Capital Markets Strategy
Essential inCights for the C-Suite

Chart of the Day

USD HY spreads have already tightened over 110 bps since September, while IG spreads have tightened more than 35 bps since October. 10 Year UST yields have also tightened around 80 bps from the 4.34% intraday highs of late October. We expect this "bear market rally" in spreads to continue in early 2023.

Looking ahead, the strength and timing of potential US recession will be the single most important variable in the outlook for US Dollar IG and HY credit spreads in 2023.

As noted below, CreditSights is currently assigning a **65% probability of credit spread tightening in 2023, and a 35% probability of spread widening**. All four of their scenarios are built around expectations for US GDP growth and inflation.

We are <u>not</u> as optimistic for the full year, but believe <u>early</u> 2023 will represent a critically important window for issuance for two reasons:

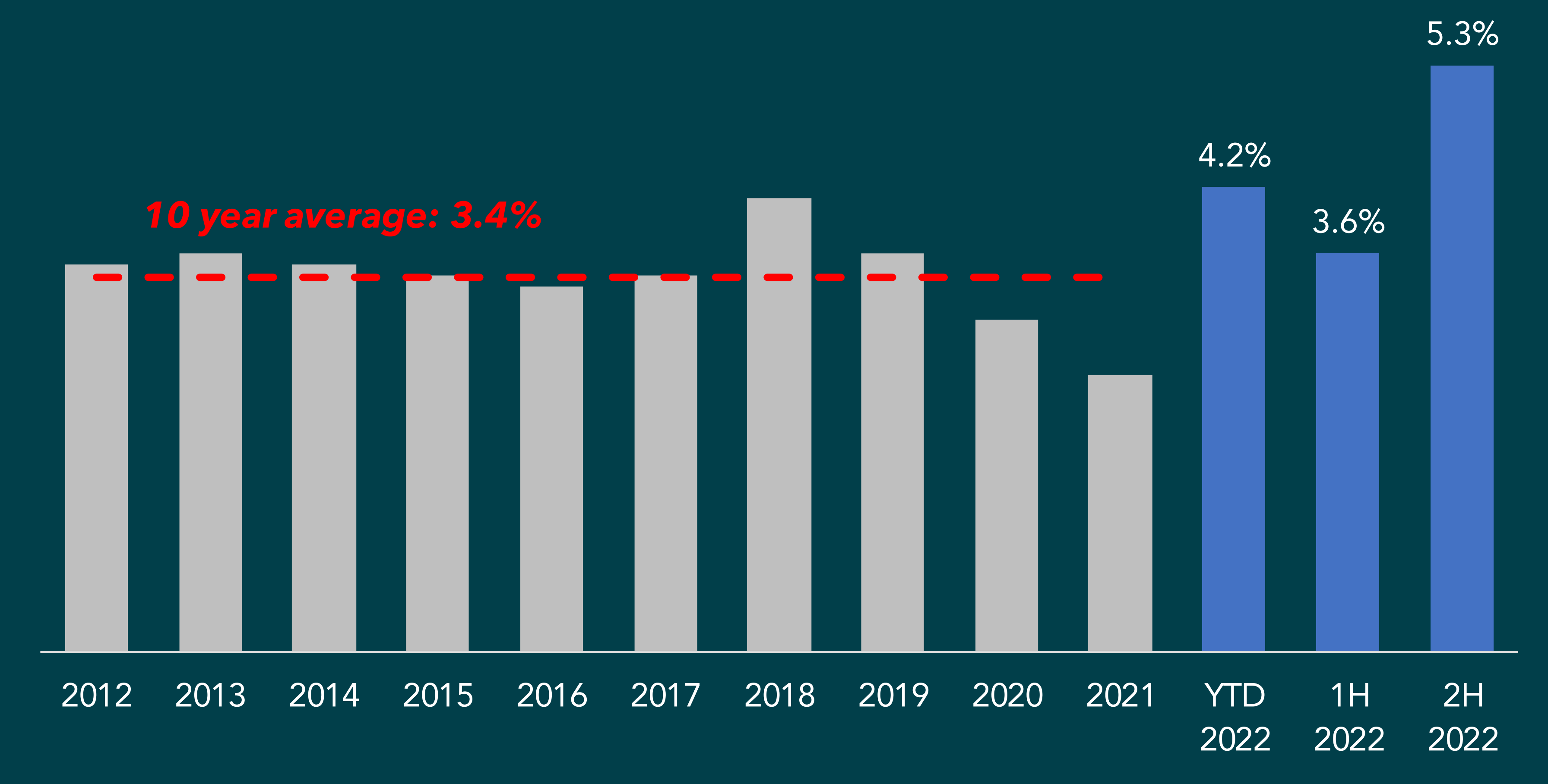
(1) we expect the current "bear market rally" in spreads to continue in early 2023; and

