ALPINEMACRO
A Unique Mind On The Markets

U.S. BOND STRATEGY

September 19, 2024

Corporate Sectors: Where To Hide In A Slowdown

- Soft landing is the base case, but with downside risks
- Capital Goods and Consumer Non-Cyclicals are traditional defensives...
- ...although both have poor financial ratios
- Despite weak oil prices, Energy offers an attractive risk/reward profile
- Barbell strategy: O/W traditional defensives, combined with O/W Energy and Basic Industries

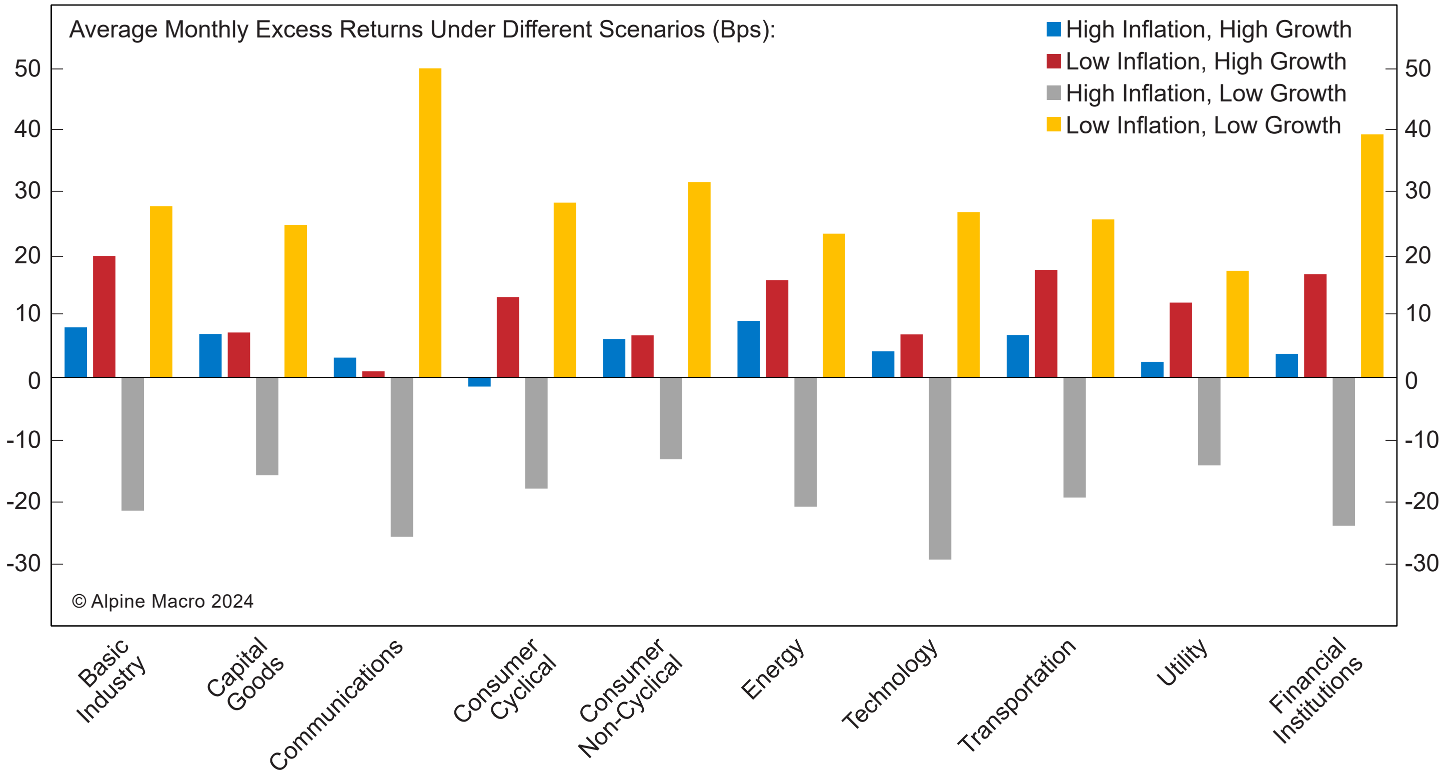
We updated the recommendations from our U.S. Corporate Sector allocation model in a report last month, which ranked Basic Industries, Financial Institutions and Utilities at the top of the list. The model employs a purely quantitative approach that is devoid of any judgement or macro view.

While the model has an impressive track record, clients should view its recommendations as supplemental information to their own bottom-up analysis and macro outlook. We are firmly in the "soft landing" camp. Nonetheless, the growth risks are skewed to the downside. Many corporate bond investors that have recession concerns are looking for sectors that provide some downside protection, but ideally without an onerous spread penalty.

This week's report delves into this matter, examining sector relative performance during downturns. No sector would escape the pain in the event of a recession. Spreads may even experience a temporary bout of mild widening if economic growth dips too close to zero. That said, what are the most defensive sectors? Are these sectors expensive? How do corporate fundamentals change the calculus?

In a nutshell, our research on past downturns across the ten primary sectors of the Bloomberg Barclays Investment-Grade Corporate Bond Index indicates that Consumer Non-Cyclicals and Capital Goods are the most defensive. Drawdowns tended to be limited versus other sectors. Unfortunately, the starting points for the spread cushion and financial fundamentals are not attractive for either sector. Energy bonds are less defensive, but offer other positive attributes even if oil prices dip a little further.

