

SEPTEMBER INVESTMENT GRADE CREDIT UPDATE

Yield Capture

TAMMY KARP | 11 OCTOBER 2023

Investment grade (IG) credit spreads remained resilient in September, as the macro headwinds from higher rates, a stronger dollar, the budget showdown, UAW strikes, and higher energy prices did not trigger a recalibration of valuations. Spreads continued to trade in a tight band (4 basis point (bp) range in September), defying signals from a hawkish FOMC, which left rates unchanged but shifted the “dot plot” higher and for longer. The extreme rise in government bond yields that ensued brought IG credit yields (of 5.95%) within spitting distance of the cycle highs reached in October 2022. Accordingly, the spread-versus-yield relationship decoupled further. At a ratio of 19%, the contribution to yield from spread reached a new (16-year) low.

Thematically, credit yields have been the dominant force behind the resilience in valuations (i.e., credit spreads). We agree that yields are too attractive to ignore. We are also acutely aware of the delicate balance between better investment yields and yields at levels that cause parts of the market to break. It is the lack of compensation above nominal Treasury rates that necessitates a more cautious approach to credit positioning. Moreover, flat term premiums across both credit spreads and yields favor a strategy of yield capture rather than one of spread compression. Consider the fact that the yield of 6.12% on the Bloomberg Long Credit Index (23yr average maturity) is only 25 bps higher than the 5.87% yield on the Bloomberg 1-3 Year Credit Index (2yr average maturity). Term premiums for credit spreads are also quite flat by historical standards. The spread differential between 30-year corporates and 10-year corporates is only 21 bps, which is the flattest that relationship has been outside of periods of severe stress (when curves tend to invert).

In addition to marginal term premiums, the beta compression witnessed over the past several months has driven the BBB-A basis to 41 bps as the reach-for-yield theme pushes investors down the quality spectrum. Any way you slice it, valuations as a whole are stretched. Spreads are trading well through long term averages, the compensation for extending maturities is marginal, and the extra spread for going down in quality is near the cycle tight. The IG credit markets are clearly pricing a Goldilocks outcome. With Q3 earnings approaching, we will get more insight on the state of the consumer. Thus far, the consumer has been resilient, underpinned by excess savings and a strong labor market. However, there are headwinds on the horizon, including the drawdown of excess savings, resumption of student loan payments, rising credit card balances, and the subsequent rise in delinquencies and charge offs. Higher rates for an extended period should continue to work their way through the economy, though the timing and severity is impossible to predict. Without the benefit of a crystal ball, our job is to assess whether the risk premiums associated with credit spreads (i.e., the expected excess return) are fairly priced. In our view, valuations in the IG credit market are priced to perfection.

