

PUBLIC FIXED INCOME

Investment Grade Corporate Market Review and Outlook

December 31, 2021

For the quarter, the Bloomberg US Credit Index generated a positive total return of 0.22% but lagged similar duration Treasuries, posting an excess return of -0.24%. In all, the index was not immune to the macro volatility.

Figure 1 | Total and Excess Returns (%)



Source: Bloomberg

What started out as a relatively benign quarter, rapidly changed in November as the Consumer Price Index jumped to 6.8% year-over-year, its highest reading in 39 years, and the unemployment rate fell to 4.2%.¹ Both of which pushed the Federal Reserve to adopt a more hawkish stance at its December meeting where the Committee announced plans to accelerate tapering with a target conclusion by the end of the first quarter 2022 and paving the way for additional rate hikes in 2022. Not surprisingly, rates fluctuated substantially. In fact, after hitting a high of 1.70% in late October, the 10-year Treasury fell to 1.34% in the last week of November, backing up to 1.51% by the end of the year – just two basis points higher than the end of the third quarter.² For the quarter, the curve flattened with 2 and 5 year yields higher by 46 and 30 basis points respectively, and 30-year yields lower by 14 basis points. Overall, both the 5s/10s and 10s/20s spreads flattened by 27 and 8 basis points, respectively.³

Trading in a 19-basis points range over the quarter, the Bloomberg US Credit Index OAS got as wide as 96 basis points in late November before settling back to 85 basis points on December 31st – just five basis points wider than where it started. For the same period, the yield on the index rose 20 basis points to close at 2.25%. For the year, the index generated an excess return of 1.51% despite a negative total return of -1.08%.⁴

Aside from a few exceptions, excess returns were generally negative across sectors and maturities. Short and intermediate corporates outperformed their longer dated counterparts, and BBBs outperformed As and AAs. In a reversal of prior quarter performance, non-corporate credit outperformed corporate credit, supported by a rebound in Sovereign debt performance. Within the corporate credit sectors, Basics posted the lone positive excess return and Capital Goods, Consumer Cyclicals, and REITS all outperformed the broader market. Consumer Cyclicals was aided by Automotive which enjoyed strong auto sales, and REITs was supported by continued return to office policies and a more robust rental market. On the flip side, Communications, Energy, and Utilities broadly were among the worst performers. Throughout the quarter, Energy was plagued by oil price volatility brought on by COVID variant concerns and tight supply.

Figure 2 | Bloomberg US Corporate Index Snapshot

	Sector	OAS TSY	QTD Excess Return	QTD OAS Δ	QTD YTW Δ	QTD Total Return
Top 5 Sectors	Finance Companies	119	0.41%	14	0.30%	0.17%
	Healthcare REITS	96	0.22%	4	0.18%	0.01%
	Chemicals	97	0.17%	4	0.14%	0.94%
	Automotive	71	0.15%	5	0.32%	-0.13%
	Refining	124	0.14%	15	0.44%	0.26%
Bottom 5 Sectors	Electric	107	-0.72%	11	0.15%	0.29%
	Life Insurance	119	-0.73%	13	0.21%	-0.17%
	P&C	99	-0.78%	10	0.16%	0.12%
	Cable & Satellite	130	-0.87%	12	0.12%	0.48%
Quality	Tobacco	152	-0.87%	16	0.24%	-0.30%
	A	74	-0.33%	7	0.20%	0.13%
	Baa	113	-0.24%	10	0.21%	0.23%
	Sector	OAS TSY	YTD Excess Return	YTD OAS Δ	YTD YTW Δ	YTD Total Return
Top 5 Sectors	Airlines	136	6.39%	-115	-0.45%	4.48%
	Oil Field Services	124	5.44%	-34	0.27%	2.45%
	Midstream	136	5.02%	-32	0.27%	2.46%
	Refining	124	4.96%	-25	0.54%	2.48%
	Independent Energy	125	4.53%	-34	0.18%	1.60%
Bottom 5 Sectors	Retailers	67	0.86%	-4	0.60%	-1.79%
	Construction Machinery	42	0.75%	-4	0.58%	-1.33%
	Banking	77	0.74%	5	0.73%	-1.32%
	Technology	80	0.53%	4	0.71%	-1.98%
	Tobacco	152	0.42%	21	0.87%	-2.32%
Quality	A	74	0.73%	1	0.61%	-1.93%
	Baa	113	2.43%	-8	0.55%	-0.22%

