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APRIL 5, 2022

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Why we haven't given up on credit

Key Takeaways

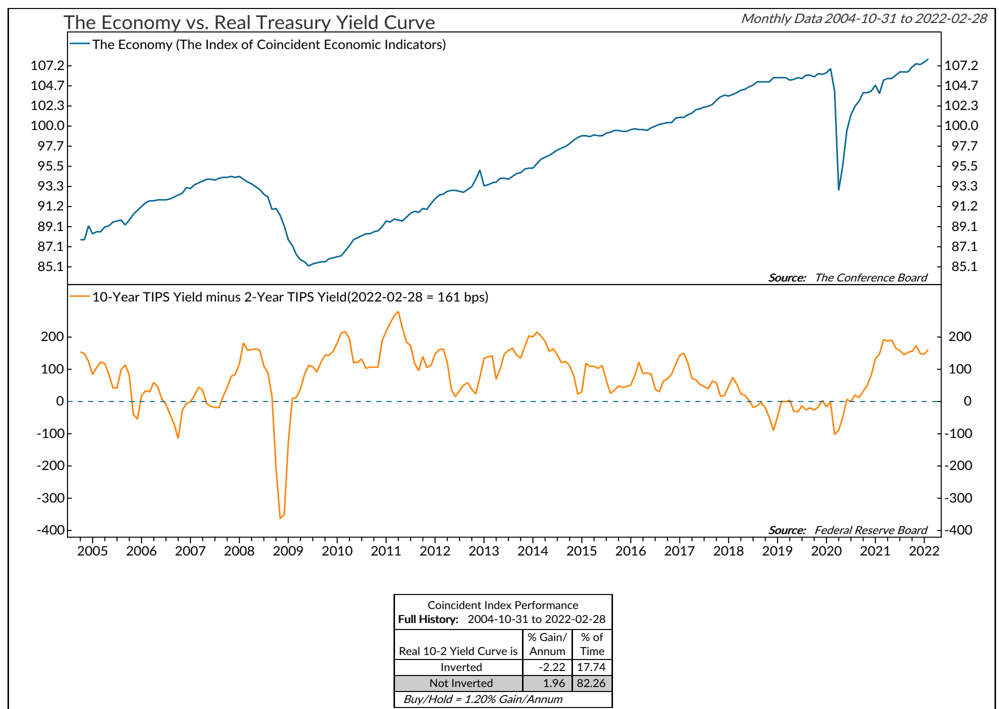
- Inverted Treasury curve not confirmed by TIPS curve or German curve, casting doubt on 2022 recession risk.
- Broad-based credit indicators remain supportive for growth.
- High yield and leveraged loans continue to outperform. We remain overweight.

With yield curves inverting and talk of recession swirling in the air, you would think that credit -- and particularly lower quality credit – wouldn't be the place to be. But you would be wrong. High yield and leveraged loans have done relatively well this year.

My take on the curve inversion is that it is related to the Fed's sudden awakening to the inflation problem more than a recession problem. The economy may eventually end up in recession, but that may be more of a story for next year – not this year.

Some strategists dismiss the yield curve inversion as a byproduct of years of central bank involvement in the markets, thereby depressing the term premium and distorting market signals.

TIPS curve indicates expansion



Coincident Index Performance
Full History: 2004-10-31 to 2022-02-28

Real 10-2 Yield Curve is	% Gain/ Annum	% of Time
Inverted	-2.22	17.74
Not Inverted	1.96	82.26

Buy/Hold = 1.20% Gain/Annum

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German curve positive

If there is one economy and region that is most at risk for recession it would surely be Germany and the eurozone. Yet, the 2s10s German curve is steep by over 60 bp – far from inverting.

To me, the U.S. and German curves are not that distorted, but rather the markets signaling that the Fed will hike rates much more than the ECB will, resulting in different curve expectations.

TIPS curve steep

Additionally, the other Treasury curve – the TIPS or real yield curve – is quite steep. Again, I attribute this primarily to the differences in inflation expectations over various time horizons. The desire for greater near-term inflation protection has pushed the cost of that protection higher in the form of lower real yields.

