Breckinridge CAPITAL ADVISORS

Q4 2021

Corporate Bond Market Outlook

Key Drivers for the Quarter

- Third-quarter bond markets were sedate until investor concerns increased near quarter end about inflation, interest rates, and fiscal and monetary policy.
- The debate about transitory versus structural inflation continued. Wage increases and higher costs across a range of products indicated price increases may stick around longer.
- Among corporate investment grade (IG) bond issuers, financial leverage continued to decline.
- Rating agency actions turned more positive, reflecting improved credit fundamentals.
- Corporate spreads widened 4 basis points (bps) in 3Q to an average 84bp option-adjusted spread (OAS).
- IG supply of $373 billion in 3Q was 19 percent lower year-over-year (Y/Y). Year-to-date (YTD) 2021 supply of $1.35 trillion is second only to 2020.
- The influence of environmental, social and governance (ESG) matters continued to increase with climate change taking center stage during the summer.

Investment Review and Outlook

After a Quiet Quarter, Investor Concerns about Interest Rates, Inflation and Debt Ceiling Increased

Third-quarter bond markets were sedate until investor concerns increased near quarter end about inflation, interest rates, and fiscal and monetary policy. After slipping lower for nearly three months, bond yields returned close to levels at the start of the quarter. The Treasury yield curve flattened.

The debate about transitory versus structural inflation continued, despite a lower-than-expected August Consumer Price Index report. Wage increases and higher shelter and commodity costs indicated price increases may prove more persistent than expected at the start of the year.

At its September meeting, the Fed's rate-setting committee indicated it could raise interest rates next year.[1] The Fed's dot plot, which indicates Fed Governors' disposition on rate increases, shifted, with 9 of 18 members seeing a 2022 hike, up from 7 in June.

The Fed signaled it will announce at its November meeting more information on gradual tapering of the $120 billion monthly purchases of Treasury and mortgage debt if the economy doesn't suffer a significant setback.

In Washington, Congress and the White House wrangled over infrastructure spending and an increase in the federal debt limit, with a potential default on the government's debt looming. While Congress approved a measure to fund the government through December 3 on the last day of the quarter, the deal did little to assuage the markets and left the debt ceiling limit unaddressed.

For the quarter, total return for the Bloomberg U.S. IG Corporate Bonds Index was flat and excess return versus duration-matched Treasuries was a negative 0.15 percent.

Fundamentals

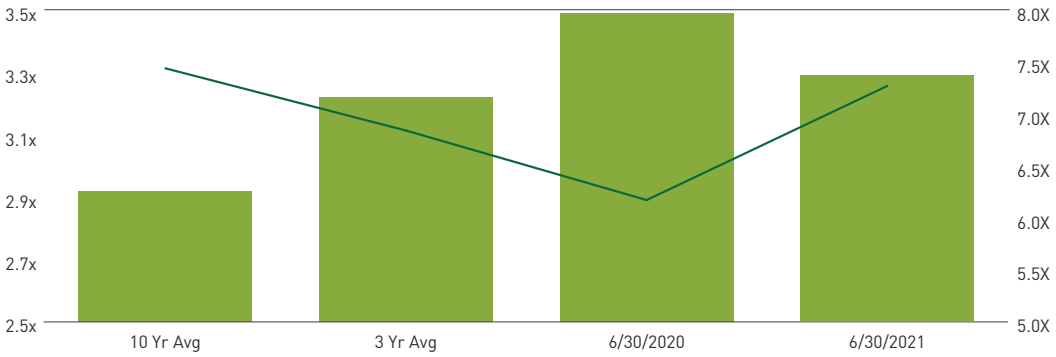
Financial Leverage is Down, and EBITDA Interest Coverage is Up

We view credit fundamentals as a modest strength for the IG market headed into 4Q. Fundamentals are stable to improving, which provides a constructive backdrop for credit in our view.

