Breckinridge CAPITAL ADVISORS

Q2 2021

# Corporate Bond Market Outlook

## Key Drivers for the Quarter

- Improving Covid-19 vaccine distribution and extraordinary fiscal and monetary stimulus during the first quarter supported above-trend economic growth.
- Net corporate leverage stabilized due to higher cash balances, while high gross leverage could improve further as cash flows rise in 2021.
- After an 11 percent decline in 2020, operating earnings for S&P 500 companies may grow strongly by 19 percent in 1Q21, per FactSet.
- Share buybacks and mergers and acquisitions (M&A) may accelerate off 2020 low levels. In fact, global M&A has picked up briskly, while buybacks are slowly recovering.
- Due to COVID-19, investment grade (IG) companies face heightened sensitivity around environmental, social and governance (ESG) issues like employee safety and supply chain management.
- Spreads remain tighter than average at the end of the first quarter, and about 5 basis points (bps) tighter compared with year-end 2020 levels.
- The IG market was resilient with the sharp rise in Treasury yields. Limited net supply and sustained demand—are likely to restrain spread widening in 2021.

## Investment Outlook

### Improved Earnings, Economic Recovery, and an Eye on Inflation

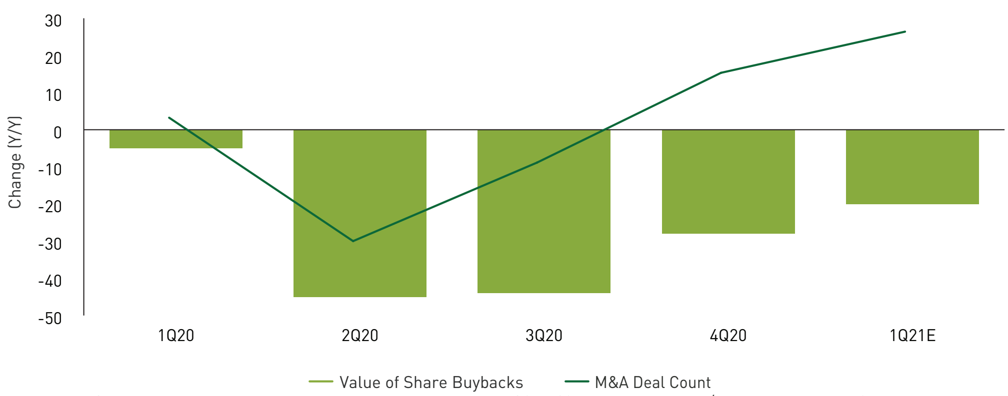
Increasing the percent of the population vaccinated against COVID-19 is central to the government's strategy to address the pandemic, to reopen the economy and society, and to increase business activity across all sectors.[1] Accelerated distribution of COVID-19 vaccinations and the $1.9 trillion America Rescue Plan Act (ARP), which passed in March, led to higher growth expectations as the economy recovers, contributing to a higher rate bias. Over the quarter, Treasury yields increased from five years and longer and the curve steepened.

The inflation narrative continued with stronger economic data. The Producer Price index headline and core figures both increased at rates that were higher than recent months. As of April 1, 2021, the Federal Reserve (Fed) Bank of Atlanta's GDPNow forecasting model estimated first quarter gross domestic product growth at 6.0 percent on an annualized basis.[2]

With the Fed's accommodative policy in place, stocks gained in the quarter of about 7 percent, as measured by the S&P 500 Index. With the material move higher in U.S. Treasury bond market yields, U.S. IG corporate bonds had a negative total return of 4.69 percent and a positive excess return versus duration-matched Treasuries of 0.95 percent in 1Q21, as measured by Bloomberg Barclays.

Corporate credit fundamentals, broadly, benefited due to corporate cash management policies during 2020. Their approach helped stabilize net leverage and balance sheet strength. As business conditions improve, companies may once again initiate debt-funded shareholder enhancements, such as share buybacks, M&A, special dividends. In fact, global M&A has picked up quickly presenting a return of event risk, while buybacks are slowly recovering from a trough in mid-2020. These activities tend to have a negative effect on credit ratings (See Exhibit 1).

EXHIBIT 1: M&A DEAL COUNT IS UP WHILE BUYBACKS SLOWLY RETURN




Source: Bloomberg, Yardeni Research. Buyback data is for S&P 500 Index companies Y/Y percent change. M&A deal count includes completed, pending and proposed deals and is a global figure.

