Investment Grade Market Update

OCTOBER 2022: OUTLOOK AND IMPLEMENTATION

	October 2022	YTD/YTD Change
Total Returns	-1.03%	-19.56%
Excess Returns	+0.60%	-3.02%
Yield	+0.24%	+3.60%
Spread	-	+66
Price	($1.14)	($24.22)

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

► Spreads remain halfway between “average” and “recessionary,” as they were unchanged in October. Yields made new highs while prices made new lows. Returns are at modern-era lows. We like investment grade (IG) corporates here. Credit metrics are starting from a position of strength, while rising rates will not impact interest coverage for several years, allowing companies to adjust to a new cost of capital. The relative value has improved over the past month as high yield spreads have compressed 90 basis points (bps), with IG spreads unchanged. New issue concessions are at historical highs and have been our preferred method of increasing exposure.

Fundamentals

- Credit metrics are in a strong starting position ahead of a potential 2023 recession. Leverage has returned to pre-COVID levels, while interest coverage metrics have improved to a near ten-year high. The average maturity is over 11 years, and maturing coupons are still at or below new issue coupons – this leaves the asset class least sensitive to rising rates, strictly from a fundamental performance standpoint. Furthermore, inflation is helpful for those with long-term fixed liabilities (EBITDA growth > interest growth) which is most true of the IG market.

- Third quarter earnings are 85% completed for the S&P 500 and, while on the soft side, they were far from the catastrophe many feared. Sales and earnings growth are clocking in at 11% and 3%, respectively, with 69% of companies beating estimates – the five-year average is at 77%. Estimates for the fourth quarter and 2023 are declining at a quick pace as macroeconomic headwinds mount.

- Ratings migration activity has slowed, with no rising stars or fallen angels for the second straight month. Notable rising stars in 2022 include Kraft Heinz, Toll Brothers, Freeport McMoRan, Targa Resources, and HCA.

Technicals

- October issuance of $104 billion was 11% below the five-year average. Financials continued to dominate the action, accounting for 50% of net supply during the month and 67% YTD. This compares to a ten-year average of 28%. The largest issuers of the month were UnitedHealth ($9 billion), Morgan Stanley ($6.5 billion), HSBC ($6 billion), Barclays ($5 billion), Lockheed Martin ($4.5 billion), and Enel ($4 billion). Year-to-date gross issuance is down 14%, but this is extremely heavy relative to other asset classes such as high yield and leveraged loans, where new issue supply is down more than 70% YTD.

- Outflows continued for much of the month, with a small inflow in the final week. Corporate-only funds have seen resilient flows YTD while aggregate and total return funds have experienced steady outflows.

Valuations

- Spreads were unchanged during October at +158, keeping them at the 91st percentile over the past decade. Another move higher in rates propelled yields to fresh 10-year highs, ending the month at 5.93%. Relatedly, dollar prices ended the month at decade lows in the mid $80s. Dollar prices are at their lowest point since the early 1980s, save for a three-week period during the Great Financial Crisis.

- Financials are at their relative wides to industrials dating back to the European debt crisis in 2012. Underperforming industries in October included banking, REITS, and brokers. Energy and communications outperformed.

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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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