



Q2 2023

# Corporate Bond Market Outlook

## Key Drivers for the Quarter

- Banking sector concerns in the U.S. that emerged late in the quarter overwhelmed expectations shaped during the prior 10 weeks of the quarter, with implications for future monetary policy and Federal Reserve (Fed) efforts to reduce inflation.
- The Federal Deposit Insurance Corporate (FDIC) assumed control of two mid-sized U.S. regional banks in March, as depositor withdrawals overwhelmed the banks' liquidity positions.
- Analysis of the two banks' capital assets indicated that, at least at a high level, as deposit withdrawals spiraled, long-term holdings were mismatched with short-term cash demands.
- At its March meeting, the Fed announced a 25 basis points (bps) increase in the federal funds rate, stating "inflation remains elevated" and removing the phrase, "inflation has eased somewhat," which appeared in its February statement.
- Fed Chairman Jay Powell also said, "The U.S. banking system is sound and resilient," while acknowledging that the Banking sector concerns are "likely to result in tighter credit conditions" and "weigh on economic activity, hiring and inflation," in effect supporting Fed efforts.
- Looking ahead, our negative view of fundamental credit conditions in the Banking sector is balanced by sector valuations that are 22bps wide to the IG Corporate Index and about 2½ years shorter in duration.



## Investment Review and Outlook

### Banking concerns contributed to volatility, as the Fed kept upward pressure on interest rates

Entering 2023, the Fed campaign to arrest inflation included eight increases to the fed funds rate totaling 450bps. In addition, beginning in June 2022, the Fed stopped reinvesting proceeds of maturing Treasury and agency mortgage-backed securities (MBS) each month, reversing the quantitative easing (QE) program that it initiated to support risk asset prices during the COVID-19 pandemic-induced economic slowdown.

At times, contradictory economic data indicated overall that inflation was moderating through January and February. Higher interest rates were suppressing housing activity and inflation measures like the personal consumption expenditures index retreated somewhat from the high increases seen in 2022. In contrast, the continued tight labor market sustained upward pressure on wages and favorable consumer sentiment.

As the Fed pursued its efforts to address inflation, investment markets were relatively strong with the Standard & Poor's 500 Index (S&P 500 Index)<sup>1</sup> up 5.4 percent through March 3 and the Bloomberg (BBG) Corporate Investment Grade (IG) Bond Index (the Corporate Index)<sup>2</sup> up 0.91 percent.

The Federal Deposit Insurance Corporation (FDIC) assumed responsibility for operations at Silicon Valley Bank (SIVB) and Signature Bank of New York (SBNY) upon their failure on Friday, March 10, and Sunday, March 12, respectively. The failure of SVB sparked concerns over uninsured deposits and potential liquidity issues at other regional banks. Banks were already tightening standards prior to this shock.<sup>3</sup>

Rapid Fed funds interest rate hikes, quantitative tightening (QT), regulations requiring minimum levels of high-quality liquid assets (HQLA), reduced reserves and tightened liquidity drove higher levels of unrealized losses across Treasury bond and MBS portfolios held in bank securities portfolios.

As investor concerns increased about the potential for widespread weakness in the financial sector, the S&P 500 fell 4.6 percent and the Corporate Index was off 1.5 percent for the week ended March 10, based on BBG data. Both indexes turned quickly, delivering positive results during the last two weeks of the month. At the end of the first quarter (1Q), the S&P 500 returned 7.0 percent and the Corporate Index gained 3.5 percent.