Chart 1 Excess Returns In Different Macro Environments



Excess Returns And The Macro Backdrop

Chart 1 presents duration-matched excess returns to Treasurys under the four combinations of growth and inflation regimes.

The low growth/low inflation regime best suits the Alpine Macro view. We expect low, but positive growth in the coming quarters. Core inflation should drop to 2%, with the possibility of even moving below the Fed's target at least temporarily.

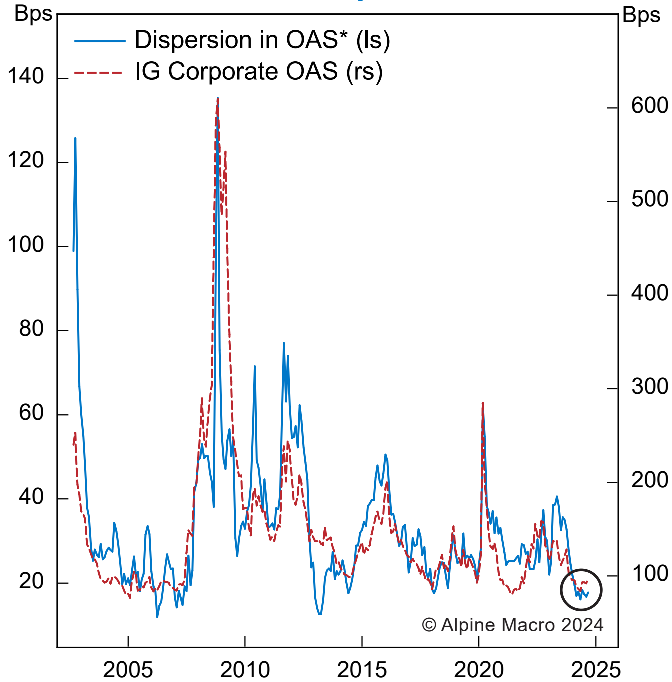
Historically, this backdrop has generally been the most flattering to Corporate excess returns (yellow bars in **Chart 1**). Growth does not have to be strong to keep corporate bond investors happy. It simply needs to be robust enough to limit downgrades and defaults. Meanwhile, modest growth and low inflation allows the Fed to maintain an easing bias. Communications, Financial Institutions, and the Consumer sectors performed the best during these periods.

Of course, the focus of this report is on the sectors that provide the best downside protection in the event that profit growth does not remain in positive territory.

Spread Beta

A sector's spread beta to the broader corporate benchmark plays a crucial role in forecasting its performance during downturns. Low-beta sectors generally outperform the index when growth slows and investors become defensive. This is especially the case when the starting point for the dispersion of spreads across sectors is extremely narrow, as is the case today (**Chart 2**).

Chart 2 Cross Sector Dispersion Is Extremely Low



*Highest OAS sector minus lowest
Note: Shading denotes recession periods

Chart 3 Historical Average Spread Beta To Corporate Benchmark

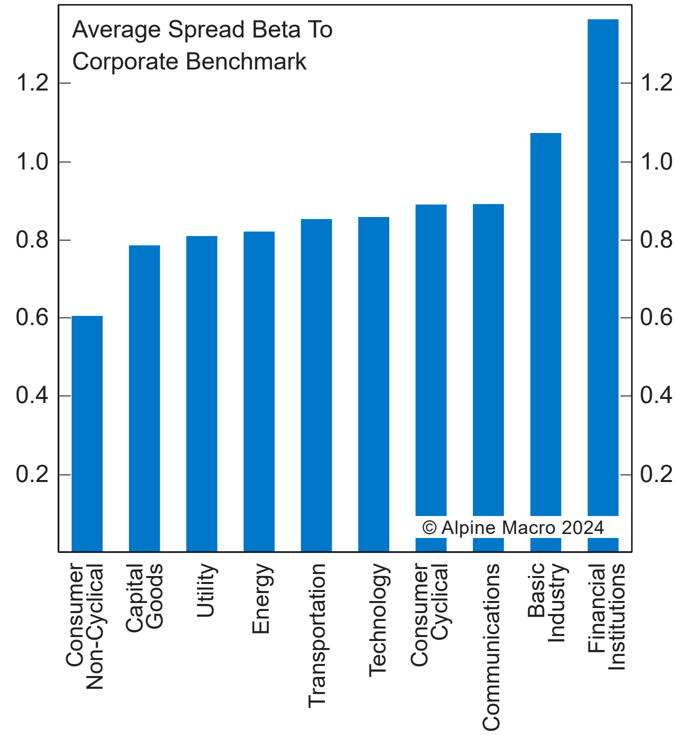


Chart 3 presents the average historical beta of the ten sectors to the corporate benchmark. We also calculated a more recent spread beta based on only the past three years as market sensitivity can vary over time (**Chart 4**).

Consumer Non-Cyclicals and Capital Goods have the lowest betas when using the entire history of the data. These two sectors also showed a low market beta when calculated over the past 3 years, although Consumer Cyclicals experienced the lowest market sensitivity. The unique character of the post-pandemic recovery may be a key factor behind the low-beta reading for the latter in recent years. Utilities was also among the bottom 4 sectors in both cases.

