Breckinridge CAPITAL ADVISORS

Q1 2023 Corporate Bond Market Outlook

Key Drivers for the Quarter

- With a cumulative fed funds increase of 125 basis points (bps) in 4Q and guidance for continued hikes in 2023, the Federal Reserve (Fed) showed that cutting inflation remains its top priority.
- In the U.S., investors appeared hopeful that the Fed would relent in the face of improving inflation readings during 4Q.
- Investment grade (IG) corporate bonds, as measured by the *Bloomberg* (BBG) U.S. Corporate IG Index (the Index),[1] delivered positive total and excess returns in 4Q, while year-to-date returns were negative.
- Yields on IG corporate bonds were sustained at the highest levels in more than a decade.
- In our view, operating trends for IG issuers will weaken as demand falls. *FactSet* estimates an average S&P 500 fourth quarter earnings decline of about 3 percent which, if realized, will mark the first year-over-year S&P 500 earnings decline since 3Q/2020 when it was 5.7 percent.[2]
- While outflows plagued IG funds during most of 2022 and new issuance was below trend on volatility, signs may be pointing to somewhat higher issuance, especially early in 2023.
- Looking ahead, we expect volatility and some spread widening pressure, but relatively high all-in yields may attract flows into IG fixed income.
- Environmental, social, and governance (ESG) considerations remained top-of-mind as regulatory and legislative initiatives bolstered efforts to adapt, manage, and mitigate ESG risks. Meanwhile, opponents and proponents of factoring in ESG analysis in security analysis pushed their agendas. Breckinridge maintained its stance that ESG in security analysis is additive to the effort to identify and understand certain nonfinancial risk factors in investment decision making.

Investment Review and Outlook

Hoping the Rate-Hiking Cycle Was Nearing an End, Investors Returned to Risk Markets

The Fed did not meet in October. In the absence of action from the central bank and improving economic data, investor sentiment improved. The economy expanded at an annualized rate of 3.2 percent in the third quarter, per Bureau of Economic Analysis data. A strong labor market and ample savings supported consumer spending, with third-quarter personal spending increasing 1.4 percent. Industrial production increased, as did new orders for durable goods. Housing sector readings lagged, suggesting the Fed's rate increases were helping to cool that hot market.

After the Fed's early-November 75bps fed funds rate increase, some investors hoped future hikes might moderate. Fed Chairman Jerome Powell suggested that future scenario was likely, but the timing of any moderation was less definitive. "While October inflation data received so far showed a welcome surprise to the downside, these are a single month's data, which followed upside surprises over the previous two months," he said.

Improving sentiment encouraged investors to reconsider risk assets, bolstering values across bond and equity markets in November. The Corporate Index gained 5.18 percent on a total return basis and 2.11 on an excess return basis, the highest monthly returns for the year.[3]

The Fed's mid-December 50bps fed funds rate increase and ratcheting higher its projected 2023 fed funds rate above 5 percent suppressed investor enthusiasm. The Corporate Index fell 0.44 percent on a total return basis, while continuing to outperform Treasuries with a 20bps excess return.[4]

Consumer Price Index (CPI) inflation readings showed inflation trended lower in November. Once again, Fed Chair Powell reiterated that while recent inflation data was encouraging, inflation was still elevated, remains well above target, and lowering it remains the top priority. His comments indicated Fed policy will remain restrictive until inflation clearly is closer to its 2 percent target. Projections also indicated rate cuts would not come until 2024, at the earliest.

The 10-year/3-month Treasury yield curve inversion steepened during the fourth quarter. A 10-year/3-month inversion has preceded recession by an average of eleven months based on eight observations since 1969, per Fed data.[5]

The Breckinridge Investment Committee's base case is for a milder recession in the U.S. compared with the rest of the world. With IG corporate spreads at 130bps as of December 31, 2022, investors appear to be pricing in a soft-landing, non-recessionary scenario, based on historical Federal Reserve Economic Data from the Federal Reserve Bank of St. Louis.

