Investment Grade Market Update

Newfleet ASSET MANAGEMENT A Virtus Investment Partner

DECEMBER 2022: OUTLOOK AND IMPLEMENTATION

	Dec 2022	YTD/YTD Change
Total Returns	-0.44%	-15.76%
Excess Returns	0.20%	-1.25%
Yield	+0.11%	+3.09%
Spread	-3	+38
Price	-$0.73	-$20.66

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

► Investment grade wrapped up its worst year on record with a quiet December. The lack of supply helped push spreads modestly lower despite a tough month for equities (-6%) while rates made one last move higher. Spreads are in the 70th percentile over a five-year range, but within just 10 bps of the five-year average. With recessionary risks elevated (65% per Bloomberg consensus), this valuation leaves something to be desired. However, we continue to see pockets of value, particularly in high-quality financial institutions where valuations are still at more extreme levels. Fundamentals remain supportive of the market overall and yields are compelling – they will enter the new year at 5.42%, the highest starting point for yields since 2009.

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 investment grade market.

- Fourth quarter earnings will be reported in January, and estimates have been trending lower. Currently, the market is anticipating a 3% earnings decline, though the average historical beat is ~4%. Consensus estimates show negative earnings growth of 1-1.5% in the first half with 5-10% growth in the back half.

- Ratings agencies have largely restored the market to pre-COVID ratings levels. The pace of improvement has slowed, with the upgrade/downgrade ratio falling as the year progressed, though it remains in positive territory (Q1: 8.4, Q2: 6.3, Q3: 4.4, Q4: 1.3).

Technicals

- December issuance of $6 billion was the lightest month in more than twenty years. For the full year, gross and net supply of $1.4 trillion and $470 billion, respectively, were both 16% below 2021 issuance. Consensus forecasts call for another modest decline in issuance for 2023 as the M&A pipeline is light and issuers adjust to more expensive borrowing costs.

- Mutual fund flows returned to negative territory in December after a blip of inflows in November. The outflows in December were driven by selling from mutual funds, while ETFs saw inflows. There is speculation that this is tax loss selling that may reverse in early 2023. Corporate-only funds had inflows for much of the year, while aggregate and total return funds have experienced steady outflows.

Valuations

- Spreads ground tighter in December despite a ~6% decline in equities and slight widening for high yield. Investment grade's outperformance in the final two months of the year has eroded some of the relative value against other sectors. Rates made a final push higher, and yields ended the year at 5.42% while starting at 2.33%.

- Energy underperformed in December as commodity prices declined. REITs, tobacco, homebuilding, and life insurance 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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