



# Corporate Cash Alert

*2023 Outlook: Act Now*

January 3, 2023

# Introduction

The financial landscape has radically shifted in 2022. After more than a decade of ultra-low rates, the current environment presents an opportunity for corporate cash investors.

Before we discuss our views on portfolio positioning, we'll first recap the major credit developments within the corporate bond market. As you can see, there's a nuanced story behind the changes.

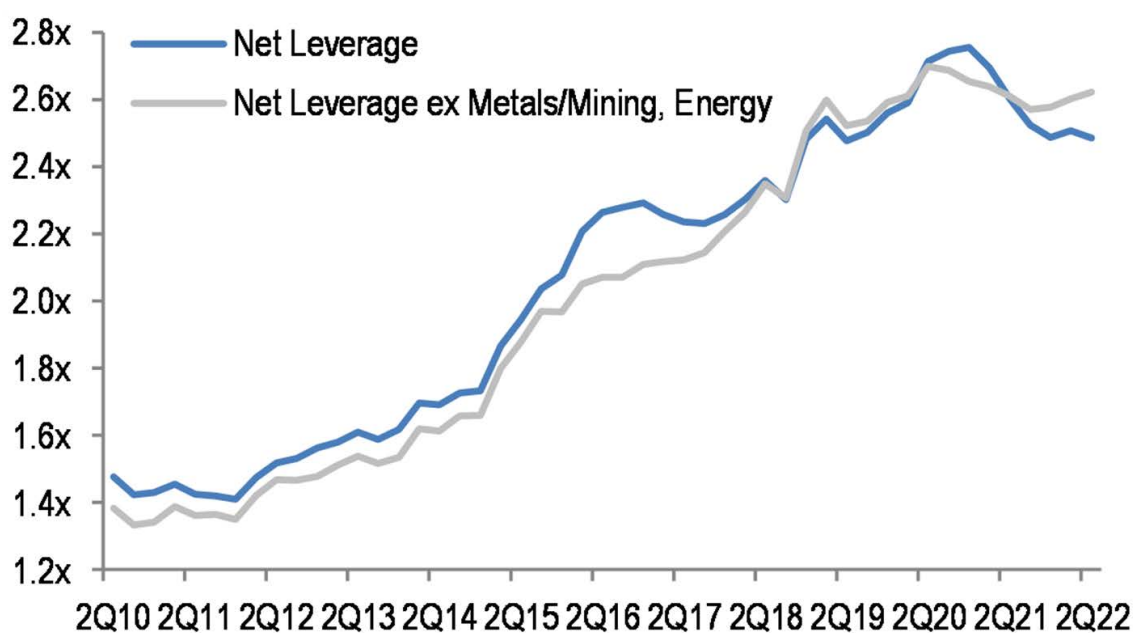
## The Changing Corporate Bond Market

Any honest discussion of today's landscape must begin with the recent past. The preceding "ZIRP" (Zero Interest Rate Policy) era, despite being a historically unique anomaly, nevertheless persisted long enough to influence every corner of the financial markets. Corporate cash investors are all too aware of the results - artificially suppressed yields and credit spreads, forcing painful choices between (meager) rates of return and extension risk.

On the other side, corporate debt issuers contended with a market that began incentivizing actions that it had typically discouraged: increased debt loads, higher leverage, and lower credit ratings suddenly made little difference in the absolute cost of borrowing. Rational actors made prudent choices, and when presented with a low-consequence opportunity to increase leverage and loosen credit metrics, companies acted on it:

- Net leverage steadily increased throughout the last decade.

