Breckinridge CAPITAL ADVISORS

Q1 2021

Corporate Bond Market Outlook

Key Drivers for the Year

- For 2021, we expect economic and profit growth normalization, particularly toward summertime and the second half of the year, as vaccine distribution accelerates.
- While credit fundamentals remain challenged, higher cash balances have begun to stabilize net leverage, while high gross leverage should steady as cash flows rise in 2021.
- Share buybacks and merger and acquisition (M&A) deals both posted double-digit declines in 2020. With high investment grade (IG) cash balances and improved visibility, both may accelerate in 2021.
- COVID-19 brought environmental, social and governance (ESG) risk exposures and management of them into greater focus during 2020. Balance sheet repair and managing for broader stakeholders was key.
- After a record year, IG supply is expected to drop notably in 2021. Gross and net may decline to $1 trillion and $0.4 trillion in 2021, respectively. Investor demand should sufficiently cover net issuance.
- Improving fundamentals and favorable technicals suggest a rangebound to slight narrowing bias to spreads. Still, spreads are tighter than average and may face resistance.

Investment Outlook

It is Déjà Vu All Over Again

One year-ago, the weighted-average option-adjusted spread on the Bloomberg Barclays U.S. Corporate Investment Grade Index stood at +93 basis points (bps). The Index ended just 3bps wider in 2020 after peaking at 373bps when credit curves inverted in March. If one fell asleep a year ago and woke up today, one might conclude that not much changed over the past year. How incorrect that assessment would be. The COVID-19 pandemic wreaked havoc on unemployment, economic growth, and risk asset performance during the first half of 2020. IG corporate spreads peaked at nearly +400bps and equities declined by about 30 percent by late March. But then the cavalry arrived in the form of extraordinary monetary stimulus. The entry of the Fed into corporate bond markets in April was a crucial catalyst and IG spreads reacted strongly to its actual and potential buying power. In 2020, with the sharp decline in Treasury yields, the U.S. IG corporate bond market generated an impressive 9.9 percent total return. However, with spreads slightly wider year-over-year (Y/Y), the excess return versus duration-matched Treasuries was a more modest 49bps.

In 2021, we expect positive vaccine results and additional fiscal stimulus to jump-start growth, particularly in the second half of the year. Technicals should continue to support spread product, but further spread tightening may be limited. Easy financial conditions, low yields, record cash balances, and a significant decline in net supply in spread products should be supportive of risk assets. In such a scenario, we think the IG corporate market can modestly outperform Treasuries and other risk-free assets at a starting point of +96bps, with our expectation for rangebound spreads.

Implications for corporate credit are notable. We expect a focus on balance sheet repair to continue, particularly for those industries most negatively impacted by the pandemic (e.g., Energy, Materials, Industrials, Consumer Discretionary). However, less-impacted sectors such as Communications, Consumer Staples, Health Care and Technology may be more apt to focus again on deploying cash for discretionary share buybacks and opportunistic M&A that were largely on hold for most of 2020.

A risk to our investment thesis is that slower than expected distribution or penetration of the COVID vaccine has a negative knock-on impact to economic growth and corporate earnings. Potentially bigger changes to U.S. policy than expected related to taxes and regulation or an exogenous shock (e.g., spike in oil prices, geopolitical or trade concerns) are additional risks. A different risk is that with an effective vaccine, companies rediscover a preference for debt-funded shareholder enhancements (e.g., share buybacks, M&A, special dividends), after a year of protecting their balance sheets, and animal spirits—those forces that Keynes posited as market drivers—accelerate.

U.S. Election - Credit Implications

For IG corporate borrowers, U.S. federal tax policy is important, and changes in tax rates seem less likely unless the Democrats win both U.S. Senate races in the runoff in Georgia and a slim majority in the Senate. As we go to press, the Dems appear to have won both seats, although the races are extremely close. If results hold, the likelihood of a boost in the corporate tax rate increases. In that case, with taxes potentially rising from 21 percent to 28 percent, estimated earnings growth would be expected to decline by a comparable amount. This outcome would clearly be a credit-negative although we would note that the corporate tax rate was 35 precent prior to the 2017 tax cut and IG issuers were well able to negotiate that. And, Democrats may look to increase fiscal stimulus, which would be a partial offset for the economy and by extension corporate profits.

