

CION Credit Market Update – January 31, 2022

Pedal to the Metal



The minutes of the December FOMC meeting, released in early January, indicated that the Federal Reserve is considering reducing its balance sheet soon after rate increases begin, potentially even in 2022. The Fed had increased its market support activities during the pandemic, and is currently holding more than \$8.3 trillion of Treasury and mortgage-backed securities. Along with short-term rate increases, the sale of these assets would raise long-term rates.

The equity markets promptly swooned – but despite a month of volatility, yields on the ten-year U.S. Treasury never hit 2%, and closed out the month at 1.74%. Most bond sectors saw negative performance as yields rose. High-yield bonds, with their higher correlation to equities, were negative even given lower durations.

The Fed's January meeting and subsequent press conference set the stage for continued volatility as Chairman Powell's remarks were notable for what he did not say. Powell left open both the pace and amount of rate increases. Expectations had already increased from a total of three rate hikes in 2022 to a potential for five, and the idea that rates could be increased by 50 basis points at a clip also began to seem likely.

In early February, the Bureau of Labor Statistics released CPI for the 12 months ended in January 2022. The increase to 7.5% was well over market expectations. Combined with an extremely strong jobs report, the futures market moved from an approximately 40% expectation of a 50 basis point rate hike in March to near certainty.

The yield on the two-year Treasury jumped 0.24% on the day of the inflation print. Yield increases throughout January were greatest among short maturities, and the curve was already beginning to flatten. With the two-year remaining above the 1.50% mark, while the ten-year struggles to hit and remain at 2.00%, increased worries about a flatter – or inverting – yield curve are at the forefront for investors.

A Closer Look: Municipals

The rise in Treasury yields put considerable pressure on the municipal market in January. The month saw \$1.1 billion of net outflows from municipal funds/ETFs, the first period of sustained redemptions since the first months of the pandemic in 2020. Returns across the municipal spectrum were negative. The municipal market hasn't seen a worse January since 1981, and it marked only the seventh January with a negative return in the forty years since.

Since municipal bonds are callable, new issuance to replace them in a portfolio is critical. While issuance was strong last year, 2022 remains uncertain. State and local governments are benefiting from both federal stimulus cash and record revenue, and may not be inclined to take on additional debt.

Performance Among Credit Indices

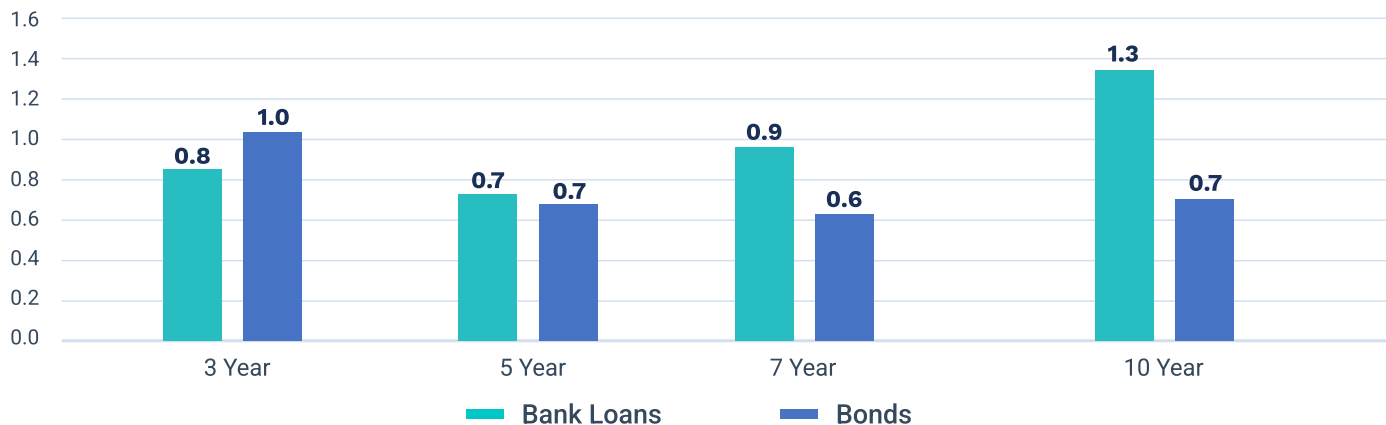
	MTD (12/31/2021 - 1/31/2022)	YTD (as of 1/31/2022)	TRAILING 1 YEAR (1/31/2021 - 1/31/2022)
Credit Suisse Leveraged Loan Total Return Index (CSLLLTOT)	0.35%	0.35%	4.45%
Bloomberg US Corporate High Yield Total Return Index (LF98TRUU)	-2.73%	-2.73%	2.06%
Bloomberg US Aggregate Total Return Index (LBUSTRUU)	-2.15%	-2.15%	-2.96%
Bloomberg Municipal Bond Index (LMBITR)	-2.73%	-2.73%	-1.88%
Palmer Square CLO Debt Index (CLODI)	0.28%	0.28%	3.51%

