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STRATEGY

OUTLOOK SNAPSHOTS

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2023 US IG & HY Sector Strategy Overview

5 Dec 2022, 1:55 AM

Executive Summary

- **In conjunction with our 2023 US IG & HY Outlook, we provide an overview of our sector strategy recommendations.** Sector strategy in 2022 proved a challenging endeavor as credit risk and duration risk weighed similarly on portfolios, an unusual dynamic that drove many to throw out the typical 'risk off' playbook.
- **Heading into 2023, we are constructive on corporate credit as a whole, affirming our Overweight allocations to IG and upgrading HY to Overweight from Market Weight in our 2023 US IG & HY Strategy Outlook.** Even so, credit selection, balancing sector nuances and idiosyncratic drivers are likely to drive portfolio performance amid tighter financial conditions and slowing global growth. Our updated sector strategy attempts to capitalize on recent dislocations, allowing for a mix of offense and defense in portfolios.
- **We provide an overview of our key sector expectations, including recent changes in recommendations.** For a robust overview of our sector strategy, we provide links to our Sector 'Snapshots', which provide the CreditSights analyst team's sector recommendations, top picks and pans, key themes and risks for the coming year, the outlook for fundamentals and new issue and ESG considerations.

Relative Value

US IG & HY Corporate OAS (bp) by Sector, Rating

Yield to Worst	IG	AAA	AA	A	BBB	HY	BB	B	CCC
Index	142	52	77	117	176	455	296	478	1,195
Automotive	131	-	-	68	179	317	252	425	979
Banking	144	97	73	129	204	375	375	-	-
Basic Industry	173	-	95	109	188	452	314	537	1,033
Capital Goods	114	99	69	76	141	375	231	333	794
Consumer Goods	124	-	57	85	151	404	265	430	794
Energy	152	-	83	114	187	344	269	420	757
Healthcare	110	45	91	91	128	611	243	561	1,605
Insurance	163	68	118	151	211	417	361	362	468
Leisure	194	-	-	89	209	441	262	424	834
Media	173	-	23	120	233	518	319	569	1,574
Real Estate	179	-	-	123	196	455	348	482	1,768
Retail	100	-	59	93	130	586	334	577	1,754
Technology & Electronics	113	38	56	87	170	457	292	514	813
Telecommunications	148	-	147	117	151	642	355	529	3,590
Transportation	141	-	-	103	166	382	296	504	520
Utility	153	-	105	129	182	271	250	351	-

Source: CreditSights, FactSet, ICE Data Indices, LLC

US IG & HY Corporate YTW by Sector, Rating									
Yield to Worst	IG	AAA	AA	A	BBB	HY	BB	B	CCC
Index	5.4%	4.5%	4.8%	5.2%	5.7%	8.6%	7.0%	8.8%	16.0%
Automotive	5.4%	-	-	4.8%	5.8%	7.2%	6.5%	8.1%	13.9%
Banking	5.5%	4.8%	4.9%	5.4%	6.1%	8.0%	8.0%	-	-
Basic Industry	5.6%	-	4.8%	5.0%	5.8%	8.5%	7.2%	9.3%	14.3%
Capital Goods	5.1%	4.8%	4.8%	4.8%	5.4%	8.0%	6.4%	7.7%	12.1%
Consumer Goods	5.2%	-	4.5%	4.8%	5.5%	8.1%	6.7%	8.3%	12.1%
Energy	5.5%	-	4.8%	5.1%	5.9%	7.6%	6.7%	8.5%	11.9%
Healthcare	5.0%	4.4%	4.9%	4.8%	5.2%	10.1%	6.5%	9.5%	20.1%
Insurance	5.6%	4.8%	5.2%	5.5%	6.1%	8.3%	7.8%	7.5%	8.9%
Leisure	5.9%	-	-	4.8%	6.0%	8.5%	6.8%	8.2%	12.4%
Media	5.6%	-	4.2%	5.1%	6.3%	9.1%	7.1%	9.6%	19.7%
Real Estate	5.7%	-	-	5.2%	5.9%	8.6%	7.5%	9.0%	21.6%
Retail	4.9%	-	4.5%	4.9%	5.2%	9.8%	7.3%	9.8%	21.5%
Technology & Electronics	5.1%	4.4%	4.5%	4.8%	5.6%	8.6%	6.9%	9.2%	12.2%
Telecommunications	5.3%	-	5.3%	5.1%	5.4%	10.3%	7.5%	9.2%	38.7%
Transportation	5.4%	-	-	5.0%	5.6%	7.9%	7.0%	9.2%	9.5%
Utility	5.5%	-	5.0%	5.2%	5.8%	6.8%	6.6%	7.5%	-