We enter 2023 with the view that IG fixed income offers value with all-in yields above 4 percent in most terms and IG products. The yield on the Index is above 5 percent, the highest it's been in more than 10 years. We are defensively positioned with corporates, as spreads may widen over the course of 2023, as the risk of a U.S. economic recession seemingly increases. Technicals have improved at the margin, with the recent sharp decline in net corporate supply and the prospect for improved flows into taxable fixed income markets. Credit fundamentals are weakening, with slowing profit growth and elevated leverage partially offset by solid cash balances and a healthy U.S. banking sector.

Fundamentals

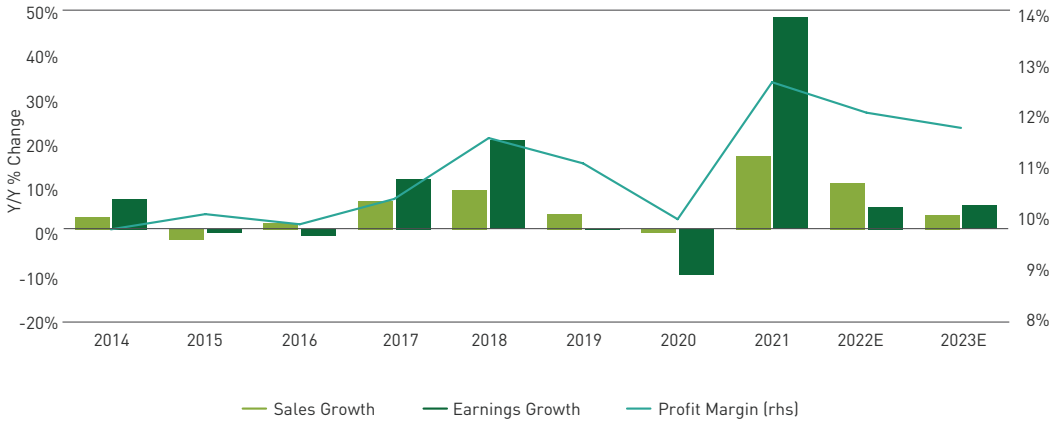
Earnings are Expected to Slow as Fed Rate Hikes Impact Demand

For 4Q2022, the estimated operating earnings decline for the S&P 500 Index[6] is 3 percent year-over-year (Y/Y), per *FactSet* (See Figure 1). For fiscal year 2022 (FY22), net earnings are expected to grow 5 percent Y/Y, with profit margins down slightly.

Energy is forecasted to be the largest sector contributor to earnings growth for the S&P 500 Index for FY22. Excluding Energy would force earnings growth down to about negative 2 percent Y/Y rather than 5 percent Y/Y.

For FY23, consensus growth is 5 percent, in line with FY22, which is noteworthy given the expected impact of rate hikes on demand.[7] 4Q22 earnings will be informative as issuers offer 2023 outlooks.

FIGURE 1: S&P 500 INDEX EARNINGS GROWTH IS FORECASTED TO SLOW



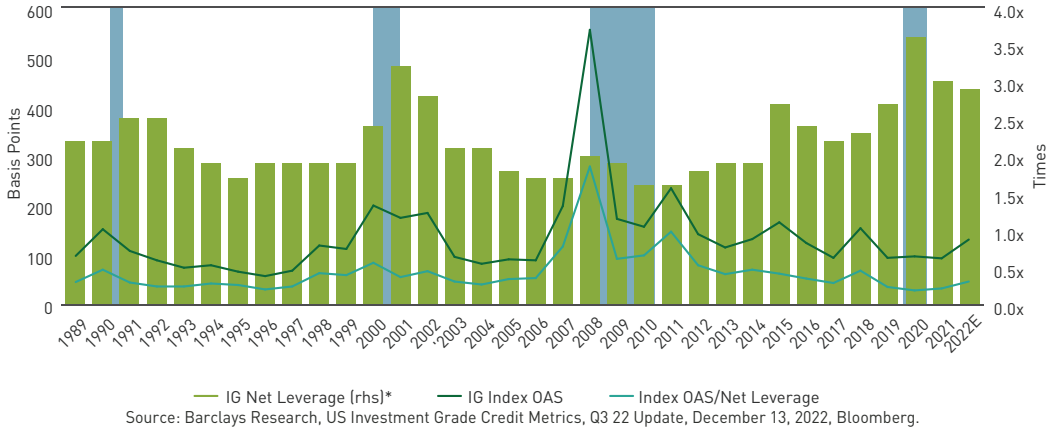
Source: FactSet, Earnings Insight, December 15, 2022.

