



Navigating Incoming Credit Risk

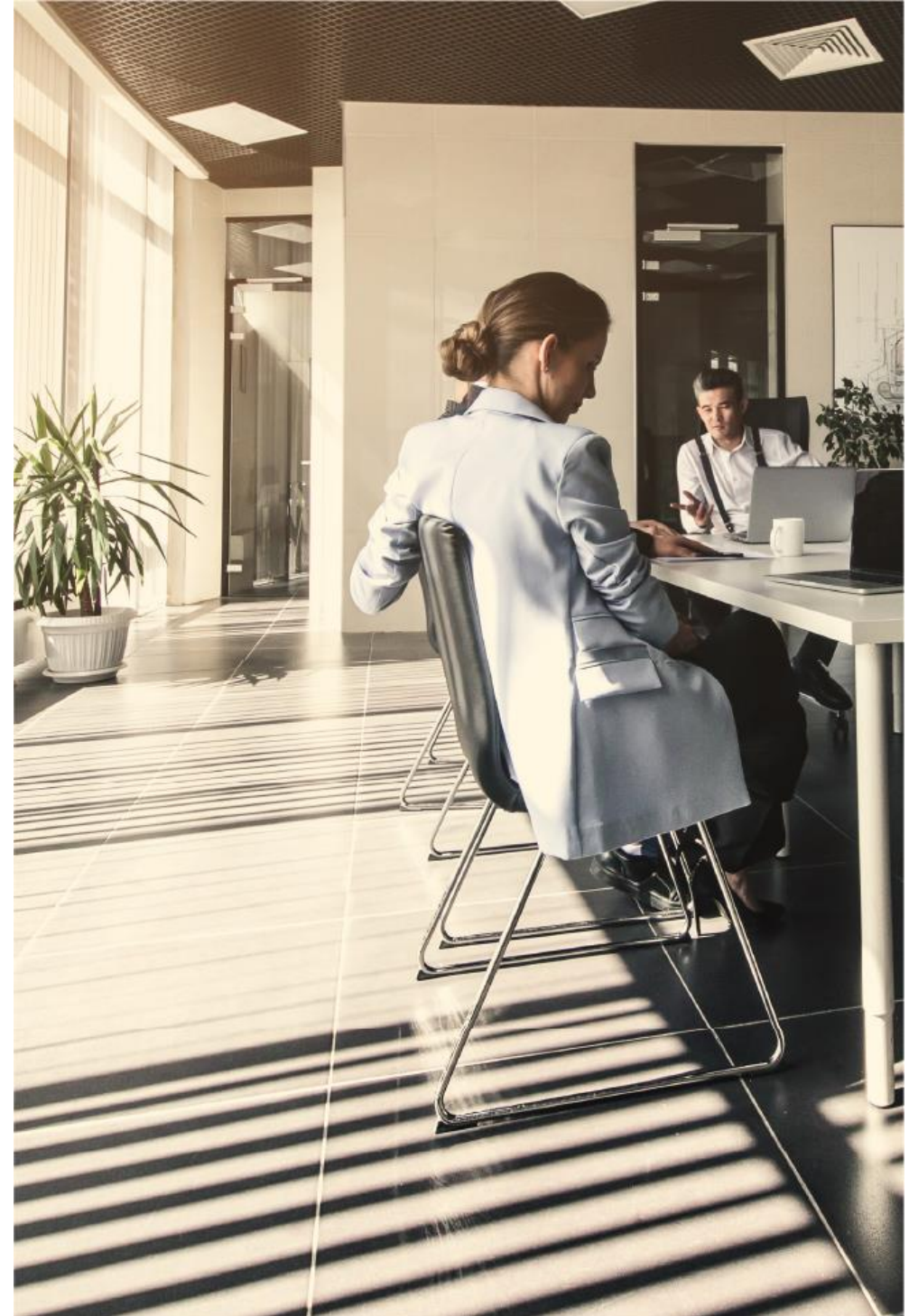
Presented by: Sun Life Capital Management

Data as of 12/29/2023

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Macro Outlook



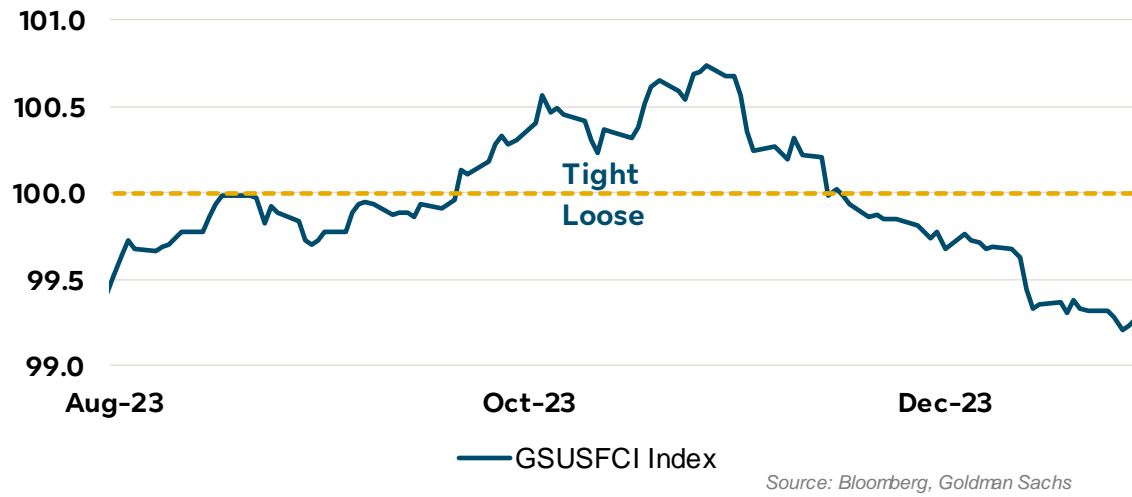
Macro outlook

Macro outlook – No rest for the weary

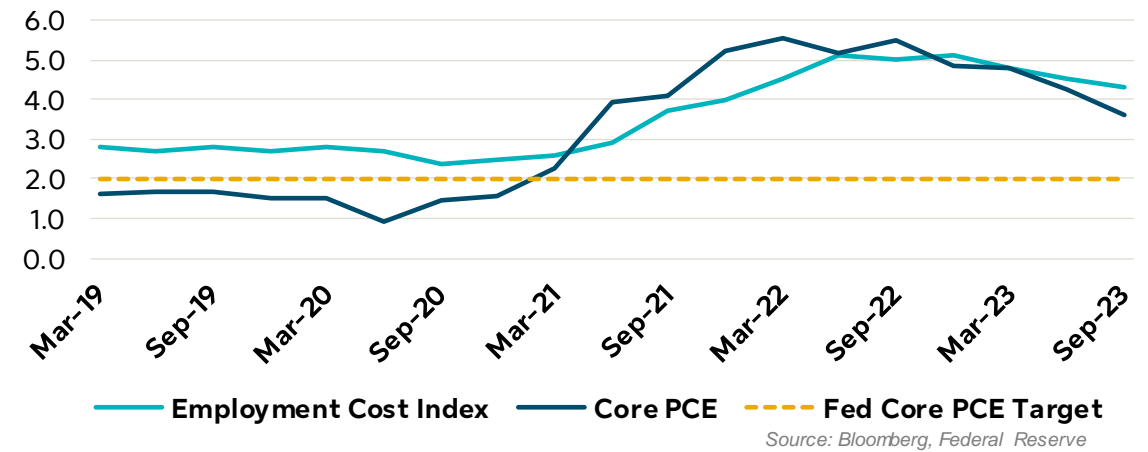
- We see an inflation rate that is still above the Fed's mandate, a strong labor market, and financial conditions that have eased dramatically
-
- None of these data points support near term rate cuts, leaving us skeptical about the market's expectations for cuts in the first half of 2024
-
- Rates staying higher for longer will continue the slow burn of higher interest costs on consumers, corporations, and the US Government

