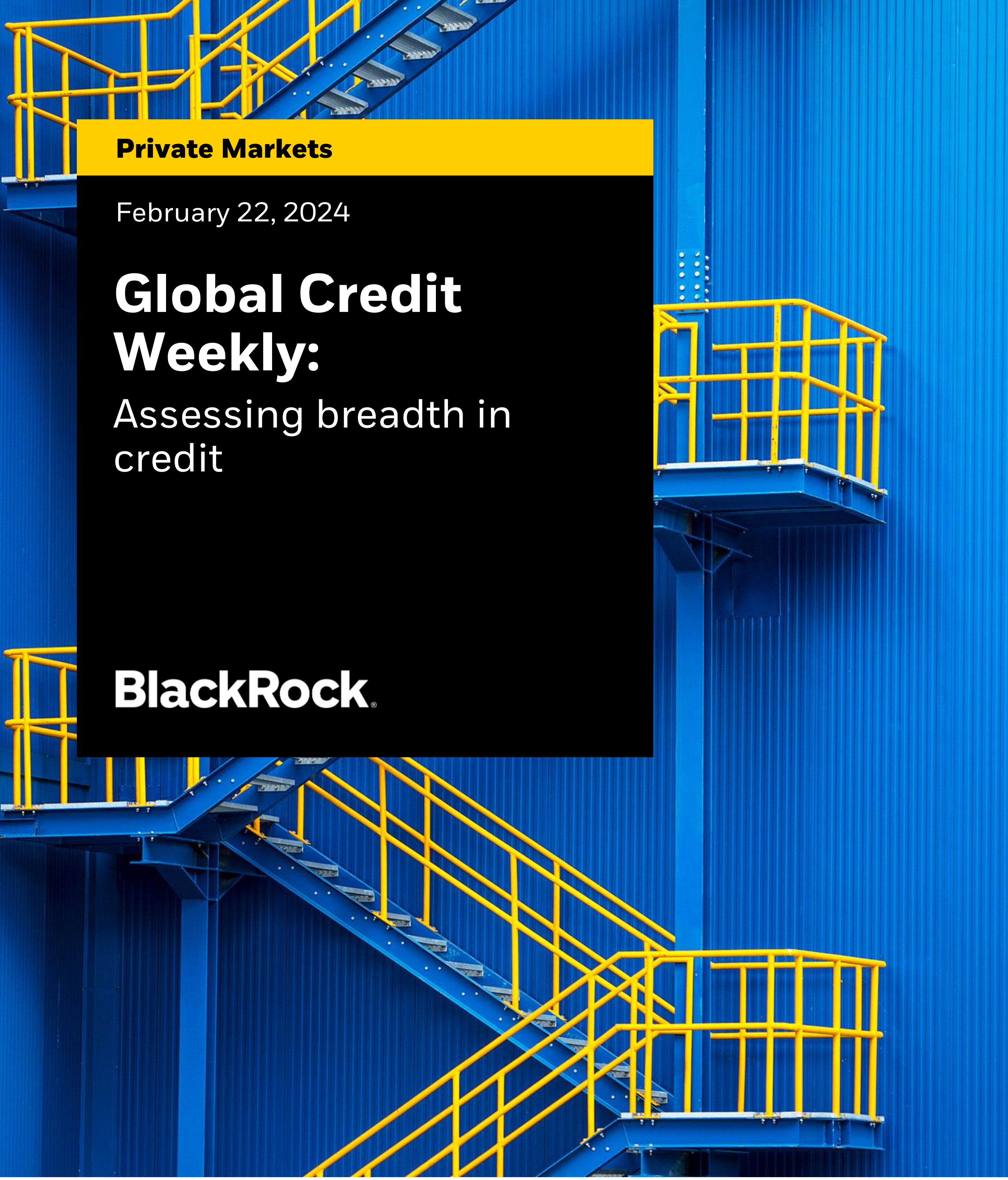

Private Markets

February 22, 2024

Global Credit Weekly:

