CION Credit Market Update – June 30, 2022

Things That Go Up for $500, Please

The Federal Reserve is now in exactly the spot it wanted to avoid. Inflation is rampant, and because of the long pause before raising rates while the Fed argued inflation was "transitory," it is now locked into a path that limits its options and narrows the runway to a soft landing.

The June inflation print at 9.1% isn't just the highest number in 40 years (that one is getting old), it's the psychological effect of the so-far failure of the Fed's interest rate moves.

We are two months into an aggressive rate-increase regime, with a surprise 75-basis point month last month, and inflation still came in WAY over consensus expectations.

Chairman Powell was candid in his remarks last month that it wasn't just the strong labor market and uptick in inflation in May that pushed them to the 75-basis point increase; it was also the University of Michigan consumer sentiment survey on inflation expectations coming in higher.

Inflation can be a self-fulfilling prophecy in that expectations of inflation tend to become reality.

How did we get here? The Fed has reiterated for months that it would be data-driven and make adjustments as new numbers came in. But it appears the only numbers it was looking at were on the Big Board. The "Fed put" that was backstopping equities was arguably the priority.

Intransigent supply chains and a reluctant labor force aren't responding as quickly as hoped, and the ongoing war in Ukraine is pushing energy prices up. Most of the 9.1% increase was energy, and we have already seen that come down in recent weeks. But core CPI (excluding food and energy) increased as well. At least a 75-basis point increase in July now appears the most likely option – and a higher rate increase is certainly on the table.

The other economic self-fulfilling prophecy? Recession. The Fed wants to control inflation while also maintaining the stated goal of full employment. Slowing the economy through monetary policy, without breaking it, isn't a precise science because the chain of impact has too many inputs. If consumers and corporations believe that rate increases to combat inflation will result in overshooting, pullbacks in spending behavior – the nicely named "retrenchment" will become a powerful force that can push the economy into recession.

How Did the Credit Markets React?

It was the worst first half of the year for equities since 1970, and the lowest performance for the Bloomberg U.S. Aggregate in the first six months of the year since the inception of the index. The index was down 1.57% in June and returned -10.35% year-to-date. Year-to-date, U.S. Treasuries returned -9.34%. While interest rate increases were largely the cause of the price declines, pessimism about the prospects for the economy resulted in spread widening in June. Bonds were negative across most sectors, with emerging markets and high yield down the most year-to-date, followed by investment grade corporates.

The 60/40 portfolio is struggling. With equities and bonds moving in tandem, diversification is hard to come by.

A Closer Look:
It's All About Inflation and Interest Rates

Demand is increasing for assets that can provide some inflation relief and help mitigate the effects of a rapidly increasing rate environment. In the credit space, loans that are structured with floating rates are seeing increased demand.

There are two loan asset classes that are linked to a short-term benchmark rate, usually either the Fed funds rate or SOFR. In private credit, direct loans are a bi-lateral agreement between lenders and private companies, and are typically structured as floating rate notes. Syndicated or leveraged loans are commercial loans provided by a group of lenders. The loan is structured, arranged, and administered by one or several commercial or investment banks.

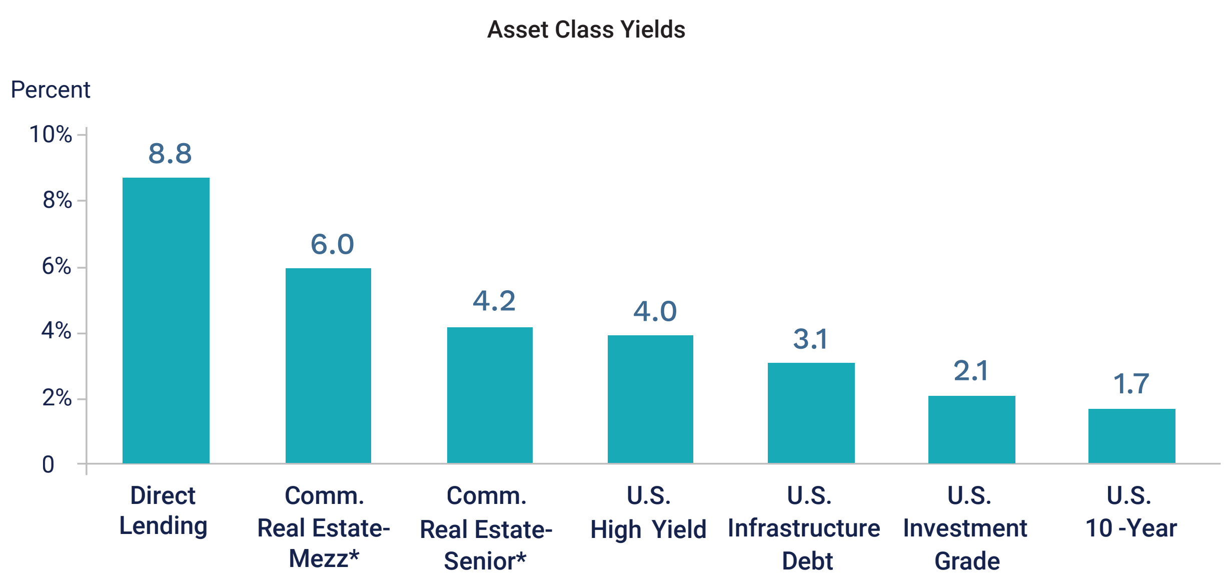
Direct lending and leveraged loans offer lower correlation to bonds and equities, and while they are below investment grade, they are usually senior, secured notes that are high in company's capital structure and are backed by the assets of the company.