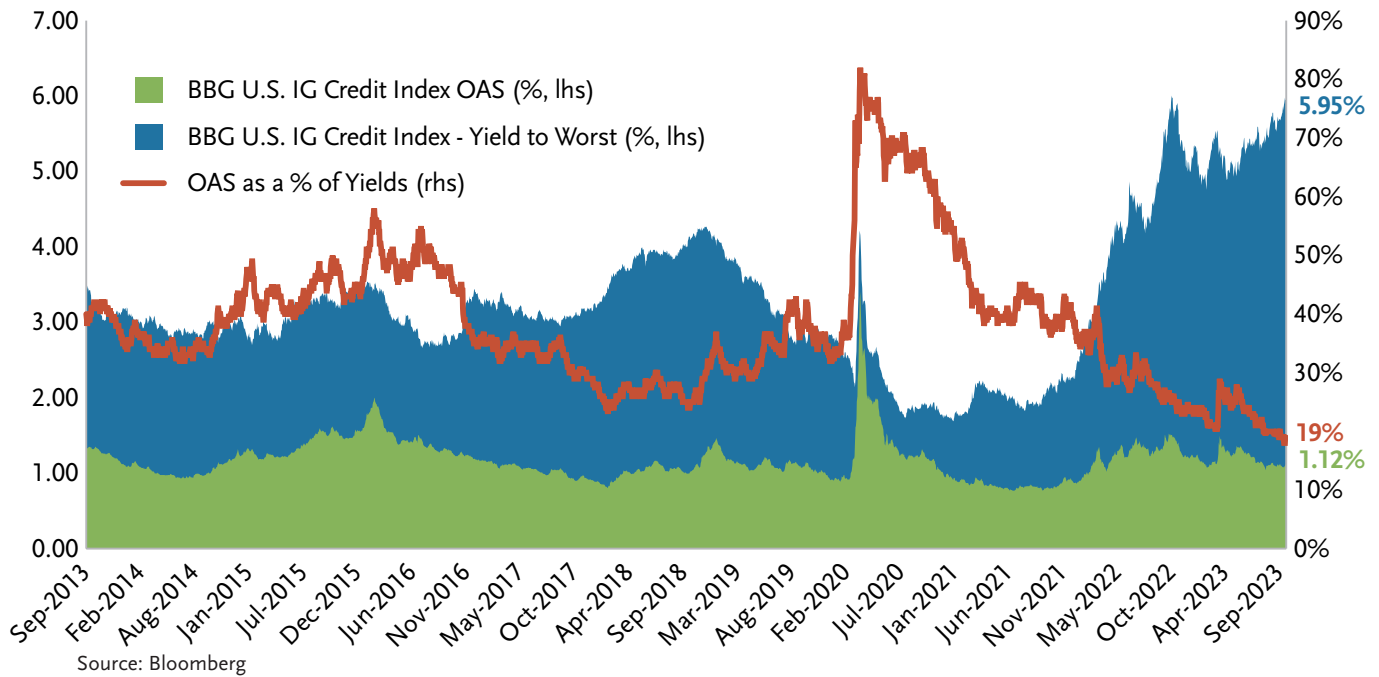


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Spread vs. Yield Decoupling: The Contribution to Yield From Spread Reached a New 16-Year Low of 19%

