

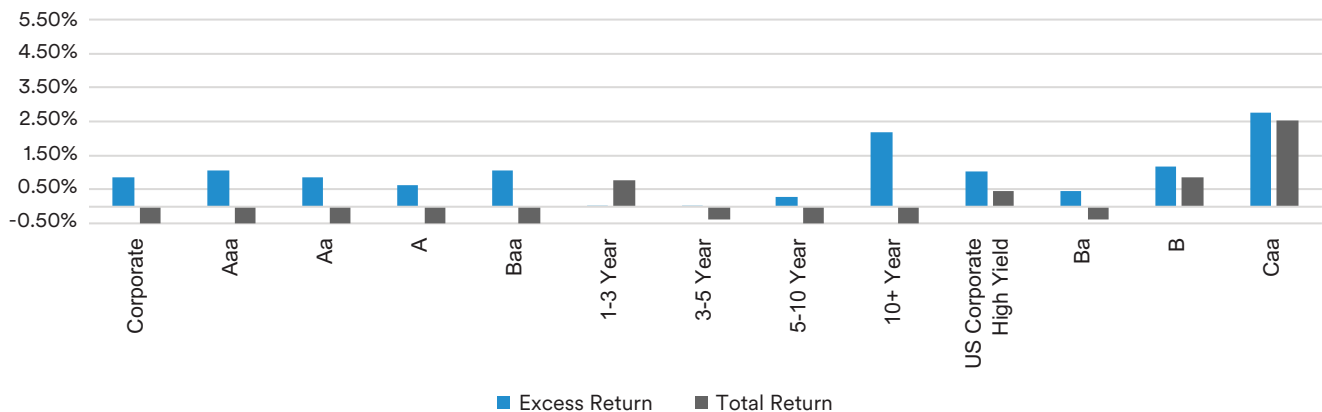


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Investment Grade Corporate Market Review and Outlook

September 30, 2023

Three quarters of the way through 2023 and 10-Year US Treasury yields have climbed to levels not seen in 16 years—having risen as high as 4.34% intra-quarter and 4.79% at the time of writing this— a 105 basis point (bps) increase off the low (3.74%, 7/19/2023) while credit spreads remain contained slightly off their tights of the year. Despite an increase in looming uncertainties, the Bloomberg US Credit Index OAS closed the quarter at 112 basis points, grinding 2 bps tighter over the quarter and 9 bps tighter since December 2022. However, we still believe the level does not appropriately reflect the forward uncertainty in the economy. Year-to-date corporates still held on to positive total returns while the “Agg” has shed its positive returns for 2023 as of September 30. On macro events over the period, the Fed raised the overnight rate another 25 basis points to 5.25% - 5.50% at the July meeting. Of note, they reaffirmed their hardline approach with a hawkish stance on not calling the end of the hiking cycle as they remain focused on pushing inflation down to the 2% target—leaving prospects for another rate hike in 2023 on the table at every speaking opportunity they had (Jackson Hole, FOMC Meetings, amongst others). Even with dissipating interest volatility over the quarter, Fed Funds traders repriced for the “higher for longer” regime with affects rippling across the entire curve. On July 3, markets were priced for more than 3 interest rate cuts in 2024 with the cycle starting as early as June which is now down to 2.6 cuts by the end of 2024 starting in September 2024. Further supporting the prospects for the higher rate regime has been a resilient economy with GDP above 2.0%, growth in Non-farm Payrolls (+157k in July, +187k in August) albeit at a slower clip since the rate hikes began and declining jobless claims despite large corporations’ headcount reductions over 2022 and 2023. While we are cognizant that this data is backward looking, we have not overlooked a weakened consumer balance sheet combined with other fundamentals such as increasing delinquencies data on auto loans in addition to a slowing housing market which we believe will contribute to a slowing of the economy—ultimately aiding the Fed’s goal in reducing inflation while providing some relief to voracious interest rate volatility.

Figure 1 | 3Q Excess and Total Returns

Source: MIM, Bloomberg L.P.

