CION Credit Market Update – December 31, 2021

The Fed’s Balancing Act

The Federal Reserve’s goal is to allow enough inflation so that the economy can recover and grow. The challenge is that the economy may overheat, causing continued spiking inflation. On the other side, if the Fed acts too aggressively on interest rates, and too soon, it can cut off the recovery and slow growth. The process for raising rates involves the two main levers the Fed uses to control monetary policy.

Early in the pandemic, the Fed moved incredibly quickly to pump liquidity into the economy. The Fed cut the short-term interest rate to the zero bound, and began to purchase $120 billion of Treasury and agency mortgage-backed securities each month. This kept the price of long-term assets up, and since price moves inversely to yield, it lowered long-term interest rates. Business and consumer debt became more affordable and helped keep the economy moving. The Fed’s continued asset purchases also signaled to the market that it was committed to supporting the economy, further raising confidence.

The Fed delayed the introduction of the specifics of a tapering process to remove liquidity from the economy until November. At the December meeting, it sped up the timing and drastically reduced the amounts of monthly asset purchases.

The Fed left interest rates unchanged but doubled the reduction in asset purchases to $30 billion less in December, from a decrease of $15 billion in November. The new intention is to wind up tapering in March rather than in June as originally planned, and asset purchases will be reduced as needed to hit that goal. The next step is to increase short-term rates. The Fed is now indicating that may happen as soon as March.

Interest Rate Increases

Chairman Powell has indicated three interest rate hikes in 2022, three rate hikes in 2023 and two in 2024, for eight in total. Assuming a 25-basis point hike each time, that puts short-term interest rates at a minimum of 2.00% by the end of 2024. Of course, the Fed could decide to increase either the amount of the rate bump or add additional hikes, depending on the data.

The Impact on Bonds

The Bloomberg U.S. Aggregate Index ended the year in the red as a bad first quarter proved impossible to overcome. Historically, difficult years for high-quality bonds are often followed by a rally. Since bond prices move inversely to yields, years in which prices are negative mean that yields have increased and the potential for total return (price plus yields) is greater as the higher yields allow for some offsetting of the decline in yields experienced as prices recover.

However, in previous periods when this relationship was in effect – the last time was 1994 – yields were much higher to start with. Today’s historically low yields and high inflation mean that even with yield increases bonds are underperforming inflation.

Added to that is the risk of longer duration positioning. Duration is a measure of a bond’s sensitivity to interest rate risk. It measures the price change of a bond given a 1% change in interest rates. The Bloomberg U.S. Aggregate started 2021 with a duration of 6.2 years and over the course of the year, duration increased to 6.8

years while the benchmark's yield increased by about 60 basis points, ending the year at 1.75%.

Though a small increase, this was enough to result in the index turning in a negative performance. A further increase in rates likely won't be enough to move the dial above inflation – but given the extended duration, it may well be enough to keep downward pressure on bond prices.

A Closer Look: Floating Rate Loans

In a rising rate environment, senior floating rate loans may become more in demand by investors. These loans are often "senior secured", meaning they are at the top of the company's capital stack and can be secured by the company's assets. They tend to have very low durations, due to their floating rate coupon.

Performance of Selected Credit Indices

	MTD (11/30/2021 - 12/31/2021)	YTD (as of 12/31/2021)	TRAILING 1 YEAR (12/31/2020 – 12/31/2021)
Credit Suisse Leveraged Loan Total Return Index (CSLLLTOT)	0.62%	5.39%	5.39%
Bloomberg US Corporate High Yield Total Return Index (LF98TRUU)	1.87%	5.27%	5.27%
Bloomberg US Aggregate Total Return Index (LBUSTRUU)	-0.25%	-1.54%	-1.54%
Bloomberg Municipal Bond Index (LMBITR)	0.16%	1.51%	1.51%
Palmer Square CLO Debt Index (CLODI)	0.20%	4.63%	4.63%

Source: Bloomberg as of 1/3/2022

Chart Spotlight: Yields Are Up, But So Is Duration

Yields increased over the course of last year, but duration also lengthened, which increases interest rate risk.

Bloomberg U.S. Aggregate Index

Source: Bloomberg

Credit Asset Classes

Private Credit	Structured Credit	High Yield
According to the most recent Preqin Ltd. Quarterly Update, with many investors looking for ways to mitigate the impact of inflation on returns, floating rate private debt becomes more attractive. High levels of private equity deal activity offer another avenue of support and potential route to deployment, notes the update. "While pockets of weakness remain, should the macro backdrop stay relatively benign, the longer-term outlook for the asset class is positive," it states. Private debt funds that closed in the third quarter of last year raised a total of $41 billion, according to the update. There are now 691 private debt funds in the market, targeting an aggregate $291 billion. The internal rate of return for direct lending funds' one-year horizon was 12.7% to March 2021.	The S&P Global LCD U.S. Loan Market Survey has been released. Some of the headlines: • A majority do not expect a correction in 2022, but instead expect periods of "mini volatility." • The loan default rate will linger near post-crisis lows. • Inflation remaining above 3% tops the list of concerns. • Leverage levels on new deals are unlikely to fall. The CLO market saw a record year last year, with a record-setting $185.2 billion of issuance, 44% more than the prior high of $129 billion from 2018. CLO issuance is expected to remain strong in 2022, market watchers say, pointing to a healthy deal pipeline. CLOs are the largest investors in leveraged loans, taking a roughly 74% share of the new-issue market as of September 2021, the highest rate ever, according to LCD.	The US high yield market ended the year on a strong note, returning 1.88% in December, leading to a full calendar year 2021 return of 5.35%, as measured by the ICE BofA US High Yield Constrained Index (HUC0). Driving the market was the view that strong nominal and real economic growth was intact, leading to expectations for strong corporate earnings in Q4 and a sense that the environment would continue for the first half of 2022. During December, the best performing sectors were Energy, Leisure, and Building Materials, while the worst were Utilities, Gaming, and Aerospace. For the full year, sectors tied to the economic recovery like Energy, Aerospace, Metals, and Leisure performed the best, while Utilities, Telecom, and Cable lagged, and CCCs were the best performing ratings category.

Other Related Asset Classes

Treasuries	Investment Grade Corporates	Municipals
The benchmark 10yr Treasury rose from 0.92% in January to the high mark for the year of 1.74% on March 31. It nearly reached that point again in October, but declined again before rallying into year-end. It ended December at 1.51%, 59 bps higher on the year. Shifts along the Treasury curve reflected both the changing sentiment of investors and the Fed's response. The release of the Fed minutes in early January from December's meeting underscored the newly hawkish Fed and the potential that in addition to tapering asset purchases and raising short-term rates, the Fed could begin to reduce its balance sheet in 2022. In the tightening cycle after the Global Financial Crisis, the Fed waited two years between the first rate hike and selling off assets.	Despite strong economic growth and surging inflation, a record amount of money ($583B) flowed into fixed income funds and ETFs, exceeding the previous record of 2019 ($459B). Despite the low yields at the start of the year and ensuing rate volatility, demand was broad based. Institutional demand was also strong, driven by abundant cash on corporate balance sheets and strong equity market returns that led to a rebalancing across asset classes.	Municipal market investors in 2021 looked to the strong credit fundamentals in the asset class, as tax revenues rebounded sharply as municipalities were bolstered by federal fiscal support. The record cash flows into tax-exempt funds were driven by expectations of higher tax rates and strong demographic support from baby boomers and others seeking safety and income. This largely insulated the municipal market from the volatility experienced in taxable fixed income sectors, leading to the outperformance of the tax-exempt market.

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