Once through the pandemic and considering President-elect Biden's goal to raise the minimum wage, we could see some upward trajectory on wages put pressure on labor-intensive issuers like Retailers and Restaurants, among others, with a credit-negative knock-on effect on margins and earnings. However, on the flipside, increasing employee wages can reduce staff turnover and increase loyalty and productively, which can be longer-term positives, from an ESG perspective.

Under a Biden Administration we may see increased regulation of the Banking sector. We would view that potential as credit neutral. Additional Banking regulation may reduce risk-taking, limit certain investing activities, and potentially lower earnings, but it could also include boosting capital requirements and taking a closer look at physical and transitional climate risks. Higher capital cushions strengthen balance sheets and generally favor credit ratings and bank bondholders.

The new Administration may look to increase regulation to counter the rise in greenhouse gas emissions in carbon-heavy sectors. This is viewed as credit negative due to the earnings and growth hit it could cause, in Energy and Utilities sectors. That said, issuers in these sectors have been transitioning to renewables and cleaner sources of energy, which could partially mitigate more regulations.

Large Technology issuers may continue to be under a microscope however we place a low likelihood of large-scale break-ups. But, even the prospect could encourage some companies to engage in divestments, spin off's or other means of selling assets to mitigate anti-trust scrutiny. While not necessarily suggesting a negative credit event, it is something we will be alert to in the sector.

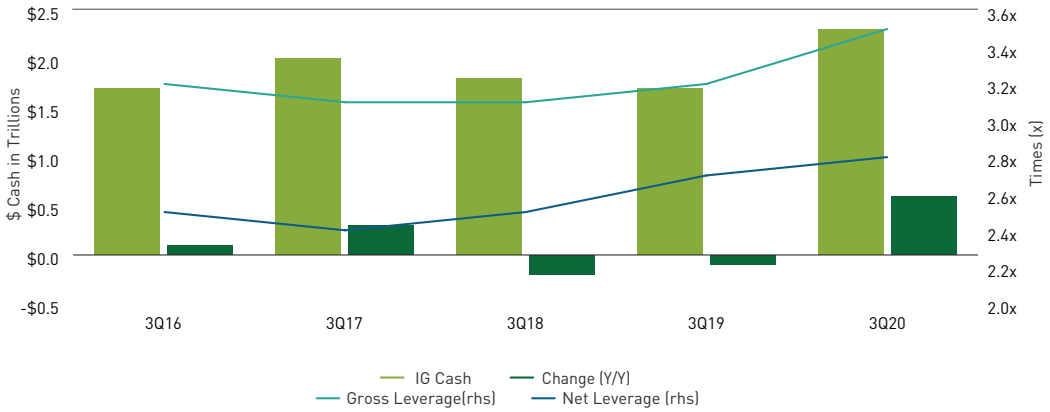
Finally, For Basic Industry, Manufacturing and Industrials, trade policies and tariffs will be a key focus.

Fundamentals

While credit fundamentals remain challenged, higher cash balances have begun to stabilize net leverage, while high gross leverage should steady, as cash flows rise in 2021. For example, net leverage for the mean IG corporate bond issuer was 2.78 times at 3Q20 compared to 2.66 times the prior year, a muted increase, per Bloomberg data. In contrast, gross leverage rose to 3.50 times at 3Q20 from 3.17 times the prior year, which is a record high.

IG companies raised cash in various ways during 2020, including record term debt issuance, to ride out COVID-19 and pandemic-related economic and profit uncertainty. Cash resources for the IG non-Financial cohort grew by about $500 billion Y/Y, per Wells Fargo. The pace of IG downgrades and fallen angels slowed in the second half of 2020, per rating agency data. However, some sectors are still vulnerable to downgrades. Balance sheet repair looks set to continue for those industries most negatively impacted by the pandemic (e.g., Energy, Materials, Industrials, Consumer Discretionary).

