Breckinridge CAPITAL ADVISORS

Q2 2022 Corporate Bond Market Outlook

Key Drivers for the Quarter

- During the first quarter, the Federal Reserve (Fed) raised the fed funds rate by 25 basis points (bps) and indicated that it would take necessary steps to reign in the high rate of inflation.
- Investment grade (IG) corporate bond spreads widened dramatically through the quarter, then narrowed as the quarter drew to a close.
- IG fixed-rate supply of $509 billion was higher than the prior quarter and lower than the same quarter in the prior year.[1] IG fund flows were negative by about $28 billion.[2]
- The profile of environmental, social, and governance (ESG) risks in corporate reporting and performance continued to rise. For example, the Securities and Exchange Commission (SEC) initiated proposed rulemaking that would bring higher levels of standardization and disclosure on climate to corporate reporting requirements.

Investment Review and Outlook

Fed initiates interest rate increases to address inflation, while sharpening the tone of its remarks.

On March 16, the Fed increased the fed funds rate by a quarter percentage point, the first such increase in more than three years. The 25bps hike came as the central bank sought to arrest price increases that have reached the fastest pace since the 1980s.

Price inflation reflects a rapid pace of economic growth fueled by government stimulus and product shortages caused by strained global supply chains, both of which can be traced the COVID pandemic. In addition, Russia's invasion of Ukraine led to shortages in commodities relied upon by the energy, food/beverage, and chemical sectors, among others, prompting further price pressures.[3]

Less than a week later, Fed Chairman Jerome Powell told the National Association of Business Economics that the Fed was prepared to raise interest rates in half-percentage-point steps—and high enough to deliberately slow the economy—if needed, according to *The Wall Street Journal*.[4]

After the comments, stocks and government bonds sold off. Many read the comments as being intended to demonstrate the Fed's resolve to cool both actual inflation and expectations among consumers for future increases. For the quarter, risk assets were volatile, and performance was negative, in some cases, historically negative.

According to Bloomberg, U.S. Treasury Bonds fell 5.58 percent on the quarter, while the broad Bloomberg Aggregate U.S. Bond Index was off 5.93 percent. Equities, as measured by the S&P 500 Index, ended the quarter 4.90 percent lower, the worst quarterly drop for stocks in two years, after being down almost 12 percent earlier in March.

The Bloomberg U.S. Corporate Investment Grade (IG) Index (the Index) spread widened by 23bps between December 31 and March 31. The average spread of the Index closed the quarter at 116bps after reaching as high as 145bps in March. The Index recorded a quarterly loss of 7.69 percent on a total return basis and a negative excess return of 1.45 percent.

While corporate credit fundamentals remain solid, global events and economic trends hold the potential of moderating positive credit rating trends. "The confluence of the Russia-Ukraine military conflict, nagging inflation and the prospects for higher interest rates, and the lingering pandemic mark a turn in the positive credit momentum of the past 14 months," S&P rating recently reported. "But while downgrades are now outpacing upgrades, ratings remain resilient overall, and pressure is mounting unevenly."[5]

For the quarter, IG corporate bond issuance pf $508.9 billion, according to Bloomberg data, exceeding the prior quarter's total of $318.7 billion and falling shy of the $523.8 billion total of the first quarter 2021. IG fund flows reflected the concerns of the investment markets in the inflationary environment, shifting to a total of $28 billion in outflows, as reported by EPFR.

