

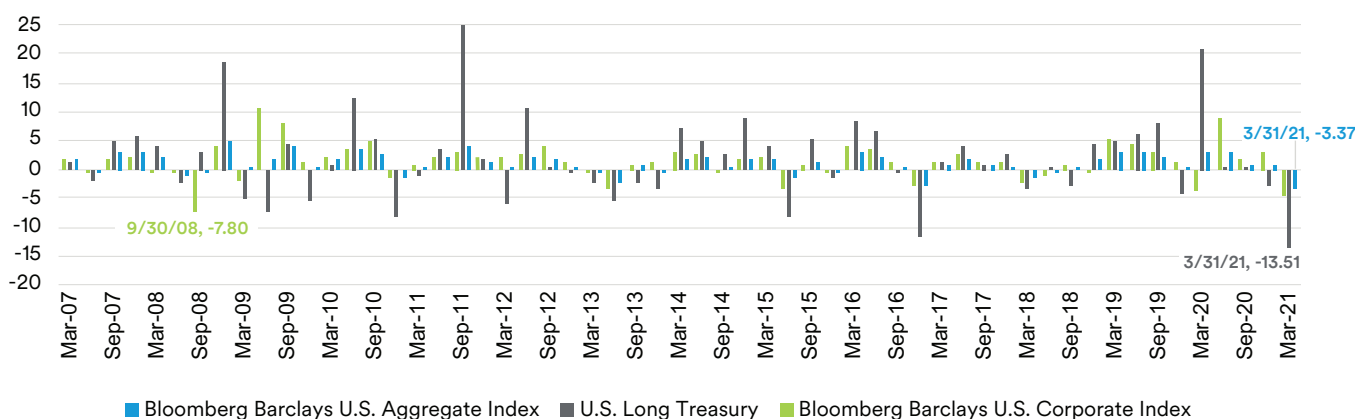
## PUBLIC FIXED INCOME

# Investment Grade Corporate Market Review and Outlook

March 31, 2021

In financial markets, asset class performance in the quarter was disparate. In fixed income, the story of the quarter was of spiking interest rates, with the 10-year note nearly doubling to end the quarter at 1.74%. However, the curve was markedly steeper as the Fed kept the front end pinned and the 2-year barely budged.<sup>1</sup> With coupons as low, and durations as long as they have ever been, the rise in rates resulted in historically poor returns for U.S. fixed income. As shown in Figure 1, the U.S. long bond and the Bloomberg Barclays U.S. Aggregate Index chalked up their worst quarter in forty years, generating total returns of -13.51% and -3.37% respectively.<sup>2</sup>

**Figure 1 | The IG Corporate Index Posted the Worst Quarterly Total Return Since 2008, and the U.S. Long Bond and U.S. Aggregate Index Posted the Worst Quarterly Total Return in Forty Years (%)**