Chart 4 Trailng 3-Year Spread Beta To Corporate Benchmark

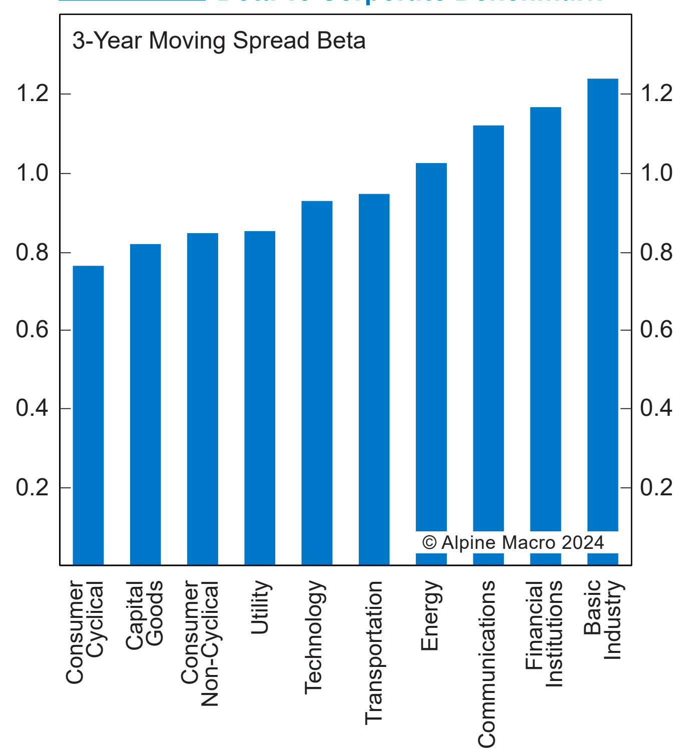


Table 1 Sector Beta-Adjusted Spreads

Sector	Current Spread/Avg. Spread Beta to Corporates	Current Spread/ 3-Year Moving Spread Beta
Consumer Non-Cyclical	141	101
Energy	137	110
Communications	134	106
Utility	126	120
Capital Goods	115	110
Transportation	110	100
Basic Industry	101	87
Consumer Cyclical	99	116
Technology	93	86
Financial Institutions	73	84

Dividing sector spreads by their betas allows us to gauge the trade-off between downside risk protection and spread (**Table 1**). Consumer Non-Cyclicals emerge as the top choice by this measure, although Energy bonds are not far behind. Communications and Utilities round out the top four sectors.

Valuation

Valuation and fundamentals also play a role in potential downside protection. Undervalued sectors provide some cushion, while financial ratios can highlight return potential and mispricing.

Chart 5 Volatility-Adjusted Breakeven (Deviation From Mean)

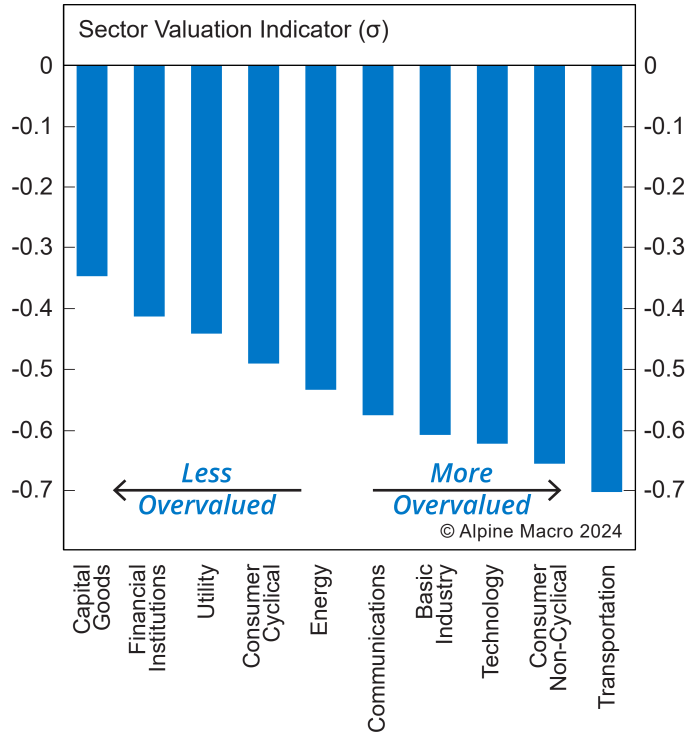
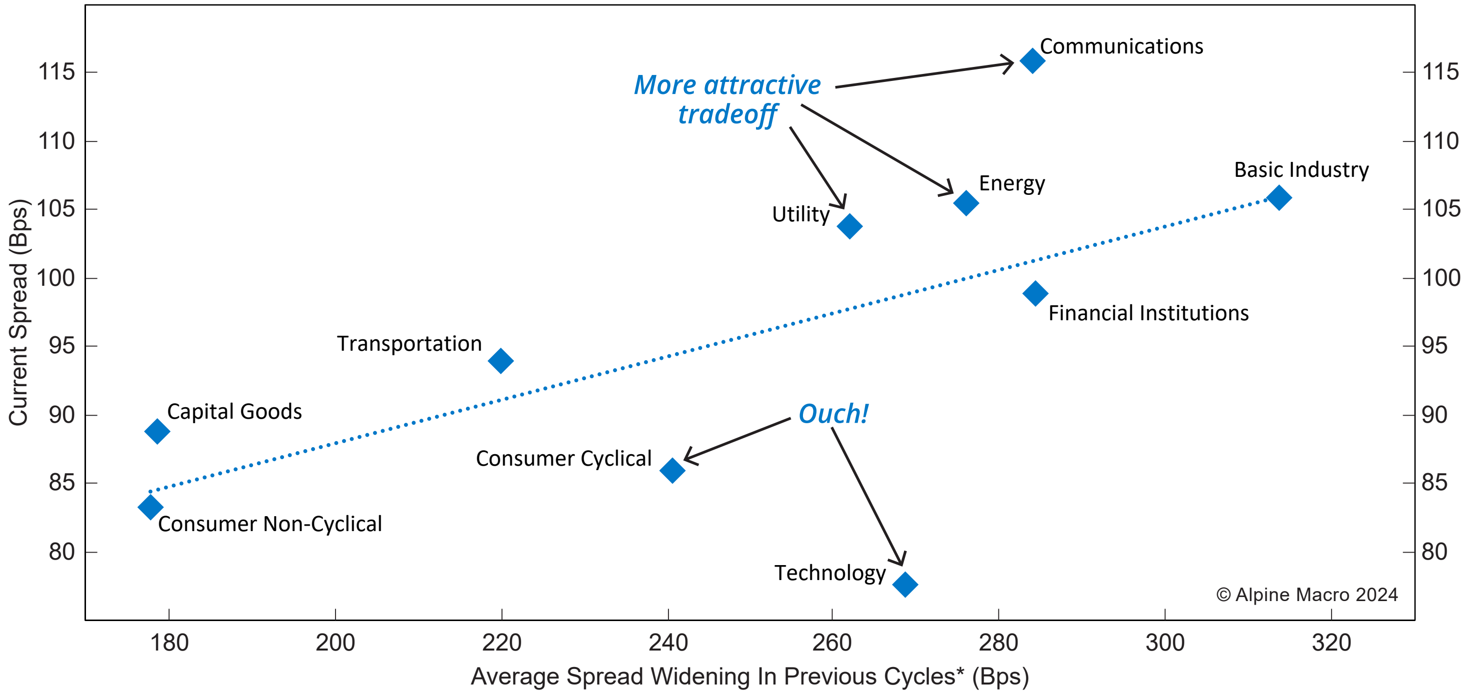