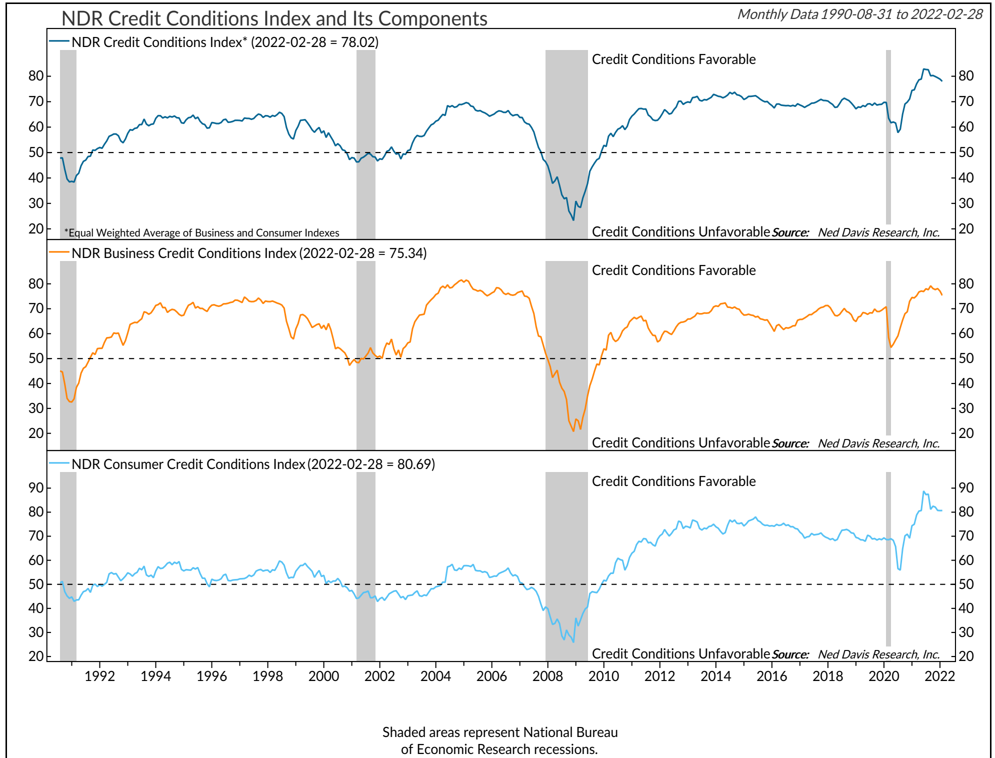
Moreover, the TIPS curve has been an effective economic indicator, as shown on the chart, although history is limited.

Outside of the Treasury coupon yield curve, there are few signs of recession on the horizon. If there is a recession out there, it

will start to show up in the credit markets. On the following pages, we review the evidence.

Our favorite broad-based credit market indexes remain supportive for growth. Our own Credit Conditions Index (CCI), which measures the cost and availability of credit, is just below record highs. Except for the pandemic, which was an exogenous shock, the CCI has fallen below 50 prior to recession.

