

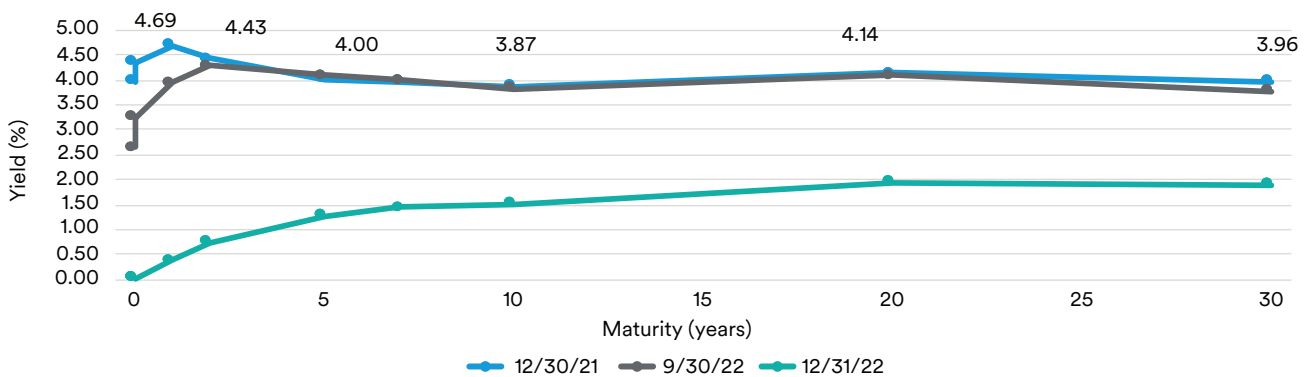
PUBLIC FIXED INCOME

# Investment Grade Corporate Market Review and Outlook

December 31, 2022

The fourth quarter of 2022 capped off the worst year on record for the fixed income markets. The Federal Reserve's fight against inflation, deteriorating corporate fundamentals, and the Ukraine conflict highlighted a year of volatility and uncertainty. The Fed raised rates by 425 basis points during the year, with 125 basis points coming in the fourth quarter as the Federal Reserve raised the target rate 75 basis points at the November FOMC meeting, and an additional 50 basis points during the December meeting. Although this marked a slowdown from the Fed's recent pace of hikes, Chairman Powell continued to emphasize a hawkish stance throughout the quarter. Powell made it clear that although smaller interest rate increases are likely ahead and the pace of hikes will slow, there will be ongoing increases until inflation is tamed, and the labor market shows signs of regression. Inflation concerns cooled following lower than expected year-over-year CPI prints of 7.7% in October and 7.1% in November; however, economic data such as job vacancies, wage growth, and job gains suggest that demand needs to better align with supply in the labor market. The 10-year Treasury started the quarter at 3.83%, increased to a high of 4.24% in October, then rallied significantly before increasing at the end of the quarter to 3.87%. Overall, the Treasury curve shifted upwards across shorter and longer maturities, while remaining relatively flat across the belly of the curve. The 5s/10s and 20s/30s curves steepened, yet still ended the year inverted -13 and -19 basis points, respectively.<sup>1</sup>

