DEEP DIVE INTO CREDIT MARKETS

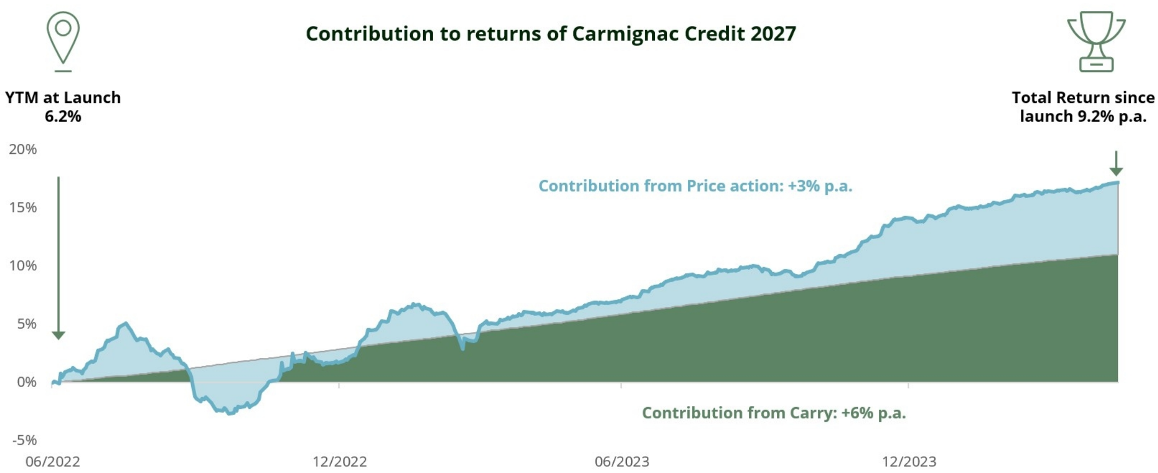
Where do we stand today?

24/06/2024 | KEVIN THOZET

Two years ago, bond yields and credit spreads experienced significant upward movements; and since then, corporate debt markets have enjoyed a very positive directional move with credit spreads tightening from more than 600 basis points (bps) to less than 350 bps[1], adding to the compounding effect of carry, with the **total returns of credit indices ranging from 3% to 10%[2] on an annualized basis since June 2022**.

Where does this leave us today? The level of risk premium across credit segments has returned closer to 2021 levels; so not particularly generous at index levels. Yet conversely and thankfully bond yields are at much higher levels, meaning that the case for credit still rests on carry. Historically, it is the combination of low bond yields and low credit spreads that have been disadvantageous for the asset class but the current **higher-yield environment means that credit spreads can act as both a kicker for investor returns and a cushion for volatility**; with potential concerns out there being that generally credit spreads reflect a perfect landing of the economy and that incrementally negative datapoints create an asymmetric risk profile to the downside for the asset class.

EXAMPLE OF RETURNS ON CREDIT MARKETS OVER THE LAST TWO YEARS



Sources: Carmignac, Bloomberg, as of May 2024.

Returns on credit markets have been strong over the past 2 years as exemplified by the performance of the **Carmignac Credit 2027 fund which has generated 18% of total returns since launch in June 2022, i.e. more than 9% on an annualized basis** .

The Fund has been benefiting from this "beta" move, since its launch with a Yield To Maturity of 6%. The Fund fully delivered on its "carry component" which on its own contributed to 6% per annum (illustrated by the shaded green area).

But in fact it has done even better than that. The blue area shows the contribution from the price action of the bonds selected in this pure credit fund, and it has been strong (+3% of contribution per annum since launch on average), **further illustrating the excellence in bond picking of the Carmignac Credit team**.

And so the "beta + alpha" capabilities of Carmignac delivered:

- As expected with the yield/carry action of bonds selected;
- Even more than this with the price action of those same bonds.

THE CURRENT STATE OF PLAY COULD LAST FOR SOME TIME

The economic outlook is rather supportive: we see continued acceleration in real wages in the UK and the Euro area and a decelerating yet resilient US economic growth environment, with capital expenditure cushioning the impact of consumer fatigue as well as prospects of a synchronized upturn of the manufacturing cycle. **Such an economic outlook combined with projections of lower policy rates are pointing at a relatively benevolent environment over defaults and impairments for the corporate world**.