Other notable events include the market looking past the United States downgrade to AA by Fitch, however since the rating action, the yields for holding such debt have moved materially higher. Most market participants attributed the bear-flattening of the curve to prospects of deteriorating fiscal policy and a slew of treasury issuance in 2024 to meet the government's spending needs. Over the third quarter, the 2s10s Treasury Curve was as deeply inverted as -108 on July 3 before steepening with the sharp rise in the 10-Year US Treasury yield over August and September closing the period -61 basis points inverted. The 5s10s and 10s30s credit curves also steepened yet, still ended inverted -11 and -26 basis points, respectively.

When taking stock of corporate fundamentals following the most recent earnings cycle, we witnessed weakened fundamentals across balance sheets and income statements. Most notably and of particular interest, debt levels and interest expense rose (not surprisingly) which pressured leverage and interest coverage metrics. However, interest costs remain low in historical context with corporations still benefiting from terming out their funding in the record low-rate environment of 2020-2021. Although the banking crisis is in the rear-view, the affects it had on markets is still one which credit markets are dealing with. In our view, most bank balance sheets still are well capitalized and have taken the appropriate measures to sure up liquidity should there be any future pull on liquidity. However, the pull back from Banks in extending credit is leading more issuers to seek funding in the private markets potentially leading to the supply/demand technicals. Away from idiosyncratic events and news, much of the move—or lack thereof—in terms of spreads on corporate debts we attribute to strong technical factors present in the market. One factor is the generic lack of issuance in the long end of the curve coupled with overwhelming demand from insurers, pensions and other long duration participants in the hopes of locking in higher coupons and yields. Another is the strong inflow of cash into bond funds with investors seeking to take advantage of the attractive all-in yields that were absent for a number of years.

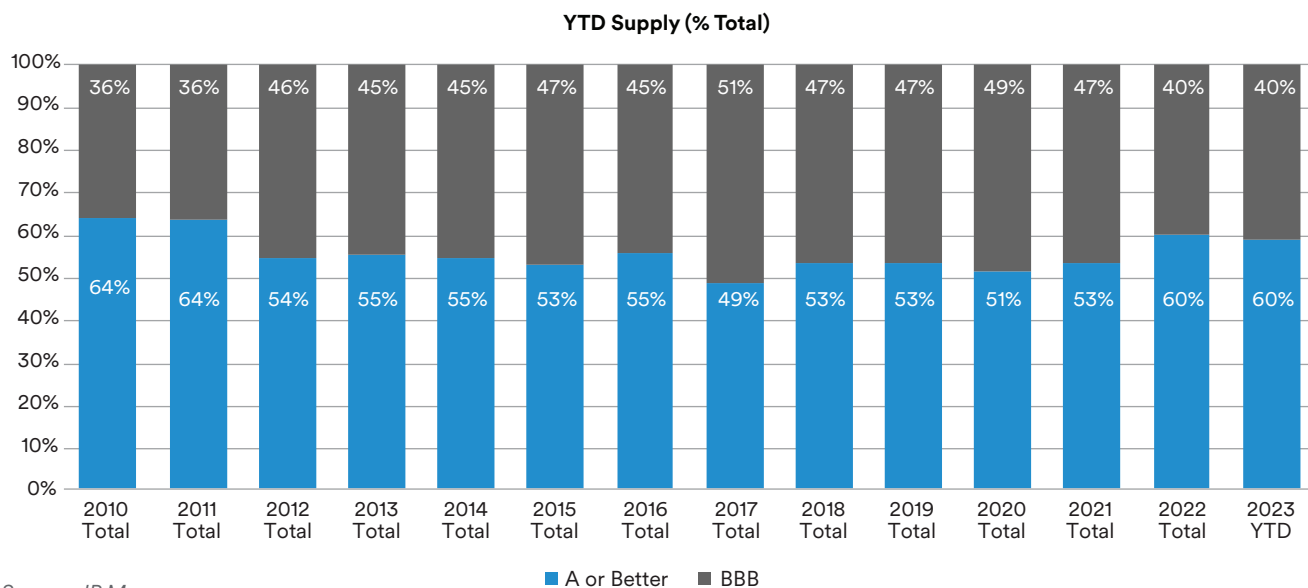
Over the quarter excess returns were strong, largely supported by spread compression in July despite mild weakness in August and a relatively muted September. Office REITs carried strong performance over again as the sector was likely oversold on fears beyond challenges from “return to office” paradigms. As real estate sensitive sectors recovered from early weakness in 2023, the Insurance sectors of Life and Property and Causality notched positive excess returns over the period. The Energy sector and underlying subsectors experienced strength brought on by a resurgence in oil prices. More broadly throughout the course of the quarter, corporate credit outperformed non-corporates. Within the index, the Long Corporate segment (+2.18% excess) outperformed the Intermediate Corporate segment (+0.12% excess) and its shorter-dated counterparts, while BBB spreads tightened six 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	112	-2	0.55%	-3.01%	0.77%
	Bloomberg US Corporate Index	121	-2	0.56%	-3.09%	0.84%
Top Corporate Sectors	Office REITS	228	-33	0.16%	-0.28%	2.44%
	Other Industrial	95	-12	0.70%	-7.20%	2.30%
	Oil Field Services	121	-20	0.58%	-3.08%	2.13%
	Refining	120	-18	0.45%	-2.35%	2.00%
	Independent Energy	145	-12	0.44%	-2.25%	1.97%
Bottom Corporate Sectors	Automotive	107	8	0.47%	-1.07%	0.28%
	Wirelines	139	2	0.74%	-5.67%	0.28%
	Lodging	119	1	0.47%	-1.01%	0.28%
	Other Financial	100	-2	0.49%	-1.32%	0.21%
	Banking	138	6	0.52%	-1.55%	0.21%
Quality	A	105	2	0.59%	-3.24%	0.63%
	Baa	146	-4	0.54%	-2.71%	1.04%
Maturity	Intermediate	115	6	0.50%	-0.96%	0.12%
	Long	134	-16	0.55%	-7.23%	2.18%