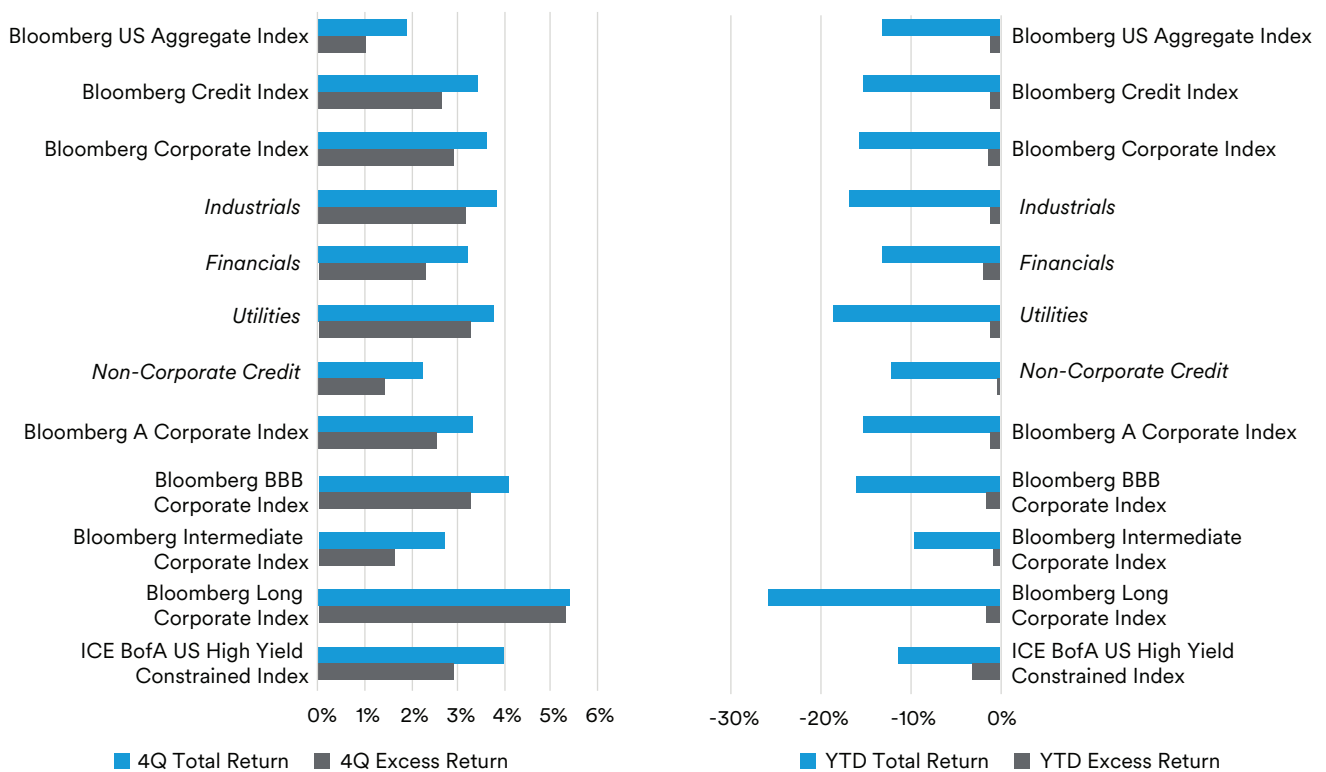
Figure 1 | US Treasury Curve



Source: Bloomberg

Despite macro uncertainty, Credit markets rallied in the fourth quarter, offsetting much of the negative performance seen in prior quarters. The Bloomberg US Credit Index generated a total return of 3.44% for the quarter and an excess return of 2.68% over similar duration US Treasuries. Spreads slightly widened from 147 basis points at the beginning of the quarter to a wide of 151 basis points in October, then tightened to end the quarter at 121 basis points. Within the index, the Long Corporate segment rebounded and outperformed its shorter-dated counterparts for the first time this year, while BBBs converged closer to single-A credit. At the sector level, Utilities and Industrials outperformed, while Financials lagged the index.<sup>2</sup> Within corporate credit, excess returns were positive across all sectors and maturities. Overall, corporate sectors rallied as spreads came off the wides of the year. In Industrials, high beta subsectors such as Tobacco and Cable & Satellite outperformed during the quarter as the overall market rebounded. In Basics, Metals & Mining outperformed during the period amid a rebound in iron ore prices with optimism around China’s reopening and subsequent commodities demand. Despite oil price volatility, commodity-based sectors also outperformed, with Oil Field Services and Refining outperforming within Energy. The low beta REITs space lagged the overall index, especially Healthcare REITs as they continued to be affected by deteriorating tenant health. Additionally, the poor economic outlook led to underperformance in several large-cap issuers.<sup>3</sup>