Sources: Bloomberg Barclays

## Overall, the first quarter of 2021 has exhibited stark changes in the landscape for investors.

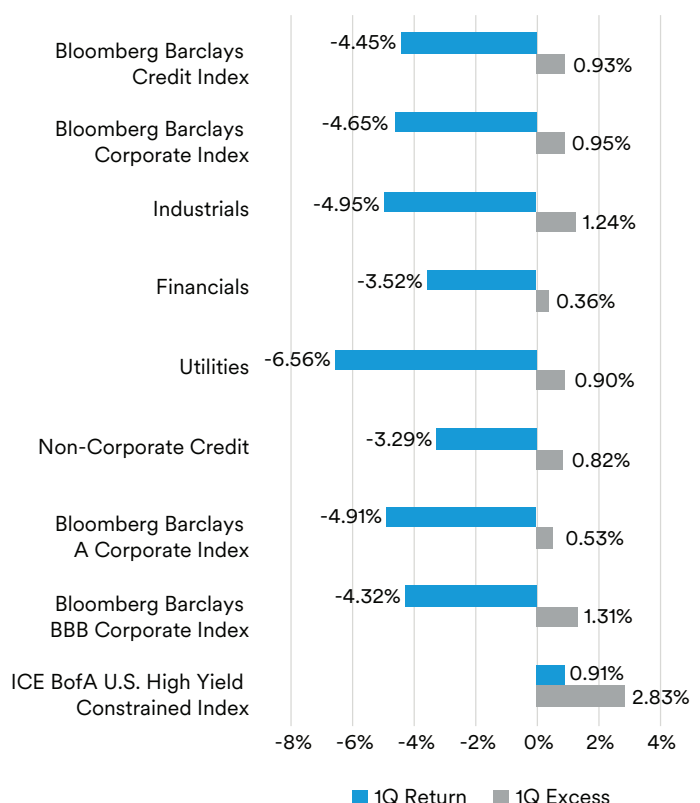
In early January, dual Democratic wins in the run-off Georgia elections resulted in a blue majority in the U.S. Senate giving the party of the administration full legislative control, albeit by the narrowest of margins in the House and Senate. As a result, while the party in control of the White House transitioned in January, the Biden administration lacks carte blanche power to enact the progressive agenda fully. Political power has shifted to the middle, with Senators Manchin, Collins, Sinema and Murkowski wielding significant influence in legislative negotiations, tempering the more ideologue wings of both parties.

One major force in the market that has not changed is the constant drumbeat of deficit financed, MMT-esque fiscal and monetary stimulus. While many of the emergency facilities have expired quietly without market impact, notably the Corporate Credit purchase program, the Federal Reserve spigots remain wide open with monthly purchases of \$80 billion treasuries and \$40 billion MBS.<sup>3</sup> On the fiscal side, the late 2020 \$900 billion package passed by the previous administration was quickly followed in March with an additional \$1.9 trillion wide-ranging stimulus program. Notably, the most recent bill passed the senate with a 50/49 vote via the process of reconciliation and only after the controversial federal minimum wage, not supported by Democrats Manchin or Sinema, was removed.

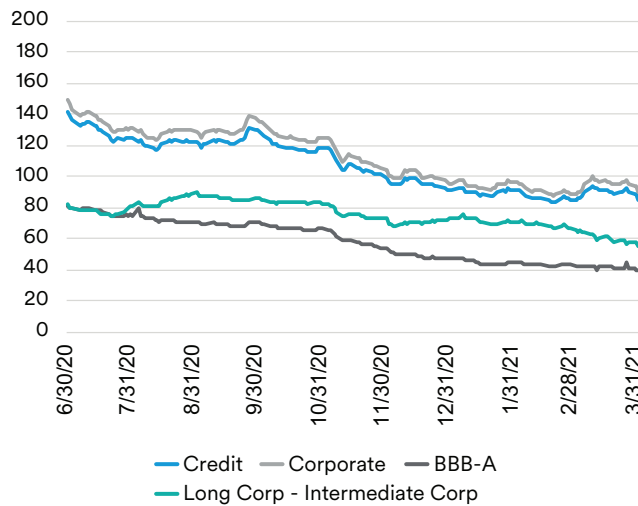
Elsewhere in the markets, commodities soared as supply bottlenecks combined with extreme demand from manufacturing and homebuilding sectors pressured prices higher. Oil and copper rose 21.9% and 13.5% respectively in the quarter. Prices in soft commodities such as lumber, corn and soy also rose markedly. Equities ended the quarter higher amidst falling volatility, but results were mixed. The bellwether S&P500 rose 5.8%, however as investors exhibited concern about rising rates and nosebleed valuations, the NDX100 was only able to rise 1.6%. The small cap Russell 2000 returned a strong 12.4% on reopening optimism.<sup>4</sup>