On the other hand, companies may continue to exercise restraint until signs of a self-sustaining recovery strengthen. While it is just one example, Keurig Dr Pepper Inc. reported decreased leverage at the end of fiscal year 2020, and management remains committed to maintaining that level in 2021. The company increased its dividend and mentioned potential for bolt-on M&A, while affirming that it did not expect any deals to derail the company's deleveraging plans.

The Fed's continued easy monetary policies, along with potentially limited net supply of IG corporate bonds in a time of sustained demand, should be supportive of risk assets. There is little pressure to force wider spread levels. We remain of the view that IG corporate bonds can benefit under these circumstances.

Risks to our investment thesis include slower-than-expected vaccine distribution or significant spread of the virus or its variants before vaccinations advance to the government's target levels.

## Taxes, Leverage Ratios and Climate-Risk May Influence Corporate Strategies

As the quarter closed, the U.S. Federal government debate regarding corporate and individual tax increases begin to heat up as the first quarter ended. While any changes in tax rates are difficult to predict at this point, the potential of a boost in the corporate tax rate cannot be discounted. Over the longer term, projected earnings growth could be tempered by a tax increase.

Specific to the banking sector, the Fed's one-year supplementary leverage ratio (SLR) capital relief program for large U.S. banks expired on March 31. The Fed excluded U.S. Treasuries and banks' deposits at the Fed from its calculation of banks' SLR, beginning April 1, 2020. Without the exclusion, the SLR margins would have been slimmer than GSIBs (global systemically important banks) typically prefer.

Banks and brokers are vital to Treasury auctions and secondary market trading. Over time, it seems reasonable to expect—and recent comments indicate—that the Fed will address the consequences of the SLR on Treasury market liquidity, growth in central bank reserves and the ability of large banks to act as intermediaries.

It is possible that the largest U.S. banks may limit absolute balance sheet growth after the elimination of the exclusion. The banks could also issue additional Tier 1 capital, qualifying preferred stock and/or retain earnings. This circumstance is likely not a credit ratings issue for U.S. banks. We revised our outlook for the U.S. bank sector from declining to stable earlier this year.

With its January arrival, the Biden Administration advanced its focus on regulation to counter the rise in greenhouse gas emissions in carbon-heavy sectors (See *Changed Power Structure in DC May Support Environmental Initiatives*). The efforts could hit Energy and Utilities sector earnings and growth. In our view, transitions to renewables and cleaner energy sources among many IG issuers in these sectors already underway could mitigate more regulations.

On balance, regulatory or market conditions that boost bank capital requirements and heighten attention to physical and transitional climate risks should strengthen balance sheets and reduce overall risks to generally favor credit ratings and bank bondholders.

Technology issuers remain under Congressional scrutiny concerning anti-trust and social media policies. We continue to place a low likelihood of large-scale changes to the sector. The prospect of change could encourage some companies to engage in divestments, spin offs or other means of selling assets to mitigate anti-trust scrutiny.

For Basic Industry, Manufacturing and Industrials, supply chain conditions, trade policies and tariffs remain key issues. Globally, pandemic-related disruptions to operations and pinched productivity for important resources during the past year ranged from construction materials to computer technology. With reduced supply come higher costs for key components across industrial sectors which negatively influences corporate profitability. In addition, trade tensions remain, particularly between the world's two largest economies America and China. These concerns could suppress global trade and economic activity, limiting corporate performance.

