Economic and Sector Summary & Outlook

Third Quarter 2022

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US Economy

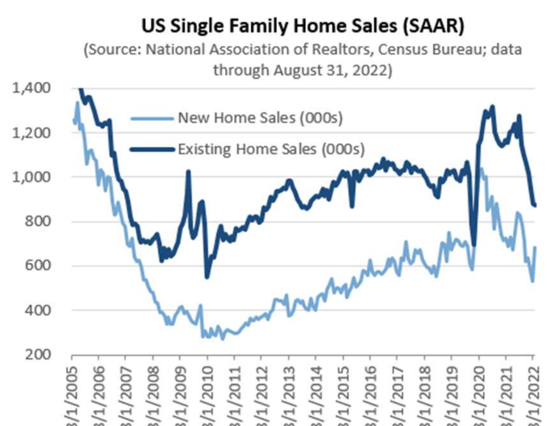
Summary

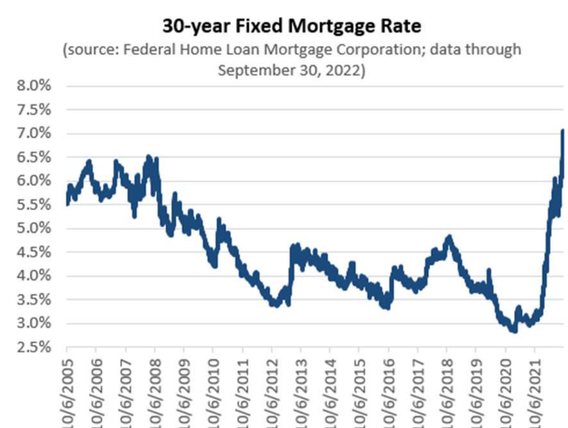
The Federal Reserve's ongoing battle to reduce stubbornly high inflation and cool tight labor markets comprised the major US economic theme in the third quarter of 2022. In its effort to quell the prevailing inflationary trend, the Federal Reserve raised short-term rates by 75 basis points in both July and September and is expected to hike rates an additional 1.25% by year end. Throughout the quarter, Federal Reserve officials expressed their commitment to raise rates and hold policy in restrictive territory to bring inflation back to the 2% target, even at the risk of potential "***pain***" to households and businesses.

Stronger-than-expected inflation reports in the third quarter dashed hopes that price pressures would quickly subside. Headline CPI declined from the peak of 9.1% in June to 8.2% in September, due primarily to declines in energy prices, but core CPI, which excludes food and energy, increased during the quarter from 5.9% in June to 6.6% in September. Consumer spending on services remains resilient while rental inflation continues to trend higher. Shelter prices represent 41% of core CPI and the owner's equivalent rent component has climbed from 3.8% to start the year to 6.7% in September.

The robust labor market remains the primary focus for the Federal Reserve in its attempt to cool demand in the economy and reduce inflation. Employment data moderated somewhat in September, suggesting that the Federal Reserve's tighter policy is beginning to have an impact. Recent data reflect a decline in job openings, higher jobless claims, a slowing trend in wage growth, and a modest step down in job creation. Despite this recent softening, the labor market remains extraordinarily strong by historical standards as the unemployment rate declined to a near record low of 3.5% in September.

The interest rate-sensitive housing market is feeling the impact of the Federal Reserve's tighter policy stance. US mortgage rates increased by 3.7 percentage points over the past year to reach 6.7% in September and housing affordability currently resides at record lows. As a result, housing activity has weakened dramatically as new and existing home sales declined by approximately 20% year-to-date, while month-over-month home price appreciation declined to -0.44% in July versus the 1.66% average increase registered in the immediately preceding six monthly periods as measured by the S&P CoreLogic Case-Shiller 20-City Composite City Home Price Index.





Outlook

The US economy, supported by a resilient consumer and strong labor markets, appears to possess sufficient momentum to finish the year with positive GDP growth. However, we continue to expect the lagged effects of the Federal Reserve's tighter monetary policy to push the US economy into a recession starting in the first half of 2023. Headwinds from higher prices, negative real earnings, softening labor markets, and declining household net worth will take a toll on the US consumer. Although we do not expect a repeat of the 2008 Global Financial Crisis, we believe the housing market has already entered a recessionary phase. Slowing economic growth globally, especially in China and Europe, will also negatively impact economic growth in the US.

