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INVESTMENT GRADE CREDIT TEAM

Deconstructing Opportunities in IG Credit

Amid narrow spreads, a focus on sector and credit research and a willingness to take tactical positions could help to capitalize on potential dislocations across the U.S. investment grade credit universe.

Continued economic resilience and solid credit fundamentals have contributed to historically narrow spreads among investment grade corporate bonds, which have recently maintained a tight trading range with limited volatility. This has happened despite a surge of supply so far this year, which has been aided by an uptick in merger-and-acquisitions-related financings.

The situation naturally leads to the question of whether currently tight spreads can be maintained, or whether the pressures of higher rates or potential economic slowing will shake investor confidence and undermine the financial foundations of some companies. Overall, we believe an increase in idiosyncratic risk is likely from here, requiring a degree of caution, but also setting the table for opportunity where there is market dislocation and asset mispricing—in other words, a situation ideally suited to skillful practitioners of sector and credit research.

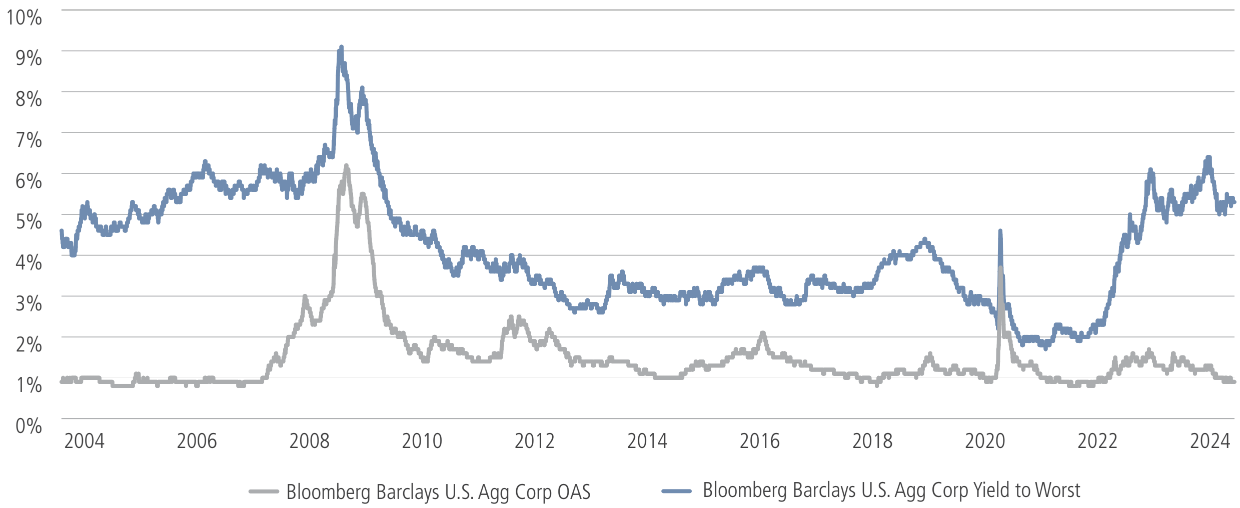
In this *Insights*, we assess the current state of the U.S. investment grade corporate sector, including market structure, technical influences and fundamental trends, to highlight potential sources of risk and opportunity in the coming months.

Valuation and Yield

The investment grade corporate market is currently characterized by narrow spreads, but also appealing all-in yields driven by the Federal Reserve's monetary tightening campaign. A healthy fundamental environment coupled with strong demand for income has helped keep changes in valuation relatively subdued.

ATTRACTIVE ALL-IN YIELDS ARE SPURRING DEMAND

U.S. Corporates Option-Adjusted Spread vs. Yield to Worst



Source: Bloomberg, as of March 31, 2024.

Credit Quality Evolution

The quality of the U.S. Investment Grade Corporate Index has improved in recent years, with the proportion of BBB industrials in decline since 2019. This "shrinking BBB" narrative and modest quality improvement among industrial issues have generally been supportive of valuations. However, our expectation is that BBBs will remain the preferred capital structure sweet spot for Industrials, even in a higher interest rate environment. That said, it's worth noting that credit quality trends alone do not fully justify the current low-spread environment.