This is especially true, as during this cycle the corporate world has been relatively frugal leverage-wise and a great number of companies have made the most of the "low rates, low spreads" environment in the direct aftermath of the Covid 19 pandemic, and have been hence relatively unscathed by the increase in the cost of financing. Moreover, due to the upcoming monetary easing cycle, the shorter the maturity of the underlying assets the quicker the benefits of lower policy rates will be felt. As money market funds will lose some of their attractiveness even more, flows coming into credit markets should provide additional support to the asset class.

Therefore, from an asset quality perspective **the central scenario is that of a relatively supportive and benign top-down environment meaning that credit spreads could remain relatively tight for an extended period**.

As the saying goes, the *"worst of loans are made in the best of times"*. But "time passes, as always" and higher yields indulge patience, allowing investors to wait for opportunities to show up.

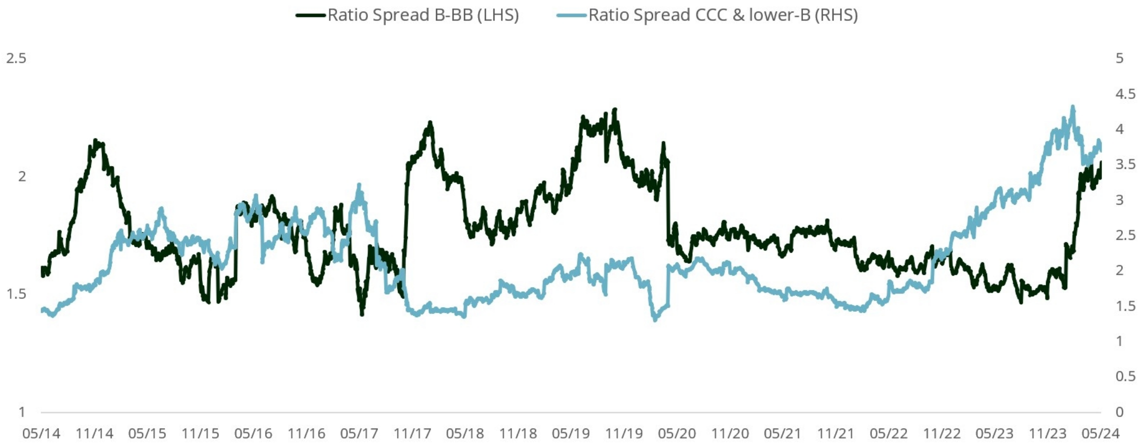
MORE OF AN ALPHA PLAY THAN A BETA VALUE PROPOSITION

The top-down environment is supportive for credit markets and yet, while expected to abate somewhat over the coming quarters, the environment in terms of higher cost of capital has drastically changed.

And a theoretical yet concrete and realistic example can serve the purpose: Let's consider an ambitious business model where the contemplated corporate has a leverage to EBITDA of about 5x to 6x (which can be found these days in Telecoms). In yesterday's world such a company would be refinancing every 2 years at ~5% (i.e. the average cost of "single B" rated bonds over the past 10 years); meaning that 30% of EBITDA would be devoted to the servicing of the debt, a demanding yet viable level which appears tenable even in a context of a sliding EBITDA and reasonable reinvestments. Fast forward to today's world and the refinancing cost has heightened to ~10%; the corollary of which is that the same company is devoting two third of its earnings to debt servicing. A bump on the road or unforeseen complication then becomes a real issue. Even more so as the increase in "risk free" short term money market instruments implies that the strive for yield has led to lesser abundance of available capital.

It's not all bad news though. The positive flip side of such a new conundrum is that dispersion remains elevated. In such an environment, qualified credit managers can find value in corporate credit issuers with decent assets and yet a poorly structured balance sheet. As well as within sectors which are, for the wrong reasons, eluded by other (mostly benchmarked) credit markets actors.

ELEVATED LEVELS OF DISPERSION CREATE OPPORTUNITIES



Source: Bloomberg, ICE index, 31/05/2024.