Inflationary pressures have expanded from the narrow categories initially impacted by the pandemic to now include service sector and shelter prices. Improvements in supply chain disruptions and reduced overall demand as the economy cools should gradually improve the outlook for inflation; nevertheless, we anticipate that inflation will remain well above the Federal Reserve's 2% target in 2023. Wage pressures have moderated, but the growth in average hourly earnings would need to fall from the current 5% rate to approximately 3.5% to be consistent with a return in the overall inflation rate to 2%. Although inflation remains stubbornly high, the Federal Reserve can take some solace in the fact that measures of inflation expectations, such as the University of Michigan Inflation Expectations survey and the TIPS market break-even inflation rate, remain well anchored.

The Federal Reserve was late in shifting to tighter monetary policy and now faces the daunting task of bringing inflation under control while attempting to navigate a soft-landing for the economy. The recent stronger-than-expected inflation and employment reports compel us to increase our outlook for Federal Reserve rate hikes. We now expect the Federal Reserve to raise rates by 75 basis points in November 2022, 50 basis points in December 2022, and a final 25 basis points in February 2023. Our view is in line with the Federal Reserve's own dot plot projection and market expectations from the federal funds futures market. We are skeptical, however, that the futures market appears to be pricing in a Federal Reserve pivot involving a rate cut in the second half of 2023; whereas we expect it to hold rates steady for the balance of 2023.

Sector Analysis

US Interest Rates

After declining in July, US Treasury yields increased sharply in the next two months to levels not seen since the height of the 2008 Global Financial Crisis. The Federal Open Market Committee ("FOMC") raised the federal funds target rate by 75 basis points in both its July and September meetings, bringing the federal funds rate to 3.25%, a full 300 basis points higher than at the beginning of 2022. The rise in yields, which reflected itself across the curve, was reinforced by Federal Reserve Chairman Jerome Powell's statements at the Jackson Hole Economic Symposium, on August 26, 2022, when he said, "The FOMC's overarching focus right now is to bring inflation back down to our 2.0% goal." He also noted that "restoring price stability will take some time", and that "higher interest rates, slower growth, and softer labor market conditions…will also bring some ***pain*** to households and businesses." The market viewed this as "higher rates for a longer period."

The US Treasury yield curve flattened considerably in the third quarter of 2022 reflecting the expectation that the FOMC will continue to raise short-term rates. The yield on the 2-year US Treasury Note increased from 2.95% to 4.28%, while the yield on the 10-year US Treasury Note rose from 3.01% to 3.83%. Consequently, the spread declined to -45 basis points, a 40 basis point decline from the beginning of the quarter. Similarly, the spread between the 10-year US Treasury Note and the 30-year US Treasury Note declined 22 basis points to -5.88% as the 30-year US Treasury Note yield increased from 3.18% to 3.78%.

The increase in short-maturity rates mostly reflects expectations for a significantly higher federal funds rate in 2023, while rates at the long end of the curve reflect investor views regarding inflation expectations, forward growth estimates and real interest rates. The continued flattening of the yield curve in the third quarter of 2022 reflects market expectations regarding slower economic growth, and a hawkish Federal Reserve. We believe rates should remain high for the remainder of the year and economic growth should slow, keeping the yield curve flat and inverted.

