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Insight INVESTMENT

APRIL 2022

US PENSION MARKET

A statistical and qualitative review of Q1 2022 and investment outlook

2022 began with hopes that the pandemic was finally drawing to a close, as governments around the world started to drop restrictions on the belief that the virus had become endemic. With the stop-start cycle of lockdowns and vaccinations appearing to be over, the combination of super easy monetary policy and multi-decade highs for inflation became harder for central banks to justify. Rhetoric hardened, and markets pulled forward their expectation for when the tightening cycle would start. In the US, forecasts solidified around a first hike in March, then an increasingly exuberant market moved to price in a 50-basis point hike.

Unfortunately, as John Lennon famously wrote in the lyrics to the song 'Beautiful Boy' – Life is what happens when you're busy making other plans… In late February Russia launched a full-scale military invasion of Ukraine and the world entered a period of deep uncertainty. Amidst the turmoil, investment grade credit spreads widened significantly, returning to long-term average levels. Treasury yields initially rallied, buoyed by concerns about the impact on growth, before reversing sharply as the Federal Open Markets Committee shifted to a more hawkish tone at their March meeting. It appears that uncertainty is here to stay.

- **Fed outlook for 2022**: The tightening cycle started with a 25-basis point hike in March but came with a hawkish shift in rhetoric; the median committee member expects a total of seven hikes in 2022, one of the fastest tightening cycles in recent history.
- **Solutions**: Many pension plans have experienced a significant improvement in funded status over recent years. With the outlook less certain, a downside protection strategy is one way to prevent your plan's funded status from deteriorating.
- **Pension news**: A Request for Information from the DOL seeks public comment on what actions it should take to protect pensions from changes in climate, while the conflict in Ukraine has resulted in Russia being removed from a broad range of indices, putting pressure on pension plans to divest any holdings they have.
- **Credit**: We outline why we believe BBB has become the new normal in investment grade credit, representing the sweet spot from a cost of capital perspective. We believe an allocation to below-investment grade credit can potentially allow a strategy to capture credits being upgraded to BBB.
- **Investment outlook**: A sharp upward move in both yields and spreads has made us more constructive on investment grade credit from a total return perspective, but we are concerned that yields could continue to move higher. In higher risk segments of credit markets, we have moved to a more defensive stance, but in structured credit and muni's we believe higher yields could present an opportunity.
- **Key risks**: An overly aggressive Fed could raise the risks of recession or events in Europe could spiral, creating a market shock.
- **Educational section**: With US inflation at the highest levels since the 1980s, investors are worried about how long it will remain elevated. We attempt to answer this question – not by looking at supply chains, energy prices or goods and services – but by focusing on what has historically been the most persistent and long-term driver of CPI: rental inflation.

Life is what happens when you're busy making other plans

JOHN LENNON (BEAUTIFUL BOY)

FED OUTLOOK 2022
– A HAWKISH SHIFT

The US FOMC raised interest rates by 25 basis points at their March meeting, as generally expected. In their accompanying statement, they noted that the implications to the US economy from the invasion of Ukraine were "highly uncertain", but that "in the near term the invasion and related events are likely to create additional upward pressure on inflation and weigh on economic activity".

The tone of the post meeting speech by Chair Jerome Powell, and the updated dot plot (see Figure 1), which shows members forecasts for future interest rates, were clearly designed to reassert Fed credibility. The median member expected a total of seven rate hikes in 2022, followed by three to four hikes in 2023.

The hawkish rhetoric continued post the meeting, Fed Governor Christopher Waller stated that "half-point rate hikes could be needed as inflation is raging", and James Bullard, President of the St. Louis Fed, called for the central bank to raise rates to above 3% "this year". Chair Powell, in a speech titled "Restoring Price Stability[1]", noted the rising risk that an extended period of high inflation could "push longer-term expectations uncomfortably higher", concluding that the Fed "has the necessary tools, and we will use them to restore price stability."

Minutes for the meeting, released some weeks after, revealed that a 50 basis point hike would have occurred if there had not been the uncertainty stemming from events in Ukraine, and that there was discussion around a plan for balance sheet reduction. It was generally agreed that once started, balance sheet reduction would increase to a cap of $95bn ($60bn in Treasuries and $35bn in mortgage-backed securities) per month within three months.

Figure 1: The median dot plot now anticipates between 10 and 11 rate hikes by the end of 2023[2]

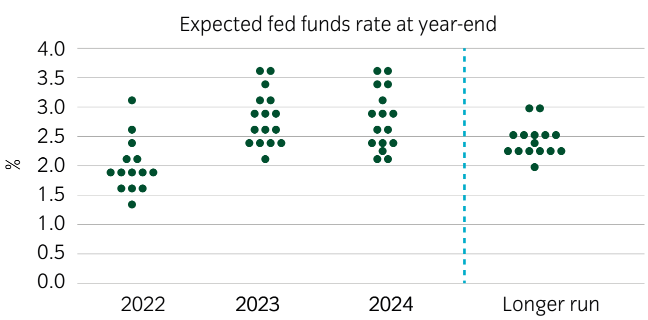
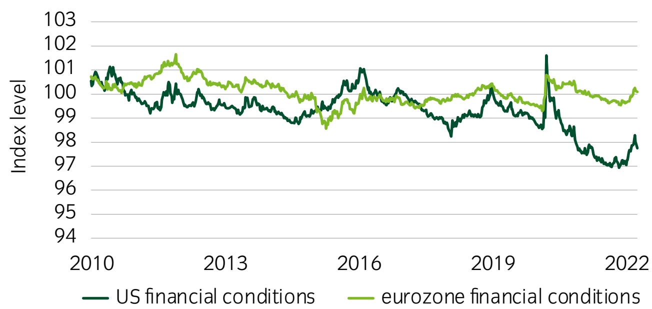


Figure 2: Financial conditions are considerably looser in the US than the eurozone[3]



Notably, the path of expected future US interest rates has now diverged considerably from other major central banks. A number of forecasters have moved to anticipate both a 50 basis point hike at the May meeting, and the announced start of the balance sheet reduction plan.

