PUBLIC FIXED INCOME

Investment Grade Corporate

Market Review and Outlook

March 31, 2023

The first quarter of 2023 opened with a risk on sentiment and positive returns, but shifted sharply amidst bouts of volatility in the late innings of March 2023. The welcomed weakness in January's inflation data coupled with investment grade supply technicals, specifically weak issuance from the banking sector as well as long dated industrials, spurred a short-lived credit rally marking January the third consecutive month of which spreads tightened. The Federal Reserve (FED) slowed the pace of hikes at the February FOMC meeting to 25 basis points on the back of a declining, but still elevated year-over-year inflation rate of 6.4%. Moreover, issuers sought funding in a big way marking a record in issuance for February which, in our opinion, initially pressure credit spreads wider across the curve. As the quarter continued, markets saw a significant uptick in volatility as tightened monetary policy worked its way through the system witnessed by the ICE BofA MOVE index, a reference for fixed income treasury volatility, increasing from a level 110 basis points on February 14th to 198 basis points on March 15th—an 80% increase and a level not seen since 2008. The indicator considerably increased on March 9th as markets digested unsettling news around liquidity challenges in the banking sector which culminated with the collapse of Silicon Valley Bank (SIVB) on March 10th. In an effort to quell liquidity fears, the Federal Reserve in coordination with the US Treasury, Federal Depository Insurance Corporate (FDIC) and President Biden created the Fed's Bank Term Funding Program (BTFD) to help support liquidity and enhance the protection of uninsured depositors at Silicon Valley Bank and Signature Bank. Furthermore, we believe, the facility was created to help contain potential contagion across the banking sector by limiting forced sales of securities' books to deal with liquidity needs and lower the likelihood of another potential bank run.[1]

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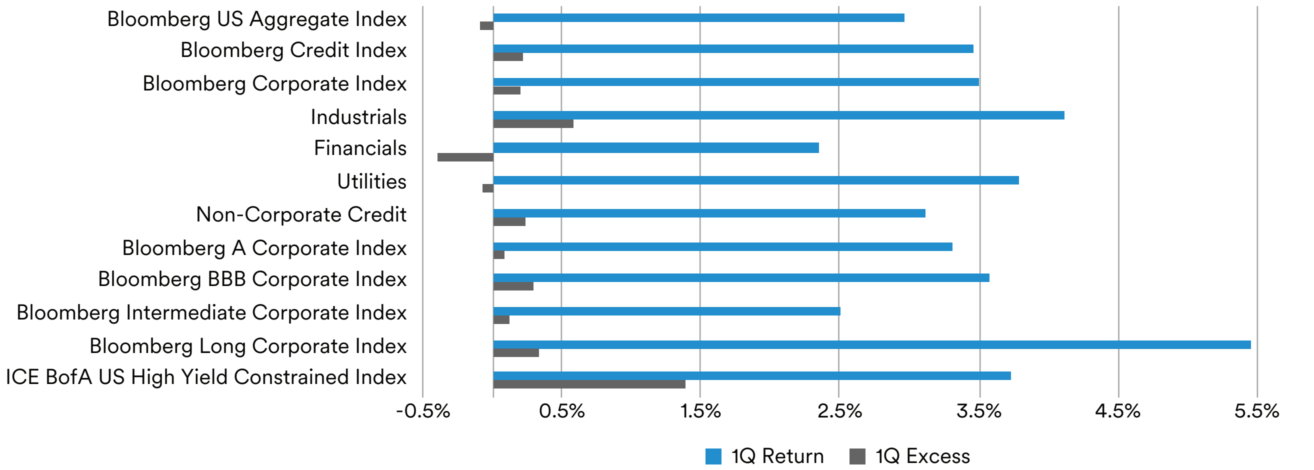
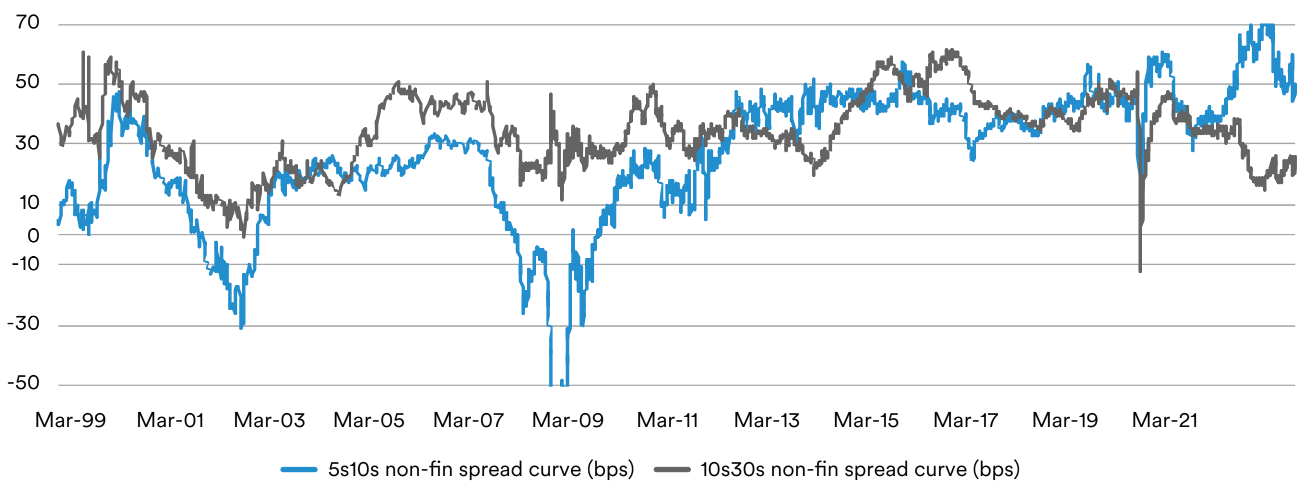
Figure 1 | First Quarter Excess and Total Returns