NDR CCI near record high



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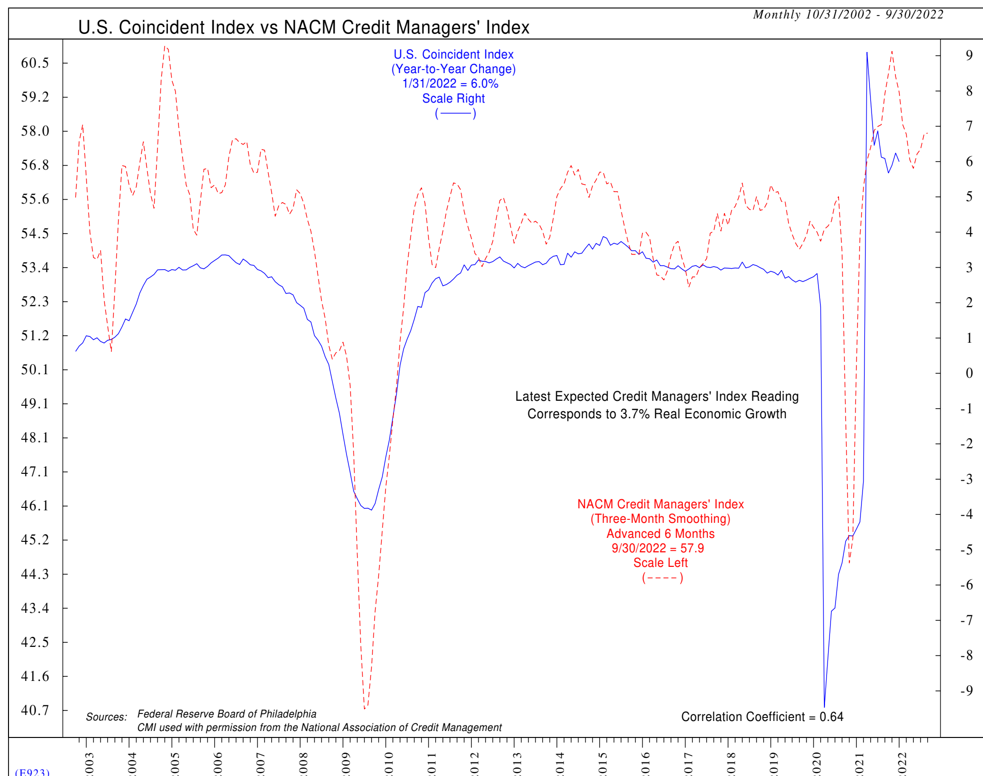
NACM CMI projects strong growth



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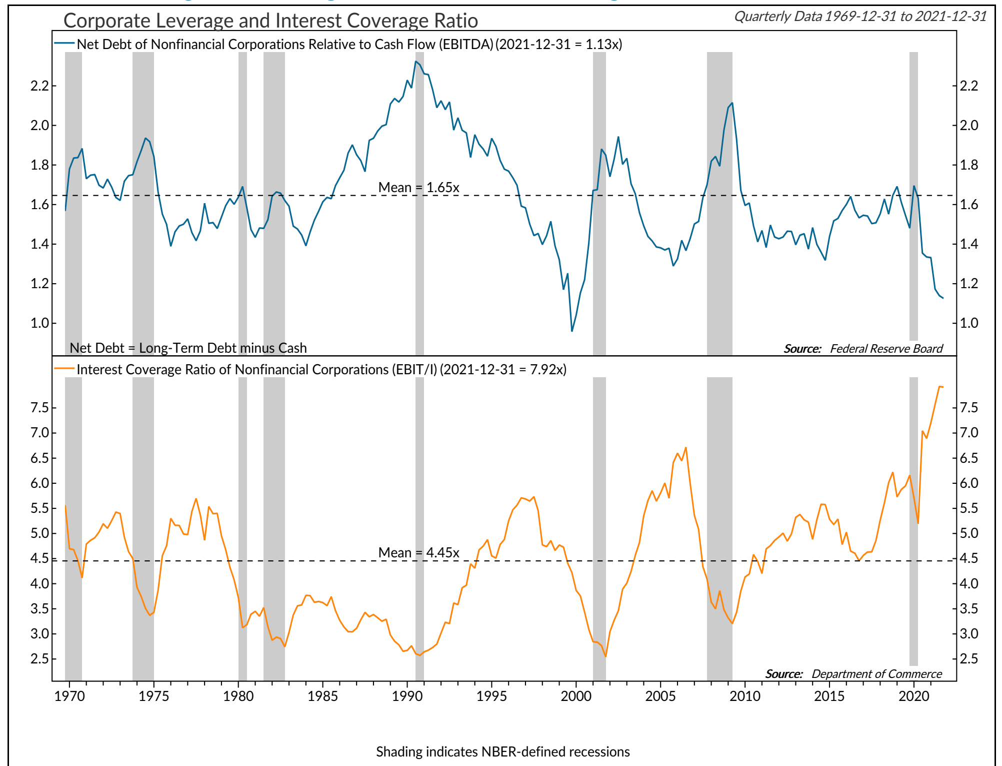
The NACM Credit Managers' Index (CMI) reflects business lending conditions. The latest reading of 58.9 is one of the highest on record.