Meanwhile in Europe, the Bank of England raised interest rates by 25 basis points to 0.75% as expected at their March meeting but noted that only a "modest" tightening of monetary policy may be appropriate in the coming months. In the eurozone, European Central Bank President Christine Lagarde noted that the ECB would only raise rates "some time" after its bond-purchase program finished, which is still expected to be some months away.

Although it helps that the US is geographically distant from the conflict, an examination of financial conditions indices shows the backdrop is significantly more stimulative in the US than the eurozone. The divergence in central bank outlooks simply reflects that US economic growth is likely to outpace other major economies, leaving the Fed with far less flexibility to wait and see on inflation.

[1] Source: March 2022, https://www.federalreserve.gov/newsevents/speech/powell20220321a.htm [2] Source: Federal Reserve
[3] Source: Insight, Bloomberg, Goldman Sachs. Data as at March 31, 2022. Financial conditions indices aggregate a broad range of financial instruments including debt, equity and currency markets to determine how easy or tight policy is in a country or region.

PENSION
TRENDS

PENSION FUNDED STATUS UPDATE

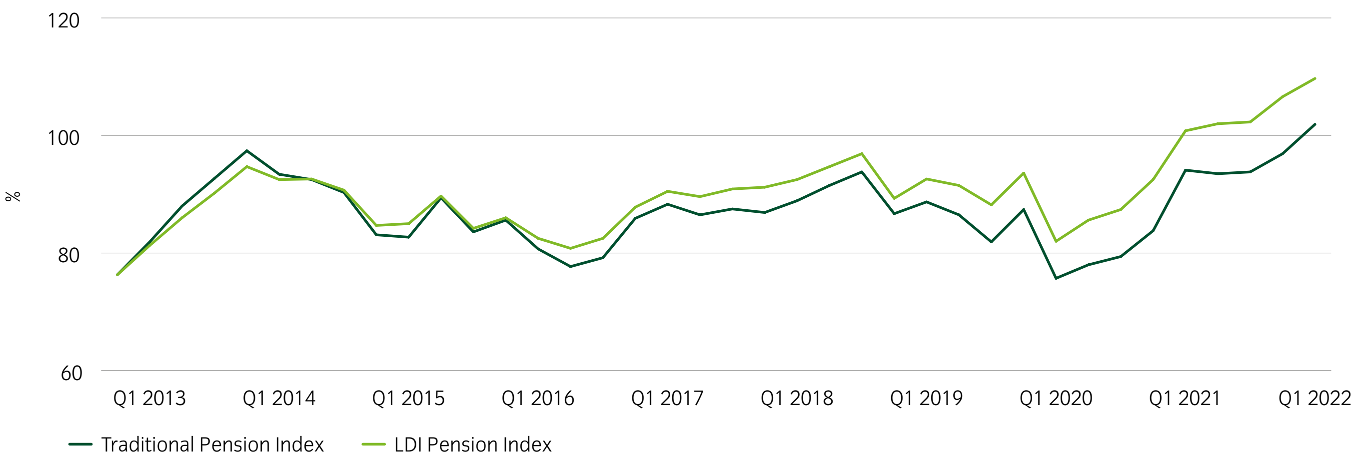
Insight maintains two model pension indices, both of which assume a 60% allocation to growth assets and a 40% allocation to bonds. The Traditional Pension Index aims to reflect those plans that have not yet adopted LDI. The LDI Pension Index aims to reflect those plans that have adopted LDI in the fixed income portion of their portfolio.

Rates increased by 66bp over the quarter and spreads widened by 12bp, resulting in a 78bp increase in discount rates. Growth assets declined by 4.3%.

Both of our pension indices saw their funded status improve over Q1, primarily due to the rise in discount rates, following a significant improvement over 2021.

The Traditional index, which contains core fixed income, saw its funded status increase by 5.0% to 101.9%, while the LDI index, which contains long duration fixed income, saw its funded status improve by 3.1% to 109.7%. Over 2021, the funded status of the Traditional index increased by 13.1% and the LDI index by 14.1%.

Figure 3: Plan funding ratios improved for another quarter[4]



[4] Source: Insight and Bloomberg. Data as of March 31, 2022. Note: Beginning in 2014, we introduced two indices to provide insight into the impact of rate and market movements on three types of pension plan investors. Traditional Pension Index: The index reflecting those pensions that have not yet adopted LDI. LDI Pension Index: The index reflecting those who have adopted LDI in the fixed income portion of their portfolio. Assumptions behind the Insight indices include 14-year typical pension liability duration, 45% equity allocation, an aggregate 5% liability impact of updated mortality assumptions effective Q4 2014 and no external cashflows. WHERE MODEL OR SIMULATED RESULTS ARE PRESENTED, THEY HAVE MANY INHERENT LIMITATIONS. CLIENTS' ACTUAL RESULTS MAY BE MATERIALLY DIFFERENT THAN THE RESULTS PRESENTED. UNLIKE AN ACTUAL PERFORMANCE RECORD, MODEL RESULTS DO NOT REPRESENT ACTUAL TRADING AND MAY NOT REFLECT THE IMPACT THAT MATERIAL ECONOMIC AND MARKET FACTORS MIGHT HAVE HAD ON INSIGHT'S DECISION-MAKING IF ACTUAL CLIENT FUNDS WERE BEING MANAGED. ALSO, SINCE SUCH TRADES HAVE NOT BEEN EXECUTED, THE RESULTS MAY HAVE UNDER OR OVER-COMPENSATED FOR THE IMPACT, IN ANY, OF CERTAIN MARKET FACTORS, SUCH AS LACK OF LIQUIDITY. SIMULATED TRADING PROGRAMS IN GENERAL ARE ALSO SUBJECT TO THE FACT THAT THEY ARE DESIGNED WITH THE BENEFIT OF HINDSIGHT. MODEL RESULTS ARE ACHIEVED THROUGH THE RETROACTIVE APPLICATION OF A MODEL. MODEL RESULTS SHOWN DO NOT REFLECT MANAGEMENT FEES, TRANSACTION COSTS AND OTHER EXPENSES THAT WOULD REDUCE RETURNS. THIS IS A HYPOTHETICAL MODEL. THE QUOTED BENCHMARKS DO NOT REFLECT DEDUCTIONS FOR FEES, EXPENSES OR TAXES. THE BENCHMARKS ARE UNMANAGED AND DO NOT REFLECT ACTUAL TRADING. THERE COULD BE MATERIAL FACTORS RELEVANT TO ANY SUCH COMPARISON SUCH AS DIFFERENCES IN THE VOLATILITY, AND REGULATORY AND LEGAL RESTRICTIONS BETWEEN THE INDEXES SHOWN AND THE STRATEGY. INVESTORS CANNOT INVEST DIRECTLY IN ANY INDEX.