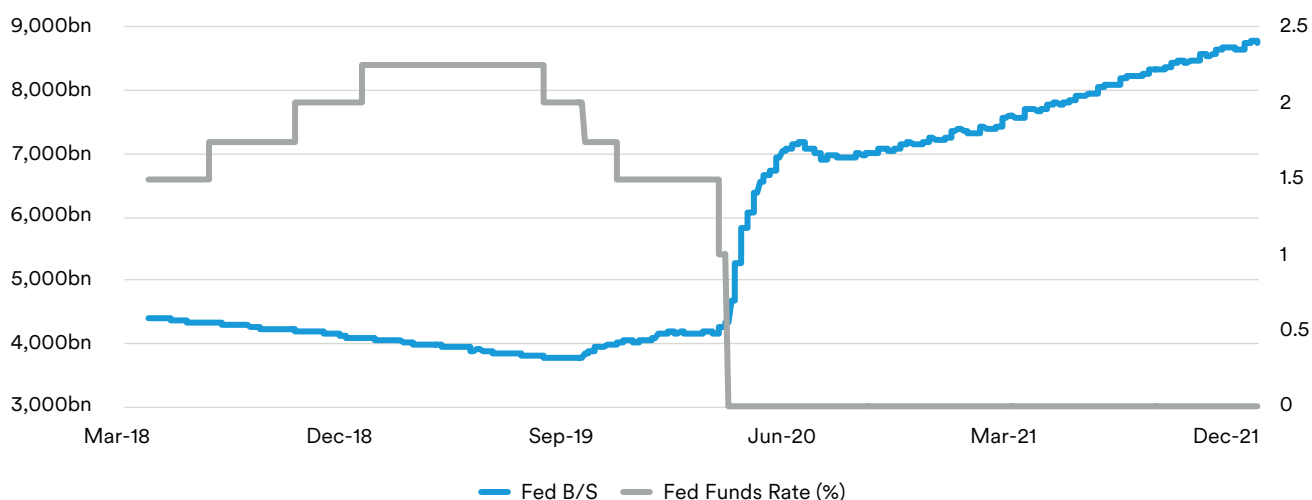
Source: Bloomberg

On the supply front, gross supply for the quarter topped \$300 billion, with investment grade primary activity finishing the year at \$1.457 trillion, exceeding market estimates and posting the second highest year on record, trailing only 2020.⁵ Additionally, liability management set a record with \$419 billion of volume, the bulk of which came from tenders with 55% funded with balance sheet cash. Finally, worth noting is ESG related supply, which also set a record at \$100 billion in new issuance, doubling the volume seen in 2020.⁶

The Bloomberg US Credit Index rings in 2022 at just a handful of basis points through where it was when the ball dropped 12 months ago, and our outlook at that point (and in the subsequent quarters) was one of tepid cautiousness. As we peer into 2022 our cautious stance takes on an increased urgency. In recent previous quarters, valuations were simply uninteresting and not satisfactorily compensatory for the risk. In upcoming quarters, we see significant potential for increased volatility in credit spreads and risk assets more broadly.

The Federal Reserve began cutting rates in June 2019, reaching zero by March 2020 with the onset of the pandemic. Concurrently, the central bank began to expand the balance sheet again. As shown in Figure 3, it started rather innocuously with the repo facility in fall 2019 and accelerated exponentially during the pandemic with the various asset purchase programs. These actions served to provide liquidity to the markets in the early weeks of the pandemic, but since have served to buoy and backstop risk assets.

Figure 3 | Recent Fed Actions Have Been a Backstop to Risk Assets



Source: Bloomberg

Additionally, fiscal expenditures have supported the economy over the last two years. Unprecedented and direct stimulus to consumers, households and business more than filled the GDP hole caused by the pandemic. In fact, as shown in Figure 4, fiscal spending is expected to be \$1.3 trillion less in 2022 versus 2021, with the majority of the decline happening in the late first quarter/early second quarter of 2022.⁷

