IR+M CORPORATE MARKET UPDATE

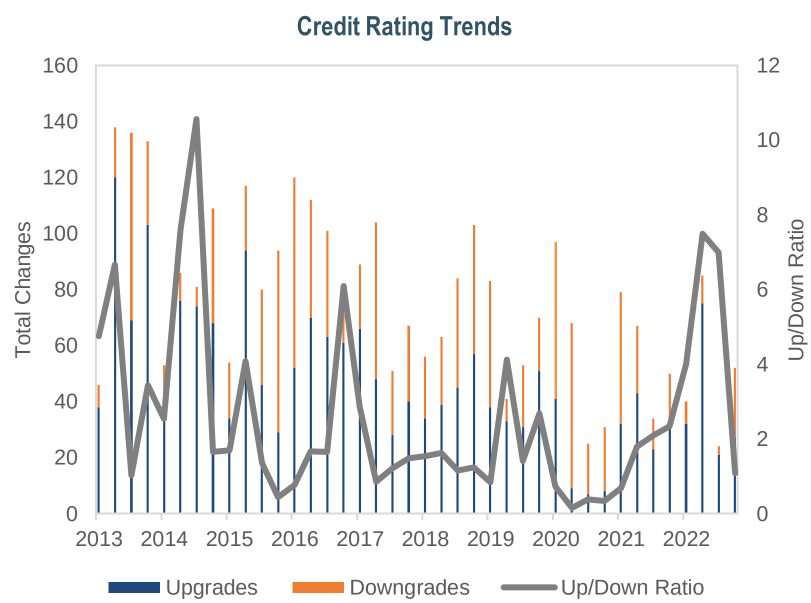
Fixed Income in 2023: Shelter From The Storm

January 20, 2023

2022 provided investors with a plethora of challenging factors to navigate including persistently high inflation, rising interest rates, a hawkish Fed, geopolitical unrest, and deeply negative returns, to name a few. Despite the uncertain macroeconomic environment, corporate fundamentals remained relatively stable as companies were able to fortify balance sheets over the last few years in the midst of record low yields. As we enter 2023, uncertainties remain amid continued tight monetary conditions and what the potential impact may be to the broader economy. In this piece, we review corporate technicals and fundamentals, and what could be in store for the remainder of the year.

Fundamentals Remain Strong, But Uncertainty Looms

- **Corporate fundamentals are healthy.** Despite a significant increase in input costs and a softening economy, corporate balance sheets ended 2022 in a relatively strong position relative to prior cycles.
- **Leverage and coverage have improved**. Leverage continued falling in 2022 to below pre-COVID levels as companies prioritized paying down debt over shareholder friendly activities. Coverage remains elevated at 12.8x, the highest since 2016, as companies benefited from low rates. This is an indication of conservative balance sheet management, allowing issuers to reduce the risk of slower growth, potentially resulting in weaker credit metrics.
- **But margins have been pressured.** Revenue and earnings remain positive, but margins have deteriorated with the rise of input and labor costs and currency headwinds impeding profitability. A slowdown in consumer demand has led to rising inventory levels, which could further compress margins as companies look to offer discounts to spur sales. However, margins are still above historical averages, especially relative to periods of higher inflation.
- **Companies are beginning to shift focus.** The narrative around inflation and its impact on specific sectors is slowly shifting to earnings amidst a potential recession. According to FactSet, the materials, consumer discretionary, and communications sectors are expected to see a decline in earnings next year, while the energy and industrial sectors are expected to see some of the highest earnings growth. Slower growth will likely mean we have seen the peak in credit fundamentals and should expect modest deterioration throughout 2023. This is beginning to show up in credit rating trends with the pace of upgrades slowing.