### Aggregate Investment-Grade Corporate Issuers - Net Leverage

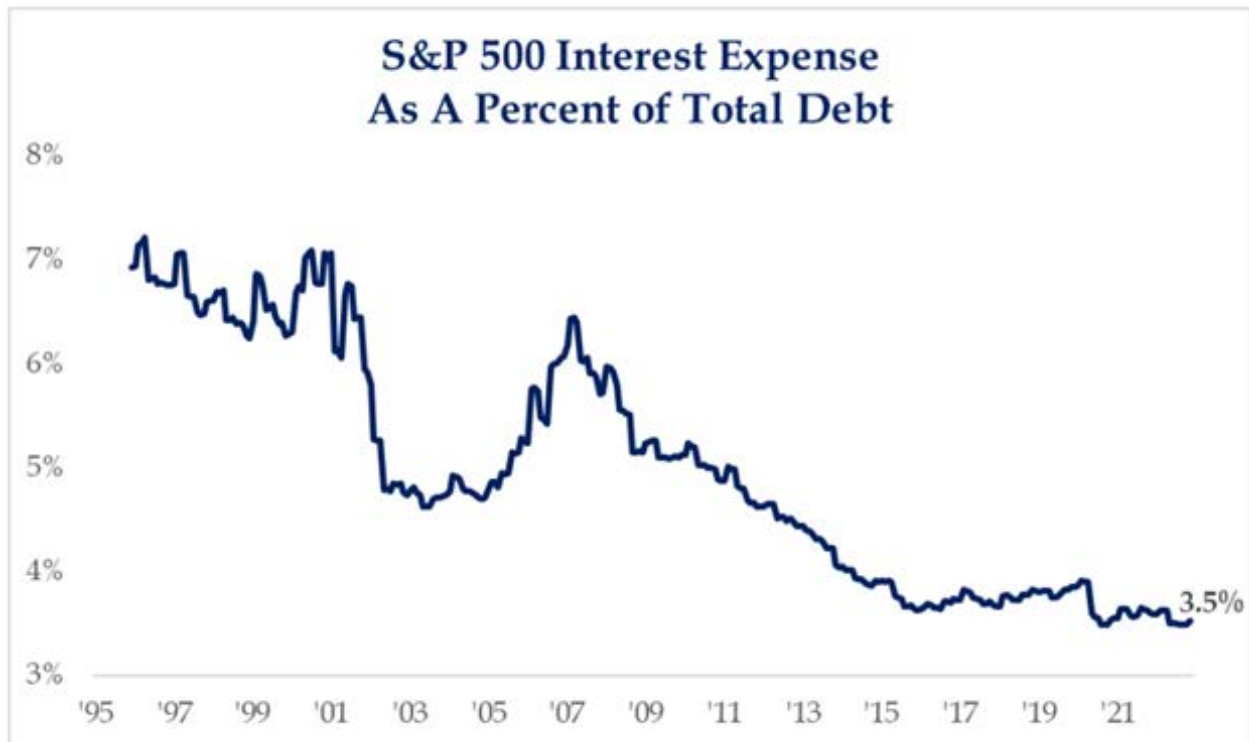


Source: JP Morgan Research ("US HG Credit 2023 Outlook: Back to Basics and Strong Balance Sheets" 11/22/22)

- Although interest expense grew to a new high in absolute dollar terms, it hit new all-time lows when measured relative to the amount of outstanding debt.



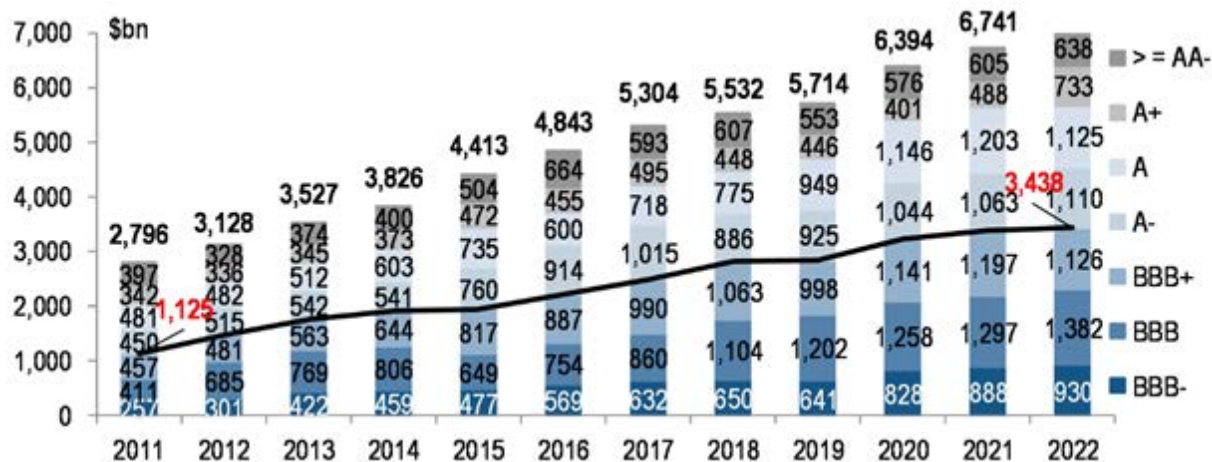
Source: Strategas ("Self-Funding a Key to Outperformance in the Coming Years; Short-Term Debt a Risk" 12/5/22)



