PUBLIC FIXED INCOME

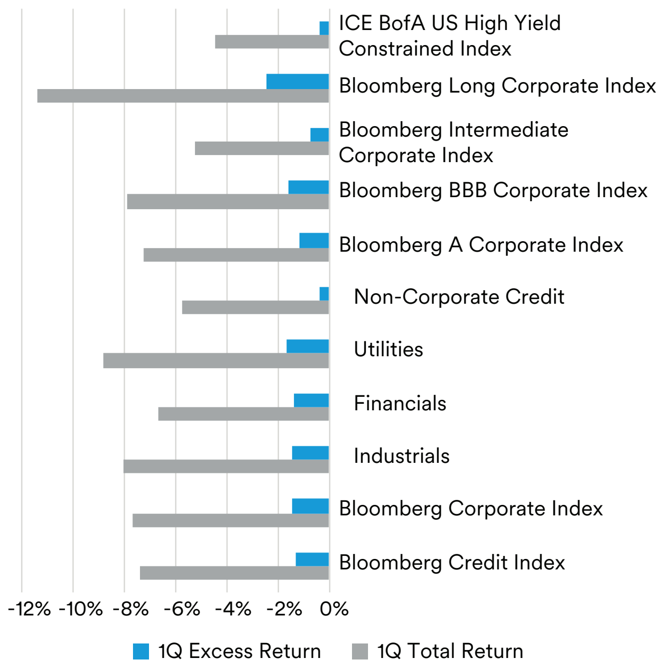
Investment Grade Corporate

Market Review and Outlook

March 31, 2022

The first quarter of 2022 was beset with elevated volatility and uncertainty as markets digested greater than anticipated inflation prints, the geopolitical events unfolding in Eastern Europe, and the forthcoming actions from the Federal Reserve. The CPI data for 2021 ultimately printed 7.5%[1] and the Fed continued to emphasize its more hawkish stance for achieving price stability and curtailing inflation. The 10-year Treasury yield started the year at 1.51% and steadily increased until Russia's invasion of Ukraine briefly pulled rates back before the path upward continued as Jerome Powell announced an expediated rate hiking schedule during the March FOMC meeting. Ultimately, the 10-year Treasury yield ended the quarter 83 basis points higher at 2.34%.[2] The MOVE index, a measure of interest rate volatility, spiked by over 80% intra-quarter only to end nearly 25% lower than the peak levels.[3] The effects of the Russia/Ukraine conflict are felt across the world as a sharp increase in commodity prices has shocked markets with natural gas rising 60% and Brent Crude increasing 64% intra-quarter before ending the period at $107/barrel.[4] Overall, the Treasury curve shifted upwards across all maturities with dramatic flattening led by the front end. The 2-year saw the most precipitous increase over the quarter, rising 160 basis points, leaving the 2s/30s curve 106 basis points flatter at a spread of 11 basis points and the 2s/10s curve 77 basis points flatter and slightly inverted.[5]

Figure 1 | Total and Excess Returns



Source: Bloomberg

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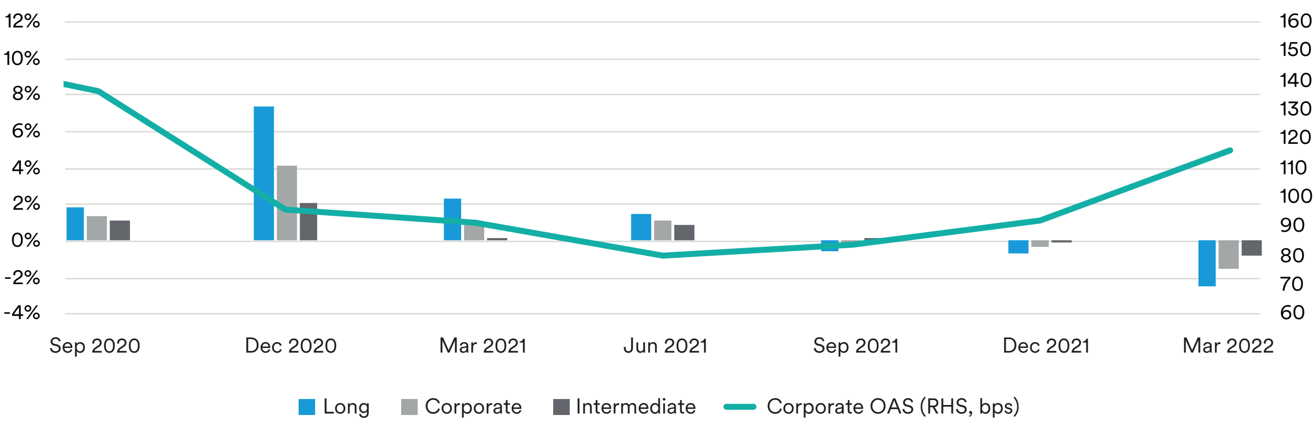
For the quarter, the Bloomberg US Credit Index generated a negative total return of -7.42% and lagged similar duration Treasuries, posting an excess return of -1.31%. The credit markets were far from immune to the macro volatility. Starting at a spread of 87 basis points, the index OAS reached a wide of 133 basis points in mid-March prior to the rates decision, then tightened to end the quarter at 107 basis points. For the same period, the yield on the index rose 127 basis points to close at 3.52%.[6]