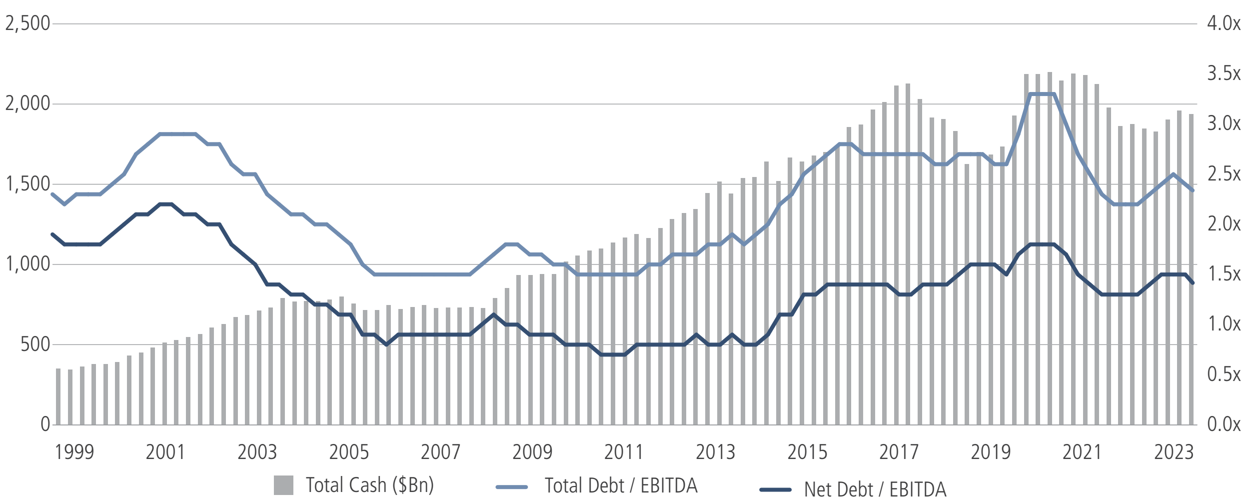
INDUSTRIAL BBB BONDS' PERCENTAGE OF U.S. INVESTMENT GRADE CORPORATE INDEX BY MARKET VALUE

Source: Bloomberg, as of March 29, 2024.

Industrial Credit Fundamentals Are Healthy

Overall, the fundamental backdrop remains supportive. Credit fundamentals are healthy, and issuers have generally behaved conservatively after emerging from the pandemic with stronger balance sheets. Some of that strength has deteriorated as excess cash balances and pandemic-era excess liquidity have appropriately abated; however, most companies have termed out maturities and exercised prudent financial policy with support from a positive macroeconomic backdrop. That said, leverage has been normalizing up from its recent trough, and interest coverage has deteriorated—leaving investors less room for error in the current narrow-spread environment. Our expectation is for leverage to remain rangebound around recent levels, supporting our view that credit fundamentals should remain healthy given the expected macroeconomic backdrop.

CORPORATE CASH AND KEY LEVERAGE RATIOS



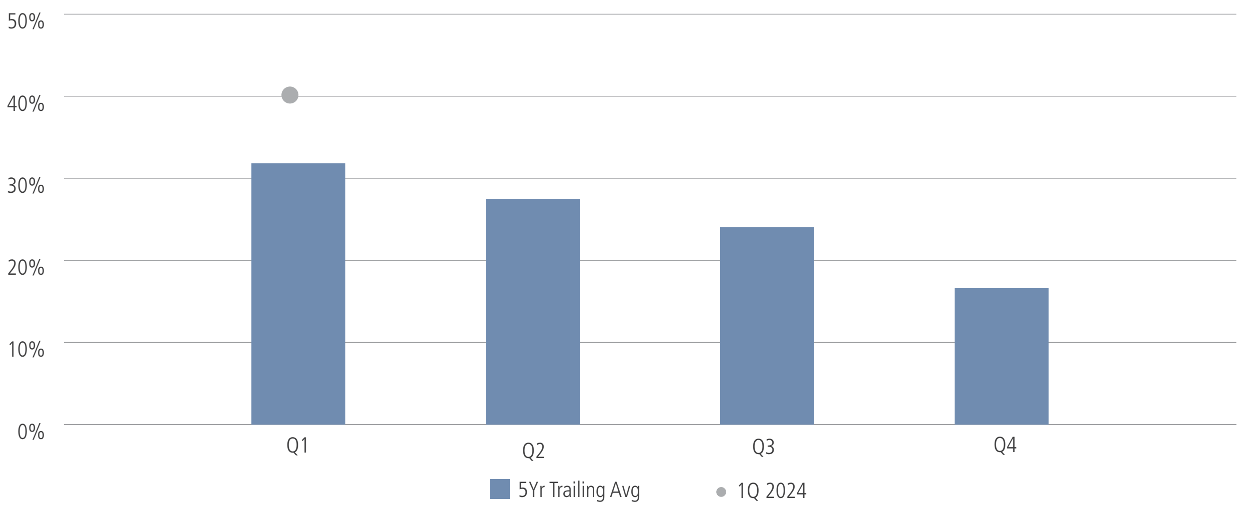
Source: Bloomberg, as of December 31, 2023; S&P 500 ex-Financials.