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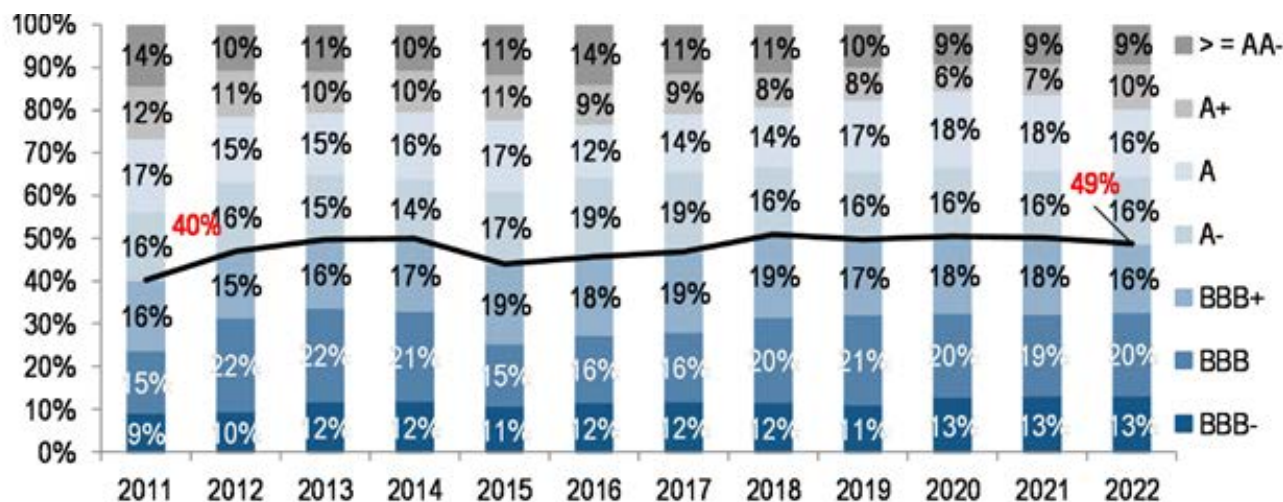
- Similarly, although the absolute amount of BBB-rated corporate debt reached new heights, the relative proportion of BBBs vs. the remainder of the IG universe has remained roughly constant for years.

### Aggregate Investment-Grade Corporate Debt Outstanding by Rating



Source: JP Morgan Research ("US HG Credit Ratings 3Q22 Recap: Positive Ratings Migration Continues" 10/7/22)