Fundamentals

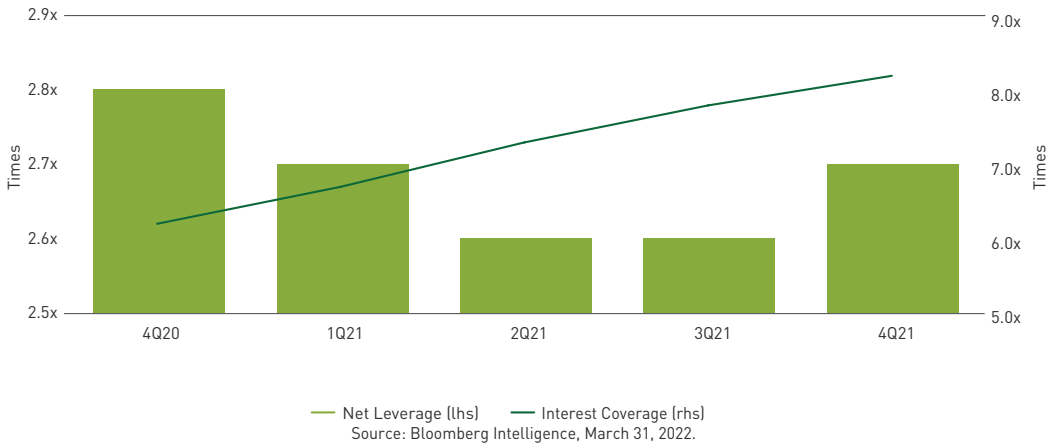
Interest Coverage and Leverage Metrics Are Well-Positioned

We view the fundamental credit backdrop as stable for IG issuers. Mean interest coverage has improved by two-full turns (from 6.2 times to 8.2 times) as all-in financing rates were low during 2021.[6]

With high cash balances and a recovery in cash flows, IG mean net leverage (for example, debt minus cash dividend by earnings before interest, taxes, depreciation and amortization (EBITDA), improved to 2.66 times at the end of 2021 from 2.84 times at year-end 2020.[7]

Leverage moved slightly higher in 4Q21 as issuers looked to deploy excess cash for cap ex, dividends and share buybacks. We expect that trend to continue, and net leverage has probably troughed.

FIGURE 1: INTEREST COVERAGE IS UP AND LEVERAGE IS DOWN



Source: Bloomberg Intelligence, March 31, 2022.

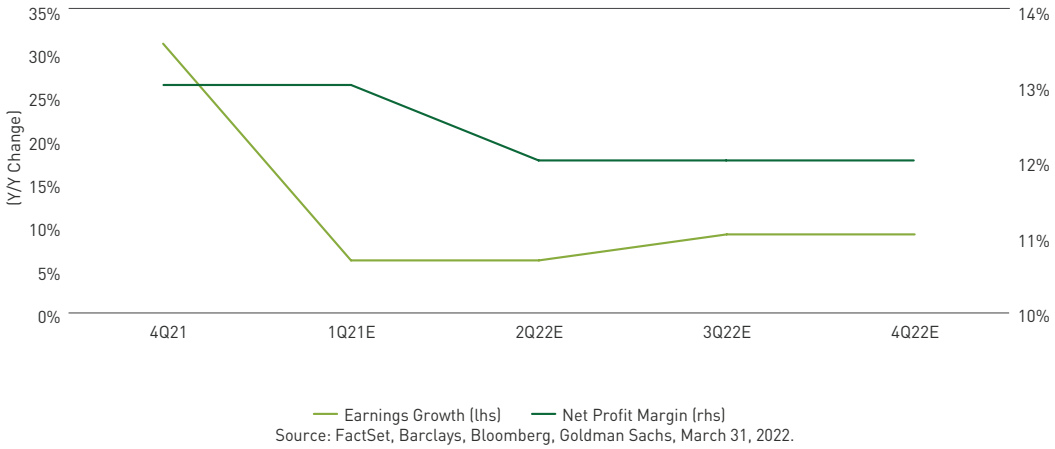
Earnings Growth and Profit Margins May Have Peaked

After bouncing back from the height of Covid-19 Pandemic lockdowns, corporate earnings grew over 30 percent in 4Q21 year-over-year (Y/Y). Profit growth is projected to slow to about 9 percent in 2022.[8]

Profit margins peaked in 4Q21 and could trend lower through 2022.[9] Wage and input cost inflation is expected to weigh on margins if issuers cannot fully pass on higher costs to consumers.

IG issuers have minimal direct exposure to the Russian economy.[10] Non-recurring write-offs and charges may be incurred but for most issuers that should not drive material credit deterioration.