Supply and Demand

Supply is up over 30% year-to-date with some pull-forward of financing, but has been easily absorbed by strong demand. After a period of subdued issuance among longer maturities, since February companies have been moving further out on the yield curve. A meaningful portion of recent long-dated issuance has been used to finance M&A activities in Health Care/Pharma, which may indicate that these companies are not finding current rates prohibitive. Rather, they may have accepted that rates have likely peaked, but believe that waiting any longer may not provide material benefits that offset delaying business plans. Overall, we expect fiscal year 2024 to see around a 10% increase in supply—slightly higher than our expectations a few months ago.

SUPPLY IS OFF TO A STRONG START THIS YEAR

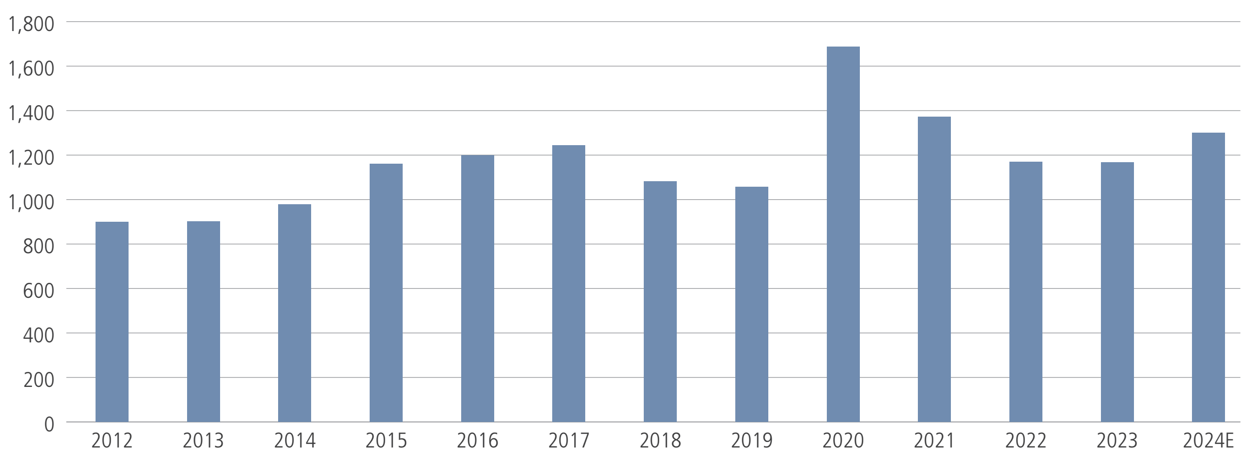
U.S. Investment Grade Corporate Supply: Quarterly Percentage of Annual Supply



Source: LCD, as of March 31, 2024. 1Q 2024 figure based on fiscal 2024 estimate.

