CION Credit Market Update – August 31, 2021

Did the Recovery Just Hit Pause?

The Data on Delta Is In

After a strong July jobs report, the employment number for August was something of a shock. The consensus expectation was that the economy would add 720,000 jobs; the actual number of non-farm jobs added back was 235,000. The U.S. Bureau of Labor Statistics reported that after averaging 350,000 jobs per month for the last six months, employment in leisure and hospitality was flat. This was largely attributed to safety concerns due to the rise of the Delta variant.

The Fed's Beige Book, out on September 8th, provided more detail on the progress of the recovery. In the language of the report, "economic growth downshifted slightly to a moderate pace in early July through August." Besides the Delta-related pullback in dining out, tourism, and travel in most Districts, several other sectors of the economy saw slowing growth or declining activity. These sectors were constrained by supply disruptions and labor shortages, as opposed to softening demand.

Wages and Prices Were Up

Demand for workers is continuing to strengthen, and all Fed Districts noted extensive labor shortages. These stem from multiple causes, including enhanced unemployment benefits that ended on September 6th. Several Districts reported an acceleration in wages, and also noted wage gains among lower-wage workers. As the Fed has stated that increasing income equality is one of its policy goals, this may be seen as a positive development in their read of the economy.

Districts were split on whether price increases were "strong" or "moderate," with half falling in each camp. Input price pressures continued to be widespread, but some Districts reported that businesses find it easier to pass along more cost increases through higher prices. Several Districts indicated that businesses anticipate significant hikes in their selling prices in the months ahead.

The Bond Markets Have a Lot to Digest

The middle and the longer end of the curve saw rate increases over the month. The benchmark ten-year Treasury yield rose eight basis points to end August at 1.31%, while the three-year rose seven basis points and the five-year rose nine basis points. The one-year was unchanged. The Kansas City Fed's annual Economic Policy Symposium in Jackson Hole provided an opportunity for Chairman Powell to elucidate his thinking around the timeline for tapering and any decisions on inflation and rate increases. He took the opportunity to separate the two events clearly. His statement included language that raising rates would require a "different and substantially more stringent test" than that applied to tapering the $120 billion in monthly bond purchases.

The tapering could begin in 2021 but if so, is more likely to be towards the end of the year. However, Powell stated this would be conditional on strong monthly job gains.

As for inflation, Powell is wary of getting out in front of the economy with policy decisions that take time to take hold. The caution comes from a fear that tightening in response to temporary factors could result in a situation where an "ill-timed policy move unnecessarily slows hiring and other economic activity." Going back to the Beige Book, businesses in most Districts remained optimistic about near-term prospects, though there continued to be widespread concern about ongoing supply disruptions and resource shortages.

