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# Credit Investing Through the Cycle.

## A risk framework for disciplined credit investing



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Successful negotiations are rarely won at the table. They are won beforehand, through preparation. Credit investing follows the same logic. Outcomes are rarely determined at the moment markets reprice; they are shaped much earlier, as leverage builds, liquidity conditions evolve and risk is priced. The credit cycle is the storyline behind those shifts - often visible in behavior and funding conditions well before it becomes visible in defaults.

### Why does the credit cycle matter for investors?

**Credit risk is asymmetric.** In credit investing, returns are earned gradually, while losses can occur rapidly when refinancing conditions tighten, liquidity weakens, and defaults rise.

**Credit is cyclical.** The credit cycle reflects the interaction between borrowers, investors, central banks, and market dynamics. When spreads widen and risk aversion increases, economic conditions typically soften, prompting policy easing and reduced investor risk-taking.

**The credit cycle provides essential context for investment decisions.** It helps assess whether returns are supported by solid fundamentals or by easy financing conditions. Ignoring the cycle does not simply mean missing carry; it risks being exposed to credit at the wrong time, when markets reprice rapidly

# The creditworthiness cycle: Four stages, two engines

Credit cycles are well known. Most investors can describe their **four broad phases: repair, recovery, expansion and downturn**. In this paper, our aim is not to re-teach the labels, but to underline **what matters most in each phase: the changing nature of risk**. In credit, the cycle is not simply about growth and recession; it is about how forgiving refinancing conditions are, how easily leverage is rewarded, and how quickly liquidity can disappear when sentiment shifts.

At Candriam, we analyse the cycle through **two complementary lenses: the debt cycle and the business cycle**.

- **The debt cycle** captures how leverage accumulates across corporates and households and how the credit supply evolves over time.
- **The business cycle** captures the economic environment in which that debt must be serviced, refinanced and priced: growth, inflation and monetary conditions.

Credit stress tends to emerge when these two cycles reinforce each other negatively – when leverage continues to expand even as growth slows and policy becomes less supportive.

The framework is deliberately upstream. **Defaults, downgrades and forced selling are typically late-cycle outcomes**; by the time they are obvious, the repricing has often already happened. **The more actionable signals often sit earlier**: the pace and purpose of borrowing, underwriting discipline, refinancing channels, and the way monetary policy changes the margin for error.

**From a debt-cycle perspective, we look at how credit is being used – not just how much of it exists**. Real estate lending (long-dated and rate-sensitive), non-financial corporate borrowing (investment versus financial engineering), consumer credit growth (household sensitivity) and leveraged M&A (a behavioral signal) help reveal whether resilience is being rebuilt or quietly spent. We also watch the breadth of credit supply across banks and capital markets, because cycles are amplified when funding remains abundant even as structures weaken.

**From a business-cycle perspective, we focus on the conditions that determine whether debt can be serviced and refinanced comfortably**: growth momentum, labor-market dynamics, inflation and central bank policy. This shapes revenues, margins and funding costs, and ultimately determines how easily debt can be serviced and refinanced. Even moderate levels of leverage can become problematic when growth slows, inflation pressures rise or financing conditions tighten.

These stages are not timestamps. They can persist for long periods, transition unevenly, or appear to reverse. **The purpose is not to call the turning point; it is to recognise when the balance between risk and compensation is improving, and when it is becoming increasingly asymmetric**.

The four stages can be summarized as follows:

**1. Stage 1 - Repair and re-opening:**

Corporates tend to deleverage by raising equity capital, selling assets and cutting costs. The default rate is high, and risk is visible and, often, priced. Dispersion is high and spreads can offer a cushion, but liquidity can still be uneven and issuers may carry hidden fragilities.

**2. Stage 2 - Recovery:**

Growth returns, earnings recover, issuance accelerates, leverage stabilises and volatility declines. With the default rate decreasing and balance sheet discipline, It's the goldilocks scenario. Here, risk is more about complacency behaviour starting, and a quiet shrinking of the margin for error.

**3. Stage 3 - Expansion:**

Corporate risk appetite returns. While fundamentals may still look acceptable, leverage increases as corporates spend on merger & acquisition and huge capex, and as underwriting weakens. With tight valuations, low default rate and a less supportive policy backdrop, risk becomes asymmetric: limited upside and high sensitivity to refinancing conditions.

