CreditSights

US Investment Grade 2022 Outlook:
Use it or Lose It

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US IG & HY: FY 2022 Forecasts

We expect a more challenging H1 given the potential for peak inflationary pressures, earnings disappointments and heavy new issue supply; even so, we have a constructive bias for spreads over the course of the year as the trajectory for growth and monetary policy becomes clearer

US Credit Strategy IG & HY 2022 Forecasts

				YE 2022 Forecast		
	YE 2020	YE 2021	YTD 2022 as of 01/13	Bull Case	Base Case	Bear Case
US Treasury Yields						
10-Yr UST	0.9%	1.5%	1.7%	2.5%	2.3%	1.3%
5-Yr UST	0.4%	1.3%	1.5%	1.9%	1.8%	1.2%
US Investment Grade						
OAS	103bp	98bp	97bp	85bp	90bp	200bp
FY Excess Return	0.5%	1.5%	0%	2.0%	1.6%	-7.4%
YTW	1.8%	2.4%	2.5%	3.2%	3.0%	3.1%
FY Total Return	9.8%	-1.0%	-1.6%	-4.8%	-3.1%	-4.0%
Gross FY Supply ($bn)	1,932	1,561	100	1,300	1,150	1,100
Net FY Supply ($bn)	705	546	35	455	391	352
US High Yield						
OAS	386bp	310bp	310bp	250bp	300bp	550bp
YTW	4.2%	4.3%	4.5%	4.3%	4.7%	6.6%
FY Total Return	6.2%	5.4%	-0.6%	5.5%	3.5%	-6.3%
Gross FY Supply ($bn)	440	493	13	475	435	375
Net FY Supply ($bn)	239	247	7	143	109	75
HY Defaults (TTM % Issuers)	7.5%	1.2%	1.2%	0.8%	1.0%	3.0%

Source: Bloomberg, L.P., FactSet, Ice Data Indices, LLC, CreditSights

Investment Themes for 2022

We view recent UST curve flattening as a false signal and caution investors from extending duration ahead of a potential surprise steepener; we maintain our bias for credit risk over duration risk

Underweight US IG Market Weight US HY	The recent revaluation in credit markets, pushing HY yields closer to 5% makes the asset class more attractive while we expect long-end curve steepening to weigh on IG return performance
YE Spread Target	Low long-end yields are a headwind to IG spreads, which are unlikely to grind tighter until curves steepen; even so, as the path of inflation becomes clearer in H2, we expect IG and HY spreads to retest levels close to recent tights (90 bp for IG and 300 bp for HY)
Curve Positioning	Exceedingly flat curves limit upside for material extension; We prefer credit risk over duration risk with preference for the belly of the curve across IG (5-10s) and HY (3-5s)
Rating Preference	BBs remain the best value across markets, particularly for crossover buyers and should be used as core/liquidity sleeve holdings; For alpha in IG, we prefer BBBs over As and Bs relative to CCCs in HY
Sector Strategy	We maintain a number of our key sector views including: OP Large US Banks (IG); OP Energy (IG & HY); OP A&D (IG & HY); OP Telecom (IG); OP Transportation (HY); OP Leisure (HY); UP Retail (IG); UP Metals & Mining (IG) We are also upgrading IG Autos to OP, IG Healthcare to MP; downgrading IG Transportation to UP and downgrading HY Telecom to UP

Source: CreditSights

Key Risks to the Outlook

We expect cash on the sidelines to bring in dip buyers; however, risks loom large in the coming months and current valuations leave little room for error

Policy Error	After characterizing inflation as 'transitory', global central banks are starting to shift messaging, including more hawkish policy from the Fed and talk of an accelerated taper
China/Commodities	Evolution of economic policy and idiosyncratic situations, like EverGrande, have material implications for Chinese (and global) growth prospects
COVID	Public health measures remain in effect while fiscal support/enhanced unemployment insurance roll off, creating labor market challenges and operating headwinds for companies with high COVID-beta
Political Brinksmanship	US political rhetoric, including debt ceiling brinksmanship and budget negotiations could drive volatility across markets if a technical default appears likely (or occurs)
New Money Supply	Despite eye-popping gross new issue, a high proportion of refi-related deals has limited new money needs; A change to this dynamic could weigh on spreads if supply begins to overwhelm demand

Source: CreditSights

US IG Sector Outlooks

Sector	Recommendation
US Airlines	While capacity will likely reach 2019 levels, we expect EBITDAR to be half that in 2019, likely reaching flat levels in 2023. Leverage to remain high after a recovery; net debt will not decline until net free cash flow is achieved until 2024 or later. Ratings upgrades are problematic.
Global Autos	Component shortages aside, inflationary cost pressures are becoming increasingly evident and will remain a key element of the automotive narrative throughout 2022. Labor, logistics and energy prices remain an increasingly important part of the cost control picture, likely serving as notable headwinds for Automakers and Suppliers alike for at least the first half of 2022. Electrification should continue to gain more prominence in 2022 globally as several OEMs continue to roll out a slew of flagship electrified family launches.
US Banks	Our headline take on banks entering 2022 is bullish: fundamentals are strong, sector valuations look supportive, and we expect a technical tailwind from declining supply after FY21 issuance massively surprised to the upside. We fully expect technicals to remain in the driver's seat for performance given strong fundamentals and a supportive macro backdrop, translating to continued focus around issuance expectations.
US Consumer Goods	Entering 2022, the key consideration for the sector involves margin trends in the face of persistent cost inflation and supply chain disruptions. These factors already drove significant margin erosion across the space in 2021, and we expect sustained pressures from new COVID variants to extend the challenging supply environment until at least mid-2022. Maintain M/P.
US Leisure	From a fundamental perspective, we expect 2022 to be a year of further operational and leverage improvement, despite Covid-19 variant headwinds, thus supporting the incremental spread/yield offered by the space, and also driving valuations tighter. Maintain O/P rec.
US Media	Five Key Themes: 1) signs of slowing streaming subscriber growth in the high-ARPU domestic market, 2) investment in scaling streaming video platforms will remain a sizable headwind to EBITDA and FCF, 3) cord-cutting remains a drag at ~5%, 4) national TV advertising (excluding CTV) will fall by ~5% and 5) lingering pandemic pressures at theme parks and film studios. Event Risk: Medium. The prospect of further consolidation will remain an overhang, even if we see a low likelihood that another transformational deal is announced in 2022.

Source: CreditSights

US IG Sector Outlooks

Sector	Recommendation
Metals and Mining	Constructive on fundamentals, with prices moderating as supply loosens; ratings momentum will continue with improving fundamentals.
Midstream	The sector reached an inflection point in 2021 with nearly every IG and HY name under coverage generating real cash flow (after capex and distributions). Increasing equity payouts in 2022 will be funded from that free cash flow with EBITDA growing and capex remaining around half of the levels seen in 2017-2019. Midstream offers stability with the Energy sector and credit metrics will continue to see improvement over the next year with pressure from the equity side to continue deleveraging efforts for names that have not reached leverage targets.
Oil & Gas	Capital discipline in 2021 led to meaningful improvement in credit profiles and we expect discipline to hold. Production growth has cooled, but cost inflation is driving budgets higher. Consolidation is likely to continue, and we expect regulatory pressures to ease.
US Pharma	The sector is expected to deliver mid-single digit revenue growth through 2026 on the back of accelerated FDA approvals, particularly for biologics, oncology therapies and orphan drugs. We expect bolt-on M&A in preparation for future patent losses, and leverage drifting higher. Expect $45 -55bn new issuance from pharma companies in 2022.
US Technology	IG tech remains a highly defensive sector given large issuers with high credit ratings, massive cash balances and equity cushions, and strong fundamentals including secular growth and recurring revenue for software and cloud. We are reiterating our Underperform recommendation for the IG tech sector. The IG tech sector offers limited carry and generally requires a flight to safety (e.g., macro downturn, renewed lockdowns) to outperform.
US Utilities	We expect mostly stable credit quality for utilities in 2021 with FFO/debt in the 14% range and FFO/debt after dividends in the 10% range with the exception of the few still high-BBB rated holdcos that we see at risk of following the peers to mid BBB. Energy transition continues to drive record capex levels across generation, distribution and transmission and we expect around $140 bn of electric utility capex in 2022 and our favorite metric for flagging aggressive capex programs is forward capex / LTM FFO.

Source: CreditSights

Macro Outlook

CreditSights | Know More. Risk Better.

