Investment Grade Credit Outlook 2023

We see limited room for credit spreads to materially outperform into the rest of 2023. With interest rates likely remaining higher for longer and corporate earnings growth expected to further slow into the remainder of 2023, we expect economic activity to decelerate. In this environment, where investment grade credit spreads are now just at their historic averages, we see limited room for credit to materially outperform. More likely, we expect credit spreads to leak wider, or at the very least remain range bound. Our base case for Q3 2023 is that we expect returns to be driven by carry rather than by spread compression.

Review of 1H 2023

Investment grade markets started 2023 off with strong returns. The Bloomberg US Corporate Bond Index posted a total return of 4.0% for the month of January. However, by the end of May the year-to-date return had slipped to just 2.8%.

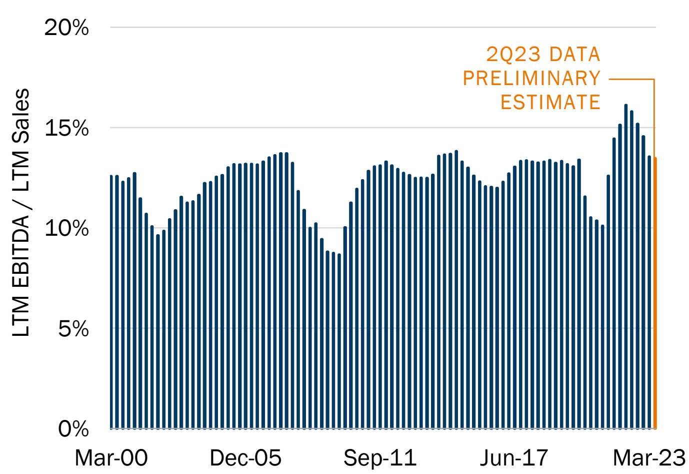
The banking sector emerged as a large source of risk in first half of 2023 with several high profile bank failures in both the US and Europe. A combination of rapid interest rate increases that resulted in falling values of banks' bond portfolios, large deposit flows among banks as depositors grew concerned about the strength of smaller banks and the prospect of lower earnings in an environment of higher interest rates drove credit spreads materially wider. At the same time, tightening credit standards and a weaker outlook for corporate earnings added to concerns of a possible recession later in the year. The end of the second quarter also saw volatility associated with the debt ceiling debacle, though fortunately this was resolved.

In this environment, we favor sectors that are less economically sensitive such as healthcare and utilities. At the same time, we are being selective in allocating to the banking sector as we expect the banking sector's performance to lag as the economy slows and asset quality weakens. Regional banks typically hold more credit risk than larger and better diversified money center banks. We remain cautious on the REIT office sector as pressures remain and improvement in office occupancy rates appear to have stalled.

Outlook for 3Q 2023

We expect earnings growth to slow and credit metrics to deteriorate over the balance of 2023. Signs of this are already evident. Within the S&P 500 Index, median EBITDA growth slowed to 1% in Q1 2023 from 3.4% in Q4 2022 and 8% in Q1 2022, and the interest coverage ratio declined to 11.9x in Q1 2023 from its peak in Q2 2022 of 13.7x. Prolonged higher interest rates likely means higher borrowing costs resulting in further declines in debt coverage ratios in the absence of debt reductions.

FIGURE 1: S&P 500 INDEX OPERATING MARGIN



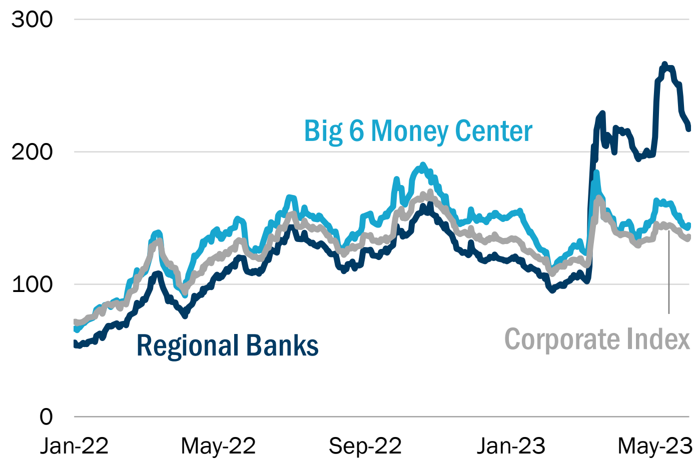
Data as of March 31, 2023.
Based on US investment grade non-financial non-utility issuers.
Source: Bloomberg

Against this backdrop, we are looking to avoid names that are over-exposed to floating rate debt and where credit ratings are toward the lower end of the investment grade rating spectrum, notably BBB- issuers. We have also noticed that the slowing earnings growth environment has begun to eat away at some of the rating buffers BBB issuers had added in recent years. To that extent, BBB downgrade rates have begun to tick up. For example, the consumer products sector has seen several downgrades from Investment Grade to High Yield as they have struggled with rising input costs, changing consumer demand and supply chain issues. Holding bonds of issuers that are likely to experience credit downgrades has typically been a source of underperformance for investment grade investors.

Regional bank credit spreads reflect a large degree of distress and bank credit spreads are trading wide to industrials. Banks are the largest issuer group in the investment grade market. We expect banks to build out their term funding bases as new regulations that require banks to issue more term debt are rolled out. Issuance of bonds by banks are likely to present interesting opportunities as banks will likely need to offer compelling new issue concessions to attract buyers. At the same time, higher for longer interest rates are likely to create ongoing earnings pressures for banks and a negative equity market sentiment could weigh on the sector.

Lastly, reflecting our view that credit spreads are not currently reflecting the risk of weakening corporate fundamentals and higher downgrade risk, and elevated front-end interest rates presents a unique opportunity, we favor shorter maturity bonds where both yields and credit spreads appear attractive, especially those of the larger systemically important banks. At the same time, we are monitoring the trajectory of credit spreads; should credit spreads materially widen and the Federal Reserve reassess its interest rates stance due to pronounced economic weakness and/or inflation reverting to acceptable levels, we would reassess our investment stance and possibly increase our risk exposure.

FIGURE 2: 5-YEAR CREDIT SPREADS: REGIONAL BANKS ARE WIDE



Data as of May 31, 2023
Source: JP Morgan

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