Assessing breadth in credit

BlackRock

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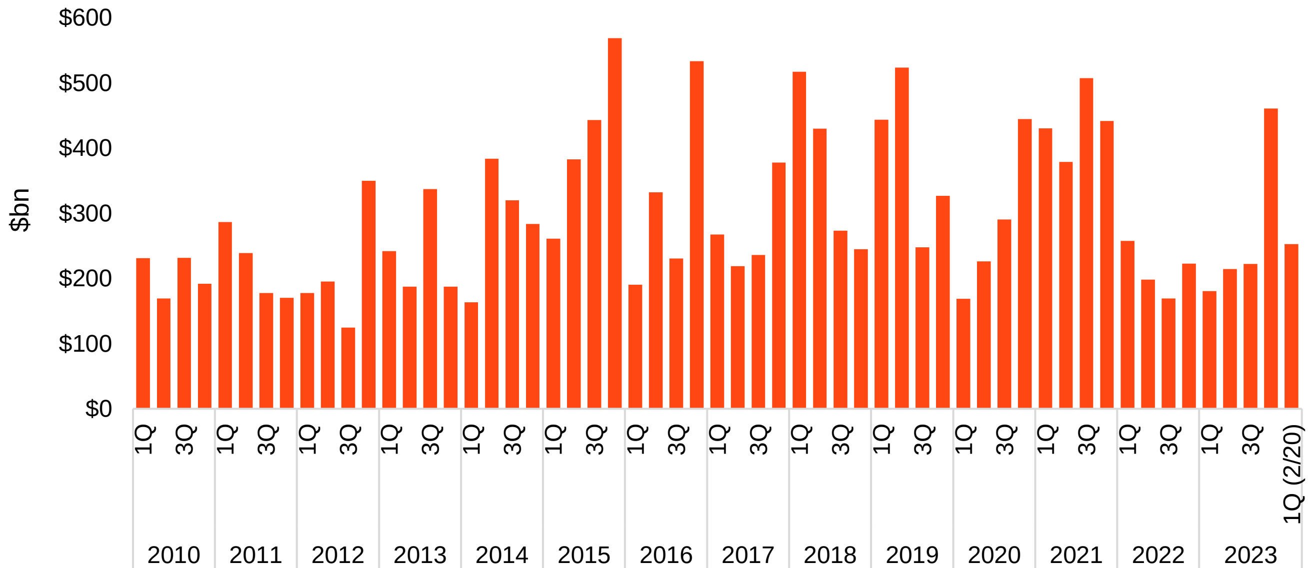
Key takeaways

- With many market participants focused on the performance dynamics of the large-cap Technology sector within the S&P 500, we assess the topic of performance breadth in the USD IG and HY corporate credit markets. In USD IG, there is a notable cyclical sector tilt in the relative outperformers so far this year, with many "traditionally defensive" sectors lagging in the early part of 2024. In USD HY, the aggregate performance at the index level masks the variation under the surface, as Cable & Satellite has meaningfully lagged the broader universe (due in large part to sector-specific dynamics).
- Separately, the rebound in strategic M&A activity – which began in 4Q2023 – has continued into the first two months of 2024 (Exhibit 1). This is consistent with our view that *clarity* on the macro and financing backdrop (not necessarily a *favorable* backdrop) is key for CFO and Treasurer confidence to move forward with large-scale M&A. After all, while financial conditions have eased as of late, the cost of capital remains elevated. A range of sectors have contributed to the M&A resurgence, including Energy, Healthcare, Technology, and Financials. In aggregate, the funding mix has been largely benign for bondholders, illustrated by a share of "all cash" deals that remains below the post-financial crisis average. That said, there is meaningful dispersion at the sector level in terms of how these announced transactions have been (or will be) funded.
- On the monetary policy front, the release of the January 31st FOMC meeting minutes highlighted a Committee that is mindful of the "risks of moving too quickly to ease the stance of policy," and "highly attentive to inflation risks." As it relates to potential upside risks to inflation, we frame the potential impact from the ongoing shipping disruptions in the Red Sea (which appears, for the moment, to imply only a modest potential pass-through effect from higher freight costs).

Exhibit 1: The strategic M&A rebound of 4Q2023 has extended into early 2024

Announced strategic M&A by North American and European acquirers. Excludes cancelled and withdrawn deals, as well as all sponsor-related deals. Captures deals valued at $1 billion or more, at announcement.



