CION Credit Market Update – September-October 2022

Peak Inflation and Market Bottom? Maybe...Maybe Not.

The Fed Plays Catch-Up; the Data Does Not

The Fed enacted a third consecutive 75 basis point increase at the September mid-month FOMC meeting. Powell's remarks at the press conference were a reiteration of the intention to prioritize getting inflation under control, over the potential economic impact of below-trend growth. The goal is to get the Fed funds rate to a restrictive level, quickly. He defined restrictive as a level that puts meaningful downward pressure on inflation.

The median of the FOMC's projections for the Fed Funds rate by end 2022 increased to 4.4%, and it projected unemployment to increase to 4.4% by late 2023. Quantitative tightening, which refers to the reduction of balance sheet holdings, was also increased to $100 billion a month in September. This was interpreted by the markets as putting a soft landing potentially out of reach.

Some key data points each month, in the order each is released, are **1)** the employment number, **2)** CPI, and **3)** consumer spending. Fed watchers attempting to predict the next rate increase, and the impact to the economy, are fixated on these numbers. The problem is that they either aren't moving in the right direction, or they aren't moving quickly enough to have the desired impact.

- The September non-farm payroll number was 263,000, versus the Dow Jones estimate of 275,000.
- September CPI was a disappointing 8.2% year-over-year, slightly above expectations for 8.1%, and a hair lower than August's 8.3%. For the month, CPI increased 0.4% as core goods were flat but services costs increased, reflecting the still-booming labor market.
- Retail sales for September, released by the Commerce Department, were flat against an August number that was revised up by 0.4%.

The combination of an aggressive Fed, continued high inflation, a strong labor market, and consumers that are not decreasing spending has generated speculation of an impending recession. The 3-month vs 10-year Treasury yield curve, which is often cited as a historically accurate recession indicator, has recently been very close to inverting. Both Fitch and S&P Global are predicting shallow recessions in late 2022 or 2023.

How Did the Credit Markets React?

The 10-year Treasury yield hit 3.95% on September 27th, which was a new closing high, and then fell to 3.84% by the end of the month. The two-year yield saw the biggest increase, of 132 basis points over the month. Investment grade corporate spreads widened 159 basis points at month end, reflecting investors fears of a recession and perceived risk in this asset class.

A Closer Look: Volatility Is Increasing

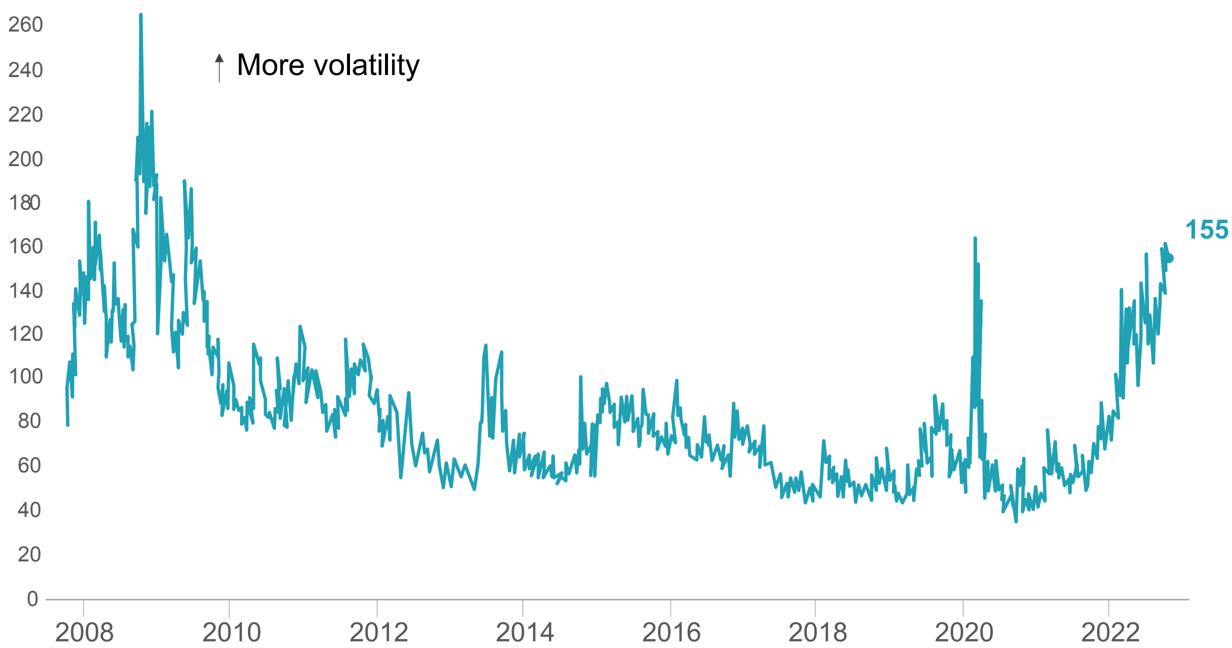
The equity market "fear index," the VIX, is familiar to many investors. The bond markets have their own version, the MOVE index. This index measures volatility using the cost to insure against larger-than-normal interest rate moves. It calculates the future volatility in U.S. Treasury yields implied by current prices of options on Treasuries of various maturities.