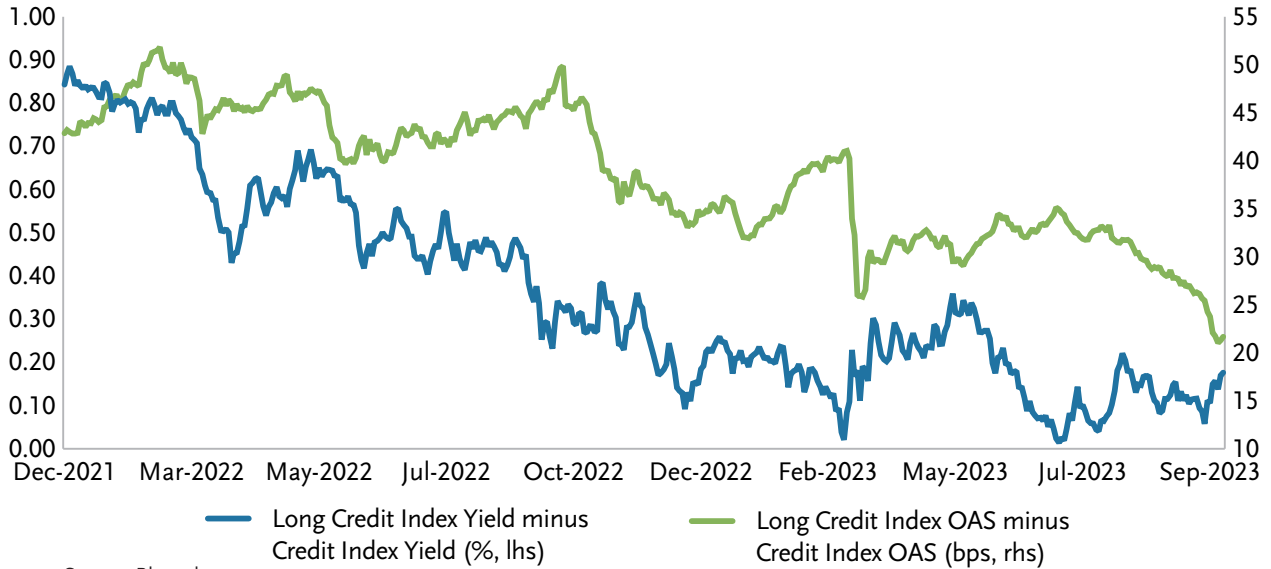


Term Premiums Have Collapsed for Both Credit Yields and Spreads



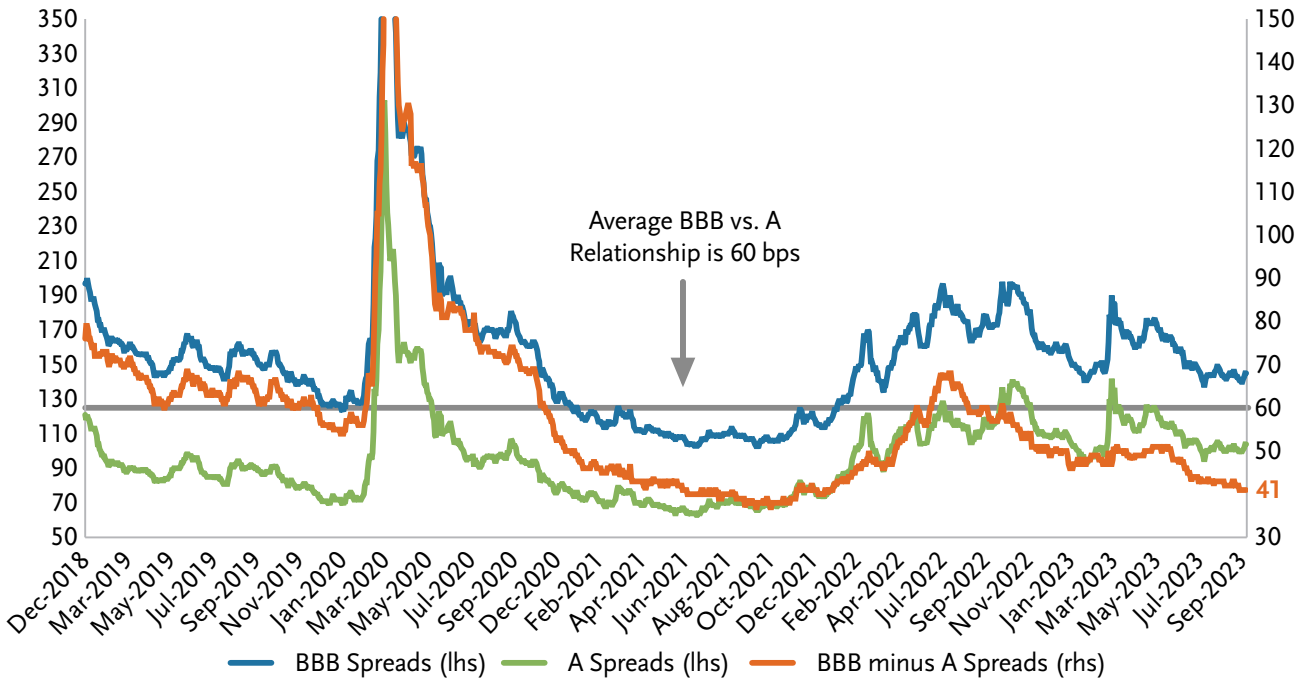
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Term Premiums Have Collapsed for Both Credit Yields and Spreads



Source: Bloomberg

BBB-A Basis of 41 bps Is Near the Cycle Tights (bps)



Source: Bloomberg

Yield Capture

Bloomberg U.S. Investment Grade Credit Index (IG Credit Index) Performance

IG credit spreads outperformed most asset classes as investor demand remained firm on the heels of higher/better investment yields. Higher risk-free rates produced the worst monthly returns (-2.6%) for IG credit since February, reversing nearly all the YTD gains. But as a whole, the impact of higher Treasury yields (highest nominal yields since 2007) did not trigger a meaningful repricing of IG credit spreads, which widened an average of 3 bps on the month to an Option-Adjusted Spread (OAS) of +112 bps.