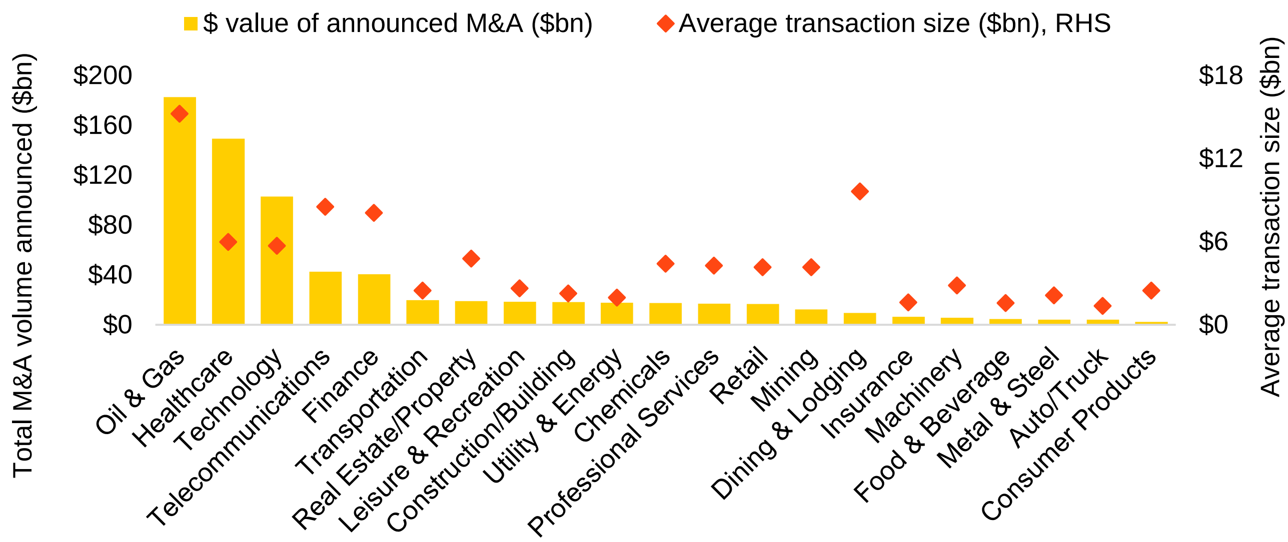
Source: BlackRock, Dealogic. 1Q2024 is as of February 21, 2024.

M&A: Momentum continues, with a benign funding mix for bondholders

After a lull in strategic M&A activity for much of 2022 and last year, 4Q2023 volumes highlighted a sharp rebound in announcements from North American and European firms. That momentum has continued into the early months of 2024, supported in large part, in our view, by increased optimism and clarity on the macroeconomic and monetary policy backdrops (Exhibit 1).

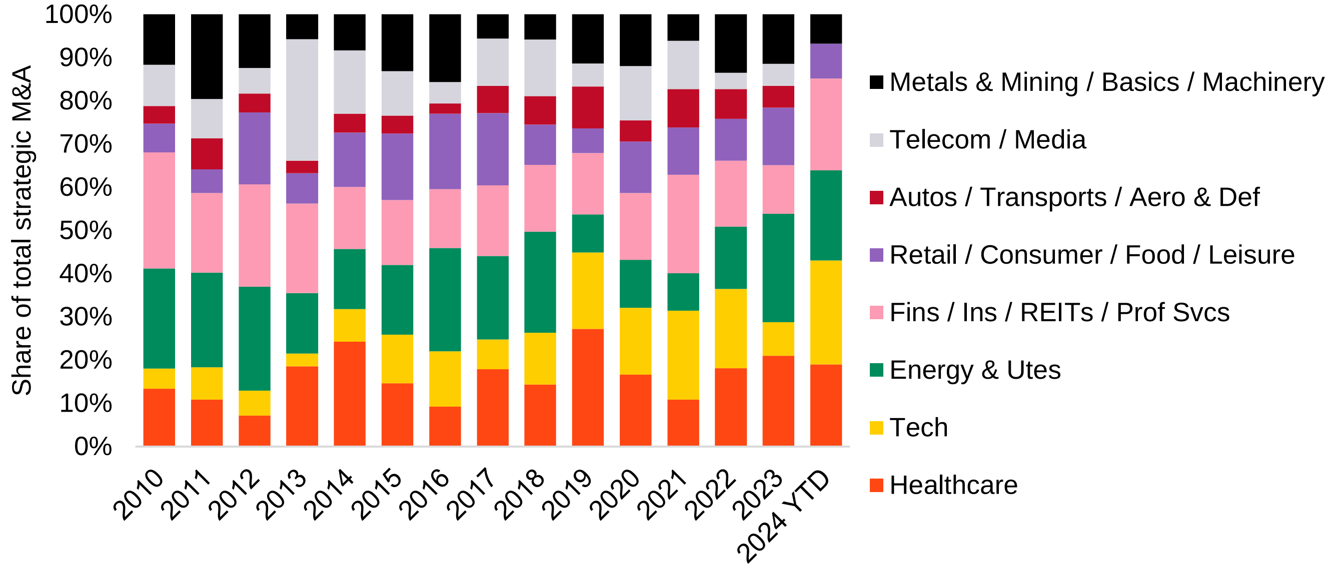
We view the recent reacceleration of M&A as a "re-start" of the pattern in place immediately following the onset of the pandemic, when corporates were laser focused on filling strategic gaps in their business models and when financing costs were ultra low. The rebound in M&A activity is also consistent with our view that *clarity* on the macro and financing backdrop (not necessarily a *favorable* backdrop) is key for CFO and Treasurer confidence to move forward with large M&A. After all, while financial conditions have eased as of late, the cost of capital remains elevated.