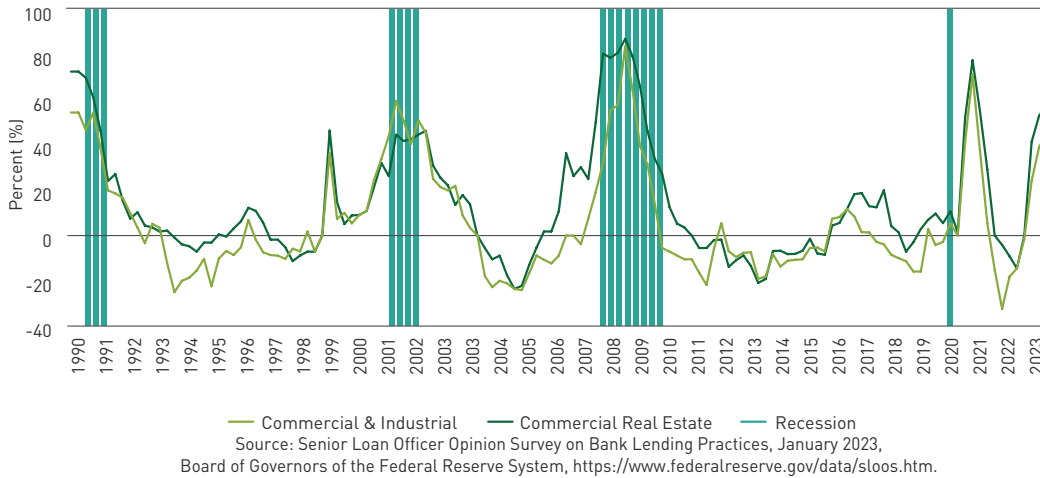
Despite Banking sector issues, the Fed prioritized efforts to reduce inflation by raising the fed funds rate 25bps at its meeting on March 21 and 22 to a range of 4.75 percent to 5 percent, with a projected rate of 5.1 percent by year end.

Chairman Powell suggested "some additional policy firming may be needed" but also acknowledged that the bank issues were likely to further tighten lending conditions (See Figure 1), which naturally limits capital in circulation and thus, creates additional tightening. The Fed also revised its gross domestic product (GDP) growth forecasts downward 0.4 percent in 2023, bigger drop for 2024, 1.2 from 1.6 percent).

In our view, until the Government and financial regulators restore full confidence in the U.S. banking system, issuers will be focused primarily on their own balance sheets, shoring up liquidity, and considering capital raises when the market settles down. Controllable lending activity from the Banking sector likely will slow materially, impacting credit creation and economic growth.



► FIGURE 1: NET PERCENTAGE OF BANKS TIGHTENING LENDING STANDARDS



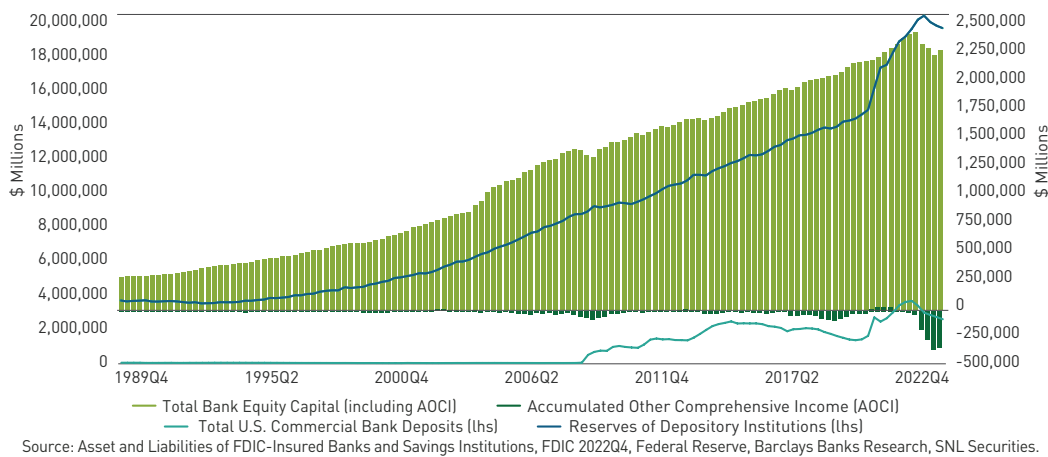
## Fundamentals

### As Unrealized Bond Losses Grow Relative To Equity Capital, Bank Credit Fundamentals May Weaken

As the Fed moved interest rates off the zero-bound to 5 percent, banks' unrealized bond losses grew during 2022 (See Figure 2). Unrealized losses were about 13 percent of bank equity capital at year-end (YE) 2022.

Unrealized losses in available-for-sale (AFS) securities are reported in a bank's accumulated other comprehensive income (AOCI), which is included as a contra account in shareholders' equity.

► FIGURE 2: RATE SHOCK BOOSTS UNREALIZED LOSSES AND DEPOSIT OUTFLOWS



Hold-to-maturity (HTM) securities are held at amortized costs and are not included in AOCI. Twenty-five large U.S. banks had HTM unrealized losses of 12 percent of bank equity capital at YE22.