Securitized Products

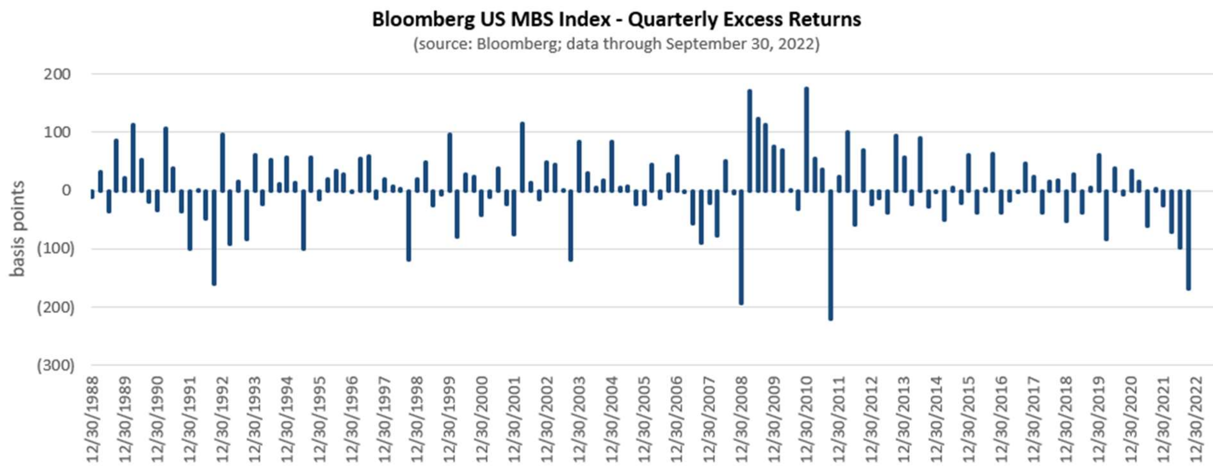
Both interest rates and interest rate volatility moved higher again during the third quarter of 2022, creating a very challenging period for the bond market, especially the MBS sector, which is much more sensitive to interest volatility than the ABS and CMBS sectors.

In addition to the effect of rates, the MBS market was also negatively impacted by the fact that the Federal Reserve's System Open Market Account ("SOMA") ended its practice of reinvesting MBS principal payments and prepayments in open market MBS purchases. The Federal Reserve first began letting its SOMA portfolio run-off at a rate of $17.5 billion per month in June 2022 by not reinvesting principal payments and prepayments in additional

MBS open market purchases. In September, the Federal Reserve increased the maximum run-off rate to $35 billion per month, further reducing its MBS open market purchases. Since the SOMA currently generates less than $35 billion per month in principal payments and prepayments, the Federal Reserve has effectively ended its purchasing of MBS in the open market.

Interest rates rose across the yield curve in the third quarter generating negative total returns for all securitized products sectors. Given the short average life and duration of the ABS Index, prices there fell the least generating a -1.16% total return for the quarter. The CMBS and MBS Indices generated total returns of -3.11% and -5.05%, respectively. These compare with the Bloomberg US Aggregate Bond Index return of -4.32%. During the period, we maintained our largest overweight in ABS and our largest underweight in the MBS sector.

Mortgage spreads, and as a result mortgage excess returns, registered one of their worst quarters ever. As measured by excess return over duration-matched US Treasuries, MBS generated a -169 basis point excess return, its third-worst quarterly performance on record going back to the mid-1980s. In spread terms, the current coupon mortgage rate widened 36 basis points in the quarter to 171 basis points over the 5-year / 10-year US Treasury blend. Previously, this spread only briefly reached this wide a level immediately following the 2020 COVID shelter in place period.