Exhibit 2: Energy, Healthcare and Technology have driven 61% of recent strategic M&A
Announced strategic M&A by North American and European acquirers, by sector, since October 1, 2023. Excludes cancelled and withdrawn deals. Captures deals valued at $1 billion or more, at announcement.



Source: BlackRock, Dealogic. As of February 21, 2024.

Exhibit 3: The sector participation of M&A typically varies over time
Historical sector shares of announced strategic M&A by North American and European acquirers. Excludes cancelled and withdrawn deals. Captures deals valued at $1 billion or more, at announcement.



Source: BlackRock, Dealogic. 2024 YTD is as of February 21, 2024.

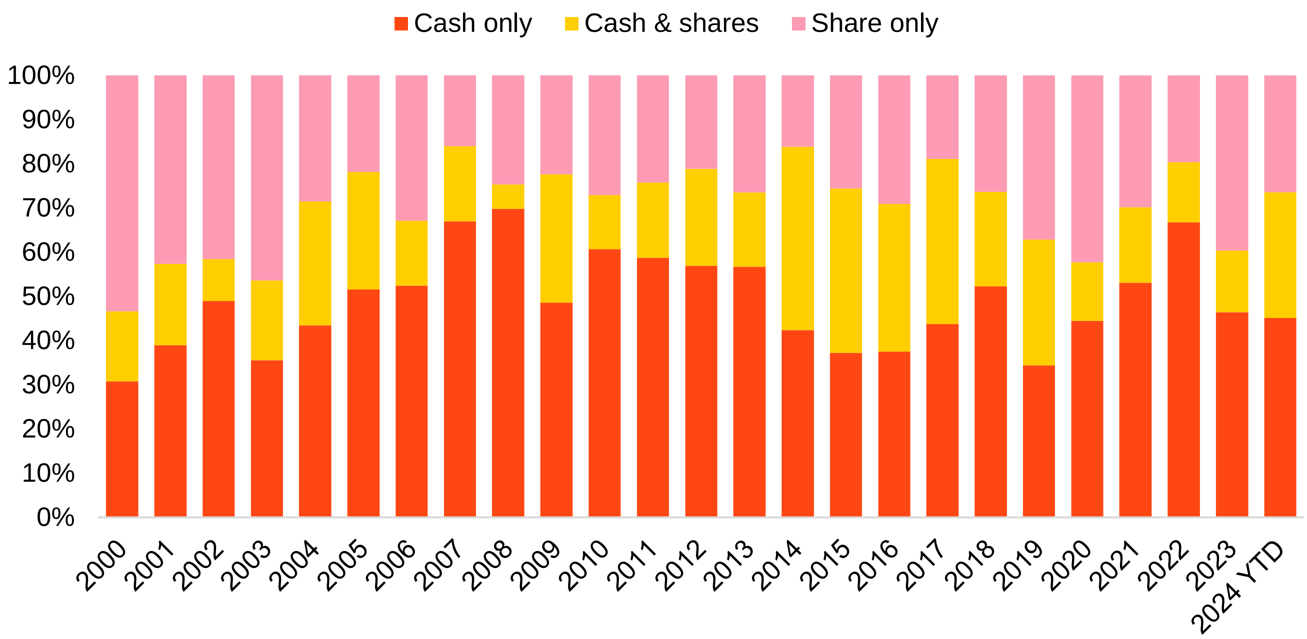
Since the start of 4Q2023, there has been more than $713 billion of announced M&A by strategic (i.e., non-sponsor related) firms, driven by the Energy, Healthcare and Technology sectors (Exhibit 2). And as of late, Financials have also been a meaningful contributor to early 2024 volumes (Exhibit 3).