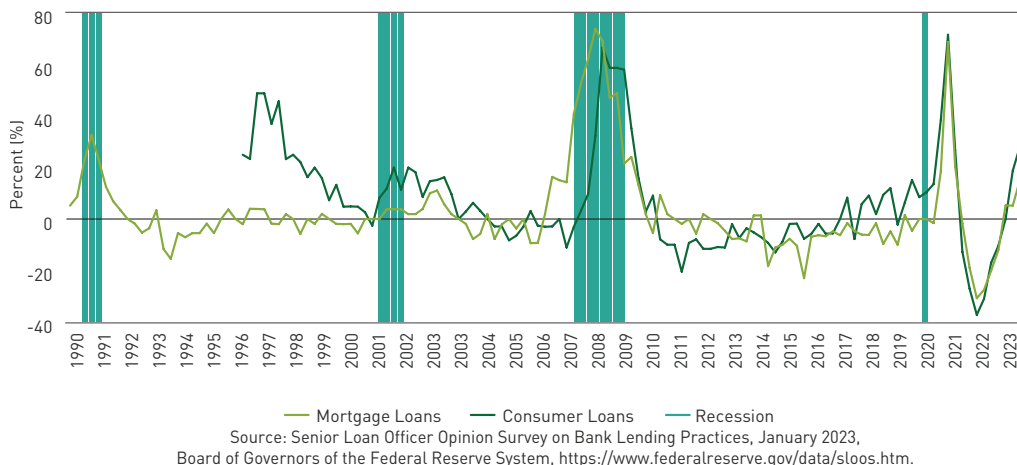
Bank deposits grew strongly during the Fed's quantitative easing, expanding from \$8.6 trillion in 2008 to a peak of \$19.9 trillion at the end of 2021. Bank deposits declined by \$718 billion in 2022.



For the latest period, 45 percent of senior loan officers reported their banks had increased loan rates or spreads over their costs of funds driving a tightening and increase in the cost of credit.

The pace of tightening and increase in the cost of credit may accelerate further in April, as the cost of bank funding has risen. If loan spreads rise further, they may approach recessionary levels.

► FIGURE 3: NET PERCENTAGE OF BANKS INCREASING LOAN RATES OVER COST OF FUNDS



Through January, 47 percent of senior loan officers reported their banks had increased the premiums charged on riskier loans while just 7 percent reported an easing in standards.

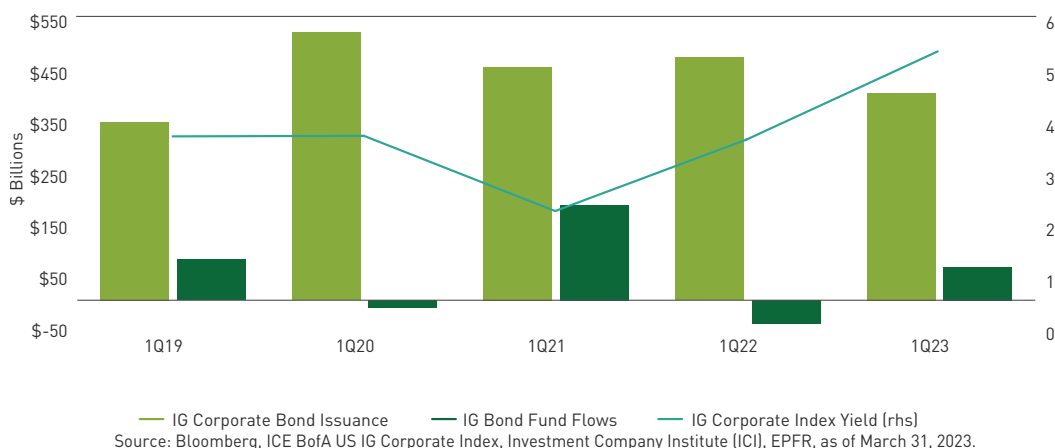
While senior loan officers are noting tightened lending standards across commercial and industrial (C&I) and commercial real estate (CRE) loans, tightening across consumer and mortgage loans is somewhat less although directionally similar.

## Technicals

### Corporate Supply Decreased, as Interest Rates and Volatility Increased

IG new issuance for 1Q23 was about \$403 billion as compared to \$472 billion the prior year (See Figure 4). Issuance during the quarter was stymied by market volatility in March, which was “only” a \$100-billion month.