Sector-level dispersion was evident, but did not follow the typical pattern of beta or cyclical decompression. For example, the sharp move in rates had a larger effect on bank and sovereign spreads than it did for life insurers or REITs (which is atypical). Cyclical generally outperformed, with the exception of autos which are impacted by the ongoing labor strikes. Both parties have moved closer to a middle ground on wages but are still far apart on several key issues, including the reduction to a 32-hour workweek and reinstatement of pension plans. In terms of wages, the UAW has moved from the original ask of a 40% increase while the automakers have moved up from 10% to around 20%. This year has seen widespread union victories across multiple industries beyond the auto sector. Examples include pilots at American, United, and Delta, who have secured wage increases of around 40% (over four years) and workers at UPS who secured a 30% wage hike over five years. This has been the year of the union. With labor costs going up across several sectors, profitability will be pressured, ahead of an economic cycle that may be turning.

Energy-related sectors outperformed (-2 bps), driven by higher oil prices (WTI up 8.5% on the month). OPEC production cuts and a global rebound in demand have created a supply/demand deficit of roughly 2 mm barrels per day in Q3. As a result, global and domestic oil inventory levels are below their five-year averages. Fundamentals for the sector have improved, as the post-pandemic rebound in profits resulted in significant de-leveraging and subsequent ratings upgrades. Balance sheets are currently in good shape but valuations already reflect that. At the current weighted average spread of +75 bps over Treasuries, integrated energy is the second tightest trading sector within the IG Credit Index (after consumer products). Current valuations are not compelling given the vulnerability to an economic downturn and asymmetric characteristics of this sector.

The worst performing sectors in September were banks (+11 bps), sovereigns (+9 bps), media (+9 bps), and autos (+6 bps). Banks underperformed for the second consecutive month, with spreads for the big six U.S. banks widening 9 bps on the month (10yr average spread of +163 bps) while regional bank spreads widened 20 bps (10yr average spread of +218 bps). Higher interest rates drove the underperformance, as the scars from the bank failures earlier this year are still impacting sentiment. While bank profitability will be impacted by higher deposit costs, earnings power has remained quite healthy for the big six banks as the diversified stream of revenues provide a stabilizing force throughout all phases of the economic cycle. A weakening consumer backdrop will result in higher credit losses (from current low levels), but banks are well reserved against it (1.7% loss reserves). Capital, asset quality, and liquidity remain strong for the large global systemically important banks (GSIBs). The strict regulatory regime under which banks operate, prioritizes capital and liquidity, thereby posing less systemic risk to the system (and bondholders). At an average spread of +163 bps over Treasuries, the big six U.S. banks still offer compelling value, in our view.