Source: CreditSights, FactSet, ICE Data Indices, LLC

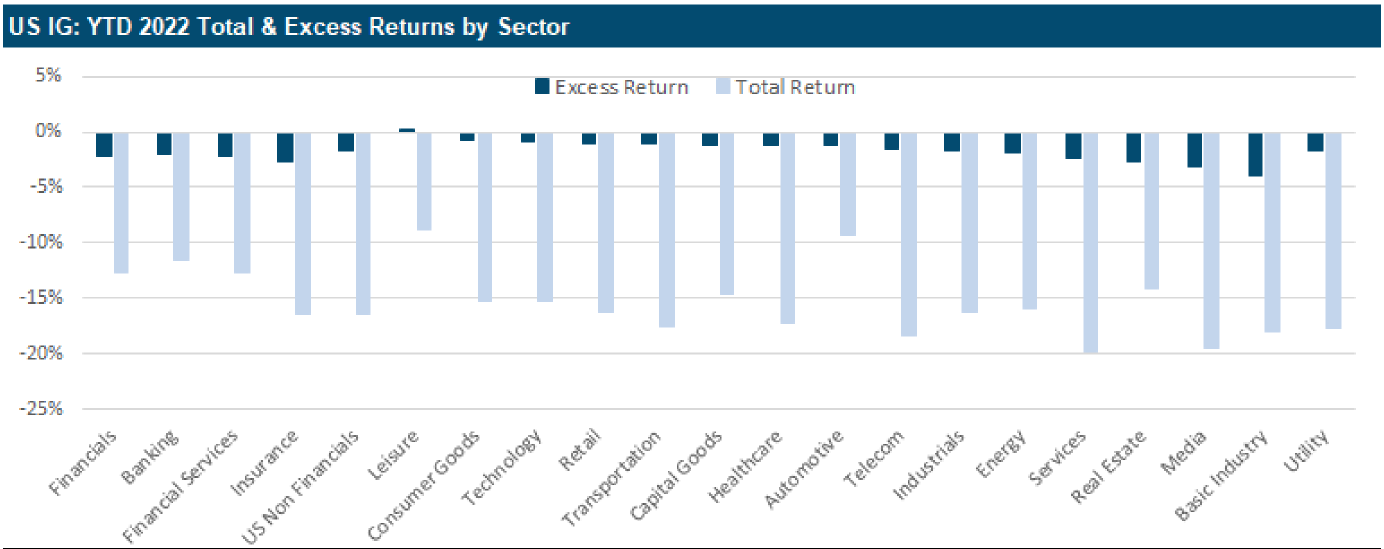
In 2022, credit risk and duration risk weighed similarly on portfolios, an unusual dynamic that drove many to throw out the typical 'risk off' playbook. This was particularly true of sector strategy, which proved a challenging endeavor as many typically 'defensive' sectors faced pressure from long duration profiles or idiosyncratic headwinds. Other more cyclical sectors, including Energy, HY Transportation and some consumer segments, like IG retail, posted far greater resiliency than many anticipated heading into an economic slowdown. Technicals also factored into sector performance as heavy new issue supply, particularly in Financials/the Big 6 Banks, weighed heavily on spreads.

Heading into 2023, we are constructive on corporate credit as a whole, affirming our Overweight allocations to IG and upgrading HY to Overweight from Market Weight in our **2023 US IG & HY Strategy Outlook**. Even so, credit selection, balancing sector nuances and idiosyncratic drivers are likely to drive portfolio performance amid tighter financial conditions and slowing global growth. Our updated sector strategy attempts to capitalize on recent dislocations, allowing for a mix of offense and defense in portfolios.