**4. Stage 4 - Downturn:**

Financing conditions tighten, earnings and liquidity deteriorate, leverage peaks, defaults rise and spreads reprice rapidly. Outcomes are driven by structure, seniority and recovery.

## 2.Recovery

**Corporates:** growth returns, easy credit conditions.

**Central Banks:** neutral

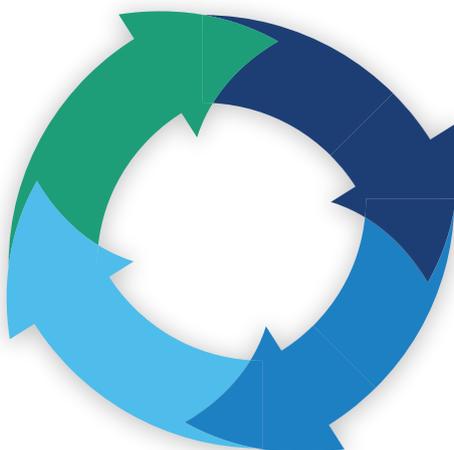
**Investors:** increasing risk, inflows continue.

## 1.Repair

**Corporates:** deleveraging, rising default rates, idiosyncratic risks remains high.

**Central Banks:** dovish

**Investors:** cautious stance, flows turn positive



## 3.Expansion

**Corporates:** leverage increases. Fast credit growth and low default rates. Credit conditions tighten.

**Central Banks:** turning hawkish-

**Investors:** embracing risk, inflows continue.

## 4.Downturn

**Corporates:** earnings deteriorate fast. Leverage increases rapidly and default rates rise.

**Central Banks:** slow to react

**Investors:** seeking to derisk but constrained by declining liquidity. Outflows.

Source : Candriam

# How Candriam manages credit through the cycle

At Candriam, we do not see credit cycle analysis as a separate activity; but as **a context layer that reinforces an issuer-led process**. We use it to stress-test creditworthiness, calibrate risk budgets and ensure portfolios are built to withstand shifts that can be swift and unforgiving. Our approach operates on two levels: **bottom-up issuer analysis**— “What is the risk we own?” — and a **top-down cycle overlay**— “Is this the moment in the cycle when we want to own it - and if so, at what size and in what structure?”.

## Bottom-up: Credit recommendations informed by cycle risk

Bottom-up research is the primary step of our investment process. Our analysts provide an internal credit recommendation for each issuer based on an assessment of its business profile, its financial profile and the event risks that surround it. ESG considerations are integrated into this analysis because they can materially affect cash-flow durability, access to capital and governance behavior - especially when conditions tighten.

Cycle risk is embedded in this analysis. Analysts focus on refinancing needs, the maturity profile of debt, liquidity buffers and the resilience of free cash flow under less supportive conditions. They examine management incentives and potential actions under stress, because event risk often accelerates when the margin for error narrows. Issue-level structure - seniority, covenants, call features and recovery prospects - becomes critical precisely when conditions shift.

Before issuing a final recommendation, analysts evaluate the risk of operating in the current phase - and the risk of moving into a less supportive one. The goal is not to predict the day the cycle turns. It is to underwrite downside in advance, require a margin of safety in fundamentals and structure, and walk away when return depends on assumptions that only hold in perfect conditions.

## Top-down overlay: Managing risks, not calling peaks

Our top-down overlay analyses the macroeconomic conditions and the broader credit environment through market fundamentals, valuations and technicals. This helps build a coherent view of where compensation is improving and where it is becoming thin.

We translate the macro backdrop—growth, inflation and the policy stance—into an assessment of financial conditions. The credit team then interprets the implications for spread risk across regions and ratings, integrating fundamentals, valuations, sentiment and technicals. Our objective is not to issue a mechanical signal, but to produce a clear risk message that informs portfolio construction.

Because regime changes can be swift and brutal, **we aim to adjust risk progressively as asymmetry builds**. That can mean taking profits when spreads have done their job, upgrading quality when the margin for error shrinks, and keeping enough liquidity to avoid forced selling. **In credit, opportunities tend to appear when others are constrained. A disciplined cycle framework is what keeps a portfolio unconstrained.**

# Being contrarian when it counts: Portfolio posture across the cycle

Being contrarian in credit is not about permanently avoiding risk. It is about owning risk when it is paid to be owned— and being cautious when the market offers the illusion of safety at the price of insufficient spread.