Market indicators

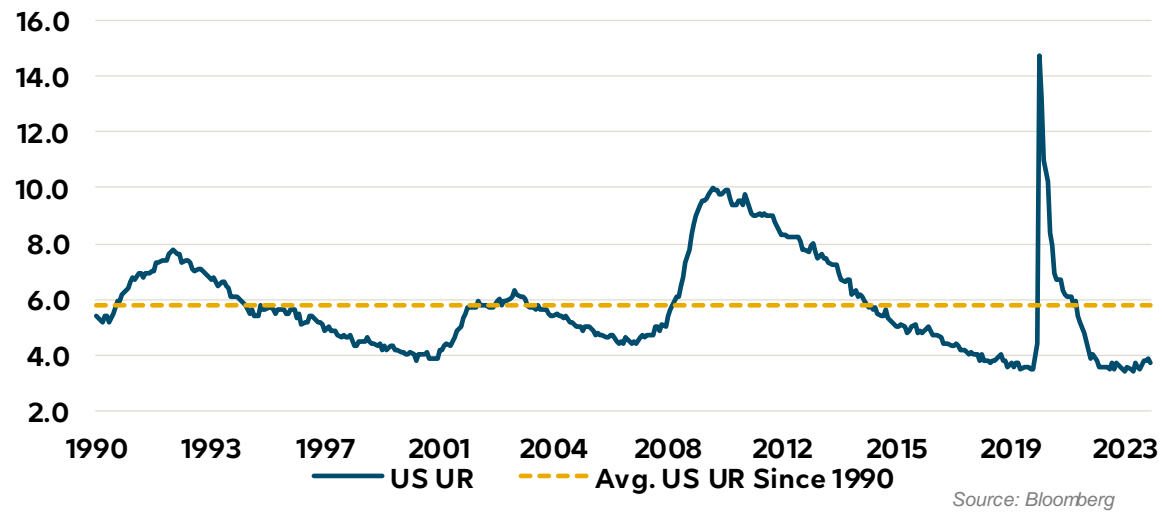
GS Financial Conditions Index



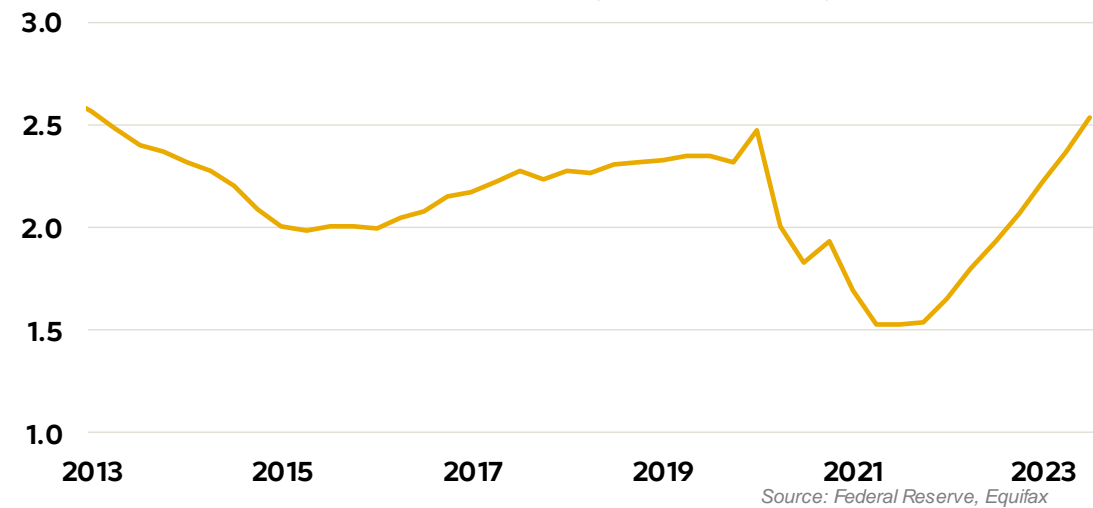
Employment Cost and Core PCE vs Inflation Target (%)



US Unemployment Rate (%)

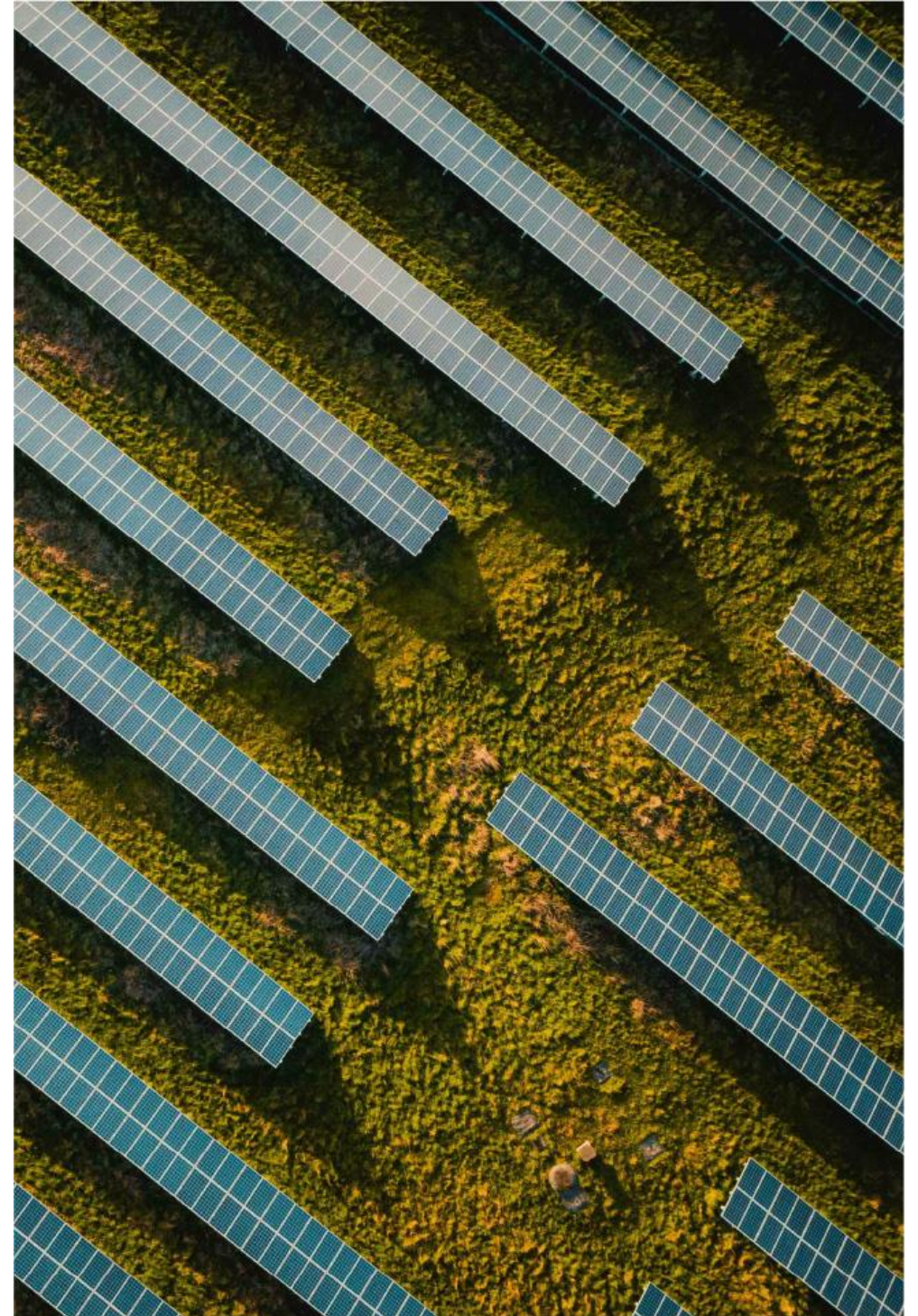


Consumer Loan 90+ Day Delinquency (%)



Performance is not indicative of future results. It is not possible to invest in an index directly.

