PUBLIC FIXED INCOME

Investment Grade Corporate

Market Review and Outlook

June 30, 2023

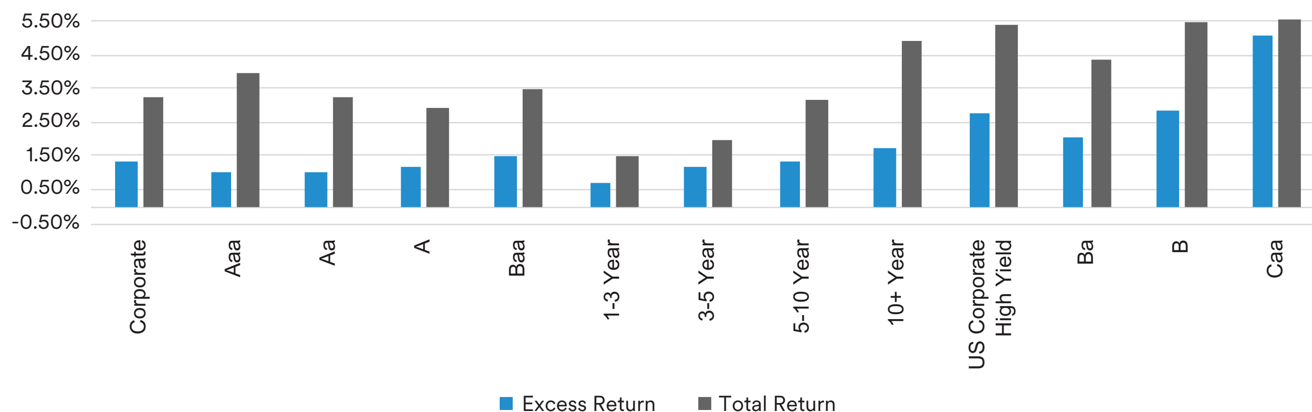
	2Q Total Return	2Q Excess Return[1]	YTD Total Return	YTD Excess Return[1]
Bloomberg US Aggregate Index	-0.84	0.59	2.09	0.52
Bloomberg Credit Index	-0.31	1.26	3.13	1.51
Bloomberg Corporate Index	-0.29	1.31	3.21	1.56
Industrials	-0.44	1.25	3.67	1.88
Financials	0.21	1.59	2.57	1.24
Utilities	-1.19	0.63	2.55	0.58
Non-Corporate Credit	-0.47	0.98	2.63	1.23
Bloomberg A Corporate Index	-0.4	1.17	2.9	1.3
Bloomberg BBB Corporate Index	-0.1	1.49	3.47	1.83
Bloomberg Intermediate Corporate Index	-0.16	1.1	2.33	1.25
Bloomberg Long Corporate Index	-0.54	1.7	4.88	2.13
ICE BofA US High Yield Constrained Index	1.64	2.77	5.42	4.25

Source: Bloomberg L.P.

MetLife Investment Management

The second quarter of 2023 began just as the aftermath of the turmoil in the banking sector started to subside. Despite the lingering risks, the Bloomberg US Credit Index OAS closed the quarter at 114 basis points, grinding 15 basis tighter over the period and 7 basis points tighter since the start of the year.[1] From a macro perspective, central banks both domestically and abroad continued their fight on taming stubbornly high inflation at the expense of the known and unknown effects of tightened monetary policy. The Federal Reserve (Fed) hiked rates an additional 25 basis points to 5.25% despite a hawkish pause at their June meeting to gauge the effects of the previous ten consecutive rate hikes. Before the May FOMC meeting, markets were priced for nearly 2 rate cuts by year end. At the end of the 2nd quarter, markets priced were priced for 1 more hike by year end and no cuts. Toward the end of May a tentative agreement was reached raising the debt ceiling for two years, relieving anxiety around potential default on U.S. government debt. This resolution aided a reduction in interest rate volatility evidenced by the MOVE Index declining from 145 to 110 by June 30th. The 2s10s Treasury Curve ended the 2nd quarter 106 bps inverted continuing to signal a weakening economy amid expectations of more rate hikes. The curve inverted 51 basis points since April 1 and we note; it is the greatest inversion in upwards of 40 years. The 2-year treasury climbed 87 basis points, the 10-year by 37 basis points to 3.84% and the 30-year by 21 basis points reaching 3.86%.1 Although the economic data of late for example, Non-Farm Payrolls adding 732k jobs in the Second Quarter and a First Quarter GDP print of 2% has signaled underlying strength, our base case remains that of a mild recession in the second half of the year or early 2024. We witnessed pressures mount through declined earnings, a weakened consumer balance sheet and increased debt service as legacy debt funding matured.