**Figure 2 | 4<sup>th</sup> Quarter and Full Year 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	121	-26	-0.23%	3.44%	2.68%
	Bloomberg US Corporate Index	130	-29	-0.26%	3.63%	2.89%
Top Corporate Sectors	Tobacco	180	-65	-0.63%	6.83%	6.00%
	Metals & Mining	159	-51	-0.52%	6.52%	5.60%
	Oil Field Services	157	-30	-0.33%	5.43%	4.50%
	Cable & Satellite	171	-38	-0.33%	4.56%	4.13%
	Refining	140	-38	-0.38%	4.87%	4.10%
Bottom Corporate Sectors	Retail REITs	149	-13	-0.12%	2.28%	1.33%
	Construction Machinery	53	-14	-0.09%	2.17%	1.29%
	Office REITs	195	-26	-0.26%	2.15%	1.25%
	Airlines	218	-23	-0.24%	2.29%	1.19%
	Healthcare REITs	167	-15	-0.14%	2.19%	1.12%
Quality	A	109	-25	-0.23%	3.31%	2.55%
	BBB	159	-33	-0.31%	4.07%	3.27%

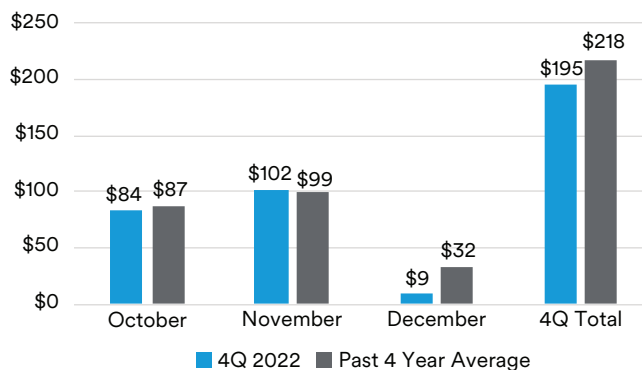
Source: Bloomberg

Full year 2022 supply came at \$1.2 trillion, which although down 12% year-over-year, was the fourth highest issuance year on record. Financials contributed 49% of total supply, the highest percentage in over 15 years and a record issuance in dollar terms.<sup>4</sup>

Count us among the many that are happy to turn the page on 2022. It was the worst year ever for total returns in the High Grade market – a market which failed to provide the refuge that is commonly associated with fixed income. We could spill unlimited ink on the unprecedented carnage across global bond markets, but we think it is best to look ahead. 2023 presents an entirely different backdrop for the asset class than one year ago, when we bemoaned the tight valuations, paltry yields, and limited opportunity set. Two of these three conditions have changed in a dramatic and positive fashion – there is once again yield in the market and the opportunity set is plentiful. Gone are the days of strategists quoting the global market size of negative yielding debt. The phrase “reach for yield” can be retired right alongside “TINA”. The alternatives to equities are plentiful, and bonds, dare we say, are cool again.

We believe the ability to generate compelling total returns in fixed income can be found across the maturity and quality spectrum. In credit, dispersion is prevalent, and the market is willing to differentiate sectors and issuers based on their underlying fundamentals. This was evident most of last year as well, with the correlation between spreads and spread directionality breaking down. Said another way, prior history would suggest that a year of wider spreads should have led to underperformance of lower quality, wide trading sectors such as Independent Energy and Metals & Mining and outperformance of a higher quality, tight trading sectors such as Healthcare and Banking. However, this playbook did not hold true last year, and we expect differentiated performance again this year. Security selection will matter in 2023.