Corporate Credit Fundamentals



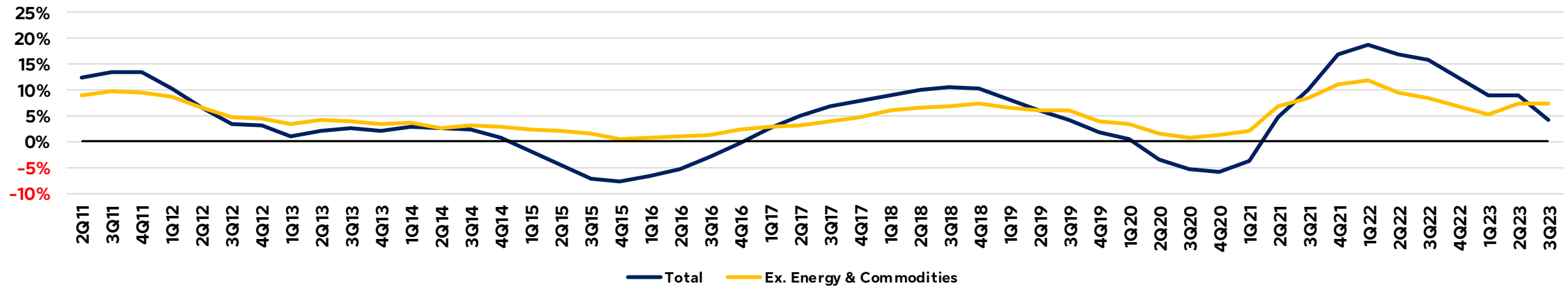
Corporate credit outlook

Corporate credit fundamentals - Past the peak

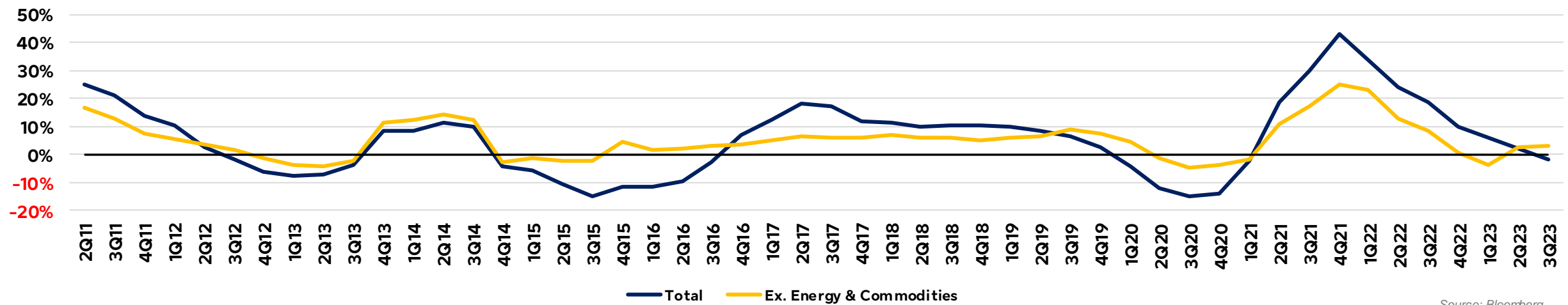
- Our current credit outlook is underpinned by top and bottom-line growth rates that continue to decelerate, while the Fed is likely to keep rates higher for longer, putting pressure on corporate credit fundamentals
-
- Elevated debt costs will continue to impact earnings, and interest coverage will deteriorate as low-cost debt matures amidst a higher refinancing cost environment, while IG net leverage levels remain historically elevated
-
- Valuation constraints loom large for spreads, which limits the scope for more tightening

Corporate credit fundamentals - Past the peak

Revenue Growth was +4% Y/Y and +7% Y/Y ex. Energy & Commodities



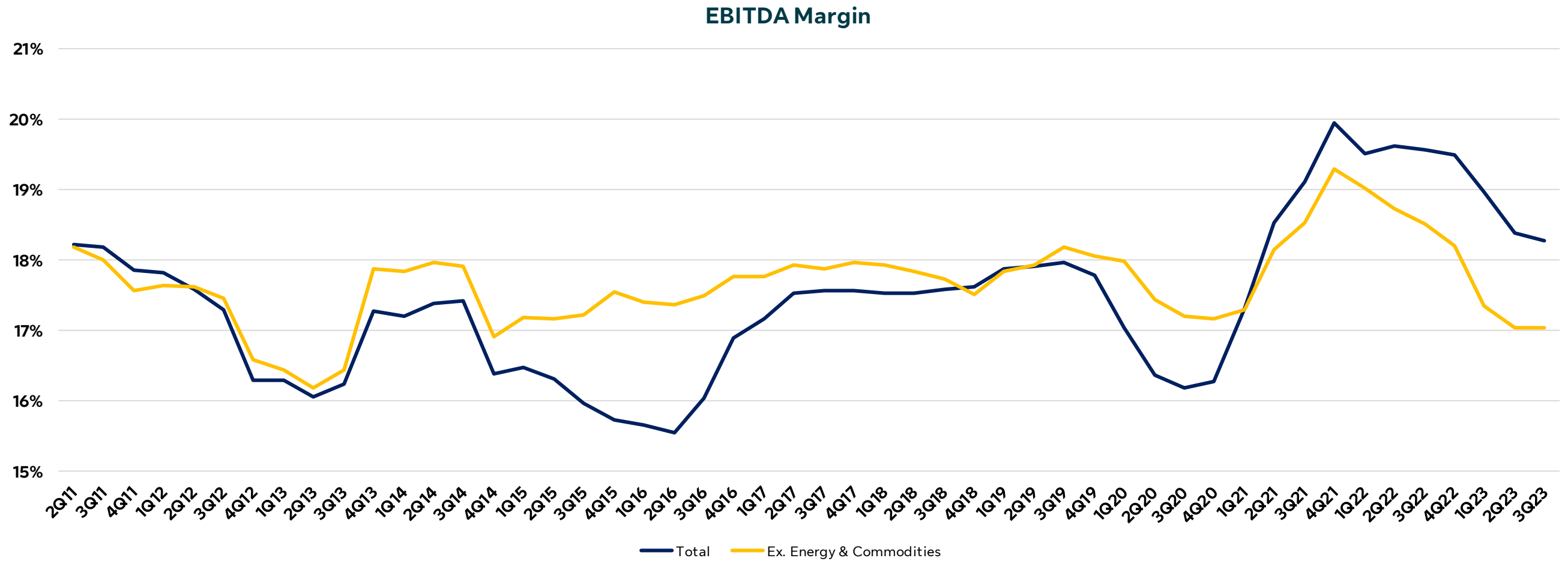
EBITDA Growth was -2% Y/Y and +3% Y/Y ex. Energy and Commodities