Key Macroeconomic Assumptions for 2022

Expect a very noisy H1 as inflationary pressures peak, corporate America faces challenging earnings comps and investors look to central banks for guidance around policy tightening; While the mid-term elections pose a risk in H2, we expect inflation to moderate, helping provide clarity around the Fed's rate hiking cycle and the outlook for consumers

Growth	We expect topline GDP to remain above pre-COVID trend in 2022 but decelerate from current levels as COVID disruptions slowly resolve and governments begin to unwind current restrictions
Inflation	Inflation will also persist through H1, though base effects and continued progress toward normalization should help ease inflationary pressures heading into 2023
Consumer Trends	Household balance sheets and labor markets remain in good shape and will drive healthy consumer activity in 2022; We expect services spending to gain traction, while goods spending is likely to remain strong, albeit at a slower pace than recent levels
Monetary Policy	We expect the Fed to conclude its taper by the end of Q2 2022, if not earlier, leaving room to commence rate hikes in Q3 or Q4; However, we believe the Fed may face slower growth and more tempered inflation prospects in 2023, making a long-term hiking cycle challenging
US Treasury Yields	We expect steeper UST curves in 2022 as the 10-year yield finally moves higher, toward 2.25% while the 5-year UST moves up at a slower pace, to 1.75%

Source: CreditSights

U.S. Consumers are Starting to Feel the Bite of Inflation…

Eye-popping CPI reports combined with acute pricing pressures in shelter, energy and food have begun to weigh on consumer sentiment

Consumer Price Index Heat Map (YoY % Change)

Consumer Price Index Heat Map (YoY% Change)														
	Weight	Dec '21	Jan '21	Feb '21	Mar '21	Apr '21	May '21	Jun '21	Jul '21	Aug '21	Sep '21	Oct '21	Nov '21	Dec '21
Headline CPI	100%	1.4%	1.4%	1.7%	2.6%	4.2%	5.0%	5.4%	5.4%	5.3%	5.4%	6.3%	6.8%	7.0%
Shelter	32%	1.8%	1.6%	1.5%	1.7%	2.1%	2.2%	2.6%	2.8%	2.8%	3.2%	3.5%	3.8%	4.1%
Food	14%	3.9%	3.8%	3.6%	3.5%	2.4%	2.2%	2.4%	3.4%	3.7%	4.6%	5.3%	6.1%	6.3%
Medical Services	7%	2.8%	2.9%	3.0%	2.7%	2.2%	1.5%	1.0%	0.8%	1.0%	0.9%	1.7%	2.1%	2.5%
Vehicles & Parts	8%	5.0%	4.6%	4.2%	4.5%	9.2%	13.3%	20.3%	19.8%	17.2%	14.9%	16.5%	19.2%	21.8%
Educ./Comm. Svcs	6%	2.3%	2.0%	2.1%	2.0%	2.0%	2.2%	2.4%	1.2%	1.3%	1.7%	1.7%	1.7%	1.7%
Energy	8%	-7.0%	-3.6%	2.4%	13.2%	25.1%	28.5%	24.5%	23.8%	25.0%	24.8%	30.0%	33.3%	29.3%
Transportation Svcs	5%	-3.5%	-4.1%	-4.4%	-1.6%	5.6%	11.2%	10.4%	6.4%	4.6%	4.4%	4.5%	3.9%	4.2%
Recreation Services	4%	1.6%	0.3%	1.1%	1.2%	1.8%	0.6%	1.9%	3.7%	3.5%	3.5%	3.8%	2.8%	3.3%
HH Furnishings/Supplies	4%	2.9%	2.4%	2.3%	2.8%	3.2%	3.7%	3.4%	3.0%	3.3%	4.8%	6.1%	6.0%	7.4%
Apparel	3%	-3.9%	-2.5%	-3.6%	-2.5%	1.9%	5.6%	4.9%	4.2%	4.2%	3.4%	4.3%	5.0%	5.8%
Recreation Goods	2%	-0.2%	-0.2%	0.3%	0.8%	2.9%	3.5%	3.2%	3.2%	3.3%	3.5%	4.0%	3.9%	3.3%
Medical Goods	1%	-2.5%	-2.3%	-2.5%	-2.4%	-1.7%	-1.9%	-2.2%	-2.1%	-2.5%	-1.6%	-0.4%	0.2%	0.4%
Core (Ex Food & Energy)	78%	1.6%	1.4%	1.3%	1.6%	3.0%	3.8%	4.5%	4.3%	4.0%	4.0%	4.6%	4.9%	5.5%
Core Services	58%	1.6%	1.3%	1.3%	1.6%	2.5%	2.9%	3.1%	2.9%	2.7%	2.9%	3.2%	3.4%	3.7%
Core Goods	21%	1.7%	1.7%	1.3%	1.7%	4.4%	6.5%	8.7%	8.5%	7.7%	7.3%	8.4%	9.4%	10.7%

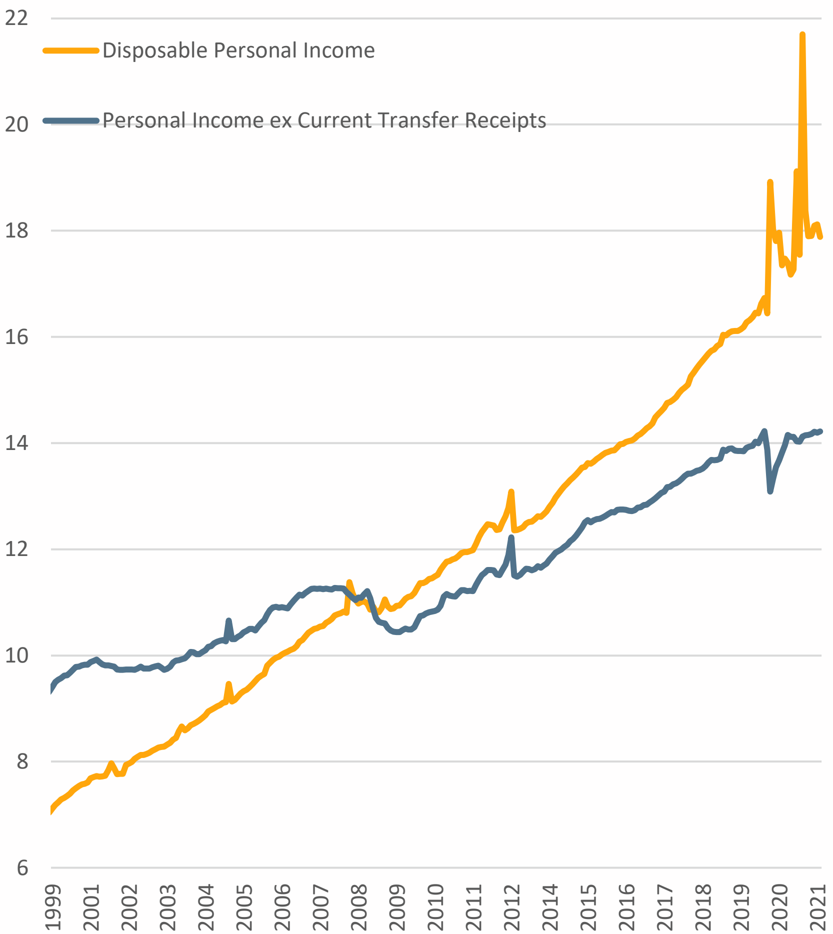
Note: Shows select YoY price change per CPI category, sorted by weight in the headline index.
Category labels abbreviated from official titles. Not Seasonally Adjusted. Intra-category color scheme.

Source: CreditSights, BLS

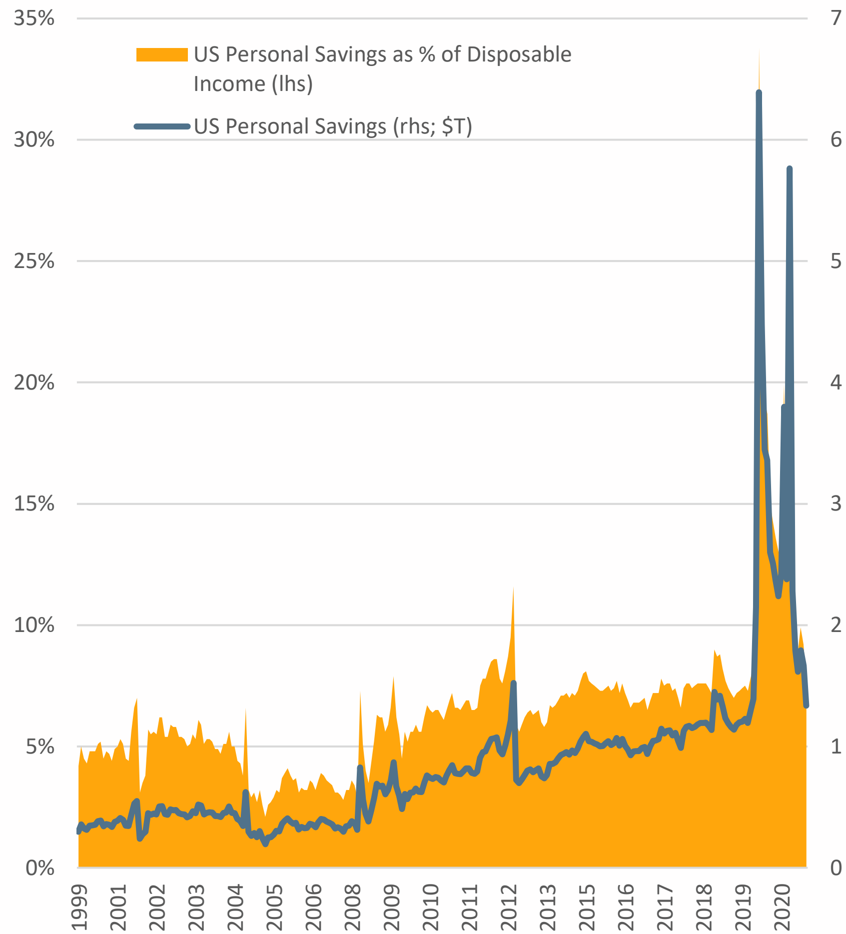
...But Household Balance Sheets Remain in Good Shape