For a robust overview of our sector strategy, we provide links to our Sector 'Snapshots', which provide the CreditSights analyst team's sector recommendations, top picks and pans, key themes and risks for the coming year, the outlook for fundamentals and new issue and ESG considerations.

2023 Sector Snapshot: US Consumer

2023 Sector Snapshot: US Energy & Basics
2023 Sector Snapshot: US Financials
2023 Sector Snapshot: US Industrials & Transport.
2023 Sector Snapshot US Real Estate & Homebuilders
2023 Sector Snapshot: US TMT
2023 Sector Snapshot: US Utilities
US Investment Grade Sector Strategy



Source: CreditSights, FactSet, ICE Data Indices, LLC

In US IG, sector performance was heavily influenced by technical factors in 2022, specifically sector duration and issuance volume. This was particularly true of the Big 6 Banks, which produced a third consecutive year of very heavy new issue supply, weighing on spreads amid elevated new issue concessions. Despite strong Energy fundamentals and relatively modest spread widening, the sector's long duration profile (7.5 years) weighed on returns. Other sectors faced fundamental challenges with Media and Real Estate underperforming amid secular pressures and tighter financial conditions. Our IG sector strategy identifies opportunities driven by some of the more technical considerations that factored heavily in 2022, while also identifying opportunities for fundamental improvement.

We are upgrading Basics to Outperform as we have a constructive view on many of the subsectors including Chemicals, Metals and Mining and Forestry and Paper. While Basics is typically a highly cyclical sector, the recent widening in spreads and concerns around economic headwinds are generally balanced by very strong credit profiles and valuations that are well above the broader IG market. We are also maintaining our constructive view on Financials, specifically the large US Banks and Financial Services (aircraft lessors), as we anticipate a mix of improving technicals and stable fundamentals to support spreads.

We have also recently downgraded a handful of IG sectors to Market Perform. These include IG Capital Goods, Consumer Goods, Energy and Leisure. While most of these sectors are still in good shape fundamentally, some, like Energy, are pivoting away from continued balance sheet improvement, while others, like Consumer Goods, trade well inside the broader IG market and provide less opportunity for outperformance. We are maintaining Market Perform recommendations on a number of other sectors, including Utilities, Transportation, Technology, Real Estate (REITs), Media, Health Care, Environmental and Autos.

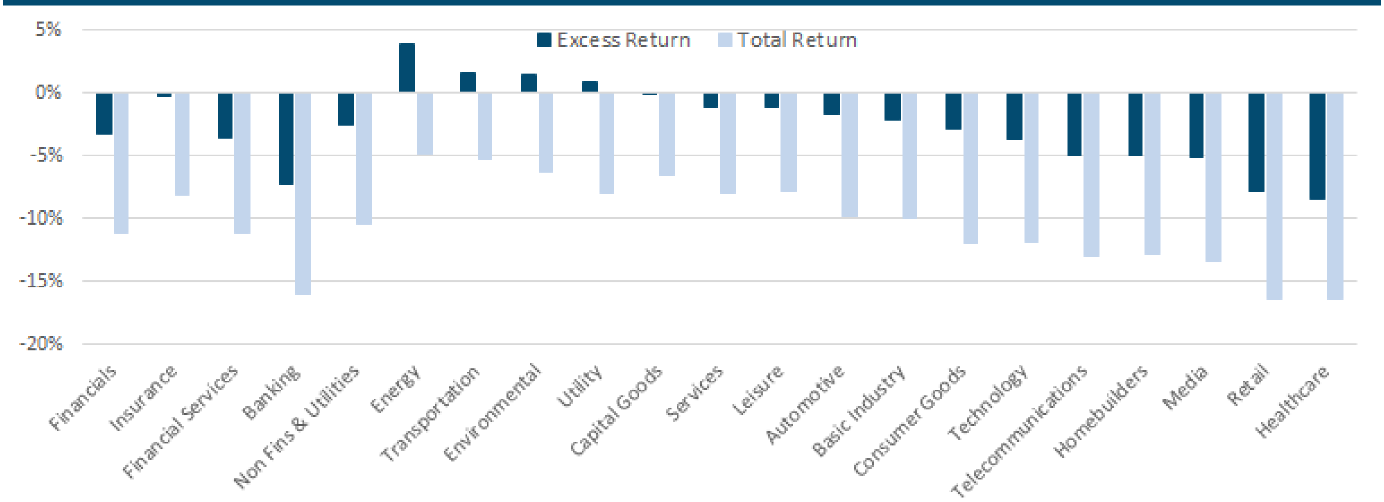
Our only Underperform recommendations in IG are for Regional US Banks and Retail. The Retail sector started to show signs of fundamental strain earlier in 2022, but the sector fared well in the IG market as many of the largest constituents are higher rated companies with sound balance sheets. The potential for continued headwinds as consumer spending shifts further away from goods combined with very tight spreads and low yields merits a cautious view of the sector overall.