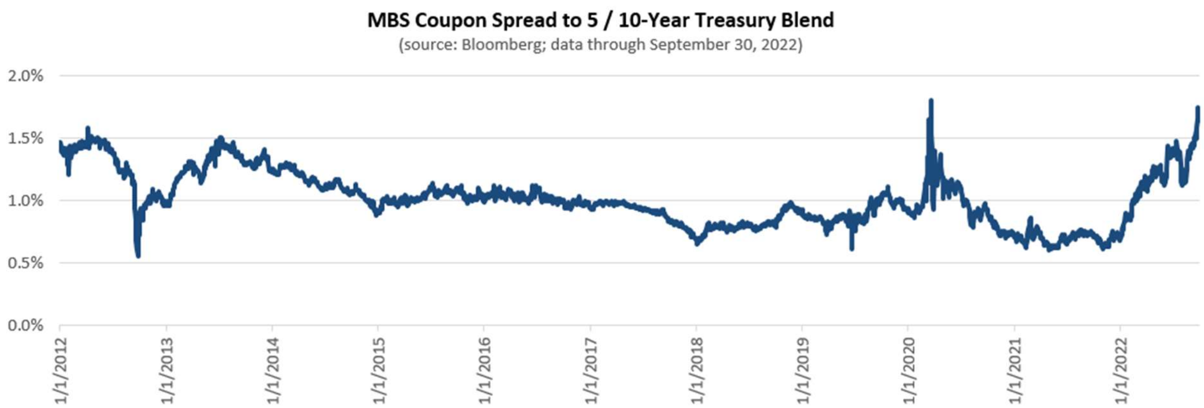


The ABS Index experienced spread widening for most of the first half of the year. However, during the third quarter of 2022, spreads reversed and tightened as the sector's attractive valuation and high quality fundamental and technical characteristics during times of uncertainty began to appeal to investors. The ABS Index OAS tightened from 75 basis points to 53 basis points over the course of the quarter, producing an excess return of 30 basis points. Market volatility during the quarter negatively impacted new issue supply as July and September represented the monthly periods of lowest issuance this year. Specifically, year-to-date ABS issuance in 2022 resides only 4.5% lower than the prior year period. However, in September 2022, the quantity of ABS new issuance declined by 60% versus the prior year period. Within the ABS sector, down-in-quality trades and to a certain degree trades in less liquid securities recovered from underperformance in the first half of the year. AAA-rated ABS, which comprises 86% of the ABS Index, generated 40bps of excess return, while other ratings categories generated excess returns as follows: AA-rated ABS: 81bps, A-rated ABS: 143 basis points, and BBB-rated ABS: 91 basis points.

CLO spreads continued to widen as the sector did not benefit from the rebound in the ABS sector. Spreads across the entire credit stack increased, according to Palmer Square CLO indices. AAA-rated CLO tranches broached a discount margin of 200 basis points for the first time since the period immediately following the 2020 COVID shelter in place period, finishing the quarter 20 basis points wider at a discount margin of 203 basis points. CLO tranche pricing is very dependent on subordination and market value overcollateralization levels. AA-rated tranches widened 7 basis points to a discount margin of 273 basis points while single A-rated tranches widened 52 basis points to a discount margin of 378 basis points. BBB-rated CLO tranches widened the most in the investment grade credit stack moving out 79 basis points to a discount margin 545 basis points. Market volatility has negatively impacted the quantity of CLO new issuance as year-to-date supply of $104 billion is down 21% versus the prior year period.

The OAS on the CMBS Index trended only modestly wider over the course of the third quarter, from 101 basis points at the beginning of the period to 105 basis points at period end. This widening resulted in an excess return of -26 basis points. Within the sector, agency and non-agency CMBS performance diverged during the period, due in part to the outperformance of agency CMBS in the first half of the year (because it was used as an agency MBS substitute by some investors) and its reversion to a mean spread level in-line with non-agency CMBS in the third quarter. The non-agency CMBS Index generated 6 basis points of excess return while the agency CMBS Index generated an excess return of -62 basis points. Overall year-to-date CMBS issuance in 2022 declined to $91.3 billion, approximately 10.3% lower versus the prior year period.

Since the second quarter of the year, the Federal Reserve has maintained that fighting inflation represents its highest priority and it has continually pushed back on market expectations regarding the potential for an easing of monetary policy in 2023. That message and the prospect that the Federal Reserve, through its SOMA, may eventually become an outright seller of MBS represent a headwind for the sector. For now, however, the technical backdrop for the MBS market leans positive as higher mortgage rates have reduced mortgage origination flows. That said, bank demand for MBS has dwindled, and REITs have been better sellers, leaving money managers as the marginal buyer. By historical standards MBS spreads appear attractive, however, volatility and relative value comparisons currently keep buyers on the sidelines. In this environment, we plan to maintain an underweight to MBS relative to index weightings, with a slight bias to begin reducing that underweight as spreads improve and technical factors stabilize.