Leverage May Rise and Spread Compensation is Below Average

IG net leverage is expected to end 2022 near 3.0 times. As we think about 2023, we observe that in the past four U.S. recessions, net leverage moved up an average of 0.5 times, peak-to-trough.[8]

Spread compensation per unit of leverage was 46bps at year-end 2022 (YE22), up from 31bps at YE21, but below the long-term average of 64bps (See Figure 2). We would expect spread compensation to increase during 2023.

FIGURE 2: SPREAD PER UNIT OF LEVERAGE IS BELOW LONG-TERM AVERAGE



Source: Barclays Research, US Investment Grade Credit Metrics, Q3 22 Update, December 13, 2022, Bloomberg.

The Index moved 29bps tighter in 4Q22, but was still 40bps wider year-to-date (YTD), finishing at an option adjusted spread (OAS) of 130bps.[9] The yield on the Index moved from 2.36 percent at YE21 to 5.26 percent at YE22.

Capital Allocations Decisions May Shift as Economic Conditions, Tax Policies Change

A number of factors may influence capital allocation decisions as well as mergers and acquisition (M&A) activity in the months ahead.

For example, the Inflation Reduction Act (the Act) created a 15 percent alternative minimum tax on large companies earning an average of more than $1 billion annually beginning in 2023. In addition, the Act also imposed a new annual excise tax that applies to repurchases of a publicly traded corporation's stock that take place after December 31, 2022.[10] The Department of the Treasury released guidance on the two new taxes in late-December including the types of transactions subject to the excise tax and how it is calculated. How corporations choose to allocate capital in light of the new tax burdens bears watching.

In general, M&A activity declined in 2022 compared to 2021. *Reuters reported* on December 21, that M&A activity globally "fell well short of the high-water mark set last year." The report acknowledged that 2021 levels may have been unsustainable and debt financing markets challenges and stock market volatility that reduced valuations exacerbated conditions. Total M&A value fell 37 percent by December 20, according to Dealogic data, after a record $5.9 trillion in 2021.[11]

With regard to shareholder dividends, Wall Street Horizon reported in December that the number of companies announcing lower dividends increased over the past two quarters, while the number increasing them fell, based on the portion of dividend-paying stocks in the more than 9,000 global stocks followed by Wall Street Horizon. In the third and fourth quarters, 16 percent lowered dividends, up from 14 percent and 12 percent in the last two quarters of 2021. There has been a corresponding decrease in the percentage that have announced higher dividends, with 21 percent doing so in the past two quarters compared with 25 percent in each year-earlier period.[12]

