PUBLIC FIXED INCOME

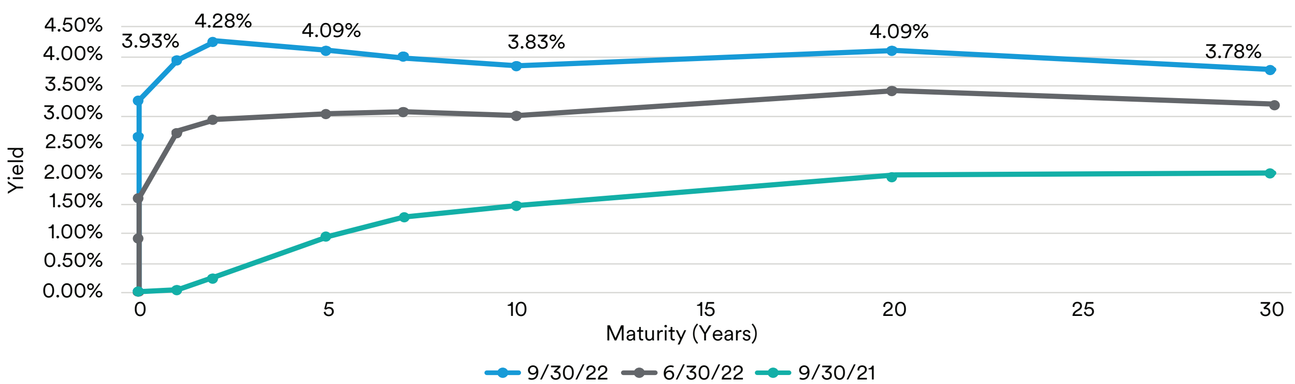
Investment Grade Corporate

Market Review and Outlook

September 30, 2022

The third quarter witnessed continued volatility and uncertainty. The macroeconomic environment continued to be the focus of the Federal Reserve, as they emphasized their hawkish stance on inflation at the July and September FOMC meetings, as well as at Jackson Hole. With the goal of curtailing inflation and achieving price stability, the Fed raised rates 75 basis points at both FOMC meetings. At the September FOMC press conference, Chairman Powell stated that the Fed will continue to hike rates until robust job gains slow, and the unemployment rate rises. Powell also cautioned against prematurely loosening policy and emphasized his decision to hike rates until inflation is at 2%. Inflation concerns remained elevated despite a two month decline in headline inflation, with the most recent year-over-year CPI print of 8.3% in August. The inflationary environment has caused consumers to increase borrowing, as higher prices for gas, food, and housing have started to take their toll on savings. Consumer sentiment has remained low, with the Michigan consumer sentiment index below 60. The 10-year Treasury yield started the quarter at 3.01%, rallied to 2.57% following the July rate hike, then climbed to 3.83% at the end of the quarter. Overall, the Treasury curve shifted upwards across all maturities and was led by the front end, with 1-month and 3-month Treasuries rising an astounding 169 and 162 basis points, respectively. The 5s/10s and 20s/30s curves ended the quarter inverted 26 and 32 basis points.[1]