Chart 5 presents our valuation measure for the 10 sectors based on volatility-adjusted breakevens, shown in standard deviations from the mean. This measure provides a sense of how far a sector's OAS is from fair value. It adjusts for the fact that sectors can have structurally higher or lower spreads than the average sector. Adjusting for volatility also aids in comparison across sectors. For example, a sector with a high spread may not really be cheap because the fatter spread simply compensates for more return volatility.

Unfortunately, there are no bargains at the moment; option-adjusted spreads are well below their long-term averages for all sectors (i.e. all the bars shown in **Chart 5** are negative). The sectors that are least expensive by this metric are Capital Goods, Financial Institutions, Utilities and Consumer Cyclicals.

Chart 6 The Trade-Off Between Spread And Protection



*Dotcom bubble, GFC & 2015 slowdown

Another way to gauge risk versus reward is to compare current spreads with the average spread widening during previous bear markets (Chart 6):

- The upward sloping market line shows that there is no free lunch; sectors offering wider spreads have tended to suffer more spread widening in past bear phases.
- The main two defensive sectors, Capital Goods and Consumer Non-cyclicals, provide some down-side protection versus the index, but at the cost of a low starting spread. Of the two, Capital Goods is somewhat more attractive by this measure.
- If investors want to move out the risk curve, Utility, Energy and Communication bonds stand out because they plot above the market line. Consumer Cyclicals and, especially, Technology are unattractive by comparison.

Fundamental Ratios

Net leverage (net-debt-to-EBTIDA) and the interest coverage ratio (ICR) are our preferred fundamental metrics. Table 2 shows net leverage and ICR along with their historical percentiles. A high percentile means that the measure is elevated relative to its own history. The leverage ranking is shown inverted so that a higher level indicates that the sector has low leverage, which is positive from the bond investor's perspective.

A few observations:

- Leverage has improved since last summer when we first reported these figures. Nonetheless, leverage is still higher than the historical mean in all but two sectors (Basic Industry and Energy).
- The ICR has deteriorated significantly in most industries over the past year as higher borrowing

Short tech corps?

Table 2 Financial Health Score

	Financial Health						
	Net Debt To Ebitda		Interest Coverage Ratio				
	Level	Rank* (%)	Level	Rank* (%)	Financial** Health Score (%)	OAS (Bps)	Breakeven Spread
Energy	2.16	78	5.5	85	82	112	14
Basic Industry	1.65	73	8.0	71	72	108	14
Communications	2.75	49	7.9	38	44	119	14
Consumer Non-Cyclical	2.08	37	7.5	10	23	85	11
Consumer Cyclical	1.39	24	10.4	22	23	88	14
Capital Goods	1.82	10	3.8	15	13	90	13
Technology	1.21	12	8.1	5	8	80	11
Transportation	2.45	0	6.8	12	6	94	10
Electric/Utility***	4.80	5	2.9	0	3	102	12

*Level as percentile of last decade. For leverage, rank is inverted such that a high reading implies low leverage.
**Average rank for Leverage and ICR. A higher reading implies a safer industry.
***Due to data availability, Electric Utilities is used as a proxy for the overall Utilities index.

rates gradually feed through. Only two sectors currently have an ICR that is above its long-term mean (Basic Industry and Energy). Four other sectors suffer from the lowest, or close to the lowest, ICR in the history of the data (Communications, Consumer Non-Cyclicals, Electric Utilities, Transportation and Technology).

