US Investment Grade Outlook

USD (H) Currency

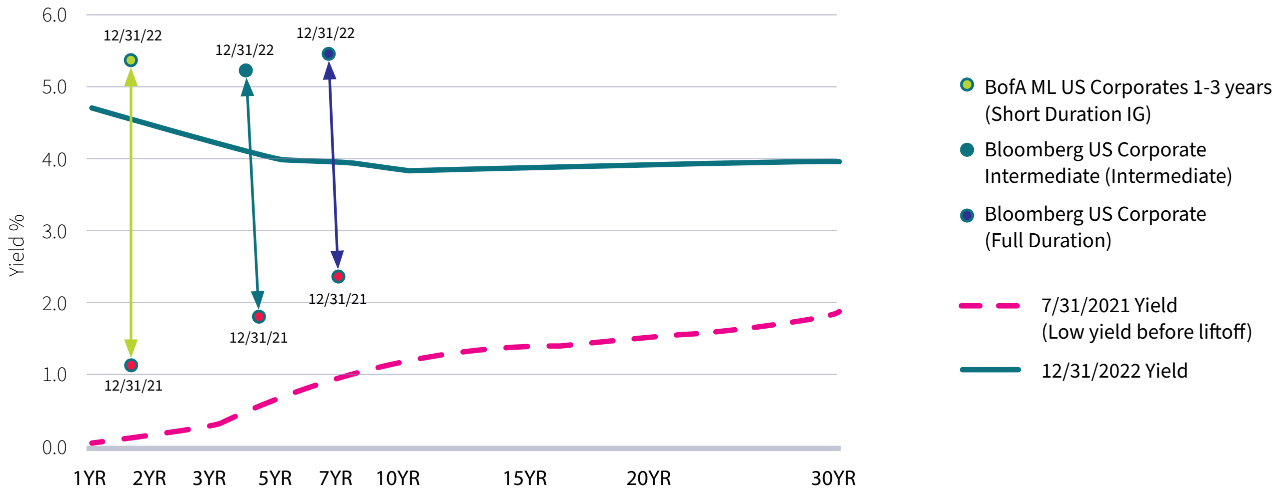
Fixed income asset classes had a challenging year in 2022 and US Investment Grade (US IG) was no exception. Elevated inflation forced the Fed to embark on an extreme tightening cycle which drove interest rates higher across the yield curve and credit spreads widened meaningfully, leading to the weakest performance in the asset class in many decades.

Indices Total Return	2022 YTD Total Return	2022 4Q Total Return	Yield to Worst	Option-Adjusted Spread	Duration
BofA ML US Corporates 1-3 years	-4.05	1.40	5.35	88	1.84
Bloomberg US Corporate Intermediate	-9.40	2.72	5.33	116	4.09
Bloomberg US Corporate	-15.76	3.63	5.42	130	7.10

Source: ICE BofAML, Bloomberg as of December 31, 2022.

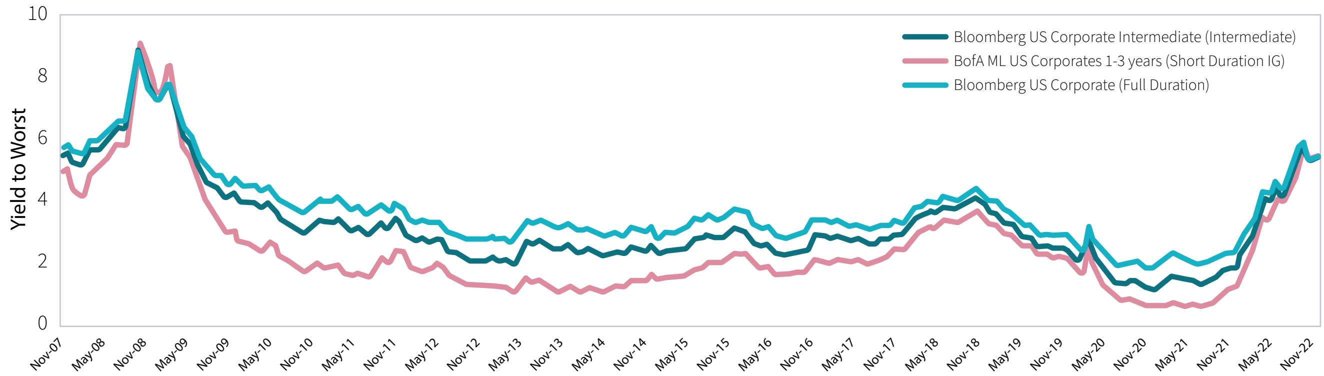
Underlying credit fundamentals remained relatively strong though, as corporate earnings proved more resilient than expectations, the consumer remained in a position of strength, and management teams prioritied financial flexibility, with leverage declining across most sectors. This led to credit spreads finishing the year well off the wides, ultimately tightening from +165 bps in October to +130 bps at year-end. This capped a volatile year in which the range for corporate credit spreads was 74 bps, up significantly from the 21 bps seen in 2021. Shorter duration strategies outperformed longer duration by a wide margin.

