CION INVESTMENTS

Inflation and Rate Increases: Higher and Sooner?

The Fed Finally Said It Out Loud

The Fed updated its stance on inflation at the June meeting. After two months of higher-than-expected inflation prints, the Fed revised their 2021 projection to 3.4%, up a full percentage point from the March number. The guidance remained the same, with "transitory" being the operative word.

Further recognition of the seriousness of the Fed's intentions of being guided by the data, however, came in the form of the "dot plot." Every quarter, each member of the Federal Open Market Committee submits their predictions for where interest rates should be, and these are then plotted on a graph.

The median of the June dot plot was an expectation for two rate increases in 2023, a full year ahead of previous expectations. The Fed's willingness to raise rates if the economy heats up isn't an absolute; Chairman Powell was careful to provide some conditionality by stating that the dot plot should be taken with "a big grain of salt."

The Fed also confirmed that it is ahead of schedule on "talking about talking about" tapering monthly bond purchases, which are currently running at $80 billion of Treasuries and $40 billion of mortgage-backed securities. This conversation wasn't anticipated to take place until later in the summer.

How Did the Bond Market React?

The two-year U.S. Treasury yield rose on news of two potential interest rate increases, and long Treasury yields declined. For the month, most credit sectors saw positive returns, with investment grade and high yield corporates leading. The duration of the Bloomberg Barclays U.S. Corporate – Investment Grade index remains high at 8.72 years, but the longer duration did not weigh on performance.

In Focus: Understanding the Resiliency in Private Credit

The genesis of the growth in private credit can be found in the last financial crisis, the GFC that started in 2008. Big banks largely stepped away from making loans to middle market companies, and were replaced by non-bank lenders. Institutional Investor magazine has been tracking the rise of private credit, with an eye on how these non-bank lenders would perform through another financial crisis. In an article from 2019, Institutional Investor cited research from a University of Pennsylvania professor that found "private

credit funds promote economic resilience."[1]

In a new piece, Institutional Investor looked at why "the sector emerged from the crisis in a healthy position."[2] What it found was that direct lenders generally invest in stable businesses that are not in cyclical industries, and that they also tend to insist on loan covenants that allow them to step into the decision-making process when companies run into trouble. This can include how costs are being managed, what cuts are being made to the business, and how cash is being managed.