For the fourth consecutive quarter, businesses reduced the ratio of gross corporate debt to earnings before interest, taxes, depreciation, and amortization (EBITDA) on the back of continued growth in cash flows.

After peaking in 2020, gross leverage was 3.3 times for the mean IG issuer at the close of 2Q (See Figure 1). We expect gross leverage should decline closer to its longer-term averages over the last quarter of 2021 based on the current outlook for continued economic growth and business improvement.

FIGURE 1: LEVERAGE IS DOWN FROM THE PEAK AND INTEREST COVERAGE IS HIGHER



Total Debt/EBITDA (IG, Mean) — EBITDA/Interest Expense (rhs)

Source: Bloomberg Intelligence, Barclays, ICE, FactSet as of September 30, 2021.

An extended period of low rates reduced interest burdens as corporations refinanced higher cost debt. Interest coverage improved to 7.3 times on June 30 from 6.2 times, year-over-year (Y/Y).

Credit rating agency actions turned more positive in 2021, reflecting improved credit fundamentals. All three major agencies—Fitch Ratings, Inc., Moody's Investors Service, Inc., and S&P Global Ratings—upgraded more U.S. IG companies than they downgraded.

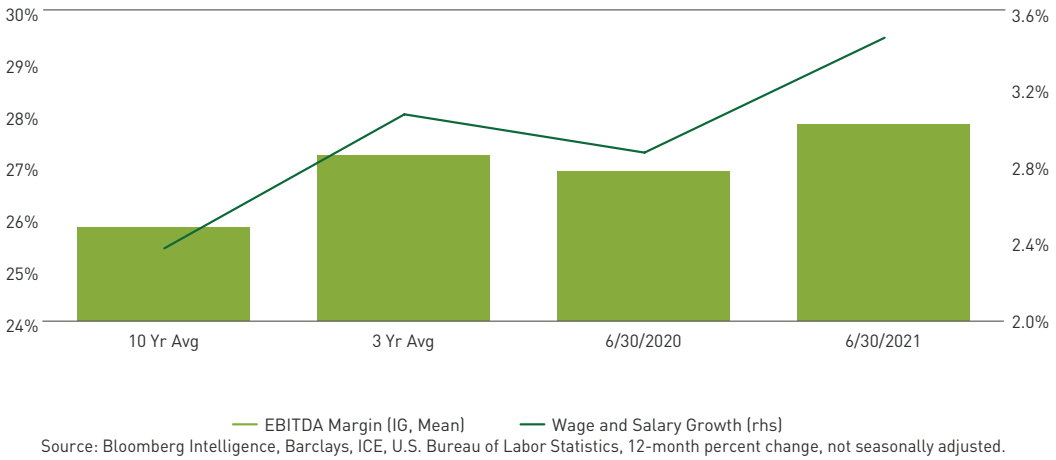
Should earnings grow by 40 percent Y/Y in 2021, as projected by FactSet, leverage should decline further. Shareholder enhancements and mergers and acquisitions (M&A) are swing factors depending on debt usage and both could be a partial offset to the IG corporate credit improvement.

M&A deal value bounced back strongly in 2021 and was at 2019 levels by the end of 3Q. In August, Reuters reported that the U.S. accounted for $2.14 trillion worth of pending and completed M&A to date in 2021, based on data from Refinitiv. With high cash balances and equity valuations, debt-funded M&A is below historical levels year-to-date, a favorable circumstance for fixed income investor. Share buybacks have rebounded but remain below peak levels, while dividends have remained steady. S&P Dow Jones Indices reported on September 23, that preliminary S&P 500 share repurchases were $198.8 billion for 2Q 2021, increasing 11.6 percent from 1Q 2021's $178.1 billion, and up 124.3 percent from a low of $88.7 billion in 2Q 2020.

Rising Wages and Input Costs May Pressure Profit Margins

After dipping during COVID-19 lockdowns in 2020, EBITDA margins have bounced back and are high relative to historical levels for IG companies, at a mean of 27.8 percent at 2Q, above the 10-year average of 25.8 percent, based on Bloomberg data (See Figure 2).

