield

Option adjusted spread differential



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Indices are unmanaged and one cannot invest directly in an index. Source: BlackRock, December 31, 2020. Indices used are Bloomberg Barclays Indices., excluding stressed credits.

Asian credit markets expand the investment universe beyond traditional EM or DM markets with potential to enhance yield, diversify sector and regional risks, and generate income.

Where we begin the new year

Stay nimble and carry on

We expect credit markets generally to deliver mid-single digit returns this year driven primarily by coupon income (carry) with spread tightening offset by modestly steeper yield curves.

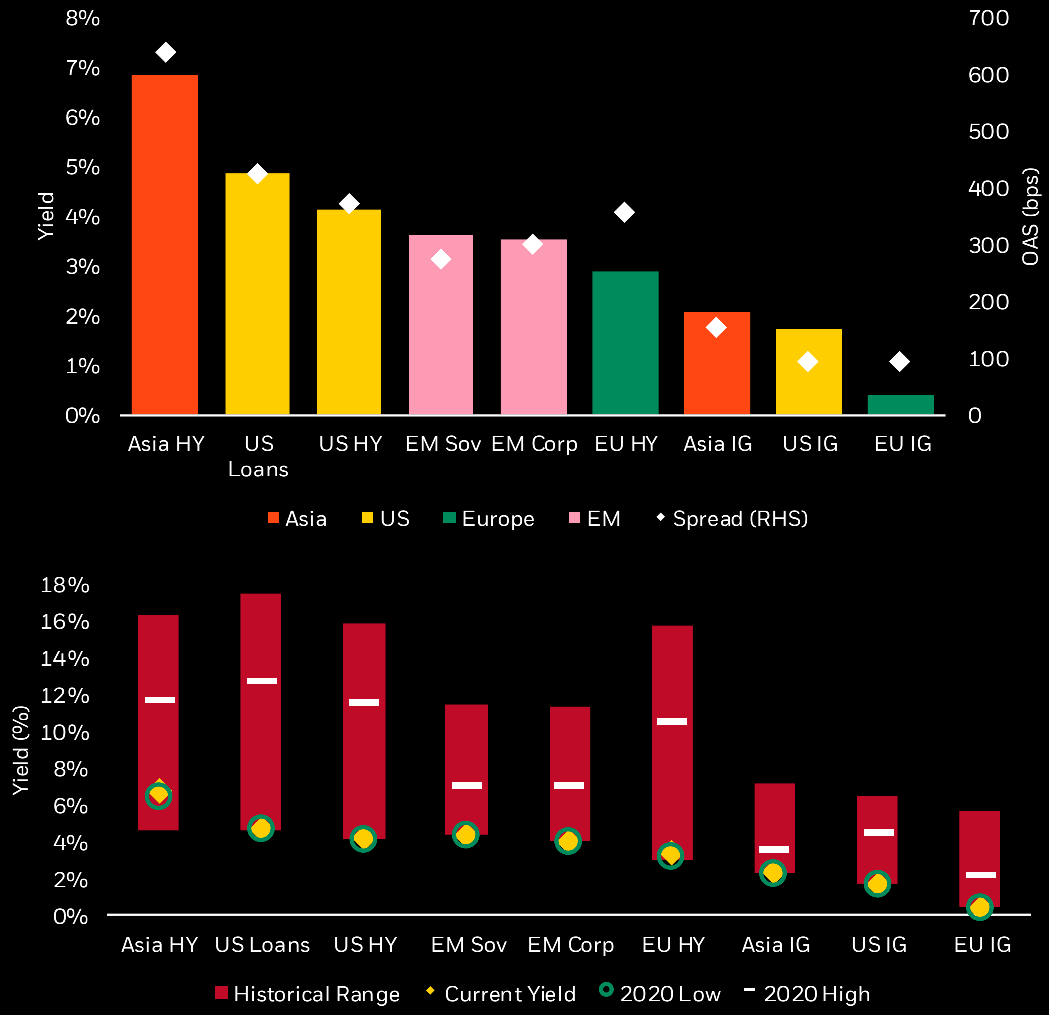
Greater dispersion and upside potential exists primarily in the most heavily COVID-impacted sectors, such as transportation, lodging and leisure that are still at trough earnings and multiples. As we have highlighted, selection is increasingly important as the uneven recovery across regions and sectors impacts corporate decisions and ultimately performance.

The income premium of credit compared to fixed income assets should continue to support demand, while supply is likely to decline relative to elevated 2020 levels. In public credit markets we believe in more balanced performance between loans and bonds due to valuations, the potential for higher rates, and modest inflation coupled with an acceleration of CLO issuance. Private credit continues to offer an income premium over public markets that we believe is attractive and should continue to attract new investors, and will perform well as M&A increases and capital is recycled due to the relatively short tenor of the market.

In summary, we believe accommodative global policy support and vaccine development and distribution will fuel pent up demand which should support an earnings recovery and lead to new investment and a multi-year expansion. Despite our overall constructive tone, investors should anticipate a wider range of outcomes across regions and sectors, and focus on credit selection to create differentiated outcomes.

Starting point for global credit carry in 2021

Yield and spreads by market



Sources: BlackRock, December 31, 2020. Asia HY = JP Morgan JACI High Yield Index, Asia IG = JP Morgan JACI Investment Grade Index, U.S. Loans = S&P Leveraged Loan Index, U.S. HY = Barclays U.S. High Yield Index, EM Corp = JP Morgan CEMBI Index, EM Sov = JP Morgan EMBI Index, EU HY = Barclays Pan European High Yield Index, U.S. IG = Barclays US Investment Grade Corporate Index, EU IG = Barclays European Investment Grade Corporate Index..

Global credit

200+
professionals

19 offices
globally

US$139bn
in client assets

Source: BlackRock, as of November 30, 2020. Client assets includes dry powder.

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