(2) investors will return in January, after the worst bond returns in 60 years, with a "clean slate" and an attractive opportunity to invest in companies with strong balance sheets at higher yields

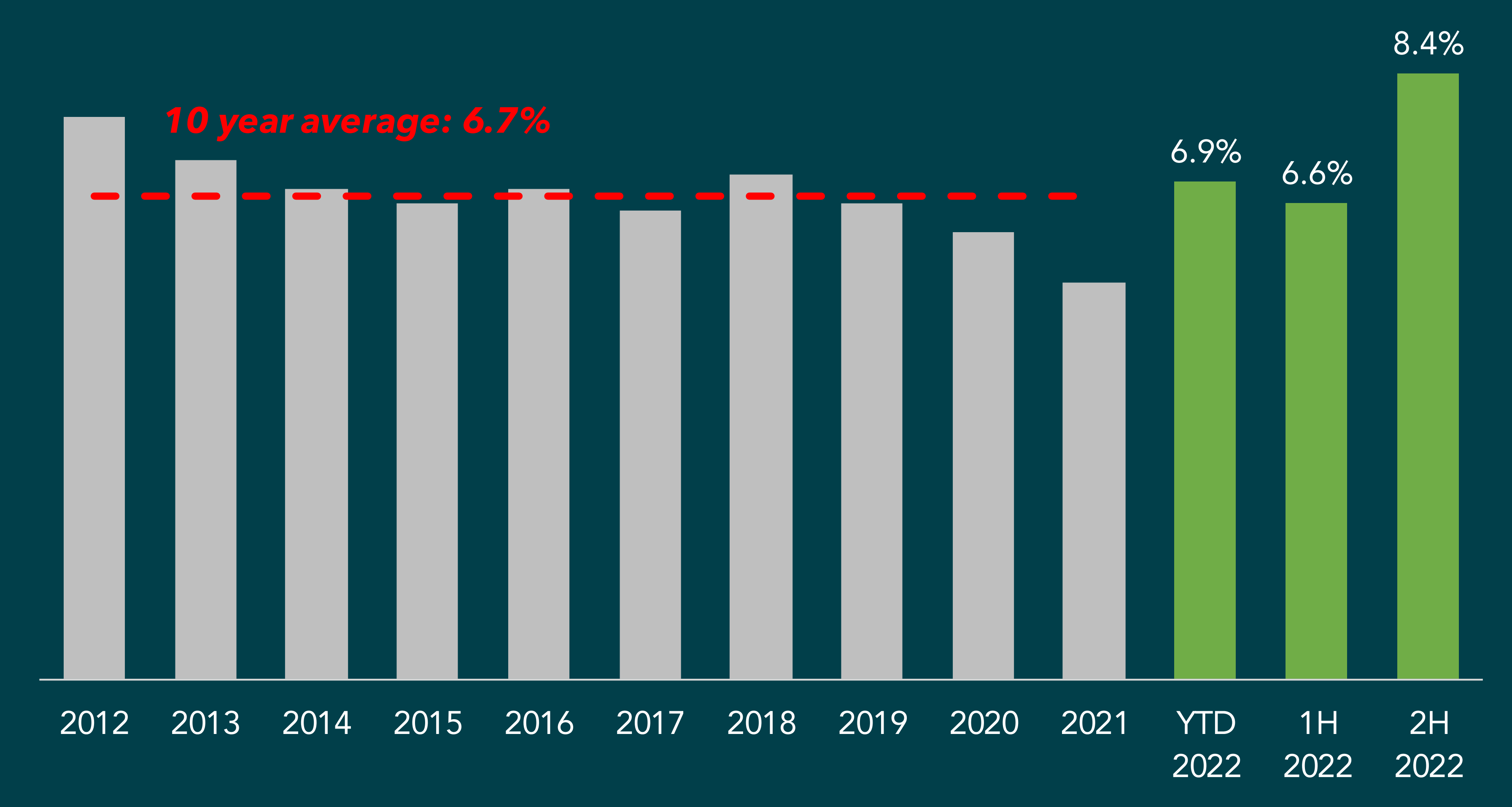
In our view, despite a strong US consumer and labor markets, data (LEI, PMI, etc.) clearly suggests the probability of US recession is rising, though the timing of that recession is increasingly pushing back to the 2H of the year. **As such, we believe that USD credit spreads will likely continue their rally in early 2023, and then gap-out sharply wider as US recession comes closer into view in the 2H of 2023.**