For illustration purposes we can refer to two issuers we hold across our credit funds:

EROSKI (SPANISH/BASQUE RETAILER)

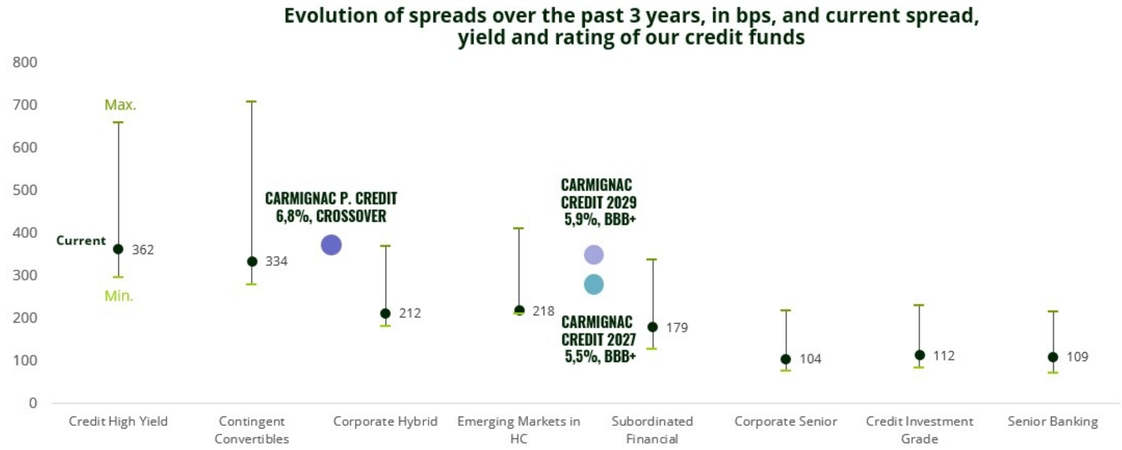
- The company operates in a challenged industry with lots of competition. And both online competition and discounters (Lidl and Aldi for example) gaining market share against traditional companies (Auchan was recently downgraded). But thanks to its strong regional ties Eroski is isolated from this trend and is even gaining market share.
- Because of its complicated past history and the fact that it is a single bond issuer, the company had to provide a coupon premium to the market to attract lenders while the fundamentals are good.
- The 2029 issue is currently trading at around 8.5%.

BEFIMMO (BELGIUM/REAL ESTATE)

- The office property sector is in difficulty due to the rise in interest rates and work from home policies, which has led to a fall in asset values.
- The portfolio of high end offices benefits from high occupancy rate, quality tenants (government, local authorities, etc.) with long-term leasing agreements.
- The bonds are senior and the fully refurbished office portfolio in a dynamic and stable market covers two times the liabilities.
- The 2029 maturity bond (B+) issued in May 2024 offers an annual coupon of 10.5% - such features in any other sector would be yielding 7% at best.

In conclusion, dispersion allows for alpha generation and for the building of an attractive yielding portfolio in combination with a command of its risk metrics. i.e. **dispersion means that an active bond picker can build a portfolio with a high aggregate yield while having an aggregate cross-over or investment grade rating**. A valuable feature as it wards off overly relying on carry to “carry” high yield markets.

EVOLUTION OF SPREADS ACROSS DIFFERENT CREDIT SEGMENTS



Sources: Carmignac, Bloomberg, as of May 2024.

GROWING MARKETS COVERS MISTAKES, EXPERIENCE ALLOWS TO AVOID (OR BENEFIT FROM) THEM

Defaults rates have been grinding higher at an annual pace of 4% and yet credit market returns are up by 20% over the past two years. As we are entering a period where credit markets are expected to be less forgiving, avoiding potentially problematic names is increasingly crucial.

As another saying goes "economic cycles don't die of old age", well good businesses rarely die of higher rates but zombie companies may, given concerns over the viability of their business models and associated excess leverage. Therefore, it **is of upmost importance for credit investors to fully appreciate and understand the business models and risks to which individual credit issuers are exposed to**. This enables investors to make sure both risks are well remunerated and that those businesses can make it through an entire economic cycle.