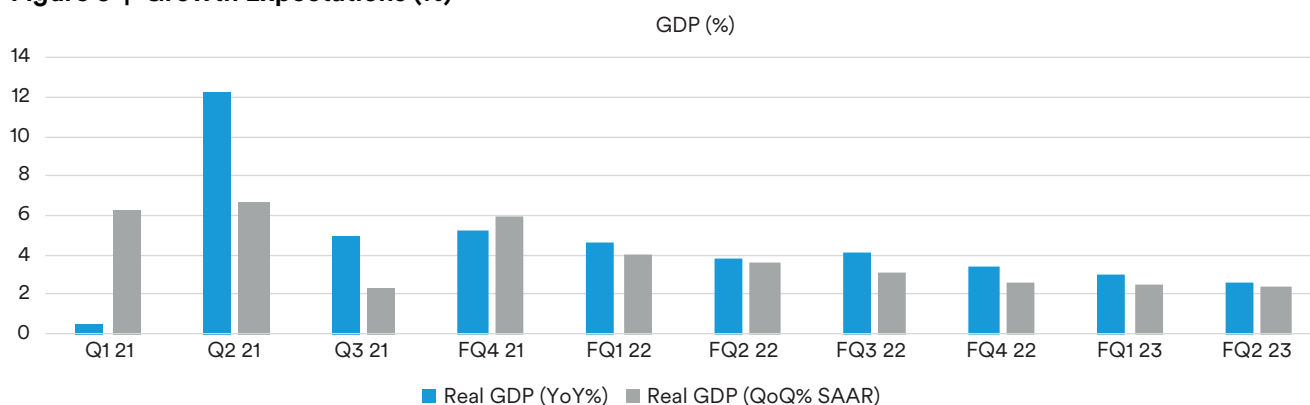
Figure 4 | CBO's Baseline Budget Projections by Category

(\$B)	2020 (actual)	2021 (estimate)	2022 (estimate)	2023 (estimate)
Revenues				
Individual income taxes	1,609	1,952	2,328	2,334
Payroll taxes	1,310	1,346	1,391	1,504
Corporate income taxes	212	238	317	379
Other	291	306	355	381
Total	3,421	3,842	4,390	4,597
On-budget	2,456	2,863	3,401	3,513
Off-budget	965	979	989	1,085
Outlays				
Mandatory	4,577	4,862	3,589	3,461
Discretionary	1,628	1,652	1,649	1,610
Net Interest	345	331	306	315
Total	6,550	6,845	5,544	5,386
On-budget	5,598	5,846	4,469	4,231
Off-budget	953	999	1,075	1,155
Total Deficit	-3,129	-3,003	-1,153	-789
On-budget	-3,142	-2,984	-1,067	-718
Off-budget	13	-19	-86	-71
Primary Deficit	-2,784	-2,672	-848	-474
Debt Held by the Public	21,017	23,012	24,392	25,156
Memorandum:				
Gross Domestic Product	21,000	22,401	24,323	25,356

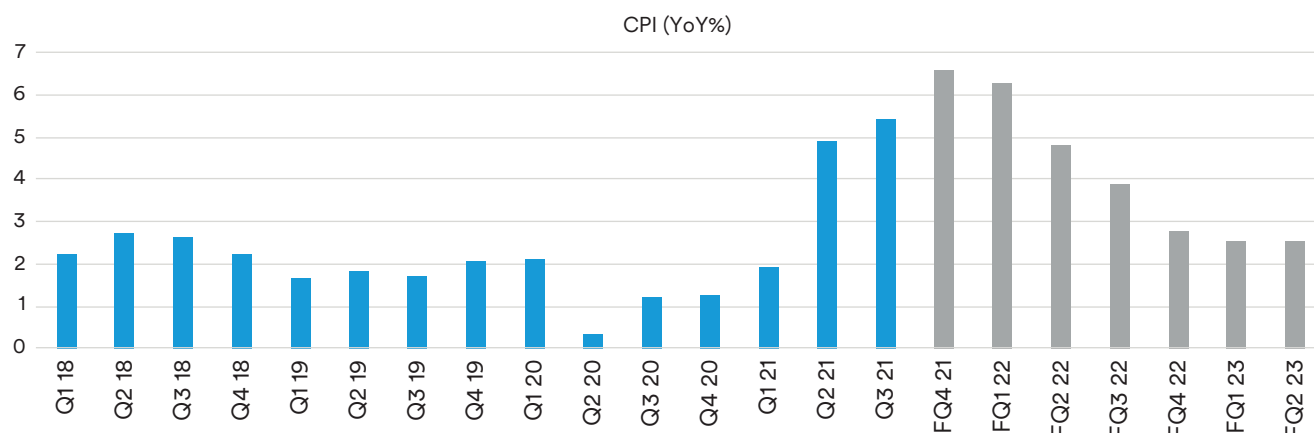
Based on CBO scoring of current law, Federal spending will drop by \$1.3 Trillion year over year from fiscal 2022, representing about 6% of GDP and with the bulk of the decline occurring in the 2Q22.