USD IG and HY coupons jumped notably higher in 2022 on the "twin shocks" of higher UST yields and wider credit spreads.

US IG annual new issue coupons



US HY annual new issue coupons



CreditSights has assigned a 65% probability of USD spread tightening in 2023, and a 35% probability of widening, across four distinct scenarios. We believe this view is too optimistic and that spreads will likely continue their rally in early 2023, but then gap-out sharply wider as US recession risk comes closer into view in the 2H 2023.

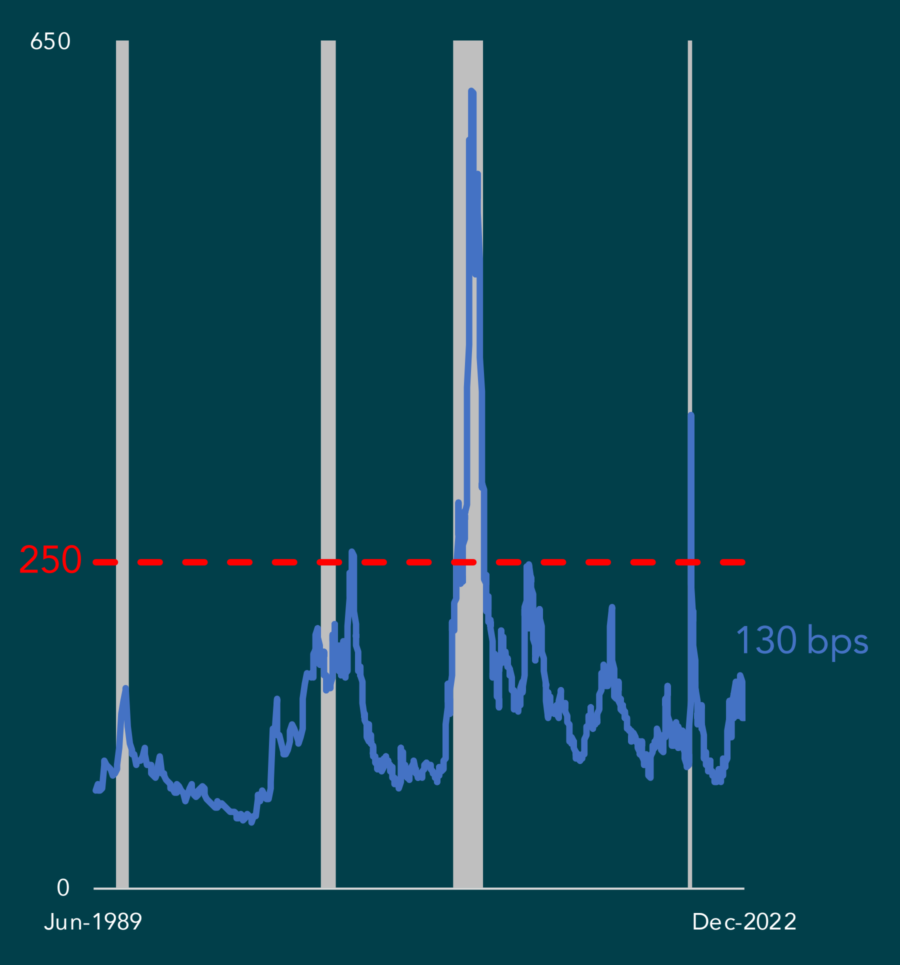
CreditSights 2023 Scenario Analysis for 10 year UST & credit spreads

