DUCENTA SQUARED
ASSET MANAGEMENT

Economic and Sector Summary & Outlook

First Quarter 2023

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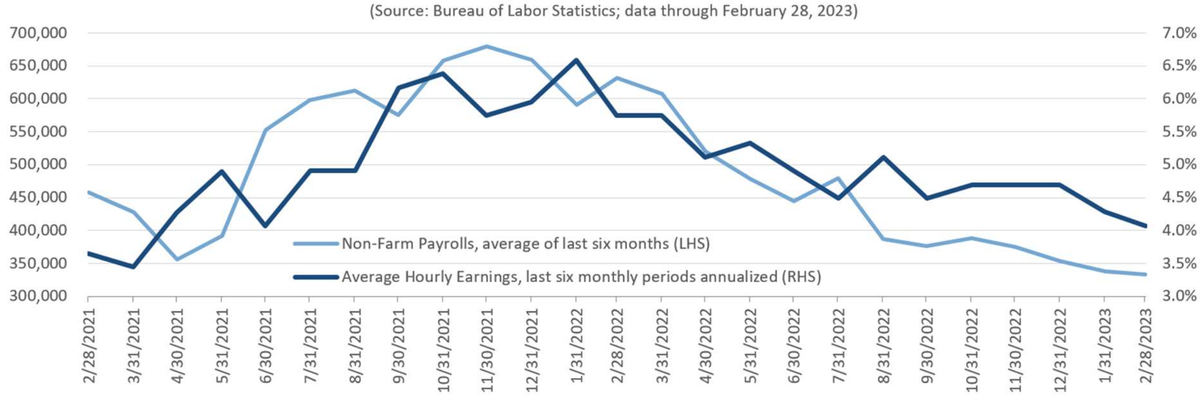
US Economy

Summary

In the first quarter of 2023, a deposit run on domestic regional banks and the forced sale of Credit Suisse to UBS disrupted what otherwise was good US economic momentum. Swift policy action helped avoid contagion across the banking system, but bank credit lending standards will likely become more restrictive over the balance of the year and could impair economic growth. Analysts still expect first quarter US GDP to increase by a modest 1.6%, supported by a rebound in consumer spending which continues to benefit from strong labor markets, rising wages, and excess savings from pandemic fiscal stimulus. The current 3.5% unemployment rate is the lowest in 54 years and the economy has added an average of 315,000 jobs per month over the past six months. Tighter monetary policy, however, is starting to impact the labor markets which have gradually softened from extremely strong levels (see chart).

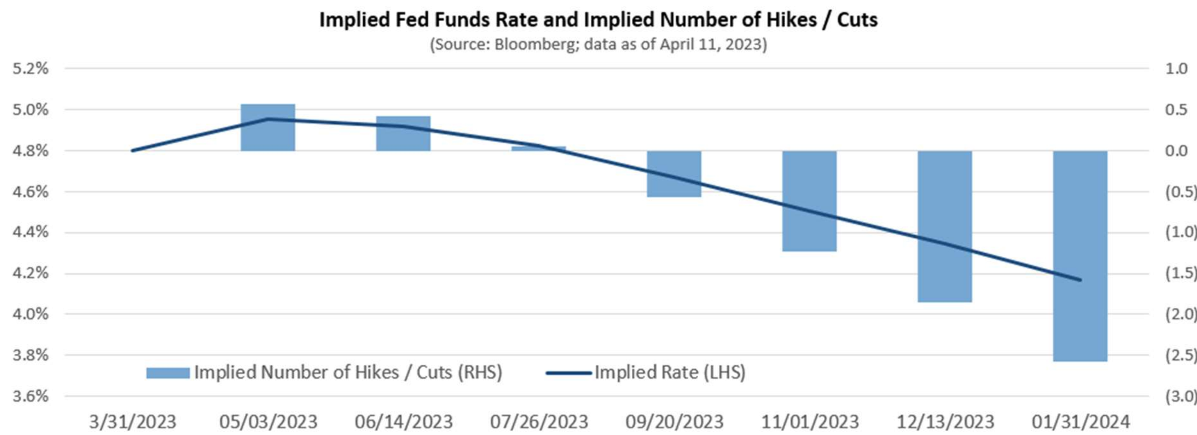
Slowing Job and Wage Growth
(Source: Bureau of Labor Statistics; data through February 28, 2023)



Housing activity stabilized over the quarter as housing starts, permits and new and existing home sales data all improved but the S&P CoreLogic Home Price Index fell for the seventh consecutive month in January. Survey data, such as the ISM Manufacturing, ISM Services, University of Michigan Consumer Confidence, and NFIB Small Business Survey generally project a pessimistic outlook across the US economy.