Source: CBO

All of this is to suggest we are concerned that the Fed will be initiating its tightening cycle into a market that has already experienced peak growth and inflation while concurrently trying to wean off historically unprecedented fiscal and monetary support. The monetary and fiscal spigots have closed. The Federal Reserve will continue to taper asset purchases and the market has priced in hiking cycle initiation in March with three total increases priced in for the calendar year. Against a backdrop of significant fiscal and monetary drag relative to the past 2+ years, consensus estimates show the rate of change expansion in both growth and inflation is in rear view mirror. We believe this is the recipe for potential significant volatility in asset markets in the middle quarters of 2022. It is an environment very reminiscent of late 2018 which ultimately led to Jerome Powell's notorious early 2019 dovish pivot. If we were to fast forward twelve months, we would be surprised to see the Fed Funds rate three notches higher than it currently stands.

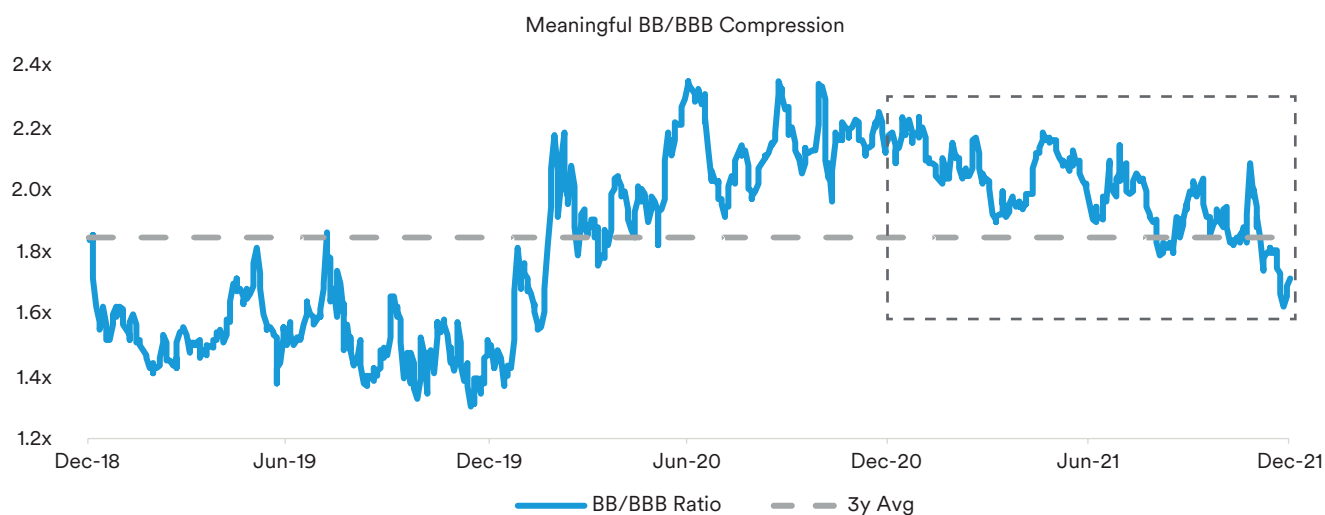
Figure 5 | Growth Expectations (%)

Source: Bloomberg

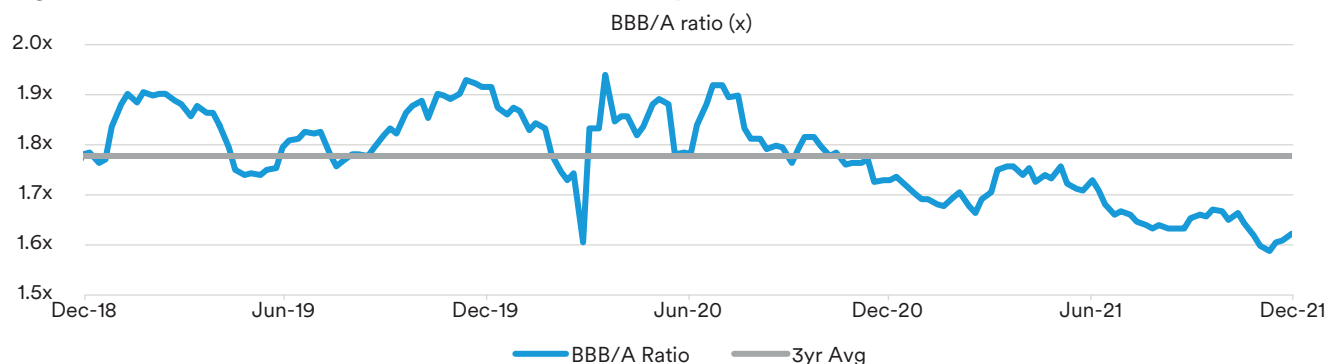
Figure 6 | Inflation Expectations (Year-over-Year, %)

