

DECEMBER 2021: OUTLOOK AND IMPLEMENTATION

	December 2021	YTD/YTD Change
Total Returns	-0.08%	-1.04%
Excess Returns	0.60%	+1.61%
Yield	+0.04%	+0.57%
Spread	-7bps	-4bps
Price	-\$0.41	-\$6.05

Source: Bloomberg U.S. Corporate Investment Grade Bond Index
Past performance is not indicative of future results.

- ▶ We enter 2022 with encouraging fundamental trends and tight valuations. The consensus forecast calls for a sideways year for spreads, which is hard to argue with given the parallels between the start of 2022 and the start of 2021 (which wound up being a flat year for spreads). Our allocation to the asset class is at a relatively low point historically due to the challenging valuations. This gives us significant capacity to add opportunistically.

Fundamentals

- Year-over-year third quarter sales and earnings growth for the S&P 500 finished at 17% and 39%, respectively. Earnings beat estimates by over 9%.
- Earnings growth is expected to hit 20% in the fourth quarter, with 8% growth in 2022. These estimates have declined modestly over the past month, which is typical as reporting dates get closer. We were concerned about margins getting squeezed amidst supply chain constraints, but margins showed demonstrable growth in the year-over-year period as large companies succeeded in passing through higher costs.
- Leverage ratios have returned to pre-COVID levels, albeit still elevated by historical standards. Per JP Morgan, debt outstanding was down 2.4% year-over-year as of 9/30.
- For the full year, S&P reported 48 rising stars versus 16 fallen angels. Moody's reported 38 rising stars and six fallen angels. Within investment grade, upgrade/downgrade activity was also highly favorable with upgrades outpacing downgrades by 57% (274 vs 174). The market anticipates very few fallen angels for 2022 with up to \$100 billion of potential rising stars.

Technicals

- Gross and net supply of \$62 billion and \$13 billion, respectively, were both ahead of expectations.
- Large deals during the month included Merck (\$8 billion – acquisition of Acceleron), Roche (\$6 billion – repurchase shares), and Daimler Trucks (\$6 billion – spin-off).
- Flows turned negative in December driven by outflows from shorter-dated funds. These negative flows were modest and made little dent in the YTD inflow totals of ~\$80 billion (JPM estimate).

Valuations

- Spreads widened 12 basis points in November and tightened 7 basis points in December to end the year at 92 basis points after being range-bound between 80-90 from mid-April to early-November. Omicron caused a two-week sell-off, though spreads seem headed back to the prior trading range.
- BBB-rated credits are trading 38 basis points wide of A-rated credits – near historical lows and stable over the last six months. BBB securities outperformed both in December and 2021 overall due to the extra carry and slight compression to single A credits. We still favor BBB-rated securities.
- Commodity industries outperformed during the month while more defensive industries like utilities and packaging underperformed. Otherwise, it is difficult to pull out any major themes. Trading activity was muted.

Investment Grade Market Update

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*At S&P, a fallen angel is when a credit is downgraded from Investment Grade (BBB- or higher) to High Yield (BB+ or lower). A rising star is when a credit is upgraded from High Yield (BB+ or lower) to Investment Grade (BBB- or higher). At Moody's a fallen angel is when a credit is downgraded from Investment Grade (Baa3 or higher) to High Yield (Ba1 or lower). A rising star is when a credit is upgraded from High Yield (Ba1 or lower) to Investment Grade (Baa3 or higher).

The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. **The Bloomberg U.S. Corporate Bond Index** is a component of the U.S. Aggregate Bond Index. It measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

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