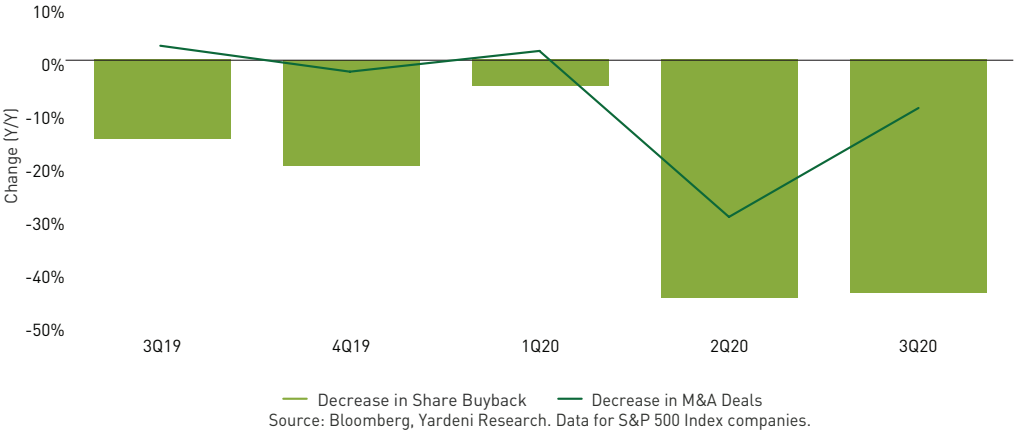
FIGURE 1: RECORD CASH RAISED IS STABILIZING NET LEVERAGE



Source: Wells Fargo, Bloomberg. Mean leverage for constituents in Bloomberg Barclays IG Corporate Non-Financial Index.

For 2021, we expect economic and profit growth normalization, particularly toward summertime and the second half of the year, as vaccine distribution accelerates. After an estimated 14 percent Y/Y decline in 2020, per FactSet, S&P 500 operating earnings are expected to grow by 22 percent in 2021, although that estimate could come down if corporate taxes rise. Share buybacks and M&A deals both posted double-digit declines in 2020. With high IG cash balances and improved visibility, both may accelerate in 2021. Less-impacted sectors (e.g., Communications, Consumer Staples, Health Care, Technology) may deploy excess cash to shareholders and refocus again on debt-funded M&A.

FIGURE 2: DECLINE IN BUYBACKS AND M&A SET TO REVERSE COURSE

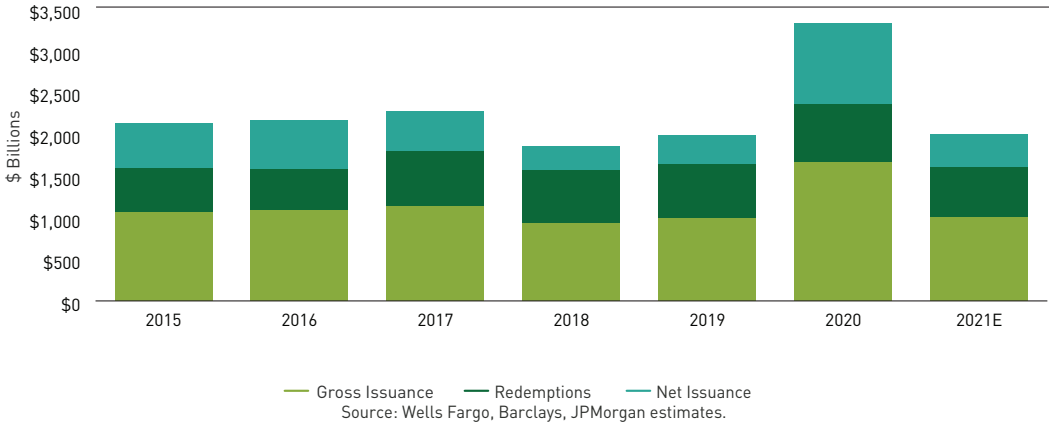


Source: Bloomberg, Yardeni Research. Data for S&P 500 Index companies.