Figure 1 | 2Q Excess and Total Returns



Source: MIM, Bloomberg L.P.

Banks across the spectrum of GSIBs to Regionals took measures to sure up liquidity and rein in credit to quell fears as they adjust to tighter financial conditions. In our view most bank balance sheets still are well capitalized. Early in the quarter First Republic Corp was placed into FDIC receivership only to be purchased by JP Morgan all while the FDIC conducted liquidation of banks' security holdings, namely mortgage-backed securities. More broadly much of the rhetoric from corporations has come with a sanguine tone, however, many have also disclosed additional rounds of layoffs across a variety of industries which gives us pause on getting hopes high for continued strength amidst tighter financial conditions and a weakening consumer. Despite each sectors challenges, we continue to see strong M&A activity in the Pharmaceutical, Health Care, and other defensive industries. Most notably, Pfizer came to market with a $31 billion primary deal across the broad maturity spectrum in one of the largest debt issuances in the history of capital markets financing their acquisition of Seagen Inc.[2]

Over the quarter excess returns, while varied across the sub-sectors, were generally supported by a rebound from the Financial sectors as defensive sectors like Utilities and Pharmaceuticals that saw heavy issuance lagged. The recent events in regional banks of the banking sector spilled over broadly into the financing sector and put the spotlight on weaknesses in Commercial Real Estate and REITs. More specifically, Office REITs was a larger turn-around story in spreads as the sector was likely oversold on fears beyond challenges from "return to office" paradigms. The Airlines sector was also a notable performer in the index as passenger statistics have eclipsed

2019 levels and further supported by an optimistic summer travel season riding on pent up COVID demand. This demand is even greater internationally as COVID policies have been relaxed across the globe and especially Asia. The Energy sector and underlying subsectors experienced weakness brought on by a slump in oil prices and fears of slower growth dampening demand for energy. More broadly throughout the course of the quarter, corporate credit outperformed non-corporates. Within the index, the Long Corporate segment (+1.70% excess) underperformed the Intermediate Corporate segment (+1.10% excess) and its shorter-dated counterparts, while BBB spreads tightened two basis points more than single-A credit.[1]

Figure 2 | High Grade Snapshot

	Sector	OAS TSY	QTD OAS Δ	QTD YTW Δ	QTD Total Return	QTD Excess Return
	Bloomberg US Credit Index	**114**	**-15**	**0.33%**	**-0.31%**	**1.26%**
	Bloomberg US Corporate Index	**123**	**-16**	**0.31%**	**-0.29%**	**1.31%**
Top Corporate Sectors	Office REITS	261	-80	-0.25%	2.67%	4.21%
	Life Insurance	176	-25	0.10%	0.93%	2.69%
	Gaming	194	-45	0.12%	0.84%	2.24%
	Oil Field Services	140	-23	0.14%	0.29%	2.23%
	Airlines	151	-47	0.09%	1.16%	2.19%
Bottom Corporate Sectors	Packaging	136	-5	0.48%	-0.60%	0.85%
	Refining	139	-10	0.38%	-0.83%	0.82%
	Construction Machinery	45	-9	0.51%	-0.47%	0.72%
	Utility	131	-5	0.35%	-1.19%	0.63%
	Electric	131	-4	0.36%	-1.22%	0.59%
Quality	A	103	-15	0.33%	-0.40%	1.17%
	Baa	150	-17	0.31%	-0.10%	1.49%
Maturity	Intermediate	109	-18	0.40%	-0.16%	1.10%
	Long	150	-10	0.15%	-0.54%	1.70%

Source: MIM, Bloomberg L.P.