As we outlined in December of last year, we believe balance sheet strength will remain a key determinant of future M&A activity, in addition to long-standing and well-known sector trends (i.e., acquisitions to assist in drug discovery in Pharmaceuticals, for example). Corporates with strong funding options will have opportunities to grow and diversify their businesses, while higher financing costs might render those same opportunities as uneconomic for financially stretched firms. This is likely to be yet another driver of dispersion – albeit over a long-term trend – in the corporate credit market, in our view.

For the most part, the funding mix – in aggregate – has been rather benign for bondholders, with a share of all-cash deals (44%) that is slightly below the 49% average of the post-financial crisis era (Exhibit 4). That said, there is a high degree of variation across sectors. For example, based on our review of recent deal level data from Dealogic, we find that deals in the Energy and Financial sectors have tended to be funded more with equity. By contrast, acquirers in the cash-rich Technology and Pharmaceutical sectors have generally used cash and/or incremental debt to fund their recent acquisitions.

Exhibit 4: A fairly benign M&A funding mix for bondholders, as of late

Funding mix of announced M&A by North American and European strategic acquirers. Excludes cancelled and withdrawn deals. Captures deals valued at $1 billion or more, at announcement.



Source: BlackRock, Dealogic. 2024 YTD is as of February 21, 2024.

FOMC minutes: key takeaways

The minutes from the January 31st FOMC meeting (released February 21st) reiterated Chair Powell's messaging from the press conference, where he noted the Committee desired more "confidence" that inflation was moving "sustainably" towards the 2% target, before starting a rate cutting cycle. Other notable takeaways, in our view, included:

- **A likely peak for U.S. policy rates.** "Participants judged that the policy rate was likely at its peak for this tightening cycle," and "generally noted that they did not expect it would be appropriate to reduce the target range for the federal funds rate until they had gained greater confidence that inflation was moving sustainably toward 2%." The minutes emphasized a "data dependent" approach and that the Committee "remained highly attentive to inflation risks."
- **The risks of cutting rates too quickly.** "Participants highlighted the uncertainty associated with how long a restrictive monetary policy stance would need to be maintained. Most participants noted the risks of moving too quickly to ease the stance of policy and emphasized the importance of carefully assessing incoming data in judging whether inflation is moving down sustainably to 2%. A couple of participants, however, pointed to downside risks to the economy associated with maintaining an overly restrictive stance for too long."
- **The Committee is watching a wide range of factors.** "Members agreed that, in assessing the appropriate stance of monetary policy, they would continue to monitor the implications of incoming information for the economic outlook…their assessments would take into account a wide range of information, including readings on labor market conditions, inflation pressures and inflation expectations, and financial and international developments."
- **Easing financial conditions are a risk.** "Several participants mentioned the risk that financial conditions were or could become less restrictive than appropriate, which could add undue momentum to aggregate demand and cause progress on inflation to stall." As shown in Exhibit 5, U.S. financial conditions eased notably in 4Q2023, but have remained largely range-bound so far in early 2024, as the (easing) impacts of higher equity prices and tighter credit spreads have been somewhat offset by the (tightening) impact from higher interest rates.

Exhibit 5: Financial conditions eased in 4Q2023, and have been range-bound in early 2024
Goldman Sachs U.S. Financial Conditions Index

Source: BlackRock, Goldman Sachs Global Investment Research, Bloomberg. As of February 21, 2024.

FOMC minutes: key takeaways (continued)

- **"Surprisingly resilient" consumer spending.** "Participants noted that momentum in aggregate demand may be stronger than currently assessed, especially in light of surprisingly resilient consumer spending last year."
- **Two-sided risks to inflation.** Beyond easing financial conditions and robust consumer demand (mentioned previously), the minutes referenced some additional "sources of upside risks to inflation, including possible disruptions to supply chains from geopolitical developments, a potential rebound in core goods prices as the effects of supply-side improvements dissipate, or the possibility that wage growth remains elevated." That said, downside risks were also noted, including "geopolitical risks that could result in a material pullback in demand, possible negative spillovers from lower growth in some foreign economies, the risk that financial conditions could remain restrictive for too long, or the possibility that a weakening of household balance sheets could contribute to a greater-than-expected deceleration in consumption."