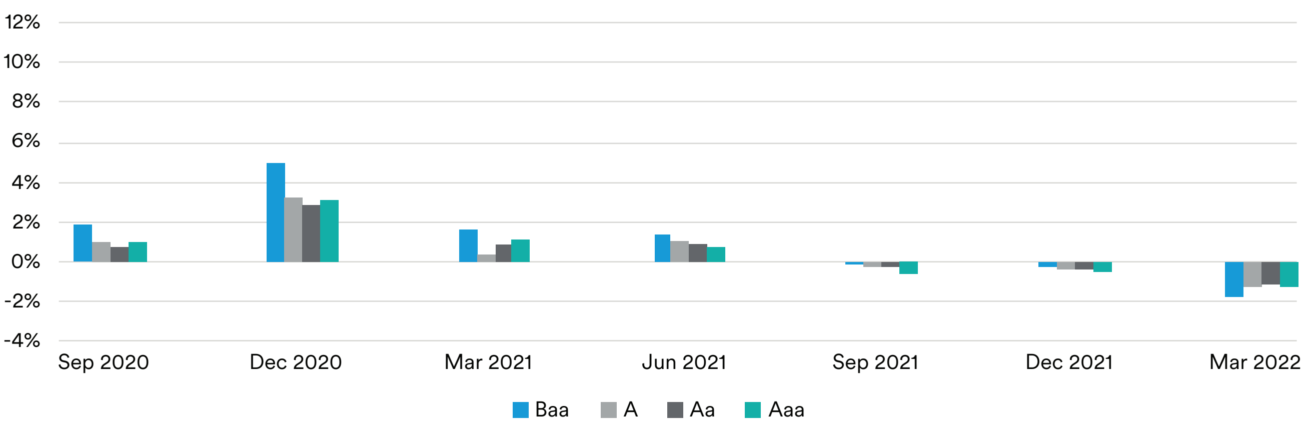
Across ratings and maturities, as shown in figures 2 and 3, investment grade spreads are back to levels last seen in 2020. Additionally, as shown in figure 4, excess returns were generally negative across sectors and maturities, with short and intermediate corporates outperforming their longer-dated counterparts. Breaking a trend over the past seven consecutive quarters, BBBs underperformed higher quality AAAs and As. Continuing a trend from the previous quarter, non-corporate credit outperformed corporate credit as Sovereign debt posted flat excess returns. Within the corporate credit subsectors, Independent Energy was the only sector to post a positive excess return. However, the entire energy sector, along with Metals and Mining, benefited from the surge in commodity prices and outperformed the broader market. On the flip side, Natural Gas within Utilities was the worst performing sector, weighed down by increased costs. Communications, Tobacco and Life Insurance were among the worst performers.