Source: Bloomberg as of 2/2/2022

Chart Spotlight: : Reducing Portfolio Volatility

Volatility is increasing, and investors seeking to mitigate it with fixed-income assets are in a difficult spot. Higher yields will ultimately be a positive, but longer durations are resulting in increased interest rate sensitivity. While pivoting to shorter maturities may help, other assets that exhibit low volatility may also be considered.

Sharpe Ratio Comparison



Bank Loans, CS Leveraged Loan Index; Bonds, Bloomberg Barclays U.S. Aggregate Bond Index. Trailing returns ended December 31, 2021. Sharpe ratio is a way to examine the performance of an investment by adjusting for its risk. It is the average annual return earned in excess of the risk-free rate per unit of volatility or total risk. It is not possible to invest directly in an index.

Source: Bloomberg

Credit Asset Classes

Private Credit	Structured Credit	High Yield
<p><i>The Journal of International Banking and Finance Law</i> has published a recent piece examining the rise of private credit, and its evolution. Private credit has been seen as an alternative to bank lending that became necessary as banks stepped back from the smaller deal sizes in this market after 2008, in light of regulatory and industry changes.</p> <p>The study argues that private credit has evolved to be a lender of choice even for large deal sizes and has become "particularly competitive with traditional bank lending, which has slower processes and offers limited support for nuanced credits. It has arguably now become the most innovative, flexible and competitive part of the finance market."</p>	<p>S&P Global reports that Institutional leveraged loan volume at \$71 billion in January marked the second-highest total for the month of January, behind \$78 billion in 2017. That output followed on the roughly \$14 billion issued in December 2021.</p> <p>Middle market CLOs saw improving credit metrics in the fourth quarter, according to Fitch Ratings. This included declining exposure to triple-C and defaulted assets. The average exposure to loans rated CCC+ or below fell 0.8%, to 11.9%.</p> <p>Fitch also noted that the average exposure to loans CCC+ or below declined by 7.3% year over year from 19.2% at the end of 2020.</p>	<p>Volatile market conditions in the face of a hawkish Fed and a restive geopolitical backdrop limited U.S. high-yield primary issuance volume to a slimmer-than-expected \$24 billion in January, less than half the record-setting \$51.2 billion logged for the month one year prior, according to S&P Global.</p> <p>When viewed against comparable periods, the figure is the lightest total for the month in three years.</p> <p>Returns were negative, but lower quality bonds suffered less. The CCC segment finalized with a negative 1.89% return. Single-B bonds returned (-2.24%), and BB bonds underperformed at (-3.34%). The overall index finalized the month with an average 5.20% yield, hitting a high last seen in early November 2020, when markets grappled with volatility surrounding the U.S. presidential election.</p>

Other Related Asset Classes

Treasuries	Investment Grade Corporates	Municipals
<p>The benchmark ten-year Treasury rose from 1.51% at the end of Decemeber to a high of 1.87% before ending the month at 1.78%.</p> <p>The differential between 2- and 10-year Treasury yields ended January at 60 bps – 98 bps flatter from March 31, 2021 – the beginning of this flattening cycle.</p>	<p>Corporate bonds suffered a negative (-3.37) return in January, more severe than other fixed income sectors, largely due to the sector's longer duration of 8.42 years.</p> <p>Corporate spreads widened 14 bps in January, indicating that investors are seeking higher risk premiums as they react to uncertainty around the pace and velocity of interest rate hikes.</p> <p>New issue supply was strong at \$154 billion.</p>	<p>Short-term municipal rates rose 69 bps while long-term yields rose 46 bps, resulting in a flatter muni yield curve. The yield adjustments in municipals were significantly more than the rise in comparable maturity Treasury yields, bringing the municipal-to-Treasury cross-market relationship back in line with long-term norms.</p> <p>The sell-off in municipals was not related to credit concerns, as state and local budgets saw revenue gains in 2021.</p>

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