After encouraging inflation declines during the fourth quarter of 2022, consumer prices have become more "sticky" to start the new year. The headline CPI and the Core CPI, which excludes food and energy prices, ended the quarter at 5.0% and 5.6%, respectively, on an annualized basis, still well above the Federal Reserve's stated inflation target of 2%. Non-shelter services prices, a focus inflation component for the Federal Reserve, ended the quarter still elevated at 5.7%. Also notable, the long-awaited decline in shelter prices has yet to materialize as the owners' equivalent rents were higher by 8.0% over the past twelve months.

Market expectations for future Federal Reserve interest rate policy gyrated wildly based on shifting views for an economic hard-landing, to a soft-landing, to no landing, and back again to hard-landing following the banking crisis. At its March meeting, the Federal Reserve took pains to distinguish between tools to address the financial market stress and interest rate policy to fight inflation. It opted to raise policy rates 25 basis points to 5% but in its statement and press conference took a more dovish tone given the prevailing financial market uncertainty. By the end of the quarter the markets were pricing in one more hike followed by aggressive cuts over the next twelve months (see chart).



Outlook

We continue to forecast a recession for the US economy in the second half of 2023; it appears unavoidable given the combined effects of the Federal Reserve's tighter monetary policy, the outlook for softening labor markets, deteriorating corporate profits, and now the risk of tighter bank lending standards. We still believe a shallow recession is more likely given the relative strength of consumer and corporate balances sheets, but the risk for a more severe hard-landing scenario has increased.

We believe progress on inflation will be more difficult in the coming months but still expect Core CPI to fall from the current 5.6% to 3.5% by the end of the year. Improvement will depend on the degree to which 1) shelter disinflation finally materializes and 2) labor markets rebalance to cool service sector inflation. We expect both events to emerge in the second half of the year. Wage pressures have softened with the three-month annualized average hourly earnings from the March labor report declining to 3.2%, returning to levels consistent with the Federal Reserve's overall inflation target of 2%.

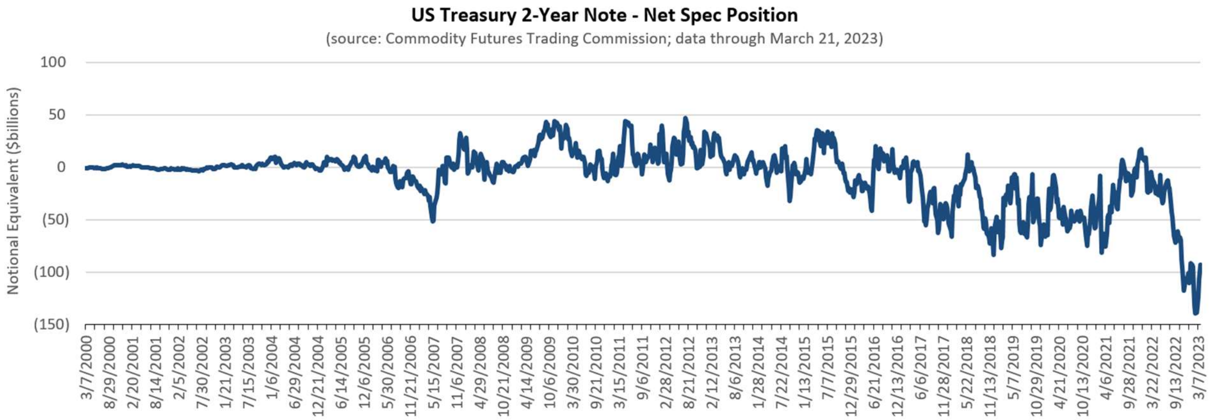
We expect the Federal Reserve to raise rates one more time at the May meeting and then remain on hold for the balance of 2023. We disagree with market pricing which implies approximately 2.5 rate cuts later this year, primarily due to the need to hold monetary policy tighter for longer than previous cycles to combat stubbornly high inflation. As Chairman Powell has warned there is still a "long way to go" to reduce inflation back to the 2% target and that bringing inflation down will "bring some pain to households and business" which leads us to believe expectations for near-term rate cuts appear premature.

Sector Analysis

US Interest Rates

The first quarter of 2023 produced extremely volatile swings in US Treasury note prices. Yields on 2-year US Treasuries began declining on the first trading day of the year to ultimately decline 40 basis points in January, only to shift back up 100 basis points in February reaching an intraday yield high of 5.08% on March 7. Finally, the market again reversed course as 2-year US Treasury rates declined 150 basis points in a matter of eight trading days. By any statistical measure, the speed and magnitude of this latest 150 basis point yield move seems almost unthinkable. In less than three months' time, short-term interest rate futures markets went from pricing three sequential 25-basis point rate hikes in 2023 to completely reversing that forecast and instead pricing in a total of four 25-basis point rate cuts.

