THE K-SHAPED RECOVERY

Real gross domestic product (GDP) increased 6.7% in the second quarter of 2021, reflecting continued economic growth in the United States. GDP rose 6.3% in the first quarter. However, the past 12 months generated a widening gap in credit risk and recovery across sectors. This phenomenon is known as a "K-shaped" recovery, where different parts of the economy recover at different rates, times, or magnitudes.

Most people are familiar with a V-shaped recovery, meaning that growth resumed quickly after a recession, or U-shaped, which signified that output remained low for a longer period before rebounding. These letters indicate the performance of an economy, measured by the value of all goods and services, i.e., by real gross domestic product (GDP), over time. However, the COVID-19 pandemic led to a new kind of recovery, not following the usual trajectories we have seen in previous recessions.

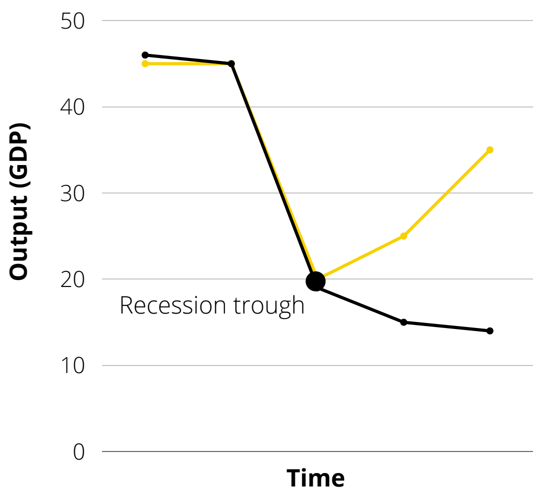


Figure A: Shows a post-recession scenario in which certain segments of the economy experience a fast recovery, while other segments remain in free fall. This creates the "K" shape.

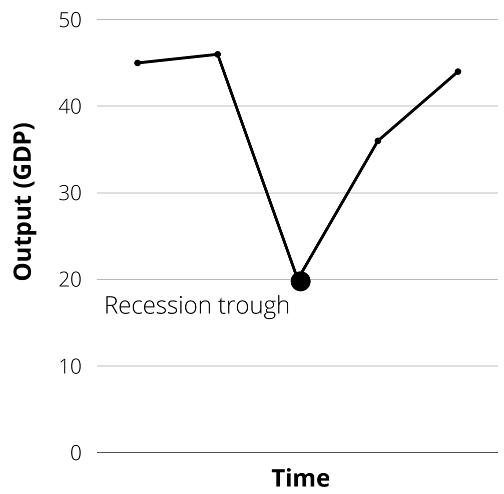
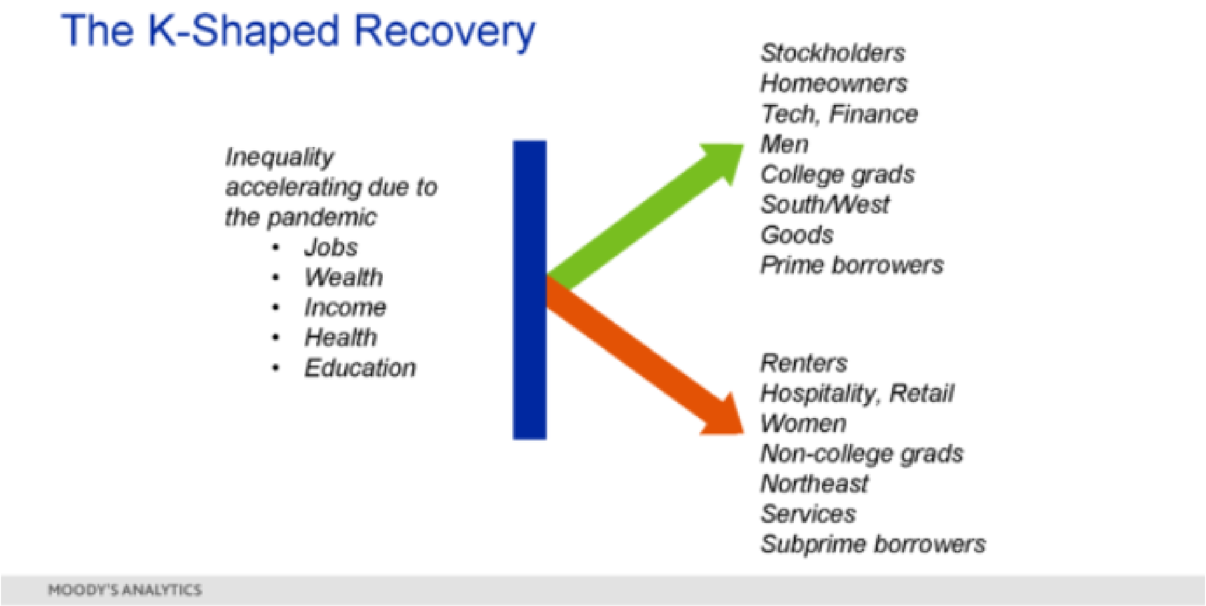


Figure B: Shows a post-recession scenario in which there is a sharp decline followed by a rapid recovery, hence creating the "V" shape.