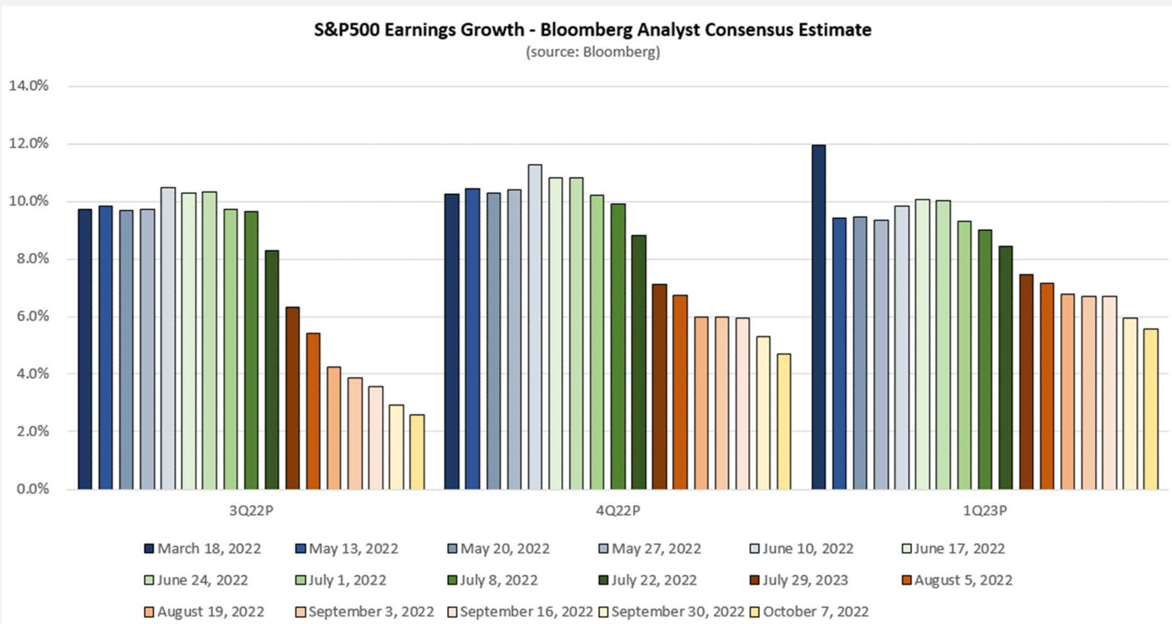
We continue to view the ABS sector favorably and remain overweight. We favor defensive holdings focusing on quality and liquidity. We expect to concentrate positions in AAA-rated senior tranches with a strong preference on more liquid and larger-sized shelf offerings. We scaled back our CLO exposure and moved up in quality and shorter in average life, positioning more defensively as well. Short average life AAA-rated CLOs now yield between 6% and 7%, levels we believe make attractive buy and hold opportunities for a small portion of our portfolios. We remain very defensive regarding CMBS in terms of both fundamentals and relative value. Underlying loans, especially in the commercial office space, will likely face meaningful long-term headwinds as expiring leases renew for lower rents and reduced square footage. Also, the swift increase in interest rates has yet to be incorporated into commercial real estate capitalization rates and we expect that building valuations could be exposed to downside risk of up to 10%. From a valuation perspective, the correlation of CMBS and investment grade credit spreads is high and our bias toward wider credit spreads causes us to disfavor CMBS except for very short average life bonds.

Credit Spotlight

Will this be the Quarter that Credit Fundamentals Start to Crack?

Corporate earnings have understandably been under a microscope this year as companies attempt to manage through a myriad of moving parts in the US and global economies, including ongoing demand shifts as pandemic trends reverse, disrupted supply chains, tight labor markets, input price inflation, and a strengthening US dollar. Despite these challenges, through the first half of the year, earnings growth has remained positive and beat expectations. For the companies in the S&P 500, earnings per share (EPS) increased approximately 10% in the first quarter of 2022, beating consensus estimate for a 5% increase going into the period. In the second quarter, EPS growth decelerated to nearly 8%, beating estimates by approximately two percentage points.

As we enter third quarter earnings reporting season, pessimism seems to be setting in again, with current estimates calling for S&P 500 EPS growth to slow to 2.6% as of October 7, 2022, with most of that gain driven by a decline in share count as a result of recent share repurchase activity. Since the end of June, estimates regarding third quarter earnings have declined by approximately 7%, with the largest negative revisions coming in the technology sector following a raft of guidance cuts announced by semiconductor manufacturers. Analysts currently expect revenues in the third quarter of 2022 to grow nearly 10% versus the prior year period, implying sales will slightly outpace the near 8% headline US inflation trend. However, that inflation also affects operating costs, and in fact, analysts expect that margin erosion will comprise a drag on earnings of approximately 9% in the third quarter, which effectively erases most earnings growth that would otherwise accrue from a 10% increase in revenues (leaving just the gain from share repurchases, as mentioned earlier). The outlook for 2023 earnings is worsening as well, as evidenced by the decline in earnings growth to less than 6% currently, versus levels of approximately 9% just a few months ago.