Figure 2 | Excess Returns by Maturity



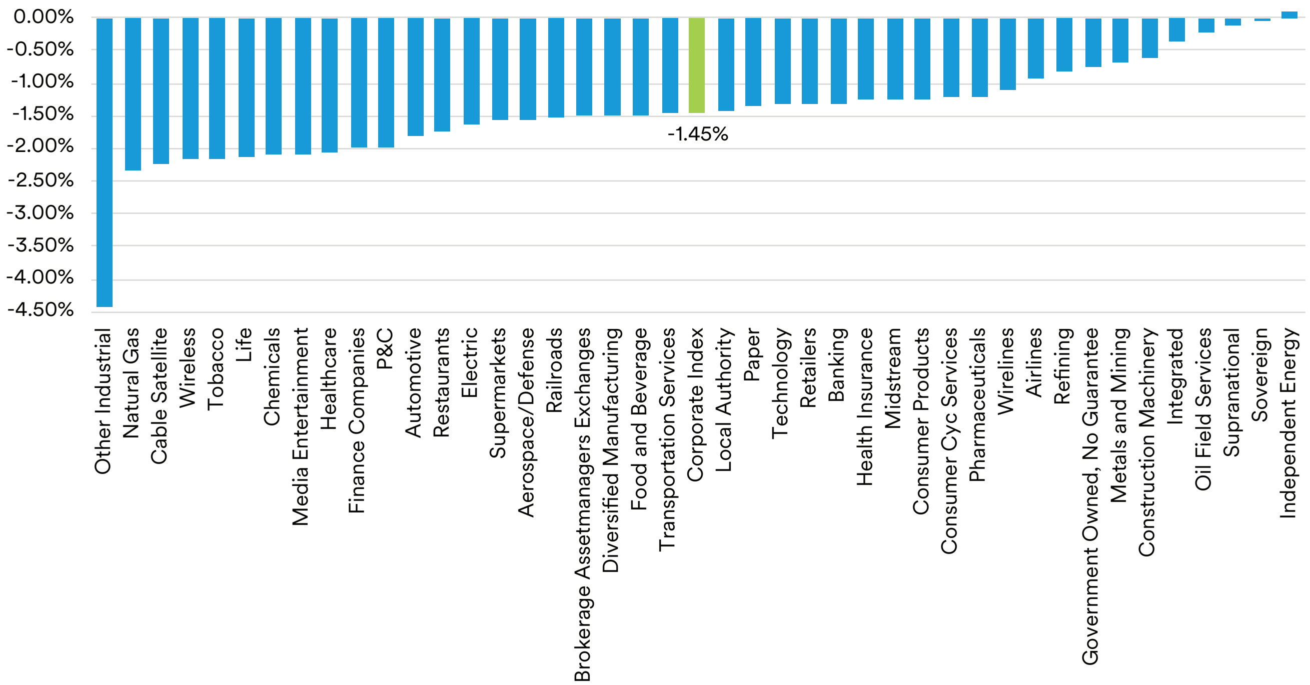
Source: Bloomberg

Figure 3 | Excess Returns by Rating



Source: Bloomberg

Figure 4 | Excess Returns by Sector



Source: Bloomberg

Figure 5 | Bloomberg US Corporate Index Snapshot

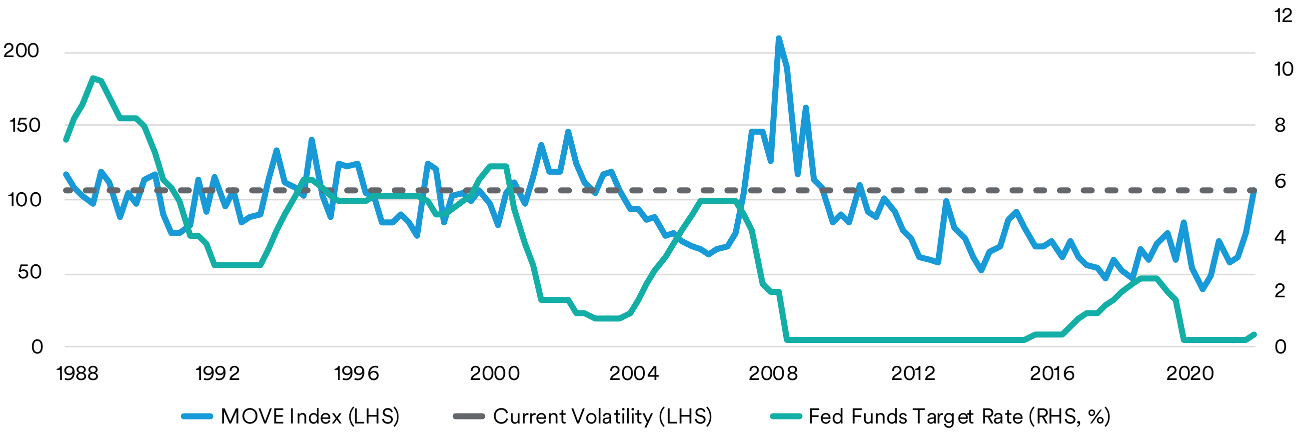
	Sector	OAS TSY	QTD OAS Δ	QTD YTW Δ	QTD Total Return	QTD Excess Return
Top 5 Sectors	Independent Energy	131	6	1.18%	-5.91%	0.11%
	Oil Field Services	135	11	1.04%	-6.88%	-0.21%
	Integrated Energy	85	8	1.09%	-6.65%	-0.37%
	Construction Machinery	50	8	1.34%	-5.37%	-0.60%
	Metals & Mining	151	11	1.05%	-7.64%	-0.67%
Bottom 5 Sectors	Life Insurance	152	34	1.30%	-8.61%	-2.12%
	Tobacco	180	8	1.29%	-8.60%	-2.15%
	Wireless	141	31	1.28%	-8.86%	-2.16%
	Cable & Satellite	155	25	1.13%	-9.83%	-2.21%
	Natural Gas	133	25	1.24%	-9.35%	-2.33%
Quality	A	94	19	1.27%	-7.30%	-1.22%
	Baa	140	27	1.31%	-7.94%	-1.70%

Source: Bloomberg

On the supply front, high grade bond supply of $461 billion was the second highest amount of issuance for the first quarter of the year on record, following only behind the first quarter of 2020. M&A-related debt issuance totaled $49 billion (with $99 billion announced and pending), highlighted by the fourth largest deal on record, a $30 billion deal in the TMT sector.[7]

The first quarter of 2022 witnessed historic drawdowns in financial assets and the fiscal and monetary contraction from unprecedented levels is just beginning. To date there has been only one rate hike, no reduction in Federal Reserve balance sheet, and fiscal comparisons that is beginning to lap the March/April 2021 round of stimulus. As shown in figure 6, despite being in the initial stages of contraction, interest rate volatility, as measured by the MOVE index, has spiked dramatically and has been higher only a handful of times since the 1988 inception. We suggest elevated volatility across financial assets will be a hallmark of the remainder of the year, and likely far eclipse levels seen in the first quarter across rates, Equities and credit spreads.

