Looking Forward in 2022, Look Backwards

Introduction

Mark R. Shenkman
Founder & President

Justin W. Slatky
Chief Investment Officer

Bob S. Kricheff
Portfolio Manager & Global Strategist

For more information, please contact:

Richard A. Keri, CPA
SVP, Global Head of Business Development & Investor Relations
(212) 867 – 9090

InvestorRelations@shenkmancapital.com

With the U.S. Federal Reserve leadership signaling an interest rate regime change and inflation news splattered across the media, it is worth looking back to the last U.S. rate hike cycle in 2017-18.

We believe that the markets are signaling that they anticipate two to four hikes in the Fed Funds rate in 2022. December 2017 through December 2018 was the last rate hike period. The Fed moved rapidly during this period with multiple moves that had a material impact on the performance of fixed income markets. It is worth noting that Chair Powell took over the leadership during this period and exhibited a willingness to take up the overnight lending rate several times over a fairly short period of time. He was also willing to end the rate hike regime relatively quickly.

If one defines the last cycle as ending in early October 2018, when the yield on the 10-year U.S. Treasury effectively peaked, it is relatively clear that the shorter duration and floating rate credit products in the leveraged debt markets outperformed materially versus other major fixed income assets.

Several changes occurred in the markets during the fourth quarter of 2018, marking an end to this cycle, which is covered later in this note.

What Happened During the Last Rate Hike Cycle

Rates

Under Chair Yellen, the Fed Funds Rate was hiked three times from 2016 into the first half of 2017 before a six-month period of no action until December 2017. The Fed then hiked the Rate five times between December 2017 and December 2018, reaching 250 bps. Chair Powell replaced Chair Yellen in February of 2018. The Fed's balance sheet had stayed fairly stable from late 2014-2017, but did not really begin to decline until mid-2018.[5]

The 10-year U.S. Treasury yield started 2017 around 2.5%, drifting downward for much of the year before spiking near year-end to close 2017 relatively flat at 2.4%. The yield move in 2018 was more dramatic, rising throughout the year to a peak near 3.2% in early October. It fluttered in that range for about a month before dropping materially in November. The drop appeared to accelerate when Chair Powell stated it looked like rates were "just below neutral level." We believe the market took this as a signal of a shifting rate regime; away from tightening to at least a neutral stance.[1] The yield on the 10-year ended 2018 at approximately 2.5%.

A few other points worth noting about rates and the linkage with inflation during this period:

After declining approximately 67bps in 2017, the 2-10 year U.S. Treasury curve tightened another 41bps in 2018 to roughly 15bps, where it remained for much of 2019. U.S. headline CPI inflation was 2.1% at the end of 2017 and reached a periodic peak of about 2.9% in July 2018.