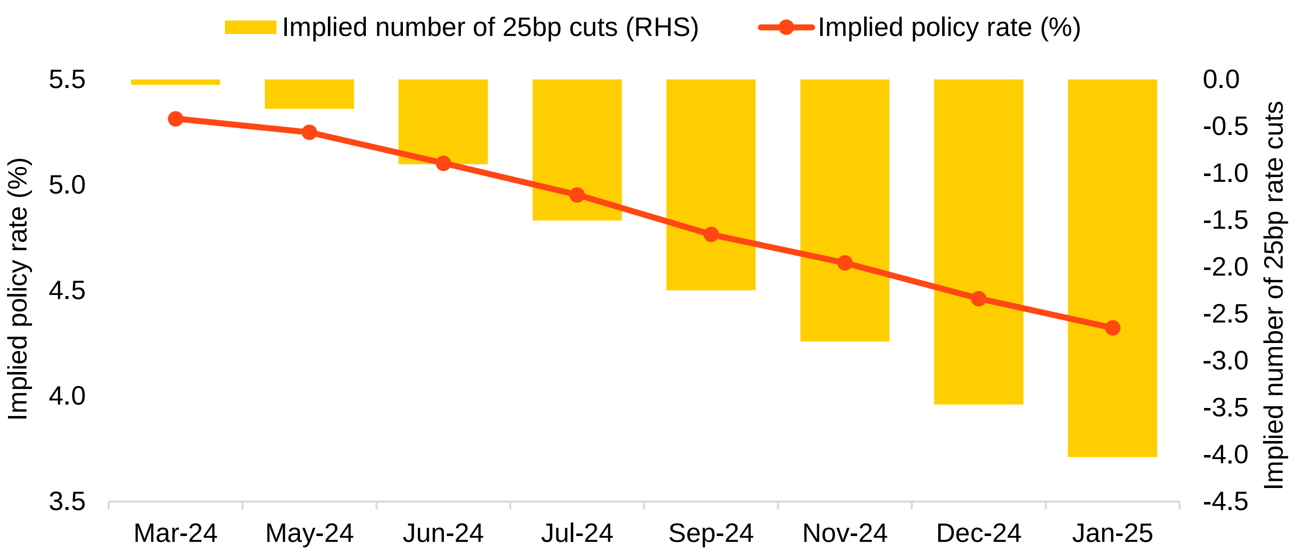
The reason for rate cuts is more important than the timing, in our view

As shown in Exhibit 6, market pricing now reflects 1) a very low likelihood of a rate cut in March 2024 – a notable shift from just a few weeks ago, and 2) a smaller number of 25bp rate cuts, in aggregate, through early 2025 (i.e., four currently, as opposed to roughly six a few weeks ago). We believe this is appropriate. With U.S. economic growth still solid and unemployment remaining low by historical standards, we do not see an obvious sense of urgency for near-term, significant rate cuts by the Federal Reserve. Our base case remains 2H2024 for the start of the rate cutting cycle, with the risks skewed earlier within that timeframe.

More important than the *timing* of the start of rate cuts, however, is the *reason* for them. Proactive cuts to calibrate real interest rates (in response to declining inflation) are a much more supportive outcome for risk assets, in our view, than cutting in response to a deterioration in economic activity. As we have emphasized previously, the key for corporate credit investors is the Federal Reserve's willingness to (eventually) cut interest rates proactively (which was referenced at the December FOMC meeting), in response to improving inflation – as opposed to waiting for evidence of a growth downturn to begin normalizing monetary policy.

Exhibit 6: Market pricing now reflects a lower probably for near-term rate cuts vs. a few weeks ago

The U.S. policy rate implied by Fed Funds Futures and the implied number of 25bp rate cuts, both through early 2025



Source: BlackRock, Bloomberg. As of February 22, 2024.

Higher freight costs: framing the potential pass-through to inflation

Following signs of recent strength in U.S. inflation data (i.e., January CPI and PPI), many market participants are increasingly looking for other potential sources of additional upside risk to price pressures. Freight and logistics costs have been one area of focus, given the ongoing geopolitical-related shipping disruptions in the Red Sea and Suez Canal. As has been widely reported over the past few months, many cargo ships have made the decision to bypass the area, instead opting to travel around southern Africa (for Asia-to-Europe routes, for example).