Investment grade credit spreads traded in a narrow range with the Bloomberg Barclays U.S. Credit Index OAS ending the quarter six basis points tighter to close at 86 basis points. On a total return basis, the index plunged into negative territory with a -4.45% total return. Credit outperformed equal duration treasuries with 93 basis points excess return. The yield on the index ended the quarter 51 basis points higher at 2.19%. The source of positive excess return for the quarter primarily came from the long end as it significantly outperformed the rest of the curve posting an excess return of 2.36%. Overall, Corporate credit outperformed Non-corporates with excess returns of 0.95% and 0.82% respectively.<sup>5</sup>

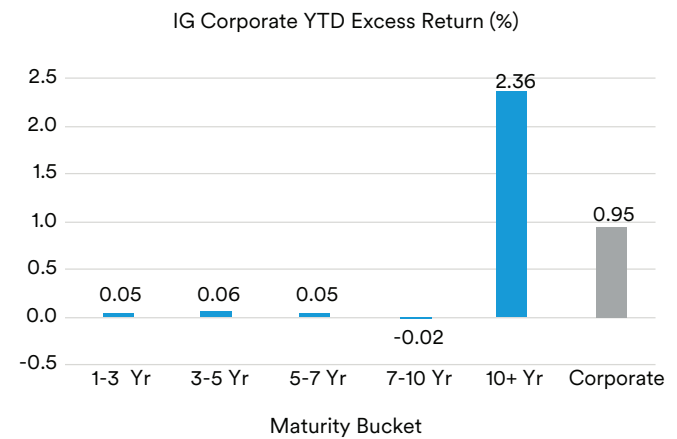
**Figure 2 | First Quarter Total and Excess Returns<sup>1</sup>**



Source: Bloomberg Barclays

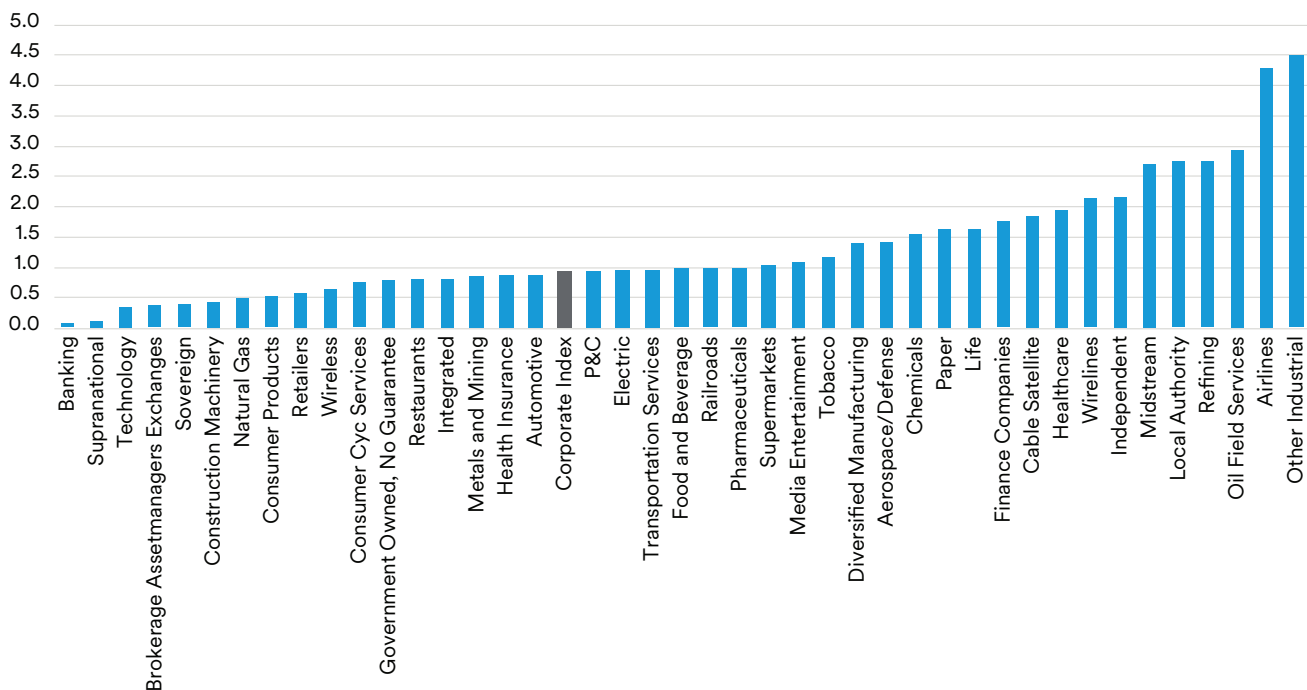
**Figure 3 | Credit Spreads Continue to Trade in a Tight Range (basis points)**