Low leverage and high interest coverage

Corporate credit fundamentals remain strong, suggesting low risk of defaults and limited impact from rising borrowing costs at this time.



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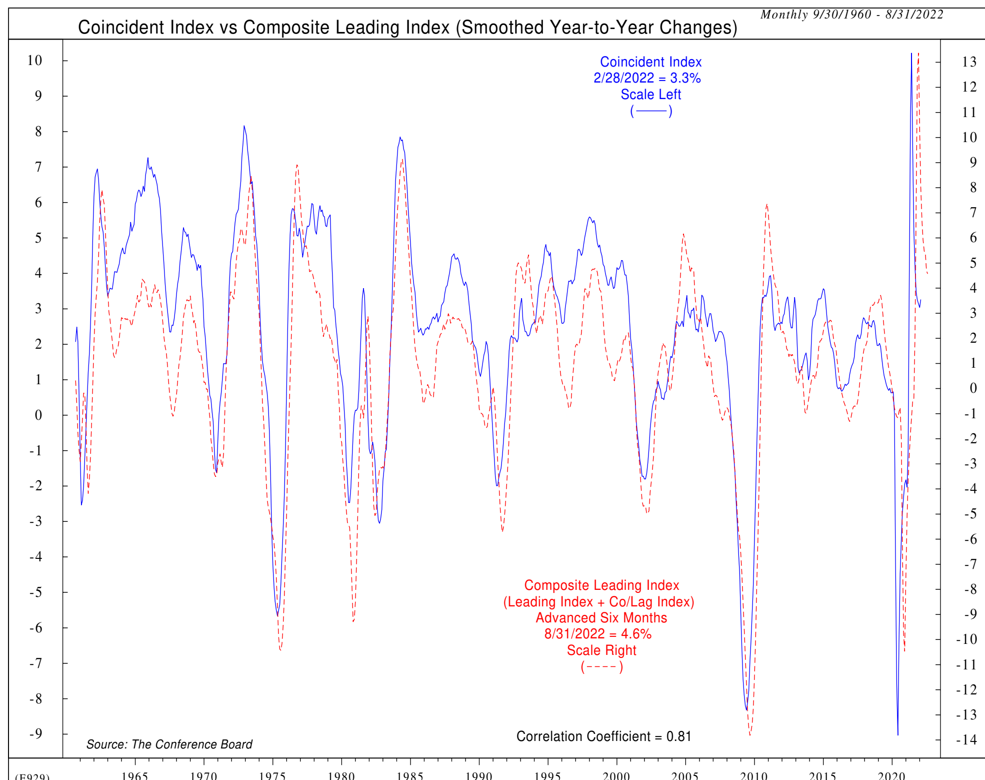
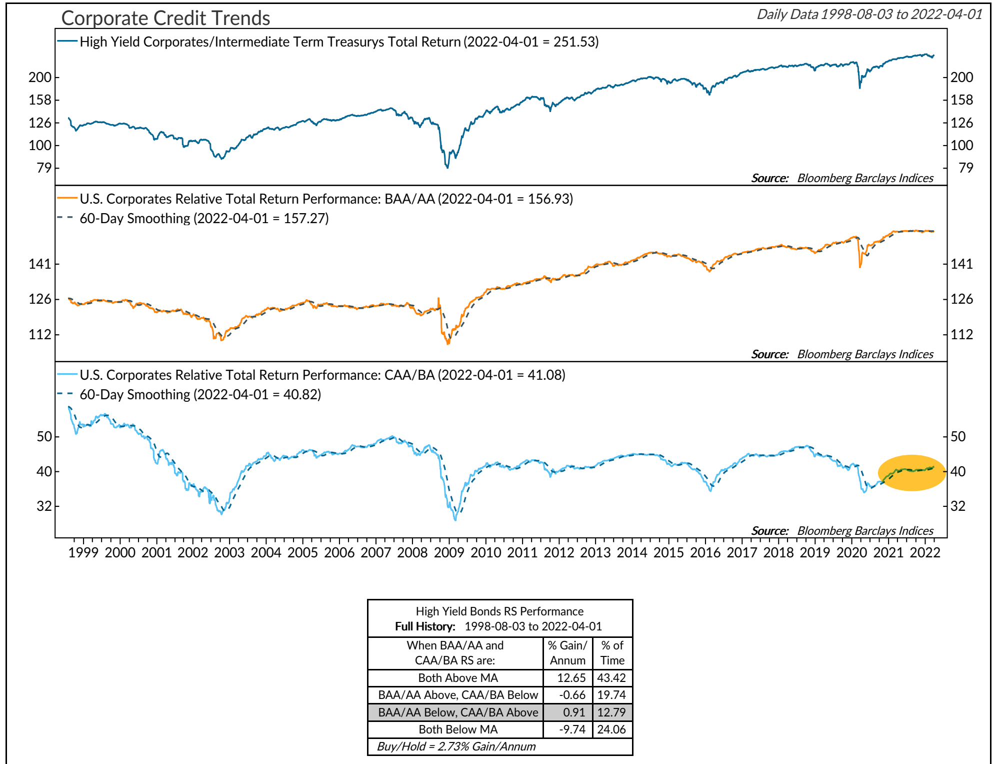
Composite leading index shows low risk of recession