Scenario	Probability	10 year UST YE 2023 forecast	IG Spreads YE 2023 forecast	HY Spreads YE 2023 forecast
Spot (Dec 12)		*3.54%*	*130 bps*	*437 bps*
CreditSights assigning 65% probability of spread tightening				
Bull Case	15%	3.8%	110 bps	350 bps
Base Case: Bumpy Landing	50%	4.0%	120 bps	400 bps
CreditSights assigning 35% probability of spread widening				
Bear 1: Stagflation	12%	5.0%	200 bps	700 bps
Bear 2: Hard Landing	23%	2.3%	300 bps	900 bps

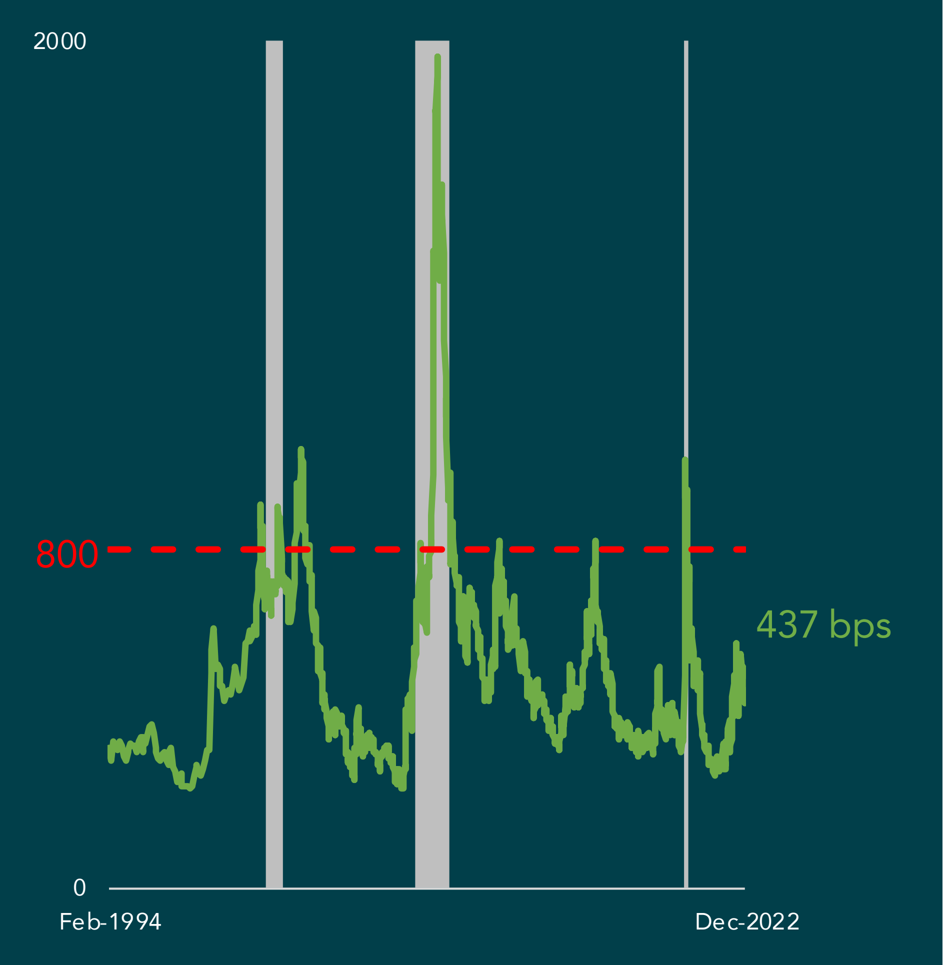
CreditSights

Historically, USD IG and HY credit spreads have risen above the 250 bps and 800 bps thresholds, respectively, during US recessions. We expect these credit spread thresholds to come closer into view as US recession risk rises, with the extent of widening closely tied to the timing and strength of the recession itself.

US IG OAS



US HY OAS



Source: (1-4) CreditSights, "US Investment Grade & High Yield 2023 Credit Market Outlook: 99 Problems, But Duration Ain't One" (Winnier Cisar). Bloomberg. Data as of December 12, 2022.

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"Macro stability isn't everything, but without it, you have nothing."