CMi2i RESEARCH & INSIGHTS

CMi2i CAPITAL MARKETS INTELLIGENCE

THE OUTLOOK FOR THE BOND MARKET IN 2024 - A SLOW DESCENT INTO PURGATORY

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It is that time of the year when we take stock of what has been achieved over the past twelve months and we start looking into the year ahead, making plans and predictions. The last couple of years have certainly been eventful, making predicting the future a rather risky business and while it is tempting to shy away from this task, we have decided to be brave and outline what we see as the main themes for 2024.

Last November when most commentators predicted that the end of inflation was in sight, we wrote that "inflation & lack of liquidity will continue to affect the bond issuers splitting them into two groups: those who do not need to refinance and will therefore have the luxury of avoiding the bond markets and those who do and will either have to refinance at great cost, restructure or potentially become bankrupt… liquidity will replace inflation as the key word in financial commentaries and investor meetings alike." (**CMi2i 2023 Bond Market Outlook**).

Overall, 2023 has proven us correct and while we would like to have a more uplifting forecast for 2024, our outlook for the next twelve months remains rather bleak – in the words of a very senior fixed income adviser we spoke to recently, 2024 will be a slow descent into purgatory.

Indeed, **we expect inflation & interest rates to remain higher than in previous years until at least the first half of 2024, in both the USA and Europe, with *stagflation* potentially taking hold in both markets.** This will negatively affect all sectors, but especially the already struggling retail and real estate markets.

With many issuers' bonds maturing towards the end 2024 and throughout 2025, we expect a growing number of restructurings and defaults. This will cause bondholders to become more vocal, often fighting back against issuers in the hope of negotiating better terms. **For issuers, having a strong debt IR program underpinned by a deep and clear understanding of their bondholders will be the key to successfully navigate the next 12 months.**

Recent geopolitical events have shown us how they can throw all predictions into the air and for this reason we feel we must mention how the growing tensions between China and the US could completely transform the future economic landscape, especially if this crisis escalates.

INFLATION & HIGHER INTEREST RATES TO CONTINUE – IS STAGFLATION ON THE HORIZON?

Markets think that the inflation problem has either been or is about to be solved but we believe that it is the wrong conclusion, and we are not alone. Torsten Sløk, Apollo's Chief economist, recently published as part of his daily blog, a very interesting chart on *supercore* inflation (inflation that excludes housing) showing that in the US it is still high at 4.5% and more importantly it does not show any signs of moving down to the Fed's target of 2% (see Graph 1).

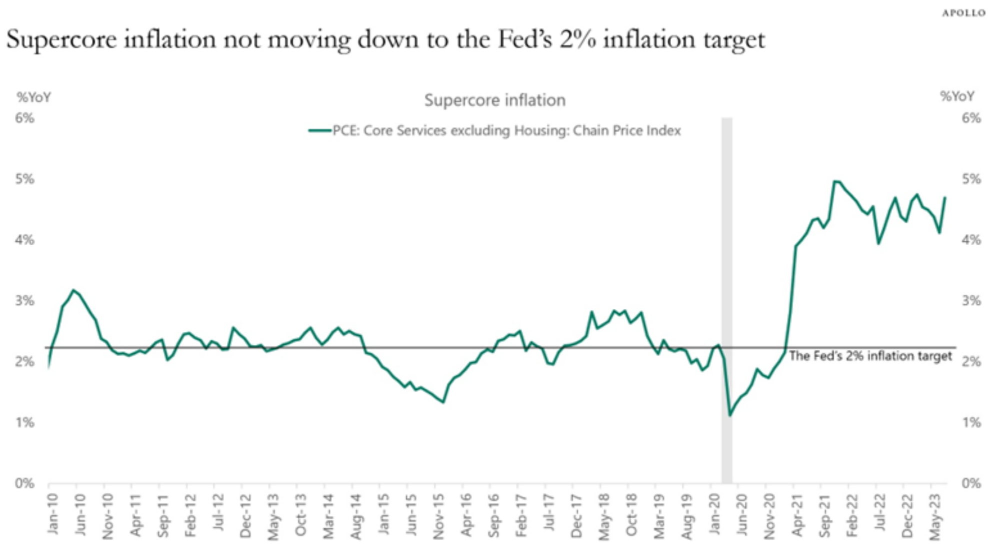
If anything, *supercore* inflation has continued to rise in recent months sparked by a strong demand for consumer services ("Inflation Is Still a Problem", Daily Sparks, September 2, 2023). This is because despite the interest rate hikes of the past six months, consumers across the globe, but particularly in the US and the UK, continue to want to travel, eat out and socialise after two long years of Covid restrictions. It is true that these same consumers are running out of their "Pandemic savings" but this hasn't affected their spending yet. **Until the Fed and the other central banks succeed in getting *supercore* inflation under control, we believe interest rates will continue to remain high and inflation will remain above pre-2019 levels.**