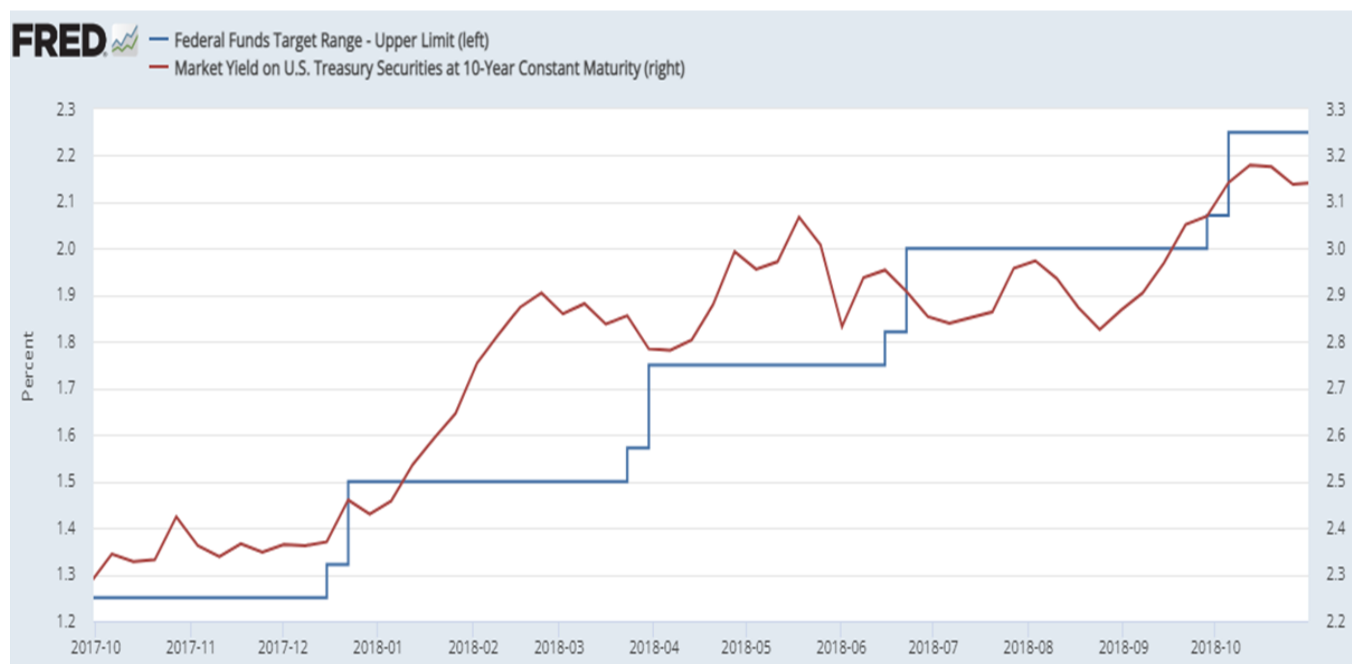
Rate movements elsewhere around the globe were not as dramatic. The 10-year German Bund rate spiked up from 0.42% at the beginning of 2018 to 0.76% in February, and then gradually declined throughout the year, finishing 2018 at 0.24%. The Japanese 10-year government rate started 2018 at 0.04% before spiking to 0.15% in October and then rapidly declined to end 2018 at -0.005%.

Credit Markets

It was a relatively benign-to-improving credit cycle in 2017-2018. Overall, credit rating agency upgrades outnumbered downgrades. The default rate for high yield bond market was 1.27% in 2017 and 1.9% in 2018 versus an historical average of 3.5%.[2] Spreads were relatively stable despite the gyrations of the 10-year Treasury. Given the rising rate environment, flows were healthy into leveraged loans and short duration assets, helping the technicals in those subsets of the leveraged debt markets.

LTM Returns

	Index	30-Sep-2018
Barclays AG		-1.21%
Investment Grade	C0A0	-1.10%
IG Short Duration	C1A0	0.78%
High Yield Bonds	H0A0	2.94%
HY Short Duration	H42C	3.51%
Leveraged Loans	LSTA	5.18%



Source: St.Louis Fed (FRED)

Source: Shenkman Capital, ICE Data Indices, Bloomberg

Comparing 2018 to 2022*

What is Similar:

- Spreads are relatively tight
- Low default environment
- An environment of improving credit ratings
- Healthy economic trends
- The cycle in 2017 started with 10-year U.S. Treasury ~2.05%, similar to today
- Federal Reserve Chair
- Entering a well-anticipated rate hike cycle
- Mid-term election year heightens political pressures

What is Different Now:

- Stronger M&A environment
- Stronger credit upgrade cycle
- Increased corporate liquidity
- Inflation pressures in 2022 more of a "shock"
- No COVID variants in 2018
- The Fed balance sheet is about twice the size in 2022
- Investment grade market is lower credit quality
- High yield bond market credit quality is higher
- Leveraged loan market credit quality is slightly lower
- The Convertible market is more diversified and has less tech exposure
- The S&P 500 multiples were ~22x in 2018 vs ~ 26x in 2022 (peak & trough in between about ~15x & ~36x)

2018 Fourth Quarter

We believe that the salient lessons for investors right now from the 2017-2018 period really come from the 12-month period ending in September 2018, but we would be remiss to not outline what occurred in the fourth quarter of 2018 as well.

