CMi2i RESEARCH & INSIGHTS

CMi2i CAPITAL MARKETS INTELLIGENCE

2023 BOND MARKET OUTLOOK – LIQUIDITY TAKES IT ALL

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It's the time of the year when we start reflecting on the events that have shaped the last 12 months while making predictions about the new year and what it might entail. 2022 has been a real roller coaster that has surprised in equal measures all market participants, especially within the bond markets. Not many people could have predicted the conflict in Ukraine, the resulting shortage in global natural resources that coupled with the Covid relief injection of money would result in both a slowdown in the global economy and a drastic increase in inflation. Only 12 months ago, UK inflation was below 6% and no one would have imagined it would reach and exceed 10%; today it stands at 11.1%!

While making predictions is clearly a risky business, corporates must plan ahead if they want to successfully navigate the financial markets. With this in mind, we will attempt to highlight few themes in the global financial markets that we believe will affect bond issuers in the upcoming year. Overall, we believe 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. For those companies that will have to tap the bond markets, a strong targeting and IR program will be imperative. **In 2023, liquidity will replace inflation as the key word in financial commentaries and investor meetings alike. Ensuring that investors understand a company's story as well as its balance sheet will be key**.

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Our predictions last year	Did they happen?
Inflation – not being transitory	✓
Defaults & spill-overs – UK energy sector & Evergrande	✗
ESG investments continuing to grow	✓
Sovereign wealth managers reducing their exposure to fixed income	✓

LIQUIDITY IS KING - AN ISSUERS' GUIDE TO NAVIGATING THE BOND MARKET

Only a year ago, many central bankers and market commentors dismissed inflation believing that it would only be transitory . As mentioned in our previous research papers, the large supply of liquidity resulting from government Covid relief measures coupled with energy price increases have meant that inflation has been the key driving force of global monetary and fiscal policy throughout the year. Central bankers across the globe have made it clear that they are ready to sacrifice economic growth for the sake of inflation. However, while the Fed's action appears to have cooled down inflation in the US, this hasn't been the case in Europe and the UK . As such, a decoupling of the US and European economies is a de facto reality.

In Europe, **inflation is still rampant due to the cost of energy, and we predict it will continue to stay above normal levels until at least the first half of 2023.** Higher energy prices will continue to have a knock-on effect on food prices and business confidence. The link between energy prices and overall inflation is perfectly illustrated by BASF's recent business decision. The German chemicals giant has paid an extra €800m to keep its plants operating in the second quarter compared with the same period last year.

To keep costs under control, it has since made the difficult decision to reduce the production of ammonia, which is used in the agricultural industry as fertiliser. This will inevitably affect the farming and food industries and contribute to the ongoing inflation. (Source)

'With liquidity shrinking, debt levels rising and competition for capital severe, corporates needing to issue new bonds must proactively engage with existing and new bondholders'.

To make things worse, economic growth is likely to continue to slow down and a global recession seems increasingly likely. With prices rising due to the cost of inflation, consumers will inevitably continue to reduce their spending leading to lower economic growth. **Low economic growth would normally slow down inflation, but we don't believe this will be the case in Europe, at least not until Q2 next year**. High energy prices, the war in Ukraine and higher mortgage rates will continue to drive inflation and slow down growth all at the same time. **Stagflation is a real possibility.**

WHAT DOES THIS MEAN FOR CORPORATES?

The combination of high inflation and low growth means that **liquidity will be key for corporates**. Investors will look out for those companies that have strong balance sheets to withstand this period of elevated costs and reduced revenues. The difference between those corporates that have enough cash reserves or whose debt will not mature in the coming years and those who don’t have this luxury will be stark. **Companies with low levels of liquidity will struggle and we foresee a rise in restructurings**.

Overall, new debt issuance and general liability management transactions will be lower as most issuers will decide to wait for better market conditions. We have already seen this happening to high yield issuers (high-yield issuance has been lower than usual in 2022) and we expect this to spread across all types of bond issuers.

'In the secondary markets, we foresee investors making investment decisions based on liquidity rather than sector or market'.

For those issuers needing to refinance and issue new debt, things will not be easy – investors’ appetite for risk is low and competition for capital is high. Vista Equity Partners and Elliott Management’s leveraged buyout of software company Citrix this year clearly illustrate this point. It’s no secret that the banks leading this deal struggled to find enough investors interested in the $8.55bn debt package. They eventually did but it required significant more effort and resources than expected (Source).

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In the secondary markets, we foresee investors making investment decisions based on liquidity rather than sector or market; investors will look out for those corporates that benefit from strong balance sheets & sufficient cash reserves no matter the sector. Therefore, we expect high volatility and an increase in secondary market trading activity as already witnessed in the second half of 2022. **The bondholder identification reports carried out in the second half of the year by CMi2i all show significant investor trading activity, even across the top 10 largest holders. Indeed, most of our clients are surprised to see so many new top holders**. The days when fixed income investors held bonds until maturity are long gone.

WHAT CAN CORPORATE ISSUERS DO?

Those corporates who can sit back and ride the next twelve months without tapping the bond markets should clearly do that. But for most corporates the next 6-12 months will be challenging to say the least. **With liquidity shrinking, debt levels rising and competition for capital severe, corporates needing to issue new bonds must proactively engage with existing and potential bondholders to make their investment case as compelling as possible**. As shown by the Citrix leverage buyout, just relying on banks and their contacts may not always be sufficient and companies may need to be more proactive and actively reach out to existing & potentially new investors themselves.

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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

Contact info@cmi2i.com for more information on our services.

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