Two major factors drove the schizophrenic movement in Treasury yields this quarter and both had been building throughout the Federal Reserve's rate hiking cycle 1) speculative net short positioning in the front-end of the yield curve and 2) the emergence of a potentially systemic banking crisis. Both of these factors developed slowly, and then emerged to prominence quickly. The rates analyst in us believes the "net spec" positioning was the more identifiable signal of potential rates volatility. While a determination of net spec positioning in one segment of the yield curve can represent a complex task involving analysis of multiple moving parts, we believe data on spec participants in the 2-year note futures published in the Commitment of Traders clearly displays the gradual increase in the net short position over the past few years and the sudden decline that pushed the net short position to its 2022 peak of $117 billion on November 15, 2022. The net short position increased further in 2023 to reach a peak of $139 billion on both February 14 and 21.



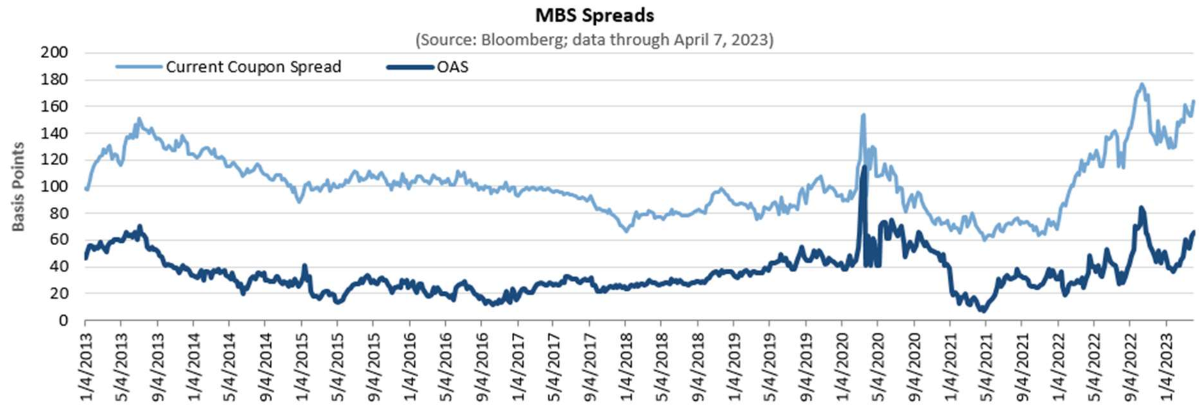
The emergence of market imbalances like the Treasury Note net spec positioning example noted above support our view that the late-cycle dynamics of this economic phase are truly beginning to unfold. Our somewhat negative perspective on broad economic trends contributes to our 3.00% target for year end ten-year US Treasury note yields versus the current rate of 3.45%.

With respect to curve shape and interest rate volatility and in concert with our view of declining yields in a late-stage economic cycle, we believe the yield curve will likely steepen to a positive slope while implied volatility remains elevated. We have seen this movie before. The Federal Reserve is approaching its terminal rate of 5.25% as soon as its upcoming meeting on May 3, the curve is deeply inverted, the rate implied vol surface is also inverted (short-dated implied volatilities exceed longer-dated measures), money supply growth is contracting, delinquencies are on the rise and stress is clearly building within the system. Historically, the auto-response in such environments is for the broad yield curve to re-steepen, the market prices in additional monetary easing, and the Federal Reserve ultimately delivers the needed liquidity. We believe the Federal Reserve is likely in the very initial stages of this policy inflection, and therefore target more neutral curve positioning versus the curve "flattener" position (i.e., underweight front-end and overweight long-end duration) which outperformed over the past year of aggressive policy tightening. We expect that re-positioning portfolio duration along the higher yielding front-end should positively contribute to performance. However, in the very short term, we believe that Treasury prices have moved too far, too fast, and appear modestly overvalued when measured on a local scale. Accordingly, we currently target neutral portfolio durations relative to the benchmark as we anticipate a retracement to marginally higher yields. Looking forward, we think any potential correction to higher yields should prove to be an important opportunity to lengthen portfolio duration and position accounts more defensively.

