CION Credit Market Update – May 31, 2022

Clear and Convincing Data

Economic uncertainty was the theme in May. The Federal Reserve enacted the long-anticipated 50 basis point rate hike, and telegraphed future 50 basis point increases. Chairman Powell's mid-month remarks indicated that the Fed considers growth to be positive, but that it would need to see "clear and convincing evidence that inflation pressures are abating and prices are coming down." Powell did not explicitly rule out a 75 basis point hike at some future point, which market participants overreacted to somewhat.

A slight decrease in headline CPI did not lessen market fears that the Fed would tighten too much, leading to a recession. Consumers appear to be feeling the same uncertainty, with the University of Michigan consumer sentiment index declining to 58.4, a cycle-low reading reflecting elevated borrowing costs and rising pricing for both goods and services.

The National Association for Business Economics reported a lower projection for GDP during the month. The median forecast for inflation-adjusted gross domestic product (real GDP) for the fourth quarter (Q4) of 2022 is an increase of 1.8% from Q4 2021, compared to a median forecast of 2.9% in the February 2022 survey. The survey also addressed respondents' outlook on recession. More than half (53%) of respondents assign a more than 25% probability of a recession occurring within the next 12 months. Recession in the second half of 2023 is seen by 27% of panelists, while 25% expect a recession either by the end of this year or in the first half of next year.

In the latter part of the month, the Fed's indications that it will follow the data and maintain flexibility led to some reassurance that after two rate hikes, the Fed would take the opportunity to reassess if inflation is trending down.

How Did the Bond Markets React?

After increasing for the first four months of the year, the 10-year U.S. Treasury yield saw its first decline in May, down 9 basis points as fears of a recession drove investors to safer assets. The Bloomberg U.S. Aggregate Bond Index finally made it into the positive column, with a return of 0.64%. It's still negative for the year, down (8.92%). With the exceptions of emerging market debt and Treasury Inflation Protected Securities, most bond sectors saw positive returns. However, returns remain negative year-to-date, with most sectors having a lot of performance to recover after the rout of the first four months of the year.

A Closer Look: The Fed's Path Gets Narrower

The spike in headline CPI from a 0.3% increase in April to a 1% increase in May was the largest since 1981. At the June FOMC meeting, The Federal Reserve raised the key short-term interest rate by 75 basis points, for the first time since 1994. The June increase will likely be followed by either a 50 or 75 basis point increase in July and another increase in September.

Besides the upward spike in CPI, among the data that the Fed looks at is the expectations for inflation going forward. Inflation tends to be a self-fulfilling prophecy, where consumer expectations for inflation in the future result in higher inflation.

The most recent University of Michigan consumer sentiment survey said that the public's expectation of inflation five years from now jumped to a reading of 3.3% from 3% in May. That was the first increase since January. Expected inflation a year from now also ticked up, hitting 5.4% versus 5.3%.

Will the moves work on inflation? Or will we end up in recession or stagflation? The Fed does have a strategy:

- The labor market currently appears to be very strong, and is supporting the economy
- The key short-term rate is currently at 1 ½ to 1 ¾ % -- for inflation to get to 2% (from 8.6%) the key rate needs to be closer to 3%.
- Moving rates dramatically now will give the Fed room to cut back if the economy begins to sputter in 2023

In the Summary of Economic Projections, the Fed indicated an unemployment rate of 4.1% by 2024. Powell acknowledged the increase in his remarks, but stated that the number is historically low, and that achieving the joint goals of low unemployment and inflation on a downward path to 2% would be a "successful outcome."

Performance Among Credit Indices

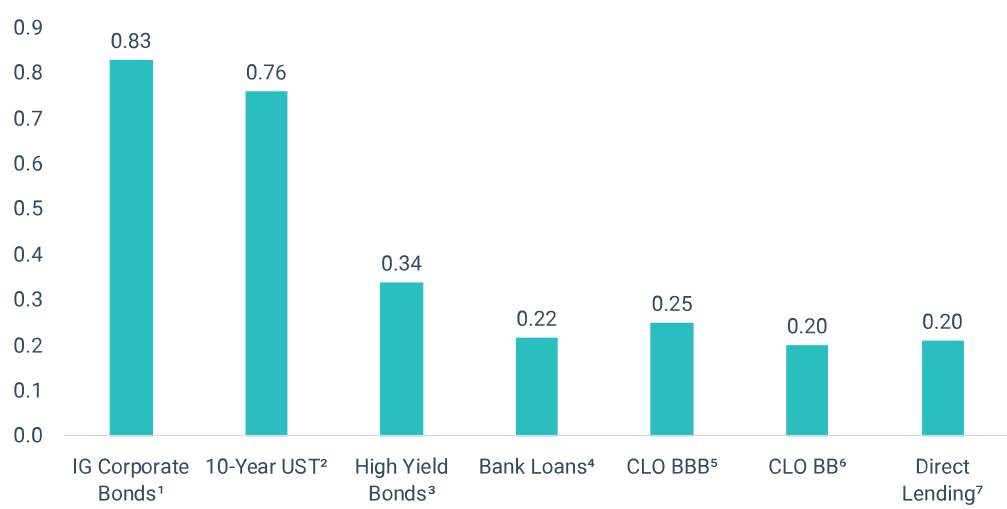
	MTD (4/30/2022 - 5/31/2022)	YTD (as of 5/31/2022)	TRAILING 1 YEAR (5/31/2021 - 5/31/2022)
Credit Suisse Leveraged Loan Total Return Index (CSLLLTOT)	-2.51%	-2.44%	-0.23%
Bloomberg US Corporate High Yield Total Return Index (LF98TRUU)	0.25%	-8.00%	-5.27%
Bloomberg US Aggregate Total Return Index (LBUSTRUU)	0.64%	-8.92%	-8.22%
Bloomberg Municipal Bond Index (LMBITR)	1.49%	-7.47%	-6.79%
Palmer Square CLO Debt Index (CLODI)	-3.65%	-4.33%	-2.66%