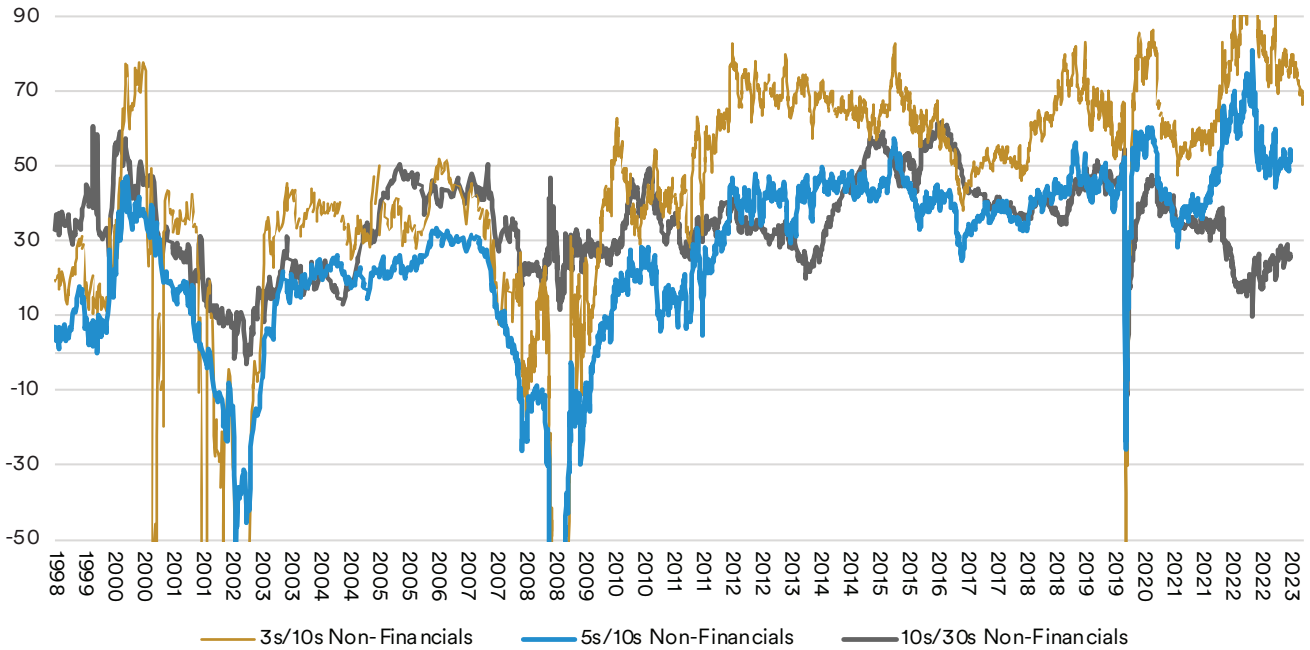
Source: MIM, Bloomberg L.P.