DEALING WITH THE ASYMMETRIC RISK PROFILE OF CREDIT MARKETS

Beyond the necessary and extensive work of issue and issuer selection, **one potential concern for investors is how one can seek a smoother ride ahead in credit markets should sentiment turn south?**

Clearly, the level of yields embedded in a portfolio allows to digest some volatility. With a Yield To Worst of 6%, it would take two weeks of carry to make up for the negative impact of a +5 bps upward move in bond yields; back in 2021 it would have taken two months to do so!

Short term to intermediate duration could also help. Indeed the Federal Reserve's (Fed) reaction function is asymmetric: if inflation grinds higher, the Fed Chair, Mr Powell will hold interest rates where they are. And if growth and employment were to deteriorate sharply, he will slash policy rates. **As such the possibility of a 'Fed Put' is back – even more so as expectations of cuts over the coming year(s) is low – which should provide some cushioning for the rates components, inherent to a credit investment**.

And finally, with the levels of credit spreads embedded in synthetic indices (around 300 bps for European High Yield and flirting with 50 bps for Investment Grade), **along with the low level of volatility for those same markets, allow for the building of protection in a credit portfolio at a reasonable cost**. Provided it stays at current levels, the cost of carry for holding such instruments is around 25 bps per month, and the payout could prove material should a risk-off environment materialise. Periods where credit spreads pick up by 50 to 100 bps over a month aren't that uncommon, and such an outcome would lead to a price action of +2.3% to +4.5% should it occur.

EXPECTED RETURNS ACROSS VARIOUS SPREADS AND RATES SCENARIOS

HY MARKETS		Spread Variation (in bps)								
		-100	-75	-50	-25	0	25	50	75	100
Rates Variations (in %)	-1,00%	12,9	12,0	11,2	10,4	9,6	8,7	7,9	7,1	6,3
	-0,75%	12,1	11,3	10,5	9,6	8,8	8,0	7,2	6,3	5,5
	-0,50%	11,4	10,5	9,7	8,9	8,1	7,2	6,4	5,6	4,8
	-0,25%	10,6	9,8	9,0	8,1	7,3	6,5	5,7	4,8	4,0
	0,00%	9,9	9,0	8,2	7,4	6,6	5,7	4,9	4,1	3,3
	0,25%	9,1	8,3	7,5	6,6	5,8	5,0	4,2	3,3	2,5
	0,50%	8,4	7,5	6,7	5,9	5,1	4,2	3,4	2,6	1,8
	0,75%	7,6	6,8	6,0	5,1	4,3	3,5	2,7	1,8	1,0
	1,00%	6,9	6,0	5,2	4,4	3,6	2,7	1,9	1,1	0,3

IG MARKETS		Spread Variation (in bps)								
		-100	-75	-50	-25	0	25	50	75	100
Rates Variations (in %)	-1,00%	13,1	11,9	10,8	9,6	8,4	7,2	6,1	4,9	3,7
	-0,75%	12,0	10,8	9,6	8,5	7,3	6,1	4,9	3,8	2,6
	-0,50%	10,9	9,7	8,5	7,3	6,2	5,0	3,8	2,6	1,5
	-0,25%	9,7	8,6	7,4	6,2	5,0	3,9	2,7	1,5	0,3
	0,00%	8,6	7,4	6,3	5,1	3,9	2,7	1,6	0,4	-0,8
	0,25%	7,5	6,3	5,1	4,0	2,8	1,6	0,4	-0,8	-1,9
	0,50%	6,4	5,2	4,0	2,8	1,7	0,5	-0,7	-1,9	-3,1
	0,75%	5,2	4,1	2,9	1,7	0,5	-0,7	-1,8	-3,0	-4,2
	1,00%	4,1	2,9	1,8	0,6	-0,6	-1,8	-3,0	-4,1	-5,3

Source: Carmignac, 18/06/2024.