Performance Among Credit Indices

	MTD (5/31/2022 - 6/30/2022	YTD (as of 6/30/2022)	TRAILING 1 YEAR (6/30/2021 - 6/30/2022)
Credit Suisse Leveraged Loan Total Return Index (CSLLLTOT)	-2.06%	-4.45%	-2.68%
Bloomberg US Corporate High Yield Total Return Index (LF98TRUU)	-6.73%	-14.19%	-12.81%
Bloomberg US Aggregate Total Return Index (LBUSTRUU)	-1.57%	-10.35%	-10.29%
Bloomberg Municipal Bond Index (LMBITR)	-1.64%	-8.98%	-8.57%
Palmer Square CLO Debt Index (CLODI)	-1.54%	-5.80%	-4.47%

Source: Bloomberg as of 7/7/2022

Chart Spotlight: Direct Lending: Historically Higher Returns



*Source: BofA Securities, Bloomberg Finance L. P., Clarkson, Cliffwater, Drewry Maritime Consultants, Federal Reserve, FTSE, MSCI, NCREIF, FactSet, Wells Fargo, J.P. Morgan Asset Management. * Commercial real estate (CRE) yields are as of September 30, 2021. CRE-mezzanine yield is derived from a J.P. Morgan survey and U.S. Treasuries of a similar duration. CRE-senior yield is sourced from the Gilberto-Levy Performance Aggregate Index (unlevered); U.S. high yield: Bloomberg U.S. Aggregate Credit - Corporate - High Yield; U.S. infrastructure debt: iBoxx USD Infrastructure Index capturing USD infrastructure debt bond issuance over USD 500 million; U.S. 10-year Bloomberg U.S. 10-year Treasury yield; U.S. investment grade: Bloomberg U.S. Corporate Investment Grade. Data is based on availability as of May 31, 2022.*

Credit Asset Classes

Private Credit	Structured Credit	High Yield
The TMF Group's Global Private Debt Insights Report from June 2022, found that 37.4% of respondents reported plans to grow their investment by more than 20%. TMF cites that this is the largest percentage represented in the data showing, a distinct trend for rising investment in the space. The report went on to look at investor concerns about headwinds in the space, including inflation, labor shortages and interest rate increases: "Private credit investors, while being mindful of short-term headwinds, remain patient and focused on meeting long-term investment objectives, and ensuring broad diversification across portfolios and compensation for the risk taken. Careful structuring of private credit investments can further help to mitigate against downside risk in portfolios – with strong origination capabilities and flexibility to invest across the full breadth of the asset class is also important when it comes to ensuring selectivity over deals."	A new report from Fitch Ratings looked at potential default rates in light of economic pressures. The 2022 default rate forecast remains unchanged at 1.5%. The year-to-date default level stands at just 0.6% following Revlon's bankruptcy. Diamond Sports, Revlon and Envision collectively account for 74% of the year's default total. While volume is up versus last year, at $10.6 billion versus $4.6 billion, there have actually been slightly fewer defaults in 2022. For 2023, Fitch raised the institutional leveraged loan default forecast by 25bps to 1.5%-2% projecting totals well below either 2009 or 2020.	U.S. High Yield returned -6.81% in June and the year-to-date return was -14.03% as measured by the ICE BofA U.S. High Yield Constrained Index (HUC0). Fear of a recession resulted in spread widening, with spreads increasing 166 bps to close at 589 bps. Year to date, spreads are 278 bps wider and yields have increased by 462 bps. All sectors declined in June, but more defensive segments such as packaging and food were better positioned while consumer-spending focused sectors such as building materials and leisure.

Other Related Asset Classes

Treasuries	Investment Grade Corporates	Municipals
The benchmark ten-year U.S. Treasury bond yield peaked at 3.47% on June 14, its highest reading since 2011, before falling to 3.02% at quarter end; up 17 bps for the month and 68 bps in the second quarter. The 30-year U.S. Treasury Bond closed at 3.19%, up from last month's 3.05%. On the short end of the curve, the 3-month Treasury jumped 63 basis points, ending at 1.71%.	Investment grade corporates under-performed both the broader market indices and U.S. Treasuries as spreads widened widened 25 bps in June and 39 bps for the second quarter. Risk aversion, coupled with lower levels of market liquidity, were a drag on performance. The Bloomberg U.S. Corporate Investment Grade Index returned -2.80%, and is down 14.39% year-to-date.	Municipal bonds as represented by the Bloomberg Municipal Index returned -1.64% in June. The rise in yields in June and over the course of the second quarter resulted in year-to-date returns of -8.98%. Longer maturities underperformed both intermediate and short maturity segments for the month and quarter. Credit strength in municipals may be seeing a peak, as COVID stimulus and the recovering economy boosted tax revenues.

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