US consumers grappling with inflationary pressures are sitting on historically elevated savings, while personal income excluding fiscal support has decelerated versus pre-COVID growth rates

US Nominal DPI & DPI Excluding Transfers /Fiscal ($T SAAR)



US Personal Savings & As a % of Disposable Income

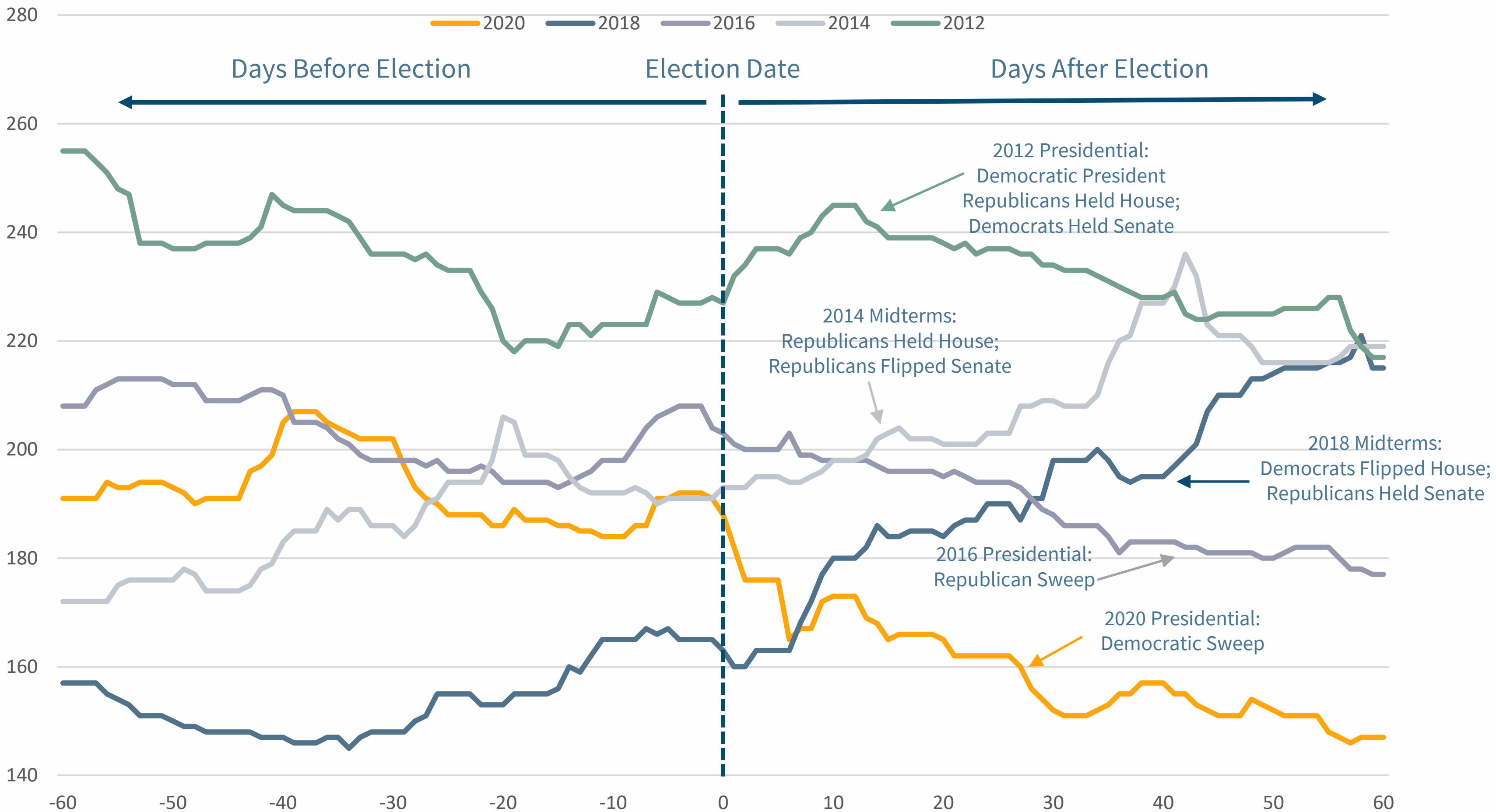


Source: CreditSights, BEA, Federal Reserve

US Midterm Elections and Shifting Risk Appetite

Credit markets have posted some volatility leading into midterm elections; we highlight 2014 and 2018 as two potentially comparable periods

US All Corporates OAS Leading Into and Immediately After Recent US Elections



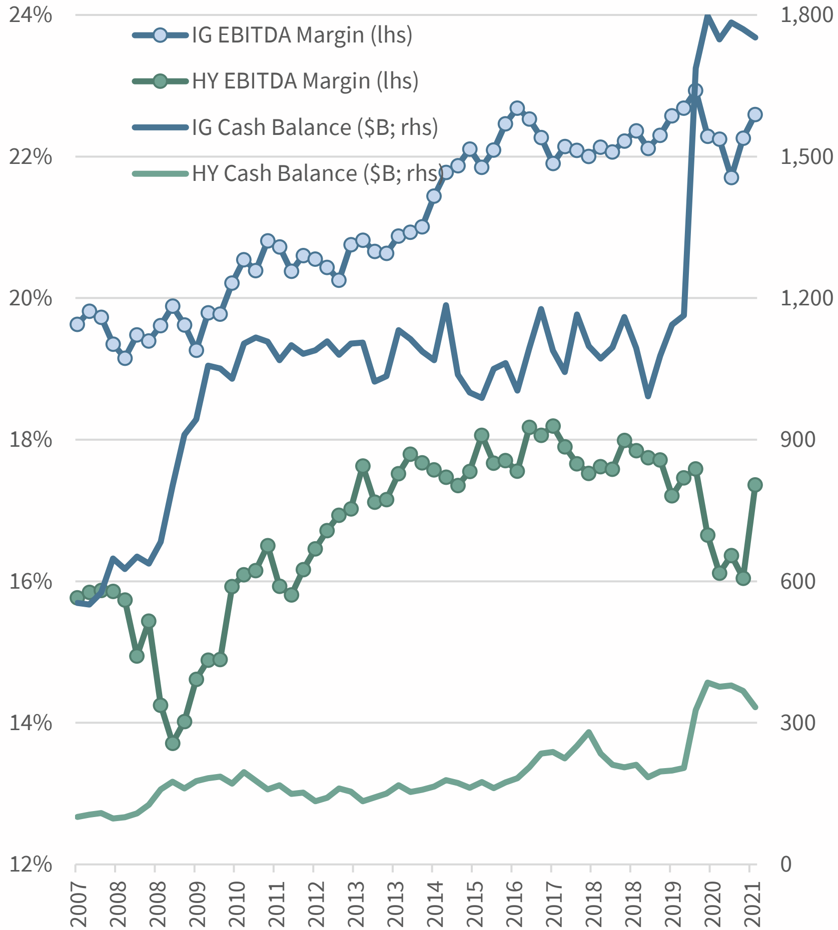
Source: CreditSights, FactSet, ICE Data Indices, LLC