- Among the most defensive sectors, both Consumer Non-Cyclicals and Capital Goods rank poorly on both financial ratios.

Table 2 also presents a Financial Health Score (FHS) that combines the rankings for the two financial ratios using a simple average. Chart 7 compares the Financial Health Score with the breakeven spread.

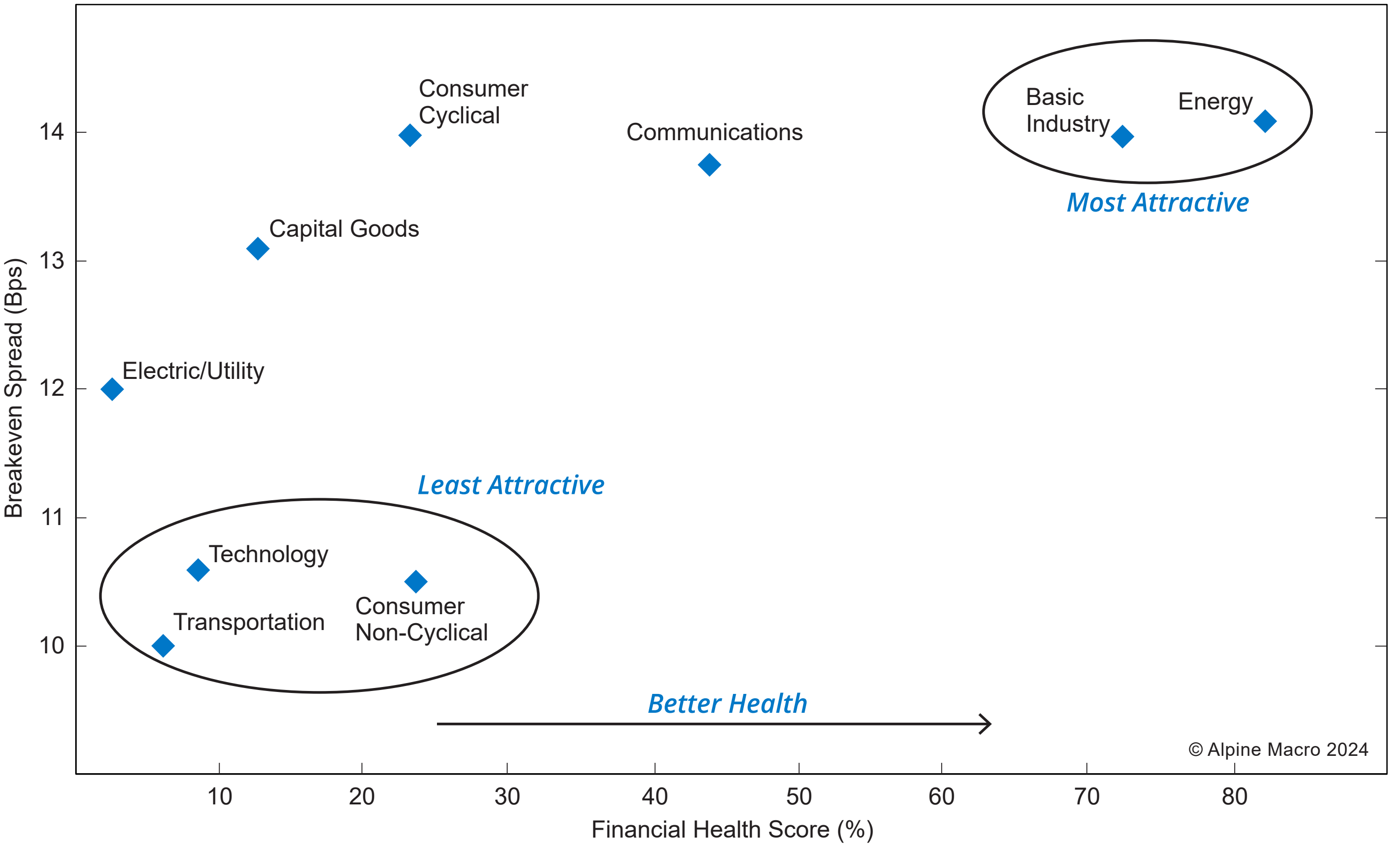
Energy and Basic Industries stand out by providing relatively attractive spreads and the highest FHS reading. Unfortunately, the opposite is true for Consumer Non-Cyclicals. Capital Goods has worse FHS reading, but at least offers a higher breakeven spread than Consumer Non-Cyclicals.

Investment Conclusions

There is no sector that really stands out in terms of its “safe haven” status at the moment. All have their own drawbacks.

- **Capital goods** and **Consumer Non-Cyclicals** are traditional safe havens because they have low market beta and have suffered the least

Chart 7 Trade-Off Between Spread And Financial Health



during previous bouts of spread widening. Unfortunately, the starting point for two key financial ratios is unattractive for both sectors. Consumer Non-Cyclicals also suffers in terms of relative valuation, although its saving grace is that its spread/beta ratio tops the list.

- **Utilities** is also defensive based on its historic market beta, although this is offset by a very poor Financial Health Score.
- Further out the risk curve, **Basic Industries** and, especially, **Energy**, have attractive value/risk profiles, at least relative to the rest of the index. The market beta of the Energy sector is toward the low end of the spectrum, and its current spread/beta ratio is second only to Consumer Non-Cyclicals. Energy is also ranked highest by our FHS.