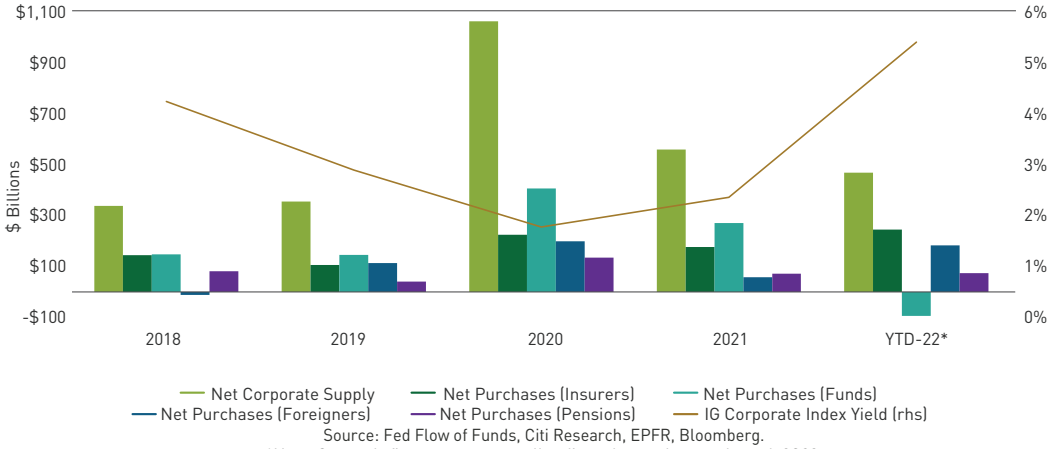
Technicals

Decrease in Net Corporate Supply on Higher Rates and Volatility

Net corporate supply underwhelmed in the second half of 2022 on higher rates and volatility (See Figure 3). Moreover, elevated refinancing in prior quarters and high cash balances contributed to a decline.

Given negative total returns, bond funds saw outflows during 2022 compared to strong inflows the prior year. However, with yields at their highest in a decade, fund inflows may pick up prospectively.

FIGURE 3: CORPORATE NET SUPPLY AND FUND FLOWS DROPPED AS YIELDS ROSE



Source: Fed Flow of Funds, Citi Research, EPFR, Bloomberg.
*Note: Quarterly figures are seasonally adjusted annual rates, through 3Q22.

Foreign demand picked up during 2022 despite high U.S. dollar hedging costs. Pension buying was muted but should increase given higher corporate bond yields. Insurers were a steady source of demand.

There are signs suggesting a potential rebound in IG corporate bond issuance, especially early in the new year.

Reporting in December, *Bloomberg* commented, "Blue-chip companies are expected to storm the bond market in January before funding costs increase and the economy deteriorates." *Bloomberg* cited a forecast for U.S. investment-grade bond sales to jump as high as $40 billion in the first week of 2023, more than four times what was issued in all of December.[13]

Valuations

Corporate Spreads Are Pricing in a Soft Landing, Not a Recession

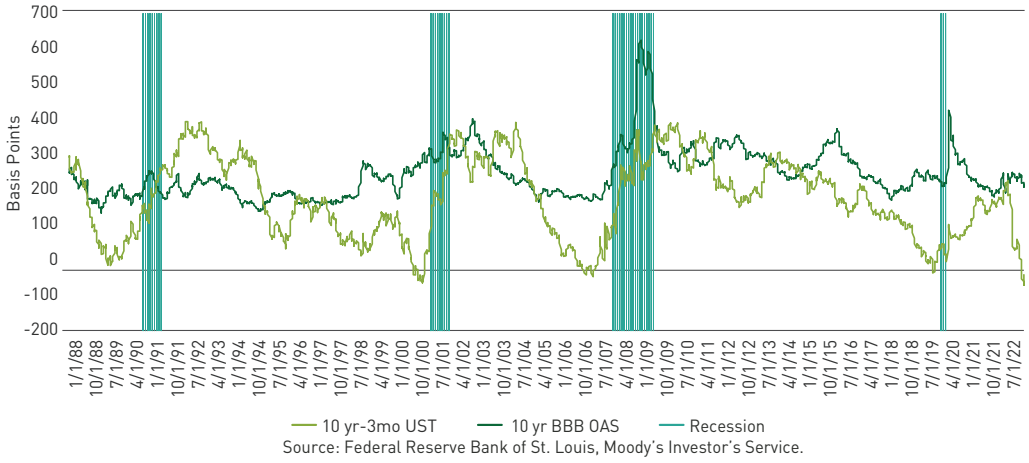
Credit spreads for 10-year corporate bonds rated BBB are pricing in a soft-landing economic scenario rather than a U.S. recession. Current valuations are trading about 30bps inside of the average spread since 1988.