Technicals

IG corporate gross ($1.7 trillion) and net ($1 trillion) fixed-rate supply were both records by a large margin in 2020, per Barclays. In 2020, corporate supply rose sharply due to very low rates, liability-management exercises and tactical cash raising. Fortunately, investor-demand indictors generally remain healthy. For example, IG fund inflows were about $0.3 trillion in 2020, per EPFR/Informa, and foreign-owned U.S. corporate bond holdings rose by a similar amount, per TICS. High U.S. Treasury net issuance should favor demand for non-government net credit issuance, which is expected to decline notably in 2021, per JPMorgan. Gross and net U.S. IG issuance may decline to $1 trillion and $0.4 trillion in 2021, respectively. U.S. IG offers yield over competing markets, and foreign flows should remain solid, prospectively. Accordingly, we think investor demand should sufficiently cover net IG issuance in 2021.

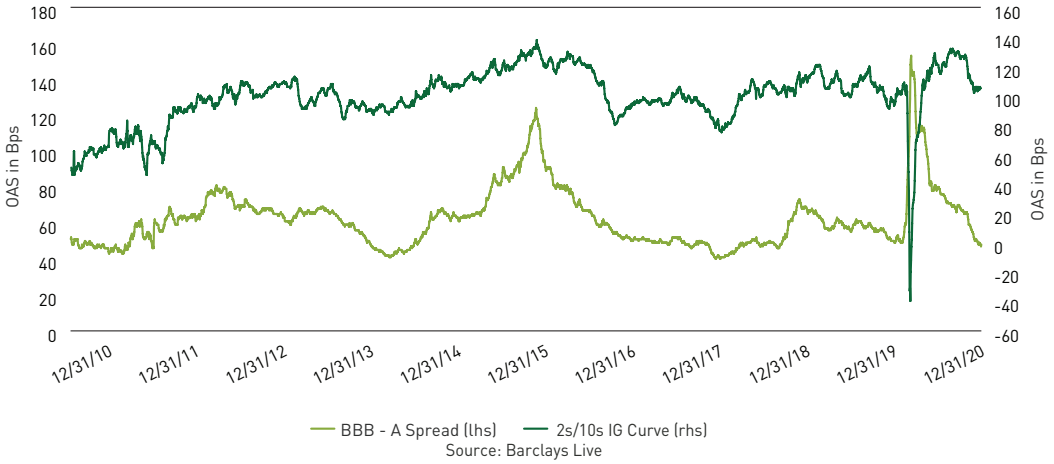
FIGURE 3: RECORD IG SUPPLY THIS YEAR IS SET TO SLOW IN 2021



Valuations

One year-ago, the spread on the Bloomberg Barclays U.S. Corporate Investment Grade Index was 93bps. The Index ended just 3bps wider in 2020, after peaking at 373bps in March when credit curves briefly inverted. Easy financial conditions, low yields, record cash balances, and a significant decline in net supply in spread products should be supportive of risk asset valuations, including corporate bonds in 2021. Technicals should continue to support spread product, but further spread tightening may be limited given current valuations. Opportunities should exist out the curve with the 2s/10s corporate spread credit curve steeper than its 10-year average. Triple-B bonds appear to offer selective value but, quality spreads are tight and credit picking is crucial.

FIGURE 4: SPREADS ARE TIGHT BUT OPPORTUNITIES CAN BE FOUND



ESG Spotlight

Expanded Engagement Adds Insights in 2020

The COVID-19 pandemic brought environmental, social and governance (ESG) risk exposures and management of them into greater focus during 2020. Balance sheet repair and managing for broader stakeholders was key. IG companies seemed more attuned to ESG issues and issuers that effectively managed finances, human capital, and supply chains should be better positioned in a recovery.

Information discovered during our more than 100 bond issuer ESG engagement meetings in 2020 explored best practices in sustainability. As issues unfolded during the year, including COVID-19 and social and racial justice issues, specific themes took on added relevancy for corporate and municipal bond issuers and our analysts. Our corporate engagement meeting assessments support our view that bond issuers are more attentive to addressing ESG issues and reporting on their progress. For more, please see the full report here: *https://www.breckinridge.com/insights/?type=esg-newsletter*.