Source: Bloomberg

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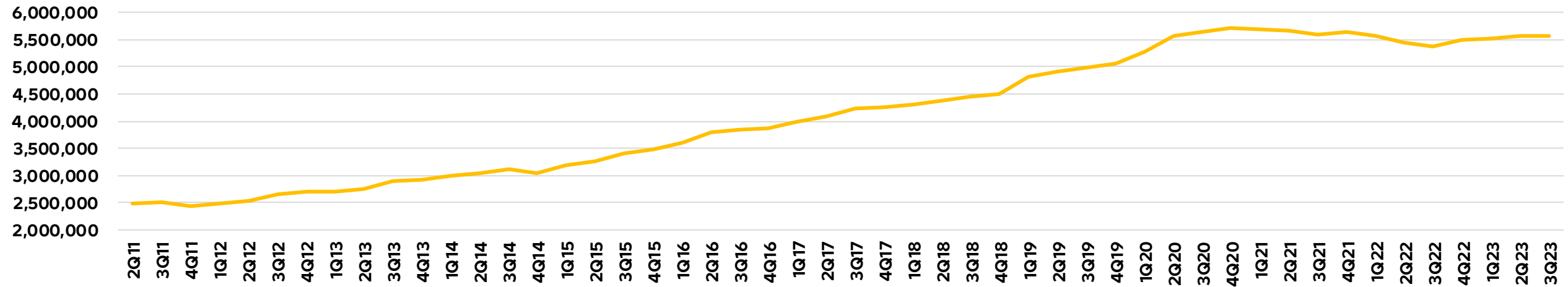
Corporate credit fundamentals - Past the peak