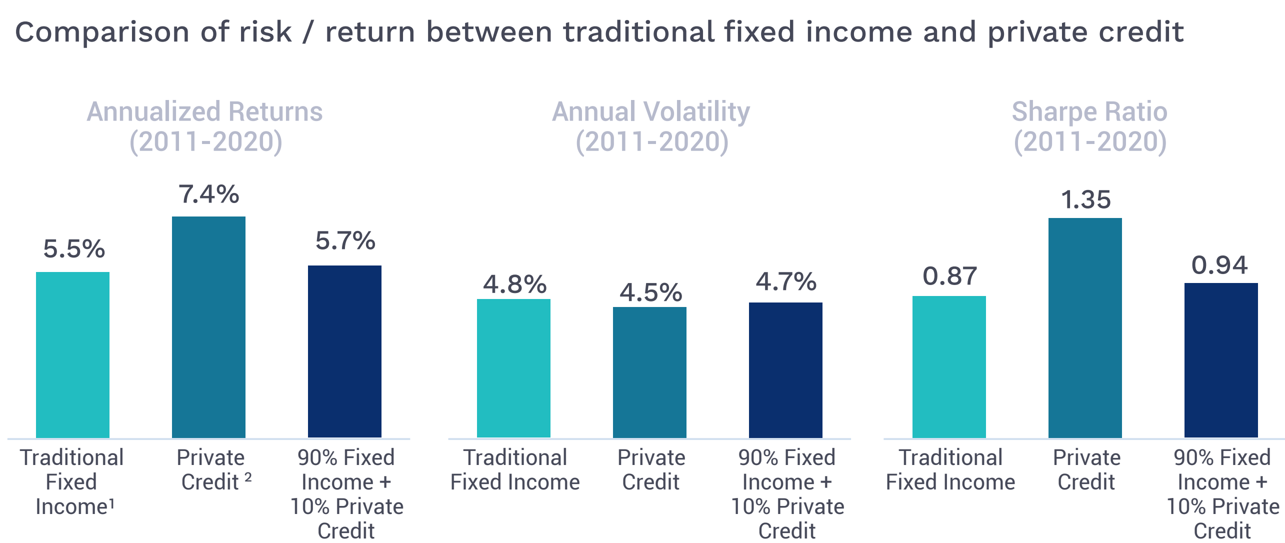
Performance Among Credit Indices

	MTD 7/30/2021 – 8/31/2021	YTD (as of 8/31/2021)	TRAILING 1 YEAR (8/31/2020 – 8/31/2021)
Credit Suisse Leveraged Loan Total Return Index (CSLLLTOT)	0.48%	3.97%	8.50%
Bloomberg Barclays US Corporate High Yield Total Return Index (LF98TRUU)	0.51%	4.54%	10.14%
Bloomberg Barclays US Aggregate Total Return Index (LBUSTRUU)	-0.19%	-0.69%	-0.08%
Bloomberg Barclays Municipal Bond Index (LMBITR)	-0.36%	1.52%	3.39%
Palmer Square CLO Debt Index (CLODI)	0.24%	4.01%	9.66%

Source: Bloomberg as of 9/8/2021

Chart Spotlight: The New Public/Private Partnership

Given low yields and struggling returns in many public credit sectors, investors are increasingly looking to add alternatives to portfolio allocations. Over the period from 2011 to 2020, adding a 10% private credit allocation to a portfolio of public, corporate bonds would have improved the return while reducing volatility, resulting in an improved Sharpe ratio.



1. 1/3 Barclays US COrporate Bond Index, 1/3 Barclays canada Corporate Bond Index, 1/3 Barclays US Corporate High Yield Bond Index.
2. 50% S&P LCD Leveraged Loan Index, 50% Cliffwater Direct Lending Index.

Source: Institutional Investor

Credit Asset Classes

Private Credit	Structured Credit	High Yield
Private debt fundraising kept a steady course in the first half of 2021, according to data from Pitchbook Inc. Low interest rates, subdued default rates, and the longer-term pivot toward alternative strategies aided allocators in committing $72.5 billion across 81 vehicles. Direct lending continues to stand out, accounting for about half of all capital raised. Default rates for middle-market loans continue to fall, indicating strength, especially in direct lending portfolios. The Proskauer Private Credit Default Index suggests that the default rate for companies with at least $50 million in EBITDA fell to just 1.0% in Q1 2021, compared to a high of 5.3% in Q2 2020.	The secondary loan market returned to the black as heightened investor demand pushed CLO formation to record levels in August. The S&P LSTA Leveraged Loan Index (LLI) returned 0.47% in August, after July registered the first negative return reading of 2021, albeit a mere -0.01%. YTD returns now stand at 3.76%, compared to the same period last year when YTD returns were in the red at -1.29%. As yields continue to decline and spreads further compress, investors continue to embrace a risk-on mentality, driving demand for riskier paper. The demand dynamics around lower rated paper means that the CCC bucket of loans is a driving component of returns.	As measured by the ICE BofA US High Yield Index, the high-yield markets saw a milestone as the index's price climbed above 100, meaning that the average high-yield bond was priced above face value. Prior to the just-completed month the index had languished at a discount since Feb. 25, 2020, when it stood at 100.13. This symbolically important level occurred in the context of extremely tight credit conditions, which are normally very difficult for non-investment grade bond prices. The Federal Reserve's latest quarterly survey of senior loan officers found that zero percent are easing standards.

Other Related Asset Classes

Treasuries	Investment Grade Corporates	Municipals
Yields in the middle to long-end of the curve increased modestly, while the short end was unchanged, and the 30-year saw only a four-basis-point increase. The Bloomberg Barclays U.S. Treasury Index remains negative year-to-date with a return of -1.43%. Chairman Powell's statements at the Jackson Hole symposium were viewed by the markets as "dovish", which was as expected.	The Bloomberg Barclays U.S. Corporate Investment Grade Index returned -0.30% for August, returning the index to negative year-to-date territory. Spreads across investment grade sectors ended the month of August little changed from July. Investment grade investors awaiting the Fed's timing for tapering off monthly bond purchases appeared to be looking at the surge of the Delta variant's impact on the economy as a determining factor. Investment grade corporate spreads remain historically low, leading corporations to seize the opportunity to issue new securities and refinance existing liabilities.	The Fed's recent language from the Kansas City Fed's Symposium made it clear that the decision to raise rates is conditional on strong, sustained data that the Fed's goals are being met. Lower rates for longer means tax-exempt municipals will continue to be of interest, which may create slight upward pressure on rates. Municipal yields remain low on an absolute basis. However, a tremendous amount of cash remains on the sidelines.

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