DOL seeks public comment on protecting pensions from climate-related financial risks

Following President Biden's Executive Order on Climate-Related Financial Risk[5], the US Department of Labor (DOL) has announced the publication of a Request for Information (RFI)[6] in which it is seeking public comment on what actions, if any, it should take under federal law to protect retirement savings and pensions from risks associated with changes in climate. The RFI will help to inform any potential future policy work. Insight will be responding to this consultation and we will discuss our response in the next edition of this publication.

Russia removed from a broad range of indices

In reaction to Russia's invasion of Ukraine, Russia has been removed from a range of equity and fixed income indices. Russian securities were removed from all JP Morgan fixed income indices from March 31, 2022 and MSCI classified Russia as "uninvestable", reclassifying it from emerging market status to stand-alone market status.

Pension plans under pressure to reduce Russian exposure

With sanctions being imposed on Russia, and the countries removal from many indices, US pension plans have found themselves under pressure to divest Russian holdings. Unfortunately, a lack of liquidity and uncertainty about the ability of counterparties to settle trades given sanctions is making this difficult. Fortunately, reports suggest that holdings are generally small. In California for example, Senator Majority Leader Mike McGuire has issued a statement[7] to confirm that a bipartisan coalition of State Legislators will be introducing legislation to divest state public funds from Russian and Russian-state entities, with the total value of Russian related assets across Californian pension plans estimated at $1bn. Although not an insignificant amount, California has the two largest US Pension funds, CalPERS and CalSTRS, which have combined assets of around $800bn alone.

Distributions to multi-employer plans start

The Pension Benefit Guaranty Corporation (PBGC) has started to distribute assistance to insolvent multi-employer pension plans. The Special Financial Assistance (SFA) program is part of the American Rescue Plan Act of 2021 and is expected to provide assistance to around 250 plans in total. Distributions need to be held separately from other plan assets and held in investment grade bonds. Insight is working with a number of plan sponsors to create custom mandates for these assets.

We outlined some of the potential investment strategy implications for eligible plans, and examined some of the potential challenges that may arise, in an article published in July 2021 which can be read here. We continue to believe it is important for eligible plans to balance the need to generate return, manage liability risks and generate cashflows to maximize the certainty that the plan will be sustainable in the future.

[5] https://www.whitehouse.gov/briefing-room/presidential-actions/2021/05/20/executive-order-on-climate-related-financial-risk/
[6] https://www.dol.gov/newsroom/releases/ebsa/ebsa20220211
[7] https://sd02.senate.ca.gov/news/2022-02-28-california-must-use-its-economic-power-help-stop-putin

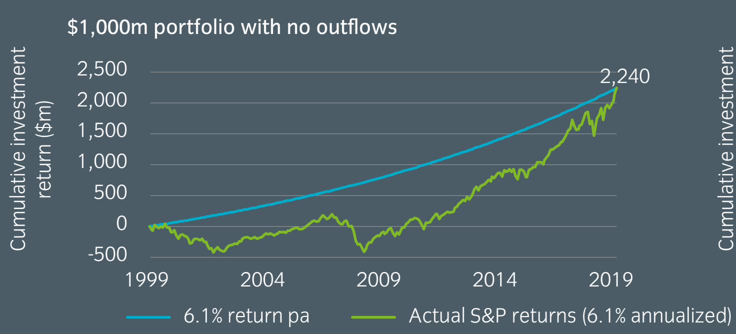
SOLUTIONS SECTION – PROTECTING YOUR EQUITY GAINS FROM MARKET DRAWDOWNS

In recent years, the extraordinary equity bull market has supported asset growth and allowed many pension plans to erase their funding deficits. However, equity performance has substantially outpaced growth in the real economy, sustained by very low central bank policy rates and quantitative easing (QE). With monetary policy now set to reverse course, and geopolitical uncertainty stemming from the Russian invasion of Ukraine, there is the potential that equity markets may experience greater volatility in the years ahead.

DRAWDOWNS ARE FAR MORE PAINFUL IN THE "DECUMULATION" STAGE

For many pension plans the outflows from pension obligations exceed income from investments and contributions, they are cashflow negative, and the asset base is shrinking. In this situation, the timing of returns becomes very important. Consider a hypothetical $1bn portfolio invested in the S&P 500 Index in 2000 and held for twenty years. During this time, the S&P 500 delivered poor returns early on (a result of the dot-com bust and the 2008 crisis), followed by spectacular returns after 2008. For the whole of that period, an investor would have earned an average return of 6.1% pa, for a cumulative profit of $2.24bn regardless of the path of the returns (see Figure 4, left hand chart). If the investor withdrew $50m each year, a 6.1% pa return would have only created a $1.30bn profit (40% less), assuming the returns were delivered consistently each year. However, because returns were weaker in the early period, using the actual path of S&P 500 Index returns, profits would have been much lower, at just $302m, or around 78% less than in the average return scenario (Figure 4). Therefore, the timing (or "sequencing") of returns is an additional risk for cashflow negative investors.