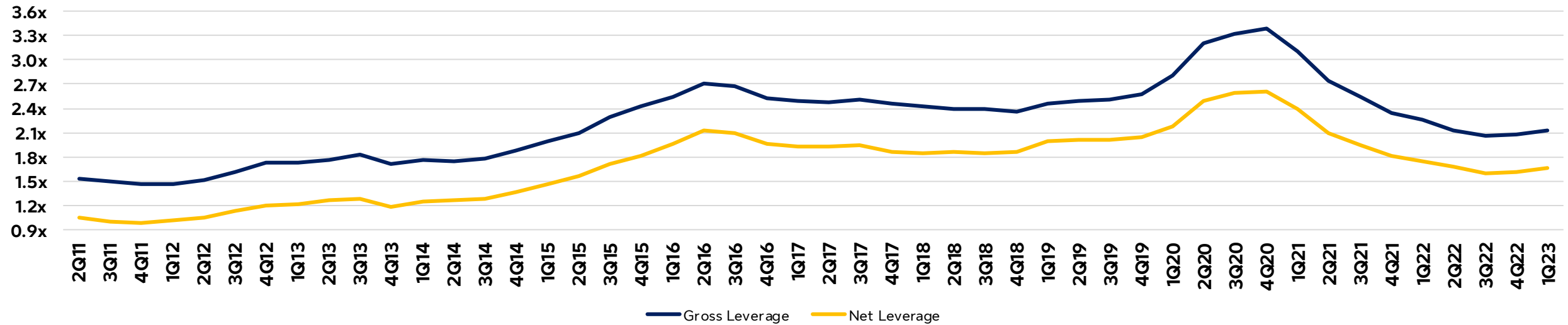
Source: Bloomberg

Corporate credit fundamentals - Past the peak

Total Debt



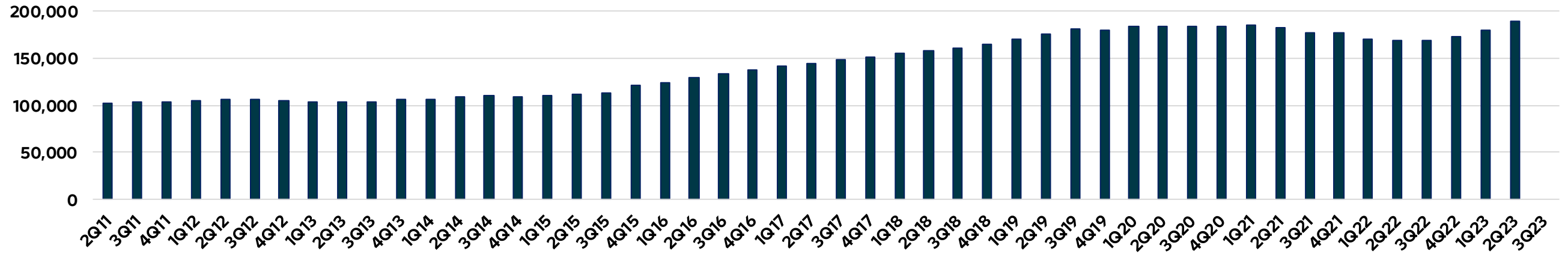
Leverage - All Sectors



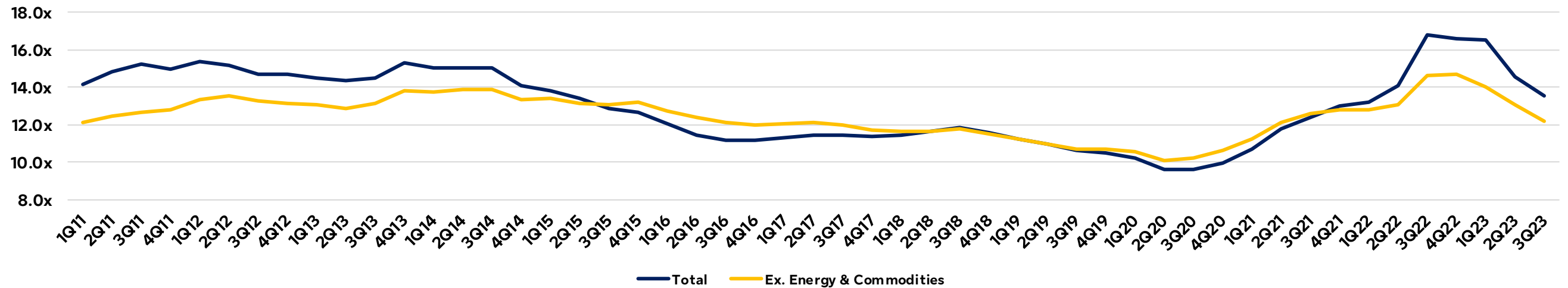
Source: Bloomberg

Corporate credit fundamentals - Past the peak

Interest Expense

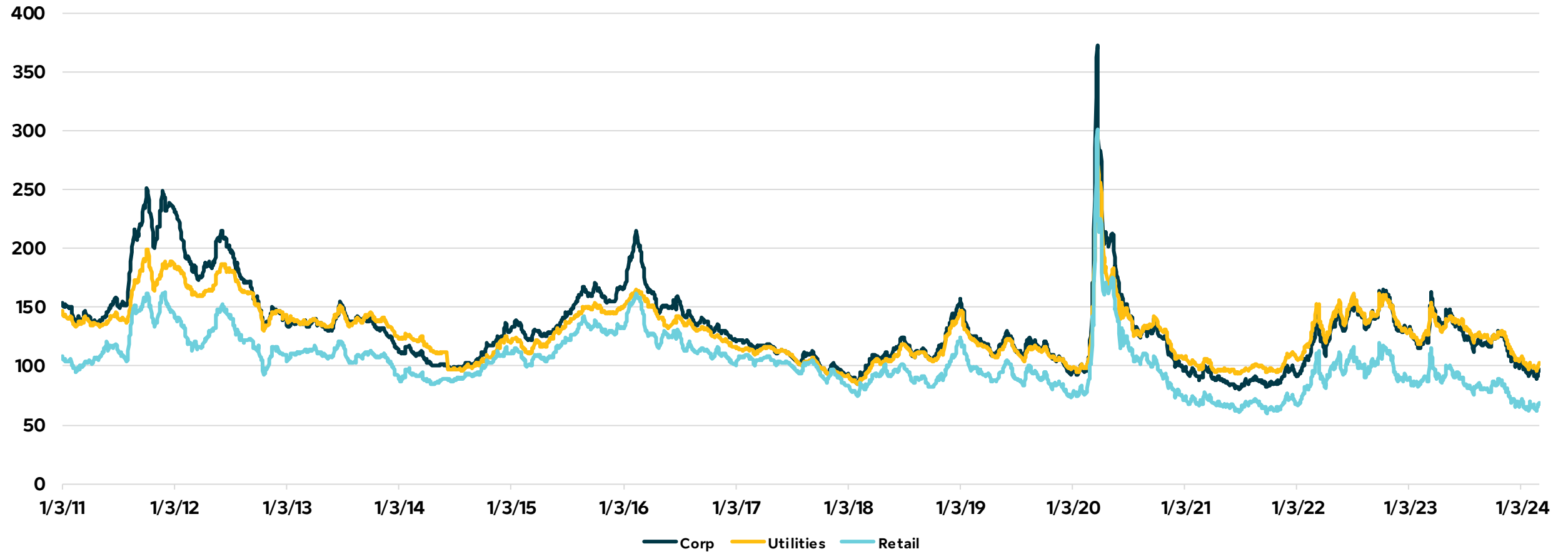


Interest Coverage



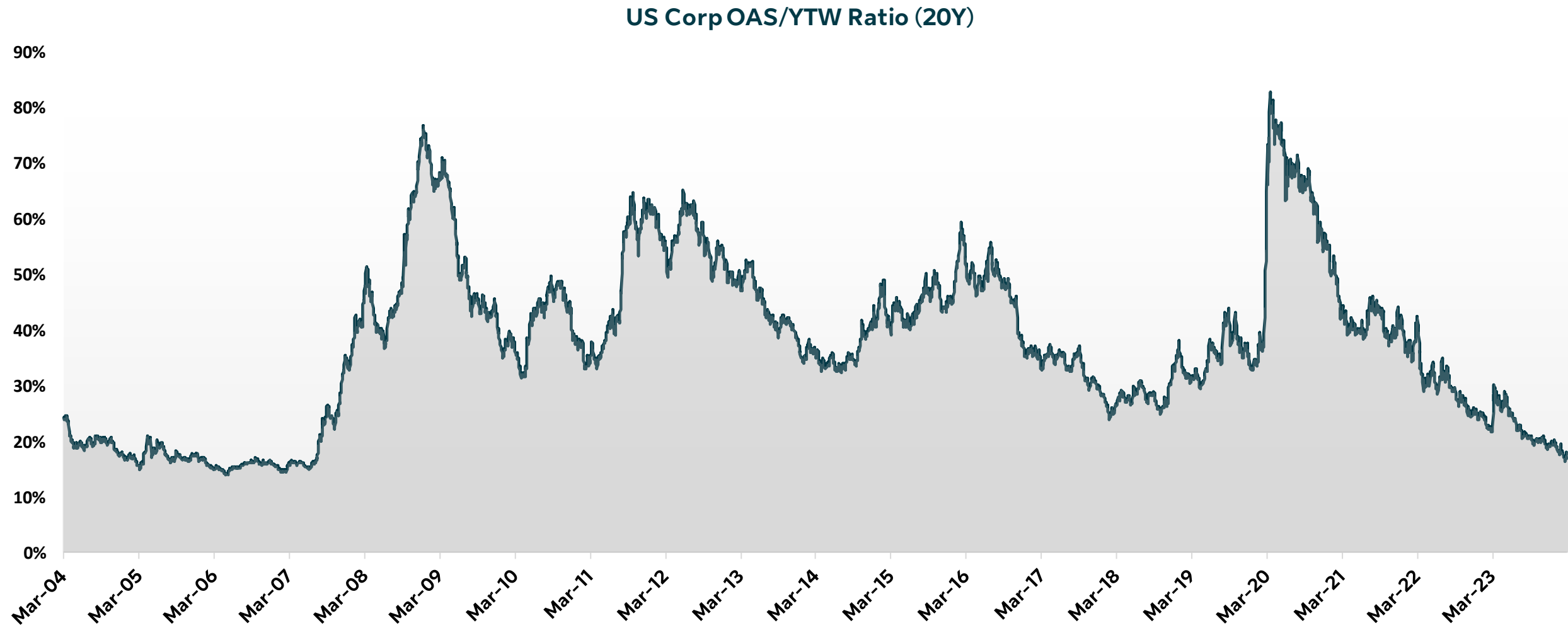
Source: Bloomberg

Corporate credit fundamentals - Past the peak



Source: Bloomberg Index Data

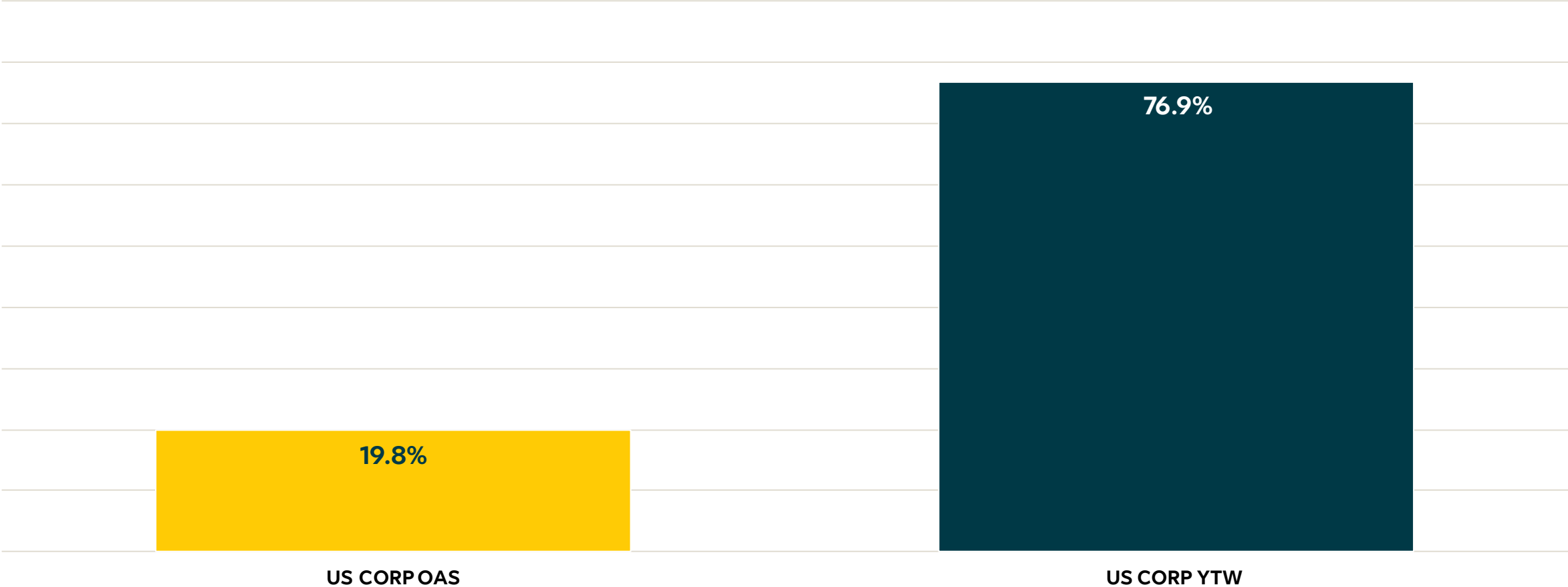
Corporate credit fundamentals - Past the peak