CARMIGNAC PORTFOLIO CREDIT A EUR ACC

(ISIN: LU1623762843)

SFDR - Fund Classification** :

Article 6

LOWEST RISK — HIGHEST RISK

1	2	3*	4	5	6	7

Recommended minimum investment horizon **3 YEARS**

MAIN RISKS OF THE FUND

CREDIT: Credit risk is the risk that the issuer may default. **INTEREST RATE**: Interest rate risk results in a decline in the net asset value in the event of changes in interest rates. **LIQUIDITY**: Temporary market distortions may have an impact on the pricing conditions under which the Fund might be caused to liquidate, initiate or modify its positions. **DISCRETIONARY MANAGEMENT**: Anticipations of financial market changes made by the Management Company have a direct effect on the Fund's performance, which depends on the stocks selected.

The Fund presents a risk of loss of capital.

*Risk Scale from the KID (Key Information Document). Risk 1 does not mean a risk-free investment. This indicator may change over time. **The Sustainable Finance Disclosure Regulation (SFDR) 2019/2088 is a European regulation that requires asset managers to classify their funds as either 'Article 8' funds, which promote environmental and social characteristics, 'Article 9' funds, which make sustainable investments with measurable objectives, or 'Article 6' funds, which do not necessarily have a sustainability objective. For more information please refer to https://eur-lex.europa.eu/eli/reg/2019/2088/oj.

FEES

Entry costs : 2,00% of the amount you pay in when entering this investment. This is the most you will be charged. Carmignac Gestion doesn't charge any entry fee. The person selling you the product will inform you of the actual charge.

Exit costs : We do not charge an exit fee for this product.

Management fees and other administrative or operating costs : 1,20% of the value of your investment per year. This estimate is based on actual costs over the past year.

Performance fees : 20,00% when the share class overperforms the Reference indicator during the performance period. It will be payable also in case the share class has overperformed the reference indicator but had a negative performance. Underperformance is clawed back for 5 years. The actual amount will vary depending on how well your investment performs. The aggregated cost estimation above includes the average over the last 5 years, or since the product creation if it is less than 5 years.

Transaction Cost : 0,43% of the value of your investment per year. This is an estimate of the costs incurred when we buy and sell the investments underlying the product. The actual amount varies depending on the quantity we buy and sell.

PERFORMANCE (ISIN: LU1623762843)

Calendar Year Performance (as %)	2017	2018	2019	2020
Carmignac Portfolio Credit	**+1.8 %**	**+1.7 %**	**+20.9 %**	**+10.4 %**
Indicateur de référence	+1.1 %	-1.7 %	+7.5 %	+2.8 %

Calendar Year Performance (as %)	2021	2022	2023
Carmignac Portfolio Credit	**+3.0 %**	**-13.0 %**	**+10.6 %**
Indicateur de référence	+0.1 %	-13.3 %	+9.0 %

Annualised Performance	3 Years	5 Years	Since launch
Carmignac Portfolio Credit	**+0.3 %**	**+3.4 %**	**+5.4 %**
Indicateur de référence	+1.6 %	+0.0 %	+0.7 %

Source: Carmignac at 28 Jun 2024.
Past performance is not necessarily indicative of future performance. Performances are net of fees (excluding possible entrance fees charged by the distributor).

CARMIGNAC CREDIT 2027 A EUR ACC

(ISIN: FR00140081Y1)

SFDR - Fund Classification** :

Article 8

LOWEST RISK HIGHEST RISK

1	2*	3	4	5	6	7

Recommended minimum investment horizon 5 YEARS

MAIN RISKS OF THE FUND

CREDIT: Credit risk is the risk that the issuer may default. **INTEREST RATE**: Interest rate risk results in a decline in the net asset value in the event of changes in interest rates. **LIQUIDITY**: Temporary market distortions may have an impact on the pricing conditions under which the Fund might be caused to liquidate, initiate or modify its positions. **DISCRETIONARY MANAGEMENT**: Anticipations of financial market changes made by the Management Company have a direct effect on the Fund's performance, which depends on the stocks selected.

The Fund presents a risk of loss of capital.