Sector/Subsector	Rec	OAS	YTW	Duration	$ Price	YTD Excess Ret.	Market Cap. ($B)	% of Market/ Sector
IG Aggregate	OP	142 bps	5.42%	6.9 yrs	$89.58	-1.8%	7,471.7	
Financials	**OP**	**152 bps**	**5.59%**	**5.1 yrs**	**$90.71**	**-2.2%**	**2,426.1**	**32.5%**
Banking (Large US)[1]	OP	149 bps	5.59%	4.7 yrs	$91.15	-2.2%	1,708.2	70.4%
Banking (Regional US)	UP							
Financial Services[2]	OP	158 bps	5.63%	5.2 yrs	$90.14	-2.2%	722.2	29.8%
Insurance	MP	165 bps	5.66%	7.1 yrs	$89.23	-2.7%	326.5	13.5%
Non Financials & Utilities		**138 bps**	**5.34%**	**7.8 yrs**	**$89.04**	**-1.6%**	**5,045.6**	**67.5%**
Industrials		**136 bps**	**5.32%**	**7.7 yrs**	**$89.15**	**-1.6%**	**4,396.7**	**87.1%**
Automotive	MP	131 bps	5.39%	4.1 yrs	$92.03	-1.3%	163.2	3.7%
Basic Industry	OP	176 bps	5.72%	7.4 yrs	$90.55	-4%	274.3	6.2%
Capital Goods	MP	114 bps	5.13%	6.9 yrs	$90.91	-1.1%	342.0	7.8%
Consumer Goods	MP	125 bps	5.20%	7.7 yrs	$90.13	-0.7%	425.5	9.7%
Energy	MP	154 bps	5.53%	7.5 yrs	$90.91	-1.9%	626.2	14.2%
Environmental	MP	100 bps	4.86%	7.5 yrs	$87.10	-0.5%	17.3	0.4%
Healthcare	MP	111 bps	5.08%	8.5 yrs	$89.17	-1.2%	686.3	15.6%
Leisure	MP	194 bps	5.90%	4.4 yrs	$91.76	0.2%	26.8	0.6%
Media	MP	172 bps	5.65%	8.5 yrs	$85.82	-3.1%	290.5	6.6%
Real Estate	MP	176 bps	5.69%	5.7 yrs	$87.25	-2.7%	250.8	5.7%
Retail	UP	101 bps	4.95%	8.1 yrs	$89.16	-1%	280.5	6.4%
Technology & Electronics	MP	114 bps	5.10%	7.8 yrs	$88.09	-0.9%	485.5	11.0%
Telecommunications	OP	149 bps	5.37%	8.9 yrs	$86.93	-1.5%	287.1	6.5%
Transportation	MP	141 bps	5.38%	9.0 yrs	$89.09	-1.1%	171.4	3.9%
Utility	**MP**	**154 bps**	**5.49%**	**8.5 yrs**	**$88.30**	**-1.7%**	**648.9**	**12.9%**

Source: CreditSights, FactSet, ICE Data Indices, LLC
Data as of November 30, 2022.
[1] Valuations based on the ICE Banking & Brokerage Index, which includes both US Large and Regional Banks.
[2] Recommendation applies to Aircraft Leasing, which is classified as Financial Services.

US High Yield Sector Strategy

US HY: YTD 2022 Total & Excess Returns by Sector



Source: CreditSights, FactSet, ICE Data Indices, LLC

Given the wide mix of issuers in the HY market, constructing a cohesive sector strategy can often prove challenging as one or two stressed names can materially skew aggregate valuations and performance profiles. We attempt to capitalize on dislocations in challenged sectors, like Telecom and Health Care, while also maintaining a more neutral view of some super cyclicals, like Basics, given less compelling relative value. Given our upgrade of HY to Overweight, we are less constructive on some more traditionally defensive sectors and those where structural challenges are likely to persist or intensify.