FIGURE 2: UPWARD PRESSURE ON WAGES MAY WEIGH ON CURRENT HIGH MARGINS



Source: Bloomberg Intelligence, Barclays, ICE, U.S. Bureau of Labor Statistics, 12-month percent change, not seasonally adjusted.

During 3Q, supply chain disruptions along with elevated commodity prices may hurt sales and margins in certain sectors such as Autos, Consumer Products, Transportation, Basic Industries, and Industrials. Selective price increases could partially offset these negative influences.

Labor shortages have placed upward pressure on wages in some of these sectors, as well as Home Builders and Building Materials. Wage growth accelerated at 3.5 percent through 2Q.

From a credit fundamentals perspective, there are also implications to consider that are associated with a shifting regulatory backdrop under the Biden Administration. For instance, mega M&A deals are receiving more antitrust scrutiny.

Discouraging M&A has mixed ramifications for bondholders. They range from the potential negative effect of restraining business growth to the potential positive effect of limiting corporate indebtedness.

In another instance, we expect that taxes may rise modestly in 2022 but not materially so.

Finally, regulation related to climate change will likely increase. Large Energy issuers may continue to divest assets in response to pressure on climate goals and targets. While these are just a few examples, we mention them to acknowledge the need to closely monitor developments moving forward and their potential to shape fundamental credit quality.

Technicals

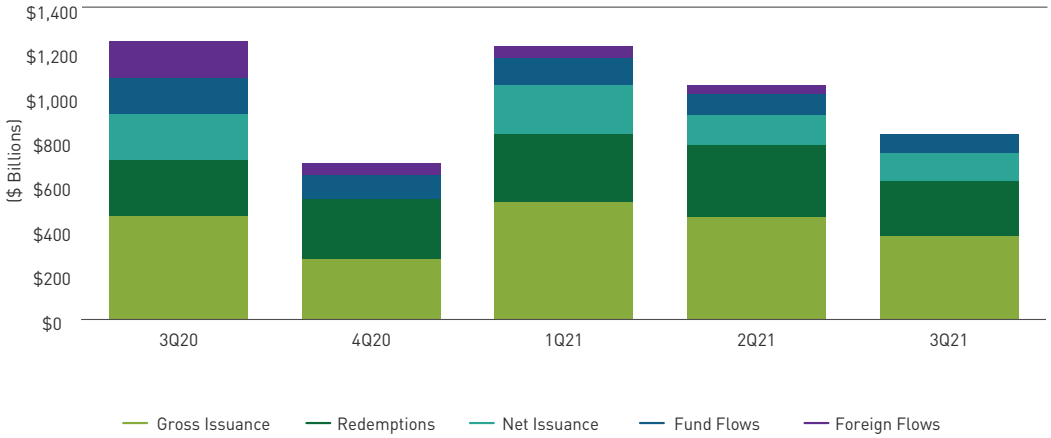
Supply is Healthy, While M&A Debt Funding is Below Average

We view technicals as a neutral influence for the IG market entering 4Q. Supply is healthy while M&A funding is below average. Foreign flows have slowed but domestic flows are strong.

IG supply of $373 billion in 3Q was 19 percent lower Y/Y, according to Barclays Research. Supply of $1.35 trillion YTD through September 30 is second only to 2020. Net IG supply of $127 billion in 3Q was average due to redemptions.

New issue supply marked for M&A funding was a modest 6 percent of issuance YTD, per CreditSights, as compared to about 15 percent in 2019 and an average of 10 percent since 2010.

FIGURE 3: IG FIXED-RATE BOND SUPPLYAND FUND/ FOREIGN FLOWS



Source: Barclays Research, CreditSights, Citi Velocity, U.S. Treasury, Wells Fargo, EPFR. as of September 30, 2021.

IG funds received $83 billion and $304 billion of inflows in 3Q and YTD, respectively, per EPFR. Foreign inflows of $77 billion YTD through 3Q were about half the pace of 2020, according to Wells Fargo.