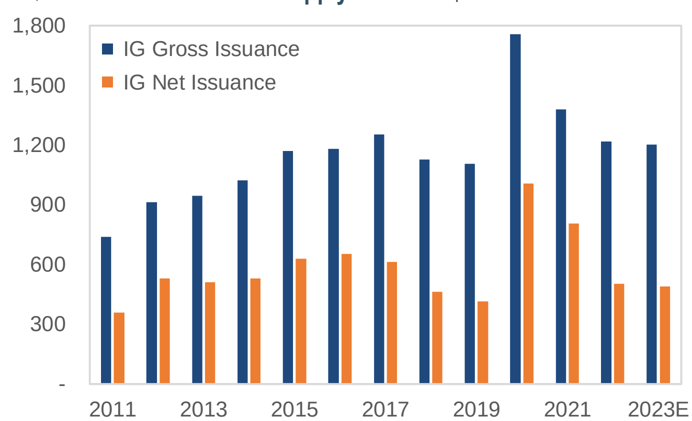
Underwhelming Supply

- **Corporate supply underwhelmed street expectations in 2022.** Although investment-grade (IG) issuance was down 12% year-over year to $1.2 trillion, it was still the fourth highest total on record. Supply was mostly front-loaded, with almost 40% of issuance being priced in the first quarter.
- **Prospective issuers were highly sensitive to market sentiment and the economic calendar.** There was no issuance at all in about a third of the business days in 2022. Issuers remained on the sidelines when rate volatility increased or if Federal Reserve (Fed) comments or inflation data was expected that day.

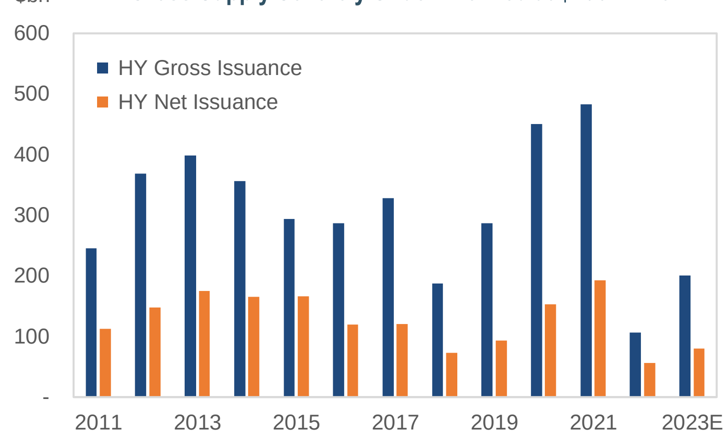
Underwhelming Supply (Continued)

- **Financials saw record issuance.** In 2022, financials saw record issuance at $597 billion, accounting for 49% of the total supply, the highest percentage since 2007. Non-financials total supply was $618 billion. In 2023, overall financial supply is expected to decrease moderately by 5% relative to 2022.
- **ESG issuance cooled**. The pace of US IG ESG bond issuance slowed in 2022 – only $61 billion was issued, representing 5% of the new issue supply, a 25% decrease year-over-year. ESG issuance is expected to increase to 10% of gross issuance in 2023, with green bonds comprising most of the labeled-bond supply.
- **Supply should reach similar levels in 2023.** Expectations are for supply to be in line with 2022, with a slight decrease in net issuance. M&A supply should be a relatively small portion of overall volume as less deal activity is expected next year.