Fundamentals

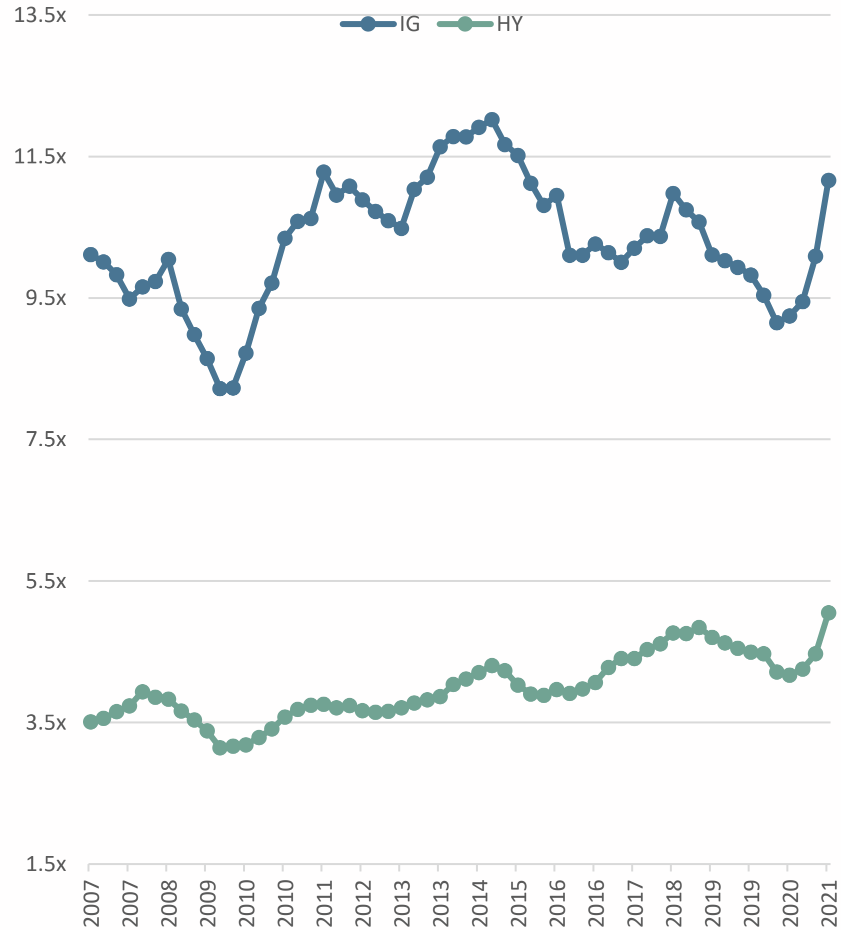
Healthy Cash Balances, Margins and Interest Coverage

Corporate America has only marginally drawn down emergency liquidity while EBITDA expansion and ultra low borrowing costs lift interest coverage levels

Median EBITDA & Cash Balances



Median Interest Coverage

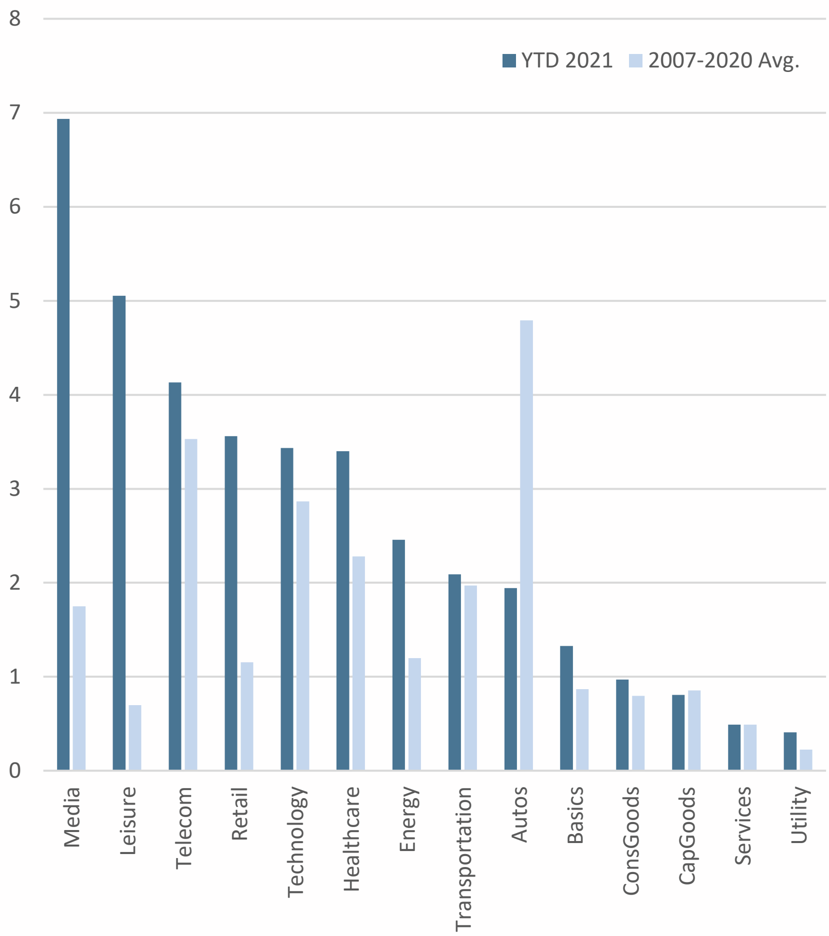


Source: CreditSights, FactSet, ICE Data Indices, LLC

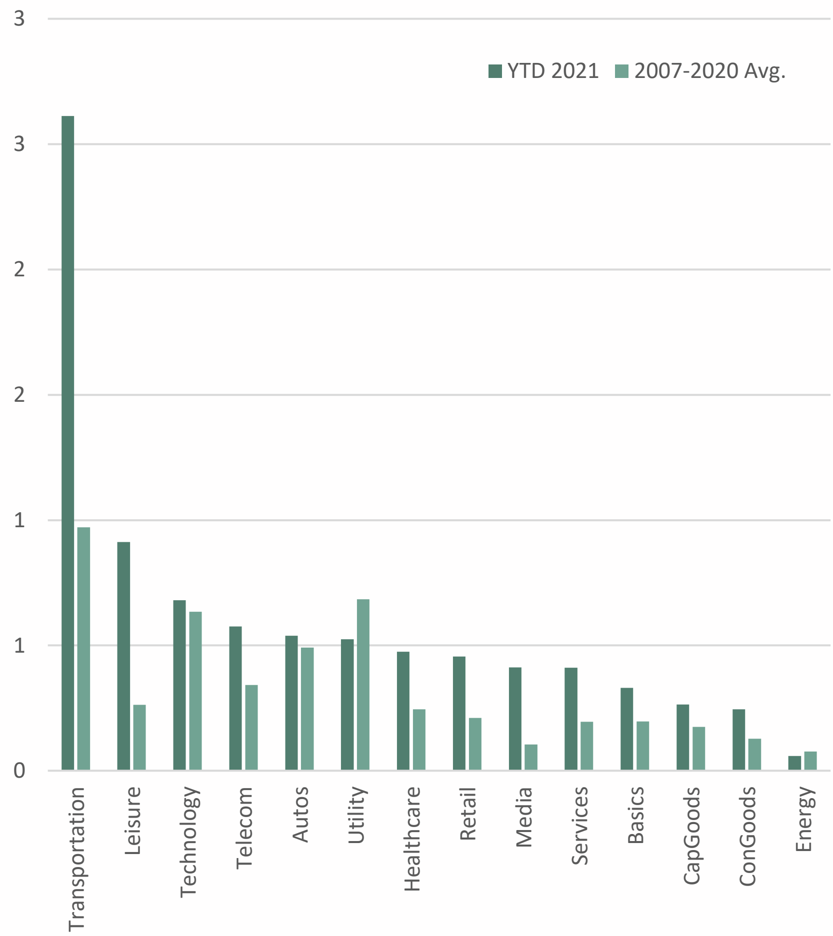
Cash Balances Lumpy Across Sectors, but Strong Overall

In IG, Media, Leisure and Telecom account for much of outsized cash balances while HY Transportation and Leisure report historically elevated cash liquidity

IG Median Cash Balance vs. LT Average by Sector ($B)



HY Median Cash Balance vs. LT Average by Sector ($B)