The index has recently come close to the levels seen during the beginning of the COVID crisis in 2020, before the Fed began stimulus measures designed to increase liquidity. However, despite the Fed's recent efforts to unwind its balance sheet, there is still considerable liquidity in markets.

Chart Spotlight: Bond Market Volatility

While higher, the MOVE index is still well below the levels seen during the GFC.

Top Picks for Future Private Credit Investment (%)



ICE BofA U.S. Bond Market Option Volatility Estimate Index (MOVE). Source: Axios

Performance Among Credit Indices

	MTD (8/31/2022 – 9/30/2022)	YTD (as of 9/30/2022)	TRAILING 1 YEAR (9/30/2021 – 9/30/2022)
Credit Suisse Leveraged Loan Total Return Index (CSLLLTOT)	-2.17%	-3.31%	-2.62%
Bloomberg U.S. Corporate High Yield Total Return Index (LF98TR.UU)	-3.97%	-14.74%	-14.13%
Bloomberg U.S. Aggregate Total Return Index (LBUSTRUU).	-4.32%	-14.61%	-14.60%
Bloomberg Municipal Bond Index (LMBITR)	-3.84%	-12.13%	-11.50%
Palmer Square CLO Debt Index (CLODI)	-3.75%	-7.36%	-6.81%

Source: Bloomberg as of 10/3/2022

Credit Asset Classes - Data as of September 30, 2022

Private Credit	Structured Credit	High Yield
Private credit fund-raising slowed slightly in total during the first six months of 2022, compared to the record amounts raised over the same period in 2021. However, the data, according to Pitchbook's H1 2022 Global Private Debt Report, showed that a smaller number of funds were raising larger amounts of capital. Sixty-six private debt funds raised a total of $82 billion, compared with the roughly $93 billion collected across 130 vehicles in the same period a year ago. This may be indicative of the staying power of larger, established players in the market. Direct lending, the largest private debt category, represented over a third of capital raised in the first six months of this year. The report went on to note that "investor enthusiasm for private debt funds will likely pick up in H2 2022 and early 2023, fueled by the asset class' higher-than-expected returns and the growing size of the private equity market."	The U.S. leveraged loan market, as represented by the Morningstar LSTA U.S. Leveraged Loan Index was down 2.27% in September, for a year-to-date return of -3.25%. Most of the loss was at the end of September, after the Federal Reserve's announcement of a 75 bps hike to the fed funds target rate on Sept. 21. The index declined by 1.5% in the seven trading days through Sept. 29th. However, on average, loans gained nine bps every seven days in 3Q22. The asset class remains ahead of longer-duration assets such as the corporate bonds, which have experienced double digit losses year-to-date.	The U.S. high yield market dropped -4.02% in September, bringing the YTD return to -14.61%, as measured by the ICE BofA U.S. High Yield Constrained Index . Given the tighter monetary policy, economic growth expectations have been pared as well, and a mild recession looks increasingly likely. In this environment, high yield sold off with the rest of fixed income and saw moderate spread widening, with CCCs lagging the market. At the same time, defaults do not appear to be on the verge of a significant increase, so high yield spreads have been relatively contained.

Other Related Asset Classes – Data as of September 30, 2022

Treasuries	Investment Grade Corporates	Municipals
The benchmark ten-year U.S. Treasury bond yield rose 64 basis points to 3.84%. The 30-year U.S. Treasury Bond rose 48 basis points to close at 3.78%. On the short end of the curve, the three-month Treasury jumped 34 basis points to 3.29%, and the two-year remained inverted against the 10-year U.S. Treasury, with a yield of 4.28%.	Investment grade corporates struggled, returning -5.26%, bringing the year-to-date return to -18.72% for the Bloomberg U.S. Corporate Investment Grade Index Spreads widened to the highest point this year of 164 basis points before tightening slightly at month end. Credit spreads indicate the credit risk perceived by market participants/investors, and can provide a "real time" take on sectors or issuers. Tighter spreads indicate less risk relative to Treasurys, and wider spreads indicate more risk.	Municipal bonds as represented by the Bloomberg Municipal Index returned -3.84% in September. Year-to-date return for the index was -12.13%. Tax-exempt yields rose sharply in September, with short maturities rising more than intermediate or longer maturities, which resulted in some curve flattening.