IG Gross Supply Reached $1.2 Trillion



HY Gross Supply Severely Underwhelmed at $106 Billion

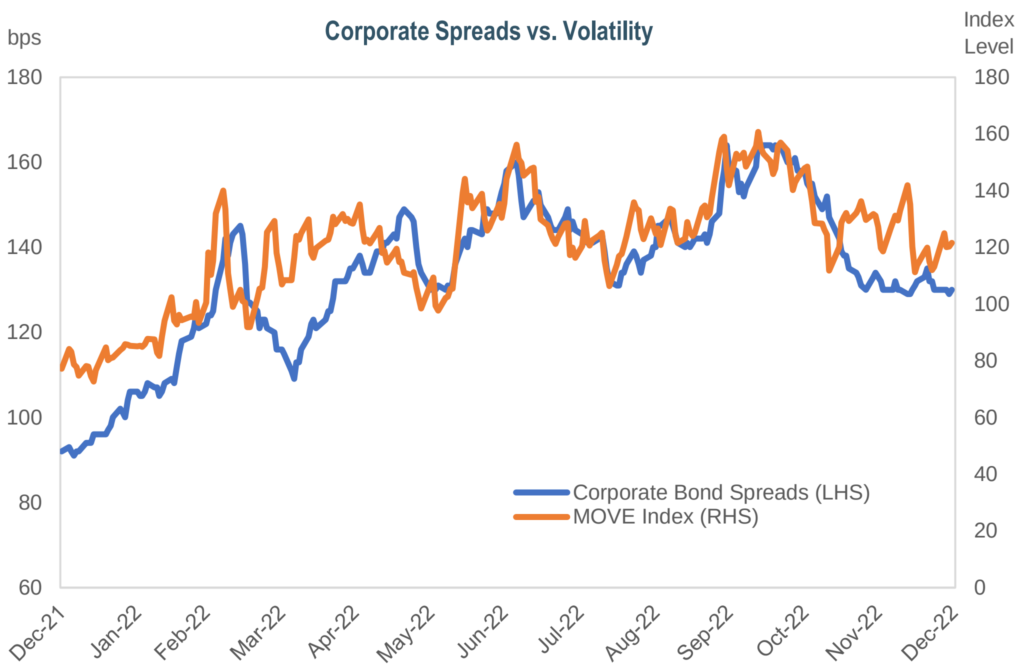


2023's Big Three: The Fed, Inflation, and Economic Uncertainty

- **Mounting uncertainty reaching a boiling point.** With 2023 underway, all eyes are on the Fed and economic data releases. Though the rate of inflation remains above the Fed's long-term target, the hiking cycle appears to have succeeded in bringing inflation down from its elevated levels in 2022. However, the rate hikes have also begun to take their toll on the economy by slowing growth and increasing the probability of a recession. Corporate issuer fundamentals have begun to deteriorate, and earnings are expected to decline in the next quarter. Nevertheless, the labor market remains strong with low unemployment, which should serve to help mitigate the depth of a potential recession. The combination of mixed signals makes it unclear if the Fed will be able to engineer a "soft landing" by avoiding a recession while reducing inflation. This uncertainty is reflected through high volatility in the markets.
- **Fixed income investors adjust to the new economic landscape.** The changing monetary and economic environment has already had an impact on fixed income assets in 2022. Higher interest rates have resulted in higher funding costs for borrowers, and these costs have pressured balance sheets for issuers that need to come to market. While most of the impact of the new economic landscape has already hit fixed income assets in 2022, it's important to note that a further weakening of economic conditions would likely have varying effects across different sectors. Projected defaults within the banking sector are minimal, for example, while defaults among consumer products companies are expected to be relatively high.

2023's Big Three: The Fed, Inflation, and Economic Uncertainty (Continued)

- **Investment-grade bonds are likely to outperform.** Despite potential headwinds, we believe corporate bonds offer attractive value compared to Treasuries and other asset classes. The yield of the Bloomberg Investment Grade Corporate Index is higher than the S&P 500 earnings yield for the first time since the Great Financial Crisis. The high yields on corporate bonds combined with their low dollar prices can make them an attractive investment option for long-term investors. Additionally, if the Fed pauses its current tightening action, volatility will likely drop, and historical data suggests that we would see a tightening in spread levels.



As we enter 2023, there is growing uncertainty in whether the US economy can withstand restrictive monetary conditions for much longer without falling into a recession. Although inflationary pressures appear to have peaked, there are signs of weakening demand and slower growth. However, investment-grade corporate fundamentals are beginning the year in a position of strength – leverage and coverage ratios are at healthy levels – which should help most issuers navigate a deteriorating market. With any economic downturn, though, there would likely be an inconsistent impact across sectors and issuers. We believe the likelihood of increased dispersion lends itself to our experience as disciplined, bottom-up security selectors.