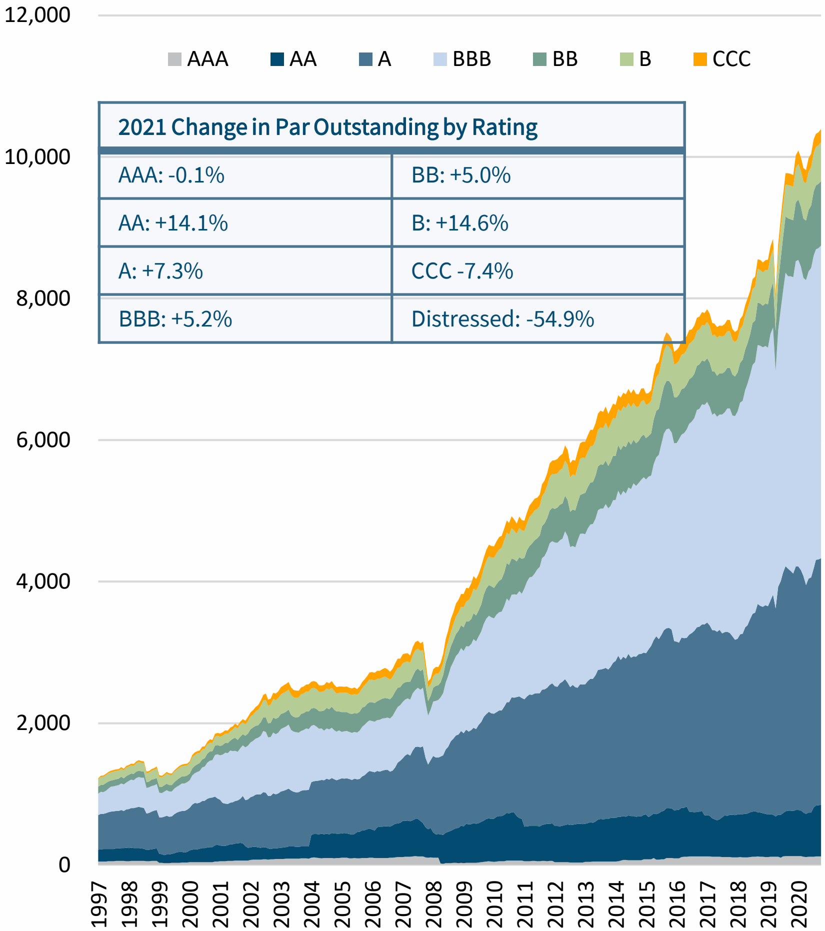


Source: CreditSights, FactSet, ICE Data Indices, LLC

Shrinking Tails and Leverage Convergence for As and BBBs

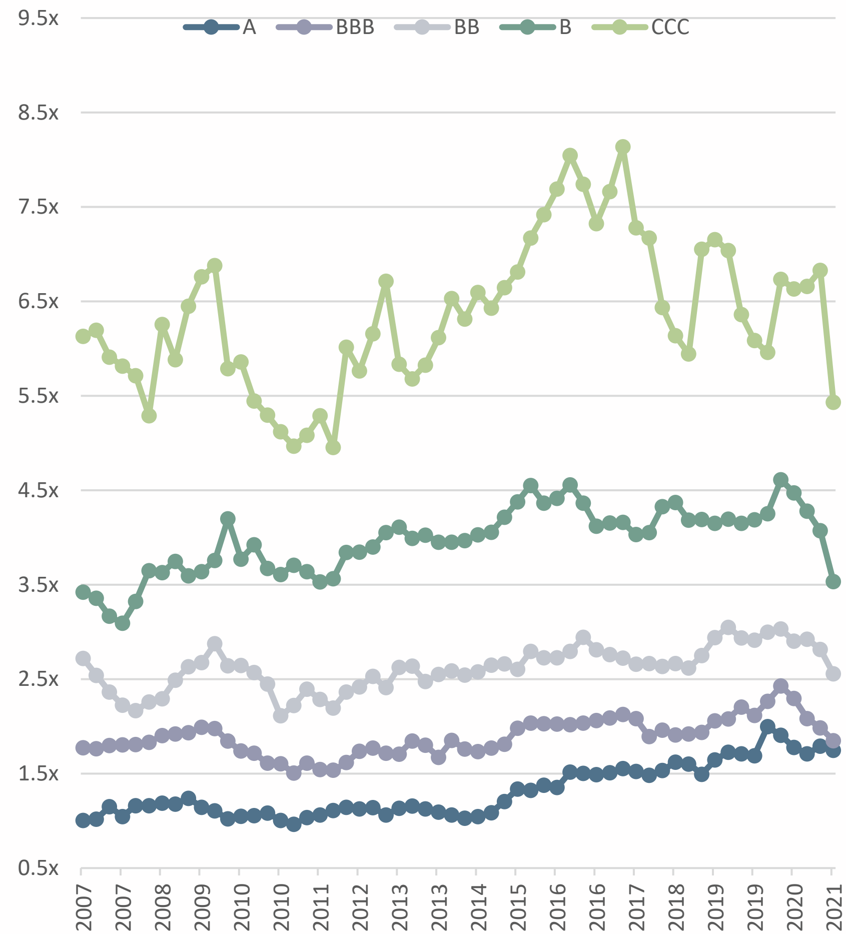
As higher-rated companies have stretched balance sheets and credit metrics, the lower-rated market segments have contracted in size

Total Par Outstanding by Rating ($B)



2021 Change in Par Outstanding by Rating	
AAA: -0.1%	BB: +5.0%
AA: +14.1%	B: +14.6%
A: +7.3%	CCC -7.4%
BBB: +5.2%	Distressed: -54.9%

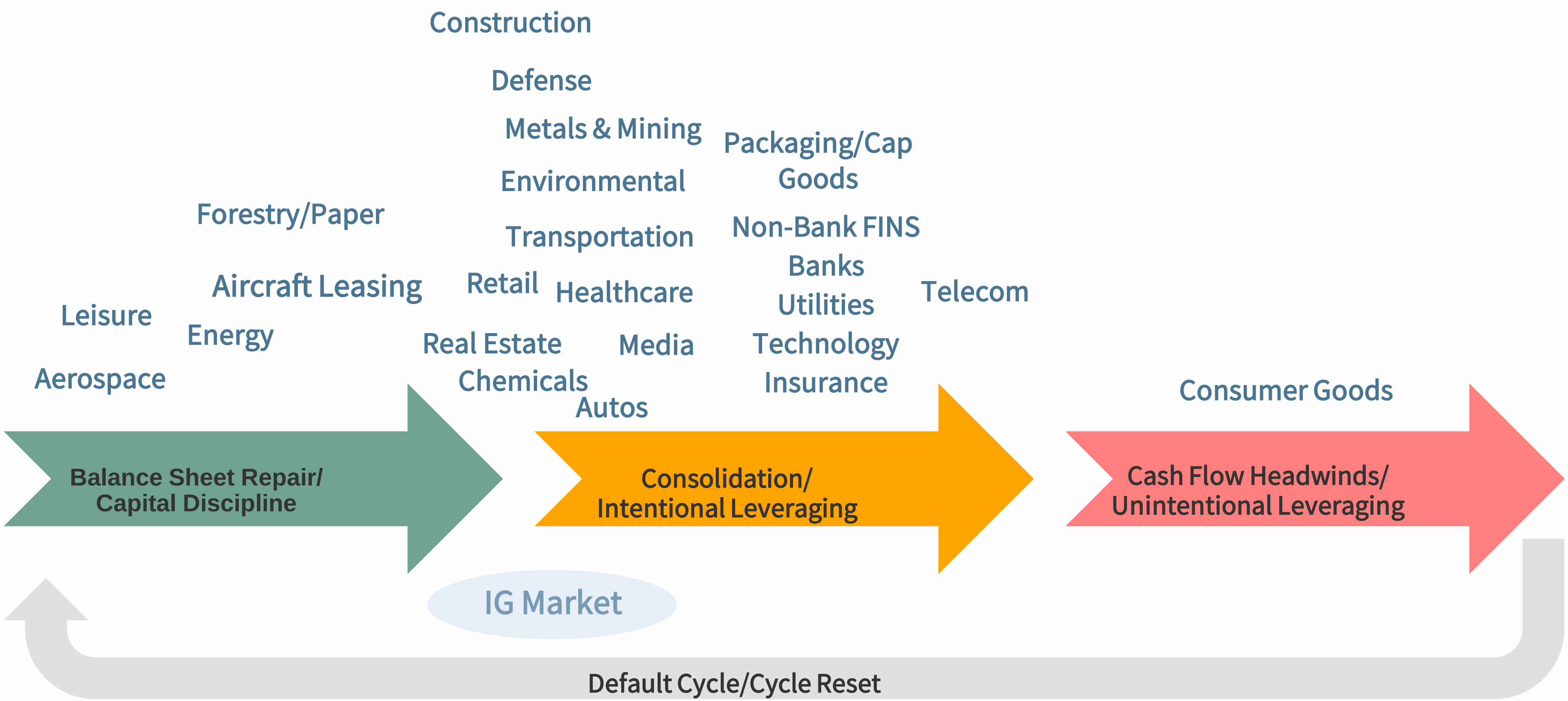
Net Leverage by Rating



Source: CreditSights, FactSet, ICE Data Indices, LLC

Investment Grade: Credit Cycle Continuum by Sector

The extraordinary nature of the COVID-related financial fallout and ensuing economic recovery leaves some sectors at the beginning of the cycle while others are already seeing a new round of challenges



Source: CreditSights

Technicals

Evolving Landscape of Corporate Bond Ownership

Mutual funds, life insurance and non-U.S. investors have increased ownership of corporate bonds over the past year; three cohorts with different portfolio mandates and relative 'stickiness' of investments

Distribution of Corporate and Foreign Bond Holdings ($bn)