With our outlook, we are upgrading two of the hardest hit sectors this year, Telecommunications and Health Care, to Outperform. While we are cognizant that some headwinds remain, particularly in Health Care, the mix of valuations and potential recovery in 2023, especially for secured paper, creates a compelling opportunity. We are also remaining constructive on the Energy sector as it should benefit from rising star upgrades, limited new issue and still supportive commodity prices. Similarly, we are maintaining our Outperform recommendation on HY Transportation, a trade that performed well in the recovery of 2022 and should continue to offer attractive ratings momentum given limited issuance and strong cash profiles.

We have a more balanced view of some cyclical sectors, including Autos, Basics, Capital Goods (A&D), Homebuilders and Retail. Each of these sectors are facing headwinds from slowing global growth, persistent supply chain disruptions, shifting consumer sentiment and tighter financial conditions. Given the mix of constituents in these sectors, we see the risks as more balanced and view valuations, in aggregate, as enough to put cash to work in higher quality/carry type opportunities. We also have a market perform recommendation on HY Utilities, typically a very defensive sector that has performed fairly well in 2022, but trades tight of the broader index.

Finally, we are downgrading our recommendations on a handful of sectors to Underperform, these include Consumer Goods, Media and Technology. These downgrades are generally driven by fundamental concerns as leverage metrics are set to rise for some of the largest issuers, especially in Consumer Goods, while operating challenges will persist, or even accelerate, in 2023 for both Media and Technology.

Sector/Subsector	Rec	OAS	YTW	Duration	$ Price	YTD Total Return	Market Capitalization ($B)	% of Market/ Sector
HY Aggregate	**MP**	**455 bps**	**8.62%**	**4.1 yrs**	**$87.02**	**-10.5%**	**1,216.9**	
Financials		505 bps	9.16%	3.8 yrs	$86.41	-11.1%	90.4	7.4%
Non Financials & Utilities		451 bps	8.58%	4.1 yrs	$87.07	-10.5%	1,126.5	92.6%
Automotive	MP	327 bps	7.30%	4.3 yrs	$89.84	-9.8%	54.3	4.8%
Basic Industry	MP	450 bps	8.53%	4.2 yrs	$87.64	-10.0%	76.0	6.7%
Capital Goods[1]	MP	379 bps	8.03%	3.4 yrs	$91.49	-6.5%	78.2	6.9%
Consumer Goods	UP	406 bps	8.12%	4.4 yrs	$87.31	-12.0%	46.0	4.1%
Energy	OP	347 bps	7.64%	4.3 yrs	$93.29	-4.8%	148.5	13.2%
Environmental		271 bps	6.78%	3.9 yrs	$90.25	-6.3%	7.5	0.7%
Healthcare	OP	612 bps	10.13%	4.2 yrs	$81.07	-16.3%	93.5	8.3%
Homebuilders & Real Estate	MP	565 bps	9.62%	4.2 yrs	$84.17	-12.8%	27.9	2.5%
Leisure	OP	447 bps	8.58%	3.5 yrs	$89.39	-7.9%	95.4	8.5%
Media	UP	524 bps	9.21%	4.4 yrs	$82.28	-13.4%	113.6	10.1%
Retail	MP	577 bps	9.77%	4.4 yrs	$80.99	-16.4%	64.7	5.7%
Services		486 bps	8.98%	3.6 yrs	$88.06	-8.0%	72.8	6.5%
Technology & Electronics	UP	451 bps	8.55%	4.1 yrs	$86.34	-11.9%	65.0	5.8%
Telecommunications	OP	511 bps	9.08%	4.5 yrs	$84.86	-13.0%	79.2	7.0%
Transportation	OP	331 bps	7.44%	3.1 yrs	$95.59	-5.3%	22.3	2.0%
Utility	MP	272 bps	6.81%	4.4 yrs	$90.49	-8.0%	37.0	3.3%

Data as of November 30, 2022.
[1] Recommendation applies to Aerospace & Defense.

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