Figure 4 | High Grade Supply



Source: JP Morgan

That is not to suggest this market is ready to look past the macro factors that have been a driving force in the market for the last three years. The macro backdrop will likely play a starring role again, and though the drivers are well understood, the outcomes and timing are not. Central banks across the globe are still tightening, though the Fed is clearly in the later innings of its hiking cycle. Frankly we are not overly focused on the precision of the terminal rate forecasts. We do; however, struggle to embrace the market's optimism for a Fed "pivot". The most damaging thing the Fed can do to the economy is to cut rates before inflation is tamed. Curiously, many market participants have seemingly been unwilling to heed the repeated emphasis from Fed speakers on the importance of their mission. We choose to take them at their word (alongside our belief that they will take all precautions to not tarnish their legacy) and so we do not believe a near term "pivot" will be the magic elixir the market is seeking. Rather, this lengthy and painstaking process to reduce inflation requires a growth slowdown and higher unemployment. Of course, those are not underlying conditions that would generally cause us to scream "BUY CREDIT" from the rooftops – unless we were being appropriately compensated, which unfortunately is not the case currently.

In our view, valuations, much like at the start of 2022, are not appropriately reflecting the risks in the market. We are the first to admit we staked a similar claim in last quarter's review, only to witness the first quarter of spread tightening since mid-2021. Tighter spreads only reinforce our conviction that there will be a better entry point for credit in the months ahead. Corporate spreads at a 130 OAS are merely bumping up against their average of the last decade, but we suggest these are anything but average times. It is widely expected that we will likely enter into a recession this year, and fundamentals should gradually erode as margins come under pressure – though they are starting from a fairly healthy place. Volatility will likely remain elevated as the market hangs on every economic data release to glean further insight into the evolution of Fed policy adjustments. This will likely lead to periods of market stress and dislocations. Thus, we do not believe the right question to ask is whether spreads will widen at some point in 2023, but rather to what extent?

All of this being said, we acknowledge the answer and timing here is more art than science. Previous periods of market stress this decade have seen credit spreads surpass 200 basis points. In gambling parlance, we will take the under, as the underlying structural demand for credit will likely be too powerful to allow for a meaningful drawdown. Despite the recent rally off the highs, yield sensitive investors can still invest at levels of yield not seen since the Great Financial Crisis. Additionally, given the extremely challenging outlook for equities, fixed income is likely to regain its status as a safe haven for retail investors, buttressed by historically elevated breakeven spreads that will provide a cushion against the wider spread environment we envision and potentially equity-like total returns. These tailwinds are likely to overwhelm a decline in foreign demand on back of higher hedging costs.

However, our gameplan is not to pick a level and sit on our hands until we get there, but rather to gradually re-allocate our healthy allocation to Treasuries into credit at progressively wider spreads. We do not know precisely when spread widening will occur, but we do know we are being compensated for our patience with a healthy yield advantage. Our favored place right now continues to be on the front end of the credit curve where we can take advantage of inverted yield curves and clear short-term visibility. Additionally, we remain focused on rotating the portfolio into credits that are best positioned to weather a rocky economic backdrop. The ability to maneuver the portfolio is largely synonymous with the liquidity of positions, and so even though liquidity premiums are gradually expanding, we believe this adjustment period is likely only in the middle innings. With that in mind, we are most focused on using the primary market as our preferred vehicle for risk addition. The primary market should be active, particularly in the first quarter as issuers look to take advantage of relative calm and depressed spreads. For those portfolios that allow for out-of-benchmark exposures, we are finding ample opportunities within the High Grade market and do not believe the additional compensation in the High Yield market is worthy of an increased allocation.

In all, 2023 promises to be an eventful year. We enter the year with firm conviction that we have built portfolios with issuers who are well positioned for an economy on the brink of recession – albeit one likely to cause much less damage to credit than previous episodes. Of equal importance will be seeking to avoid those issuers that are likely to struggle under such conditions. We think that our healthy liquidity profile (via a Treasury allocation) and significant yield advantage leave us well positioned to increase credit exposure at more attractive valuations.

## Endnotes

<sup>1</sup> Bloomberg

<sup>3</sup> Bloomberg

<sup>2</sup> Bloomberg

<sup>4</sup> JP Morgan

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