FIGURE 2: PROFITS AND MARGINS MAY HAVE PEAKED



Source: FactSet, Barclays, Bloomberg, Goldman Sachs, March 31, 2022.

Technicals

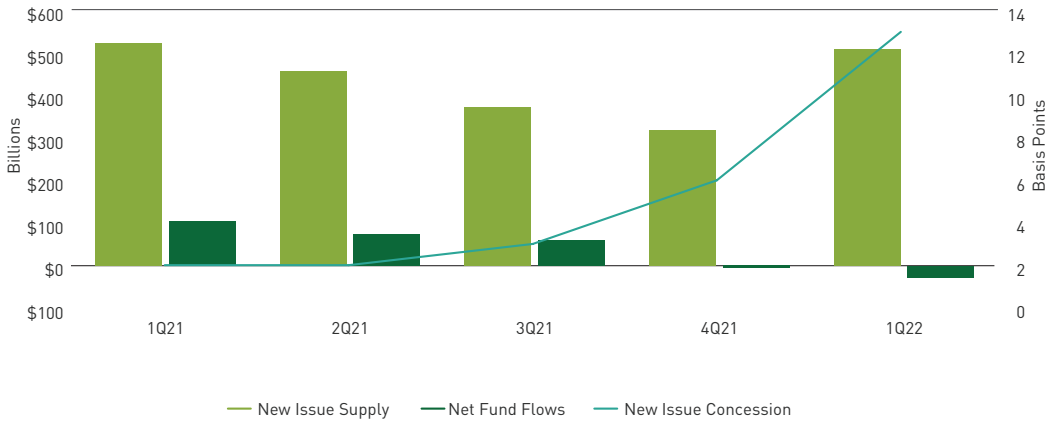
Elevated Supply and New Issue Concessions as Outflows Picked Up

IG fixed-rate corporate supply of $509 billion in 1Q22 was the highest quarterly amount issued since 2Q21. Net supply of $226 billion was moderate due to redemptions and bond tenders.

IG bond mutual and exchange-traded funds experienced net outflows of -$28 billion in 1Q22 as compared to -$5 billion of inflows in 4Q21 and $105 billion of inflows in 1Q21.

IG new issue bond concessions rose to their highest point in recent quarters on elevated supply and fund outflows. Spread concessions can create attractive new issue opportunities.

FIGURE 3: SUPPLY CONCESSIONS ROSE ON HIGH SUPPLY AND OUTFLOWS



Source: Barclays Research, Wells Fargo, EPFR, BofA Securities.

Valuation

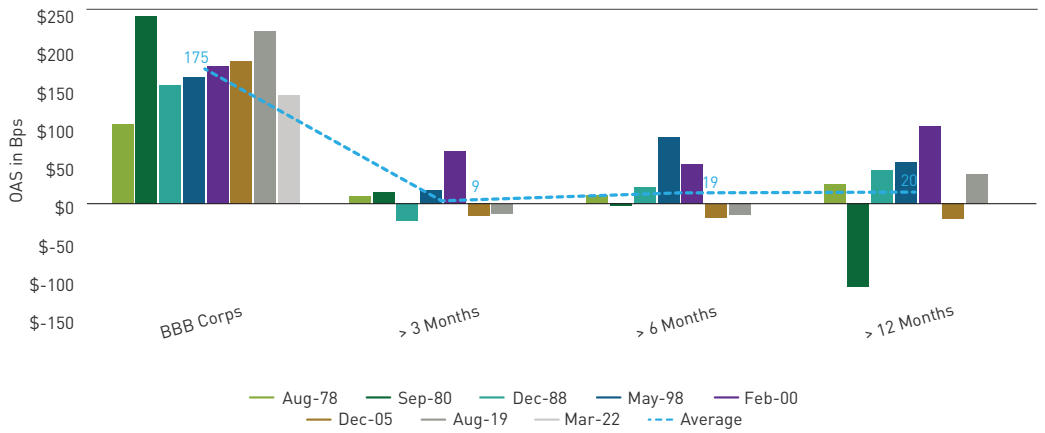
IG Spreads Widened Sharply on Inflation Concerns and Russia

The IG Corporate Index finished 1Q22 at an option-adjusted spread of 116bps or 23bps wider on the quarter. The Russian invasion of Ukraine saw spreads peak at 145bps on March 14, 2022, before retracing.