Source: Bloomberg

Corporate credit fundamentals - Past the peak

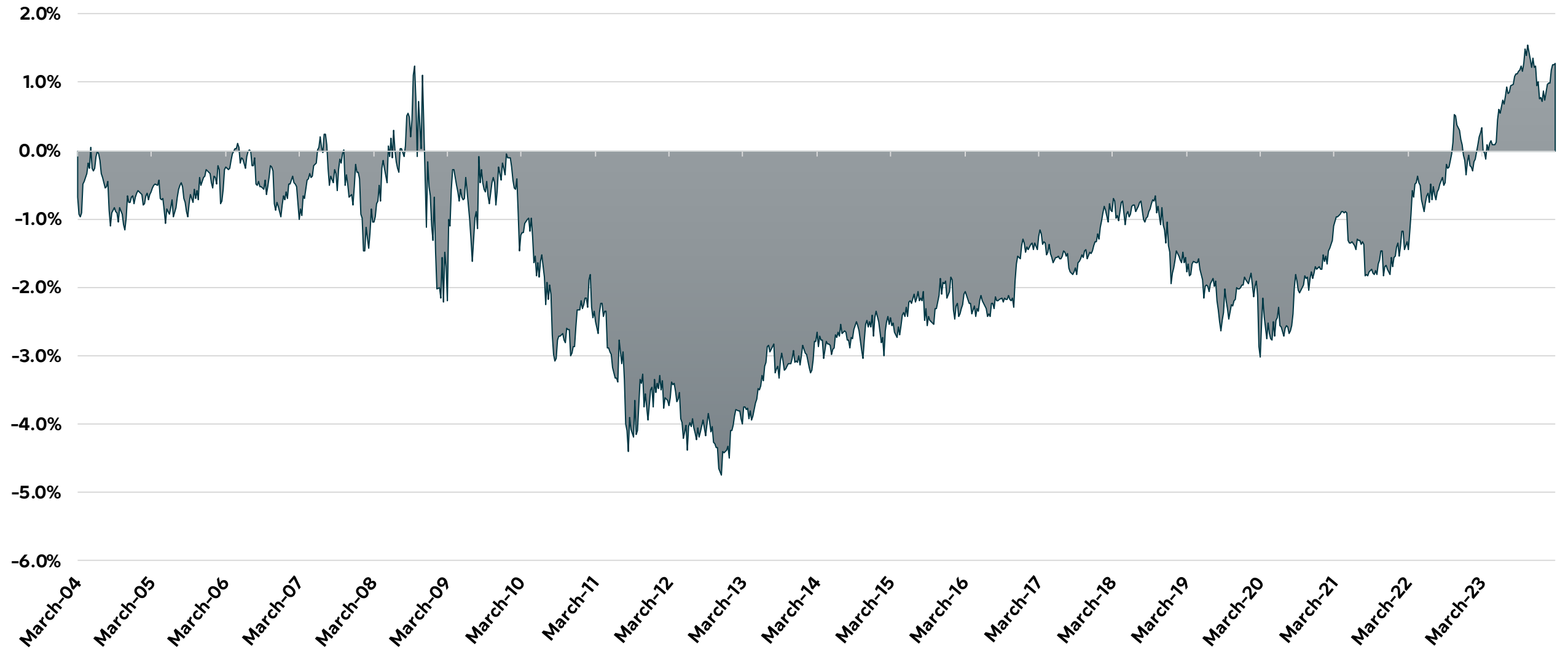
Percentile Rank (20Y)



Source: Bloomberg

Corporate credit fundamentals - Past the peak

Corp YTW vs. S&P Earnings Yield Difference (20Y)



Source: Bloomberg

Sector Risks and Opportunities



Sector risks

Retail subsector

- Demand shifting away from discretionary goods has led to a challenging outlook for many names
-
- 2023 results benefited from lower shipping costs, which have reversed course on the fallout from the Red Sea attacks, while domestic operations continue to be impacted by elevated wage pressure, and persistent shrink
-
- The sector has tight spreads relative to the index (Retail +71 vs. Index +99, BofA), despite an average duration one year longer than the index

Sector opportunities

Utilities subsector

- Strong multi-year organic growth profile, underpinned by energy transition investment

- Regulation provides revenue visibility and mechanisms for cost recovery

- Defensive sector in the event of economic weakness

Private Fixed Income



Private fixed income

Investment grade private fixed income - Opportunities abound for those willing to do the work

- IG Private Fixed Income is an intensive underwriting asset class, which provides bespoke solutions for issuers. The asset class is characterized by unusual tenors or amortization schedules, delayed fundings, single rating or unrated deals, sectors or structures that require a lot of work, and deals well below the index eligible size

- The market competes on pricing, not covenants, unlike the below investment grade private credit market, where sponsors will take higher pricing for a covenant-lite loan