With earnings growth rolling over, and potentially at risk of turning negative should a recession take place in 2023, as we expect, fundamental credit metrics across US corporate credit markets are likely to peak soon. For US high yield issuers, leverage metrics returned to pre-pandemic levels in the second quarter, thanks to strong EBITDA growth in excess of 30% on a year-over-year basis. However, that figure includes outsized gains from sectors still recovering from pandemic-driven weakness, including transportation, gaming and energy. At the end of the second quarter, high yield leverage had returned to 4.2x, a level in line with the pre-pandemic fourth quarter of 2019 and down from the recent peak of 6.2x in the first quarter of 2021. Thanks to record low interest rates in 2021, interest coverage metrics reflected an even more meaningful recovery, reaching a record high 5.7x in the second quarter, up from the recent trough of 3.6x in the fourth quarter of 2020.

Looking forward to the next few quarters, we see several risks to earnings and credit fundamentals. First, despite all the anecdotes and headlines highlighting cost and wage inflation, these factors have yet to show up in aggregated corporate profit margins. For high yield issuers, EBITDA margins improved to 17.2% in the second quarter of 2022, the highest level since the fourth quarter of 2018, albeit the improvement was again driven by recovery in sectors where COVID shutdowns negatively affected EBITDA. Excluding these "COVID depressed" sectors, second quarter 2022 high yield issuer EBITDA margins actually declined on a year-over-year basis, and we expect this trend to continue. According to a recent Barclays analysis on the S&P500, given current inflation rates, profit margins may be exposed to downside risk of as much as 500 basis points as the effects of inflation ultimately start driving operating costs higher.

Credit Spotlight (continued)

For leveraged finance issuers, and in particular those that have issued term loans, the recent spike in LIBOR and SOFR will soon begin to hit earnings as well. Those issuers that don't hedge such floating rate liabilities will experience an increase in interest expense as rates continue to increase. Barclays estimates that a 300 basis point-move higher in LIBOR / SOFR could cut interest coverage levels by 1.25x to 1.50x, a meaningful reduction for single-B loan issuers that currently cover interest expense only 2x to 3x. Fixed-rate high yield bond issuers, by contrast, will not experience the impact of higher rates on their earnings until they refinance currently outstanding low-coupon bonds at higher rates.

Finally, we note that the wave of recent high yield issuer ratings agency upgrades has already started to reverse as downgrades exceeded upgrades in September. Additionally, while it still resides at a very low level, the high yield default rate has increased 60 basis points thus far in 2022 to just under 1%. We believe earnings comprise the third leg of the stool (i.e., earnings, ratings upgrades / downgrades, and defaults) at risk of following these indicators lower, as the fundamental credit improvement witnessed over the past six quarters appears poised to recede.

Investment Grade Credit

During the third quarter of 2022, the OAS on the Bloomberg US Corporate Bond Index trended from levels as wide as 160 basis points in June to as tight as 130 basis points in mid-August, only to then quickly revert back to a new year-to-date wide of 164 basis points near the end of the period. Initially, investors hoped that the Federal Reserve would be able to navigate a soft landing without excessively raising interest rates. Unfortunately, data released in the third quarter suggest that inflation is more structural in nature than originally assumed. Consequently, markets began to reflect an increase to the terminal federal funds rate of approximately 100 basis points, implying that the Federal Reserve will pause its rates increases in mid-2023 when the rate reaches 4.5%. This caused yields to track a bear flattener trend, where rates increase across the curve, but with a greater increase on the short end than the long end. The yield on the 10-year US Treasury Note increased 81 basis points during the quarter to 3.83%, contributing to a total return for the Bloomberg US Corporate Bond Index of -5.6% in the quarter and -18.7% for the year-to-date period. The current year-to-date return represents the worst on record, easily surpassing the -8.6% September 2008 year-to-date return registered during the 2008 Global Financial Crisis. Excess returns for the current year-to-date period now stand at -320 basis points, a level in-line with historical averages attained during the early stages of a recession.

Primary market investment grade bond supply declined 7% year-over-year for the first three quarters of 2022 to $1.02 trillion. New issuance in the third quarter totaled only $283 billion, down 16% year-over-year. Reduced issuance in the third quarter of 2022 is largely due to very muted issuance in September of only $82 billion, versus overall expectations of $140 billion to $150 billion and higher issuance in the comparable prior year periods (i.e., $156 billion in 2020 and $162 billion in 2021). Corporations restrained new issue activity as both bond yields and spreads increased significantly as Chairman Powell maintained a hawkish posture, especially in statements at the Jackson Hole Economic Symposium and following the September FOMC meetings.