Our composite leading index, which is a combination of the Conference Board's Leading index and Co/Lag index, is coming off its peak growth, but remains historically high. It takes time to unwind strong upward momentum.

Caa outperforming Baa this year!

If the economy were headed for recession, we would expect the weakest areas of credit – the CCCs – to be underperforming, as they have in the past. They aren't.



High Yield Bonds RS Performance
Full History: 1998-08-03 to 2022-04-01

When BAA/AA and CAA/BA RS are:	% Gain/ Annum	% of Time
Both Above MA	12.65	43.42
BAA/AA Above, CAA/BA Below	-0.66	19.74
BAA/AA Below, CAA/BA Above	0.91	12.79
Both Below MA	-9.74	24.06

Buy/Hold = 2.73% Gain/Annum

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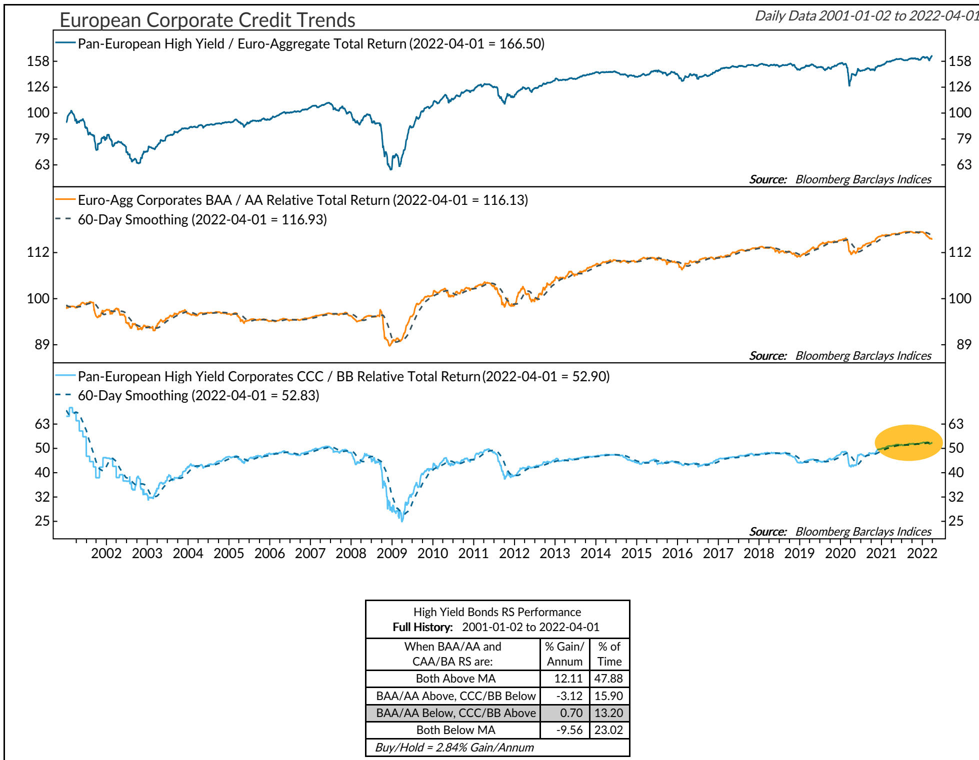
European CCCs hanging tough!