Figure 1 | US Treasury Curve



Source: Bloomberg

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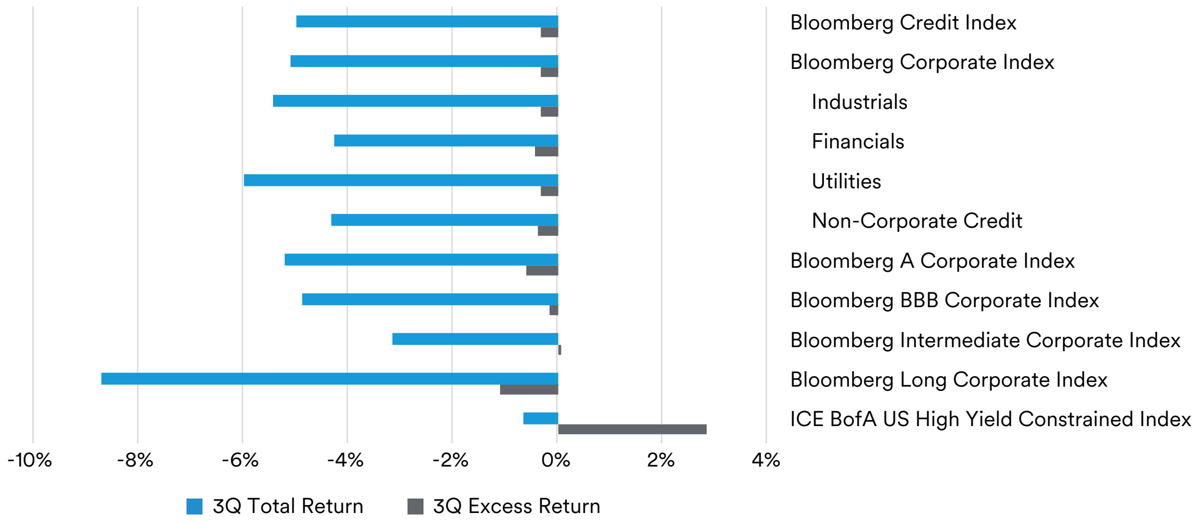
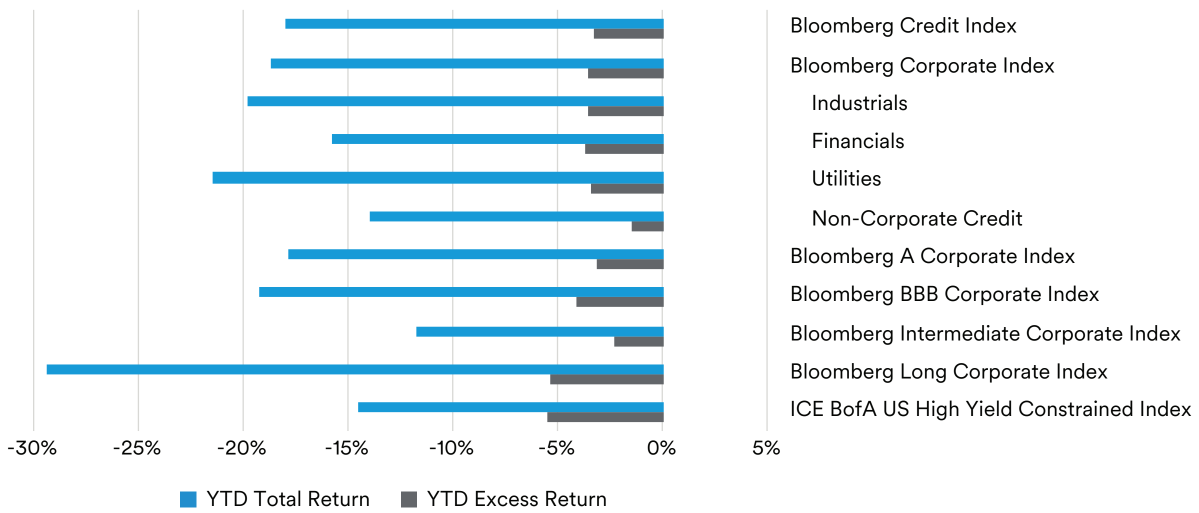
Credit markets continued to be affected by macro volatility. The Bloomberg US Credit Index generated a negative total return of -4.95% for the quarter, lagging similar duration Treasuries with an excess return of -0.33%. Spreads tightened from 143 basis points at the beginning of the quarter to a tight of 123 basis points in August, only to widen back out to 146 basis points at the end the quarter. Within the index, excess returns were mixed across sectors and maturities. Short and intermediate corporates outperformed their longer-dated counterparts. BBBs tightened over the quarter and outperformed higher quality AAAs, AAs and As. Breaking a trend from the previous two quarters, corporate credit outperformed non-corporate credit. Within the corporate credit subsectors, Finance Companies was the top performer as heavy index weighted names involved in aircraft leasing benefitted from an increase in global demand amid aircraft shortages. Airlines outperformed due to an uptick in consumer demand over the summer months, which was met with increased staffing levels and less flight cancellations. Capital Goods also relatively outperformed, led by Diversified Manufacturing and Environmental. On the flip side, Communications was the worst performing sector, with Wirelines, Media & Entertainment, and Cable & Satellite posting the worst performances of the quarter. Overall, the sector saw corporate credit fundamentals deteriorate amid a challenging macroenvironment.[2]