Essentially, the economy split in two. The COVID-19 pandemic created big winners (such as technology, software services, and some online retail) and big losers (hospitality, restaurants, and travel). The initial shock of the pandemic and economic shutdown also caused many manufacturers to significantly reduce or pause production.

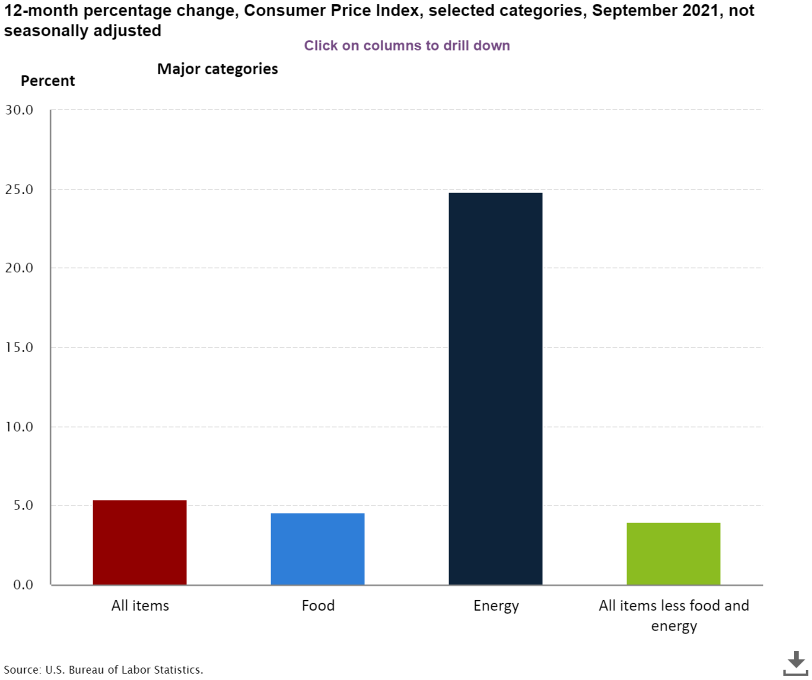
According to S&P Global Ratings, the top 5 industries most impacted by COVID-19 during 2020 were airlines, hotels, restaurants, & leisure, retail, auto components, and automotive. The least impacted were health care technology, insurance, life sciences services, semiconductors, and household products. Fast forward to 2021, the K-shaped recovery emerged. The rebound has been uneven across industries. The recovery also varies depending on the individual. This particular recovery has generated a widening cap between income classes. According to Moody's, the upper end of the K shows economic growth and includes stockholders, homeowners, tech industry, financing industry, and men. The lower end of the K shows economic decline and includes renters, hospitality, retail, and women. Across the board, it shows a greater level of inequality.



While GDP growth has continued to climb, the recovery in demand remains uneven across sectors. We also note supply-chain bottlenecks, combined with resurgent consumer demand and labor shortages, have inflated input costs for many industries. As a result, the overall economic recovery has hit a snag. U.S. annual GDP is expected to come in at 5.7% for 2021, a downgrade from previous expectations because of the impact from the Delta variant. We expect EBITDA and profit margins to be negatively affected by these issues for the next few quarters. We can also expect an uptick in bankruptcies in the next 12 months.

