

A photograph of a stream flowing over mossy rocks with a wooden plank bridge in the foreground. The scene is set in a forest with fallen leaves on the ground.

CION Credit Market Update – October-November 2022

Will the 60/40 Work Again? Recession and Volatility May Have Something to Say About That

CPI Moved in the Right Direction. Why Doesn't the Fed Seem Happy?

The surprise CPI number of a 7.7% increase over the last twelve months beat expectations. This would seem to be completely in line with Chairman Powell's remarks at the early November FOMC meeting that indicated the size of future rate increases would take into account "the lags with which monetary policy affects economic activity and inflation." In other words, rate increases are likely to be lower than the 75 basis point hikes we've seen repeatedly this year, to give the economy time to catch up.

The problem is that Powell also indicated that overall rates would likely be higher than previously announced. In recent weeks, various Fed officials have reiterated the message. This means the emphasis has shifted from how high, to how many.

What's behind this new messaging? With GDP growth turning positive, labor markets still demonstrating strength, and robust consumer spending, the goal is to get inflation under control, and to telegraph that very clearly to keep markets from expecting a pivot.

- The October non-farm payroll number was 261,000. The report from the Department of Labor marked the slowest increase since December of 2020. This was a slight decrease from the September number, released in early October, of 263,300.
- The unemployment rate increased to 3.7%. The unemployment figure that includes discouraged workers and those holding part-time jobs increased to 6.8%.
- Third quarter GDP came in at 2.6%. The positive number is a bounce back from the negative first and second quarter numbers.
- U.S. retail sales rose 1.3% in October. This is the biggest monthly gain since February. The Census Bureau report showed sales up 8.3% over the twelve-month period.

The question around a recession in 2023 has also shifted, from whether we will have one to the likely length and duration.

To get from 7.7% to an average of 2% CPI means the economy may have to slow substantially, and unemployment will increase. However, that doesn't necessarily translate into a long or deep recession.

There are several factors that could indicate a recession may be shallow and short.

Since the run-up to the Global Financial Crisis, the Federal Reserve has seen intervention as a key part of its role. Powell is continuing to communicate that while the economy will need to cool off to get inflation under control, getting rates back down is also a priority, just not as quickly as markets may prefer.

The ability to throw off a recession also depends on the overall health of the economy and the markets. Systemic risk is not a factor the way it was during the GFC. Banks are healthy, and the extended period of low rates and liquidity throughout the pandemic allowed many companies to refinance at a very low cost of capital.

A Closer Look: A Traditional Credit Cycle, But With Extra Volatility, May Not Serve the Traditional Portfolio 60/40 Allocation

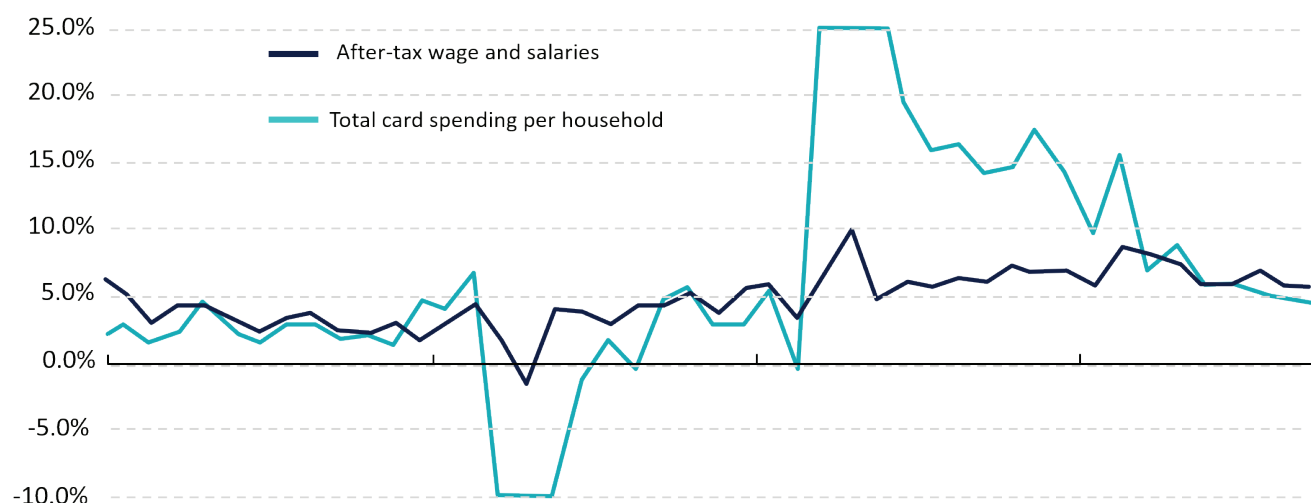
So where does that leave credit markets? We're entering a more traditional credit cycle as interest rates increase and the Fed continues to reduce its massive balance sheet. In case anyone's forgotten what that looks like (it's been a minute), consumer spending tends to shift to credit cards, which is already underway. High prices and high interest rates eventually create a slowdown in consumer spending, which impacts corporate profits. Added to that is ongoing geopolitical risk.

Volatility will likely remain elevated over the next six-to-twelve months, with even the Treasury market seeing higher volatility. These factors create much greater dispersion in the performance of industry sectors and individual companies. Credit evaluation and selection are key to avoiding issues as defaults return to normal levels.