► FIGURE 4: IG CORPORATE SUPPLY SLOWED WHILE FUND FLOWS PICKED UP





IG fund flows, per Emerging Portfolio Fund Research, were \$3 billion in March, a downshift from about \$32 billion of inflows in February and \$30 billion in January. Intermediate term bond funds have brought in about 85 percent of net flows year-to-date (YTD).

With yields still relatively high on the IG Corporate Index (5.25 percent at 1Q23, per BBG), we would expect further rotation into fixed income by institutions acting as a tailwind for the IG market.

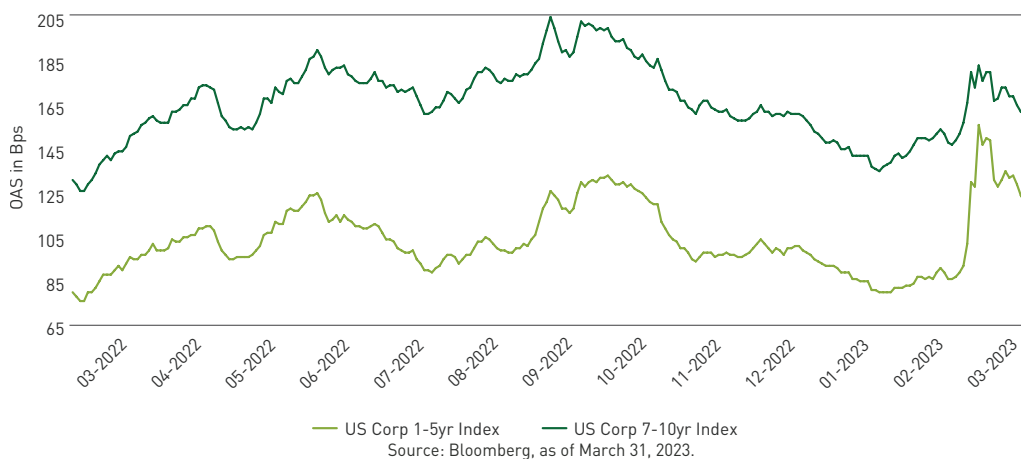
## Valuations

### Credit Curves Flatten as Spreads Widen Most in the Front End

IG corporate spreads widened 8bps in 1Q23, finishing the quarter at 138bps. In an unusual occurrence, spreads for bonds rated A and BBB both widened 9bps, with bonds rated A slightly outperforming in March.

Credit curve flattening was particularly noteworthy during the quarter with 1- to 5-year maturity bond spreads gapping out 20bps while 7- to 10-year corporate bond spreads were 4bps tighter in 1Q 2023 (See Figure 5).

#### ► FIGURE 5: SHORT MATURITY IG BONDS MATERIALLY UNDERPERFORMED IN 1Q23



The sharp flattening and move wider in shorter-maturity spreads created some opportunities during the quarter, particularly in higher-quality issuers that recently issued new corporate bonds.

## ESG Spotlight

In March, the UN Intergovernmental Panel on Climate Change (IPCC) released its latest report. It found current emissions reduction targets were insufficient to prevent the worst effects of climate change. As such, environmental risks will continue to represent a significant environmental, social and governance (ESG) investment considerations across sectors and geographies.

Breckinridge published its 2022 ESG Issuer Engagement report *Wider Engagement Lens Deepens Examination of Material ESG Risks*. During 2022, our corporate and municipal bond research team members held 131 direct engagement discussions with issuers and subject matter experts (SMEs) in 12 sectors across bond markets. Our engagement meetings were in addition to numerous interactions our analysts routinely have with issuers and SMEs in the conduct of new security research and ongoing bond surveillance, including regular quarterly earnings calls.



The CFA Institute issued the first global voluntary standards for disclosing how an investment product considers environmental, social and governance (ESG) issues in November 2021. The Standards are intended as ethical principles for the fair representation and full disclosure of an investment product's ESG approaches. Breckinridge is developing its disclosures in compliance with the standards, with support from the CFA institute, with the goal of finalizing them in 2023.