### Aggregate Investment-Grade Corporate Bond Market Rating Distribution



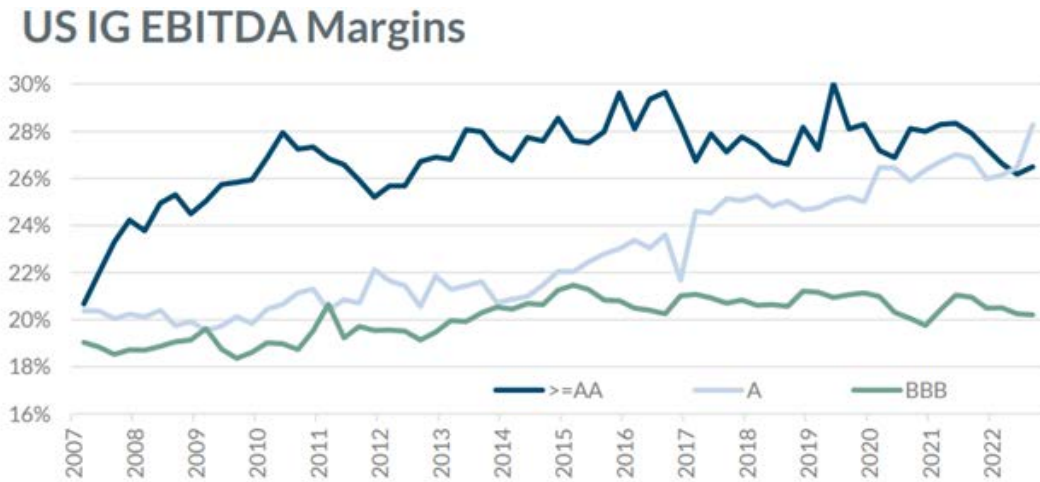
Source: JP Morgan Research ("US HG Credit Ratings 3Q22 Recap: Positive Ratings Migration Continues" 10/7/22)

### Different Rate Structure Today

Needless to say, times are different now. With Fed Funds over 4% and credit spreads noticeably wider, we are now undoubtably past the ZIRP era. Borrowing rates again resemble levels that would seem familiar in pre-2008 market environments, when "normal" conditions and economic relationships held.

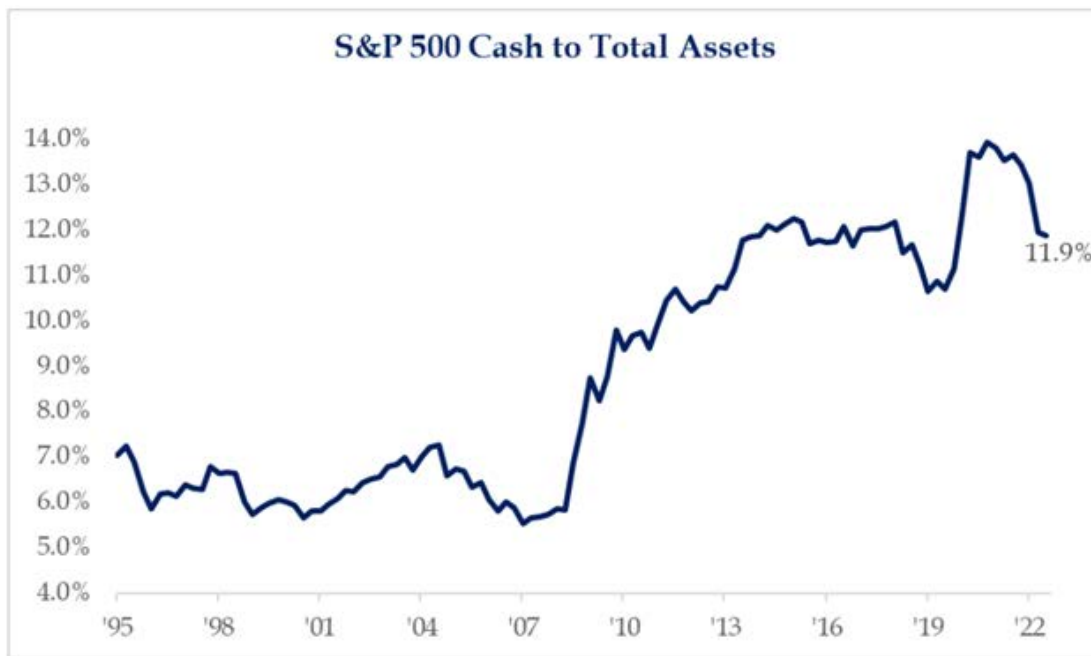
Now that the ZIRP party is over, does that mean the hangover is coming? Not necessarily. With the obvious caveat that exceptions abound, the overall state of high-grade corporate credit remains robust:

- Profit margins, although declining, remain very strong.