Things changed dramatically in the fourth quarter, but only for a brief period. In our view, this was primarily driven by a sell-off in technology equities. This sell-off was a relatively short-lived, but very aggressive, risk-off trade in credit that reversed itself in the subsequent quarter.

The tech sector started 2018 with a strong tone but came under pressure from the U.S. Congress and the Administration for a number of issues, including fair trade practices and privacy. [3] This rising concern about government scrutiny of the technology industry is evidenced by their stock market performance. The S&P 500 technology sector posted an annualized return of 28.3% year-to-date through September

2018 but had an annualized loss of (52.2%) in the fourth quarter as tech company CEOs were called to testify before Congress.[4] This "tech-wreck" also spurred a risk-off tone in the credit markets. The Leveraged Loan market was hurt more than the bond market in this sell-off in large part to the shift in the interest rate regime coupled with the risk-off tone. The Loan market was hurt as Chair Powell's November comments reduced the risk of rising rates, and thus the attractiveness of floating rate products, leading to some outflows and further weakened technicals in the asset class.

To highlight how brief this tech-wreck and risk-off tone was, one can look at returns in the fourth quarter of 2018 relative to the first quarter of 2019. Following the Q4-2018 (17.3%) loss, tech equities rebounded with a first quarter 2019 return of 19.9%. In the leveraged debt markets, the broad high yield bond index had a fourth quarter 2018 loss of (4.7%) but posted a gain of 7.4% in the first quarter of 2019.

Conclusion

While there are certain to be differences in 2022 from 2018, we believe one common and critical theme will be that the interest rate environment should be one of the strongest influences on the credit markets for much of the year. We believe that the potential similarities between 2018 and 2022 are strong enough that it could influence returns by asset class; specifically, high yield, shorter duration high yield, leveraged loans in particular, could all benefit materially relative to other fixed income asset classes. The ability to rotate among these leveraged debt sectors through this type of rates cycle should enhance investors' returns.

PLEASE SEE EXHIBITS ON FOLLOWING PAGE

SOURCES

[1] https://www.wsj.com/articles/market-slide-foils-investors-11545154550?mod=ig_2018yearinreview
[2] Source: JP Morgan
[3] Ibid. footnote 1
[4] S&P 500 GICS Level 1 Information and Technology
[5] https://www.statista.com/statistics/1121448/fed-balance-sheet-timeline/
* With additional references to: ICE Data Indices, https://www.bea.gov/, St.Louis Fed (FRED), https://www.federalreserve.gov/, LSTA, Exhibits 1-4

Exhibit 1 - Performance

		LTM Returns 30-Sep-2022	LTM Returns 30-Sep-2018	LTM Returns 31-Dec-2018
Barclays AG		-1.60%	-1.21%	0.01%
Investment Grade	C0A0	-2.19%	-1.10%	-2.25%
IG Short Duration	C1A0	0.81%	0.78%	1.62%
High Yield Bonds	H0A0	2.52%	2.94%	-2.27%
HY Short Duration	H42C	3.05%	3.51%	2.23%
Leveraged Loans	LSTA	4.03%	5.18%	0.44%
S&P 500	SPX	10.56%	17.91%	-4.38%
NASDAQ	CCMP	17.49%	25.21%	-2.81%
Convertibles	V0A0	10.89%	12.91%	0.65%