Figure 4 – Decumulation amplifies the effect of equity drawdowns[8]



AN INTELLIGENT HEDGE CAN POTENTIALLY PROVIDE RELIABILITY AT A LOWER COST

Put option strategies can offer full risk protection with a high degree of precision and certainty even through stressed market conditions. However, it can come with high costs that detract from investment returns, which is particularly problematic for plans in decumulation and for those that are underfunded. However, there are ways to reduce the cost of hedging, while partially trading off on effectiveness. Investors can reduce costs of an option strategy by opting for a partial hedge instead of a full hedge and by taking an intelligent approach – dynamically switching strategies as option prices change. We believe that this approach can keep costs in check without impacting the quality of protection.

Figure 5 – The cost of a 90% put spread can vary significantly over time[9]

A more detailed paper on option strategies and how they can be used in an equity protection strategy is available on request.

[8] Bloomberg. For illustrative purposes only. 2000-2019 S&P500 total returns and the impact to a sample portfolio.
[9] For illustrative purposes only. Source: Insight, Optionmetrics as of May 14, 2021.

ECONOMICS AND MARKETS

Uncertainty prevailed in Q1, with the Russian invasion of Ukraine causing commodity prices to spike higher. The Fed shifted to a considerably more hawkish position, and the expectation of both higher inflation and higher interest rates resulted in a sharp upward move in yields.

US Treasuries recorded a significant negative return, with longer-duration issues underperforming on a total return basis.

With risk assets broadly under pressure credit spreads widened, compounding the impact from the upward move in Treasury yields, especially in longer maturities and lower rated credits.

US equity markets declined, with the S&P 500 Index down 4.6%.

The US dollar, as measured by the dollar index, appreciated.

KEY MARKET MOVEMENTS: Q1 2022

Table 1: Q1 2022 Fixed Income/Equity Index Returns (%) and Volatility Index Levels[10]

Index	Q1 2022 total return	Q1 2022 excess return
Bloomberg Treasury Index	-5.58	-
Bloomberg Intermediate Treasury Index	-4.21	-
Bloomberg Long TreasuryIndex	-10.58	-
Bloomberg Corporate Index	-7.69	-2.11
Bloomberg Intermediate Corporate Index	-5.25	-1.05
Bloomberg Long Corporate Index	-11.41	-0.83
BofA Merrill Lynch High Yield (H0A0)	-4.51	1.06
S&P 500 Index	-4.60	-
MSCI Emerging Markets Equity Index	-6.97	-
Dollar Index	2.76	-
VIX[11]	21	
MOVE[11]	**107**	

ECONOMICS

The conflict between Russia and Ukraine sent an additional inflationary pulse around the world. Although small economically, the two countries have an oversized position in key energy and agricultural markets, with a risk that supply chains in some commodities are now permanently damaged.

Forecasts for global inflation in 2022 increased by 1.2% over the quarter, causing central banks to accelerate their tightening cycles. With higher expected rates and inflation expected to dampen consumption, forecasts for global growth declined for both 2022 and 2023.

Table 2: Consensus GDP and CPI expectations[12]

Real GDP	Consensus*			Change over Q1	
	2021F	2022F	2023F	2022F	2023F
United States	5.7	3.5	2.3	-0.4	-0.2
Euro area	5.3	3.1	2.5	-1.1	0.0
Japan	1.7	2.4	1.7	-0.5	0.3
China	8.1	5.0	5.2	-0.2	-0.1
Developed markets	5.2	3.4	2.4	-0.5	-0.1
Emerging markets	6.5	4.4	4.7	-0.5	-0.1
Global	**5.8**	**4.0**	**3.5**	**-0.4**	**-0.1**

CPI	Consensus*			Change over Q1	
	2021F	2022F	2023F	2022F	2023F
United States	4.7	6.2	2.6	1.8	0.3
Euro area	2.6	5.5	2.1	3.0	0.6
Japan	-0.3	1.3	0.9	0.6	0.2
China	0.9	2.2	2.2	0.0	0.0
Developed markets	3.5	5.7	2.6	2.2	0.4
Emerging markets	3.2	5.0	3.9	0.9	0.3
Global	**4.0**	**5.1**	**3.3**	**1.2**	**0.4**

[10] Source: Barclays and Bloomberg. Data as of March 31, 2022. [11] VIX and MOVE are actual value at month end.
[12] Source: Insight and Bloomberg. Data as of March 31, 2022. F=Forecast. * Bloomberg consensus forecast.

DERIVATIVES

European investors to be allowed easier access to US markets

The European Union (EU) plans to widen access for US exchanges and clearing houses, which will allow EU-domiciled investors to clear US products such as mortgage-backed securities. The European Securities and Markets Authority will work to overcome any technical obstacles.

TREASURY MARKETS

The curve shifted upwards and flattened

With the FOMC signalling interest rate hikes through 2022 and inflation surging, the Treasury curve shifted upwards and shorter maturity yields rose significantly. Two-year yields ended the quarter at 2.42%, 169bp higher. At the longer end of the curve, 30-year yields ended the quarter at 2.46%, 55bp higher.

A surge in tax receipts is resulting in a significant decline in borrowing needs

At its February 2022 presentation, the US Treasury Borrowing Advisory Committee estimated that tax receipts in Q1 of the 2022 financial year totaled $1.05trn (+31%). Total outlays were $1.43trn (+6%) over the same period.

The Treasury's Office of Fiscal Projections forecast a net privately held marketable borrowing need of $729bn for Q2 FY2022, and $66bn for Q3, assuming a cash balance of $650bn at end March, rising to $700bn at end June.

The rebound in economic activity is resulting in a significant increase in tax receipts, reducing borrowing needs.

Shift to quantitative tightening should increase supply

With Fed Governor Powell noting that balance sheet reduction will be faster than in 2019, the Fed is likely to become a significant source of Treasury supply in the months ahead.