FULL-YEAR SUPPLY EXPECTATIONS ANTICIPATE SOME SECOND-HALF DECELERATION

Annual U.S. Investment Grade Corporate Issuance ($Bn)

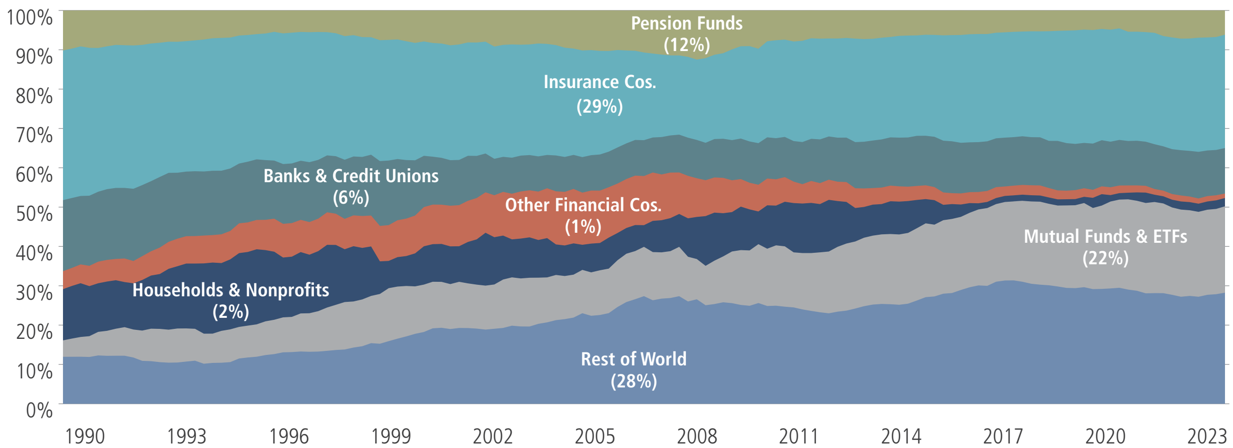


Source: LCD, as of March 31, 2024.

On the demand side, we have seen strong demand from insurance companies, pension funds and ETFs, while investment flows from the rest of the world have also been robust. Given the level of all-in yields, we expect this trend to continue for the rest of the year.

DIVERSE SOURCES OF DEMAND

Percent of Investment Flows Into U.S. Investment Grade Corporates



Source: Goldman Sachs. Data as of December 31, 2023.

Investment and Sector Strategy

Industrial companies have outperformed Financials since February 2023, with valuations in Financials affected by the residual overhangs of regional bank stress that culminated in the bankruptcies of Silicon Valley Bank and Signature Bank in March 2023 and the release of significant supply into the financial sector during that year. We expect the recent developments around New York Community Bank to remain idiosyncratic, with limited implications for the broader sector; moreover, we expect Financials valuations to continue to compress relative to Industrials.

Within Industrial sectors, we currently believe that a tactical approach is preferable. Leaders in bond market value growth have included sectors such as Technology, Health Care, and Aerospace and Defense, which have historically generated substantial, stable cash flows, which in our view should contribute to the resilience of their credit spreads. Fast growers in the Technology sector are often high-quality issuers with strong market positions in business segments benefiting from positive long-term secular trends. Mergers and acquisitions have been a key driver in the Health Care sector as issuers have repositioned their portfolios for future growth while generally maintaining a commitment to conservative financial policies. That said, some outliers within the Health Care/Pharma space warrant monitoring as not all leveraged deals will be successful. Elsewhere, Aerospace and Defense companies continue to have strong cash flow streams, despite higher incidents of idiosyncratic risk (with Boeing as a recent high-profile example), requiring a more tactical approach.

The Path Forward

Sector dispersion is low, volatility is low and spreads are low, but all-in yields are elevated. In our view, this sets up an environment where the room for error is also limited, despite the very supportive technical backdrop. We continue to emphasize fundamental sector and issuer research, mindful that positive technical dynamics should not lead to complacency.

Overall, we favor a tactical approach and believe that, should volatility pick up, greater dispersion among issuers is likely to occur, helping make credit selection a key driver of alpha. We continue to favor Financials given current valuations and fundamentals. More broadly, we like cashflow-generative bonds in the BBB rating category, and believe that idiosyncratic risks will present attractive opportunities as valuations over- or underreact to macro and credit news. This may be particularly true moving toward the U.S. election, which could increase market turbulence and create new opportunities based on volatility-driven displacement.

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