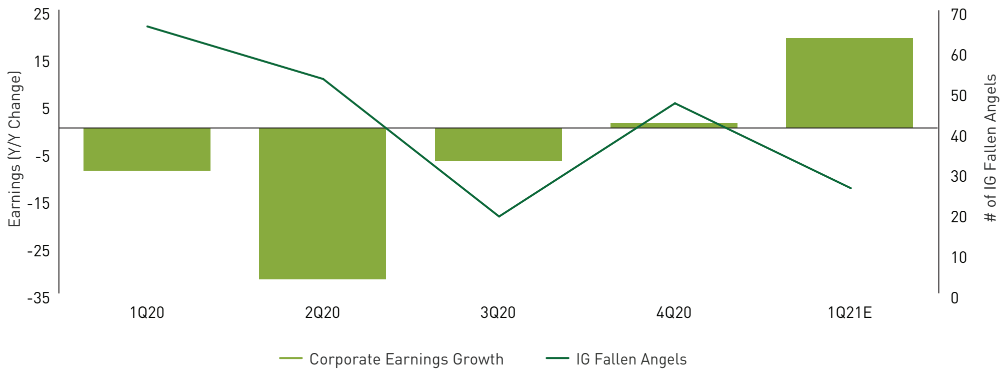
## Fundamentals

### Positive Earnings Growth and Fewer IG Fallen Angels in 1Q

Heading into the end of the first quarter, FactSet reported that the number of companies issuing negative earnings-per-share (EPS) guidance is well below the five-year average, while the number of companies issuing positive EPS guidance is well above the five-year average.

Current consensus projections are looking for strong growth in S&P 500 Index profits in 1Q21, up 19 percent Y/Y (See Exhibit 2).

EXHIBIT 2: PROFIT RECOVERY AND FEWER FALLEN ANGELS IN 1Q




Source: FactSet, Bloomberg, Moody's, S&P and Fitch Fallen Angel count includes U.S. issuers downgraded from investment grade to speculative grade. Corporate earnings growth is Y/Y percent change. Non-Financial Index.

Robust growth is forecast in sectors hard hit in the pandemic such as Financials, Consumer Discretionary and Materials.

Rating agency downgrade activity is moderating based on stabilizing fundamentals. The number of IG issuers downgraded to speculative grade (that is, fallen angels) dropped in 1Q21 as profits improved.

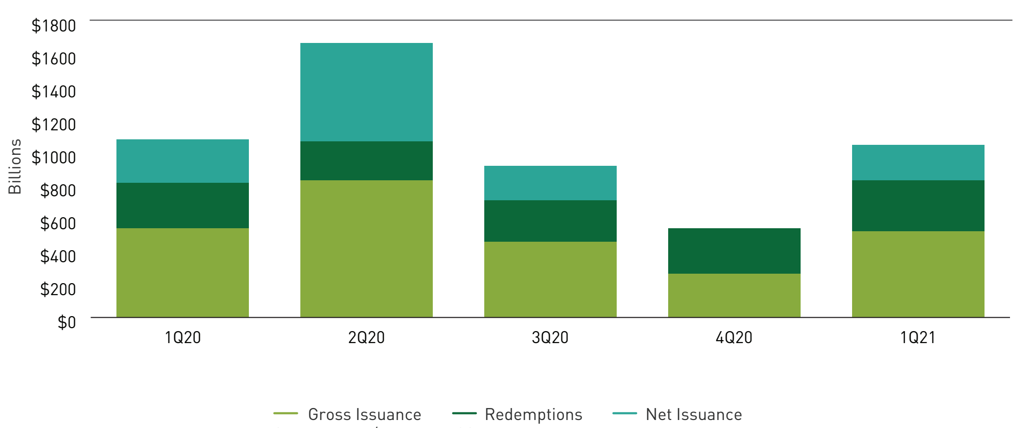
## Technicals

### Supply Picked up Sharply in 1Q after a Slowdown in 4Q

IG fixed-rate bond index-eligible new issuance was a brawny $524 billion in 1Q, per Barclays, bouncing back from a sluggish 4Q (See Exhibit 3).

IG funds received over $100 billion of positive inflows in 1Q, according to EPFR, although long maturity IG funds saw outflows ($13 billion).

EXHIBIT 3: IG FIXED-RATE BOND SUPPLY BOUNCED BACK IN 1Q




Source: EPFR/Informa, TICS, Wells Fargo, Barclays, Fed Flow of Funds

Steady buying from insurance and non-US investor segments are important sources of demand as yields have moved up.