High Yield Bonds RS Performance
Full History: 2001-01-02 to 2022-04-01

When BAA/AA and CAA/BA RS are:	% Gain/ Annum	% of Time
Both Above MA	12.11	47.88
BAA/AA Above, CCC/BB Below	-3.12	15.90
BAA/AA Below, CCC/BB Above	0.70	13.20
Both Below MA	-9.56	23.02

Buy/Hold = 2.84% Gain/Annum

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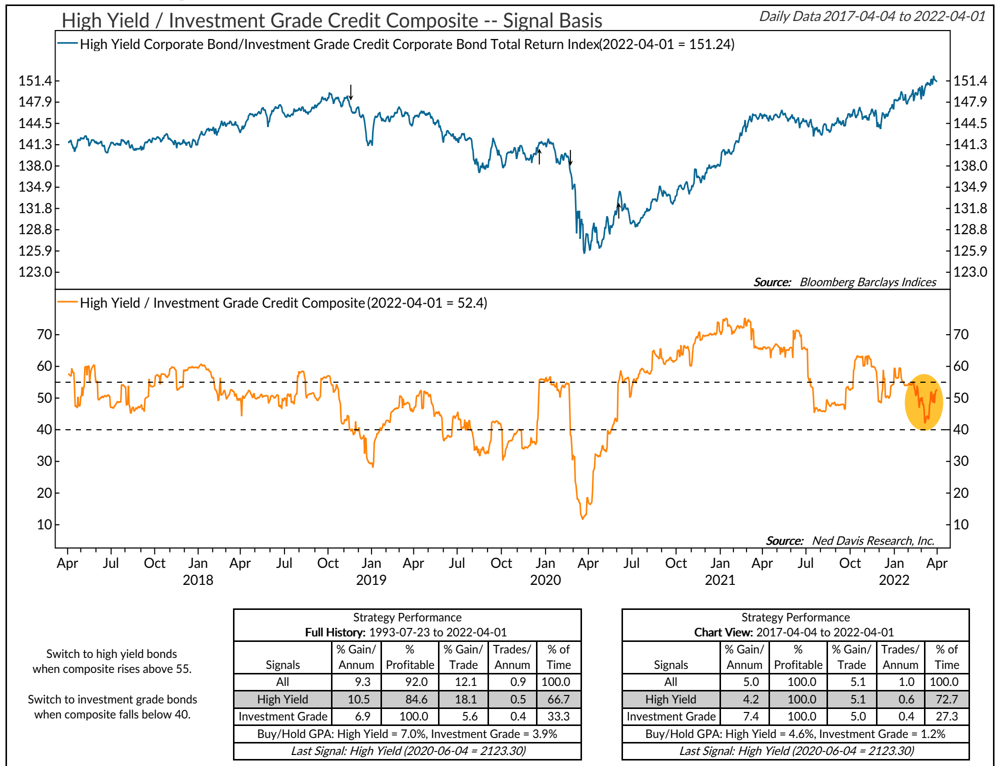
What's even more amazing is that we see similar outperformance from European high yield. If European high yield is going to avoid defaults, Europe will avoid recession.

HY/IG composite continues to favor HY

Our new HY/IG Credit Composite deteriorated to the low end of the neutral zone, but never turned negative, nor did we. In fact, we have kept our overweight on high yield all year. The composite has since moved toward the upper end of the neutral zone.