Securitized Products

The year 2023 got off to a wild start as markets, including those for securitized products, broadly experienced significant volatility. Relative calm prevailed in January as yields on spread products tightened to generate positive excess returns. In February, the market narrative shifted toward the prospect of sticky inflation and the Federal Reserve targeting a higher terminal federal funds rate. This resulted in a deeper inversion of the yield curve which hindered MBS performance. Finally, in March, three bank failures, a spike in volatility across multiple markets, and a reversal in expectations of the forward path for the federal funds rate upset the securitized products trading environment.

The rate rally during the quarter resulted in a strong +2.53% total return for mortgage products. The MBS Index widened in OAS by 12 basis points, ending the quarter at +63 basis points to generate a -50 basis point excess return relative to Treasuries.



A significant spike in rates volatility, net selling of MBS by bank portfolios, and the continued runoff of the Federal Reserve's balance sheet holdings all contributed to MBS underperformance in the period. In March, the failure of three US banks drove volatility to peak levels and threw the future path of interest rates into question, shifting banks' appetite for MBS. In the beginning of 2023, analysts incorrectly expected that banks would be modest net buyers of MBS; they have, in fact, been net sellers. According to the Federal Reserve's April 7, 2023 h.8 report, commercial bank MBS holdings decreased by $197 billion, or approximately 7% year-to-date. The Federal Reserve's MBS balance sheet holdings decreased by $47 billion during the quarter, declining by an average of over $15 billion per month. Although slower than the stated cap of $35 billion per month, this still meaningfully impacted the MBS market as it represented a reduction of what the Federal Reserve would have purchased had it maintained the size of its holdings. As we discussed earlier, this leaves money managers as the marginal buyer of MBS. During the second half of last year surveys show that money managers reduced their underweight to the sector to near neutral, however, there has been little incentive to move to an overweight given the relative outperformance of the credit markets.

We remain underweight MBS versus Index exposures, although we continue to opportunistically add to our holdings in the sector. On a historical basis, the current coupon mortgage spread appears attractive. It should be noted however, that prior to the 2008 financial crisis both Fannie Mae and Freddie Mac purchased significant quantities of MBS and acted as a market backstop and buyer of last resort. After 2008, the Federal Reserve became a price insensitive buyer of MBS and in certain periods purchased over 50% of all issuance. Bottom line, it has been decades since the MBS market didn't have some kind of government backstop, which makes historical relationships less useful. Our focus within the MBS sector remains conventional 30-year mortgages and we continue to avoid Ginnie Mae 30-year issues. We also prefer 20-year MBS versus 15-year. In the current environment we have eliminated our exposure to non-agency MBS but continue to closely monitor the sector for opportunities. Within the coupon stack we are focused on the belly coupons, 3.5% through 5.0%, while avoiding the wings.

The asset-backed sector provided a total return of 1.86% in the first quarter of 2023 while performing roughly in-line with duration matched Treasuries. The ABS Index widened in OAS by only 9 basis points to a historically attractive 85 basis points, resulting in an excess return over the quarter of -5 basis points. Generally speaking, ABS spreads tightened through the first two months of the quarter with esoteric sub-sectors such as aviation and data center-backed deals tightening the most, as well as lower rated deal tranches. ABS fundamentals remain supportive as consumers appear buoyant, supported by a very low unemployment rate. ABS new issue origination slowed in the first quarter versus 2022 by approximately 10% which has supported market technicals and contributed to a favorable pricing environment along with strong investor demand. The steep inversion of the yield curve also benefited sector performance as ABS securities generally have short average lives and price on a spread basis against the highest yielding portions of the Treasury yield curve. In the first quarter of 2023, this contributed to in all in yields of 5% to 6% for triple-A rated securities. We remain overweight the sector versus benchmarks given the high quality and attractive yields currently offered by ABS securities. During the quarter we took advantage of the risk rally during January and February to sell mostly off-the-run holdings and lower-rated

CLOs as they rallied. We repositioned portfolios into larger more liquid triple-A senior securities given our expectation for slowing economic growth.

CMBS sector fundamentals deteriorated during the first quarter. The CMBS Index generated a total return of 1.81% while the OAS widened 22 basis points to 142 basis points and resulted in an excess return of -74 basis points. Investors increasingly scrutinized commercial real estate fundamentals as work from home habits continue to pressure space utilization, especially in central business districts. Kastle Systems reports that building traffic still resides at only approximately 50% of pre-COVID levels. Over $1 trillion of office space loans will come due through 2025 and the outlook for routine refinancing looks increasingly troubling, as evidenced by the default by Brookfield DTLA on two of its buildings in February. Extremely low supply represents the only positive CMBS sector attribute. We maintain low exposure to CMBS, hold only well-seasoned deals, and intend to remain very defensive with regard to positioning within the sector.