Figure 6 | Interest Rate Volatility is Elevated

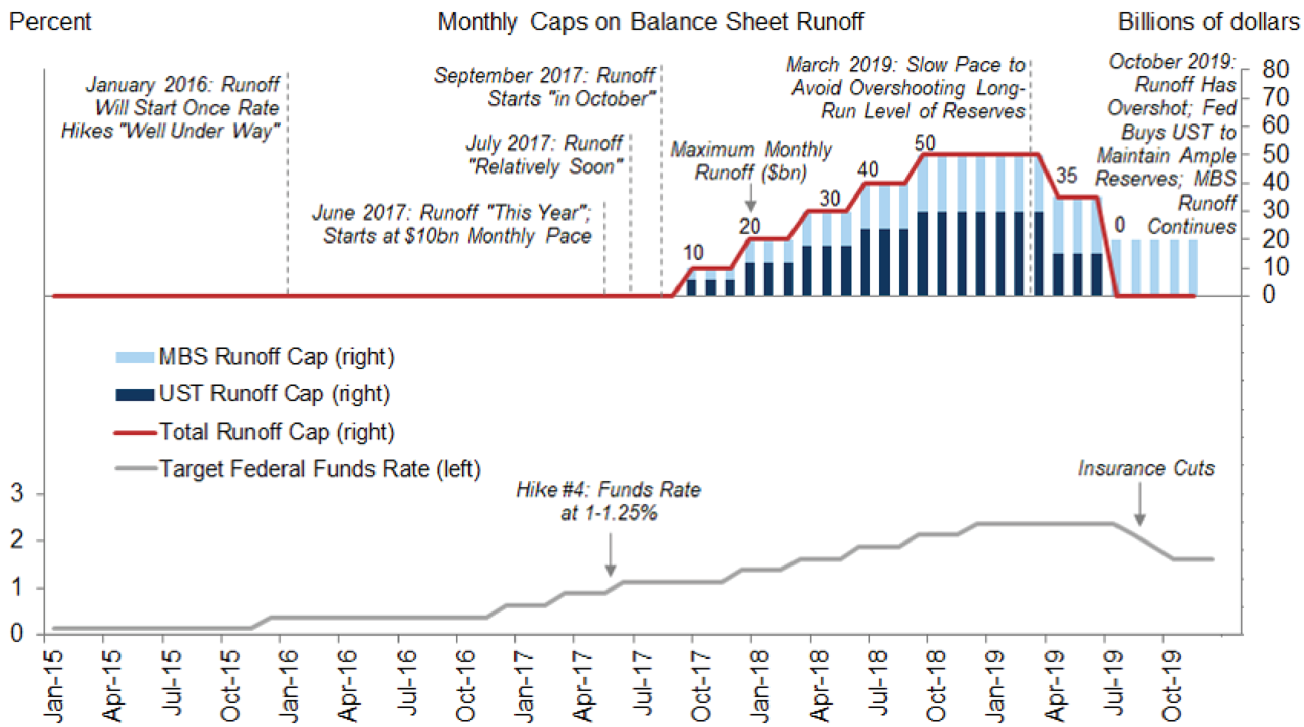


Source: Bloomberg

At the time of writing, market participants are pricing in nearly nine quarter point rate hikes by the FOMC by the end of 2022, roughly mirroring the 2004 cycle. Additionally, in the FOMC meeting minutes released on April 6th, the Committee has telegraphed balance sheet reduction of $95 billion ($60 billion Treasury and $35 billion RMBS) per month once fully initiated, an annual pace of over $1.1 trillion.[8]

While we certainly cannot be sure how such a rapid and aggressive retreat from fiscal stimulus and monetary accommodation will impact markets, we can only look back to the most recent cycle for guidance. For comparison and as shown in figure 7, the previous balance sheet reduction commencing in 2017 gradually increased from $10 billion to $50 billion per month and ultimately resulted in $725 billion total balance sheet reduction. Concurrently, the central bank raised the target from 0% to 2.5% gradually over three years. The 2018 balance sheet reduction and concurrent hiking cycle ended with a broad 20-30% equity drawdown, a near doubling of High Grade credit spreads, a nearly 250 basis point rise in High Yield credit spreads, and a 1.15% rise in 30-year mortgage rates. The Federal Reserve in early 2019 ultimately reversed course on balance sheet reduction and initiated a rate reduction cycle just seven months after the last 2018 hike.[9]

Figure 7 | Previous Balance Sheet Reduction



Source: Goldman Sachs

Against this backdrop, we are closely monitoring the situation of the average US consumer. Elevated prices, especially among food and energy, have remained higher for longer than we had previously anticipated, and this has the potential to place enormous pressure on consumers to substitute, cut back in other discretionary spending, or take on more debt. Additionally, housing prices that have risen dramatically since the onset of COVID are vulnerable due to increased financing costs. Mortgage rates have skyrocketed with interest rates, and while it's too early to see the impact on prices, historical experience suggests they are headed lower, effectively reducing home equity.

We often see the strength of the consumer balance sheet as a counterargument to these concerns, but we note this data is in aggregate and not evenly distributed. Remaining unspent stimulus and excess savings is concentrated among those not likely to spend it while the lowest income consumers' savings has ebbed below pre-pandemic levels and are experiencing negative real wage growth. We are beginning to see consumer credit increase which we don't see as a sign of confidence, but rather a sign of last resort.

Turning to credit markets, after one of the worst quarters on record for Investment Grade Credit, we see low probability for improvement of the current trend. Corporate spreads reside just 24 basis points wider than the beginning of the year after an aggressive, late quarter, short covering rally off wider levels. In mid-March, spreads on the corporate index tightened by over 12.5% in just three trading days.[10] This was the sixth fastest move since even before the 2008 financial crisis, with the other five occurring in March and April 2020 when the Fed announced unprecedented actions to save financial assets immediately after the onset of the COVID pandemic. We suggest this was driven more by low liquidity and investor positioning rather than warranted by fundamentals. In fact, while difficult to quantify, we suggest liquidity in the Investment Grade Credit market, as approximated by turnover, is amongst the poorest we have seen (figures 8 and 9). Additionally, the willingness of sell side traders to use balance sheet, on the long or short side, is plummeting the lowest levels we can recall, which serves to increase spread volatility both wider and tighter.