Source: MIM, Bloomberg L.P.

The Banking sector turmoil bled over to Credit Suisse, with FINMA, the Swiss Financial Market Supervisory Authority, ushering an acquisition by UBS in a historic moment for the Swiss banking industry. Shortly thereafter, the FED followed through on their guidance with another 25 basis point rate hike at the March FOMC meeting in the wake of the recent financial turmoil as they reiterated their fight against inflation. It is worth noting that the recent stress in certain pockets of the banking system around deposit bases have, in our view, altered the FED's view on additional rate hikes as there is a belief that tightened credit standards may constrain growth more than previously thought. Over the course of these bouts of volatility we saw the 2s/10s invert by as much as 107 bps before flattening to -43 bps as investors reassessed their views on the interest rate outlook. Additionally, as shown in Figure 2, the 10s/30s credit curve remains flat, while 5s/10s continue to normalize from historically steep levels.

Figure 2 | 5s/10s and 10s/30s Credit Curve



Source: Bank of America Research

Over the quarter excess returns, as shown in Figure 3, were generally supported by the Industrials space as Financials detracted. The recent events in regional banks of the banking sector spilled over broadly into the Finance sector and put the spotlight on weaknesses in Commercial Real Estate and REITs. More specifically, Office REITs was the largest detractor from excess returns as vacancies climbed in higher rent districts affected by an underwhelming return-to-office cohort. Like Office REITs, we also saw Retail REITS detract from the quarterly excess returns. Life Insurance was another underperformer during the period as concerns mounted over the asset side of the balance sheet due to contagion risk from banks and their exposures to commercial real estate. Of note on Banks, the bail-in of the CS Additional Tier 1 Contingent Capital Notes (AT1 / CoCo's) put pressure on all Financial sectors before they re-traced some of the widening into quarter-end. On the bright side, the high beta Communications sector was a strong performer despite high volatility during the period. The sector in general was able to withstand the market widening that was driven by the Financials sector. Additionally, the Airlines sector outperformed as US and International travel continued to recover, prompting US carriers to raise first and second quarter capacity guidance.

More broadly throughout the course of the quarter, non-corporate credit outperformed corporates. Within the index, the Long Corporate segment (+0.34% excess) outperformed the Intermediate Corporate segment (+0.12% excess) and its shorter-dated counterparts, while BBB spreads converged closer to single-A credit.[2]