Flat US treasury yield curve favours short/intermediate duration



Probabilities improve for positive entry point

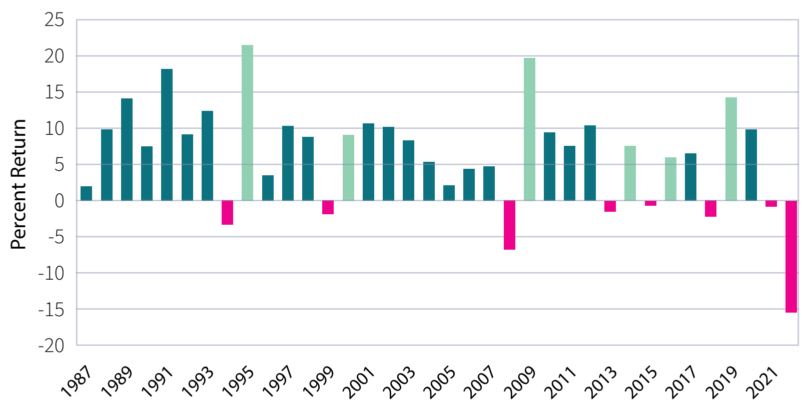
Highest yields since 2009



Despite potential for recession and additional rate volatility, we see several positive drivers for US IG credit in 2023 – yields are at the highest level since 2009, the asset class has minimal direct exposure to the impacts of the war in Ukraine, banking fundamentals remain strong, and positive technicals are supported by a reasonable expected pace of supply. Lastly, we note that our philosophy is based on compounding income and avoiding loss through fundamental credit analysis. As yields have increased substantially, the prospect for better returns improves as coupons are reset at these higher levels.

Negative returns followed by positive as income takes over

ICE BofAML US Corporate Index



As a result, it is rare to see consecutive negative return periods in fixed income, particularly given the magnitude of negative returns in 2022. Interestingly, the shape of the yield curve is highly unusual today, significantly inverted such that comparable yields can be achieved without adding incremental interest rate risk; **short duration and intermediate strategies should be a superior risk reward in this environment.**

As we look forward to 2023, key areas of focus include:

1 Central banks and their ability to fight inflation

The Fed is expected to continue hiking rates in 1H'23 before pausing at a terminal rate of ~5%. Recent CPI data has shown signs of easing inflation, albeit from very elevated levels.

2 Potential for recession

Interest rate hikes may further tighten financial conditions and raise the likelihood of a recession in the process. To the extent that a US recession does materialise, this would likely influence rates lower and put mild upward pressure on credit spreads, particularly if corporate earnings, which have been resilient through the current inflationary environment, ultimately decline.

3 Credit fundamentals and the severity of an economic downturn

Our base case view is a mild recession with -0.2% GDP growth in 2023, driven by a combination of weaker consumer spending, lower business investment, and inventory adjustments. In other words, we expect a potential recession to be milder than the 2008/09 Global Financial Crisis and pandemic-driven economic shutdown in 2020. With that said, IG issuers would enter a potential recession in relatively good shape in our view, with leverage below pre-pandemic levels and other late cycle periods given strong earnings growth over the past several years, limiting the degree of spread widening. In addition, many issuers took advantage of the low-rate environment in 2020-2021 to proactively refinance near-term maturities, insulating credit profiles from higher rates.

4 Attractive yields support income-driven returns

All-in yields are at the highest level since 2009, with a discounted average bond dollar price of $89,* which provides an income cushion to the extent that rates and/or spreads move higher. This enhances the prospect for better returns as coupons are reset at higher levels. As a result, it is rare to see consecutive negative return periods in fixed income, particularly given the magnitude of negative returns in 2022.

5 Positive technicals

Issuance is expected to decline 5-10% in 2023 relative to 2022 levels, which itself saw a 16% decline from 2021.* The US market has a yield advantage relative to global government bonds, though we note the headwind of higher FX hedging costs.