Source: Bloomberg

Digging into IG credit, our outlook is similar to the past several quarters. Spread valuations in aggregate are slightly rich in our opinion and unlikely to grind significantly tighter, especially given the environment as described above. We instead focus themes for 2022 on curve positioning, liability management, ratings migration and, as always, issuer selection. While we have been touting BBB issuers relative to single A issuers for a number of quarters, we admit this relationship has compressed with a smaller and smaller number of BBB issuers still screening attractive. That said, we are weary of select A-rated companies that may be incentivized to engage in re-leveraging transactions and debtholder unfriendly activity, including in Industrials (like TMT and Healthcare) and Utilities. At such tight spreads navigating the potential intra-IG downgrades has become paramount.

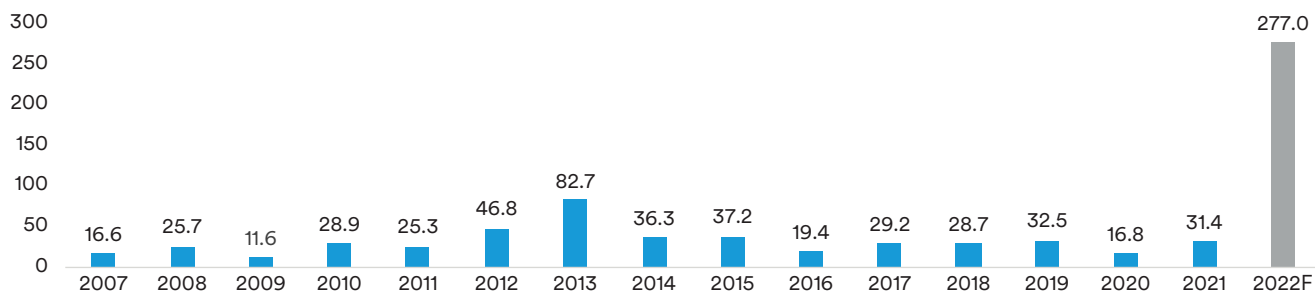
Figure 7 | The BB/BBB Spread Has Compressed Substantially in Recent Months

Source: Barclays

Figure 8 | The BBB/A Ratio Has Limited Room to Compress

From a corporate credit curve perspective, we continue to favor the 15–20-year part of the curve versus the 30-year sector as valuations, in relative terms, appear more attractive. In addition, we expect the theme of liability management to persist in 2022 and within this segment of the market, we are increasingly focused on 2038-2039 paper which currently trades to the cheapest point on the Treasury curve (20-year point) but will roll into the 10-year sector over the next 12-24 months. The robust supply, as noted above, also affords additional opportunities, where we can rotate to issuers we favor.

Similar to the spread convergence between As and BBBs, we have seen convergence within BBB/BB credit, especially in a number of fallen angels over the last year. We still see value in potential rising star credits as cross-over BB debt is poised for upgrades in the next few years; however, the magnitude of spread compression to be had is largely diminished in our view.

Figure 9 | Balance Sheet Improvements and a Rebounding Economy Have Pushed Rising Stars to the Forefront (\$B)

The emerging market sovereign and quasi-sovereign space has lagged corporates for most of this year and we believe there are some opportunities in this space on a relative value basis. However, as we have seen, political and policy dynamics can have a considerable bearing on performance and hence, we are paying close attention to key events that may drive return.

Endnotes

- ¹ Bloomberg
- ² Bloomberg
- ³ Bloomberg
- ⁴ Bloomberg
- ⁵ JP Morgan
- ⁶ Deutsche Bank
- ⁷ CBO

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