Sources: Bloomberg Barclays

**Figure 4 | Long End Corporates Have Significantly Outperformed Shorter Dated Paper in YTD Excess Returns (%)**

Sources: Bloomberg Barclays

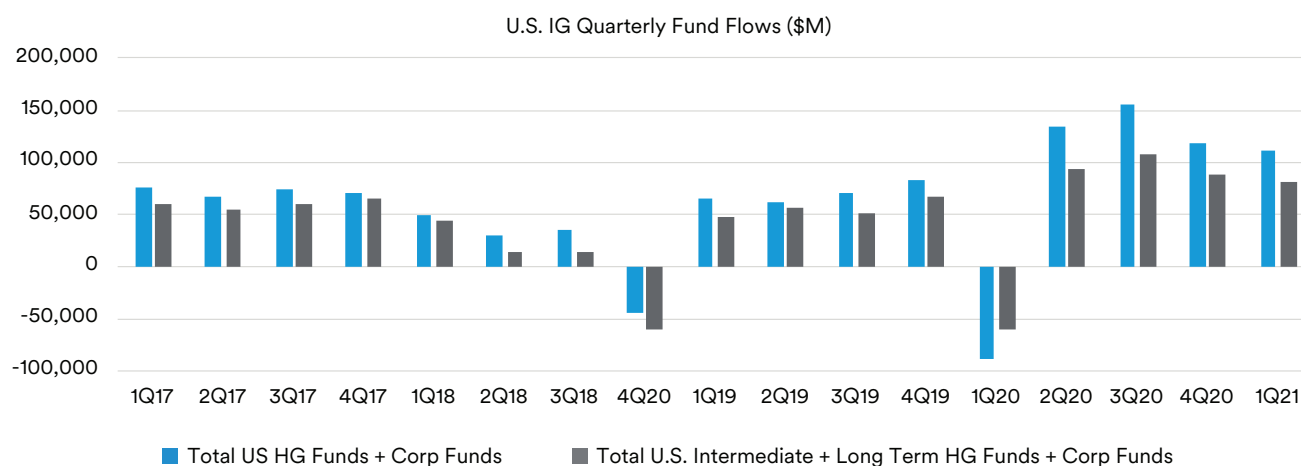
With the exception of Packaging, all of the corporate sub-sectors outperformed equal duration Treasuries despite posting negative total returns. Similar to last quarter, commodity-related and COVID-19 impacted sectors continue to outperform on improving economic expectations and vaccine progress. Airlines, Oil Field Services, Midstream, Refining and Wirelines led the gains, while Banking, Technology, Consumer Cyclical, REITs apart from Retail, and Wireless underperformed but still generated positive excess returns. Corporate BBBs continue to outperform higher quality credits posting an excess return of 1.36% versus 0.45% for As.<sup>6</sup>

**Figure 5 | 1Q 2021 Credit Excess Return (%)**

Source: Bloomberg Barclays

Primary market activity in IG corporates remained elevated in the quarter. With the exception of 2020, supply has surpassed all previous first quarter levels by 10%, totaling over \$400 billion. The fast pace of new issuance was driven by a surge of M&A financing in March, which was double the amount issued in January and February, bringing total issuance to \$75 billion for the quarter. Further, despite negative returns, as shown in Figure 6, demand remains robust with solid net inflows of over \$100 billion into U.S. investment grade funds.<sup>7</sup>