Looking at historical data BBB credit spreads have troughed near 150bps five times and peaked above 300bps five times. Spread peaks have coincided with earnings or economic recessions or other market shocks.

A 10-year/3-month Treasury yield curve inversion has preceded recession by an average of 11 months based on eight observations since 1969 of Federal Reserve Economic Data (FRED) compiled by the Federal Reserve Bank of St. Louis.[14]

With an inverted curve and recession risk, spreads may widen in 2023. Even mild or earnings recessions have seen IG spreads tend to peak in the 175 to 200bps range. Typically, outside of recessions stemming from the Great Financial Crisis and the COVID pandemic, in a hard-landing, economic recession scenario, spreads historically have widened to the 200 to 250bps range.

FIGURE 4: INVERTED TREASURY CURVES, RECESSIONS AND CORPORATE SPREADS



Source: Federal Reserve Bank of St. Louis, Moody's Investor's Service.

ESG Spotlight

During the fourth quarter, the growing influence of climate policy in global trade was evident. The U.S. Inflation Reduction Act includes, among other environmentally oriented initiatives, several climate-friendly industrial subsidies to bolster domestic investment. Meanwhile, European Union (EU) trade laws imposed a levy on high-carbon imports; made more urgent by the energy crisis stemming from Russia's war in Ukraine.

Bloomberg noted in a report that, "The initiatives show how major economies are trying to create incentives to contain the damage from global warming while also keeping pace with high-stakes technological shifts."

For its part, Breckinridge and other asset managers and financial institutions have advanced their efforts to focus attention on global efforts to limit global warming to 1.5 degrees Celsius. The stance is based on science showing evidence that if global temperature rise cannot be limited to less than 1.5 degrees Celsius compared to pre-industrial levels, dramatic consequences will follow, including natural disasters such as floods, more severe and frequent weather events, longer and more severe droughts, and food shortages exacerbated by a changing climate.

Writing in *Harvard Business Review* in December, Andrew Winston offered this view: "In truth, climate change and clean tech create enormous risks and opportunities for companies and deeply affect their profitability and prospects. Investors need to understand and incorporate those risks into their assessments." Mr. Winston is an adviser and speaker on how to build companies that profit by serving the world. His books include *Green to Gold, The Big Pivot, and Net Positive*.[15]

CORPORATE TRENDS DASHBOARD

Key Drivers: Low Event Risk and Healthy Cash Balances are Offset by Tight Fed Policy and Soft Operating Trends

TRENDS	Weakness				Strength	
Event Risk				X		Mergers are down nearly one-third Y/Y as event risk has moderated on higher rates and market volatility.
Financial Leverage			X			Leverage typically rises in economic slowdowns, but healthy cash balances offer added financial flexibility.
Regulatory			X			Regulatory shifts are increasing scrutiny for large mergers and select sectors including Banking and Tech.
Supply/Demand			X			Net corporate bond supply has underwhelmed on high rates and volatility, while fund flows have stabilized.
Central Bank Policy		X				The Fed expect restrictive monetary policy to be necessary for some time to combat high inflation.
Economy		X				Real economic growth is expected to remain below trend with inflation weighing on consumer demand.
Management/ESG		X				Share buybacks accelerated in 1H22, reducing cash resources, and then declined; IG issuers remain focused on ESG risks.
Operating Trends		X				For 4Q22, the estimated operating earnings decline for the S&P 500 Index is -3% Y/Y, per *FactSet*.
Rating Trends		X				Agency rating outlooks are biased slightly negative after a positive period and downgrades may increase.
Valuations		X				At +130bps, IG corporate spreads are pricing in a soft-landing economic scenario rather than a recession.
Geopolitical Risk	X					The Russia/Ukraine war and China's implicit threat to Taiwan have escalated tensions with the West.

