Investment Grade Market Update

MAY 2022: OUTLOOK AND IMPLEMENTATION

	May 2022	YTD/YTD Change
Total Returns	0.93%	-11.92%
Excess Returns	0.79%	-1.99%
Yield	-0.10%	+1.88%
Spread	-5bps	+37bps
Price	+$0.62	-$14.64

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

► May started off ugly, but a fierce rally in the final week brought spreads and yields back from the YTD highs. A volatile earnings season concluded with aggregate numbers that were positive, though forward visibility is becoming more challenging. The new issue market granted a reprieve that allowed for the rally to take place, but we do not expect this to last, with some large deal potential in June (Oracle).

Fundamentals

- With 99% of constituents reporting, S&P 500 revenue and earnings growth for the first quarter are 13% and 10%, respectively. Earnings came in ahead of expectations by 4.7%, with 76% of companies beating estimates – consistent with the five-year average beat/miss ratio.
- Earnings estimates for 2022 call for 4.1% growth in the second quarter (down from 5.5% month-over-month), with a ramp to 10% earnings growth in the back half of the year. We are surprised that full year estimates have climbed from 8% to >10% given the macro uncertainty. Estimates got as high as 11% but are starting to slip. Unsurprisingly, energy estimates are up dramatically while consumer discretionary and industrial estimates have moved lower.
- Ratings trends are overwhelmingly positive, with Moody's and S&P together posting an upgrade/downgrade ratio of 8.1x. YTD we have had a growing list of rising stars (Kraft Heinz, Toll Brothers, Freeport McMoRan, Targa Resources, MasTec, HCA) with just one small fallen angel (Steelcase).

Technicals

- The new issue market slowed in May with $108 billion of gross issuance, but just $10.5 billion of net issuance (down 76% year-over-year). With yields at ten-year highs and cold investor reception for new issues, the market took a breather towards the end of the month. The largest deals included: Intercontinental Exchange ($8 billion – acquisition of Black Knight), UnitedHealth ($6 billion), and Citigroup ($6 billion).
- Mutual funds have seen trickling outflows all year despite historically bad total returns. Corporate-only funds are surprisingly positive YTD, while aggregate and total return funds have seen outflows. Per JP Morgan, which blends these totals, YTD outflows are $15 billion YTD – roughly 1% of the AUM base.
- The big upcoming question is, what do foreign buyers do with rising hedging costs and positive yields in their home countries? Foreign buyers represent >25% of the holder base for investment grade corporate debt, and the U.S. market is no longer the only big liquid market with positive yields. Negative yielding debt is down from $16 trillion at the peak to $2.5 trillion.

Valuations

- Spreads peaked at a post-COVID high of 147 bps on May 20th before a 19-bps rally in the final six trading days of the month. At 129 bps, spreads are 15 bps higher than the five-year average. Yields flirted with the ten-year highs for much of the month before retracing to 4.2%. The five-year average is 3.0%.
- Industry performance was mixed in May, with communications (-11 bps), non-cyclicals (-8 bps), and banking (-7 bps) leading the charge tighter. The most liquid names are found in those industries. Given the speed of the month-end rally, we believe some of the laggards are driven by lack of activity: finance companies (+15 bps), REITS (+10 bps).

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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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