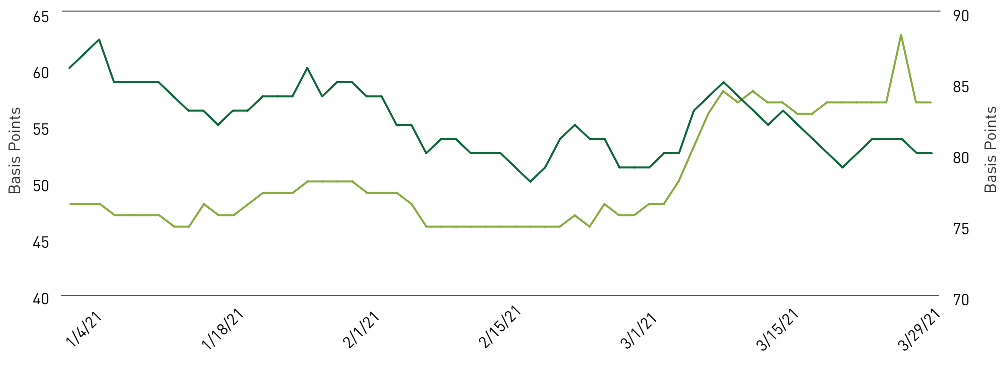
## Valuations

Spreads Tightened in 1Q with a Flattening in Credit Curves

EXHIBIT 4: LONG CORPORATES TIGHTENED WHILE SHORT CORPORATES WIDENED

IG corporate spreads ended the quarter at an average OAS of 91bps, 5bps tighter despite a material rise in interest rates (See Figure 4).

To date, the IG market has resisted the experience during the Taper Tantrum[3] when rates and spreads both rose sharply.




Source: Bloomberg Barclays

Curves flattened with 10bps of tightening in longer maturities and 6bps of widening in 1-5yr creating select opportunities.

## ESG Spotlight

The role of ESG in the investment markets noted some significant milestones during the first quarter. For example, FactSet reported that more than one in four S&P 500 companies cited ESG when reporting earnings for the fourth quarter.

Going forward, the new U.S. administration may propel ESG investing. President Biden's focus on renewable infrastructure, along with key appointments that could influence investment regulations, are likely to have further impact on ESG investing, according to Moody's. Both the SEC and the Fed have recently announced initiatives to consider climate risks more closely.

In a recent decision, the Department of Labor announced that it will not enforce rules finalized by the prior U.S. administration. One of the rules being reversed would have increased the requirements for retirement plans to select ESG investments for their lineups.

We also noted increases in issuance of sustainable bonds and innovations in sustainability-linked bond structures. Sustainable bond issuance soared to $491 billion in 2020, per Moody's. Issuers use the social and sustainability bond labels for bonds intended to finance ESG projects. Moody's predicts sustainable bonds to grow by 32 percent in 2021 to $650 billion.

During the quarter, we released the results of an institutional investor survey that documents the increasing interest among institutions in adding ESG strategies to their portfolios through their allocations to investment grade fixed income. A copy of the full report is available on our website. (See *Investment Grade Without ESG Isn't Really Investment Grade*.)

## 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 | The FOMC forecasts that it will maintain the Fed Funds rate at the 0% lower bound into 2023 and continue to make bond purchases. |
| Economy | | | | X | | Improving COVID-19 vaccine distribution and extraordinary fiscal and monetary stimulus is expected to drive above-trend economic growth. |
| Management/ESG | | | | X | | Due to COVID-19, IG companies face heightened sensitivity around ESG issues like employee safety and supply chain management. |
| Operating Trends | | | | X | | After an 11% Y/Y decline in 2020, per FactSet, S&P 500 operating earnings are currently forecasted to grow by 25% Y/Y in 2021. |
| Financial Leverage | | | X | | | Healthy corporate cash balances have stabilized net leverage, while high gross leverage should improve, as cash flows rise in 2021. |
| Rating Trends | | | X | | | The number of IG corporate issuers downgraded to speculative grade (e.g., fallen angels) dropped in 1Q21, as profits have improved. |
| Supply/Demand | | | X | | | IG fixed-rate index-eligible bond new issuance was a brawny $524B in 1Q. IG funds received $100B of positive inflows in 1Q. |
| Geopolitical Risk | | | X | | | Tariffs among major trading partners can negatively impact global growth and stability. China and U.S. foreign relations are a key risk. |
| Event Risk | | X | | | | Global M&A activity has picked up notably with both deal count and deal value in 1Q21 exceeding figures in 1Q20 and 1Q19. |
| Regulatory | | X | | | | Regulations in some sectors (e.g., Banking, Energy, Tech) may shift under a Biden administration and corporate tax rates may rise. |
| Valuations | | X | | | | Spreads are tight but fair in a global context and relative to IG alternatives. Widening in short-maturities has created opportunities. |