The United Nations Conference on Trade and Development (UNCTAD) estimates the Suez Canal handled 12% to 15% of global trade in 2023. And according to a January 2024 Moody's analysis, 20% of all European Union goods imports (from Asia) were transported by sea in 2022 – most of which passed through the Suez Canal (including retail, general manufacturing, autos).

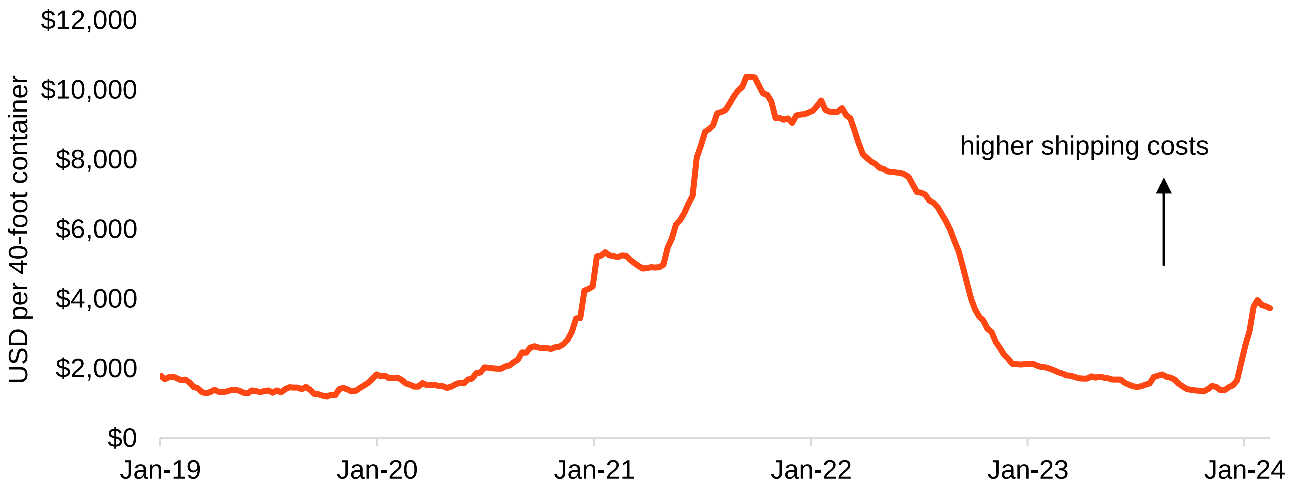
While imports into Europe (from Asia) are likely most impacted from this disruption, the U.S. is not immune. Moody's estimates that more than a third of U.S. East Coast ports' container trade with Asia moves through the Suez Canal (utilizing data from the U.S. Army Corps of Engineers and published ocean carrier schedules).

As shown in Exhibit 7, container freight rates have increased since late 2023 but remain below the pandemic-related supply chain disruption levels of late 2021.

The persistence and magnitude of heightened freight costs will be important to monitor, as they have the potential to pass-through to import price inflation, albeit in a modest way. For example, an August 2022 study by the St. Louis Federal Reserve found that a 1 percentage point increase in shipping price growth resulted in an increase in import price inflation of 0.064 percentage point. Moreover, the analysis found more pass-through in food and materials goods, compared to consumer goods, machines, electronics and parts. Whether the good is perishable, and whether it is an intermediate good vs. a final good may be relevant in determining the extent of the pass-through. An April 2017 study by the Kansas City Federal Reserve found that a 15 percent increase in shipping costs led to a 0.10 percentage point increase in core inflation after one year.

There is a significant amount of uncertainty related to the potential persistence of these disruptions. For example, shipping firm A.P. Moller-Maersk A/S disclosed (in a Bloomberg interview on February 8th) that it expects disruptions in the Red Sea to last anywhere from one quarter to one year.

Exhibit 7: Shipping costs have increased, but remain below the pandemic peaks
Drewry World Container Index



Source: BlackRock, Bloomberg, Drewry World Container Index (WCI). The WCI reports actual spot container freight rates for major East West trade routes, consisting of 8 route-specific indices representing individual shipping routes and a composite index. The composite represents a weighted average of the 8 shipping routes by volume: Shanghai - Rotterdam, Rotterdam - Shanghai, Shanghai - Genoa, Shanghai - Los Angeles, Los Angeles - Shanghai, Shanghai - New York, New York - Rotterdam, Rotterdam - New York.