As 2024 progresses, we believe ***supercore* inflation will decrease but will remain higher than expected by most market commentators, spurred by pay rises and the cost of energy** (and in the US, health insurance costs)**.** With tight labour markets, especially in the UK where there are over 1 million unfilled job vacancies, wages continue to increase, and official figures show that in Q2 2023, UK nominal regular pay, that excludes bonuses, rose at an annual rate of 7.8%, the highest since records began in 2001. In the US and the Eurozone, things are not much different with wages rising by over 4% (**Source: FT**). **Such wage increases counterbalance the financial constraints designed by the central banks leading to an increase in money velocity and thus keeping inflation above pre-2022 levels.**

At the same time, we believe **energy costs will also continue to drive inflation.** With Saudi Arabia and its allies cutting production, the oil price has increased by more than 20% since mid-June.

This price increase cannot but add pressure on inflation, especially throughout the winter months. The cost of other commodities have also risen supported by increasing demand from hedge funds (**Source**). **If commodity prices continue in this direction, it will be difficult for central banks to keep inflation within their targets, even throughout a global economic downturn.**

Graph 1: US Supercore Inflation Jan-10 to May-23



Source: "Inflation is still a Problem, Daily Sparks, September 2, 2023

THE USA & CHINA - THE WILD CARD

The current challenges facing the US-China relationship are greater than many expect, and we believe they are likely to be resistant to any quick fix. Indeed, in a note recently published by the Nomura Research Institute, the economist Takahide Kiuchi warned that, "between them, the US and China were leading the world into a quiet crisis" (**Source**). The US has already put sanctions against a selective list of Chinese companies – and this list has only grown over time. If the situation were to deteriorate, it is not implausible for the US to apply tougher sanctions, in similar fashion to what happened to Iran and Russia.

From an issuer and fixed income investor's point of view the fundamental question is whether China's geopolitical issues could escalate to the point that its long-term *investibility* may be put into question and become a long-term threat to its economic growth.

> ***"We have already seen an increase in liability management and consent solicitations...At the same time, issuers must be aware that bondholders will not accept any form of liability management/restructuring proposals"***

WHAT DOES THIS MEAN FOR ISSUERS AND BONDHOLDERS?

Many issuers are faced with a significant portion of their bonds maturing between the end of 2024 and throughout 2025. These bonds had been issued either before or during the first Covid lockdowns when interest rates were extremely low. With economic growth slowing down and a potential economic recession around the corner, many corporates will be forced to issue new bonds to manage their liabilities and continue to survive. The economic backdrop outlined above, however, means that the higher interest rates will make it more challenging for them to refinance. We have already seen an increase in liability management and consent solicitations within the retail and real estate sectors, especially in Southern Europe and China, but we expect most sectors to be affected as 2024 progresses.

At the same time, issuers must be aware that bondholders will not accept any form of liability management/restructuring proposals. It has always been the case that in distressed situations, bondholders come together to form **a** bondholders' group to better negotiate with the issuer. However, **now more than ever, we have witnessed bondholders come to block a consent solicitation process even in non-distressed situations**. This is due to several factors, including investors facing a tougher economic environment themselves and having to ensure the best possible return on investment for their own clients (the UK 2020 Stewardship Code clearly spelt out this responsibility for fixed income investors for the first time).

Within only a few weeks, Solvay had to at first postpone and then cancel a bondholder meeting and completely overhaul its strategy as it became clear that they wouldn't be able to meet the required quorum. They instead bought back the bonds as demanded by its investors.

In the secondary markets, we expect high volatility and an increase in secondary market trading activity as hedge funds and other market players will try to take advantage of the market conditions. The bondholder identification reports carried out by CMi2i in recent months, already show significant investor trading activity, with some hedge funds buying large stakes unbeknown to the issuers. **The days when fixed income investors held bonds until maturity are long gone.**

The combination of higher refinancing costs, increased market liquidity and more demanding bondholders make having a strong debt IR department or policy even more important for issuers. Corporates must proactively engage with existing and potential bondholders to make their investment case as compelling as possible. A proactive debt IR function will help issuers avoid the rather painful descent into the purgatory of stagflation and restructurings.

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ABOUT CMi2i

CMi2i provides unique capital markets intelligence and guidance to issuers and their advisors.

CMi2i is known for the world's most accurate share and debtholder identification service, supporting both corporates and their advisors with investor relations, M&A, shareholder activism, capital restructuring and proxy solicitation. Our team has provided intelligence and advice to over 500 of the largest, most structurally complex companies in the world, and supported numerous corporate transactions and general meetings. As a result, we offer clients a unique combination of skills, experience and methodologies within the following areas:

- Capital Market Intelligence & Investor Relations Support
- ESG & Corporate Governance Advisory
- Proxy Solicitation & Engagement

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