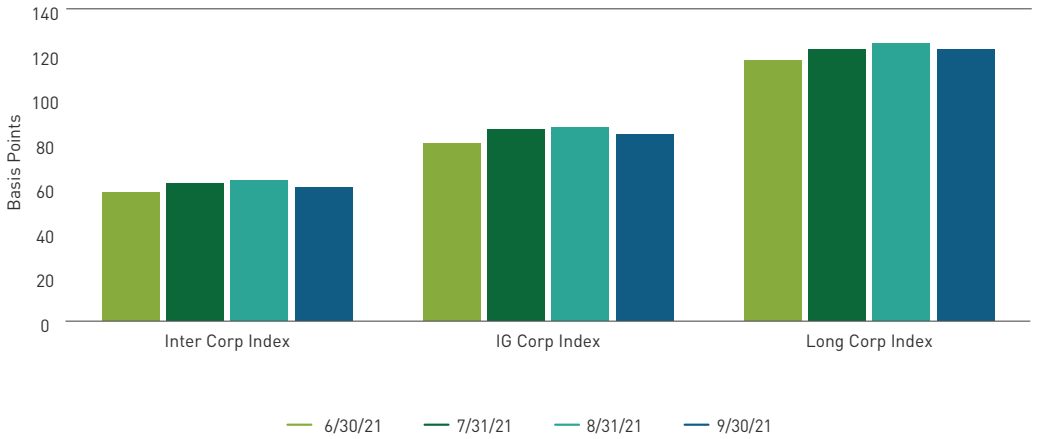
Valuations

Spreads Moved in a Tight Trading Range during the Quarter

We view valuations as a modest weakness for the IG corporate market. Spreads are tight but they offer some value compared with other IG sectors. Spreads are wider in the U.S. than foreign IG markets.

Corporate spreads moved 4bps wider in 3Q to an average OAS of 84bps, based on Bloomberg data. The BBB segment, widening 4bps, outperformed AAA- through A-rated bonds, which widened 5 bps on average during 3Q. Spreads moved in a tight range, with an 11bps trading range in 3Q. Spreads began the third quarter at 80bps, hit 91bps on August 19, 2021, and then retraced to 84bps by the end of 3Q.

FIGURE 4: IG SPREADS MOVED IN A TIGHT RANGE IN 3Q



Source: Barclays Live, Bloomberg Indices.

Movement in corporate credit maturity curves were minimal in 3Q, according to Bloomberg index data. Intermediate maturity corporate bond spreads widened by 3bps while long maturity corporates widened by 5bps in 3Q.

ESG Spotlight

While the 2021 trend continued to elevate the role ESG considerations play among global investors, governments, and communities, the threat of climate change demanded center stage attention.

The September release of Breckinridge's 2021 Issuer Engagement Report *Addressing the Materiality of Climate Change Risk Through Issuer Engagement* in September amplifies the importance of climate risk in ESG analysis and provides insights into our discussions with issuers in 2021 about their plans to address the risks.

Corporate awareness of the need to transition to a low- or no-carbon economy appears to be growing. Issuance continues of green, sustainable, or sustainability-linked bonds (SLB) that use proceeds for advancement of sustainability goals.

During 3Q, a European oil company announced plans to raise 1.25 billion euros ($1.5 billion) through an SLB, according to Reuters. SLBs allow firms to raise money for general corporate purposes while promising investors that if they do not meet the sustainability targets set, such as cutting carbon emissions, they will pay bond investors extra interest.

Closer to home, the New York Federal Reserve published a report on climate stress testing during 3Q. The report outlined how the New York Fed is beginning to quantify the systemic risks from climate change on the financial sector.

While the paper has no immediate policy implications, the authors said, it represents an important step towards measuring the climate-related risk exposures of large global banks.