Figure **6**: Treasury yield curve change[13]

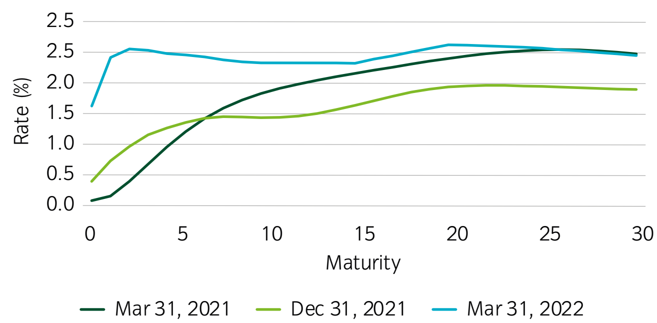


Table **3**: US Treasury net marketable borrowing[14]

Market ($bn)	2020 FY	2021 FY	2022 Q1	Yr/Yr change
Bills issuance	2,652	-1,315	56	-3,741
Floating rate issuance	54	101	24	47
2-5yr Treasury issuance	477	849	156	306
5-10yr Treasury issuance	425	1,066	266	440
Over 10yr Treasury issuance	354	674	134	182
5-10yr TIPS	37	27	54	-5
Over 10yr TIPS	16	18	0	2
Buybacks	0	0	0	0
Total	**4,014**	**1,420**	**689**	**-2,770**

[13] Source: BAML as of March 31, 2022.
[14] Source: Insight and US Treasury. Data as of February 28, 2022. Yr/Yr change is February 28, 2022 versus February 28, 2021.

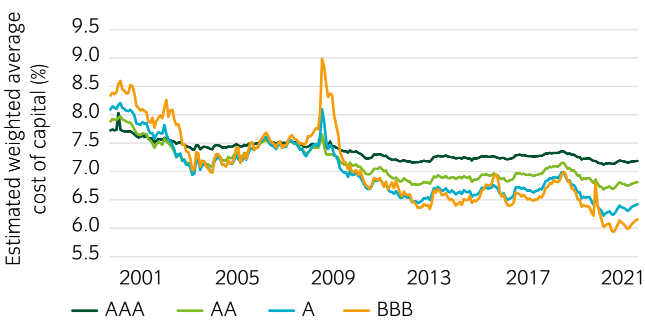
From a cost of capital perspective, BBB has become the rating sweet spot

In the 1980s, it was structurally common for large bellwether corporates to maintain AAA ratings, but a secular decline in interest rates and credit spreads has made BBB the new optimal capital structure, resulting in downgrades to BBB.

To demonstrate, in 2000, investment grade yields were around 7.5% to 8% but at the end of March 2022 were 3.6%. As such, the cost of debt for many firms is no longer comparable to their cost of equity – which is around 8.5% on average for companies in the S&P 500 Index.

Therefore, we believe it makes sense for corporate capital structures to increasingly skew toward debt over equity (i.e. higher leverage). The weighted average cost of capital (WACC) associated with a BBB rating has gone from the most expensive to the cheapest, if there is no associated credit distress (Figure 7).

Figure 7: On average, the WACC associated with a BBB rating has gone from most expensive to cheapest[15]



A BBB rating could be desirable for both higher rated investment grade and high yield issuers

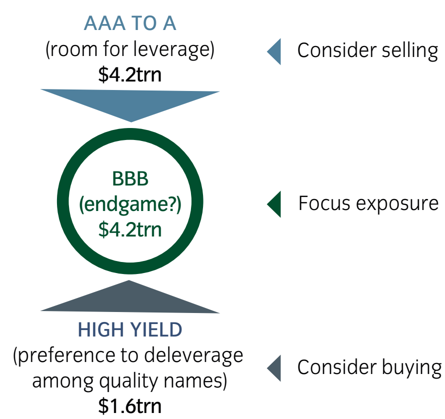
We project that roughly half of the remaining A or better universe, up to $1.5 trillion of outstanding debt, is likely to be downgraded to BBB for the reasons noted above. We believe the only major sectors that will structurally opt to retain high credit ratings are financials, such as banks (whose business models are predicated on lending at higher rates than they borrow), insurance companies and operating utilities companies (given their structural debt seniority over their holding companies – which are often rated BBB). This leaves a sizable universe of industrials, amounting to around $1.5trn and $0.7trn for the all maturity and long-dated corporate indices respectively that may yet opt for downgrades.

At the same time, there are structural forces that can incentivize high yield corporates to chase upgrades to BBB. As corporate credit ratings fall into high yield, the WACC benefits diminish, and debt comes with additional constraints. The high yield market is less than a fifth of the size of the investment grade market, so high yield issuers can see less demand and lower liquidity for their debt. Another demand constraint is less favorable insurance statutory capital treatment. As a result, high yield corporates sometimes need to include additional bond covenants to raise debt. Further, the spread "cliff" between investment grade and high yield bonds is significant, making the cost of debt significantly more onerous for high yield companies on average.

Embracing the great BBB convergence

BBB has become the new normal in investment grade and we believe it should be the heart of any investor's core corporate credit allocation. Investors are used to thinking of AAA to A rated corporates as the most dependable. However, in some ways they may be riskier than BBB companies given downgrade risks that are not compensated by the scant credit spreads on offer.