Figure 3 | Financials' Issuance Declined This Year as a Percent of Total Supply Compared to 2022

	Total IG Gross Issuance	Financials	Non-Financials	Financials % of Total	Domestic	Yankee DM	Yankee EM	Domestic % of Total
January	144,083	92,900	51,183	64%	76,283	63,150	4,650	53%
February	152,012	21,437	130,575	14%	125,280	25,732	1,000	82%
March	100,844	24,654	76,190	24%	68,490	31,754	600	68%
April	67,050	35,400	31,650	53%	52,000	9,900	5,150	78%
May	154,730	23,800	130,930	15%	105,380	18,350	31,000	68%
June	94,281	52,850	41,431	56%	53,581	34,200	6,500	57%
Total	**713,000**	**251,041**	**461,959**	**35%**	**481,014**	**183,086**	**48,900**	**67%**

Source: JP Morgan

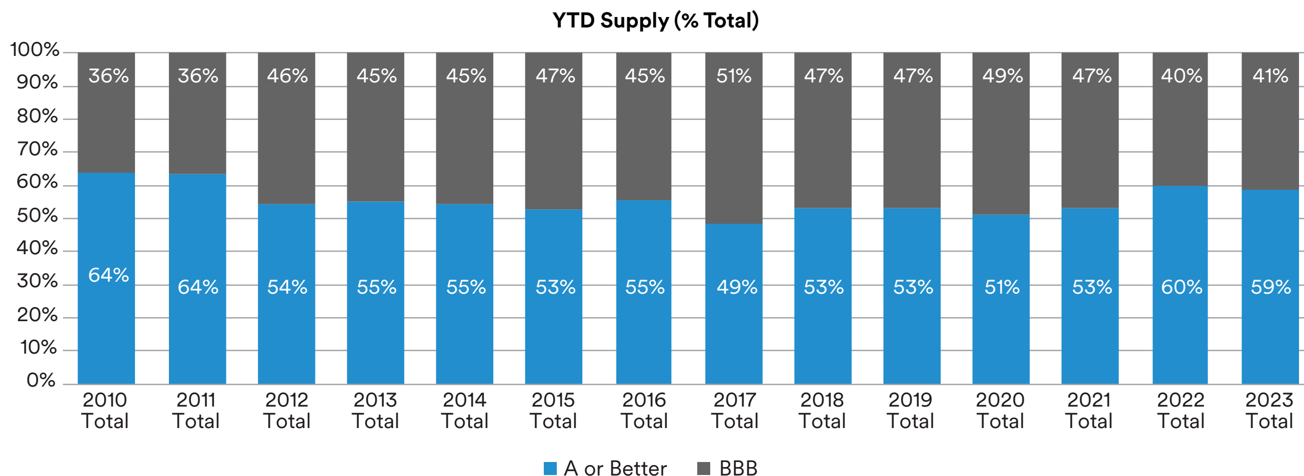
Figure 4 | Issuance Has Been Concentrated in the Short to Intermediate Part of the Curve

	3yr	5yr	7yr	10yr	20yr	30yr
January	45,100	46,525	3,950	39,250	0	9,258
February	28,837	27,100	11,800	49,650	4,250	30,375
March	21,404	20,100	4,450	30,065	4,300	19,775
April	13,950	18,150	3,600	27,600	1,250	2,500
May	22,000	28,530	10,900	45,150	11,500	36,650
June	23,000	24,650	6,300	27,275	6,470	6,586
Total	**154,291**	**165,055**	**41,000**	**218,990**	**27,770**	**105,144**
% of total	22%	23%	6%	31%	4%	15%