Holders of Corporate Bonds - Current Amounts and Recent Changes ($bn) as of 2Q21

	Current		Change					
	2Q21		2Q21 v 1Q21		2Q21 v 4Q20		2Q21 v 2Q20	
Total Market Value	**$ 15,289**	**% of Total**	**$ 454**	**3.1%**	**$ (36)**	**0%**	**$ 610**	**4%**
Households & Misc.	$ 290	2%	$ (63)	-18%	$ (217)	-43%	$ (356)	-55%
Households, Hedge Funds, PE	$ 75	0%	$ (65)	-47%	$ (218)	-74%	$ (360)	-83%
Nonprofits	$ 215	1%	$ 2	1%	$ 0	0%	$ 4	2%
Mutual Funds	$ 2,791	18%	$ 82	3%	$ 99	4%	$ 312	13%
Closed-End Funds	$ 82	1%	$ 2	3%	$ 5	6%	$ 15	22%
ETFs	$ 782	5%	$ 51	7%	$ 58	8%	$ 164	26%
Money Market Funds	$ 12	0%	$ (0)	-4%	$ (1)	-4%	$ (1)	-5%
US Banks	$ 659	4%	$ 34	6%	$ 154	31%	$ 161	32%
Life Ins Cos	$ 3,486	23%	$ 101	3%	$ (70)	-2%	$ 103	3%
Property & Casualty Cos	$ 670	4%	$ 32	5%	$ 9	1%	$ 34	5%
Private Pension Funds	$ 842	6%	$ 17	2%	$ (40)	-5%	$ (39)	-4%
Fed Govt Ret Funds	$ 17	0%	$ 0	2%	$ (1)	-3%	$ 1	8%
State & Local Gvt Ret Funds	$ 490	3%	$ 14	3%	$ (22)	-4%	$ (12)	-2%
Other	$ 733	5%	$ 36	5%	$ 1	0%	$ (2)	0%
Rest of the World	$ 4,435	29%	$ 148	3%	$ (10)	0%	$ 231	5%

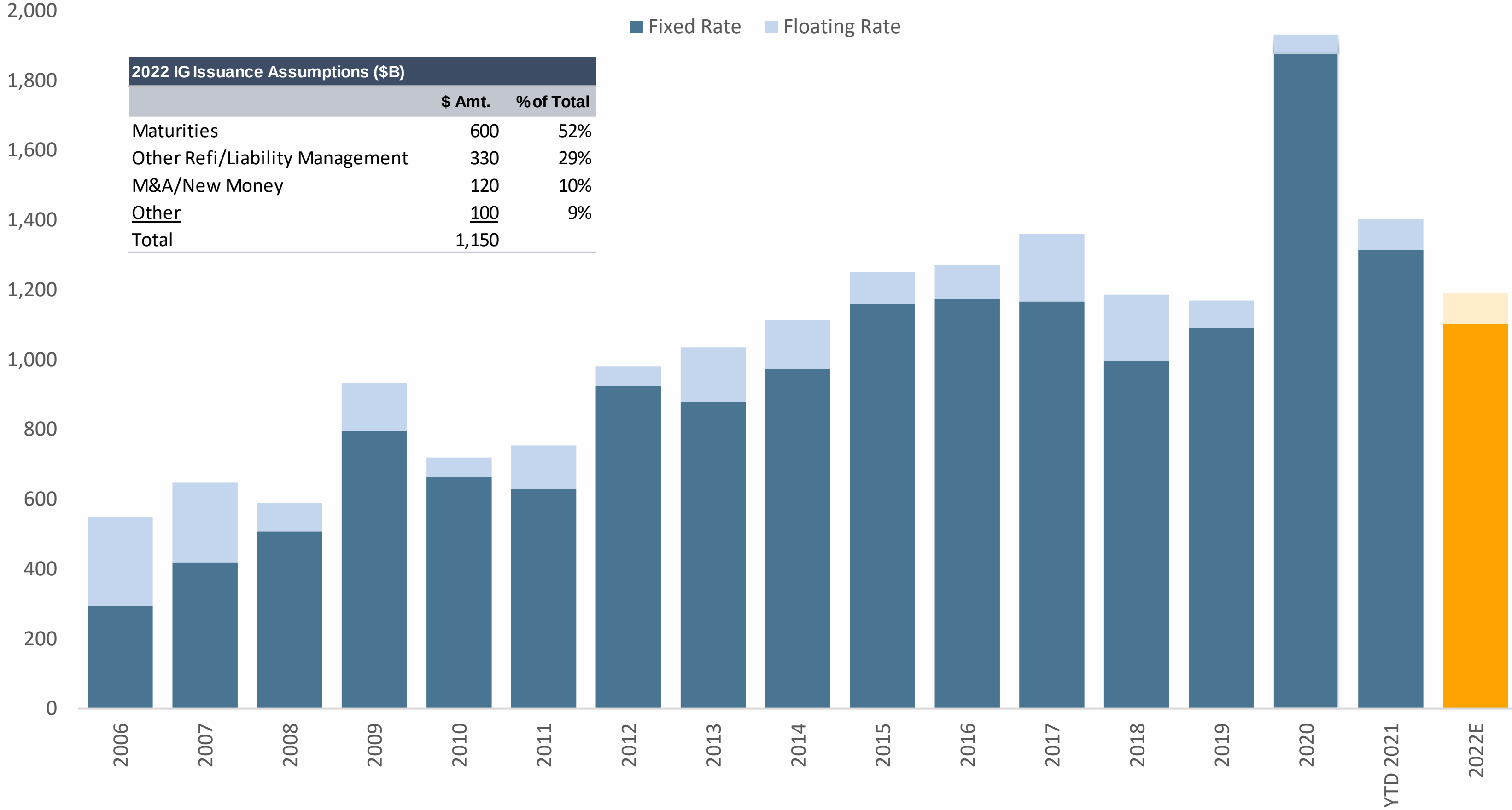
Updated 9/23/21. Source: CreditSights, Federal Reserve System.

Source: CreditSights, Federal Reserve System

Despite Robust New Issue, Limited New Money Needs in 2021

We expect gross new issue totaling $1.1-$1.2 trillion for IG; we expect new money issuance (M&A, share buybacks and dividends) to account for a larger percentage of supply in 2022

Gross USD Investment Grade Supply, by year ($bn)



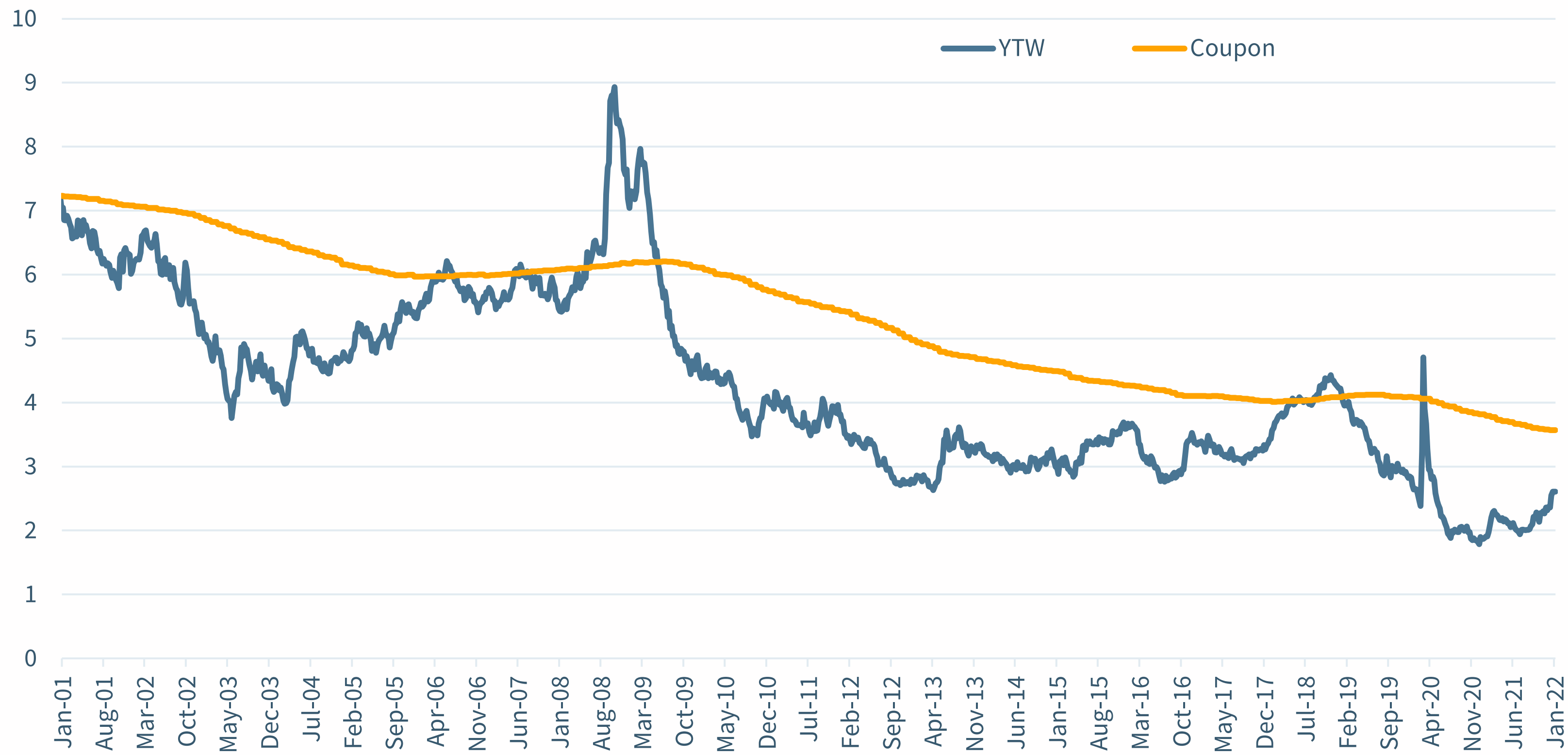
2022 IG Issuance Assumptions ($B)		
	$ Amt.	% of Total
Maturities	600	52%
Other Refi/Liability Management	330	29%
M&A/New Money	120	10%
Other	100	9%
Total	1,150	

Source: CreditSights, Dealogic, Bloomberg, L.P.