The caveat is that the risk for oil prices in the next six months is to the downside as global growth weakens. This could place some pressure on parts of the Energy sector, leading to wider spreads. However, the industry should be able to weather the storm even if oil prices drop temporarily into the $50-$60 range. Beyond that, we remain structurally bullish on oil.

Investors that are concerned about the downside economic risks and are benchmarked against the Bloomberg Barclays IG Corporate index might consider a barbell strategy: overweight Consumer Non-Cyclicals, Utilities and Capital Goods for relative safety, combined with overweights in the higher-spread Energy and Basic Industries sectors.

Subsector favorites based on our Corporate Sector Allocation Model are as follows:

- Consumer Non-Cyclicals: Pharma and, mainly, Healthcare
- Capital Goods: Packaging and Manufacturing
- Energy: Independent Energy and Oil Services
- Utilities: Electric
- Basic Industries: Paper

Mark McClellan
Chief U.S. Bond Strategist

Alpine Macro U.S. Bond Allocation (Duration: At Benchmark)

1-5 Scale; 3 Represents Benchmark	Allocation Score	Comments
Treasurys	2	
Spread Product	4	
Spread Product Composition:		
IG Corporates	3	Avoid AAA; favor upper-end of BBB
High-Yield	3	
Agency CMBS	5	
Non-Agency CMBS	4	Favor AAA
Government-Related	4	Favor Local Authorities and Agencies
ABS	4	Favor up-in-quality, favor sub-prime autos
Agency MBS	4	
Municipals	4	Favor highly-rated taxables in the belly, and BBB non-taxables at the long end

Note: The allocation score presents Alpine Macro's recommended weighting relative to benchmark. It is based on a five-point scale, with "1" being "maximum underweight", and "5" being "maximum overweight". A benchmark weighting is represented by "3". The underweights and overweights across bond sectors notionally sum to the overall recommendation for spread product versus Treasurys. Our benchmark is the Bloomberg Barclays U.S. Aggregate Bond Index, augmented with High-Yield Corporates and Municipal bonds.

Historical Returns

	Excess Return to Treasurys (Bps)			Total Return (Bps)			Option Adjusted Spread (Bps)				
	Past 5 Days	Past Month	YTD	Past 5 Days	Past Month	YTD	Latest	Past 5-Day Change	Past Month Change	YTD Change	Duration
Barclays Aggregate	12	11	64	18	212	554	37	-1	-1	-7	6.2
Treasury Index				7	199	482	0	0	0	0	6.2
IG Corporate	46	20	154	50	238	656	94	-5	-2	-11	7.2
AAA	72	31	109	76	304	599	34	-6	-3	-8	10.7
AA	50	14	87	54	252	592	49	-5	-1	-3	8.5
A	41	20	132	44	238	633	79	-5	-3	-12	7.2
BBB	50	21	185	54	236	688	115	-6	-1	-12	6.9
High-Yield	69	65	369	75	200	837	317	-18	-1	-33	2.9
BB	55	16	270	60	156	733	192	-17	1	-28	3.1
B	55	32	291	61	160	747	297	-15	13	-40	2.6
CCC	146	301	740	152	437	1238	732	-28	-66	-97	2.7
ABS	7	6	79	15	134	524	64	-1	1	-3	2.8
Government Related	28	6	67	32	191	546	49	-3	1	-1	5.4
Domestic Agency	2	2	28	9	135	461	18	1	1	0	3.1
Foreign Agency	4	3	49	10	156	511	24	0	1	-6	3.7
Sovereign	116	16	156	119	263	663	128	-12	0	-2	8.8
Local Authorities	5	9	90	8	243	592	68	0	0	-6	7.9
Supranationals	0	2	26	5	157	501	9	0	0	-3	3.7
MBS	-2	21	76	3	214	573	40	1	-2	-10	5.5
CMBS	9	25	192	12	193	672	97	-2	-5	-29	4.2
Non-Agency	12	18	280	16	177	758	157	-2	-2	-46	3.8
Agency	6	31	103	9	210	585	39	-1	-6	-10	4.6
Municipals*	22	-87	-319	26	97	222	-21	-4	14	47	6.1