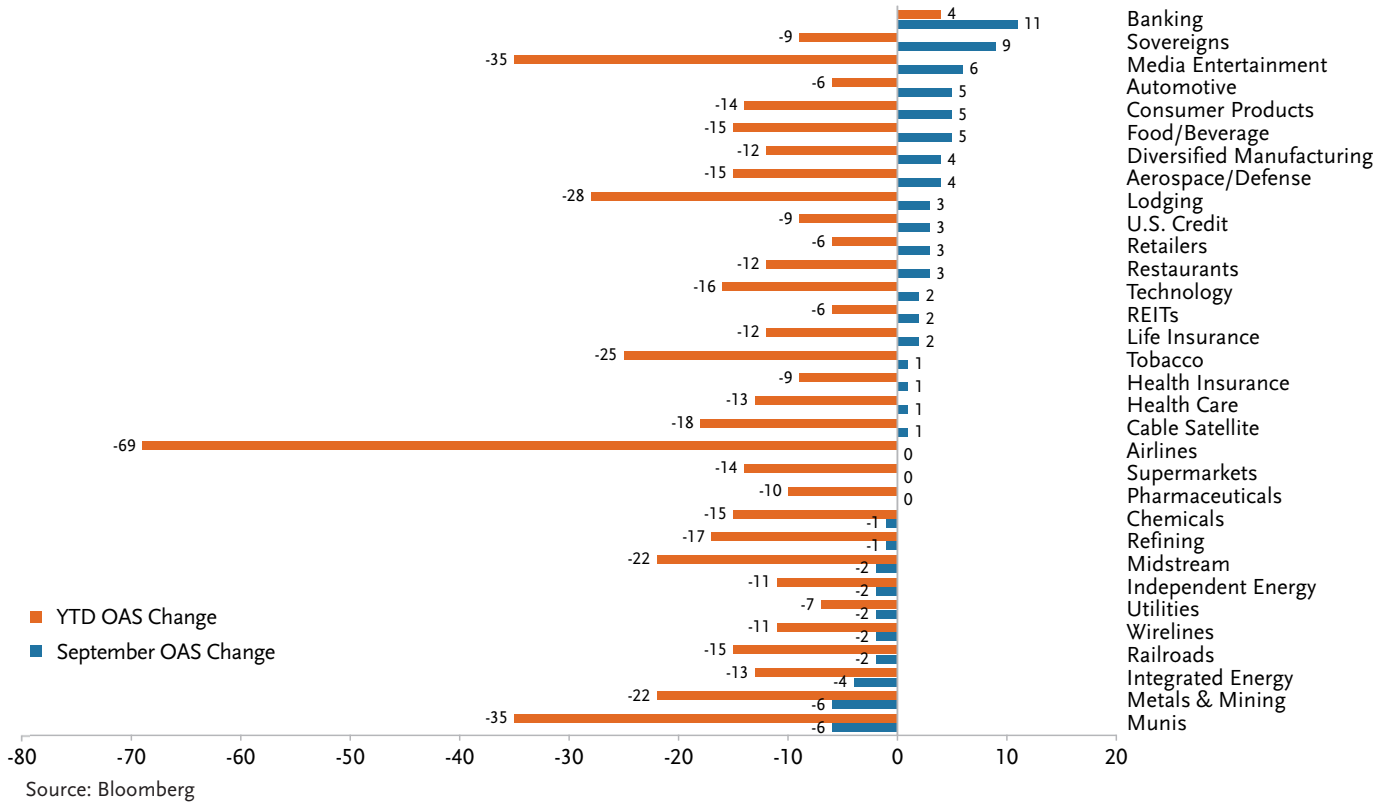
IG Credit Index Returns

	September Excess Return	September Total Return	YTD Excess Return	YTD Total Return	9/30/2023 OAS (bps)	MTD OAS Change (bps)	YTD OAS Change (bps)
Credit Index	0.03%	-2.60%	2.25%	0.03%	112	+3	-9
Industrials	0.15%	-2.97%	2.76%	-0.16%	110	+2	-15
Financials	-0.22%	-2.03%	1.76%	0.73%	140	+8	0
Utilities	0.45%	-3.14%	2.00%	-1.58%	122	-2	-7
Municipals	0.49%	-3.64%	4.27%	-0.12%	93	-6	-35
Sovereigns	-0.74%	-4.39%	2.16%	-1.58%	122	+9	-9
AA	0.17%	-2.85%	2.07%	-0.72%	58	0	-12
A	-0.05%	-2.73%	1.92%	-0.43%	105	+5	-4
BBB	0.07%	-2.63%	2.84%	0.56%	146	+3	-13
1-5yr	-0.16%	-0.49%	0.71%	1.90%	85	+8	+6
5-10yr	-0.32%	-2.57%	2.00%	0.26%	130	+6	-11
10+ yr	0.56%	-5.29%	4.21%	-2.62%	133	-4	-24