Strategy Performance
Full History: 1993-07-23 to 2022-04-01

Signals	% Gain/ Annum	% Profitable	% Gain/ Trade	Trades/ Annum	% of Time
All	9.3	92.0	12.1	0.9	100.0
High Yield	10.5	84.6	18.1	0.5	66.7
Investment Grade	6.9	100.0	5.6	0.4	33.3

Buy/Hold GPA: High Yield = 7.0%, Investment Grade = 3.9%

Last Signal: High Yield (2020-06-04 = 2123.30)

Strategy Performance
Chart View: 2017-04-04 to 2022-04-01

Signals	% Gain/ Annum	% Profitable	% Gain/ Trade	Trades/ Annum	% of Time
All	5.0	100.0	5.1	1.0	100.0
High Yield	4.2	100.0	5.1	0.6	72.7
Investment Grade	7.4	100.0	5.0	0.4	27.3

Buy/Hold GPA: High Yield = 4.6%, Investment Grade = 1.2%

Last Signal: High Yield (2020-06-04 = 2123.30)

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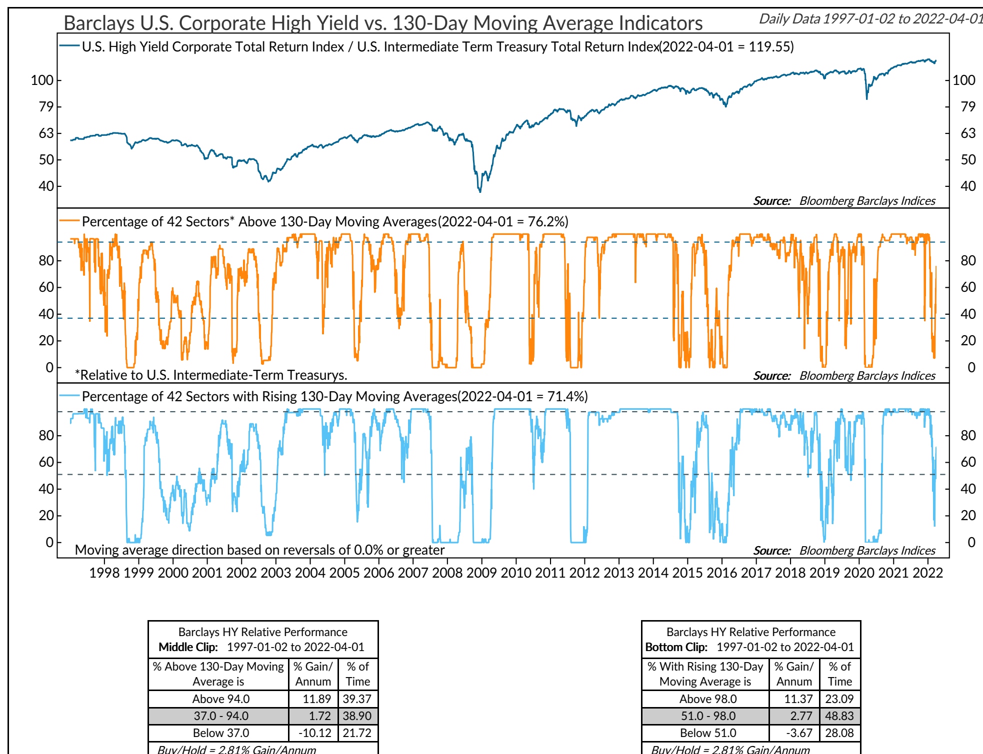
HY breadth momentum rebounding



Barclays HY Relative Performance
Middle Clip: 1997-01-02 to 2022-04-01

% Above 130-Day Moving Average is	% Gain/ Annum	% of Time
Above 94.0	11.89	39.37
37.0 - 94.0	1.72	38.90
Below 37.0	-10.12	21.72

Buy/Hold = 2.81% Gain/Annum

Barclays HY Relative Performance
Bottom Clip: 1997-01-02 to 2022-04-01

% With Rising 130-Day Moving Average is	% Gain/ Annum	% of Time
Above 98.0	11.37	23.09
51.0 - 98.0	2.77	48.83
Below 51.0	-3.67	28.08

Buy/Hold = 2.81% Gain/Annum

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Finally, our high yield breadth momentum indicators are rebounding strongly. Our intermediate-term indicators are firmly in neutral territory now after being negative (chart left), while our long-term indicators are just shy of the bullish zone.