*YTW used instead of OAS

Detailed U.S. Bond Allocation

	Allocation Score	Yield			Duration			Weight		
	PF	PF* (%)	BM* (%)	Exposure (Bps)	PF*	BM*	Exposure	PF* (%)	BM* (%)	Exposure (Bps)
U.S. Bond Strategy		4.2	4.2	4	6.2	6.2	0.0	100.0	100.0	0.0
Treasurys	2	3.7	3.7	1	7.6	6.5	1.0	29.7	39.4	-9.7
Spread Product	4	4.5	4.6	-7	5.6	6.0	-0.4	70.3	60.6	9.7
Corporate	3	4.9	5.0	-7	5.6	6.7	-1.1	26.0	26.0	0.0
Investment Grade	3	4.6	4.7	-9	6.1	7.4	-1.3	21.9	21.9	0.0
AAA	1	4.2	4.2	0	11.3	11.3	0.0	0.1	0.3	-0.1
AA	3	4.2	4.3	-13	6.9	8.7	-1.8	1.5	1.5	0.0
A	3	4.4	4.5	-9	6.1	7.3	-1.3	9.8	9.7	0.1
BBB	3	4.8	4.9	-10	5.9	7.1	-1.1	10.5	10.4	0.1
High Yield	3	6.9	6.9	0	2.9	2.9	0.0	4.1	4.0	0.0
BB	3	5.9	5.9	0	3.1	3.1	0.0	2.0	2.0	0.0
B	3	7.0	7.0	0	2.6	2.6	0.0	1.5	1.5	0.0
CCC	3	10.7	10.7	0	2.7	2.7	0.0	0.5	0.5	0.0
Government Related	4	4.2	4.2	5	6.0	5.5	0.5	4.3	4.0	0.4
Agency	3	4.1	4.0	6	3.5	3.1	0.5	0.7	0.7	0.0
Foreign Agency	5	3.9	3.8	6	4.2	3.7	0.6	0.9	0.6	0.3
Local Authorities	5	4.5	4.4	7	9.1	7.9	1.2	1.0	0.7	0.3
Sovereign	3	5.1	5.0	7	10.1	8.8	1.3	0.9	0.9	0.0
Supranationals	2	3.7	3.7	5	4.3	3.7	0.6	0.9	1.1	-0.3
Securitized	4	4.4	4.4	0	5.4	5.4	0.0	33.7	25.7	8.0
Agency CMBS	5	3.9	3.9	0	4.6	4.6	0.0	1.1	0.7	0.4
Non-Agency CMBS	4	5.1	5.1	0	3.8	3.8	0.0	0.9	0.7	0.2
ABS	4	4.3	4.3	0	2.8	2.8	0.0	0.5	0.4	0.1
Agency MBS	4	4.4	4.4	0	5.5	5.5	0.0	31.3	24.0	7.4
Municipals	4	3.3	3.3	0	6.1	6.1	0.0	6.2	5.0	1.3

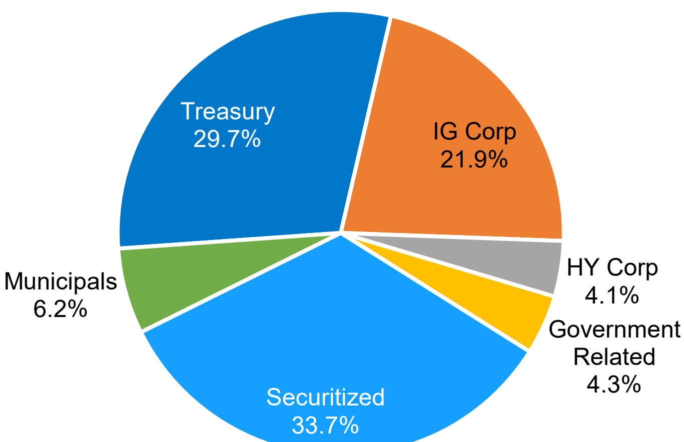
*PF = Portfolio; BM = Benchmark
Source: Bloomberg Finance L.P.
Note: Our methodology incorporates a restriction that the maximum deviation from the benchmark weight is 50%. However, due to the adding-up constraint, the actual weight shown in the table can deviate by slightly more than 50% at times.

Detailed U.S. Bond Allocation

	Contribution to Duration (CTD)			Contribution to Yield (CTY)		
	PF*	BM*	Exposure	PF* ()	BM* ()	Exposure
U.S. Bond Strategy	6.2	6.2	0.0	4.2	4.2	4
Treasurys	2.2	2.6	-0.3	1.1	1.4	-35
Spread Product	3.9	3.6	0.3	3.2	2.8	39
Corporate	1.5	1.7	-0.3	1.3	1.3	-2
Investment Grade	1.3	1.6	-0.3	1.0	1.0	-2
AAA	0.0	0.0	0.0	0.0	0.0	-1
AA	0.1	0.1	0.0	0.1	0.1	0
A	0.6	0.7	-0.1	0.4	0.4	-1
BBB	0.6	0.7	-0.1	0.5	0.5	-1
High Yield	0.1	0.1	0.0	0.3	0.3	0
BB	0.1	0.1	0.0	0.1	0.1	0
B	0.0	0.0	0.0	0.1	0.1	0
CCC	0.0	0.0	0.0	0.1	0.1	0
Government Related	0.3	0.2	0.0	0.2	0.2	2
Agency	0.0	0.0	0.0	0.0	0.0	0
Foreign Agency	0.0	0.0	0.0	0.0	0.0	1
Local Authorities	0.1	0.1	0.0	0.0	0.0	2
Sovereign	0.1	0.1	0.0	0.0	0.0	0
Supranationals	0.0	0.0	0.0	0.0	0.0	-1
Securitized	1.8	1.4	0.4	1.5	1.1	35
Agency CMBS	0.0	0.0	0.0	0.0	0.0	1
Non-Agency CMBS	0.0	0.0	0.0	0.0	0.0	1
ABS	0.0	0.0	0.0	0.0	0.0	0
Agency MBS	1.7	1.3	0.4	1.4	1.1	32
Municipals	0.4	0.3	0.1	0.2	0.2	4

*PF = Portfolio; BM = Benchmark
Source: Bloomberg Finance L.P.
Note: Our methodology incorporates a restriction that the maximum deviation from the benchmark weight is 50%. However, due to the adding-up constraint, the actual weight shown in the table can deviate by slightly more than 50% at times.