Credit Spotlight

The Banking Mini-Crisis of 2023

Old timers got a chance to relive the past and the new kids on Wall Street experienced a taste of history, as multiple recent bank failures rekindled memories of the 2008 Global Financial Crisis. Currently, any potential for further contagion appears contained, but recent events suggest that it won't be business as usual in the banking industry, and follow on effects could slow economic growth and contribute to the likelihood of a 2023 recession.

In the first quarter of 2023, three US banks failed, one came very near failure and one large international systemically significant financial institution was acquired by a competitor:

- Silvergate Capital Corp (SI; $15 billion in total assets) – Entered voluntary liquidation on March 8, 2023 following the bankruptcy of a major customer (Sam Bankman's FTX failed in November 2022) which led to concern regarding the bank's reliance on cryptocurrency customers, triggering a decline in its stock price and a run on deposits that became evident in early January 2023.
- Silicon Valley Bank (SIVB; $212 billion in total assets) – Shut-down and seized by regulators on March 10, 2023 due to an accumulation of outsized securities portfolio losses and questions regarding liquidity and capital adequacy as a funds raising effort led by Goldman Sachs failed. SIBV focused on banking development stage technology companies. Several venture capital firms exacerbated the situation and essentially created an organized run on deposits by advising portfolio companies to withdraw any cash held at SIVB.
- Signature Bank of New York (SBNY; $110 billion in total assets) – Shut down and seized by regulators on March 12, 2023 as an accumulation of outsized securities portfolio losses eroded the faith of investors, customers and depositors in the immediate wake of the failures of SI and SIVB.
- First Republic Bank (FRC; $213 billion in total assets) – Identified by investors as the next domino to potentially fall following the failure of SI, SIVB and SB, due to concern regarding its large balance of uninsured deposits and capital adequacy in light of outsized securities portfolio losses. On March 16, 2023, as deposit outflows worsened, a group of eleven large US banks pledged to deposit $30 billion with FRC. FRC continues to operate and hasn't yet been seized by regulators, but its common stock price has declined nearly 90% year-to-date.
- Credit Suisse (CS; $588 billion in total assets) – A perennially weak-performing and internationally systemically important Swiss bank that repeatedly found itself on the wrong side of regulatory investigations. In October 2022, Credit Suisse raised $4.2 billion in capital from Saudi National Bank and other investors amid a restructuring effort. Despite that effort, worried depositors and customers moved as much as $100 billion from the bank in the fourth quarter of 2022. As news of the US bank failures spread, investors increasingly pressured CS's stock and bond trading levels, and Saudi National Bank, the company's largest shareholder, explained it likely wouldn't increase its ownership position past the 9.9% it already owned. Ultimately, failing investor confidence forced Swiss regulators to intervene and force a merger of UBS ($1.1 trillion in total assets), the largest Swiss bank, and Credit Suisse.

This time, the catalyst driving US bank failures was rooted in an accumulation of bank securities portfolio losses that reduced customer faith and triggered runs on deposits at certain relatively small institutions. One could also argue that these smaller US banks weren't subject to the more stringent capital requirements placed on large banks. The failed US banks also shared another key characteristic: a large proportion of deposits that exceeded the FDIC $250,000 deposit insurance limit. Additionally, in recent years, the banking industry significantly advanced the ubiquity of mobile banking, which allows deposits to move into and out of financial institutions more freely than ever before. Today, corporate depositors, some of which hold hundreds of millions or billions of dollars in deposits, can move funds in a matter of minutes. These factors contributed to the deposit runs that exhausted liquidity at SI, SIVB and SBNY, and continue to challenge FRC. No bank can withstand a run on deposits; we recommend watching Jimmy Stewart in It's a Wonderful Life, if you need a reminder on why that is the case.

Credit Spotlight (continued)

On March 12, 2023, to calm depositor and investor fears, the US Federal Reserve, Department of the Treasury and the FDIC announced the guarantee of all deposits at SIVB and SBNY, including those exceeding the $250,000 FDIC limit. While the guarantee wasn't extended to all banks, it came with the implication that a similar guarantee could be extended to any other US bank that might experience a run on deposits. On the same day (March 12), the Federal Reserve announced a Bank Term Funding Program that would lend against bank securities portfolios at par. These two government initiatives appear to have 1) calmed bank depositors and investors and 2) resolved bank liquidity shortfalls caused by the decline in the value of their securities portfolios.