6 Flat yield curve

A shorter duration strategy is attractive in the current market, whereby the inverted yield curve provides comparable yields in the front-end and belly of the curve without adding incremental interest rate risk. In 2022, 2-year Treasury yields increased by 369 bps while the 10-year and 30-year part of the curve increased 236 bps and 206 bps, respectively. This caused the yield curve to significantly invert, with the spread between 2-year and 10-year Treasuries ending 2022 at -56 bps, the most inverted level since the early 1980's.*

7 Returns across credit quality – potential for sector dispersion

We expect bottom-up security selection and sector rotation will be a critical element of alpha generation in 2023. BBB spreads lagged higher quality credits by a considerable margin in 2022 (BBB excess return of -1.55% vs. -1.06% for A and -0.28% for AA).* In the near-term, we maintain a more cautious view on risk and have proactively scaled back across cyclical sectors and favor US credits over Yankees (bonds issued by a foreign entity that are in dollars and trade on US exchanges). That being said, a potential recession could drive further dispersion and create opportunities to become more offensive.

Source: *ICE BofAML, Bloomberg, Barclays & JPMorgan as of 12/31/2022

Sector Commentary:

INVESTMENT GRADE INDUSTRY	2022 Returns (%)				Option-Adjusted Spread			Yield to Worst
	Current Month Total Return	YTD Total Return	Current Month Excess Return	YTD Excess Return	Current Month	MTD Change	YTD Change	Current Month
US CORPORATE INDEX	-0.21	-15.44	0.51	-1.37	138	-4	40	5.51
Automotive	-0.10	-9.42	0.14	-1.12	129	-2	55	5.49
Banking	0.12	-11.52	0.45	-1.58	139	-6	58	5.61
Basic Industry	0.44	-17.69	1.23	-2.98	162	-14	35	5.72
Capital Goods	-0.34	-14.91	0.37	-0.81	112	-2	25	5.24
Consumer Goods	-0.46	-15.71	0.40	-0.37	123	-2	27	5.31
Energy	-0.36	-16.22	0.45	-1.37	152	-2	26	5.63
Financial Services	-0.10	-12.82	0.35	-1.89	155	-3	70	5.74
Healthcare	-0.62	-17.67	0.34	-0.92	111	0	27	5.21
Insurance	0.30	-16.15	1.05	-1.78	155	-10	51	5.69
Leisure	0.11	-8.68	0.49	0.71	193	-1	45	6.02
Media	-0.83	-20.19	0.17	-2.96	170	-2	53	5.77
Real Estate	0.12	-14.09	0.70	-2.03	168	-8	68	5.75
Retail	-0.66	-16.82	0.26	-0.78	99	-2	22	5.08
Services	-0.19	-20.03	0.91	-1.65	129	-8	41	5.36
Technology & Electronics	-0.59	-15.78	0.28	-0.62	114	0	30	5.23
Telecommunications	-0.91	-19.04	0.18	-1.23	149	0	30	5.52
Transportation	-0.15	-17.68	0.88	-0.32	136	-5	22	5.46
Utility	0.11	-17.60	1.08	-0.82	144	-10	27	5.52

Source: ICE BofA Merrill Lynch as of December 31, 2022.

Automotive

We remain cautious on the Automotive sector heading into 2023 ahead of possible recessionary conditions. The US SAAR is forecasted to modestly increase to a range of ~14.5-15.0mn in 2023 from around ~13.9mn in 2022 and should remain below the ~16-17mn pre-Covid run-rate. The improvement in automotive sales in 2023 should be concurrent with OEMs' production rates gradually recovering as supply chain constraints slowly ease, in particular the semiconductor supply shortage that materially impacted automotive production growth over the last 2 years. Industry inventory levels remained in the low '20s DOS (i.e. days of supply) for more than 1 year, levels not observed since the '90s, and only started to recover in the last few months to end December at 33 DOS. Current inventory levels remain well below historical averages and pre-Covid levels but should continue to recover in 2023 (and possibly in 2024) towards more "normalized" levels. Despite the modest inventory build-up observed since September, the new car market supply-demand dynamic remains tight, as illustrated by industry-wide pricing remaining at record levels and limited incentive spending on some segments of the market. Beyond the projected auto sales and production growth in 2023, the industry is facing some headwinds namely around consumer affordability given the combination of rising interest rates, average transaction prices for new vehicles that continue to test record highs, and slowing economic growth likely to weigh on consumers. Supply discipline got the industry in trouble in prior cycles and it will important for OEMs to remain disciplined in 2023 given that they got used to generate healthy profits at low inventory levels in the last 2 years.