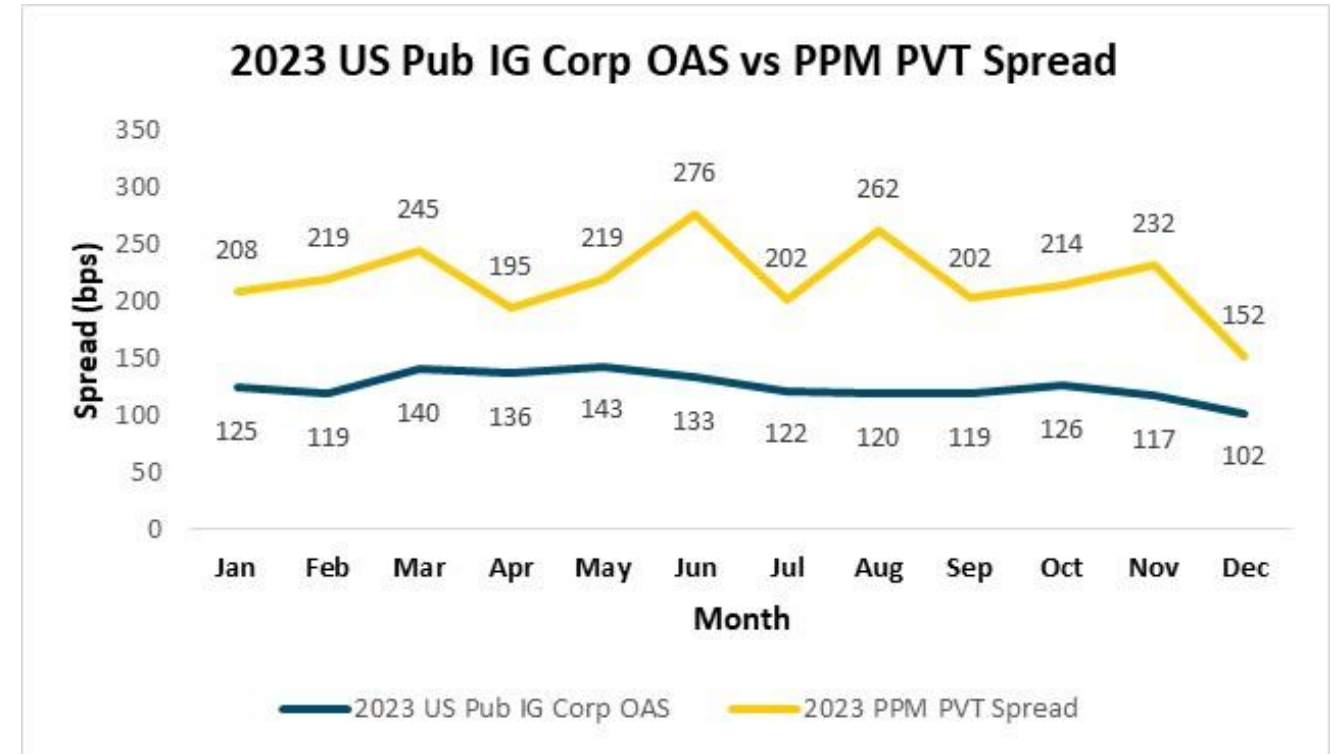
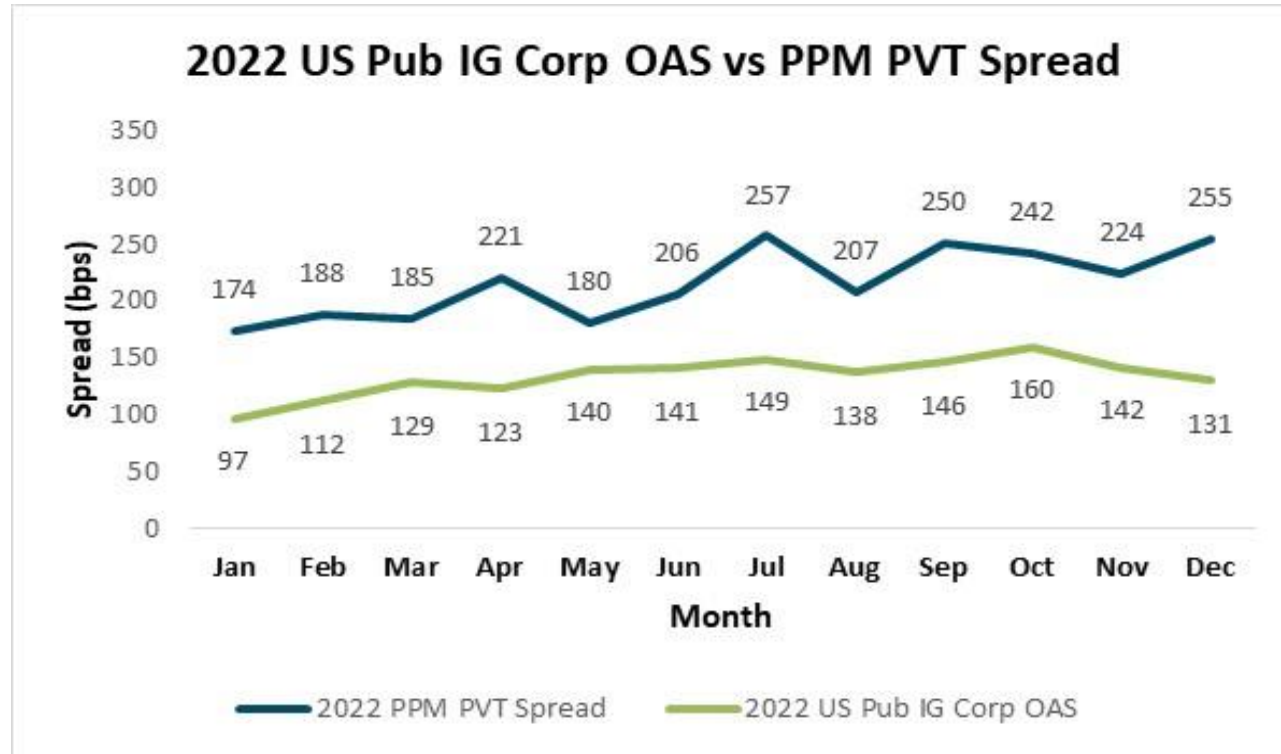
- We see strong value in some of the structured finance opportunities that require significant work underwriting

Private fixed income - What is investment grade private credit?

	Investment grade public corporate credit	Investment grade private credit	Below investment grade private credit
Issuers/obligors	Large corporations	Companies, governments, non-profits	Mid-market companies
Use of proceeds	General corporate purposes	Project and asset specific	Leveraged buyouts
Income	Fixed	Fixed	Floating
Rating	AAA-BBB	Typically A-BBB, some AA	BB+ and below
Security	Unsecured	Secured and unsecured	Secured and unsecured
Ranking	Can be subordinated	Senior	Senior and subordinate
Covenants	Limited	Maintenance / comprehensive	Pressure due to increased competition among lenders
Tenor	5, 7, 10, 30 years	Flexible 2-30 years	Typically 5 years
Liquidity	Liquid	Limited	Illiquid
Historic spread to comparable public credit	N/A	10 - 100+ basis points	50 - 400+ basis points
Annual issuance	\$1.2 - \$1.3T	\$90B+	\$200B+

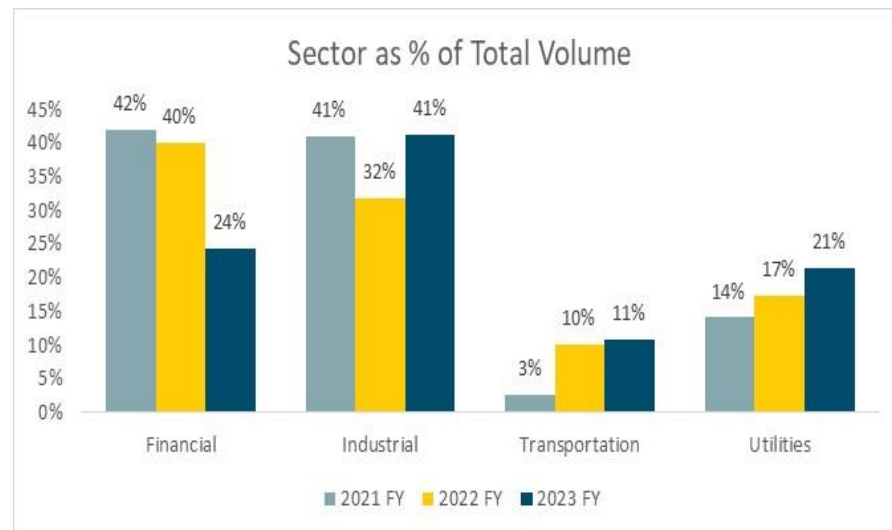
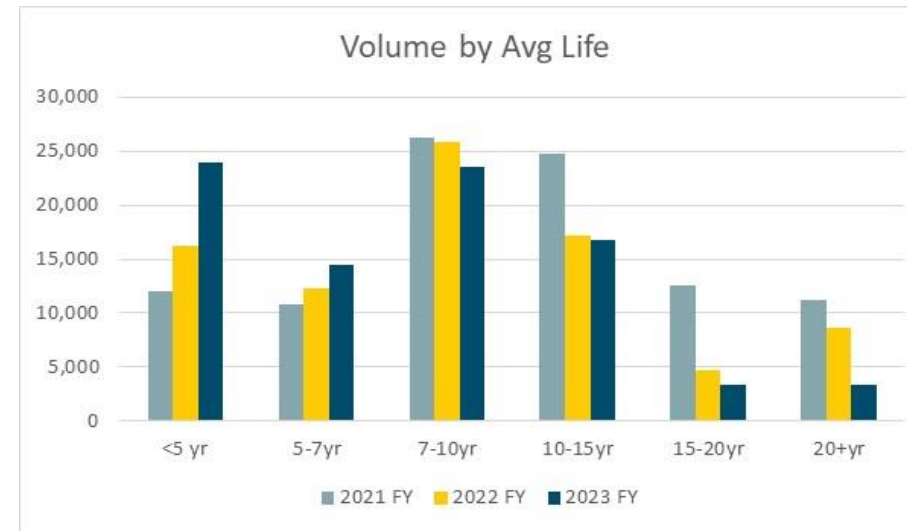
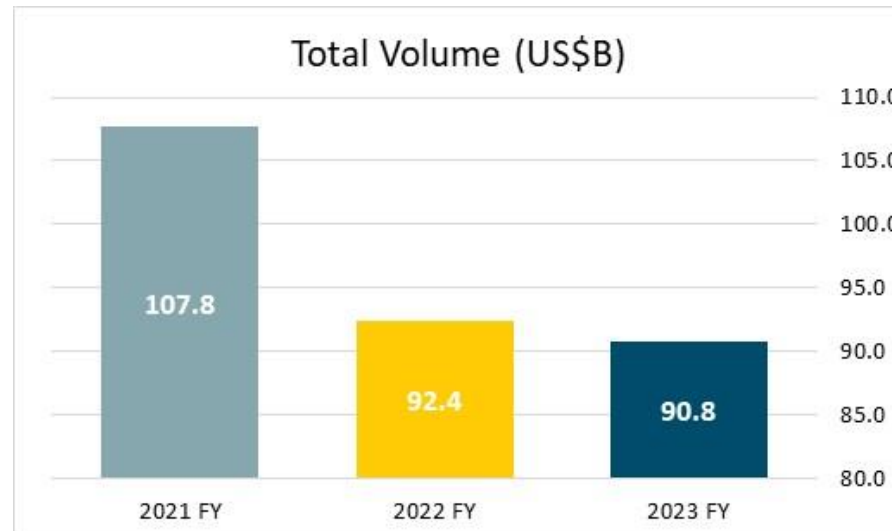
Investment-grade credit ratings of our private placements portfolio are based on a proprietary, internal credit rating methodology that was developed using both externally-purchased and internally developed models. This methodology is reviewed regularly. More details can be shared upon request. There is no guarantee that the same rating(s) would be assigned to portfolio asset(s) if they were independently rated by a major credit ratings organization. The spreads to public credit information has been sourced internally. Appendix for a summary of the methodology used to estimate relative value to appropriate public benchmarks.