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NDR HOUSE VIEWS (Updated March 21, 2022)

For global asset allocation, NDR recommends overweight allocation to cash, marketweight allocation to stocks and underweight allocation to bonds. Equities remain in the secular bull market started in 2009. But we have been expecting increased volatility and recognize the possibility of a cyclical bear market.

Equity Allocation

U.S. | Our intermediate-term outlook for U.S. equities is neutral. On an asset allocation basis, we are overweight cash and underweight bonds. We favor large-caps over small-caps and are neutral on Growth versus Value.

INTERNATIONAL | We are overweight Europe ex. U.K. and Canada, underweight Pacific ex. Japan and the U.S., and marketweight on all other regions.

Macro

ECONOMY | The global economy is poised for slower, but still strong growth in 2022, as high savings and wealth, pent-up demand, and the broadening of vaccines globally support growth. The COVID pandemic, supply chain issues, elevated inflation, and tighter global monetary policy present risks to the outlook.

FIXED INCOME | We are 85% of benchmark duration and expect the yield curve to flatten. We are overweight CMBS, ABS, and HY corporates, and marketweight everything else.

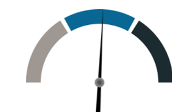
GOLD | Long-term uptrend intact. We are bullish.

DOLLAR | Our long-term technical composite is positive. We are neutral, also recognizing real interest rate differentials.

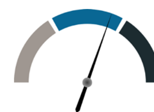
Economic Summary

April 4, 2022

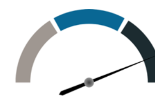
Near term activity: ● Accelerating ● Neutral ● Decelerating



Global Economy
(4.3%)



U.S. Economy
(3.0%-3.5%)



U.S. Inflation
(4.0%-4.5%)

Economic gauges reflect changes in near-term economic activity. Numbers in parenthesis refer to NDR 2022 forecasts.

Global Asset Allocation

● Overweight ● Marketweight ● Underweight

- ● Cash (15%)
- ● Stocks (55%)
- ● Bonds (30%)

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Equities — Regional Relative Allocation

- ● Europe ex. U.K. (16%) | Canada (6%)
- ● Japan (6%) | Emerging Markets (13%) | U.K. (4%)
- ● U.S. (54%) | Pacific ex. Japan (1%)

Benchmark – U.S. (59.5%), Europe ex. U.K. (12.7%), Emerging Markets (12.2%), Japan (6.0%), U.K. (3.7%), Pacific ex. Japan (2.9%), Canada (2.9%)

Global Bond Allocation

- ● Europe (30%) | Japan (20%)
- ● U.K. (5%)
- ● U.S. (45%)

Benchmark: U.S. (52%), Europe (27%), Japan (15%), U.K. (6%)

U.S. Allocation

- ● Cash (15%) | Large-Cap
- ● Stocks (55%) | Growth | Value | Mid-Cap
- ● Bonds (30%) | Small-Cap

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Sectors

- ● Energy (5%) | Materials (4%) | Consumer Staples (9%) | Health Care (16%)| Utilities (4%)
- ● Consumer Discretionary (10%) | Communication Services (8%) | Technology (23%)

Benchmark: Technology (27.4%), Health Care (12.9%), Financials (10.9%), Communication Services (10.9%), Consumer Discretionary (13.1%), Consumer Staples (6.4%), Industrials (8.2%), Energy (2.8%), Utilities (2.4%), Real Estate (2.5%), Materials (2.5%)

U.S. Bonds — 85% of Benchmark Duration

Please see important disclosures at the end of this report.

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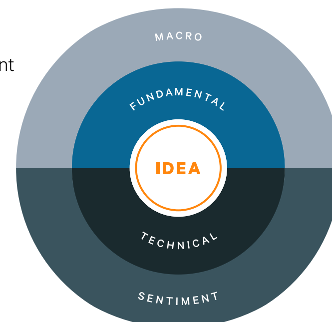

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