## 2Q23 CORPORATE TRENDS DASHBOARD

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

Trends	Weakness Strength				
Event Risk			X		Mergers are down nearly 40 percent 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		IG new issuance of about \$403bn was 15% lower Y/Y. IG fund inflows in March were a modest \$3bn.
Valuations			X		At +140bps the IG Index is near to pricing in an "earnings" recession but not an economic recession.
Central Bank Policy		X			The Fed expect restrictive monetary policy to be necessary for some time to combat above target inflation.
Economy		X			Real economic growth is expected to remain below trend with a no growth or moderate recession scenario.
Management/ESG		X			Share buybacks are the primary use of excess liquidity; Issuers remain focused on managing ESG risks.
Operating Trends		X			For 1Q23, the estimated decline in operating earnings for the S&P 500 Index is -6% Y/Y, per FactSet.
Rating Trends		X			Rating agency outlooks are biased negative across a variety of industries including Banking.
Geopolitical Risk	X				The Russia/Ukraine war and China's implicit threat to Taiwan have escalated tensions with the West.

Sources: Breckinridge Capital Advisors, Barclays, Bloomberg, Bureau of Economic Analysis, EPFR, FactSet, Rating Agencies, Wells Fargo., as of March 31, 2023, unless otherwise indicated.





## STATISTICAL SUMMARY

	As of 03/31/23		OAS Change (bps)		
	Yield to Worst (%)	OAS (bps)	Month to Date	Quarter to Date	Year to Date
<b>Bloomberg U.S. Corporate Bond Index**</b>	5.17	138	13	8	8
<b>Corporate Curves</b>					
Corporate 1-3 Year	5.22	101	37	28	28
Corporate 1-5 year	5.12	111	29	20	20
Corporate 5-10 year	5.06	149	7	-1	-1
Corporate 10 + year	5.29	160	2	2	2
<b>Corporate Quality</b>					
AAA Corporate	4.26	55	-4	-2	-2
AA Corporate	4.48	70	1	1	1
A Corporate	4.98	118	15	9	9
BBB Corporate	5.45	168	16	9	9
<b>Corporate Sector Spreads</b>					
Banking	5.48	160	40	25	25
Basic Industry	5.28	154	8	1	1
Capital Goods	4.87	109	1	-1	-1
Communications	5.23	153	-2	-7	-7
Consumer Cyclical	4.84	106	5	2	2
Consumer Non-Cyclical	4.88	112	-1	-2	-2
Energy	5.26	147	7	3	3
Insurance	5.22	147	16	11	11
REITS	5.71	199	53	40	40
Technology	4.87	112	-1	1	1
Transportation	5.01	127	6	2	2
Utility	5.11	136	6	7	7
<b>Supply/Demand (\$ Billions)</b>	<b>4Q22*</b>	<b>4Q21*</b>	<b>2022</b>	<b>2021</b>	<b>2020</b>
Net Corporate Supply	267	633	496	875	1038
Net Purchases (Foreigners)	24	-10	174	46	181
Net Purchases (Funds)	102	327	121	463	425
Net Purchases (Households)	-92	-9	-233	-157	31
Net Purchases (Insurance)	251	288	250	171	199
Net Purchases (Other)	-18	37	184	352	202

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.



For Investment Professional and Institutional Use Only.

#329436 (4/5/23)

### FOOTNOTES:

1. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is 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.
2. 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.
3. The FDIC, appointed as receiver, closed SVB on March 10, 2023, and created a bridge bank to protect insured depositors. Initially, uninsured depositors were not described in the same manner. Concerns over uninsured deposits in the banking system sparked volatility, particularly in regional banks. On March 13, 2023, the FDIC clarified that all depositors would have full access to their money. Breckinridge did not hold SVB bonds. <https://www.fdic.gov/news/press-releases/2023/pr23016.html>, <https://www.fdic.gov/news/press-releases/2023/pr23019.html>.

**DISCLAIMER:** This material provides general and/or educational information and should not be construed as a solicitation or offer of Breckinridge services or products or as legal, tax or investment advice. The content is current as of the time of writing or as designated within the material. All information, including the opinions and views of Breckinridge, is subject to change without notice.

There is no assurance that any estimate, target, projection or forward-looking statement (collectively, "estimates") included in this material will be accurate or prove to be profitable; actual results may differ substantially. Breckinridge estimates are based on Breckinridge's research, analysis and assumptions. Other events that were not considered in formulating such projections could occur and may significantly affect the outcome, returns or performance.

Not all securities or issuers mentioned represent holdings in client portfolios. Some securities have been provided for illustrative purposes only and should not be construed as investment recommendations. Any illustrative engagement or ESG analysis examples are intended to demonstrate Breckinridge's research and investment process.