The speed of deposit flight played an important role in the Banking Mini-Crisis of 2023. In addition, this crisis caused deposits to flow from weaker institutions (mostly smaller banks with total assets less than $200 billion) to large systemically important financial institutions which don't necessarily suffer from the same depositor concentrations that fueled the runs at SI, SIVB, SBNY and FRC. This creates a potential existential problem for small regional and community banks, as investors and depositors now perceive these institutions as a less safe place to hold deposits, as compared to large banks which many investors believe will be rescued due to their systemic importance and the likelihood that large banks are less vulnerable to deposit runs due to the composition and diversity of their depositors. Regulators will likely focus on that issue soon, as they consider various alternatives, including a simple guarantee of all US bank deposits, including those in excess of the current $250,000 FDIC limit. Deposit flows will likely continue as higher yields on money market instruments and other investments begin to entice sleepy depositors to move funds out of low yielding bank accounts. As banks raise deposit rates to compete, they may also adjust lending standards accordingly, putting further pressure on loan growth. Finally, we note that ratings agencies previously viewed deposit-funded financial institutions (i.e., banks) as better capitalized than finance companies that rely exclusively on term financing (i.e., secured financing and bonds). With the fragility of certain deposit funded financial institutions now laid bare for all to see, its likely that ratings agencies, regulators and investors will reassess the strengths and weaknesses of deposit funding.

As the events of the first quarter of 2023 unfolded, bank common stock, preferred stock and bond prices declined significantly, even for institutions that effectively managed their securities portfolios during the period of unprecedented Federal Reserve rates increases. Those price movements have a meaningful negative effect on banks' ability to raise capital and continue lending to customers. Most analysts believe that banks will tighten lending standards in the first half of 2023, a move that could contribute to recessionary trends.

Amid the recent market volatility, some investors appeared satisfied enough to sell or short bank equities and bonds, while others took that well-worn page from the Wall Street playbook and sought avenues to "express a view" on other potential weaknesses related to this banking crisis. In that pursuit, commercial real estate surfaced as the primary focal point of investor attention. Coupling the thought of tighter lending standards and weakening fundamentals in commercial real estate, investors targeted regional banks that lend heavily on commercial real estate, as well as insurance companies. As a result, over the next few quarterly periods, investors will scrutinize trends relating to commercial real estate loans, especially loans on out-of-favor office buildings. We believe insurance companies may be less affected by problem commercial real estate exposures than some recent market price movements suggest.

Governments and regulators actively intervened to prevent the recent crisis from spreading beyond SI, SIVB, SBNY, FRC and CS. The marriage of UBS and CS harkens back to the Great Financial Crisis of 2008 when debilitating losses on mortgage backed securities and the direct interconnectedness of large derivatives counterparties motivated US regulators to broker the combinations of JPMorgan Chase & Co. (total assets: $2.2 trillion in 2008) and The Bear Stearns Companies Inc. (total assets: $399 billion in 2008), Bank of America (total assets: $1.8 trillion in 2008) and Merrill Lynch & Co., Inc. (total assets: $668 billion in 2008), and Wells Fargo & Co. (total assets: $1.3 trillion in 2008) and Wachovia Corporation (total assets: $764 billion in 2008).

But the interconnectedness and the systemic threat posed by SI, SIVB, SBNY and FRC appears modest compared to that of Bear Stearns, Merrill Lynch and Wachovia. As such, the unprecedented guarantee of all deposits at SIVB and SBNY allows pundits to suggest that regulators panicked and threw out the window all the regulatory advances made since 2008. Given the renewed regulatory framework, including the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, some lament the active part that regulators played in the recent bank failures and argue that a better discipline in the long run might have been to let the chips fall where they may. Moreover, the guarantee of all deposits at SIVB and SBNY seems to represent an extreme measure that benefits "wealthy depositors", and while the estimated $23 billion cost of that guarantee won't be paid by the government, consumers will ultimately pay as banks will pass higher FDIC rates onto customers as part of the cost of doing business. Indeed, more government involvement appears certain, as the Federal Reserve, US Treasury, FDIC and Congress now appear committed to reviewing the bank regulatory environment from the perspective of the Banking Mini-Crisis of 2023.

Investment Grade Credit

Investment grade credit markets experienced significant volatility during the first quarter of 2023. After beginning the year 130 basis points wide of comparable US Treasuries, the OAS on the Bloomberg US Corporate Bond Index initially tightened to 115 basis points in early February before sharply widening out to 163 basis points in March, only to end the quarter relatively unchanged at 138 basis points. The failures of three US banks and Credit Suisse, a large internationally systemically significant financial institution violently disrupted the relative calm that characterized the start of the year. Turmoil in the banking sector shook the market's confidence in the soundness of our financial system and pushed investment grade corporate bond spreads wider to levels last seen in October 2022. While strong and decisive actions by the Federal Reserve restored some semblance of normalcy to most of the market, investors continue to scrutinize regional banks and issuers exposed to commercial real estate. While investment grade corporate bond spreads widened slightly in the quarter, the broad repricing of rates in the period contributed to a positive Bloomberg US Corporate Bond Index total return as yields tightened 29 basis points and ended the period at 4.39%, versus 4.68% at year end 2022.