Assessing performance breadth in the USD corporate credit market

Many market participants remain focused on the large-cap Technology sector in the equity market, given its significant contribution to overall performance. With that in mind, we briefly take stock of performance breadth in USD corporate credit, on a year-to-date (YTD) basis. As shown in Exhibit 8, there is a notable cyclical trend to performance in the USD investment grade (IG) universe, as many of the traditionally defensive (and cash-rich) sectors are lagging (i.e., Technology, Pharmaceuticals). Beyond the cyclical tilts, this is also likely a function of the different duration exposures across USD IG sectors.

Exhibit 8: Cyclical sectors have been outperforming in USD IG

Sector contributions to the USD IG Bloomberg Corporate Index YTD total return of -1.68%

	YTD Index Total Return (%)
USD IG Index	-1.68

	Sector contribution to YTD Index Total Return (%)
Airlines	0.00
Home Construction	0.00
Other Financial	0.00
Lodging	0.00
Packaging	0.00
Gaming	0.00
Finance Companies	0.00
Supermarkets	0.00
Healthcare REITs	0.00
Office REITs	0.00
Other Utility	0.00
Paper	0.00
Consumer Cyc Services	-0.01
Refining	-0.01
Building Materials	-0.01
Apartment REITs	-0.01
Oil Field Services	-0.01
Environmental	-0.01
Automotive	-0.01
Other REITs	-0.01
Construction Machinery	-0.01
Retail REITs	-0.01
Other Industrial	-0.01
Natural Gas	-0.01
Transportation Services	-0.01
Independent	-0.02
Restaurants	-0.02
Life	-0.02
Tobacco	-0.02
Brokerage / Asset managers / Exchanges	-0.02
Metals and Mining	-0.02
Consumer Products	-0.02
Chemicals	-0.03
Diversified Manufacturing	-0.03
P&C	-0.04
Wireless	-0.04
Integrated	-0.04
Health Insurance	-0.04
Media Entertainment	-0.04
Midstream	-0.05
Railroads	-0.05
Aerospace/Defense	-0.06
Cable Satellite	-0.07
Wirelines	-0.07
Retailers	-0.08
Healthcare	-0.08
Food and Beverage	-0.09
Banking	-0.10
Pharmaceuticals	-0.13
Electric	-0.18
Technology	-0.21

Source: BlackRock, Bloomberg. As of February 21, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

In the USD HY market, the aggregate year-to-date performance masks the variation under the surface. As highlighted in Exhibit 9, the Cable & Satellite sector has been a notable laggard relative to the broader index. This has been driven by a confluence of headwinds including secular shifts, increased competition, elevated leverage and a lack of growth (which has prevented some issuers from "growing into" their debt capital structures).

Exhibit 9: Cable & Satellite has been a notable underperformer in USD HY

Sector contributions to the USD HY Bloomberg Corporate Index YTD total return of -0.06%

	YTD Index Total Return (%)
USD HY Index	-0.06

	Sector contribution to YTD Index Total Return (%)
Healthcare	0.08
Retailers	0.07
Independent	0.05
Gaming	0.04
Midstream	0.04
Leisure	0.02
Oil Field Services	0.02
Automotive	0.02
Other Industrial	0.01
Building Materials	0.01
Brokerage / Asset managers / Exchanges	0.01
Other Financial	0.01
Airlines	0.01
Diversified Manufacturing	0.01
Paper	0.01
Consumer Cyc Services	0.01
Refining	0.01
Aerospace/Defense	0.00
Home Construction	0.00
Life	0.00
Chemicals	0.00
Tobacco	0.00
Environmental	0.00
Restaurants	0.00
Supermarkets	0.00
Banking	0.00
Metals and Mining	0.00
Retail REITs	0.00
Cash	0.00
Lodging	0.00
Natural Gas	0.00
Railroads	0.00
Other REITs	0.00
Health Insurance	0.00
Finance Companies	0.00
Transportation Services	0.00
Construction Machinery	0.00
Consumer Products	0.00
Food and Beverage	-0.01
Healthcare REITs	-0.01
Office REITs	-0.01
Pharmaceuticals	-0.01
P&C	-0.01
Technology	-0.02
Wirelines	-0.02
Packaging	-0.02
Electric	-0.02
Wireless	-0.02
Media Entertainment	-0.05
Cable Satellite	-0.29

Source: BlackRock, Bloomberg. As of February 21, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

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