Source: CreditSights ("US IG & HY 2023 Credit Market Outlook: 99 Problems, But Duration Ain't One" 12/5/22)

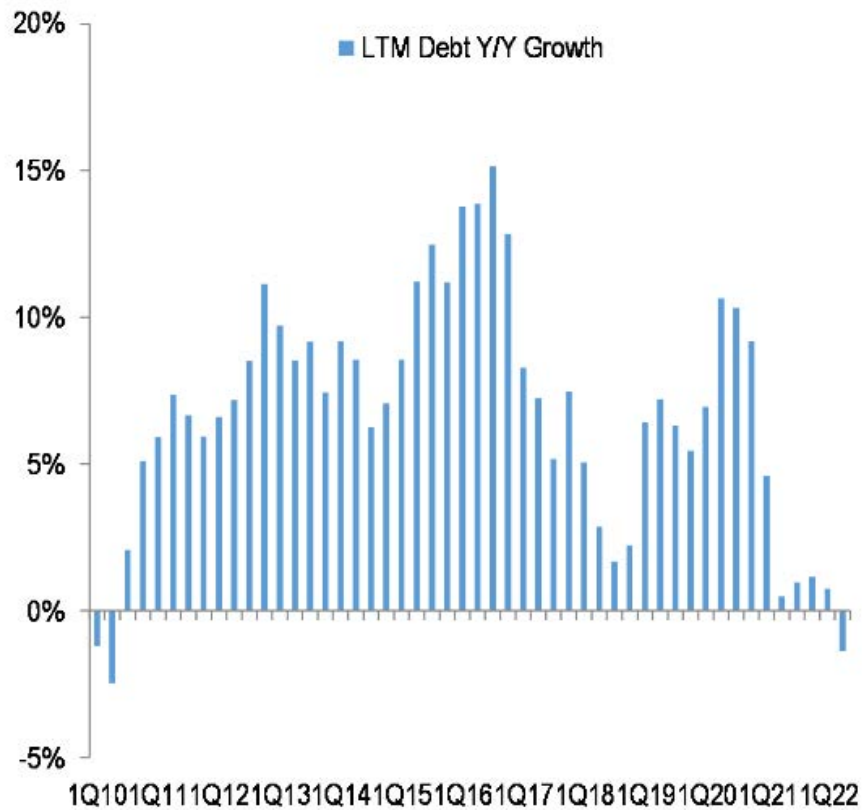
- Given those excellent profit margins, it's no surprise that balance sheet cash levels are healthy.



Source: Strategas ("Self-Funding a Key to Outperformance in the Coming Years; Short-Term Debt a Risk" 12/5/22)

- Just as issuers acted logically in responding to the incentives of the ZIRP era, they are doing the same now that conditions have flipped. For example, now that leverage is no longer as cheap as it was previously, debt growth is turning negative.

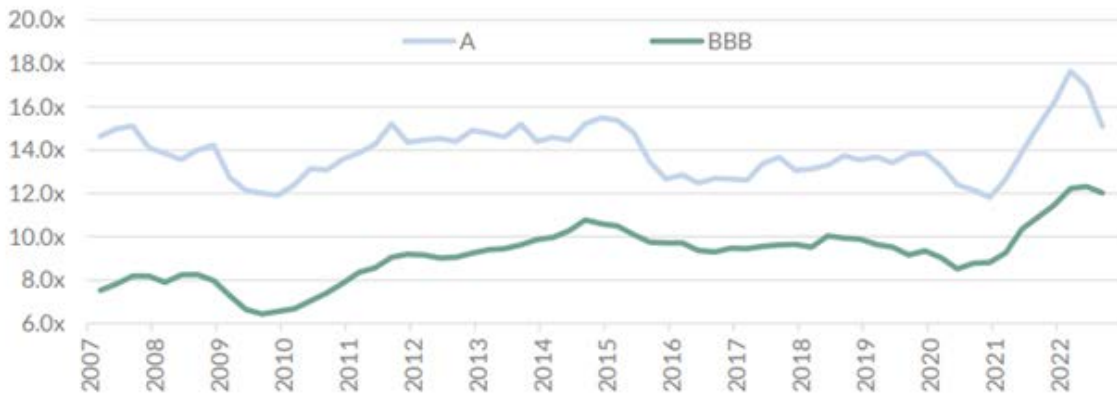
## Aggregate Investment-Grade Corporate Bond Market YoY Growth in Outstanding Debt



