CION Credit Market Update – July 31, 2022

Tug of War, Fed Edition

The Fed raised the short-term interest rate by 75 basis points at the July FOMC meeting, as expected. In his comments, Fed Chairman Powell indicated that previous interest rate cuts may have an impact on the economy that is “in the pipeline” but not yet reflected in the data. This was initially interpreted by some market participants to mean that the Fed may slow down rate increases and even consider cuts later in 2023.

The annualized rate of GDP was -0.9% in the second quarter, following the -1.6% rate in the first quarter.

The early August release by the U.S. Bureau of Labor showed a booming job market, with new non-farm payrolls of 528,000. This was more than double consensus estimates. The strength of the labor market may be seen as a cushion against a recession, with a potential mitigation effect that could make a recession shallow and short.

One other significant piece of data is consumer expectations of inflation. The Fed has previously indicated it pays a great deal of attention to this forward-looking number. The 75-basis point rate increase in June was in part deemed necessary because consumer expectations for ongoing inflation had increased. The University of Michigan Consumer Expectations Index in July showed consumers think inflation will decrease.

July CPI (released August 10th) showed a decline to 8.5% year over year. Core CPI, excluding food and energy, increased 0.3%. This is a smaller increase in core CPI than we saw in April, May or June. But it’s still headed the wrong way.

How Did the Credit Markets React?

Despite a 150-basis point increase over two months in the Fed funds rate and persistently higher inflation, the benchmark 10yr Treasury yield dropped 37 bps to end the month at 2.65%. This is 83 bps below its 2022 peak. The rally was sparked by investor sentiment that the Fed’s view was becoming more dovish, which the Fed worked hard to counter towards the end of the month. By month end, the 2-year – 10-year segment of the yield curve inverted as investors began to price in the potential for a recession.

The Bloomberg U.S. Aggregate Index followed up the worst first half since the inception of the index with a positive return of 2.44% in July. It’s still in negative territory for the year. All major fixed income sectors turned positive for the month, but remain underwater.

A Closer Look: How Meaningful Is the Data?

The Fed keeps talking about “evolving data,” and new releases of data that reflect smaller subsets of the economy make headlines daily. The economic commentariat then weighs in on how this or that piece of data relates to future expectations for the economy or what the Fed will do. What does it all mean? What is the big picture?

For investors, whether we are officially in a recession isn’t as useful a measure for guidance as a look at some recent performance history. Traditional credit assets have struggled all year, and persistently high inflation and a hawkish Fed means those assets are more likely to continue to be a drag on the 60/40 portfolio.

Demand has increased from investors that want to expand the credit spectrum in their portfolios with alternative private credit assets that could provide further diversification to traditional public credit assets.

Floating rate assets that can mitigate the risk of rising interest rates, including direct lending and leveraged loans, continue to see interest.