Source: JP Morgan

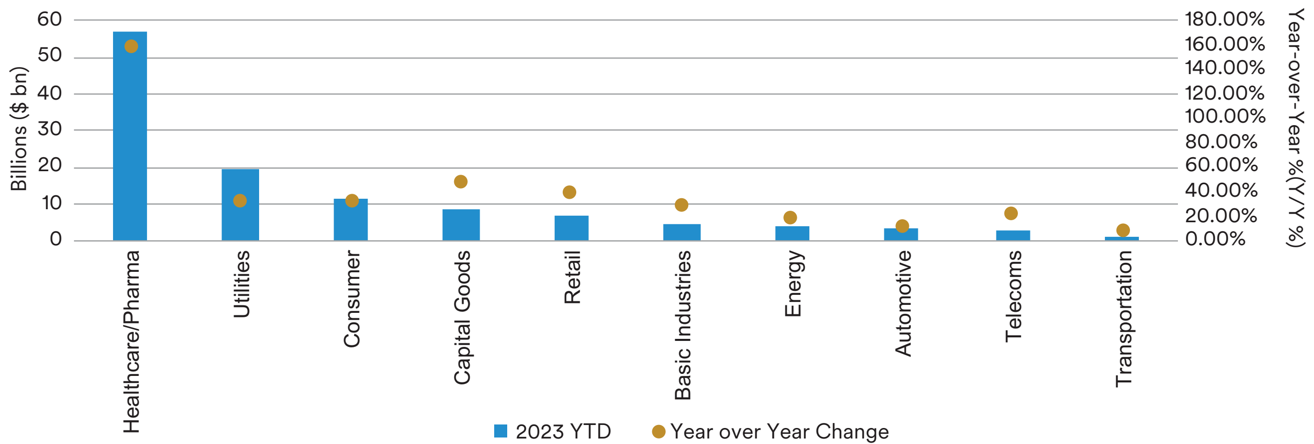
Total supply in the second quarter was $316 billion, which was marginally higher than the past four years excluding 2020 of $308 billion. May posted the second highest issuance for the month of $155 billion, trailing only 2020. Non-Financials made up 65% of total supply, led by Healthcare and Utilities issuance in May. Participants suggested that May's large issuance was the result of muted issuance in March and April as a result of the increased market volatility combined with a robust start to the year. In addition to the aforementioned pick-up in M&A issuance a la Pfizer, Amgen etc., in 2023, use of proceeds for M&A activities is 16% in 2023, up 5% versus the prior 4-year average. We also note that while May brought robust supply across the curve, June's supply was heavily tilted towards the front-end, bringing the average maturity down 5.8 years month-over-month to 8.4 years.[2]

Figure 5 | Up in Quality Sectors & Issuers Remain a Bulk of the Supply Relative to History