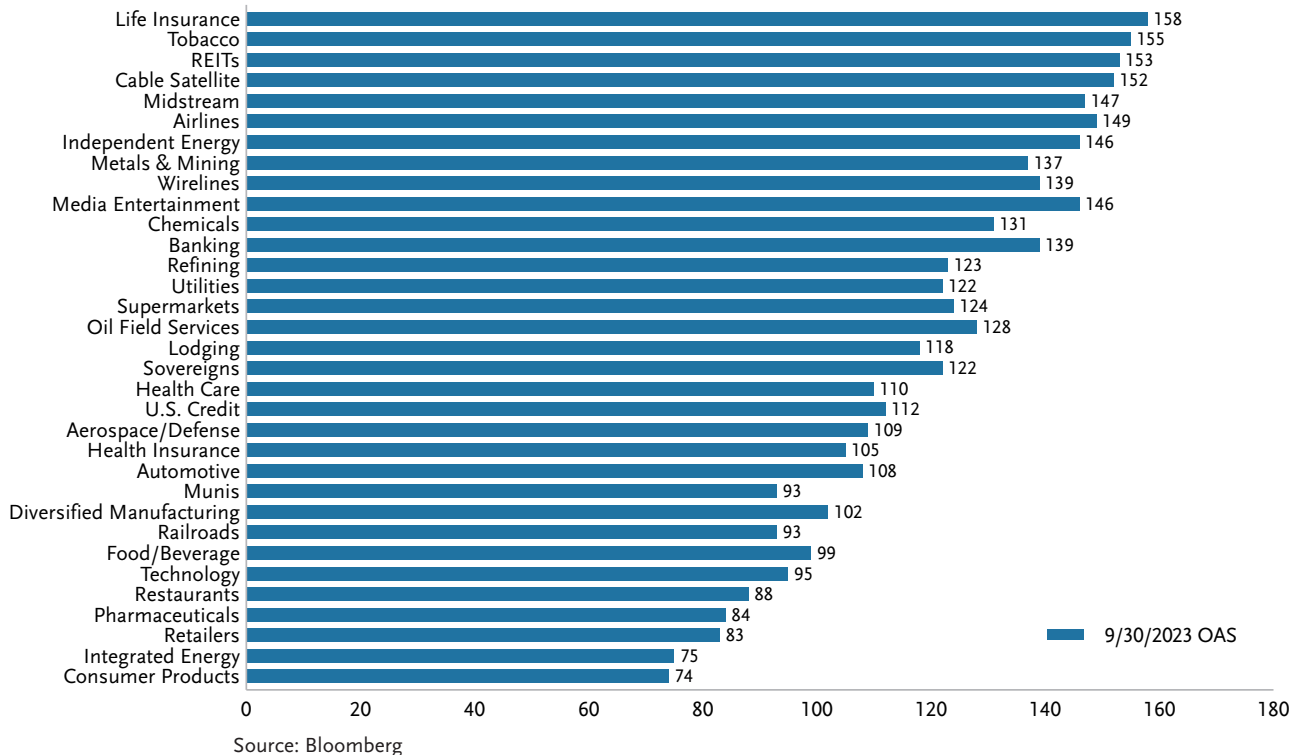
Source: Bloomberg

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September and YTD Sector OAS Changes (bps)