Figure 8: The great convergence to BBB[16]

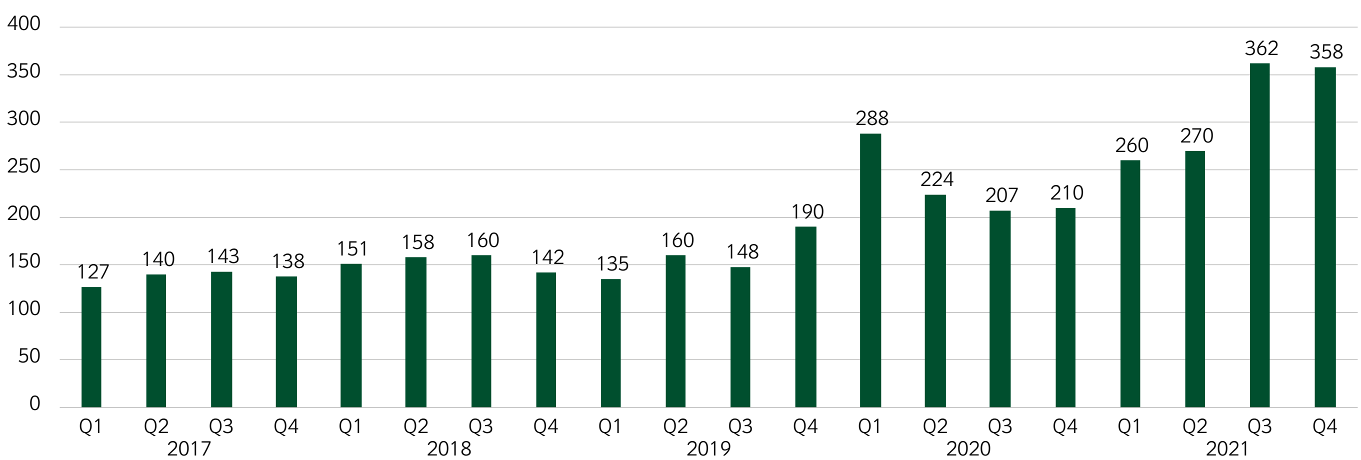


[15] Bloomberg, Insight calculations. Debt costs based on corporate bond yields. Assumes 10% weighting to debt financing for AAA corporates, 20% for AA, 30% for A and 40% for BBB to reflect higher leverage. Assumes 8% cost of equity for AAA corporates, 8.25% for AA, 8.5% for A and 8.75% for BBB, based on S&P 500. WHERE MODEL OR SIMULATED RESULTS ARE PRESENTED, THEY HAVE MANY INHERENT LIMITATIONS. MODEL INFORMATION DOES NOT REPRESENT ACTUAL TRADING AND MAY NOT REFLECT THE IMPACT THAT MATERIAL ECONOMIC AND MARKET FACTORS MIGHT HAVE HAD ON INSIGHT'S DECISION-MAKING. INDICES: BLOOMBERG INDUSTRIAL AAA CORPORATE INDEX, BLOOMBERG INDUSTRIAL AA CORPORATE INDEX, BLOOMBERG INDUSTRIAL A CORPORATE INDEX, BLOOMBERG INDUSTRIAL BAA CORPORATE INDEX. SEE INDEX DESCRIPTIONS AT THE BACK OF THE DOCUMENT. [16] For illustrative purpose only.

The number of companies reporting supply chain problems at a record high

Factset[17] has analyzed earnings reports from companies in the S&P 500 Index and recorded that a total of 362 talked about "supply chains" in Q3 2021, with 358 using the term in Q4. Industrials and Information Technology firms were the sectors that had the highest number of uses. Forecasts for net margins in Q1 2022 earnings reports have declined from 12.4% at the end of 2021 to 12.1% as of March 18, 2022 – suggesting that cost pressures are starting to feed into concerns about reduced profitability, a potential negative for ratings if sustained. A focus for Q1 earnings reports will be how effectively companies have been able to pass these cost pressures on to consumers.

Figure 9: Supply chain problems remain a significant concern[18]



Credit market performance

Credit spreads widened in Q1, with aggregate US corporate spreads ending the quarter 24bp wider than where they began. The intermediate and long sections of the credit curve performed broadly in line, with BBB underperforming.

Table 4: Average spread (bp) of corporate bonds[19]

Bloomberg Index	03/31/21	12/31/21	03/31/22	Change QTD	Weight (%)
Corporate	91	92	116	24	100.0%
Intermediate	70	68	92	24	62.8%
Long	125	130	155	25	37.2%
– Long AAA	62	74	90	16	
– Long AA	84	91	108	17	
– Long A	97	104	124	20	
– Long BBB	150	154	185	31	

Issuance breakdown

Market volatility caused some divergence in issuance trends during Q1. For investment grade issuers, there was a rush to lock in issuance given the prospect of higher interest rates. In high yield, more difficult borrowing conditions caused issuance to dry up. There was a notable increase in 'rising stars' during Q1, with $42bn of issuance upgraded to investment grade from high yield.

Table 5: New US bond issuance in $billions[20]

Market	2020 total	2021 total	Q1 2022 total	Yr/Yr change (%)
US investment grade	2,102	1,673	509	-20.4
US high yield	418	469	43	-28.0

Table 6: High yield issuance breakdown in $billions[21]

Market	2021	Q1 2022
New issuance	457	41
Downgraded to high yield	10	0
Called or falling below 12mths	324	46
Upgraded to investment grade	55	42
Defaults	2	0