Investment grade corporate bond primary issuance of $396 billion in the first quarter tracked 5% below the average issuance over the four immediately preceding first-quarter periods. Activity in the quarter was bifurcated between a very active January and February, and a near halt as the banking crisis unfolded. March, a historically active period, underwhelmed expectations as the market priced only $100 billion of new supply; down 50% from the preceding 4-year average of $202 billion. While limited new supply represents a positive technical for the investment grade market, lower overall yields and the return of rates volatility pushed many participants to the sidelines.

The best-performing industries and sub-segments of the Bloomberg US Credit Index on an excess return basis included autos, consumer products, food & beverage, industrial, and aerospace & defense. REITs, banks, insurance, media, transportation, and packaging ranked among the worst-performing industries and sub-segments during the quarter.

While corporate balance sheets still remain relatively healthy, economic growth is slowing and the consumer is weakening. In addition, banks will likely tighten credit standards as they deal with the consequences imposed by markets and regulators in the wake of three US bank failures. As the Federal Reserve remains steadfast in its fight against inflation, the odds of a harder landing increased in recent weeks. We remain cautious on credit spreads and maintain an underweight position in investment grade credit as we wait for more attractive entry points.

High Yield

The US high yield bond market, as measured by the Bloomberg US Corporate High Yield Bond Index, rode a strong January, as well as a recovery in the final week of the quarter, to post a strong 3.57% return in the first quarter of 2023, despite significant volatility stemming from the sudden failure of three US banks. Unlike the rally in the fourth quarter of last year, lower-rated credit led returns to start 2023, with CCC-rated issues gaining 4.96% in the first quarter, including a 6.06% return in January alone. Bonds rated BB and B gained 3.44% and 3.47%, respectively. High yield spreads began the year at 469 basis points and traded in a wide, 130-basis-point range before ending the quarter essentially unchanged. The sharp rally to start the year brought spreads to a recent tight of 385 basis points in early February, but spreads gapped out to 516 basis points during the height of volatility in March. In the last week of the quarter, the market rallied 60 basis points tighter to 455 basis points. Yields also traded in that same 130-basis point range in the quarter, briefly touching a low of 7.73% in early February before widening to just over 9% in March. From start to finish, however, yields compressed 44 basis points during the quarter to 8.52% as the 5-year US Treasury bond yield dropped over 40 basis points. Performance varied widely across sectors in the first quarter, with leisure (+9.4%), building materials (+5.8%) and healthcare (+5.6%) outperforming, while wireline telecommunications (-3.7%) and the pharmaceuticals (-0.2%) sectors posted the only negative returns.

High yield issuer credit fundamentals remain solid, although there are clear signs that the post-Covid recovery has peaked. Issuers reported modest quarter-over-quarter declines in fourth quarter 2022 revenue and EBITDA, while leverage remained steady at 4.0x (as compared to the 6.1x peak registered in the fourth quarter of 2020). Although still below the long-term average, high yield bond default rates climbed from 0.84% to 1.27% in the first quarter, and we anticipate that this trend will continue as the year progresses. Conversely, in the first quarter, rating upgrades outpaced downgrades, reversing the trend experienced in the fourth quarter of 2022. With the first quarter 2023 earnings reporting season nearly upon us, we expect that issuer credit fundamentals deteriorate further as a result of continued profit margin pressure, sequential earnings declines, and more restrictive access to credit. Defaults will likely climb and could approach the long-term average of approximately 3% by year-end 2023.

As yields declined below 8% in February (for the first time since August 2022), companies opportunistically tapped the high yield market, issuing $40.5 billion in new debt during the first quarter, the largest quarterly total since the first quarter of 2022 and significantly higher than the $16.5 billion issued in the fourth quarter of 2022. On the demand side, retail fund outflows accelerated to $16.0 billion in the period, more than reversing the $7.2 billion inflows in the fourth quarter of 2022. However, rising stars trends continued to support technicals; $21.6 billion of high yield bonds migrated up to the investment grade market in the first quarter, while fallen angels totaled $13.5 billion. The high yield maturity wall remains manageable given the wave of refinancings completed in 2021, and we expect companies to access the primary market in 2023 only if high yield market conditions remain favorable for issuers.

