Investment Grade Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

JUNE 2022: OUTLOOK AND IMPLEMENTATION

	June 2022	YTD/YTD Change
Total Returns	-2.80%	-14.39%
Excess Returns	-1.68%	-3.45%
Yield	+0.49%	+2.37%
Spread	+27bps	+64bps
Price	-$2.97	-$17.61

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

► Trailing 12-month returns bottomed at -13.8% in the Great Financial Crisis (GFC) and -15.8% in the Fed-induced early 1980s recession. Trailing 12-months returns through the end of June were -14.2%. This is about as bad as we have ever experienced in the asset class. It could certainly get worse, with spreads now well wide of averages at 156 basis points (bps), but inside of recessionary levels (+285 – COVID, +200 – Oil Collapse, +250 – Euro Debt Crisis, +600 – GFC). Rates would typically provide an offset from a total return standpoint, but inflation needs to cooperate for that to happen. While valuation is being restored to the asset class, we are being very selective with additions and focusing almost exclusively on the new issue market given the massive concessions being offered; these often pull secondary levels wider.

Fundamentals

- Credit metrics fully retraced the pandemic-era weakening and are now moving sideways. We saw an acceleration of share repurchases in the second quarter, which began to eat into the cash piles that companies raised as a contingency during the pandemic. Fortunately, we have seen lower-rated BBB companies behaving in a more conservative manner. The value of investment grade ratings increased following the Fed actions from the last crisis.

- Earnings estimates for 2022 call for 4.1% growth in the second quarter (unchanged month-over-month), with a ramp to 10% earnings growth in the back half of the year. These figures have not budged despite rising risks of a recession and unsupportive economic data. Whether anyone still believes in these forecasts is another question altogether, and we suspect the answer is “no.” We are expecting sharper than normal revisions to back half earnings.

- Ratings trends are overwhelmingly positive, with Moody’s and S&P together posting an upgrade/downgrade ratio of 6.3x in the second quarter. 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

- It was a difficult month for the new issue market with concessions high and investor interest low, especially for the BBB industrials cohort. Gross and net supply of $92 billion and $26 billion were 15% and 33% below the five-year averages, respectively. Large deals included: TD Bank ($5.5 billion), JP Morgan ($4.5 billion), NextEra ($4 billion), and Parker Hannifin ($3.6 billion). Much larger deals were rumored, but remained on the sidelines (Oracle, Broadcom, Celanese) with the soft backdrop.

- Per JP Morgan, “every single week this quarter has seen outflows, which is not something we’ve observed since Q1 2004.” YTD outflows have been consistent, but modest, totaling roughly 2% of corporate fund AUM. Corporate funds are close to flat, with aggregate and total return funds firmly in negative territory.

Valuations

- Spreads ended the month at 156 bps, a two-year high, and equivalent to the highs reached in the late 2018 growth scare. Yields hit 5% during the month and ended at 4.7%. The last time yields were this high was coming out of the GFC in 2009. The average dollar price of a bond in the IG index ended the month at $92. The average price dipped into the mid $80s during 2008 and hit $92 during the dot-com collapse.

- Basic industries (+33 bps) and energy (+30 bps) were the underperforming sectors during the month, with commodities giving back much of the YTD outperformance. Risk-off was the prevailing sentiment through the month and utilities (+17 bps) were the best performer.

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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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