CION Credit Market Update – January 31, 2021

The Song Remains the Same

A Headline-Driven Start to the Year

The first two weeks of January saw concerning data releases that depicted a worsening labor situation. The Bureau of Labor Statistics (BLS) reported that the economy shed 140,000 non-farm jobs in December, the first negative number since April. The U.S. Department of Labor reported that for the first full week of 2021, ending January 9th, initial unemployment claims hit 965,000, a level not seen since August. By the third week of the month, initial claims had fallen back to 847,000 as the pace of layoffs moderated and every state began to see improving coronavirus numbers.

In their first policy statement of 2021, the Federal Reserve kept the key interest rate unchanged. Positive economic data and expectations for a stronger recovery as vaccine deployment gains scale had led to comments from some regional Fed presidents about recalibrating quantitative easing (QE) purchases if the economy rebounded strongly later in the year.

Is Inflation Really a Thing?

Chairman Powell addressed this in his remarks, noting that it was "premature" to discuss reducing the Fed's pace of QE asset purchases. He focused on employment and inflation goals and said that it would be "some time" before the Fed began to slow down. This led market participants to infer that QE would likely remain in place throughout 2021.

The Fed continued to note in the policy statement that "weaker demand and earlier declines in oil prices have been holding down consumer price inflation." However, the yield curve continued to steepen over the month, with yields on the 10-year U.S. Treasury gaining 15 basis points to end the month at 1.07. A steepening yield curve is generally seen as a sign of expectations for economic growth – and for increased inflation.

Towards the end of the month, ongoing worries about slow vaccine deployment and potential delay of a third stimulus package created a negative environment for risk assets, leading to a slight drop in Treasury yields.

Overall, for most asset classes we saw a continuation of the trends that were shaping up towards the end of 2020. Municipals, leveraged loans and high yield continued to perform well. Investment grade bonds and U.S. Treasuries saw negative performance.

Not Much Room for Error

Given the Fed's assurances on interest rates, yields are likely to remain low for some time to come. While price appreciation may have compensated investors somewhat in 2020, expectations for 2021 are muted, particularly if the expected scenario of burgeoning economic growth and increased inflation becomes a reality. Bloomberg reports that, while U.S. debt has seen a streak of annual gains, with the Bloomberg Barclays Treasury Index returning a total of around 27% over the past seven years, or around 3.5% a year, the streak may end. Bloomberg Intelligence chief U.S. interest rate strategist Ira Jersey cautioned that "with yields so low, even a modest sell off would push returns below zero."

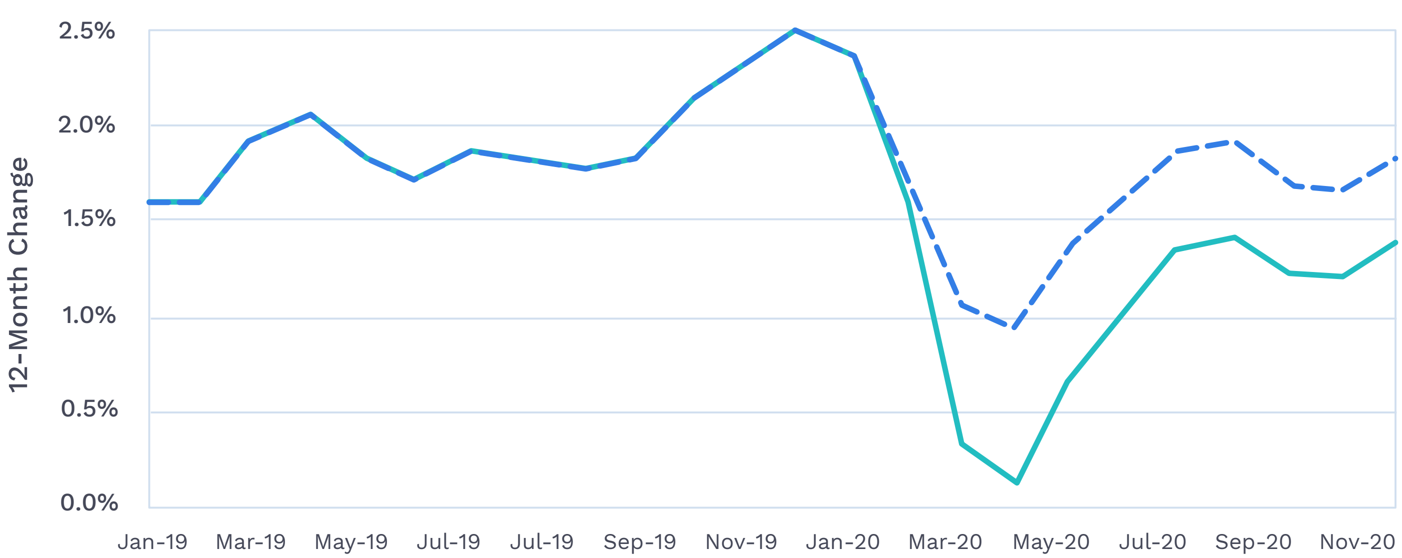
Performance Among Credit Indices

	12/31/2020 - 1/29/2021	YTD (as of 1/29/2021)	TRAILING 1 YEAR (01/31/2020 - 1/29/2021)
Credit Suisse Leveraged Loan Total Return Index (CSLLLTOT)	1.26%	1.26%	3.53%
Bloomberg Barclays US Corporate High Yield Total Return Index (LF98TRUU)	0.33%	0.33%	7.46%
Bloomberg Barclays US Aggregate Total Return Index (LBUSTRUU)	-0.71%	-0.71%	4.73%
Bloomberg Barclays Municipal Bond Index (LMBITR)	0.63%	0.63%	4.02%
Palmer Square CLO Debt Index (CLODI)	1.36%	1.36%	6.16%