With regard to industry sector performance, financials marginally underperformed both industrials and utilities as financial issuers continue to represent an outsized share of overall US investment grade new issue volume. In terms of tenure, the 7 to 10-year part of the curve continues to underperform as investors reduce credit exposure by selling relatively liquid 10-year on-the-run issues. Technicals remain supportive on the front end of the curve as certain yield-driven investors see value in short-dated maturities and on the long end of the curve as insurance companies become attracted to higher yielding longer-maturity investment opportunities to match their long-dated liabilities. With regard to ratings categories, BBB-rated issues underperformed higher rated securities in the period.

Corporate fundamentals remain relatively healthy, but we see signs of deterioration as supply chain bottlenecks continue, input costs pressure margins and corporate earnings estimates trend downward. Additionally, although consumer balance sheets and employment remain supportive, purchases of major items such as automobiles and homes have declined, and evidence suggests that households are trading down in quality to economize. Also, declining residential real estate prices may negatively affect household net worth and consumer confidence.

As markets attempt to recalibrate and price-in an adequate level of risk, we expect that spreads will widen further and therefore maintain an underweight position in investment grade credit with a preference for up-in-quality and liquid, on-the-run bonds.

High Yield

US high yield bond market returns stabilized in the third quarter, following an extremely challenging first half of 2022. However, overall third quarter returns mask continued underlying volatility within the period, as July's sharp gains (5.90% total return on the Bloomberg US Corporate High Yield Bond Index, ("the HY Index")) only partially reversed June's losses (-6.73%), while negative returns resumed in September (-3.97%) as it became clear that the Federal Reserve's tightening cycle is far from over. For the third quarter, the HY Index returned -0.65%, bringing the year-to-date return to -14.74%. Performance was consistent across rating tiers, with CCCs returning -0.42%, Bs -0.66%, and BBs -0.71%. At the sector level, pharmaceuticals returned -9.5%, driven by Bausch Health's distressed exchange, and proved an outlier to the downside, while aerospace & defense, gaming, refining, and oilfield services all gained more than 2%. To exemplify the market's ongoing volatility, high yield spreads touched a year-to-date wide of 583 basis points in early July before tightening 175 basis points to a spread of 408 basis points in mid-August, only to end the quarter relatively unchanged at 552 basis points. With rates continuing to push higher (the 2-year Treasury note yield increased 132 basis points to 4.28% during the quarter), the HY Index yield-to-worst finished the third quarter 79 basis points higher at 9.68%, a level not seen since April 2020.

Although fundamentals remain on solid footing with credit metrics having largely returned to pre-pandemic levels, we expect that this positive trend has peaked and will likely reverse in coming quarters. Second quarter earnings results were decidedly better than feared, as high yield issuer revenues and EBITDA increased 25% and 34% year-over-year, respectively. Leverage declined for the fifth consecutive quarter to 4.2x, down from 4.6x in the first quarter of 2022 and in line with the pre-pandemic level in the fourth quarter of 2019 (and well off the 6.1x high registered in the fourth quarter of 2020). Default activity tapered off slightly in the second quarter (two issuers defaulted on approximately $6.9 billion in debt), and the default rate remained under 1% at the end of September (compared to a long-term average of approximately 3.2%). Although ratings upgrades continue to outweigh downgrades, the trend is slowing quickly from the pace set in recent quarters, as the upgrade / downgrade ratio fell to 1.5x in the third quarter of 2022 from 1.7x in the second quarter and 3.2x in the first quarter. With third quarter earnings season just about to start, weaker profitability represents a major risk for high yield fundamentals. Rising input and labor costs and supply chain disruptions remain topical and pose risks to credit metrics in coming quarters.

A higher yield environment and market volatility continue to suppress high yield primary market issuance. Just $19 billion of high yield bonds priced in the third quarter, the lowest quarterly total in over a decade and down from $25 billion in the immediately preceding quarter. Year-to-date through September, new issue supply totals only $90 billion, representing nearly an 80% decline from the first nine months of 2021. On the demand side, retail fund outflows slowed to $8.7 billion in the third quarter, down from $17.8 billion in the second quarter and $27.2 billion in the first quarter. These outflows have been more than offset by rising star volumes, which remained elevated at $21.3 billion in the third quarter, bringing the year-to-date total to $90.6 billion. While access to capital markets is clearly challenged for high yield issuers at this point, lower primary market supply provides a somewhat positive technical element as investors hold ample cash balances. With the exception of a few large LBO financings that appear likely to get shelved (a problem for the banks that will ultimately have to fund their commitments), for the time being, the need for most high yield issuers to tap the market appears minimal given the wave of refinancings completed last year.

