Investment Grade Market Update

FEBRUARY 2023: OUTLOOK AND IMPLEMENTATION

	Feb 2023	YTD/YTD Change
Total Returns	-3.18%	0.70%
Excess Returns	-0.54%	+0.61%
Yield	+0.54%	-0.38%
Spread	+6	-7
Price	-$3.16	+$0.25

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

► Spreads and rates both moved higher in February, erasing much of January's hot start. Sticky inflation data, the most relevant macro driver for the month, pushed rates higher. Investment grade spreads widened while high yield spreads tightened. We would attribute this divergence to an unrelenting calendar. Both January and February set the monthly records for supply (22% higher than 2021's record pace), and we have not slowed down in early March.

Fundamentals

- Credit metrics remain healthy overall. 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 came in soft, registering a 4% earnings decline. An earnings recession is now the base case scenario as consensus forecasts call for mid-single-digit declines in earnings for the first half of 2023. Risk markets seemed to shrug off this softness – the punishment for misses was light. Revenues came in as expected, but margins are compressing quickly back towards pre-COVID levels.

- Ratings agencies have mostly restored the market to pre-COVID ratings levels. The agencies have been quieter YTD. The bulk of YTD downgrades are limited to a few idiosyncratic situations: Intel, MMM, and Stanley Black & Decker. Beyond that, the majority of ratings actions are positive. Year-to-date, two credits were upgraded to investment grade (Booz Allen, MSCI), with no fallen angels to date. We expect rising stars to outpace fallen angels in 2023.

Technicals

- A record January was followed by a record February for issuance. $180 billion of gross supply in February was 30% ahead of the prior record (2021) and YTD supply of $396 billion beats the 2021 record by 22%. While we expect full year supply to moderate on a year-over-year basis, this would require a meaningful slowdown over the remainder of 2023, as supply is currently running 50% ahead of 2022's pace. February's supply was driven by industrial issuers, and the average tenor of new issuance was long – this reverses the recent trend towards front end issuance.

- Large issuers during the month included Amgen ($24 billion – ninth largest deal on record), Intel ($11 billion), CVS ($6 billion), Philip Morris International ($5.25 billion), Oracle ($5.25 billion), and Eli Lilly ($4 billion).

- Fund flows are positive thus far in early 2023, reversing some of last year's record outflows. Foreign buyers are subdued, held back by the increasing costs of hedging the currency risk as the Fed raises rates. Institutional domestic buyers appear to be active, locking in these higher yields for a longer period. The 10s/30s curve is historically flat as a result.

Valuations

- Spreads widened 7 bps in February, with financials outperforming, which widened by only 4 bps. Heavy issuance weighed on the industrial sector, which was wider by 8 bps.

- Outperforming industries in February included: airlines (-37 bps), packaging (-3), homebuilders (-2) and auto (-1). Underperformers included: cable (+17 bps), railroads (+13), health insurance (+13), and energy (+11).

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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).

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