Source: JP Morgan Research ("US HG Credit Fundamentals 2Q22 Review: A Detailed Review of Credit Metrics" 9/8/22)

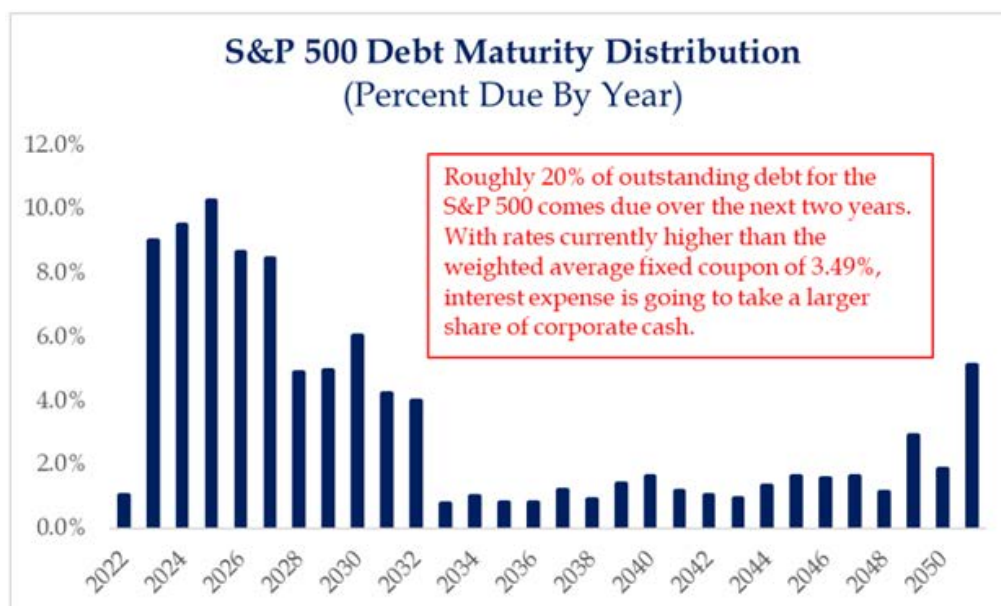
- Interest coverage on the remaining debt is still very high.

## US IG Interest Coverage by Rating



Source: CreditSights ("US IG & HY 2023 Credit Market Outlook: 99 Problems, But Duration Ain't One" 12/5/22)

- Unlike the US federal government, during the ZIRP years corporate borrowers seized the opportunity to term out their debt maturities. While today's higher rates will slowly but surely filter into issuers' debt stacks, it will be a delayed process that provides plenty of time to adjust to the new reality.



Source: Strategas ("Self-Funding a Key to Outperformance in the Coming Years; Short-Term Debt a Risk" 12/5/22)

## Treasury Partners View

Our investment strategy is clear; now that investors can achieve meaningfully higher returns than at any time over the last 15 years, we've been aggressively extending maturities. Specifically, we've been reinvesting maturities within client portfolios out to their maximum investment policy limits, subject to liquidity requirements, and will continue doing so as long as the Fed appears set to keep hiking. Let's unpack the rationale.

The Fed Funds rate is currently set in the 4.25-4.50% range and we believe further tightening is yet to come. Specifically, our expectation is that the Fed will tighten to at least 5.00% and maintain these levels at least through early 2024. However, rates typically move in advance of the Fed, both up and down, reacting to the implication of the data that will ultimately drive the Fed's future actions. At this advanced point in the hiking cycle (where many investors think we're close to reaching the apex), *each additional tightening in the Fed Funds rate is no longer automatically accompanied by a lockstep increase in market interest rates.*