Banking

We are relatively constructive on US banking for 2023 as the industry continues to benefit from higher interest rates that have restored net interest margins to healthy levels. Net interest income remains the industry's most impactful source of revenue, and its increase should more than offset expected softness in fee revenues due to a potential economic slowdown and reduction in institutional finance activity. In addition, US banks continue to be effective at increasing cost efficiencies via technology and branch closures. Also, while a slowdown could lead to generally higher loss provisions, we see this effect as limited given the historically low unemployment rate and still-high consumer activity. All-in, we see average ROE at ~10%, and that a good share of this should be retained and be supportive of capital and liquidity as regulatory requirements have strengthened.

Basic industry

We remain cautious on Chemicals as most end-markets important for the sector are slowing down. The petrochemical sub-sector will continue to be the most challenged as the combination of higher energy costs, margin compression, and weaker demand are unlikely to reverse in the near-term. Coatings companies will see gross margin expansion in 2023, but in the context of deteriorating housing fundamentals and slowing consumer demand. The fertilizers' space remains a bright spot given strong farmers' economics, constructive Ag fundamentals, and global demand-supply dynamics to remain unbalanced until Russian & Belarus tons return to market. For Steelmakers, HRC prices should remain supportive of operating fundamentals for IG-EAF domestic steel producers. Moderating residential demand is expected to be a headwind, but non-residential end markets should be resilient. Metals & Mining fundamentals are inflecting more positively after China demonstrates it has navigated the initial hurdles post reopening but continue to espouse a more conservative view of the sector until that junction. Homebuilders face significant headwinds given a sharp run up in 30Y mortgage rates and new/existing home prices that remain near all-time highs, but we view the peer group as broadly better positioned for this downturn than they were during the prior financial crisis.

Cable & satellite

We continue to have a positive view on the sector due to its defensive nature, non-cyclicality, and stability of its recurring revenue model. Valuations are on the wider range of historical averages, the overall market, and vs. the telecom sector. After many years of competitive strengths, 2022 saw headwinds emerge, with new competition ranging from fixed wireless access from the national wireless networks to fiber builders in the traditional wireline space that previously were unable to offer competitive broadband speeds. For 2023, we expect the cyclical pressure from the telcos to gain momentum as FWA continues to drive most subs gains, although market shares are still low. The heightened competitive dynamics is pushing cable operators to increase Capex spend and expand their footprint with the consequence that free cash flows will likely be pressured. Capital allocation policies remain a negative as operators continue to "solve" their capital structure towards the high-end of the stated leverage targets.

Capital goods

In the Machinery sub-sector, supply chain challenges appear to be abating and there is scope to see releases of cash from working capital in coming quarters. Companies have remained aggressive in distributing excess cash to shareholders. Despite an impressive Q3 and generally supportive management commentaries, deteriorating macro indicators suggest that overall volume growth is likely to slow, and may even stall or reverse in coming quarters. Paper and Packaging financial performance should moderate in 2023 as they give back some of the pricing gains seen in 2021-22 in the context of weaker demand and capacity expansions. Inflationary pressures that drove recent price increases have significantly abated through the end of 2022, which should help offset margin pressures associated with demand softening. For Diversified Cap Goods, organic sales volumes are expected to see negative growth at least through 1H, but elevated backlogs and stickier pricing should support performance in the next twelve months. In particular, we see comparative upside in late cycle market such as energy, O&G, process industries/technologies, and Aerospace and Defense as well as select short-cycle industries such as HVAC and Fire & Security. Conversely, we maintain a less favorable view of companies more aligned with residential demand trends and/or big-ticket discretionary consumer purchases.

Consumer goods

Inflationary pressure was a key theme in 2022 and we expect this to continue in 2023, notably in Food Wholesale and Beverages. Inflationary pressures easing and increasing macro pressures should be a tailwind to food at home consumption as consumers look for savings. These tailwinds will be supportive of Food Wholesalers and improving margins. The Beverages subsector continues to be well positioned in a recessionary environment with less impact from elevated input costs. We have historically seen large scale M&A in the past but focus should remain on portfolio optimization and divestitures. Finally, balance sheets are in good shape and management teams are being more conservative. For example, both KHC and SJM lowered leverage targets to 3x in 2022.