Figure 8 | Annualized Turnover

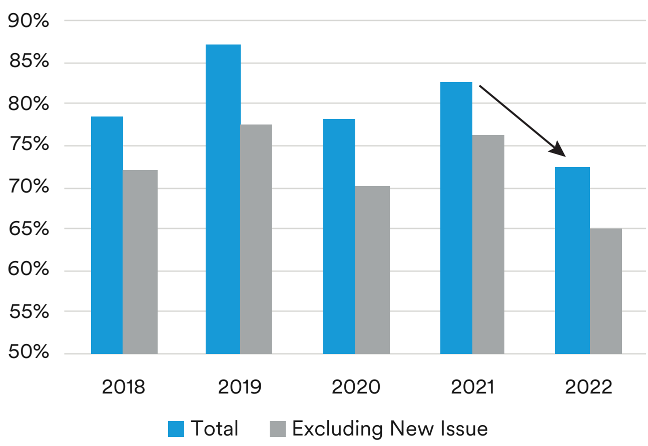
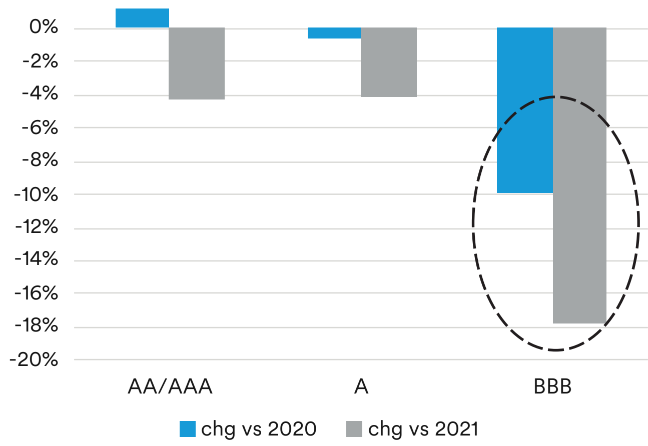


Figure 9 | Annualized Turnover Change



Source: Barclays

With respect to fundamentals, we are focused on the upcoming earnings releases for the first quarter period, especially as it relates to margins. Given the rapid and broad-based increase in input costs, we will be diligently monitoring which issuers are able to maintain profitability and those that are unable to exercise pricing power. As of yearend, fundamentals were supportive of tighter valuations with leverage back to pre-pandemic levels and strong coverage. With interest costs rising and elevated margin pressure, this quarter could signal a turn in what has been, for several quarters, a gradually improving fundamental backdrop.

In terms of current positioning, our risk remains at the low end of historical ranges. Market liquidity, as noted above, is poor but the primary market activity is quite high. In fact, as noted in our review, the first quarter was the second highest first quarter of new issuance ever. It is much easier to maneuver risk into portfolios via the primary market than reduce risk into the secondary market. Additionally, we currently are finding interesting opportunities in both the short and long end of the maturity spectrum. Due to the extreme flattening of the yield curve, we now find value in short-dated corporates that carry yields not seen in years. For example, the Bloomberg 1-5-year Credit Index currently yields 3.33%. This index yield averaged 0.96% for calendar year 2021. Short-dated corporates now have more than 3x the yield they had in the past year.[11] Alternatively, out the curve, due to the rapid rise in long term rates combined with low coupons of issuance the past few years, there are many securities trading at deep discount prices, in many cases in the $70s and $80s. In fact, the Bloomberg 10+ Year Corporate Index has declined in price by over $29 since August 2020.[12] To summarize, we currently favor both high yielding, short duration bonds and low dollar, longer duration corporates as attractive in the current environment.

Endnotes

1 Bloomberg
2 Bloomberg
3 Bloomberg
4 Bloomberg
5 Bloomberg
6 Bloomberg
7 JP Morgan
8 Bloomberg
9 Goldman Sachs
10 Bloomberg
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12 Bloomberg

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