CION Credit Market Update – December 31, 2020

Markets Get the Goal, the Fed Gets the Assist. And Next Year?

2020 Is Finally Done ...

December saw vaccine deployment, drama around passing a stimulus, and continued spikes in the coronavirus as the holiday season got into full swing.

Credit markets, however, were decidedly taking a break from volatility. Even before the mid-month FOMC meeting and Powell's statements, the yield on the 10-year U.S. Treasury was largely stuck in a narrow range, between .90% and .95%. The benchmark rate ended the year at .93%.

Powell's comments that rates will remain "the same for many years" was given scope by the Fed's projections that it does not see a rate increase until 2023. Despite projections of more robust growth in 2021 and 2022, the Fed also does not see unemployment getting back to pre-virus levels until 2023, which ties to its belief that average inflation will not reach 2% until then.

The Fed's policy statement adjusted its stance on quantitative easing (QE) asset purchases. It is committed to continuing to increase holdings of Treasury securities by at least $80 billion per month, and of agency mortgage-backed securities by at least $40 billion per month. The Fed's policy statement notes that these asset purchases "help foster smooth market functioning and accommodative financial conditions."

The wording would seem to indicate that the Fed is more focused on using QE as a tool to promote accommodative monetary policy, which likely means that QE will persist even as the COVID-19 crisis abates. Along with additional fiscal stimulus, whether through direct stimulus packages or additional federal spending, the Fed's dovish stance on monetary policy should result in the economy heating up and achieving the goals of lower unemployment, expanded participation in the labor force, and lower inequality through rising wages for more of the workforce.

What about 2021?

The Global Aggregate Index which comprises governments, mortgages and asset-backed securities, and investment grade corporate bonds returned 7% in 2020, and the Corporate Bond index turned in a 9% total return performance. Is it repeatable next year? Consensus expectations are that the 10-year U.S. Treasury will end 2021 at or slightly above 1.5%, if the recovery gains momentum. Short-term rates likely remaining unchanged and long-term yields potentially moderately higher could result in a steeper yield curve. For investors, that may put a damper on price appreciation.

Expectations are that spreads will continue to narrow in 2021, as investors become more confident about the recovery. However, bond selection and thorough credit analysis will be critical.