Figure 3 | Up in Quality Sectors & Issuers Remain a Bulk of the Supply Relative to History



Source: JP Morgan

Figure 4 | The 10s/30s Credit Curve Remains Flat, While 3s/10s & 5s/10s Steepness Remains

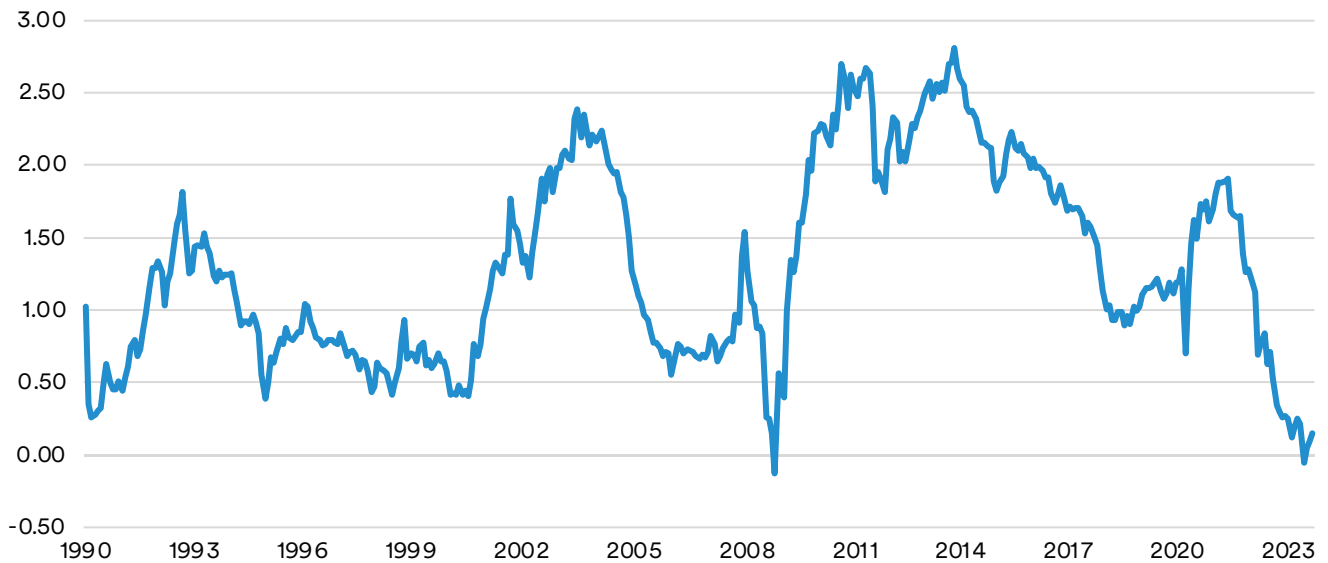


Source: Bank of America Research

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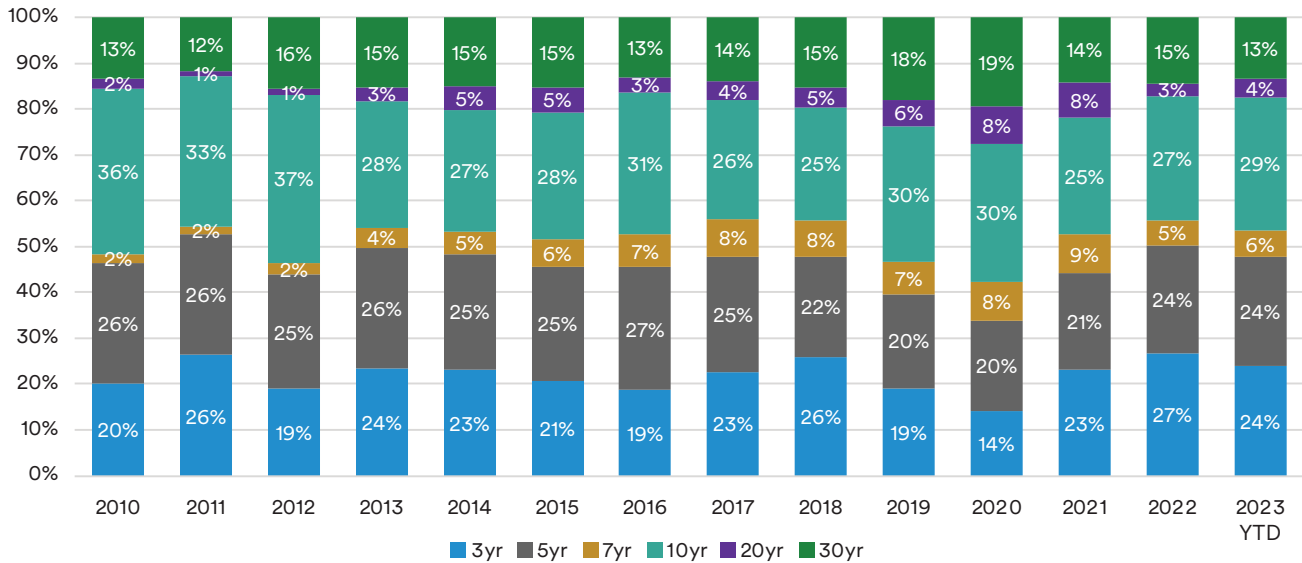
Figure 5 | The Differential Between Intermediate and Long Corporate Yields is at Historic Lows

Intermediate Corporate / Long Corporate Yield Differential



Source: MIM, Bloomberg L.P.

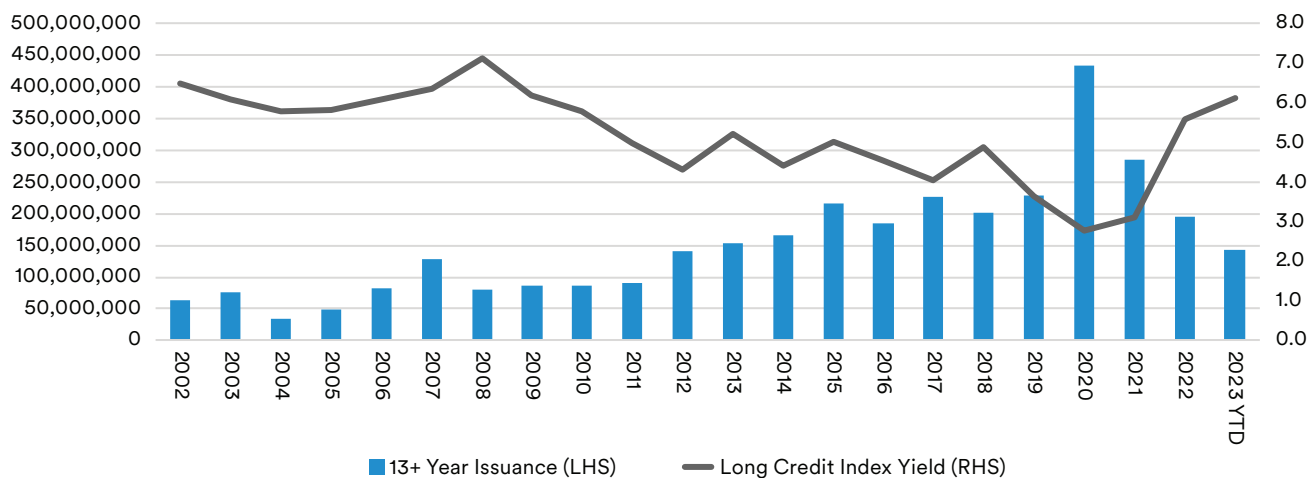
Figure 6 | US High Grade Issuance



Source: JP Morgan

Total supply in the third quarter was \$286 billion, which was lower than the past four years average excluding 2020 of \$297 billion. Most notably on the issuance front has been the lack of long-end issuance—adding a strong technical to the part of the market largely bought by insurers and pensions. With September bringing robust issuance following a summer slow down, the long-end only accounted for 10% versus a 16% average YTD. As expected, bond tender activity is down 54% year-over-year given the sharp rise in funding costs across the curve. Non-Financials have made up 61% of total supply, led by Healthcare (6.9% of YTD Supply) and Utilities (7.2% of YTD Supply) with a majority of the issuance purposes for M&A. We continue to see a similar theme in the third quarter where supply was heavily tilted towards the front-end in addition to A rated issuers accounting for 51% of supply, the largest percentage since 2000.²