The shift to private assets that can find opportunity in volatility, and are not correlated to public markets, will most likely continue as demand for assets that can smooth help volatility remains high. Private debt has proven resilient through market downturns, and middle market, privately held companies have held up during past recessions. The National Center for the Middle Market reports that, during the GFC, large businesses shed 3.7 million jobs, while the middle market added over 2 million new positions.

Chart Spotlight: Default Rates Remain Below Historical Averages

Current low default rates are projected to increase to more normal levels over the next few years.



Source: Credit Suisse, as of September 30, 2022. Loans represented by the Credit Suisse Leveraged Loan Index. High Yield represented by the Credit Suisse High Yield Index. Distressed exchanges included in default rate calculation. Visuals: CION.

Performance Among Credit Indices

	MTD (9/30/2022 - 10/31/2022)	YTD (as of 10/31/2022)	TRAILING 1 YEAR (10/31/2021 - 10/31/2022)
Credit Suisse Leveraged Loan Total Return Index (CSLLLTOT)	0.85%	-2.49%	-2.03%
Bloomberg U.S. Corporate High Yield Total Return Index (LF98TR.UU)	2.60%	-12.53%	-11.76%
Bloomberg U.S. Aggregate Total Return Index (LBUSTRUU).	-1.30%	-15.72%	-15.68%
Bloomberg Municipal Bond Index (LMBITR)	-0.83%	-12.83%	-11.98%
Palmer Square CLO Debt Index (CLODI)	0.46%	-6.94%	-6.90%

Source: Bloomberg as of 11/1/2022

Credit Asset Classes - Data as of October 31, 2022

Private Credit	Structured Credit	High Yield
<p>Preqin has released a report titled "The Future of Alternatives in 2027." Private equity, venture capital, private debt, infrastructure, real estate, and natural resources, are expected to reach \$18.3 trillion by the end of 2027, up from \$9.3 trillion in 2021.</p> <p>According to Preqin, private debt will have an annual asset growth rate of 10% between 2021 and 2027.</p> <p>Recent fundraising supports the projections. Private credit funds raised \$45 billion in the first quarter, a pace that would make 2022 the biggest fundraising year for the asset class ever, according to Institutional Investor.</p>	<p>The default rate of the Morningstar LSTA U.S. Leveraged Loan Index fell slightly, to 0.83% in October from 0.90% in September.</p> <p>While this figure remains well below the 10-year-average for the index, Pitchbook reports that individual credit situations are increasing, as distressed volume topped \$100 billion in October, the most since June 2020.</p> <p>Default rates are expected to increase in 2023.</p>	<p>The U.S. high yield market, as measured by the ICE BofA U.S. High Yield Constrained Index increased by 2.84% in October, bringing the YTD return to -12.18%.</p> <p>Cable, paper, and metals were the best performing sectors, while Entertainment, Publishing, and Broadcasting lagged.</p> <p>Spreads tightened, and the U.S. high yield market ended the month with a yield of 9.07% and spread of 465.</p>

Other Related Asset Classes – Data as of October 31, 2022

Treasuries	Investment Grade Corporates	Municipals
<p>The benchmark ten-year U.S. Treasury bond yield rose 21 basis points to 4.05%.</p> <p>The 30-year U.S. Treasury Bond rose 39 basis points to close at 4.17%.</p> <p>On the short end of the curve, the three-month Treasury jumped 80 basis points to 4.09%, and the two-year remained inverted against the 10-year U.S. Treasury, with a yield of 4.49%.</p>	<p>Investment grade corporates turned in another negative month, returning -1.03%, bringing the year-to-date return to -19.56% for the Bloomberg U.S. Corporate Investment Grade Index</p> <p>Spreads widened again to a year-to-date high of 165 basis points before closing at 158 basis points.</p> <p>Credit spreads indicate the credit risk perceived by market participants/investors, and can provide a “real time” take on sectors or issuers. Tighter spreads indicate less risk relative to Treasuries, and wider spreads indicate more risk.</p>	<p>Municipal bonds as represented by the Bloomberg Municipal Index returned -0.83% in September. Year-to-date return for the index was -12.86%.</p> <p>Tax-exempt rates rose modestly across the curve in October. Fund redemptions across the municipal industry were largely related to tax-loss harvesting activity, with year-to-date outflows reaching \$104.8 billion.</p>

The information contained within is for educational and information purposes ONLY. It is not intended nor should be considered an invitation, inducement to buy or sell any security or a solicitation to buy or sell any security. The information is not designed to be taken as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from us or any of our subsidiaries to participate in any of the transactions mentioned herein. Any commentary provided is the sole opinion of the author and should not be considered a personal recommendation. This is also not intended to be a forecast of future events nor is this a guarantee of any future result. Both past performance and yields are not reliable indicators of current and future results. Information contained herein was obtained from third party sources we believe to be reliable; however, this is not to be construed as a guarantee to their accuracy or completeness. Observations and views contained in this report may change at any time without notice and with no obligation to update.

All investments carry a certain degree of risk, including possible loss of principal and there is no assurance that an investment will provide positive performance over any period of time. There are specific risks associated with investing in various types of financial assets and in different countries. The information contained within should not be a person's sole basis for making an investment decision. One should consult a financial professional before making any investment decision. Investors should ensure that they obtain all available relevant information before making any investment. Financial professionals should consider the suitability of the manager, strategy and program for their clients on an initial and ongoing basis.