Source: Bloomberg as of 1/29/2021

Chart Spotlight: The Pandemic's Influence on U.S. Inflation

Consumer spending patterns changed dramatically in 2020 because of COVID. Taking these new patterns into account to calculate inflation shows that COVID CPI-based inflation is typically about 50 basis points higher than that associated with the official measure produced by the BLS.



NOTES: CPI is the official consumer price index for all items. COVID CPI is a similar index, but its expenditure weights are adjusted to reflects monthly changes in estimated consumer spending patterns.
SOURCE: Alberto Cavallo (projects.iq.harvard.edu/covid-cpi); St. Louis Federal Reserve (FRED).

Credit Asset Classes

Private Credit	Structured Credit	High Yield
Seventy-five percent of global institutional investors increased or maintained their allocations to private debt in 2020, as reported by a recent industry survey by Private Debt Investor. Since 2017, the average portfolio allocation to the asset class has increased to 6.32%, from 4.72%, a 33% increase in allocation. Additionally, these investors are confident in their expectations for 2021 performance, with 77% of investors expecting that private debt funds will meet or exceed their benchmarks in 2021. One reason for the continued growth of the asset class and confidence from investors may be the ability to be defensive. S&P Global Market Intelligence highlighted recent loan activity in the middle market. Reflecting investors' preference for defensive sectors, business services led all industries for loans recently launched – at 45.4% the sector far outpaced all other sectors. The Financial Times, citing research by Preqin, notes that "there is also a much larger dispersion in terms of performance by private managers than seen in those running corporate bond funds". A study from 2010 to 2017 revealed that managers in the top quartile for net IRR had returns that were double those of bottom quartile managers.	The S&P/LSTA Leveraged Loan Index returned 1.19% in January as demand outstripped supply and pushed prices in the trading market beyond pre-pandemic levels. S&P Global reports that 75% of all outstanding loans were priced at 99 or higher at month end, the highest share since October 2018, marking a sharp increase from just 12% at the end of October 2020. Demand for loans from both CLOs and retail fund inflows was strong. The U.S. collateralized loan obligations (CLO) market started 2021 with a healthy $8.2 billion issued in January, from 16 vehicles, the highest reading for any January since 2013. By comparison, January 2020 featured just $4.1 billion, and during the record-setting 2018 only $6.3 billion was issued in the first month. CLOs are securities backed by a pool of debt, often corporate loans. At the same time, U.S. retail funds investing in leveraged loans continued their inflow streak, totaling $3.7 billion in the eight weeks through Jan. 27, according to Lipper weekly reporters.	High yield corporates outperformed all other sectors except municipals, and they outperformed the S&P 500, which declined by 1.1% in January. However, they did finally break their streak, posting negative returns for the first time in 13 weeks as equity market volatility affected the asset class. Spreads widened by 14 bps, and the asset class suffered its largest fund outflows ($1.3 billion) since early December. This makes four straight weeks of outflows, adding up to $3.7 billion. Continued heavy new issuance capped the busiest January on record, with roughly $55 billion coming to market last month.

Other Related Asset Classes

Treasuries	Investment Grade Corporates	Municipals
The Bloomberg Barclays U.S. Treasury Index ended the month with yield over 1%. Performance was negative and the index declined by -0.96%. Despite the Fed's continued reassurance that it intends to continue QE at the present level and will keep rates unchanged as the economy remains vulnerable to the path of COVID, positive economic news and the prospect for growth is highlighting investor fears of inflation.	Investment grade corporates turned in negative performance for the first month of the year, with the Bloomberg Barclays U.S. Corporate Index down 1.28%. Duration at month end was 8.70 years. Given the lack of performance, the increased interest rate risk may be a drag on investor interest going forward. However, despite the negative performance, fund inflows remained robust. The Wall Street Journal reports that "Last year's record $1.7 trillion in new bond sales helped bring the amount of debt relative to earnings—or leverage—on corporate balance sheets near record-high levels, raising concerns about companies' ability to weather future downturns." Corporate earnings fundamentals so far look promising for this reporting season.	Municipal yields were largely unchanged over the month, and the asset class had positive performance. Fund inflows continue to be strong, with four consecutive weeks of over $3 billion in net inflows. Over $50 billion in net inflows came in over the second half of 2020 and the trend looks to be continuing as investor demand is unsated. The intermediate part of the curve continues to provide the most value to investor positions, and the additional stimulus has resulted in a very bullish market tone.