Source: Shenkman Capital, ICE Data Indices, Bloomberg

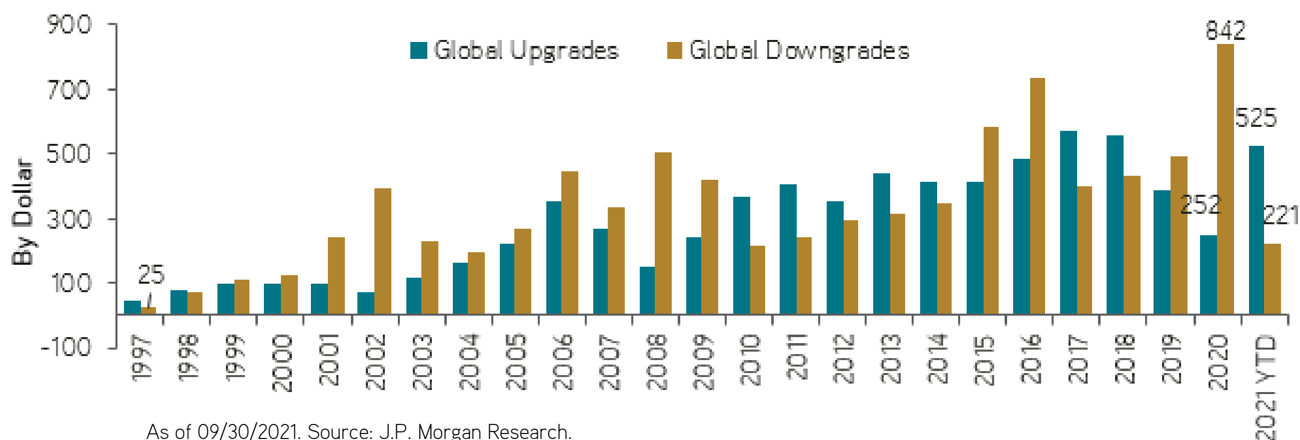
Exhibit 2 - Spreads

		30-Sep-2017	2-Jan-2018	30-Sep-2018	31-Dec-2018
Barclays AG		38 bps	36 bps	39 bps	54 bps
Investment Grade	C0A0	107 bps	98 bps	113 bps	159 bps
IG Short Duration	C1A0	57 bps	51 bps	57 bps	93 bps
High Yield Bonds	H0A0	356 bps	355 bps	328 bps	533 bps
HY Short Duration	H42C	204 bps	210 bps	177 bps	334 bps
Leveraged Loans	LSTA*	416 bps	396 bps	371 bps	551 bps

*Using 3-year Maturity

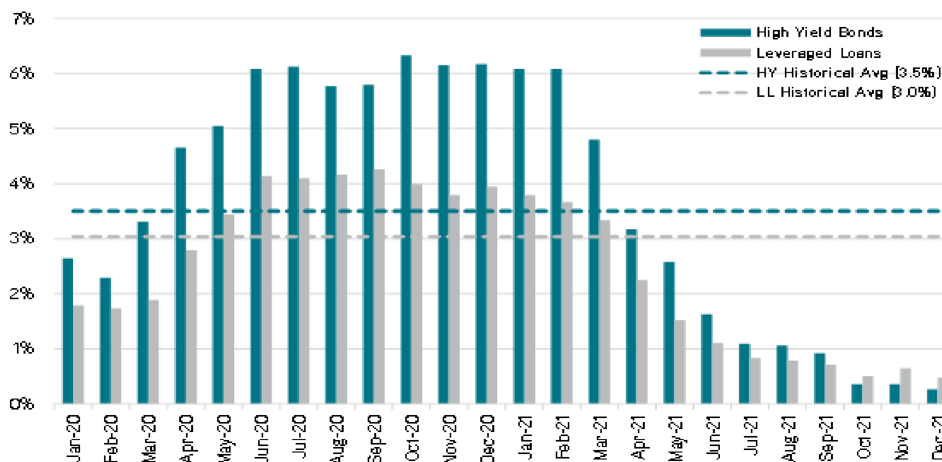
Source: Shenkman Capital, ICE Data Indices, Bloomberg

Exhibit 3 – High Yield Ratings Upgrades & Downgrades (By Dollar Volume, $Bn)



As of 09/30/2021. Source: J.P. Morgan Research.

Exhibit 4 - Defaults



Sources: J.P. Morgan; Moody's Investors Service; S&P LCD

OFFICES

SHENKMAN CAPITAL MANAGEMENT, INC.

461 Fifth Avenue
New York, NY 10017
(212) 867 – 9090

262 Harbor Drive
Stamford, CT 06902
(203) 348 – 3500

SHENKMAN CAPITAL MANAGEMENT LTD

49 St. James's Street
London, UK SW1A 1JT

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