Energy

Upstream energy companies have been able to strengthen their credit profiles in 2022 and we expect relatively firm oil and natural gas prices in 2023, which remain above breakeven levels. Recession risk is a concern from a demand perspective but production discipline and production resource constraints (e.g. materials and labor) are expected to keep supply in check. The relatively low level of inventory for both oil and natural gas entering 2023 should prevent a sharp decline in oil and natural gas prices in case of a recession. Midstream companies continue to show capital discipline, utilising operating cash flow to fund CapEx projects, limiting the need to access capital markets beyond refinancing and M&A needs. Entering 2023, we see higher M&A risk as midstream operators look to enhance their position within key operating basins and/or buy out minority stakes in assets for which they are the majority owner, which could increase downgrade risk in the event of a recession. Refineries enter 2023 in a strong position as inventory levels for refined products remain low, utilisation levels high and crack spreads robust. While constructive on refiners in the near-term, we remain cognizant of the long-term risks facing the sector due to energy transition. Oilfield Services & Equipment (OFS&E) should continue benefiting from strong upstream demand over the next twelve months against the backdrop of elevated oil prices. 2023 could see top and bottom-line expansion for the OFS&E space as it provides critical drilling and completion solutions for their customers, which are expected to grow capex in the double-digits. Absent worse-than-expected recessionary conditions, major OFS&E players should continue deleveraging their balance sheets through 1H23, with credit metrics further improving on the back of sustained

Financial services

We expect mixed performance for asset managers in 2023. For large firms where business models are geared to alternative products, performance should remain good as net inflows remain strong, dry powder is healthy, and investment opportunities are more attractive. We note that the alternative players have good operating ability through cycles given their core funds require commitments from investors of three or more years. For more traditional managers we expect less favorable operating trends but with some recovery from what was a weak 2022. Nevertheless, any softness in performance is not a concern from a credit quality standpoint as those traditional managers that fund through the IG markets are generally conservatively managed and maintain strong financial flexibility.

Healthcare

We remain constructive on the Healthcare sector overall given its defensive nature. Within Pharmaceutical, companies continue to show an ability to develop new products and expand product labels to limit the impact of products coming off patent protection. Residual headwinds from COVID persists, but we don’t expect a material impact on the financial performance of most IG pharmaceutical companies. Generic manufactures may benefit from the patent expiry of Humira in the US in 2023. In the Medical Products segment, companies face several near-term challenges entering 2023 as supply chain issues and inflationary pressure persists. In addition, sporadic COVID outbreaks and labor shortages have prevented a full recovery in many medical procedures. While we do not believe these issues will materially impact credit profiles, companies more levered to elective procedures are likely to be more impacted. As with the pharmaceutical sector, large scale M&A remains a tail risk for medical products companies. Large scale M&A remains a tail risk as pharma companies augment their development pipeline; that said, we see medical products companies more at risk given less cushion within their ratings to engage in large debt financed M&A.

Distributors' resolution of opioid lawsuits in the US resolve a key negative overhang for these companies and the ratings impact from these settlements were limited. Entering 2023, we have a neutral view on distributors as normalizing healthcare activity helps volumes but continued downward generic pricing pressure and inflationary pressure limits margin expansion. Lab companies are seeing revenue and earnings contract as COVID test volumes decline. This is expected to continue in 2023, resulting in declining profitability and cash flow generation along with higher leverage, although we don't expect rating pressure on the two main IG lab companies as their credit metrics should remain in line with current ratings.

Insurance

For life insurers we believe performance in 2023 should be favourable due to higher interest rates that comprise a strong revenue source via high-quality investment portfolios, and in the near-term we think is likely to outweigh negative effects of market volatility that could impact a small portion (i.e. <10%) of investments. Starting in 2H'22, life insurers saw improved flows into core fixed rate and indexed products, and we think this will continue into the new year. For Property & Casualty (P&C) insurers, we expect an even more poignant benefit from higher rates as investment portfolios are shorter in duration, and in turn flows from premiums and interest income will have a greater reinvestment effect. The P&C industry is also two years into a "hard market" for premium rates and better policy terms, and we believe this trend will continue. Finally, we are hopeful that the industry is past unusual COVID related claims and will see more relief in 2023 from recently higher claim costs due to supply chain issues.

Leisure

We remain slightly negative on hotel companies within the leisure sector. Hospitality recovery continues but pace is slowing as recovery becomes more uneven. Consumers continue to show strong demand for leisure activity driven by a combination of pent-up demand and continued macroeconomic growth. Recent growth in the sector has slowed but not yet been derailed amid intensifying financial, geopolitical and health related tensions in certain parts of the world. We expect the global lodging recovery will continue this year driven by US growth, while Europe and Asia will lag due to a more uneven recovery and regional differences over COVD-19 policies and infection rates. This year's recovery should be aided by increased business travel as employees of large corporations continue to return to office and meet clients face to face.