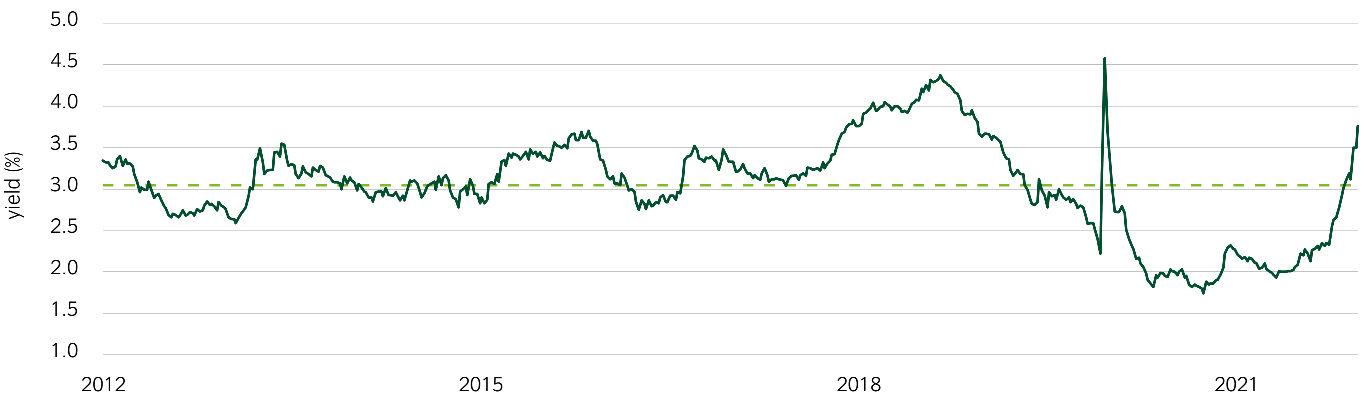
[17, 18] Source: https://insight.factset.com/second-highest-number-of-sp-500-cos.-citing-supply-chain-on-q4-earnings-calls-in-over-10-years.
[19] Source: Insight and Bloomberg. Data as of March 31, 2022. [20, 21] Source: Barclays research. Data as of March 31, 2022.

MARKET
OUTLOOK

A LESS CERTAIN WORLD SEES VALUE RETURN TO CREDIT MARKETS

Although tensions at the border between Russia and Ukraine had been building for some time, the decision by President Putin to launch a full-scale invasion of Ukraine took many investors by surprise. In terms of global economic footprint, Russia and Ukraine are relatively small[22], with Russia becoming isolated since the annexation of Crimea in 2014. However, although small economically, the two countries have far larger roles in global commodity markets, notably in the energy and agricultural sectors. The conflict caused the prices of several key commodities surge, sending an inflationary pulse around the world. Uncertainty around the longer-term consequences of the conflict, combined with a significantly more hawkish Fed, caused Treasury yields to rise and credit spreads to widen. The yield of the Bloomberg US Aggregate Index has almost doubled in a short period (see Figure 10), returning some value to credit markets.

Figure 10: The yield of the Bloomberg US Aggregate Index has moved sharply higher[23]



MARKET OUTLOOKS

Investment grade credit: The sharp upward move in both yields and spreads resolves some of the concerns we had with investment grade credit from a total return perspective. The position within the economic cycle is less supportive than before, with a more moderate pace of growth ahead, and central banks are responding to higher inflation by raising policy rates. Cost pressures are also a concern, with more evidence needed regarding how effectively firms have been in passing rising costs on to consumers. However, yields now arguably reflect the less positive outlook, at least to a degree. It is also notable that the Fed is raising interest rates because the economic recovery has been so robust. Labor market tightness is leading to higher wage pressures, house prices have risen, increasing home equity for many, and there remains a degree of pent-up demand carried over from the pandemic. Although investment grade credit is now trading at more interesting levels, we remain concerned about the potential for higher yields and therefore a neutral position to credit market exposures is warranted, although idiosyncratic opportunities that have arisen remain attractive.

High yield credit: The highly supportive environment that we have seen over recent years is starting to moderate, with a slower growth outlook, elevated levels of inflation and tighter monetary policy ahead. With market volatility rising after the conflict broke, new issuance has notably declined, running substantially below the levels seen at the start of 2021. Many issuers used the period of low yields and buoyant market conditions to extend maturity profiles and build liquidity buffers, increasing their flexibility on when to return to markets. We believe that a defensive position is most appropriate for now, with the risk off tone of markets likely to persist until the conflict is concluded and the peak in inflation is in place. The regular dialogue that we have established with management teams can prove invaluable during periods such as this. For our active mandates we have been in contact with the management of all of the issuers held in our portfolios to discuss the impact of the war on their operations, second and third order impacts on their business and liquidity and we will take decisive action on any holding should it become necessary. Our active high yield strategies have no material exposure to either Russia or Ukraine, directly or indirectly.

[22] The Russian economy is around 1.75% of global GDP (similar in size to Spain) and the Ukrainian economy is just 0.2% of global GDP.
[23] Source: Insight and Bloomberg. Data as of March 31, 2022.

Emerging markets: The Russian invasion of Ukraine sent an inflationary pulse around the world, with the two countries significant exporters of energy and key agricultural commodities. As a result, we believe inflation will now likely peak at higher levels than previously expected in many emerging markets, and that this will cause central banks to accelerate tightening programs, despite a potentially slower growth outlook. We expect this to be a challenging environment for local rates, and the asset class more generally but we are most constructive on emerging market credit (largely denominated in US dollars), with the higher yields available in both investment grade and high yield issuers offering some value for dedicated emerging market investors. More broadly, the outlook for the asset class in the short term is likely to remain dominated by events in Ukraine, with investors wary of tail risks, and with Latin America and Asia benefiting from some safe haven flows away from Europe.

Structured credit: The Russian invasion of Ukraine acted as a catalyst for a broad-based widening of spreads within structured credit markets, although spreads widened less than in other segments of credit markets. This appears to have been primarily driven by a decline in trading volumes, amplifying the impact of the move despite very limited actual selling pressure. Issuance moderated quickly as spreads widened, with some issuers having the flexibility to wait for better market conditions and others unable to issue during periods where capital structures are too expensive. We would view the widening in spreads as an opportunity to increase exposure to high quality collateral pools which we expect to perform well even in an environment of higher inflation and interest rates. We favor issues with seniority in the capital structure, robust transaction structures that divert cashflow in the event of underperformance, and strong underwriting and servicing policies, all of which should act to insulate investors during economic downturns.