Historically and on average, following inversion of the 2-year and 10-year U.S. Treasury bond yields, BBB corporate spreads have widened moderately prospectively, but in some cases they have tightened.

We continue to expect volatility and a slight widening bias in IG spreads related primarily to inflation concerns, monetary policy tightening, and prospects of a material slowdown in economic and profit growth during 2022.

FIGURE 4: IG SPREAD PERFORMANCE POST 2/10 INVERTED TREASURY CURVE



Source: Longtermtrends.net, Capital Markets Data, Federal Reserve Bank of St. Louis, Stooq.

ESG Spotlight

Investor focus continued to sharpen during the quarter on the material risks that ESG factors can pose to future corporate performance and the ability of bond issuers to meet their obligations to shareholders.

Climate change remains a central concern among investors, policymakers, and corporate bond issuers. In late February, the Intergovernmental Panel on Climate Change (IPCC), a body of experts convened by the UN, released the most detailed look yet at physical threats posed by global warming. Robert Fernandez, CFA, director ESG Research, and Andrew Teras, director, Municipal Research, discussed the report: *Latest IPCC report underscores urgency of climate action for investors and businesses move toward more consistency*.

In a related development, the SEC proposed rule changes on March 21 that would require corporations to include certain climate-related disclosures in their registration statements and periodic reports[11] including information about climate-related risks that are reasonably likely to have a material impact on their business, results of operations, or financial condition, and certain climate-related financial statement metrics in a note to their audited financial statements.

While climate change, including transitioning to a low- or no-carbon future economy—are prominent themes in ESG investing, a report by S&P Ratings[12] highlights several other themes that are capturing increasing attention among investors, regulators, and others. They include effects of economic activity on natural capital and biodiversity; social issues in corporate operations and supply chain management, including human rights monitoring and reporting, labor conditions, and diversity, equity, and inclusion; divestment and engagement strategies in investing; the sustainable debt market, and net zero investing approaches.

We updated our report on the sustainable debt market in the most recent edition of our *ESG Newsletter*. A consistent increase in issuance during early 2022 demonstrates the market's continued favorable view of sustainable bonds. You can learn more about our analysts' views on this growing market here: *Sustainable Bond Issuance Is Growing Across Bond Market Segments*.

In addition, members of the corporate and municipal bond research teams shared their thoughts on recent developments regarding net zero carbon emissions and net zero pledges. Our article *Corporations Sign Net Zero Pledge, But Can They Back It Up?* explains what net zero is and how Breckinridge Capital Advisors monitors progress as companies pursue a pathway to towards net zero.

CORPORATE TRENDS DASHBOARD

Key Drivers: Solid Economy and Rating Trends Partially Offset by Tighter Central Bank Policy and Geopolitical Risk

TRENDS	Weakness				Strength	
Economy				X		U.S. GDP growth is expected to slow but remain healthy this year, with low unemployment and strong wage gains.
Event Risk			X			Merger activity is down 15 percent Y/Y and may be less of a concern now given geopolitical and inflation risks.
Financial Leverage			X			Leverage has probably troughed, as issuers deploy excess cash for capital expenditures, dividends and share buybacks.
Operating Trends			X			Profit growth is expected to slow this year, as wage and input cost inflation are expected to weigh on margins.
Rating Trends			X			IG rating agency upgrades were about two-thirds of actions in 2021. Actions may be more balanced in 2022.
Central Bank Policy		X				The Fed is poised to hike interest rates multiple times and tighten monetary policy to combat high inflation.
Management/ESG		X				During the Pandemic, supply chain and labor issues were risks that may be exacerbated by the war in Ukraine.
Regulatory		X				Regulations in some certain sectors may shift under a Biden administration and corporate taxes may rise.
Supply/Demand		X				IG bond funds saw net outflows of $28 billion in 1Q21. Heavy new issuance pushed up spread concessions.
Valuations		X				We continue to expect volatility and a slight widening bias in IG spreads on policy tightening related to inflation.
Geopolitical Risk	X					A Russia invasion of Ukraine and China's military buildup are threats to the U.S. and Europe and risks to stability.