Real estate

REITs enter 2023 on mixed footing. Given the large number of companies and property types within the sector, some parts of the market will fare better than others. We expect to see stronger and more consistent performance in Multifamily, Industrial, Self-Storage and certain parts of Retail (e.g., grocery-anchored centers) and more challenging conditions for Office, Health Care and Regional Malls. The sharp spike in interest rates will pressure Commerical Real Estate (CRE) valuations as cap rates move higher in sympathy. A potential recession would pressure rent growth and stall momentum in sectors that have recovered since Covid, while office demand will continue to be negatively impacted. KBW expects CRE volumes to decline 35-40% and values 10-20% in 2023. On a positive note, REITs are well-positioned for a tougher macro environment given reasonable leverage, ample liquidity, and minimal debt maturities over the next two years. Technicals are favourable with limited issuance expected again in 2023.

Retail

The space is facing multiple headwinds such as elevated inventory levels, rising interest rates, declining EBITDA, and slowing consumer demand. Although inflationary and supply chain pressures are easing, higher food and energy costs have hurt the lower-end consumer, which will continue to crowd out discretionary spending. Margins have also been negatively impacted. We are seeing signs of trade down, as credit card data indicates that higher income consumers are trading down or consolidating shopping at discounters/dollar stores. Similar to consumer companies, management teams are being more conservative, with balance sheets in a good position. We prefer non-discretionary retailers over discretionary, as well as Home Improvement and Discounters in 2023.

Services

We remain positive on waste management companies, which benefit from an underlying industry profile that is stable with good visibility, predictable cash flow, and a modest but steady growth rate. Waste management companies provide an essential service to the communities and clients they serve with no cost-efficient substitute available, providing predictable demand for its services, even during economic downturn. Data Analytic companies with long term subscription-based business model and high recurring revenue profiles generate above industry margins and strong free cash flows. The services and data they provide tend to be well integrated in their customer's workflows and processes which is hard to eliminate even in time of economic slowdown.

Technology

We have a neutral view heading into 2023. IG tech generally lags performance of the IG index in most periods especially in "risk-on" mode, given its limited carry. In the current macro uncertainty and worries regarding a potential recession, IG tech should hold up well, given its defensive nature, resilient balance sheet, continued secular growth and higher average ratings (A2/A3). 2023 should provide pockets of outperformance over the rest of the IG market, in selective sub-sectors and individual idiosyncratic names, despite tight valuations.

Telecommunications

We have a neutral view on the Telecom sector heading into 2023. The defensive business model in a weak macroeconomic environment is a positive but valuations seem tight vs. historical averages and overall market. Surprisingly, 2022 turned out to be a solid year for the sector overall, with net additions, rising ARPU, and the emergence of Fixed Wireless Access (FWA) as an important new product and source of growth. We expect a lower growth rate in 2023 and decelerating Key Performance Indicators (KPIs) as – despite an above 2022 trend year – fundamentally the industry is mature with low single digit growth, high margins, and decent free-cash-flows, balanced by increasing competition and investment needs to continually upgrade the network. Operators might take additional price actions in 2023, following increases announced in 1H'22 and while this should help inflationary pressure on the cost side, we expect impacts on churn and increased competition which merits watching. Finally, although most of the US IG Telecom issuers remain in stated deleveraging mode, 2023 will likely see more capital returns to shareholders.

Utilities

We remain favourable on Utilities given the trend of focusing on domestic regulated assets. Carbon transition risk away from fossil fuels continues to be a longer-term business risk but we highlight associated growth opportunities via renewables, grid mod, and transmission investments, for which the regulatory environment remains supportive. This will require close monitoring of the balance between capex and leverage, which appears to have stabilized, albeit at weaker levels. Coal exposure continues to trend lower as utilities are benefitting from renewables expansion, a trend that will accelerate in the medium-term. All in all, utilities are looking to go back to basics – become more regulated with greener generation and sell non-utility and non-US. The uptick in natural gas costs presents a potential headwind. Though utilities largely pass through commodity costs to customers, they are indirectly impacted as higher fuel costs create less headroom to increase bills via infrastructure investment, thus potentially creating a contentious regulatory environment.

References to companies and sector are for illustrative purposes only and should not be viewed as investment recommendations.