Figure 2 | 3rd Quarter and Year to Date Returns





Source: Bloomberg

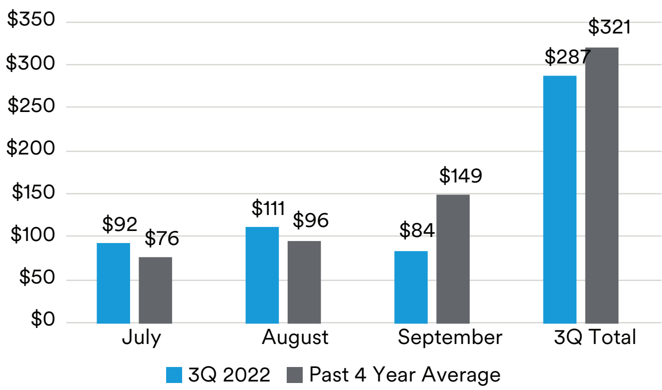
Figure 3 | US Corporate Snapshot

	Sector	OAS TSY	QTD OAS Δ	QTD YTW Δ	QTD Total Return	QTD Excess Return
	Bloomberg US Credit Index	**146**	**3**	**0.99%**	**-4.95%**	**-0.33%**
	Bloomberg US Corporate Index	**158**	**3**	**0.99%**	**-5.06%**	**-0.33%**
Top Corporate Sectors	Finance Companies	256	-25	0.93%	-1.69%	1.18%
	Airlines	241	-12	0.96%	-2.08%	0.73%
	Environmental	121	-8	0.82%	-4.38%	0.69%
	Diversified Manufacturing	140	-8	0.86%	-4.34%	0.48%
	Other REITS	182	5	0.99%	-3.89%	0.46%
Bottom Corporate Sectors	Health Insurance	135	10	0.95%	-6.73%	-0.95%
	Communications	193	10	0.95%	-6.84%	-1.25%
	Cable & Satellite	209	12	0.94%	-7.33%	-1.33%
	Media & Entertainment	204	7	0.95%	-6.54%	-1.34%
	Wirelines	186	16	0.98%	-7.66%	-1.64%
Quality	A	133	8	1.05%	-5.17%	-0.56%
	BBB	192	-1	0.94%	-4.80%	-0.13%

Source: Bloomberg

High Grade bond supply for the quarter was $287 billion. As shown in Figure 4, this was 11% lower than the past four-year average of $321 billion as September issuance was the second lowest on record driven by non-Financials, which was 50% if its past four-year average.[3]