Source: Bloomberg as of 6/2/2022

Chart Spotlight: Diversifying on the Income Side

With traditional fixed income struggling and remaining positively correlated to the equity markets, the potential for portfolio volatility has increased. A look at how different income asset classes correlate to the Bloomberg Global Aggregate Bond Index provides some insight.

Correlation to Bloomberg Global Aggregate Bond Index



Note: As of March 31, 2022. (1) ICE BofA US Corporate Index (2) ICE BofA Current 10-Year U.S. Treasury Index (3) ICE BofA U.S. High Yield Index (4) Credit Suisse Leveraged Loan Index (5) JPM CLOIE BBB Post-Global Financial Crisis. (6) JPM CLOIE BB Post-Global Financial Crisis. (7) Cliffwater Direct Lending Index

Credit Asset Classes

Private Credit	Structured Credit	High Yield
A recent report from S&P Global Market Intelligence compares private credit to more liquid options. “The volume of high-yield bond issuance has plunged this year in the face of market volatility. That’s not unusual when equity markets swing wildly. But private credit providers, still flush with cash, have swooped in, underwriting transactions that may have been done in the traditional high-yield bond market in the past.” The report went on to describe the advantage of the structure of private loans. “In private credit, lenders agree to provide loans at prescribed levels and terms. This is particularly useful when markets are volatile, as they have been in recent months.” Another sector of the liquid markets, syndicated loans, also came in for comparison to private credit: “For lenders, private loans are appealing because they have generally retained covenants. In contrast, the vast majority of syndicated loans are covenant-lite.” And finally the report addressed a shift to larger deal sizes in the private credit space: “In recent months, private credit providers have increasingly taken down larger deals that in the past would have been done in the syndicated loan market.”	A new report from Fitch Ratings assessed the state of the leveraged loan market in the first quarter as compared to a year ago. Issuance slowed, to $76.1 billion from $120.9 billion in 4Q21 and $80.6 billion in 1Q21. Refinancing or repricing transactions tallied $27.3 billion, a stark contrast to the $185.2 billion record level in 1Q21. Nearly 95% of the leveraged loan issuance in the quarter was priced in reference to SOFR. The YTD U.S. institutional leveraged loan default rate stands at just 0.5% despite a slight pickup in activity over the past six weeks. Fitch forecasts a 1.5% default rate for year end 2022.	The US High Yield market returned 0.24% in May, bringing the YTD return to -7.74% as measured by the ICE BofA US High Yield Constrained Index (HUC0). Signs that the Federal Reserve would be flexible in rate hikes led to a rally later in the month. BBs rallied first and outperformed for the month, while Bs and CCCs lagged. Utilities and energy were among the best performing sectors, while retail and media were among the worst. The US high yield market ended the month with a yield to worst of 7.14% and an option-adjusted spread of 423 bps, wider YTD by 281 bps and 112 bps, respectively.

Other Related Asset Classes

Treasuries	Investment Grade Corporates	Municipals
The benchmark ten-year U.S. Treasury bond yield closed at 2.85% down from last month's 2.94%. This marked the first decline in the yield in 2022. The 30-year U.S. Treasury Bond closed at 3.05%, up from last month's 3.00%. On the short end of the curve, the 3-month Treasury jumped 23 basis points, ending at 1.08%.	Corporate bonds were the best performers of all sectors except municipals in May. The Bloomberg U.S. Corporate Investment Grade Index returned 0.93%, but is still down 11.92% year-to-date. Corporate spreads widened during the first three weeks of May, rallied durling the last 6 trading days of the month.	Municipal bonds as represented by the Bloomberg Municipal Index returned 1.48% in May. The fundamentals of the municipal market remain strong, with April tax revenue data solid as state and local governements experienced record tax collections. Higher sales tax revenue is also contributing. Municipal flows turned positive after 20 consecutive weeks of net outflows.

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