Past performance is not a guarantee of future results. Breckinridge makes no assurances, warranties or representations that any strategies described herein will meet their investment objectives or incur any profits. Any index results shown are for illustrative purposes and do not represent the performance of any specific investment. Indices are unmanaged and investors cannot directly invest in them. They do not reflect any management, custody, transaction or other expenses, and generally assume reinvestment of dividends, income and capital gains. Performance of indices may be more or less volatile than any investment strategy.

Performance results for Breckinridge's investment strategies include the reinvestment of interest and any other earnings, but do not reflect any brokerage or trading costs a client would have paid. Results may not reflect the impact that any material market or economic factors would have had on the accounts during the time period. Due to differences in client restrictions, objectives, cash flows, and other such factors, individual client account performance may differ substantially from the performance presented.

All investments involve risk, including loss of principal. Diversification cannot assure a profit or protect against loss. Fixed income investments have varying degrees of credit risk, interest rate risk, default risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer-term securities. Income from municipal bonds can be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the IRS or state tax authorities, or noncompliant conduct of a bond issuer.

Equity investments are volatile and can decline significantly in response to investor reception of the issuer, market, economic, industry, political, regulatory or other conditions. In addition, when interest rates rise, equity investments, including dividend-paying securities, may become less attractive to investors as bonds and other fixed-income investments may offer higher yields. There is no guarantee that a company will continue to pay, increase or declare a dividend.

Breckinridge believes that the assessment of ESG risks, including those associated with climate change, can improve overall risk analysis. When integrating ESG analysis with traditional financial analysis, Breckinridge's investment team will consider ESG factors but may conclude that other attributes outweigh the ESG considerations when making investment decisions.

There is no guarantee that integrating ESG analysis will improve risk-adjusted returns, lower portfolio volatility over any specific time period, or outperform the broader market or other strategies that do not utilize ESG analysis when selecting investments. The consideration of ESG factors may limit investment opportunities available to a portfolio. In addition, ESG data often lacks standardization, consistency and transparency and for certain companies such data may not be available, complete or accurate.

Breckinridge's ESG analysis is based on third party data and Breckinridge analysts' internal analysis. Analysts will review a variety of sources such as corporate sustainability reports, data subscriptions, and research reports to obtain available metrics for internally developed ESG frameworks. Qualitative ESG information is obtained from corporate sustainability reports, engagement discussion with corporate management teams, among others. A high sustainability rating does not mean it will be included in a portfolio, nor does it mean that a bond will provide profits or avoid losses.

The effectiveness of any tax management strategy is largely dependent on each investor's entire tax and investment profile, including investments made outside of Breckinridge's advisory services. As such, there is a risk that the strategy used to reduce the tax liability of the investor is not the most effective for that investor. Breckinridge is not a tax advisor and does not provide personal tax advice. Investors should consult with their tax professionals regarding tax strategies and associated consequences.

Federal and local tax laws can change at any time. These changes can impact tax consequences for investors, who should consult with a tax professional before making any decisions.

Separate accounts may not be suitable for all investors.

The content may contain information taken from unaffiliated third-party sources. Breckinridge believes the data provided by unaffiliated third parties to be reliable but investors should conduct their own independent verification prior to use. Some economic and market conditions contained herein have been obtained from published sources and/or prepared by third parties, and in certain cases have not been updated through the date hereof. All information contained herein is subject to revision. Any third-party websites included in the content have been provided for reference only.

Certain third parties require us to include the following language when using their information:

BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). Bloomberg does not approve or endorse 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.

The S&P500 Index ("Index") and associated data is a product of S&P Dow Jones Indices LLC, its affiliates and/or their licensors and has been licensed for use by Breckinridge. © 2023 S&P Dow Jones Indices LLC, its affiliates and/or their licensors. All rights reserved. Redistribution or reproduction in whole or in part are prohibited without written permission of S&P Dow Jones Indices LLC. For more information on any of S&P Dow Jones Indices LLC's indices please visit [www.spdji.com](http://www.spdji.com). S&P® is a registered trademark of Standard & Poor's Financial Services LLC ("SPFS") and Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"). Neither S&P Dow Jones Indices LLC, SPFS, Dow Jones, their affiliates nor their licensors ("S&P DJI") make any representation or warranty, express or implied, as to the ability of any index to accurately represent the asset class or market sector that it purports to represent and S&P DJI shall have no liability for any errors, omissions, or interruptions of any index or the data included therein.