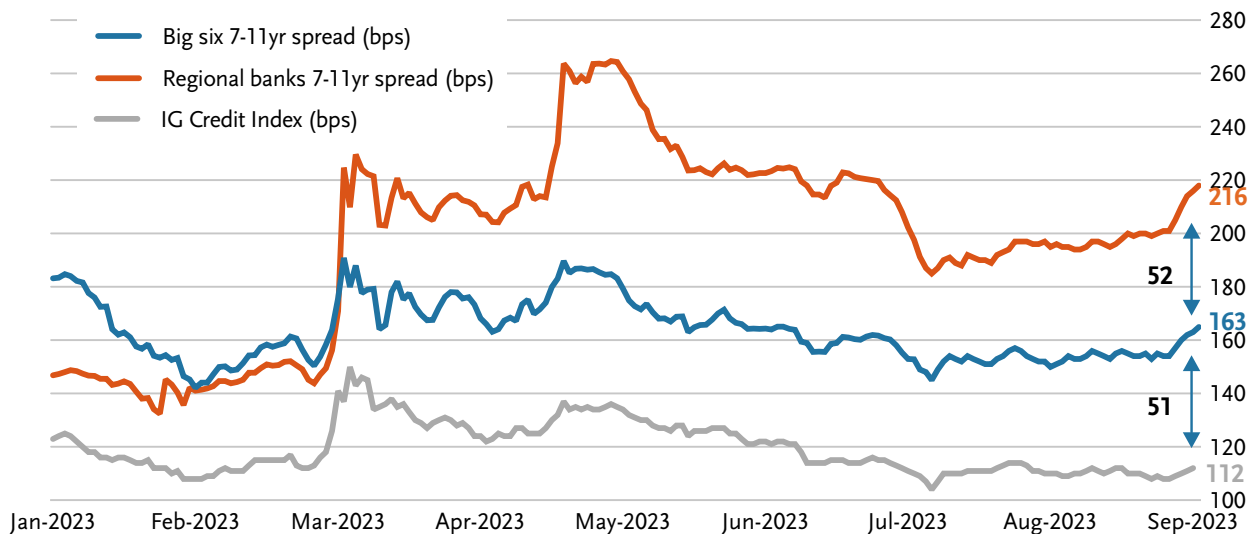


Sector Spreads as of September 30, 2023 (bps)



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Banks spreads underperformed for the second consecutive month.
On a relative basis, the sector is still trading wide versus its historical relationship to the overall index.