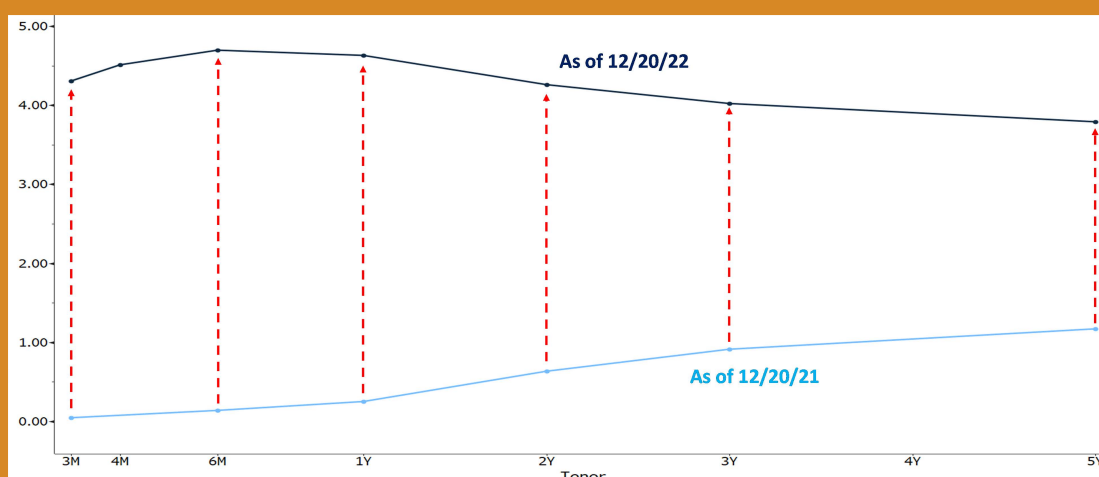
For an illustrative example, look no further than the 2-Year Treasury's intraday trading moves around the week of the latest Fed tightening (a +50-bps hike on Weds, 12/14/22):

- Mon 12/12 began with the 2-Year Treasury yield trading close to 4.35%
- On the morning of Tues 12/13, a below-consensus November CPI print reset investors' expectations about the pace of future Fed action, sending 2-Year yields 15 bps lower on the day.
- On Weds 12/14, a hawkish Fed hiked 50-bps and the 2-Year ended basically flat on the day, at a level slightly below the new 4.25% Fed Funds floor.
- Ultimately, the 2-Year ended the week even lower at 4.18% - nearly 20-bps lower than where it started.

Given our outlook, investors who extend maturities at current levels likely run the risk of the 2-Year Treasury moving another 50-bps higher. But while that would be painful, not all is lost - at today's absolute level of approximately 4.25%, the 2-Year Treasury (to continue the example) offers sufficient income protection to potentially offset potential unrealized price losses. As we've written before, don't discount the benefits of 'roll-down' protection: this time next year, investors who buy today's 4.25% 2-Year Treasury will instead be left holding a 1-year maturity with a 4.25% purchase yield. Although there's no guarantee that this seasoned position won't still price with an unrealized loss, this automatic 'rolling down the yield curve' offers some natural protection against such a possibility.

Finally, as readers know, we have experienced a parabolic move higher in short term rates.

## Treasury Yields



Source: Bloomberg (as of 12/20/22)



In our experience of investing through forty years of market cycles, one of the most consistent patterns is that all parabolic moves (in this case, higher) eventually tend to get walked back (in this case, move lower). Stated differently, rates might tick higher - but once the bond market gets a whiff of imminent recession, rates will likely decline significantly, irrespective of Fed policy. It pays to take advantage of these absolute levels while they're still available.

## Happy Holidays!

As always, whether markets are calm or volatile, know that we're working hard to help you optimize your corporate cash portfolios. We're grateful for the trust and confidence you continue to place in us and thank you for your continued support.

Our best wishes for a wonderful holiday season and, and we look forward to partnering with you once more in 2023 and beyond.

## About Treasury Partners

For over 37 years, corporations, high-net-worth individuals, family offices, trusts, foundations and endowments have sought our help to construct diversified portfolios positioned to perform throughout market cycles. Among other industry recognitions, Barron's has ranked us in the top tier on its annual listing of "America's Top 100 Financial Advisors" every year since the survey was introduced in 2004. Speak with Our Barron's Top-Ranked Team Today.



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