**Figure 6 | Strong IG Fund Inflows Despite Negative Total Returns**



Source: J.P. Morgan

Several key themes loom large on our radar screen as we look towards the rest of the year. Front and center is certainly the COVID-19 pandemic entering a new phase of global vaccine distribution, and economic activity returning to normal amid relaxed restrictions. We anticipate vaccine administration to continue apace, and by mid-second quarter the entire country should be free of business and social restrictions that currently remain in place. We caution however that the “reopening” narrative may not ultimately provide as much of a growth boost as hoped, mainly because many areas of the U.S. are currently open and have largely returned to normal. Local perspective of investors in the northeast is likely clouded by local COVID response and lingering restrictions. However, much of the south of the U.S. has resumed normal economic activity, and thus, there is less of a reopening boost to be had.

As noted in our previous quarterly outlook, the economic data is about to literally jump off the charts. As we lap the most severe data points of the early pandemic, rate of change and year over year data will break records. Additional tailwinds remain in the form of continued and persistent central bank stimulus and the recent \$1.9 trillion fiscal response. Furthermore, there is potential for additional fiscal spending in the form of infrastructure, however that legislation is in its nascent stages. The Federal Reserve has openly moved to an average inflation target framework and won’t be moving rates this calendar year. While much ink has been spilled recently about inflation and rising prices in certain parts of the economy, and we are keenly watching wages and employment to ascertain whether durable inflation is taking hold amidst ultra-powerful disinflationary forces of demographics and technology.

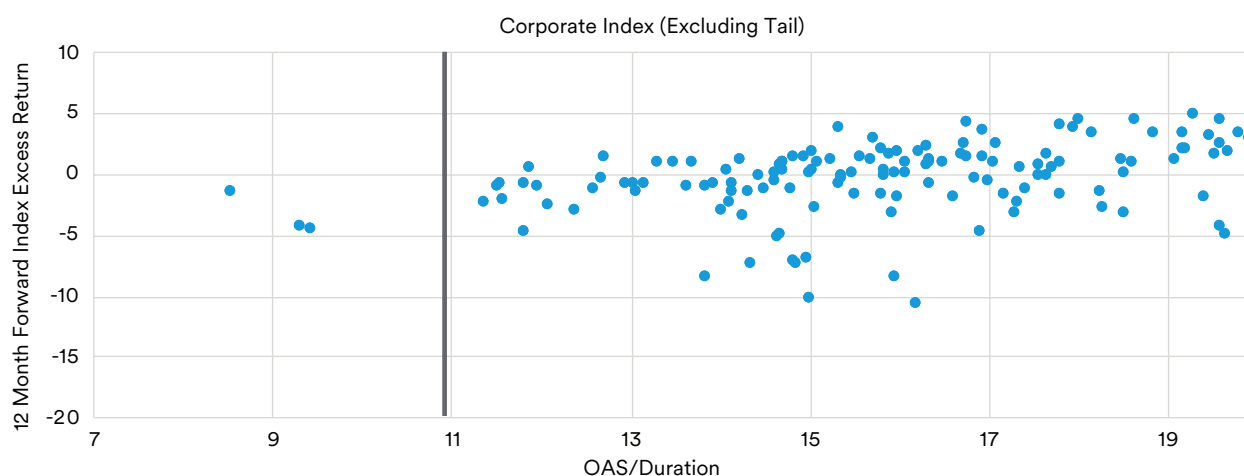
From a fundamental perspective, pandemic depressed earnings and record issuance has left investment corporate balance sheets over-levered for their ratings with debt ratios more than a full turn higher than pre-pandemic highs. While a negative on the surface, the current state of balance sheets could limit bondholder unfriendly activity as shareholders and lenders are aligned with respect to balance sheet repair. That being said, the siren call of M&A and return of cash to shareholders may be too strong to resist. We wouldn’t be surprised to see continued M&A announcements and are closely watching for continued

migration into the BBB cohort. In fact, in the first quarter, a historically strong single A issuer opted to migrate to the BBB bucket, returning a slug of cash to shareholders and issuing billions in additional debt. Additionally, previous deleveraging trends in the wireless space have stalled out as these issuers will be taking on more debt to finance C-Band auction purchases. At current valuations, we believe avoiding re-leveraging or leveraging M&A situations will be key to generating alpha for the foreseeable future. In the aggregate however, against the backdrop of already stretched balance sheets and a pick-up in economic activity, we are hopeful to see fundamentals trending in a positive direction from a bondholder perspective.