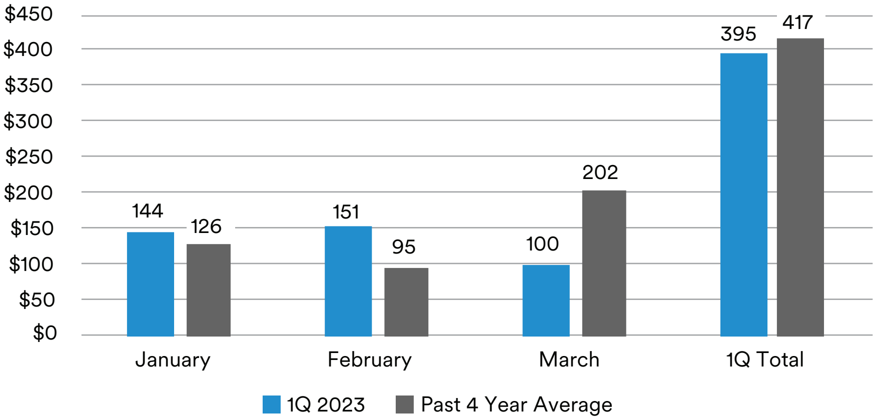
Figure 3 | US Corporate Snapshot

	Sector	OAS TSY	QTD OAS Δ	QTD YTW Δ	QTD Total Return	QTD Excess Return
	Bloomberg US Credit Index	**129**	**8**	**-0.27%**	**3.45%**	**0.21%**
	Bloomberg US Corporate Index	**138**	**8**	**-0.26%**	**3.50%**	**0.20%**
Top Corporate Sectors	Media & Entertainment	162	-19	-0.53%	5.65%	2.13%
	Communications	153	-7	-0.41%	4.99%	1.20%
	Aerospace & Defense	120	-4	-0.41%	4.80%	1.19%
	Wirelines	143	-7	-0.40%	5.18%	1.16%
	Airlines	198	-20	-0.52%	3.22%	1.04%
Bottom Corporate Sectors	Retail REITs	176	27	-0.08%	2.22%	-0.70%
	Brokerage/Asset Managers	156	37	0.01%	2.08%	-0.96%
	REITs	199	40	0.04%	1.48%	-1.44%
	Life Insurance	200	30	0.00%	1.49%	-2.05%
	Office REITs	337	142	1.05%	-3.25%	-6.28%
Quality	A	118	9	-0.25%	3.31%	0.09%
	BBB	168	9	-0.25%	3.57%	0.29%
Maturity	Intermediate	127	11	-0.23%	2.50%	0.12%
	Long	160	2	-0.31%	5.45%	0.34%

Source: MIM, Bloomberg L.P.

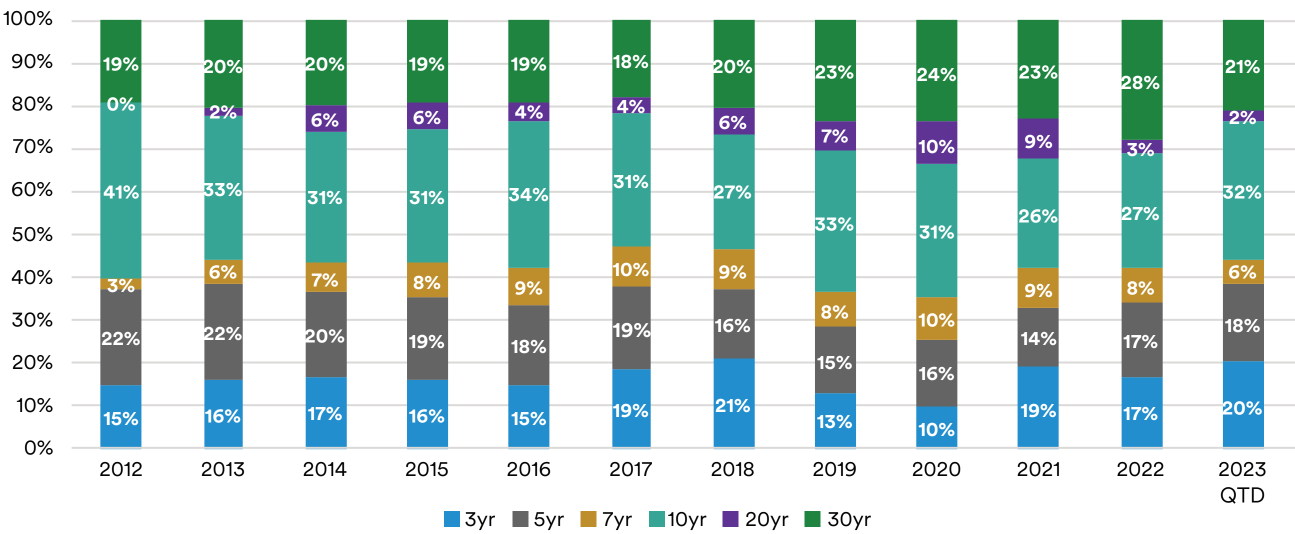
First quarter supply, as shown in Figure 4, totaled $396bn—only down 5% compared to the past four-year average of $417bn as issuers secured their funding needs in January and February. February posted its highest issuance on record for the calendar month, making up $151bn of supply, while March issuance was the lowest since 2012 as the primary markets were fully closed for a week following the regional banking turmoil. Within Financials, Yankee Banks led the way with $88bn in new issuance while US Banks lagged, posting $30bn of total supply. In Non-Financials, Utilities and Healthcare/Pharma made up the largest share of supply with $45bn in new issuance.[3]