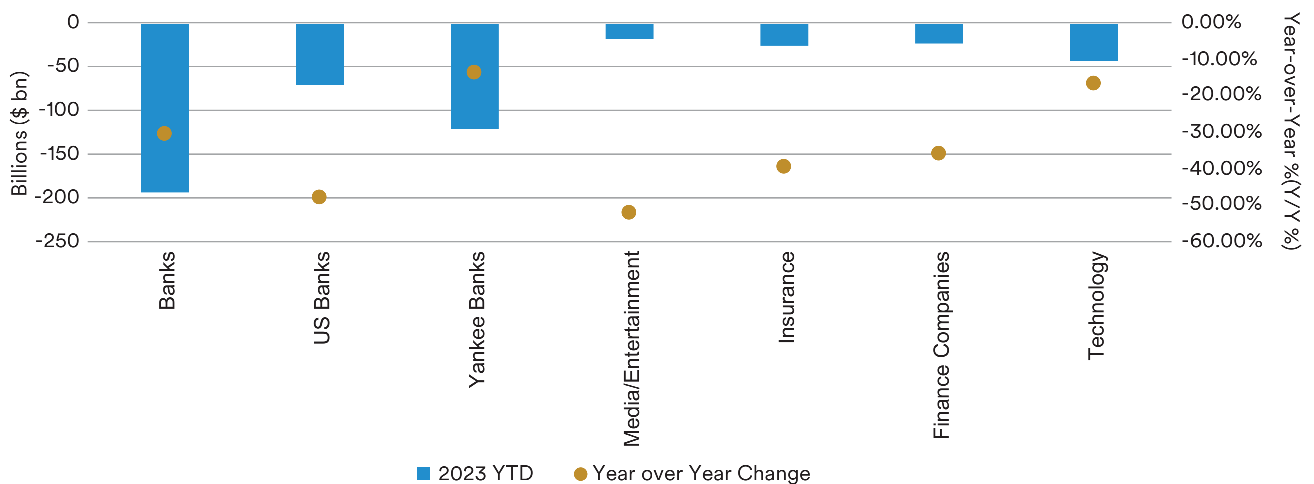


Source: JP Morgan, MIM

Figure 6 | Sectors with the Largest Y/Y Increases in Supply



Source: JP Morgan, MIM



Source: JP Morgan, MIM

Market Outlook

Timing is everything. This axiom certainly applies to our risk posture in portfolios, which continues to be skewed conservatively as our conviction remains high that credit valuations remain too frothy given the macroeconomic backdrop. The market has clearly been slower to adopt this view with spreads sitting at almost identical levels to where the year began. We believe this sanguine view on credit is incongruent with a mounting wall of headwinds, including (but certainly not limited to) higher borrowing costs, more debt, and slowing earnings that should ultimately erode the health of corporate balance sheets. These particular inputs are more germane to credit markets, but are likely on a collision course with the continued tightening of global monetary policy conditions that could have unintended consequences for broader risk markets.

Even if we continue to be wrong about the timing of a correction, we are hard pressed to envision a scenario in which we miss out on a significant spread rally. Historically from this starting level of spreads, average forward (12-month) excess returns for the broad credit index are negative (-0.6%). Interestingly, when you decompose those excess returns into the two broad maturity buckets, Long (10+ years) Credit excess returns are materially negative (-2.0%) and are twice as frequent as positive returns, while Intermediate Credit excess returns are nearly flat and are more equally distributed. While each environment is different, we do believe the inverted yield curve

offers a compelling opportunity to favor front end credit. An allocation in the front-end allows portfolios to build a yield advantage where the breakevens are far more attractive than out the curve. We are cognizant that a flood of T-Bill issuance will compete for short duration dollars, but with meaningfully tighter levels of spread an unlikely outcome, we believe building this portfolio level yield advantage with front end credit allows us the patience and flexibility to be wrong about the timing of a spread widening event.

A silver lining to frustratingly snug valuations is the opportunity it allows us to further reposition the portfolio for a spread correction. To that end, we maintain our first quarter theme upgrading the quality of portfolio in addition to rotating into sectors that are better positioned for an economic slowdown. For instance, Utilities, Pharmaceuticals, and Healthcare all continue to see above average issuance, and have presented compelling opportunities to rotate out of more cyclical sectors like Chemicals and Midstream. We have also taken advantage of bids for less liquid holdings, as we prefer to give liquidity at more attractive valuations. Admittedly, one of our worst decisions to date has been our aversion to high yield in those portfolios that allow for 'plus' sector allocations. We maintain our view that it is nearly impossible to find instances where high yield would outperform investment grade credit in the risk-off environment that we have envisioned this year, but this benign environment has allowed the elevated carry and favorable technical picture for high yield to generate 3x the excess return of investment grade in the first half of the year. Time decay to 2025 maturity walls only further emboldens our call for decompression. Default rates will rise as less resilient business models are pressured by higher interest rates, and that is a not a risk we covet to introduce to investment grade portfolios.

We do not wish to be the subject of the sequel to Waiting for Godot, but we believe our conservative posture to be prudent. Yield remains a powerful tool in the market that we will use to our advantage to clip and wait. As spreads present opportunities we have ample liquidity through our Treasury allocation to add spread duration. Solid carry and positive security selection are dependable tools by which to generate alpha, though we would welcome a back-up in spreads which would provide a far more robust opportunity set.

Endnotes

[1] Bloomberg
[2] JP Morgan

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