CREDIT TRENDS DASHBOARD

In our Credit Trends Dashboard, we capture our views of the key drivers of IG corporate credit.

TRENDS	Weakness				Strength	
Central Bank Policy					X	FOMC forecast it will maintain the Fed Funds rate at the 0% lower bound through 2023 and continue to make bond purchases.
Management/ESG				X		Balance sheet repair and managing for broader stakeholders was a focus in 2020. IG companies are more attuned to ESG issues.
Supply/Demand				X		IG issuance is expected to drop notably after a record in 2020. Fund and foreign investor demand should comfortably cover net supply.
Economy			X			While near-term growth may be weak with rising caseloads, positive vaccine results and fiscal stimulus should jump-start growth 2H21.
Event Risk			X			M&A declined by double-digits in 2020. Sectors less impacted by COVID-19 may deploy excess cash and refocus on M&A in 2021.
Financial Leverage			X			Higher cash balances have begun to stabilize net leverage, while high gross leverage should steady as cash flows rise in 2021.
Operating Trends			X			After an estimated 14% Y/Y decline in 2020, per FactSet, S&P 500 earnings may grow by 22% in 2021, unless taxes increase.
Regulatory			X			Regulations in certain sectors (e.g., Banking, Energy, Tech) could shift under a Biden administration and corporate tax rates may rise.
Geopolitical Risk		X				Tariffs among major trading partners negatively impact global growth and stability. COVID-19 fallout may further strain relations.
Rating Trends		X				The pace of IG downgrades and fallen angels slowed in the second half of 2020. Some sectors are still vulnerable to downgrades.
Valuations		X				Fundamentals and solid technicals suggest a slight narrowing bias. But spreads are tighter than average and may face resistance.

Sources: Breckinridge Capital Advisors, Barclays, Bloomberg, Bureau of Economic Analysis, FactSet, Rating Agencies.

STATISTICAL SUMMARY

	As of 12/31/20		OAS Change (bps)		
	YTW (%)	OAS (bps)	MTD	QTD	YTD
Bloomberg Barclays U.S. Corporate Index	1.74	96	-9	-40	3
Corporate Credit Curves					
Corporate 1-3 Year	0.48	35	-5	-24	-8
Corporate 1-5 year	0.66	47	-8	-29	-7
Corporate 5-10 year	1.52	89	-9	-42	0
Corporate 10 + year	2.78	140	-8	-48	5
Corporate Quality Spreads					
AAA Corporate	1.59	55	-3	-21	3
AA Corporate	1.40	58	-4	-22	10
A Corporate	1.49	73	-6	-30	4
BBB Corporate	2.01	121	-12	-52	1
Corporate Sector Spreads					
Banking	1.23	72	-8	-38	-1
Basic Industry	2.10	121	-10	-45	-11
Capital Goods	1.79	98	-10	-41	16
Communications	2.20	120	-5	-36	10
Consumer Cyclical	1.53	82	-8	-41	-11
Consumer Non-Cyclical	1.79	90	-5	-32	-2
Energy	2.17	137	-21	-63	9
Insurance	1.96	105	-5	-39	3
REITS	1.70	107	-17	-55	13
Technology	1.50	75	-6	-31	1
Transportation	2.12	115	-7	-42	19
Utility	2.06	106	-5	-34	9
Supply/Demand ($Billions)					
	3Q20*	**3Q19***	**2019**	**2018**	**2017**
Net Corporate Supply	91	625	480	370	604
Net Purchases (Foreigners)	-5	92	155	-60	332
Net Purchases (Funds)	713	437	99	190	275
Net Purchases (Households)	-1184	-185	65	94	-26
Net Purchases (Insurance)	288	381	141	145	81
Net Purchases (Other)	279	-100	20	1	-58

* Note: Quarterly figures are seasonally adjusted annual rates.
Sources: Bloomberg Barclays, Fed Flow of Funds.