Figure 7 | With The Increase in Interest Rates, The Share of Long-End Issuance Has Come Down



Source: Barclays, MIM

The tug of war between the economic trajectory, corporate fundamentals, valuations and technicals has resulted in tighter spreads and flatter credit curves. The economy has largely shrugged off the over 5% of Fed hikes over the past 18 months, with unemployment still under 4% and inflation, while slowing, remains above the Fed’s target. Corporate fundamentals have been resilient. Defaults rates, while rising, remain low.

Economic bulls forecasting a soft landing are quick to point to the excess savings generated from easy money during the Covid period as supportive moving forward. We have certainly underestimated the staying power of the unprecedented stimulus, but with monetary policy decisively restrictive and many fiscal programs winding down, we have our eyes on cracks forming. High and rising delinquency rates on subprime loans without any significant uptick in unemployment indicates the effects of higher rates are certainly feeding into the lower rungs of consumer balance sheets. Combined with tight C&I lending standards, consumer strength is likely more fragile than economic data would suggest and the mere passing of time will continue to chip away at households and corporations.

For some time, we have felt the uncertain economic outlook amidst snug valuations warranted a defensive risk posture in portfolios and have leaned on security selection to offset the drag from our treasury allocation. We continue to believe we are steadily marching into the latest stages of the credit cycle, and ample liquidity from our credit underweight will eventually bear fruit with spread levels skewing risk to the downside. The at times frustrating technicals driving spreads tighter and curves flatter (minimal long dated supply, lack of secondary liquidity, market preference for on the run securities) have been a headwind to relative performance, but simultaneously provide opportunity for those willing to do relative value work down to the individual bond level. With that, it's unlikely we make wholesale changes to the portfolio absent a material change in valuations, and instead will continue to refine positioning into sectors, issuers, and securities we believe hold long term value.

From an overall quality perspective, we continue to favor BBB credit improvement stories vs single-A and better paper, which been tremendously supported from a lack of high-quality supply in the higher yield environment. Within BBB, we believe successfully identifying improvement stories in low BBB names and avoiding downgrades will be paramount in differentiating excess return as the credit cycle turns. From a sector perspective, we continue to favor less cyclical sectors like Healthcare, Pharmaceuticals, Aerospace Defense and Utilities and also favor less cyclical names within more cyclically oriented sectors (i.e. gold names in Metals & Mining). We remain overweight Banking and continue to favor the front end of the curves as a defensive way to maintain a healthy yield advantage.

Technicals have been powerful this year, and with that in mind we continue to closely monitor the supply outlook given its highly correlated impact on spreads this year. Opportunistic issuance in 30-year space has all but vanished and M&A outside of Healthcare and Pharma has also dried up. What little 30-year issuance we have seen has come at levels at or through secondary bonds and flat to shorter duration credit spreads, which we do not believe appropriately compensates investors for lending to companies for longer. While we broadly remain concerned about valuations, we do concede the symmetry of outcomes is far more balanced on the intermediate part of the curve relative to the long end, and that is where we have chosen to bias our credit curve positioning within portfolios.

For those client portfolios that allow for high yield exposure, we remain extremely selective in our positioning, with nearly the lowest allocation since inception. It is extremely difficult to find instances where high yield would outperform investment grade credit in the risk-off environment that we have envisioned this year. Time decay to 2025 maturity walls only further emboldens our call for decompression from extremely tight levels to IG credit. Default rates will rise as less resilient business models are pressured by higher interest rates, and that is a not a risk we want to introduce to investment grade portfolios.

Like a toddler on a long road trip, our positioning for an economic dustup and repricing of risk assets (that seem to never arrive) often begs the rhetorical question, "Are we there yet?" While we cannot point to the exact catalyst or timing for spread widening, we firmly believe the path of spreads to be wider and curves steeper in an unwind of the stalwart and supportive technicals that have diverged valuations from forward fundamentals. We will continue to carry a treasury balance to take advantage of this eventuality and will look to refine and reposition the portfolio along the way. 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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