Figure 4 | High Grade Supply



Source: MIM, JP Morgan

Figure 5 | Investment Grade Total Gross Issuance to Date



Source: MIM, JP Morgan

It has long been our view that the Fed's unrelenting focus on dampening inflation would have unforeseen consequences, and ultimately result in something "breaking". This has been the backbone of our more cautious stance on valuations and the above average allocation to Treasuries as a source of liquidity for a spread widening event. We did not, however, envision the well-capitalized and highly regulated Banking sector would become the source of the break. The spate of bank failures, culminating with Credit Suisse's absorption by UBS, clearly has introduced a more complex headwind to the already uncertain macroeconomic backdrop. As a fundamental credit manager, this variable is particularly uncomfortable, given that depositor psychology does not dovetail nicely alongside a more traditional framework of credit analysis. At the time of this writing, tensions in the sector seem to be cooling as the Regional and Yankee banks are finding more solid footing. Nonetheless, we are keenly aware that in the age of digitization and social media-induced hysteria that further flare-ups could be just a mere "tweet" away. Undoubtedly, our positioning within Financials will remain of paramount focus, as increasing bifurcation in the sector is creating significant opportunity (of course, not without its attendant risks).

More broadly, we believe the banking crisis is inherently deflationary and will likely lead to tighter lending standards, which should aid in the Fed's mission to reduce inflation. This dynamic may pull forward the timing of a recession and certainly impacts how we are thinking about portfolio positioning. At a high level, finishing the quarter a mere six basis points off the year's starting option-adjusted spread (OAS) level, it is difficult for us to get too excited about the prospects for credit. We still believe that valuations are too frothy for an economy on the brink of recession amidst a likely steady deterioration in credit fundamentals. Against what we would deem to be an asymmetric risk/reward profile for high grade corporates, we still believe it makes sense to maintain a sizeable Treasury allocation that we can deploy into progressively wider levels of spread—acknowledging the difficulty in calling the bottom and aggressively allocating at such a point in time. As we wrote more extensively about last quarter, we still believe a more durable bid for fixed income given the healthy yield environment will put a lower ceiling on spreads than we have seen in previous recessions.

Meanwhile, we continue to find opportunities to do something that we are often vocal in cautioning against, and that is, upgrading portfolio quality. We find such trades to often be accompanied by excessive transaction costs, but those costs have greatly diminished now as it is the more defensive issuers who are frequently patronizing the new issue market. Sectors like Pharmaceuticals, Healthcare, and Utilities are among the subsectors seeing the biggest year-over-year changes in issuance (and which you may be hard pressed to find us espousing the virtues of in previous outlooks). We are finding value in the more inflation-resistant issuers who are coming to market during a volatile time and paying elevated concessions to do so. We welcome the elevated liquidity offered by these new issues, as off-the-run issues continue to lag their on-the-run peers. Meanwhile, sector dispersion remains high and with investors still willing to differentiate sectors based on fundamentals, rather than traditional beta stereotypes, we are finding opportunities to rotate exposures away from more cyclical sectors and better protect portfolios against a recession without a meaningful sacrifice in yield.

Away from our conservative positioning, we are still finding value in the front end of the credit curve. Inverted Treasury curves and flat credit curves (depending on tenor) are still offering a historically attractive opportunity to shorten spread duration without sacrificing yield. While we do not expect a substantial tightening of spreads, we believe building this portfolio level yield advantage allows us the patience and flexibility regarding the timing of a spread widening event.

For those portfolios that allow "plus" sector allocations, we do not believe now to be an optimal time to increase our exposure in those areas. High yield in particular is a tool in the tool kit that we find most valuable when we are highly constructive on risk—a view we do not hold today. High yield can also be quite additive as a way to bolster our yield advantage when a dearth of such opportunities exists in the high grade market. That is not how we would describe today's market, where the higher yielding segments of the high grade market compete quite favorably with many BB issuers. Additionally, current conditions do not seem ripe for a wave of rising stars that could drive further spread compression. None of the above is to suggest individual situations within these "plus" sectors do not warrant consideration as we are always looking for such opportunities, but broadly we are inclined to eschew high yield until we see a material cheapening of valuations.

Above all, the events of the first quarter have proven once again the importance of security selection, and how not only issuer selection, but individual securities within an issuer's capital stack can have a meaningful impact on performance. We continue to believe security selection will remain of paramount importance, and avoiding the losers will be just as critical as identifying the winners. As challenging as the first quarter was, we recognize—to borrow a well-worn but apt cliché—this is marathon not a sprint, and we have great conviction that our portfolios are positioned to do well in what we believe will continue to be a challenging period for credit.

Endnotes

1 Bloomberg L.P.

2 Bloomberg L.P

3 JP Morgan

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