*Risk Scale from the KID (Key Information Document). Risk 1 does not mean a risk-free investment. This indicator may change over time. **The Sustainable Finance Disclosure Regulation (SFDR) 2019/2088 is a European regulation that requires asset managers to classify their funds as either 'Article 8' funds, which promote environmental and social characteristics, 'Article 9' funds, which make sustainable investments with measurable objectives, or 'Article 6' funds, which do not necessarily have a sustainability objective. For more information please refer to https://eur-lex.europa.eu/eli/reg/2019/2088/oj.

FEES

Entry costs : 1,00% of the amount you pay in when entering this investment. This is the most you will be charged. Carmignac Gestion doesn't charge any entry fee. The person selling you the product will inform you of the actual charge.

Exit costs : We do not charge an exit fee for this product.

Management fees and other administrative or operating costs : 1,04% of the value of your investment per year. This estimate is based on actual costs over the past year.

Performance fees : There is no performance fee for this product.

Transaction Cost : 0,40% of the value of your investment per year. This is an estimate of the costs incurred when we buy and sell the investments underlying the product. The actual amount varies depending on the quantity we buy and sell.

PERFORMANCE (ISIN: FR00140081Y1)

Calendar Year Performance (as %)	2022	2023
Carmignac Credit 2027	+1.7 %	+12.8 %
Indicateur de référence	+0.0 %	+0.0 %

Annualised Performance	1 Year	3 Years	Since launch
Carmignac Credit 2027	+10.8 %	- %	+8.3 %
Indicateur de référence	- %	- %	- %

Source: Carmignac at 28 Jun 2024.
Past performance is not necessarily indicative of future performance. Performances are net of fees (excluding possible entrance fees charged by the distributor).

CARMIGNAC CREDIT 2029 A EUR ACC

(ISIN: FR001400KAV4)

SFDR - Fund Classification** :

Article 8

LOWEST RISK — HIGHEST RISK

1	2*	3	4	5	6	7

Recommended minimum investment horizon: 5 YEARS

MAIN RISKS OF THE FUND

CREDIT: Credit risk is the risk that the issuer may default. **INTEREST RATE**: Interest rate risk results in a decline in the net asset value in the event of changes in interest rates. **LIQUIDITY**: Temporary market distortions may have an impact on the pricing conditions under which the Fund might be caused to liquidate, initiate or modify its positions. **DISCRETIONARY MANAGEMENT**: Anticipations of financial market changes made by the Management Company have a direct effect on the Fund's performance, which depends on the stocks selected.

The Fund presents a risk of loss of capital.

*Risk Scale from the KID (Key Information Document). Risk 1 does not mean a risk-free investment. This indicator may change over time. **The Sustainable Finance Disclosure Regulation (SFDR) 2019/2088 is a European regulation that requires asset managers to classify their funds as either 'Article 8' funds, which promote environmental and social characteristics, 'Article 9' funds, which make sustainable investments with measurable objectives, or 'Article 6' funds, which do not necessarily have a sustainability objective. For more information please refer to https://eur-lex.europa.eu/eli/reg/2019/2088/oj.

FEES

Entry costs : 1,00% of the amount you pay in when entering this investment. This is the most you will be charged. Carmignac Gestion doesn't charge any entry fee. The person selling you the product will inform you of the actual charge.

Exit costs : We do not charge an exit fee for this product.

Management fees and other administrative or operating costs : 1,14% of the value of your investment per year. This estimate is based on actual costs over the past year.

Performance fees : 20,00% max. of the outperformance when the unit outperforms its annualised performance objective by 4.22% during the performance period. Any underperformance is recovered over 5 years. The actual amount will vary depending on how well your investment performs. The estimate of aggregated costs above includes the average for the last five years, or since the creation of the product if it is less than five years old. If the outperformance is constituted, the commission will be collected no earlier than December 2024.

Transaction Cost : 0,40% of the value of your investment per year. This is an estimate of the costs incurred when we buy and sell the investments underlying the product. The actual amount varies depending on the quantity we buy and sell.

PERFORMANCE (ISIN: FR001400KAV4)

Calendar Year Performance (as %)	2023
Carmignac Credit 2029	**+5.3 %**
Indicateur de référence	+0.0 %

Source: Carmignac at 28 Jun 2024.
Past performance is not necessarily indicative of future performance. Performances are net of fees (excluding possible entrance fees charged by the distributor).

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