With spreads back in the mid-400 basis point area, roughly the midpoint of the 6-month range and well inside historical recessionary periods, we remain unconvinced that valuations reflect the potential earnings downside and credit deterioration that could materialize in coming quarters. Consequently, we maintain a cautious positioning and currently prefer higher-rated credits (including an allocation to BBBs) and less-cyclical sectors. The market is pricing in FOMC rate cuts in the second half of 2023, a scenario that we find difficult to envision absent a materially weaker economy that would also be negative for high yield spreads. As we wait for more clarity, we remain content to be positioned to add risk to portfolios should spreads widen in coming quarters and offer a more attractive entry point.

Leveraged Loans

Strong leveraged loan market momentum continued from the fourth quarter 2022 and helped the Credit Suisse Leveraged Loan Index post a 3.11% return in the first quarter, its best quarterly performance since the fourth quarter of 2020. As was the case in the high yield market, lower-quality loans drove performance, with Bs and BBs gaining 3.75% and 2.25%, respectively. Average loan prices finished the quarter up three quarters of a point at 92.67, with Bs up nearly 2 points. At the sector level, most industries gained 2% to 3% in the quarter with the notable exception of telecommunications, which returned -2.01%. Loan spreads, as measured by the 3-year discount margin, tightened 43 basis points in the period to 609 basis points. Spread tightening, combined with a sharp repricing of forward rate cuts (i.e., pricing in rate cuts in the second half of 2023), drove the average loan yield down 77 basis points to 9.99% in the quarter, even as LIBOR (and SOFR) continued to march higher along with the federal funds target rate.

Although many market participants maintain a cautious stance on loan market fundamentals going forward, fourth quarter earnings remained resilient for most issuers. Revenue and EBITDA declined 3% and 5% from the prior quarter, a trend similar to that exhibited by high yield issuers. Despite this, leverage metrics improved to 4.6x from 4.8x at the end of the third quarter of 2022 and 7.8x at the end of the first quarter of 2021. With the rapid increase in interest rates, investors appear justifiably concerned with the potential for declining loan issuer fixed charge coverage ratios. Data show that interest expense increased 9% quarter-over-quarter, yet interest coverage metrics held steady at 4.9x. We expect this number to deteriorate as the year progresses, and particularly for highly-leveraged loan issuers, some of which may experience cash flow and liquidity difficulties. Rating agency downgrades continued to outpace upgrades in the first quarter at a margin of roughly two-to-one, reflecting the potential credit troubles ahead for many loan issuers. Additionally, eleven loan issuers defaulted in the first quarter, pushing the loan default rate to 1.72%, up from 0.97% at year-end 2022. As 2023 progresses, we expect that the default rate will continue to rise as the loan market appears particularly at risk from deteriorating fundamentals, given a concentration of highly-leveraged, private equity-owned issuers with lower average credit quality.

Despite financial market volatility in the first quarter, CLO issuance remained fairly active as 78 deals totaling $33.9 billion priced, up from only $22.6 billion in the fourth quarter of 2022. On the flip side, retail fund outflows continued, as investors redeemed $9.3 billion in the first quarter following the $12.8 billion outflow in full-year 2022. In order to match tepid demand, the primary loan market slowed to begin 2023. New issuance totaled $70.3 billion in the first three months of the year, but if refinancings are excluded, just $14.0 billion came to market. These figures compare to $120.5 billion ($84.2 billion ex refinancings) in the first quarter of 2022. Looking forward, the loan market faces a larger maturity wall in coming quarters than the high yield market. As a result, we expect to see more refinancing transactions to deal with near-term maturities.

After maintaining a constructive view on leverage loans versus high yield bonds for much of 2022, we view the trade-offs more balanced at this point. Although the loan market yield still exceeds that offered by the high yield market, that relationship could reverse as soon as the Federal Reserve reverses course and starts cutting rates. Additionally, with most loans still trading near par, we remain cautious regarding performance over the next few quarters as a possible recession poses significant risk to loan market fundamentals. Compared to the high yield market, the loan market comprises a higher concentration of lower-rated issuers that are much more susceptible to higher interest expenses and deteriorating earnings trends in 2023. Therefore, we remain focused on higher-rated loan issuers that also have high yield bonds in their capital structures; these bonds provide both fixed rate interest expense as well as a recovery cushion should fundamentals deteriorate.

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The MOVE Index is a measure of US interest rate volatility that tracks the movement in US Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries.

The Bloomberg US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

The Bloomberg US Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

The Bloomberg US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1 / BB+ / BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

The Credit Suisse Leveraged Loan Index tracks the investable market of the US dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's / S&P ratings of Baa1 / BB+ or Ba1 / BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.