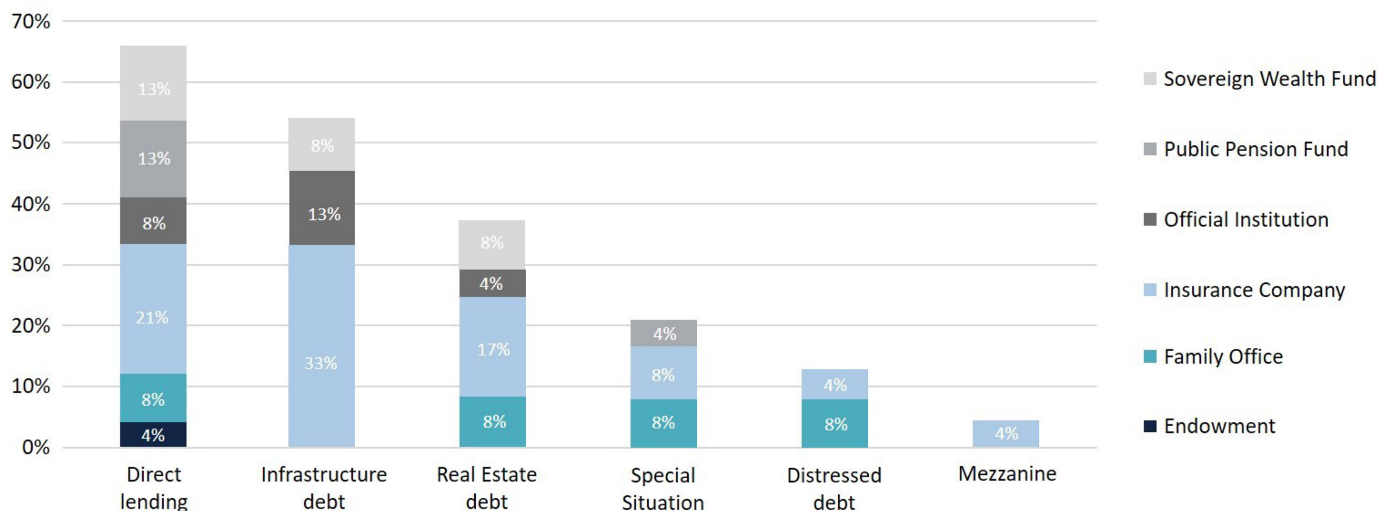
Performance Among Credit Indices

	MTD 5/28/2021 – 6/30/2021	YTD (as of 6/30/2021)	TRAILING 1 YEAR (6/30/2020 – 6/30/2021)
Credit Suisse Leveraged Loan Total Return Index (CSLLLTOT)	0.40%	3.48%	11.66%
Bloomberg Barclays US Corporate High Yield Total Return Index (LF98TRUU)	1.33%	2.61%	15.36%
Bloomberg Barclays US Aggregate Total Return Index (LBUSTRUU)	0.70%	-1.60%	-0.33%
Bloomberg Barclays Municipal Bond Index (LMBITR)	0.27%	3.42%	4.16%
Palmer Square CLO Debt Index (CLODI)	0.27%	3.11%	11.79%

Source: Bloomberg as of July 7, 2021

Chart Spotlight: Investor Preferences on Private Debt in Next 6-12 Months

Across a broad range of investors, the appetite for private credit is outpacing other types of debt. As interest rates may be set to increase, the nature of the loans – they are typically floating rate – may offer some mitigation of interest rate risk. Assets from North American and Asia ex-Japan are drawing increasing amounts of interest from regional and global investors.



Source: Source: Asset Owner Insights (AOI) survey of asset owners/funds at Asian Investor magazine Asian Investment Summit. June 3, 2021.

Credit Asset Classes

Private Credit	Structured Credit	High Yield
The Cliffwater Direct Lending Index (CDLI) has published performance for the first quarter (there is usually a lag in reporting on private assets). The CDLI is an asset-weighted index of over 7,000 directly originated middle market loans totaling $139 billion (as of March 31, 2021). CDLI produced a 3.24% total return in the first quarter, bringing the trailing four quarter CDLI total return to 14.41%. Realized losses, which generally lag economic downturns, dropped to -0.19% for the first quarter, suggesting that COVID-induced losses are largely over. Unrealized gains were 1.25% for the first quarter, following gains in the prior three quarters and completely reversing the -6.80% unrealized loss in the first quarter of 2020.	Fitch Ratings lowered its default rate forecast for U.S. leveraged loans to 1.5% from 2.5% as “constricted sectors” reopen from pandemic-induced lockdowns and confidence grows in capital markets. A 1.5% default rate for this year would be the lowest level since the 0.6% level in 2011, Fitch said. The ratings company did not alter its 2.5% to 3.5% default rate forecast for next year. Fitch further reported that deal making has fueled leveraged lending this year. Issuance totaled $46 billion last month, a 39% decline from $75 billion in April but still healthy compared with the historical average.	High yield saw positive returns for the month June and the second quarter. With a YTD return of 3.62%, high yield is substantially outperforming every other credit sector. The combination of a supportive environment for companies as their balance sheets improve and they are able to pass on rising costs to consumers, as well as the short-duration of the asset class are fueling investor demand. In addition, last year’s record fallen angel activity, as otherwise healthy companies were downgraded during the pandemic, is resulting in large numbers of companies that may be eligible for upgrades to investment grade, which is presenting opportunities for investors.

Other Related Asset Classes

Treasuries	Investment Grade Corporates	Municipals
The unexpectedly hawkish tone from the Fed on inflation and the likelihood that it will begin tapering bond purchases resulted in a flatter yield curve. The Fed left rates unchanged at its June meeting as anticipated, but the 2yr yield rose on expectations of rate increases and long Treasury yields declined, despite the forecast for higher GDP. The Bloomberg Barclays U.S. Treasury Index returned 0.64% for the month of June and 1.75% for the second quarter but remains negative year-to-date with a return of -1.27%.	Investment grade corporate bonds as represented by the Bloomberg Barclays U.S. Corporate Investment Grade Index returned 1.63% for the month of June, and 3.55% for the second quarter, but remain negative year-to-date with performance of -1.27%. Corporations have begun issuing debt at shorter maturities in response to limited demand for longer-dated bonds at current low yields, given the flatter US Treasury curve.	Municipal fund inflows of $60B YTD were a first-half record and with just a half year in, it's the third highest calendar year of inflows ever. The story of potentially higher taxes, and a better-than-expected fiscal outlook for state and local governments have been contributing to the positive market sentiment. Bloomberg is estimating that $165B of cash will be available for reinvestment over the June–August period, which will continue to push demand.

[1] McIlheney, Alicia. Private Credit Funds Stabilize Markets, Research Shows. Institutional Investor. February 15, 2019.
[2] Segal, Julie. How Private Credit Survived It's First Test. Institutional Investor. June 10 2021.

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