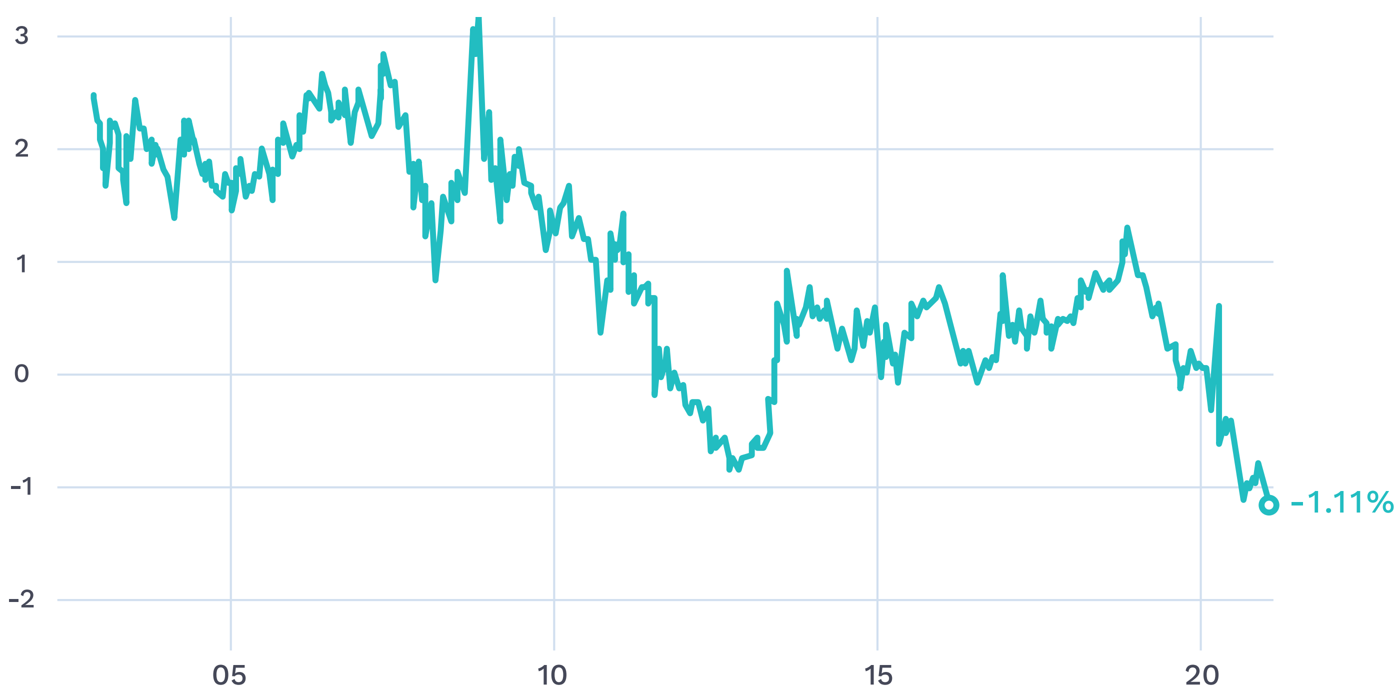
Performance Among Credit Indices

	11/30/2020 - 12/31/2020	YTD (as of 12/31/2020)
Credit Suisse Leveraged Loan Total Return Index (CSLLLTOT)	1.29%	2.78%
Bloomberg Barclays US Corporate High Yield Total Return Index (LF98TRUU)	-1.88%	7.11%
Bloomberg Barclays US Aggregate Total Return Index (LBUSTRUU)	0.13%	7.51%
Bloomberg Barclays Municipal Bond Index (LMBITR)	0.60%	5.21%
Palmer Square CLO Debt Index (CLODI)	1.54%	6.82%

Source: Bloomberg as of 1/06/2021

Chart Spotlight: Real Yields Continue to Decline

On January 4th, the real yield on the U.S. 10-year Treasury note fell to its lowest level on record, declining to -1.11%, meaning that, after accounting for expected inflation, holding a 10-year U.S. Treasury bond to maturity will mean *losing* more than 1% annually.



Source: St. Louis Fed (FRED), Axios

Credit Asset Classes

Private Credit	Structured Credit	High Yield
Private Debt Investor (PDI) reports that for 2020, "Private debt managers and their investments, on the whole, have been resilient, as demonstrated by the relative lack of defaults." According to Proskauer, a law firm that tracks private debt loans in the US, the default rate for Q3 was 4.2%, down from 8.1% in Q2 and lower even than the 5.9% rate in the first three months of the year. Every year, PDI names a "PDI 50" of top fundraisers. The capital raised by the class of 2020 is around $880 billion, easily surpassing the $775 billion total for last year and 2018's $700 billion. Even more interesting, 46.4% of the total capital raised was accounted for by the top 10 managers – demonstrating that size, scale and flexible capital do matter.	The U.S. leveraged loan market experienced a fourth-quarter recovery, despite the Fed's near-zero rate policy, and limited Central Bank support in comparison to other asset classes, such as high-yield bonds. Year-to-date returns were 2.79% at the Dec. 16 close, from year-to-date losses of 20.07% on March 23. In early December, S&P Global conducted a Leveraged Loan Survey that polled a mix of buy-side, sell-side and advisory firms for their point of view on the upcoming 12 months. Market participants, on average, expect the default rate of leveraged loans to end 2021 at 4.76%, up from 3.89% currently. In almost equal measure, the majority of buy-side and sell-side respondents expect the default cycle to end in 1 to 2 years, and to not exceed 6% at the height.	High yield corporates finished the year extremely strong, posting positive returns for seven consecutive weeks and 11 of the last 12. Spreads continued to narrow and decreased by 8 basis points (bps) on the last full week of the year, to 377 bps — far tighter than their long-term average of 528 bps. High yield is likely to see continued strength on investor appetite for both risk and yield in this persistent low yield environment. While the record issuance of 2020 meant many companies were able to extend their runway, not all will survive. As we enter the "repair" phase of the credit cycle and companies seek to bolster their balance sheets, credit selection will be paramount in finding opportunities.

Other Related Asset Classes

Treasuries	Investment Grade Corporates	Municipals
Longer-dated Treasury yields have risen and the yield curve has steepened as expectations of more fiscal spending, and the likelihood that the Federal Reserve will maintain its dovish monetary policies for years to come, led investors to increase bets on higher inflation. The yield curve between two-year and 10-year notes hit a three-year high of 83 basis points during the month. Ten-year Treasury-Inflation-Protected-Securities (TIPS) are pricing in expectations of 1.95% average annual inflation for the coming decade, the highest since April 2019.	Investment grade bonds saw record issuance in 2020 – and led the pack in returns. By the last week of the year, continued spread tightening couldn't offset the long duration of the asset class (8.8 years) and performance was negative, with only Treasuries finishing lower. Is this a harbinger? In terms of issuance, the Financial Times, citing data from Refinitiv, notes that "Bankers expect a steep drop in corporate fundraising next year after a record borrowing binge of $5.35 tn in 2020." Analysts at Bank of America predict net new issuance of US investment-grade bonds will drop 76 per cent in 2021. This would result in the lowest amount since the bank began tracking data in 2002.	Municipal yields finished the year in the midst of yet another rally as technicals continue to support the asset class. The start of the vaccine rollouts, future potential for increased taxes, lack of relative supply, and heavy cash positions, as well as the additional stimulus has resulted in a very bullish market tone. New issue supply for the last full week of the year before the holiday of $9.2 billion was priced to sell and well received. Fund flows were positive at $915 million.

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