With high yield spreads now hovering at approximately 500 basis points, having now tested – and failed to breach – the 600 basis point mark twice this year, our positioning remains consistent: spreads reside in the "average" long-term range, a point that has not proved stable historically. With US employment and inflation not yet responding to FOMC tightening, and the Federal Reserve's official rhetoric growing more aggressive, we continue to believe that there is a risk that high yield spreads gap out to the 800 basis point area that represents past recessionary valuations.

Leveraged Loans

The floating rate feature of leveraged loans continued to drive strong relative performance during the third quarter as the Federal Reserve raised rates further and emphasized its hawkish stance. The Credit Suisse Leveraged Loan Index (the "CSLLI") returned 1.19% during the third quarter, leaving the year-to-date return at -3.31%, a sharp outperformance relative to the -14.74% return in the US high yield market. With growing concern that a possible recession could negatively impact lower-quality tiers of the loan market, BB-rated loans outperformed during the quarter by returning 2.29% versus Bs at 1.05% and CCCs at -1.62%. Cyclical concerns also factored into sector-level performance, with continued outperformance by less cyclical industries such as food & beverage (3.6% total return) and utilities (2.9%) while metals & mining (-3.2%) and consumer durables (-1.2%) lagged. Average loan prices declined approximately 1/3 of a point to $91.60 during the quarter, representing a two-year low, while spreads remained steady at +668 basis points (as measured by the 3-year discount margin). During the third quarter, the average loan yield climbed 129 basis points to 10.96%, the highest level attained since 2009, as LIBOR jumped to 3.75% in response to the Federal Reserve's 150 basis increase to its benchmark federal funds rate.

Loan market credit fundamentals continued to improve as a result of better-than-expected second quarter 2022 earnings, although rising defaults portend weakness ahead. Revenue and EBITDA increased 25% and 28% year-over-year, respectively, which represents accelerating growth from the first quarter. As a result, leverage declined for the fifth consecutive quarter to 5.2x as of June 2022 from 5.6x at the end of March and 6.7x in June 2021. While high yield issuer leverage is back in line with pre-pandemic levels, loan issuer leverage remains elevated at 5.2x in June 2022 versus 4.9x in December 2019. Six loan issuers defaulted in the third quarter, pushing the loan default rate to 1.14% in September 2022, versus 0.68% in June and just 0.39% at the end of March. Although credit fundamentals continue to improve, upgrades have slowed and trailed downgrades in both the second and third quarters, leaving the upgrade / downgrade ratio slightly below 1.0x on a year-to-date basis. With the Federal Reserve intent on slowing the US economy, we continue to view the loan market as particularly at risk for deteriorating fundamentals, given a concentration of highly-leveraged, private equity-owned issuers with lower average credit quality.

Despite interest rates continuing to move higher, retail loan funds experienced accelerating outflows in the third quarter ($13.2 billion in third quarter 2022 outflows versus $4.5 billion in the second quarter), pressuring market technicals. Additionally, CLO market activity also slowed, with $33.8 billion pricing in the third quarter versus $40.0 billion in the second quarter. As loan demand waned, the primary market slowed to a near halt in the third quarter, with just $24.0 billion in new issuance priced (the lowest total since the first quarter of 2010), down from $60.6 billion in the second quarter and $120.5 billion in the first quarter. With fundamental credit concerns overtaking the allure of floating rate product, we anticipate that loan market technicals will remain challenged, particularly as several large LBO financings remain on the sidelines and act as a market overhang.

Although loan performance remains positive relative to the high yield market, we are cautious on performance over the next few quarters as the increasing odds of a Federal Reserve-induced recession poses significant risk to loan market fundamentals. The loan market, which is now dominated by single-B rated issuers (compared to the double-B heavy high yield market), faces the potential twin challenges of significantly higher interest expense burdens and deteriorating earnings trends, which are likely to pressure loan prices in coming quarters.

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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.