The implications of climate risk and broader ESG factors for bond issuers and investment research continue as a focus for Breckinridge, which integrated ESG and fundamental security research a decade ago, as well as a growing community of investors and bond issuers.

CORPORATE TRENDS DASHBOARD

Key Drivers: The Economy Has Strengthened but the Pace of Recovery Has Slowed and Inflationary, Interest-Rate, and Fiscal and Monetary Policy Headwinds Exist.

TRENDS	Weakness				Strength	
Central Bank Policy				X		Policy is stimulative with rates still low; however, expected tapering of bond purchases is a shift in accommodation.
Economy				X		U.S. GDP is projected to grow above trend in 2021 based on a rebound in consumer spending and investment.
Operating Trends				X		After a 14 percent decline in 2020, S&P 500 earnings are projected to grow by over 40 percent Y-o-Y in 2021.
Rating Trends			X			Rating actions have turned more positive. Agencies have upgraded more than they have downgraded YTD-21.
Financial Leverage			X			Financial leverage has declined due to growth in cash flows. Low rates have helped reduce interest burdens.
Supply/Demand			X			Supply is healthy while M&A funding is below average. Foreign flows have slowed but domestic flows are strong.
Geopolitical Risk		X				China and U.S. foreign relations are a risk to IG credit. Tariffs can negatively impact global growth and stability.
Event Risk		X				M&A has picked up with deal count and deal value in 3Q21 handily exceeding figures in 3Q20 and 3Q19.
Management/ESG		X				Supply chain disruptions, rising input costs, labor shortages, and wage pressures are ongoing challenges
Regulatory		X				Regulations in some certain sectors may shift under a Biden administration and corporate taxes may rise.
Valuations		X				Spreads are tight but they offer some value vs. other IG sectors. Spreads are wider than foreign IG markets.

Sources: Breckinridge Capital Advisors, Bloomberg, Bureau of Economic Analysis, FactSet, Rating Agencies.
As of September 30, 2021, unless otherwise indicated.

STATISTICAL SUMMARY

	As of 09/30/21		OAS Change (bps)		
	Yield to Worst (%)	OAS (bps)	Month to Date	Quarter to Date	Year to Date
Bloomberg U.S. Corporate Index**	2.13	84	-2	4	-12
Corporate Credit Curves					
Corporate 1-3 Year	0.61	32	-1	1	-3
Corporate 1-5 year	0.97	43	-1	3	-3
Corporate 5-10 year	2.08	80	-3	3	-9
Corporate 10+ year	3.14	122	-2	5	-18
Corporate Quality Spreads					
AAA Corporate	2.00	47	-1	5	-7
AA Corporate	1.87	52	-2	5	-6
A Corporate	1.91	67	-2	5	-6
BBB Corporate	2.34	104	-3	4	-18
Corporate Sector Spreads					
Banking	1.65	68	-1	4	-4
Basic Industry	2.52	109	1	8	-12
Capital Goods	2.07	80	-3	4	-18
Communications	2.64	109	-1	6	-10
Consumer Cyclical	1.92	73	-3	4	-9
Consumer Non-Cyclical	2.23	82	-2	4	-8
Energy	2.35	105	-7	3	-31
Insurance	2.32	89	-3	2	-16
REITS	2.04	86	0	3	-21
Technology	1.99	72	-2	6	-3
Transportation	2.43	93	-5	3	-22
Utility	2.46	96	-4	3	-10
Supply/Demand ($Billions)					
	2Q21*	**2Q20***	**2020**	**2019**	**2018**
Net Corporate Supply	691	2197	1064	489	366
Net Purchases (Foreigners)	529	719	193	155	-60
Net Purchases (Funds)	228	763	495	99	190
Net Purchases (Households)	-401	468	-57	65	94
Net Purchases (Insurance)	104	117	257	141	145
Net Purchases (Other)	231	130	176	29	-3

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.

FOOTNOTES:
1. *https://www.wsj.com/articles/fed-tees-up-taper-and-signals-rate-rises-possible-next-year-11632333617*