Performance Among Credit Indices

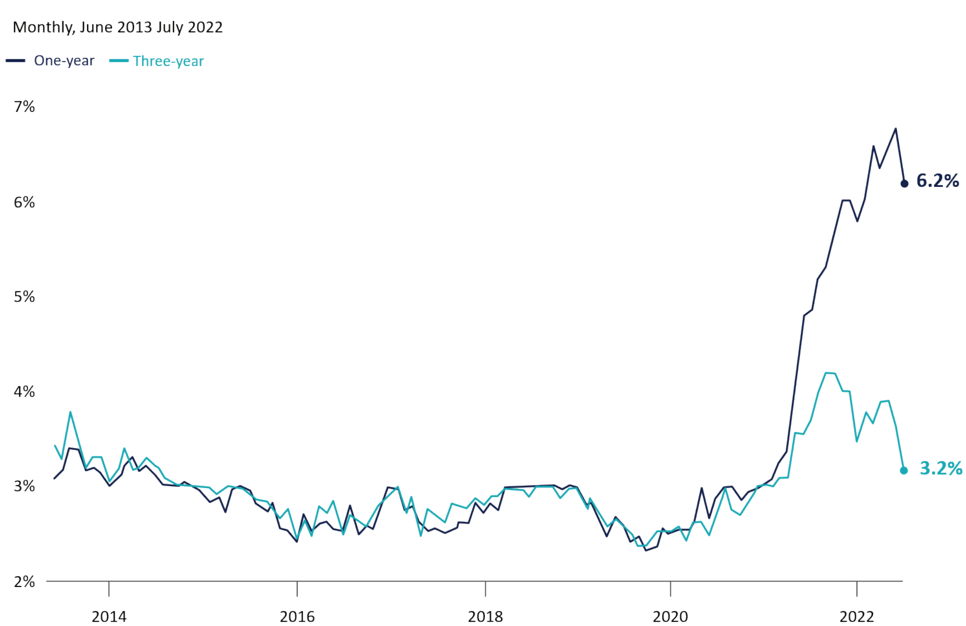
	MTD (6/30/2022 - 7/29/2022	YTD (as of 7/29/2022)	TRAILING 1 YEAR (7/30/2021 - 7/29/2022)
Credit Suisse Leveraged Loan Total Return Index (CSLLLTOT)	1.87%	-2.66%	-0.86%
Bloomberg U.S. Corporate High Yield Total Return Index (LF98TR.UU)	5.90%	-9.12%	-8.02%
Bloomberg U.S. Aggregate Total Return Index (LBUSTRUU).	2.44%	-8.16%	-9.12%
Bloomberg Municipal Bond Index (LMBITR)	2.64%	-6.56%	-6.93%
Palmer Square CLO Debt Index (CLODI)	-0.06%	-5.86%	-4.29%

Source: Bloomberg as of 8/1/2022

Chart Spotlight: Inflation Expectations Are Ever-So-Slightly Heading Down

Consumers expectations for inflation decreased in July from a peak in June – but 6.2% isn't even remotely close to the Fed's long-term goal of an average of 2%, and even over the medium term, prices are expected to be elevated.

New York Federal Reserve Survey of Consumer Expectations



Source: New York Fed Survey of Consumer Expectations

Credit Asset Classes

Private Credit	Structured Credit	High Yield
A recent Cerulli Associates/Blue Vault poll of advisors asked respondents their goals for using alternative investments. Reducing exposure to public markets is reported by advisors as a top reason (69% report this as a goal) for using alternative investment products in 2022, while volatility dampening and downside risk mitigation is a close second (66%). Cerulli reports on the importance of fixed-income replacement in a market where bonds may not offer adequate income (59% report this a goal of their alternative allocations).	S&P Global's recent LCD Leveraged Finance Survey looked at the sentiment of leveraged finance professionals with respect to defauts. "While clearly sentiment has declined, especially with respect to volatile market conditions and even recessionary pressure in the year ahead, the good news is that the pain of defaults is not expected to be a trouble spot for some time yet." "Leveraged finance professionals expect the loan default rate, as measured by the S&P/LSTA Leveraged Loan Index, to rise from a near record low of 0.21% in May to between 1% and 1.49% by June 2023. This still sits well below the long-term average of 2.77%."	The U.S. high yield market returned 6.02% as measured by the ICE BofA U.S. High Yield Constrained Index. Year-to-date, the market is down -8.86%. Bonds rallied on relatively strong Q2 earnings reports from high yield issuers, along with the emerging view that a slower economy could lead to less aggressive Fed tightening in the second half of the year.

Other Related Asset Classes

Treasuries	Investment Grade Corporates	Municipals
The benchmark ten-year U.S. Treasury bond yield fell to 2.66%, down from last month's 3.02%. The 30-year U.S. Treasury bond closed at 3.02%, down from last month's 3.19%. On the short end of the curve, the 3-month Treasury jumped again, ending the month at 2.34%, and the 2-year U.S. Treasury hit 2.89%.	Investment grade corporates rallied and outperformed Treasuries as spreads tightened 16 basis points over the month. The Bloomberg U.S. Corporate Investment Grade Index returned 3.24%. Year-to-date the index returned -11.61%.	Municipal bonds as represented by the Bloomberg Municipal Index returned 2.64% in June. Municipal yields fell across all longer maturities, with the 7-year maturity yield dropping by 52 basis points. Flows into municipal bond mutual funds stablilized a bit relative to the first half of the year, with two weeks of positive inflows. Demand was supported by lower supply.

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