Our portfolio posture evolves with risk compensation across the four stages.

- Stage 1 - Repair and re-opening**  
 Corporates turn bondholder-friendly. We look for deleveraging credit stories where spreads still offer a cushion. **The focus is on selectivity:** issuers with credible balance-sheet repair, strong liquidity and refinancing optionality. **The aim is to add risk with discipline.**
- Stage 2 - Recovery**  
 We seek to gradually **increase the beta** as in this phase, market conditions may be more supportive for delivering positive returns. Position sizing and structure become important as risk premium compensation compresses. We seek to harvest carry without outsourcing risk control to the market.
- Stage 3 - Expansion**  
 Our position is defensive carry. We monitor the potential excesses in corporate behaviour: leverage-funded M&A, shareholder distributions, covenant erosion and underwriting slippage. This is when discipline is least fashionable - and most valuable. We tend to prioritize balance-sheet resilience over marginal spread, reduce exposure to credits that depend on continuous market access, and avoid structures with poor downside protection.
- Stage 4 - Downturn.**  
 Portfolio outcomes are dominated by liquidity management and downside underwriting. We focus on preserving flexibility, while remaining prepared to redeploy risk selectively as dislocations create opportunities. When spreads widen beyond what fundamentals justify, a prepared portfolio can redeploy risk selectively - becoming contrarian when risk is visible and priced.



Source: Candriam

At Candriam, **the balance between top-down and bottom-up work is not static; it flexes with the credit cycle.** We always run both lenses in parallel—issuer research to define the risk we own, and a macro/cycle overlay to frame whether the market is paying us appropriately to own it. But at the point of portfolio construction, the cycle determines which perspective carries more weight.

In phases where dispersion is high and outcomes hinge on issuer behaviour and capital structure, bottom-up conviction and security selection drive differentiation. In phases where correlations rise and price action is dominated by broad repricing of risk, top-down discipline becomes the anchor—shaping beta, liquidity, and the overall risk budget even as we continue to screen for idiosyncratic opportunities.

In practice, this means that:

- **Late-cycle expansion**—when spreads are tight, exuberance can mask fragilities, and the margin for error shrinks—**calls for a stronger emphasis on fundamental bottom-up underwriting:** we prioritise balance-sheet resilience, refinancing optionality and downside-protective structures as we prepare the portfolio for a turn.
- **In repair**, as spreads decompress and stronger credits recover sooner, **we again lean heavily on bottom-up analysis** to identify the names most likely to re-open market access and re-rate first.
- By contrast, **downturns** typically deliver a more uniform move in spreads, where liquidity conditions and regime dynamics dominate returns; here, **top-down perspectives guide portfolio posture**, even if selective, issuer-specific dislocations emerge.
- **Recovery** similarly tends to be characterised by broad spread compression and beta-driven performance—making **top-down beta management and risk calibration central**—while bottom-up work ensures we capture carry without compromising the portfolio’s resilience as conditions evolve.

## Conclusion

Drawing the four stages of the cycle is certainly not a novel concept. What is, however, important is how analysis of these stages is used. **The credit cycle is not a forecasting exercise; it is a risk management framework.** It highlights when liquidity is abundant or fragile, when leverage is rewarded or merely tolerated, and when the market is compensating for uncertainty – or rewarding you based on market complacency.

At Candriam, our approach of the cycle is both bottom-up and top-down, because credit risk is both idiosyncratic and systemic. We aim to anticipate risk – by scrutinising refinancing channels, balance-sheet behaviour and the shrinking margin for error – rather than attempting to predict the day the cycle turns. In a world where transitions can be abrupt and warnings are often subtle, preparation matters more than prophecy.

**In credit investing, the best time to manage risk is precisely when it feels unnecessary because markets appear comfortable.** That is why our process insists on reading the cycle early, underwriting downside continuously, and maintaining liquidity so as to be able to act when others cannot. What we aim for is resilient credit performance across cycles— and the ability to turn market stress into opportunity when compensation returns.

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**The time to repair the roof is when  
the sun is shining**

**–John F. Kennedy**

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Investing in credit markets involves risks, including the risk of capital loss.

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