Figure 4 | High Grade Supply



Source: JP Morgan

Looking ahead, it is hard to ignore the irrefutable truth that the Federal Reserve has one goal right now (and one goal only), and that is to temper inflation. To accomplish this will require more restrictive monetary policy and slower growth—which is not supportive of risk assets. To get the pendulum to shift to a more attractive environment for risk taking, the market will need to be able to better grasp both the timing of achieving peak inflation and the duration of the adjustment period necessary to return to the Fed's targeted level of inflation. Neither of those signposts seem imminent. Brief rallies in the market have generally been accompanied by murmurs of Fed easing. We believe these to be misguided. Fed speakers are going out of their way to emphasize that their job will not be done until inflation is tamed—and we believe them. To us, the inflation battle is the overarching risk factor in the market right now, but that is not to diminish the quantity or severity of the other risks present. The war in Ukraine, the European gas crisis, and COVID lockdowns in China are part of a myriad of "knowns" in the market. What is more troubling are the second, third, fourth derivative "unknowns". The recent UK pension fund crisis was a sobering reminder of the intertwined nature of markets, with collateral calls in the UK being met by selling of US credit (which is a much deeper market for the long duration assets owned in these funds). It is hard enough to assess the value of credit amidst the known issues—but the likelihood of further knock-on effects is too high to not anticipate a further discount for spreads.

It is not all bad news for credit investors. Valuations are getting more attractive by the day. Investment grade corporates ended the quarter at +159 OAS—67 basis points wider year-to-date. More eye-popping is the 5.69% yield of the Bloomberg Corporate Index.[4] That is 336 basis points higher on the year. The phrase "There is No Alternative" or "TINA" was in vogue for the last few years when there seemed to be no attractive alternative for equities. We are not creative enough to invent new acronyms, but we feel comfortable suggesting TINA can be retired for now because the alternatives are plentiful. If you wanted 4% yields at the start of 2022 you had to buy high yield. Now you can get 4% from T-Bills. The resetting of valuations in 2022 should ultimately provide some level of support for fixed income assets—though the buyer base is likely to shift. Yield hungry domestic buyers—both institutional (e.g., pension, insurance) and retail are likely to welcome the new paradigm of a higher rate environment, while foreign investors are pulling back. They are pulling back due to the rapidly changing economics of hedged yields which have made US corporates hedged back to their local currency increasingly unattractive. It is too early to decipher which flow dynamic is likely to win out—but there are likely to be periods of uneven transition to add to an already volatile environment.

As we evaluate current valuations, we are reticent to get too mesmerized by spreads and yields that we have not seen since the onset of COVID. Historically there has been no magic ceiling for spreads, but credit has been no stranger to visiting OAS levels in the low 200s during periods of elevated volatility and recession. We may not reach those levels this time around due to the health of consumer and corporate balance sheets, but we believe there is enough global uncertainty that a future moment of capitulation could ultimately propel spreads towards those levels.

This process could take some time. There has been a well-defined trend this year of wider wides and wider tights in credit spreads. We would expect this pattern to persist within a broader widening trend. We recognize the difficulty in picking the lows, and so we will use these backups to gradually add risk back to the portfolio. One area of the market we feel comfortable adding to right now is short-dated credit. Flatter rate and spread curves have created extremely attractive opportunities to allocate capital in a maturity window in which we believe we can get very comfortable with the trajectory of the balance sheet. We believe we can structure portfolios to continue to add some yield advantage to the portfolio (at the expense of cash and Treasuries) while still maintaining a generally conservative risk posture until valuations cheapen further. Away from these front-end opportunities, we are intensely focused on the fundamental outlooks for the credits in which we are invested, and their ability to generate attractive risk adjusted returns in the context of a recessionary environment. To the extent that we can identify better opportunities, we are going to reposition into those more resilient credits. We will also continue to be active in the new issue market. Primary issuance has slowed dramatically as many issuers are waiting for calmer conditions, but elevated volatility has resulted in elevated concessions that offers us an opportunity to allocate to liquid credit at attractive valuations. Liquidity is valuable in this market, and so any tactical trading opportunities will likely be concentrated in the primary market, whereas we recognize that relative value trades into less liquid curve points will take longer to monetize.

The "all clear" for credit remains just a dot in the distance, but we believe this to be an environment where fundamental credit research will be critical to not only picking winners, but also avoiding the losers in what is likely to be a period of elevated volatility.

Endnotes

[1] Bloomberg
[2] Bloomberg
[3] JP Morgan
[4] Bloomberg

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