Portfolio Exposure



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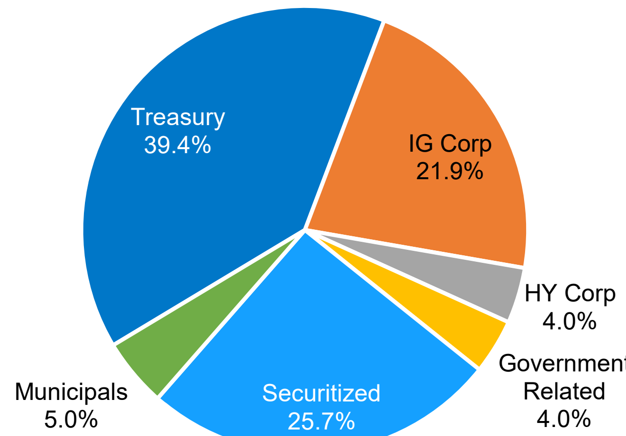
Source: Bloomberg Finance L.P.

Benchmark Exposure



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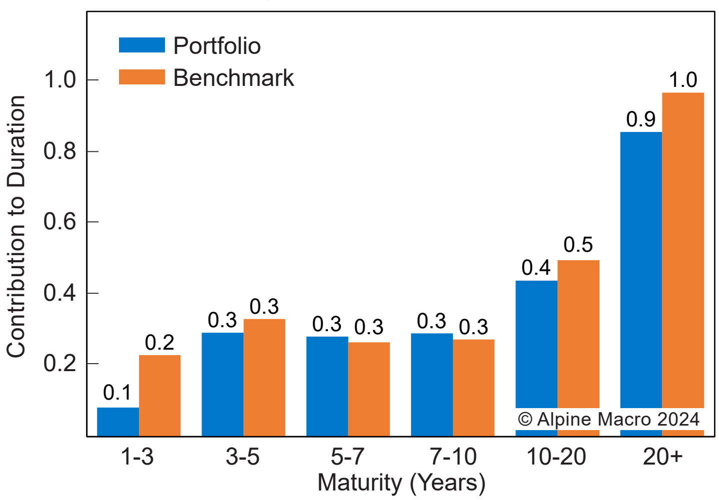
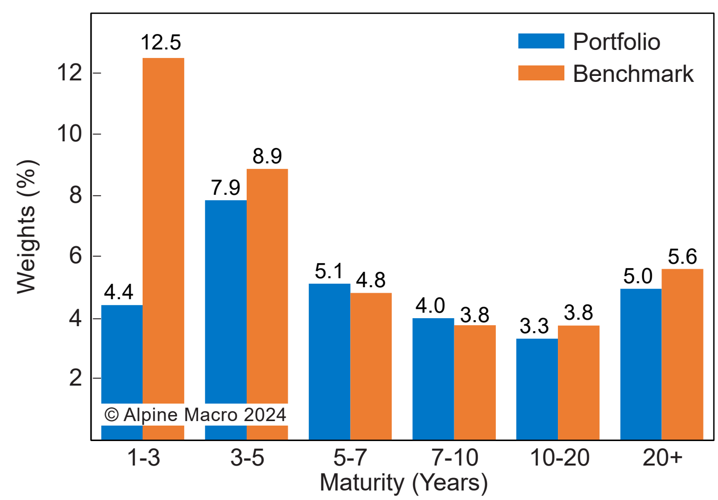
Source: Bloomberg Finance L.P.

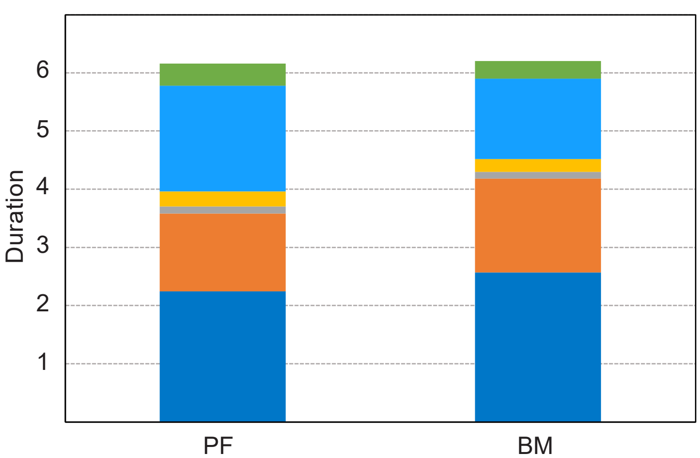
Treasury Contribution To Duration



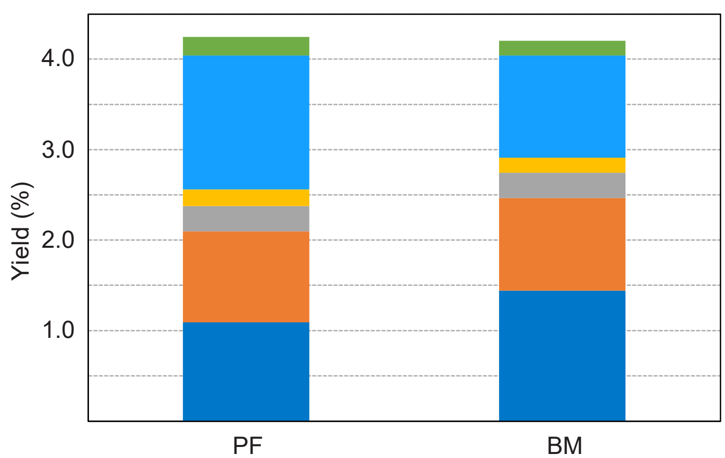
Treasury Weight



Contribution To Duration



Contribution To Yield



Treasury IG Corp HY Corp Government Related Securitized Municipals

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