Private fixed income



Source: Napolitano

Private fixed income

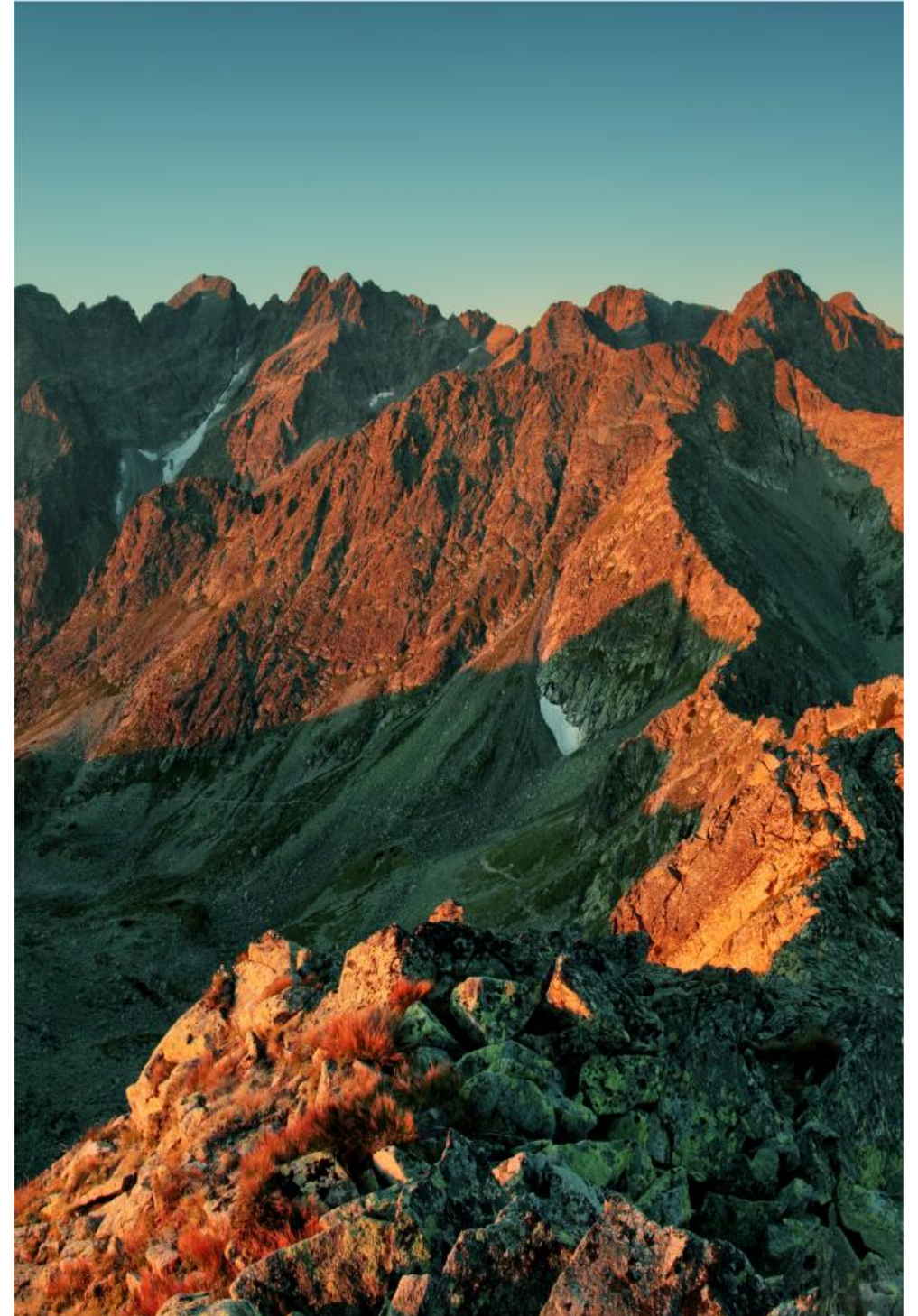


Overview

- Issuance declined over the last two years
- Issuance was pushed into the front end of the curve (<10yrs), and fewer Financials issued, which was offset by an uptick in Utilities issuance

Source: Napolitano

Final Thoughts



Regional banks and commercial real estate

Hot button issues

Regional Bank stress has piqued investors attention yet again, as memories of 2023 remain fresh

- Sell-off in New York Community Bank's stock was precipitated by a large write-down of its real estate portfolio, which subsequently led to sell-offs in other small-medium regional bank equities.
- The biggest threat is via contagion from smaller regional banks tightening lending (they account for 40% of total credit supply in the banking system)
- However...
 - Larger GSIB and Super Regional banks typically have low concentration in Commercial Real Estate (CRE)
 - Regulatory scrutiny on banks' exposure to the CRE market will likely increase, however the odds of a systemic shock driven by large and accelerating losses on CRE portfolios is very low due to the Treasury and Fed programs created in 2023

US Commercial Real Estate (CRE) tops the list of concerns for market participants and policymakers

- Three challenges plaguing CRE are high vacancy rates, higher interest rates and therefore higher cost of capital, and the tightening of credit conditions, making loan financing harder to come by
- The largest issue is office exposure, with vacancy rates approaching 20% in the US
- However...
 - Commercial Real Estate is much smaller than Residential Real Estate. It represents about 25% of total US Real Estate, and only 13% of banking-sector assets.
 - US Office Property values are estimated at ~\$3tn, backed by ~\$0.75tn in debt. A 50% decline in office property values, or \$1.5tn unlevered, is less than the ~\$2tn rise in the value of the S&P 500 in the month of February.

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