Source: Bloomberg

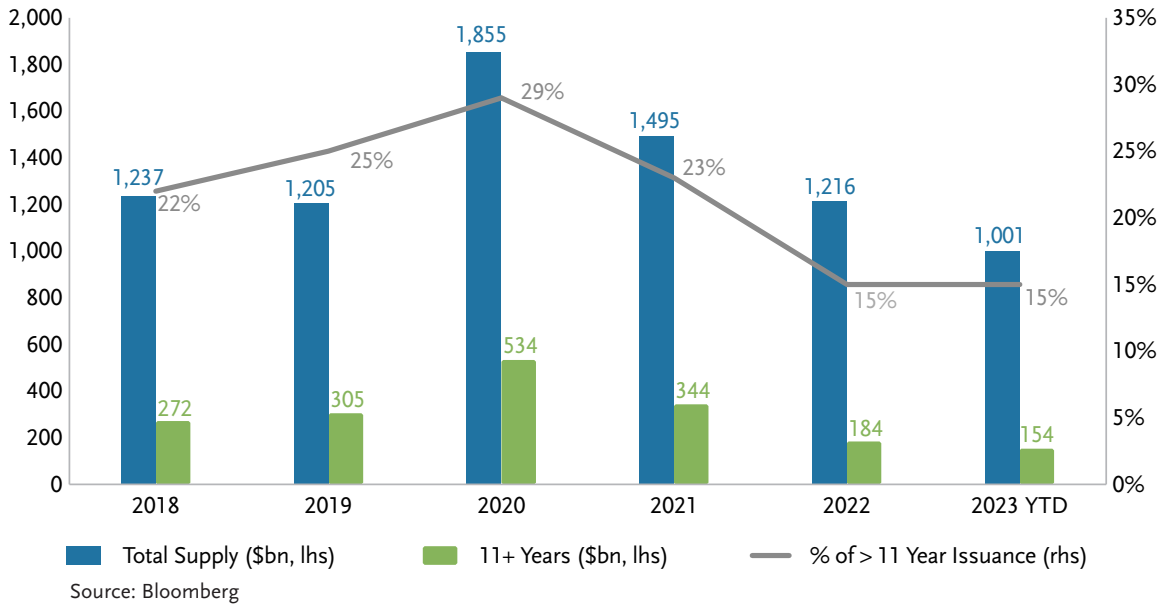
New Issue Recap

After an underwhelming new issue calendar in August, September volumes resumed a more typical pattern. Monthly new issue volumes totaled \$128.4 bn, balanced between financials (\$65.5 bn) and non-financials (\$62.9 bn). Within financials, bank supply accelerated to \$54.7 bn (versus YTD monthly average of \$33 bn), dominated by non-U.S. issuers. Supply out of the big six U.S. banks totaled \$13.5 bn, bringing the YTD total to \$82 bn, a 48% decline versus 2022. The two largest deals came from Bank of America (\$8.5 bn across three maturities, 5yrs priced at +140 bps, 10yrs at +160 bps) and Citibank (\$5 bn bank level debt, 2yrs priced at +73 bps, 5yrs at +118 bps).

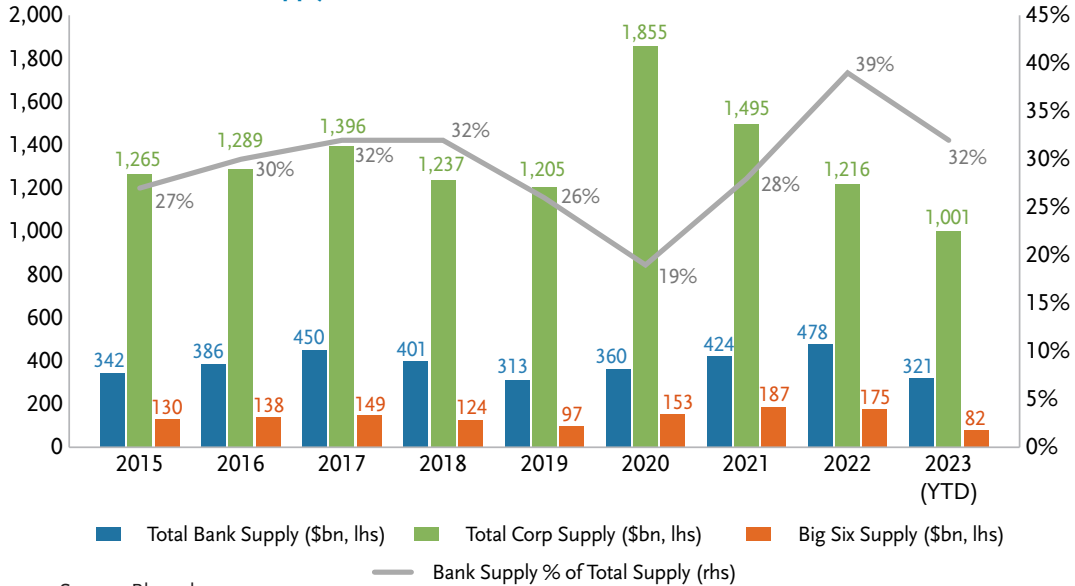
M&A-related issuance remained modest at \$11.5 bn. Thematically, several issuers have opted to fund acquisitions with short-term financing vehicles like commercial paper (in the case of Microsoft) and/or bank loans (in the case of Broadcom) as they wait for a lower rate environment. The reluctance to lock in higher funding costs has impacted long dated corporate bond issuance most acutely. Issuance in the long-dated part of the IG credit market (defined as > than 11 years) was a meager \$12.5 bn in September, which is just 10% of total supply. YTD, long dated supply of \$154 bn comprises just 15% of the total, down from the five-year average of 23%. This has exacerbated the supply/demand imbalance for longer dated corporate bonds and has contributed to the extreme flattening of credit curves.

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The Share of Long Dated Issuance Continues to be Well Below Historical Averages



Bank Supply Volumes Have Normalized After Last Year's Record



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