Municipal bonds: At a broad market level, elevated levels of inflation and a more hawkish Fed are creating a more challenging environment than we've seen for some time. The buy-and-hold nature of muni investors makes the market more defensive than other segments of credit markets, and dampens volatility, but is unable to fully protect against upward moves in yields. When looking at individual issuers, the story generally remains a positive one. A continued economic recovery, generous federal aid and better than expected tax receipts are helping to bolster state and local government balance sheets, while strong equity returns have improved the funded position of pension plans. For many local government issuers, which derive significant revenues from property taxes, the strength of the housing market is a further positive. We would view the backup in yields as an opportunity to search for value among lower grade A and BBB rated issues that are fundamentally sound and with a bias towards issuers that provide essential services, benefiting from stable cashflows as a result. We also remain cognizant of the potential for a further upward move in yields and would target defensive coupon structures and yields that would provide some cushion against the threat of higher interest rates.

KEY MARKET RISKS

A more aggressive response from the Fed raises recession risks

With the FOMC trying to re-establish their credibility, markets are pricing in one of the most aggressive tightening cycles in recent history. This could destabalize the recovery, tipping the economy into recession. The inversion of the yield curve may already reflect market concerns about the medium-term economic outlook.

Events in Europe spiral, causing market dislocations around the world

Tensions between Russia and the West have reached levels not seen since the Cold War, and the risk of an extreme event is growing. This could take the form of a chemical or nuclear attack on Ukraine, a coup in Russia or a direct conflict between Russian and NATO forces. There is also a risk that other countries such as China or India get drawn into the conflict and/or Western sanctions. The risk of a supply shock in commodity markets is also growing, with the potential for permanent damage to global supply chains for some commodities, keeping inflation elevated for longer than currently expected.

Pressure to increase leverage leads to credit downgrades

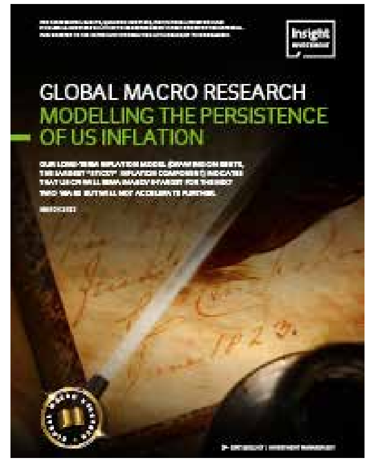
Corporate leverage has already increased over recent years as a result of M&A activity and share buybacks, but a desire to maintain investment grade status has constrained this to a degree. In an environment where abundant demand makes corporate treasurers and investors believe that credit ratings are no longer so important, it could lead to a further rise in leverage and corresponding downward shift in credit ratings.

EDUCATIONAL:
MODELING THE PERSISTENCE OF US INFLATION[24]

With US inflation at the highest levels since the 1980s, investors are worried about how long inflation will remain elevated. We attempted to answer this question – not by looking at supply chains, energy prices or goods and services – but by focusing on what has historically been the most persistent and long-term driver of CPI: rental inflation.

- Our results show that inflation will remain stable but well above target for the next two years
- Our central case indicates CPI will start to converge on the Fed's target by the end of 2023, but it could take longer
- If house prices continue to rise at a strong pace, we expect this to put upward pressure on rents. If the Fed instead raises rates enough to contain the housing market, it will likely result in higher mortgage rates, which would also potentially put upward pressure on rents

FURTHER READING



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Information about the indices shown here is provided to allow for comparison of the performance of the strategy to that of certain well known and widely recognized indices. There is no representation that such index is an appropriate benchmark for such comparison. You cannot invest directly in an index and the indices represented do not take into account trading commissions and/or other brokerage or custodial costs. The volatility of the indices may be materially different from that of the strategy. In addition, the strategy's holdings may differ substantially from the securities that comprise the indices shown.

The ICE BofA US Corporate Index measures market performance of USD-denominated investment grade corporate debt publicly issued in the U.S. domestic market.

The ICE BofA 15-Year+ US Corporate Index measures market performance of USD-denominated investment grade corporate debt publicly issued in the US domestic market with a remaining term to maturity above 15-years.

The Bloomberg Industrial Aaa Corporate Index measures market performance of USD-denominated investment grade corporate debt publicly issued in the U.S. domestic market with a Aaa rating from Moody's.

The Bloomberg Industrial Aa Corporate Index measures market performance of USD-denominated investment grade industrial corporate debt publicly issued in the U.S. domestic market with a Aa rating from Moody's.

The Bloomberg Industrial A Corporate Index measures market performance of USD-denominated investment grade industrial corporate debt publicly issued in the U.S. domestic market with a A rating from Moody's.

The Bloomberg Industrial Baa Corporate Index measures market performance of USD-denominated investment grade industrial corporate debt publicly issued in the U.S. domestic market with a Baa rating from Moody's

The Bloomberg US Corporate Investment Grade Index measures market performance of USD-denominated investment grade industrial corporate debt publicly issued in the US domestic market.

The Bloomberg US Long Corporate Bond Index measures market performance of USD-denominated investment grade corporate debt publicly issued in the US domestic market with a remaining term to maturity above 10-years.

The ICE BofA AAA US Corporate Index measures market performance of USD-denominated investment grade corporate debt publicly issued in the US domestic market with AAA ratings.

The ICE BofA AA US Corporate Index measures market performance of USD-denominated investment grade corporate debt publicly issued in the US domestic market with AA ratings.

The ICE BofA A US Corporate Index measures market performance of USD-denominated investment grade corporate debt publicly issued in the US domestic market with A ratings.

The ICE BofA BBB US Corporate Index measures market performance of USD-denominated investment grade corporate debt publicly issued in the US domestic market with BBB ratings.

The ICE BofA BB US High Yield Index measures market performance of USD-denominated high yield corporate debt publicly issued in the US domestic market with BB ratings.

The ICE BofA B US High Yield Index measures market performance of USD-denominated high yield corporate debt publicly issued in the US domestic market with B ratings.

The Bloomberg US Corporate High Yield Index measures market performance of USD-denominated high yield corporate debt publicly issued in the US domestic market.

[24] Source: https://www.insightinvestment.com/globalassets/documents/us-redesign-documents/perspectives/us-global-macro-research-modelling-the-persistence-of-us-inflation

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