Sources: Breckinridge Capital Advisors, Bloomberg, Bureau of Economic Analysis, EPFR, FactSet, Rating Agencies, Wells Fargo. as of December 31, 2022, unless otherwise indicated.

STATISTICAL SUMMARY

	As of 12/31/2022		OAS Change (bps)		
	Yield to Worst (%)	OAS (bps)	Month to Date	Quarter to Date	Year to Date
Bloomberg **U.S. Corporate Index****	5.42	130	-3	-29	38
Corporate Credit Curves					
Corporate 1-3 Year	5.25	73	0	-16	31
Corporate 1-5 year	5.26	91	0	-18	41
Corporate 5-10 year	5.44	150	-6	-31	61
Corporate 10+ year	5.60	158	-1	-40	29
Corporate Quality Spreads					
AAA Corporate	4.62	56	7	-24	3
AA Corporate	4.80	69	2	-19	12
A Corporate	5.23	109	-3	-26	35
BBB Corporate	5.70	159	-4	-33	46
Corporate Sector Spreads					
Banking	5.57	135	-5	-27	58
Basic Industry	5.61	153	-12	-40	38
Capital Goods	5.23	110	-2	-30	24
Communications	5.64	160	1	-33	42
Consumer Cyclical	5.15	104	-1	-29	26
Consumer Non-Cyclical	5.23	114	0	-29	26
Energy	5.57	144	2	-32	28
Insurance	5.44	136	-7	-26	37
REITS	5.66	159	-6	-18	68
Technology	5.20	111	0	-27	30
Transportation	5.33	125	-3	-30	27
Utility	5.39	129	-7	-29	22
Supply/Demand ($Billions)					
	3Q22*	**3Q21***	**2021**	**2020**	**2019**
Net Corporate Supply	-55	987	876	1041	526
Net Purchases (Foreigners)	163	47	58	185	170
Net Purchases (Funds)	104	300	481	521	258
Net Purchases (Households)	-864	177	-108	51	-62
Net Purchases (Insurance)	245	289	220	200	141
Net Purchases (Other)	297	174	225	84	19

Sources: *Bloomberg*, Fed Flow of Funds.
*Note: Quarterly figures are seasonally adjusted annual rates.
** The *Bloomberg* U.S. Corporate Bond Index is an unmanaged market-value-weighted index of investment-grade corporate fixed-rate debt issues with maturities of one year or more. You cannot invest directly in an index.

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FOOTNOTES:

1. The Bloomberg U.S. Corporate Bond Index is an unmanaged market-value-weighted index of investment-grade corporate fixed-rate debt issues with maturities of one year or more. You cannot invest directly in an index.
2. Earnings Insight, FactSet, December 15, 2022.
3. US Investment Grade Corporate Update, Barclays, as of November 30, 2022.
4. US Investment Grade Corporate Update, Barclays, as of December 31, 2022.
5. FRED, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/
6. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. Itis a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.
7. Earnings Insight, FactSet, December 15, 2023.
8. US Investment Grade Credit Metrics, Q3 22 Update, Barclays Research, December 13, 2022.
9. The Bloomberg US Corporate Bond Index, December 30, 2022.
10. H.R.5376 - Inflation Reduction Act of 2022, 117th Congress.
11. "Dealmakers brace for slow 2023 recover after M&A sinks," Reuters, December 21, 2022.
12. "Does a Spike in Dividend Decrease Announcements Portend 2023 Volatility?", Wall Street Horizon, December 2022.
13. Bond Issuers Plot New Year Blitz as Rates Rise, Economy Slows, Bloomberg Law, December 23, 2022.
14. FRED, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/.
15. 2022: A Tumultuous Year in ESG and Sustainability, Andrew Winston, Harvard Business Review, December 21, 2022.