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

## STATISTICAL SUMMARY

| | As of 3/31/2021 | | OAS Change (bps) | | |
|---|---|---|---|---|---|
| | YTW (%) | OAS (bps) | MTD | QTD | YTD |
| **Bloomberg Barclays U.S. Corporate Index** | 2.28 | 91 | 1 | -5 | -5 |
| **Corporate Credit Curves** | | | | | |
| **Corporate 1-3 Year** | 0.61 | 41 | 7 | 6 | 6 |
| **Corporate 1-5 year** | 0.97 | 54 | 7 | 7 | 7 |
| **Corporate 5-10 year** | 2.26 | 89 | 4 | -1 | -1 |
| **Corporate 10 + year** | 3.45 | 125 | -6 | -15 | -15 |
| **Corporate Quality Spreads** | | | | | |
| **AAA Corporate** | 2.17 | 46 | -4 | -9 | -9 |
| **AA Corporate** | 1.94 | 54 | -3 | -5 | -5 |
| **A Corporate** | 2.03 | 71 | 2 | -2 | -2 |
| **BBB Corporate** | 2.52 | 112 | -1 | -10 | -10 |
| **Corporate Sector Spreads** | | | | | |
| **Banking** | 1.75 | 77 | 9 | 5 | 5 |
| **Basic Industry** | 2.65 | 111 | 1 | -9 | -9 |
| **Capital Goods** | 2.27 | 88 | -2 | -10 | -10 |
| **Communications** | 2.78 | 109 | -7 | -11 | -11 |
| **Consumer Cyclical** | 2.05 | 80 | 1 | -2 | -2 |
| **Consumer Non-Cyclical** | 2.35 | 83 | -2 | -7 | -7 |
| **Energy** | 2.61 | 121 | -3 | -16 | -16 |
| **Insurance** | 2.50 | 96 | 0 | -9 | -9 |
| **REITS** | 2.26 | 100 | 5 | -7 | -7 |
| **Technology** | 2.09 | 75 | 1 | 0 | 0 |
| **Transportation** | 2.59 | 100 | -3 | -15 | -15 |
| **Utility** | 2.63 | 99 | 2 | -7 | -7 |
| **Supply/Demand ($Billions)** | | | | | |
| | 4Q20* | 4Q19* | 2020 | 2019 | 2018 |
| **Net Corporate Supply** | 376 | 336 | 996 | 480 | 370 |
| **Net Purchases (Foreigners)** | 58 | 194 | 193 | 155 | -60 |
| **Net Purchases (Funds)** | 371 | 158 | 495 | 99 | 190 |
| **Net Purchases (Households)** | -263 | 72 | -57 | 65 | 94 |
| **Net Purchases (Insurance)** | 174 | 13 | 257 | 141 | 145 |
| **Net Purchases (Other)** | 36 | -101 | 108 | 20 | 1 |

Sources: Bloomberg Barclays Indices, Fed Flow of Funds.

*Note: Quarterly figures are seasonally adjusted annual rates. Seasonal adjustments are made to remove the seasonal components of time series graphs.

FOOTNOTES:

1. *https://www.npr.org/sections/health-shots/2021/01/28/960901166/how-is-the-covid-19-vaccination-campaign-going-in-your-state*
2. *https://www.frbatlanta.org/cqer/research/gdpnow*
3. Taper tantrum refers to the 2013 collective market reaction that triggered a spike in U.S. Treasury yields after investors learned that the Federal Reserve was slowly putting the brakes on its quantitative easing (QE) program following the Great Financial Crisis.

DISCLAIMER: The opinions and views expressed are those of Breckinridge Capital Advisors, Inc. They are current as of the date(s) indicated but are subject to change without notice. Any estimates, targets, and projections are based on Breckinridge research, analysis and assumptions. No assurances can be made that any such estimate, target or projection will be accurate; actual results may differ substantially. Past performance is not indicative of future results. Nothing contained herein should be construed or relied upon as financial, legal or tax advice. All investments involve risks, including the loss of principal. An investor should consult with their financial professional before making any investment decisions. While Breckinridge believes the assessment of ESG criteria can improve overall credit risk analysis, there is no guarantee that integrating ESG analysis will provide improved risk-adjusted returns over any specific time period. Some information has been taken directly from unaffiliated third-party sources. Breckinridge believes such information is reliable, but does not guarantee its accuracy or completeness. Any specific securities mentioned are for illustrative and example only. They do not necessarily represent actual investments in any client portfolio. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.