Sources: Breckinridge Capital Advisors, Barclays, Bloomberg, Bureau of Economic Analysis, FactSet, Rating Agencies, as of March 31, 2022, unless otherwise indicated.

STATISTICAL SUMMARY

	As of 03/31/22		OAS Change (bps)		
	Yield to Worst (%)	OAS (bps)	Month to Date	Quarter to Date	Year to Date
Bloomberg U.S. Corporate Index	3.60	116	-6	23	23
Corporate Credit Curves					
Corporate 1-3 Year	2.88	59	-2	17	17
Corporate 1-5 year	3.12	70	-4	21	21
Corporate 5-10 year	3.61	119	-5	29	29
Corporate 10+ year	4.03	155	-9	26	26
Corporate Quality Spreads					
AAA Corporate	3.04	61	-12	7	7
AA Corporate	3.12	68	-9	11	11
A Corporate	3.38	94	-8	20	20
BBB Corporate	3.87	142	-4	28	28
Corporate Sector Spreads					
Banking	3.48	105	-4	28	28
Basic Industry	3.84	136	-11	21	21
Capital Goods	3.50	106	-6	21	21
Communications	3.89	144	-7	26	26
Consumer Cyclical	3.43	102	-6	23	23
Consumer Non-Cyclical	3.54	109	-8	21	21
Energy	3.77	132	-11	16	16
Insurance	3.70	124	-5	25	25
REITS	3.61	117	-2	26	26
Technology	3.44	100	-9	19	19
Transportation	3.63	118	-6	20	20
Utility	3.74	127	-9	20	20
Supply/Demand ($Billions)					
	4Q21*	**4Q20***	**2021**	**2020**	**2019**
Net Corporate Supply	729	552	827	923	399
Net Purchases (Foreigners)	90	50	46	181	156
Net Purchases (Funds)	467	341	463	425	52
Net Purchases (Households)	-242	5	-157	31	40
Net Purchases (Insurance)	135	141	171	199	138
Net Purchases (Other)	279	15	304	87	13

Sources: Bloomberg, Fed Flow of Funds.
*Note: Quarterly figures are seasonally adjusted annual rates.
** The Bloomberg Barclays 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. "US Investment Grade Corporate Update", *Barclays Credit Research*, April 1, 2022,
2. "Credit Flows: Supply & Demand", *Wells Fargo Credit Strategy*, EPFR, March 31, 2022.
3. "*Federal Reserve announces interest rate hike*," *CBS News*, March 16, 2022.
4. "*Stocks End Lower After Powell Interest-Rate Comments*," *The Wall Street Journal*, March 21, 2022.
5. "*Global Credit Conditions: Q2 2022 Confluence Of Risks Halts Positive Credit Momentum*," *S&P Ratings*, March 31, 2022.
6. "Investment-Grade Fundamentals: 4Q21", *Bloomberg Intelligence*, April 6, 2022.
7. Ibid.
8. Earnings Insight, *FactSet*, April 1, 2022.
9. Global Credit Trader: Range-Bound Until Further Notice, *Goldman Sachs Credit Strategy*, March 24, 2022.
10. U.S. Company Exposures to Russia and Ukraine, U.S. Credit Alpha, *Barclays Research*, March 18, 2022.
11. "*SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors*," U.S. Securities and Exchange Commission, March 21, 2022.
12. "*Key trends that will drive the ESG agenda in 2022*," *S&P Ratings*, January 31, 2022.