Capital Markets Still Offer Historically Cheap Debt

Even with a recent leg higher, IG and HY yields remain well below average coupons, supporting continued refinancing activity into 2022

US Investment Grade YTW vs Par-Weighted Coupon (%)



Source: ICE Data Indices, LLC, CreditSights.

Valuations & Investment Recommendations

Total Return Headwinds for Longer-Duration IG in 2022

IG FY 2022 Total Return Forecast = -3.4%

HY FY 2022 Total Return Forecast = +6.0%

IG FY 2022 Total Return Sensitivity Analysis

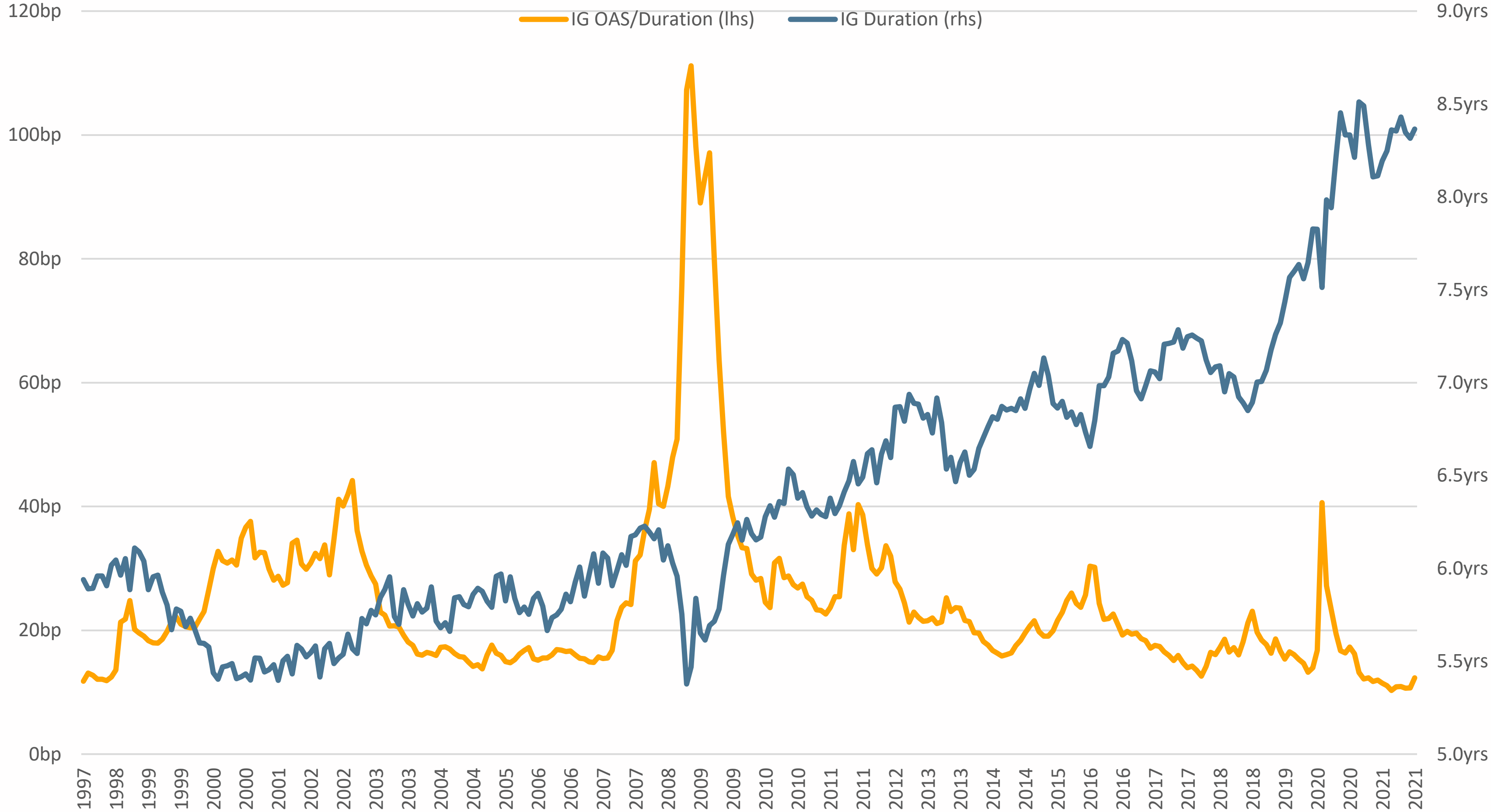
		10-Year UST										
		1.00%	1.25%	1.50%	1.75%	2.00%	2.25%	2.50%	2.75%	3.00%	3.25%	3.50%
IG OAS	75 bp	8.4%	6.3%	4.2%	2.1%	0.0%	-2.1%	-4.2%	-6.3%	-8.4%	-10.5%	-12.5%
	80 bp	7.9%	5.8%	3.7%	1.7%	-0.4%	-2.5%	-4.6%	-6.7%	-8.8%	-10.9%	-13.0%
	85 bp	7.5%	5.4%	3.3%	1.2%	-0.9%	-2.9%	-5.0%	-7.1%	-9.2%	-11.3%	-13.4%
	90 bp	7.1%	5.0%	2.9%	0.8%	-1.3%	-3.4%	-5.4%	-7.5%	-9.6%	-11.7%	-13.8%
	95 bp	6.7%	4.6%	2.5%	0.4%	-1.7%	-3.8%	-5.9%	-8.0%	-10.0%	-12.1%	-14.2%
	100 bp	6.3%	4.2%	2.1%	0.0%	-2.1%	-4.2%	-6.3%	-8.4%	-10.5%	-12.5%	-14.6%
	105 bp	5.8%	3.7%	1.7%	-0.4%	-2.5%	-4.6%	-6.7%	-8.8%	-10.9%	-13.0%	-15.0%
	110 bp	5.4%	3.3%	1.2%	-0.9%	-2.9%	-5.0%	-7.1%	-9.2%	-11.3%	-13.4%	-15.5%
	115 bp	5.0%	2.9%	0.8%	-1.3%	-3.4%	-5.4%	-7.5%	-9.6%	-11.7%	-13.8%	-15.9%
	120 bp	4.6%	2.5%	0.4%	-1.7%	-3.8%	-5.9%	-8.0%	-10.0%	-12.1%	-14.2%	-16.3%

Source: ICE Data Indices, LLC, CreditSights, Bloomberg, FactSet

IG Spreads Still Near Historic Tights on Duration-Adjusted Basis

Recent curve flattening leaves IG even more susceptible to return losses from long-end volatility