We also find technicals to be supportive of credit spreads. Last year's record new issuance was easily absorbed by the market, both domestic and foreign. As noted in the review, and surprising to us, flows into IG corporates remained strong in the first quarter in the face of dismal total returns. U.S. credit markets also remain attractive globally from a relative value perspective, and even more so given the recent increase in yields. Market forecasts for 2021 are for \$1.2 trillion in new issuance,<sup>8</sup> but as rates have increased, many issuers have accelerated liability management exercises (LME) to retire higher coupon debt sooner than previously expected, which could result in higher volumes. We expect LME trends to remain a key theme in 2021 and look to position portfolios in securities and parts of the credit curve that may benefit. The increased liquidity in 15 to 20 year maturities, largely due to the growth of the 20 year Treasury, is an area of focus and provides opportunities to both extend from 10 year and shorten from 30 year holdings into more attractive bonds. Elsewhere on the curve, we continue to look for roll down opportunities provided by the steepness of the 2s/5s and 2s/10s curves.

While technicals remain supportive of investment grade corporate spreads, valuations remain less compelling. Because of the significant downward move in rates in 2020, the duration risk in markets is significantly greater than it was when we last saw these spread levels; and adjusting for credit quality and duration, spreads are well through historical tightness. From these valuations, as shown in Figure 7, there has never been a 12-month forward positive excess return as measured by spread compensation per unit of duration. Furthermore, any recovery is likely to be uneven and the longer lasting impact of the pandemic on sectors such as travel related, Retail, Technology, and Energy remain to be seen; whereas more resilient sectors are likely to perform better as consumer spending and corporate profits pick up. Of course, the bifurcation does not stop at the sector level, and performance is likely to vary widely across names, within ratings cohorts, and across the curve. Therefore, we believe security selection will continue to play a crucial role in portfolio construction and alpha generation will likely be driven by opportunistic positioning in select names and at select points on the curve; and not through beta trades and large-scale sector themes.

**Figure 7 | At the Current Low Levels of Spread per Unit of Duration, Historically the Corporate Index Delivered Negative Excess Returns on a 12-Month Forward Basis**



Source: Bloomberg Barclays



We came into the year conservatively positioned on the view that valuations were stretched and did not adequately compensate investors for the multitude of risks in the market. This positioning has allowed us to actively participate in the healthy new issue market and selectively add to opportunistic positioning. Outside of the index, we continue to monitor the relative value between investment grade issuers and fallen angels in comparable sectors to identify High Yield opportunities, and in non-corporate credit, the supportive macro backdrop and weaker U.S. dollar have presented opportunities in select Emerging Market Sovereign/Quasi names to pick up additional yield. Overall, our focus continues to be on seeking out opportunities in select intermediate and longer duration bonds, while taking advantage of robust new issuance, market dislocations, and further volatility to uncover attractive entry points.

### Endnotes

- <sup>1</sup> Bloomberg
- <sup>2</sup> Bloomberg Barclays
- <sup>3</sup> Bloomberg
- <sup>4</sup> Bloomberg
- <sup>5</sup> Bloomberg Barclays
- <sup>6</sup> Bloomberg Barclays
- <sup>7</sup> JP Morgan
- <sup>8</sup> Bloomberg

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<sup>2</sup> As of December 31, 2020. Includes all public fixed income assets managed by MIM. estimated fair value. Includes MetLife general account and separate account assets and unaffiliated/third party assets

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