IG OAS/Duration & Market Effective Duration

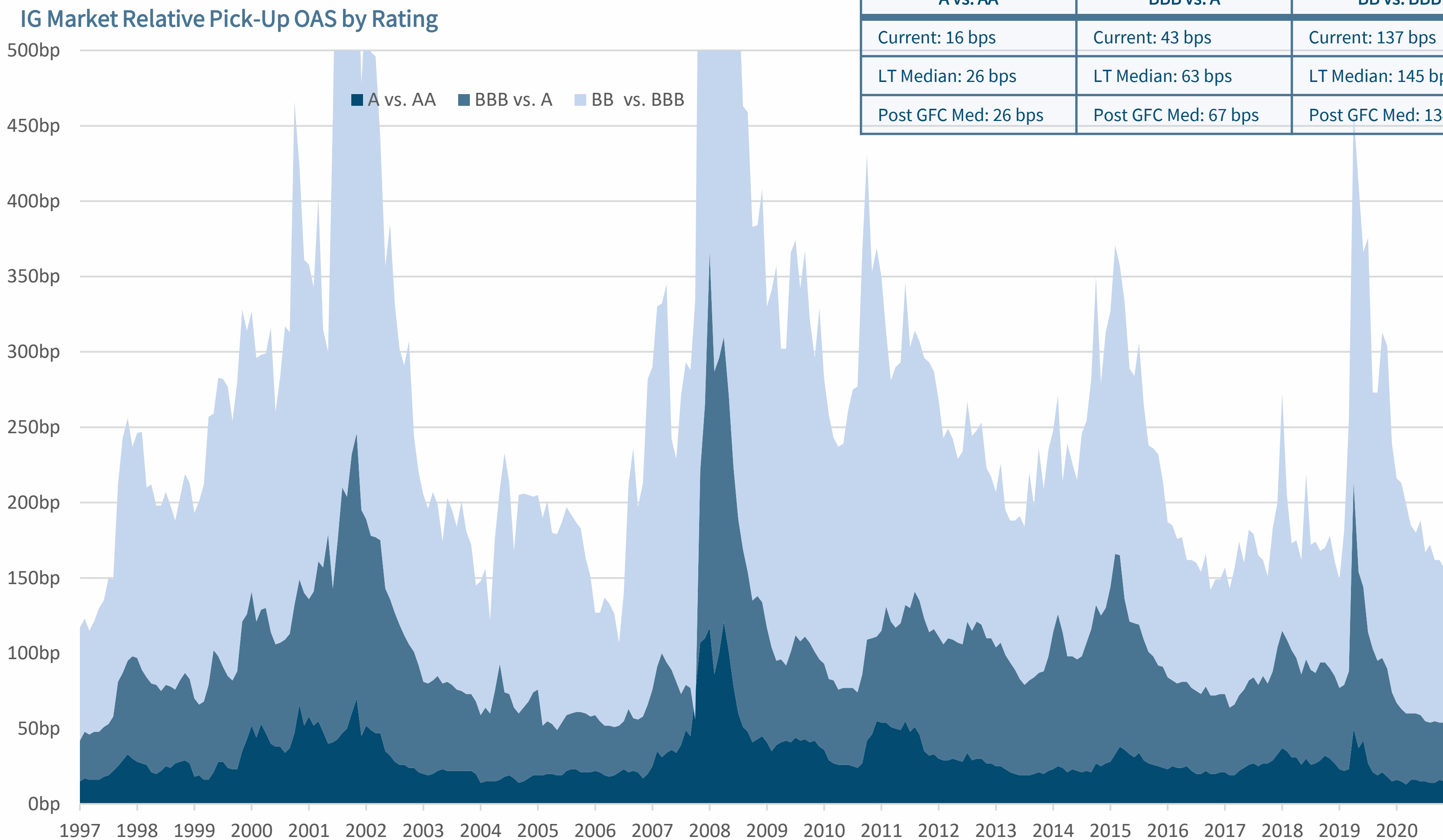


Source: ICE Data Indices, LLC, FactSet, CreditSights

Spread Curves Remain Flat Across IG

We continue to see value in the BB/crossover segment where relative value is closer to historic medians

A vs. AA	BBB vs. A	BB vs. BBB
Current: 16 bps	Current: 43 bps	Current: 137 bps
LT Median: 26 bps	LT Median: 63 bps	LT Median: 145 bps
Post GFC Med: 26 bps	Post GFC Med: 67 bps	Post GFC Med: 134 bps

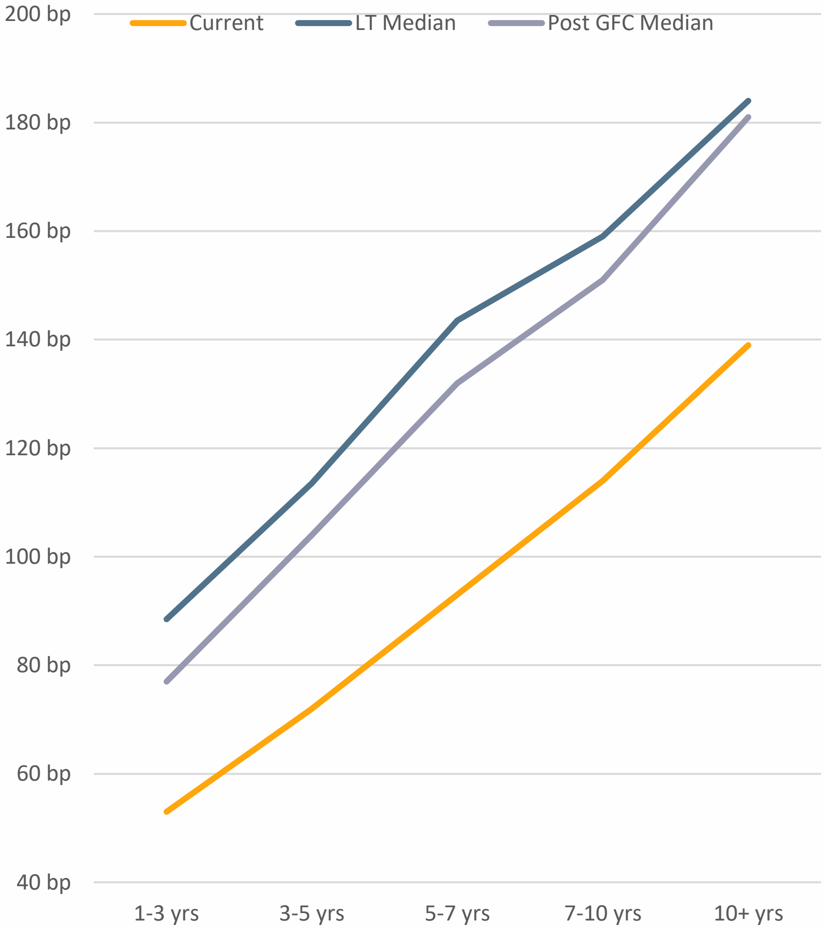


Source: ICE Data Indices, LLC, FactSet, CreditSights

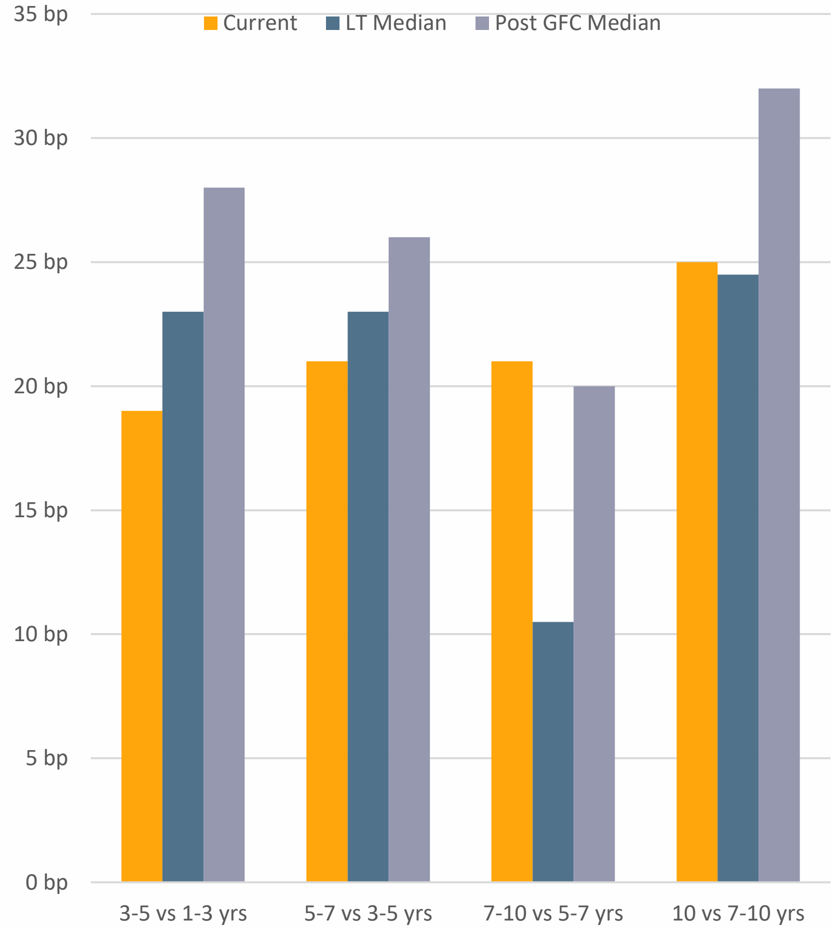
IG Spread Curve is Tight, But Steep Further Out

As the long-end of the market has grown, tenors longer than seven years offer relatively attractive spread pick-up compared with historic median levels; even so, tight valuations leave little room for error

IG Spread Curve by Tenor



IG Spread Pick-Up Across Tenors



Source: ICE Data Indices, LLC, FactSet, CreditSights

CreditSights | Know More. Risk Better.

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