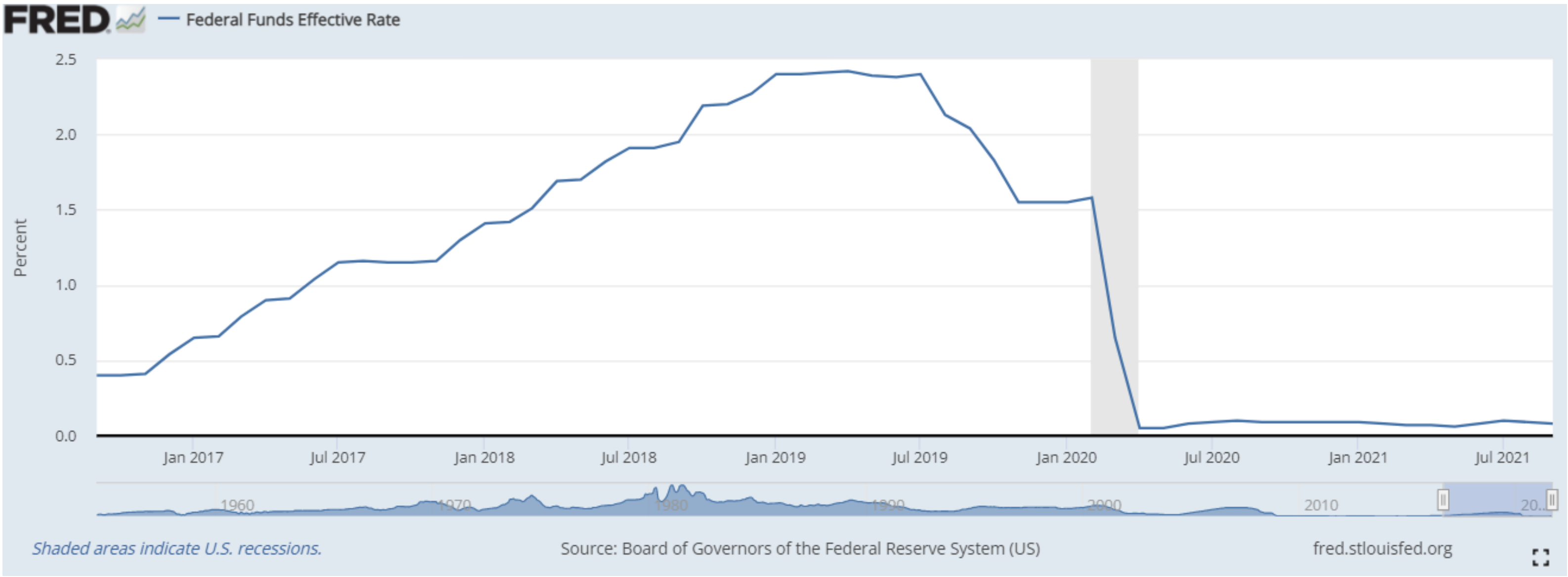
IS ELEVATED INFLATION HERE TO STAY?

If you've paid attention to the news lately, you've probably heard talk of rising consumer prices. It is impacting a range of items such as used cars, groceries, gasoline, building materials, furniture, rent, and more. Over the last year, consumer prices have risen more than 5%, the fastest pace in more than a decade. According to the U.S. Bureau of Labor Statistics, the all items index rose 5.4% for the 12 months ending September. The Federal Reserve initially stated this high level of inflation was "transitory," being temporarily impacted by supply chain and pandemic issues.



However, as inflation remains elevated, the Federal Reserve has stated it will likely begin reducing its monthly bond purchases in November and could look to raise interest rates next year. The monthly bond purchases are intended to keep long-term loan rates low to encourage borrowing and spending. The Fed predicts an annual inflation rate of 4.2% by year end, up from 3.4% in earlier forecasts. Inflation is expected to cool to about 2.2% in 2022 as pandemic pressures fade. The International Monetary Fund's (IMF) October 2021 analysis indicates that inflation and medium-term inflation expectations are projected to revert to pre-pandemic levels by mid-2022.

At its September 21-22 Fed meeting, several participants stated they are eager to conclude their asset buying to get flexibility to raise rates next year, if needed, because they think inflation may continue to run above the Fed's 2% target. New projections released at the end of the month's meeting showed half of the 18 officials that participated expected the economy to require an interest-rate increase by the end of 2022. Although, Fed Chairman Jerome Powell has stated that he would like the job market to show further improvement before the Fed begins to raise its key short-term rate. Raising rates too soon could undermine the Fed's commitments to keep inflation around 2%. Current interest rates hover near zero.



If interest rates are raised earlier than expected, this will likely impact businesses and consumers alike. When interest rates rise, this means borrowing becomes more expensive and it could become harder to raise or borrow capital. This is something to keep an eye on as the Federal Open Market Committee has two regularly scheduled meetings for the remainder of 2021.

RECENT EVENTS IMPACTING CREDIT RISK

M&A Activity

2021 has become the biggest year yet for global M&A, according to Refinitiv. World-wide deal-making has topped $4.4 trillion from more than 40,000 transactions, making it the strongest opening nine months of any year since records began in 1980. In the U.S. alone, target M&A has surged 139% to $2 trillion. Some noteworthy deals include:

- Cleveland-Cliffs Inc. announced on October 11, 2021, that it has entered into a definitive agreement to acquire Ferrous Processing and Trading Company, including certain related entities ("FPT"), for a total enterprise value of approximately $775 million, on a cash-free, debt-free basis and subject to customary adjustment ("the FPT Acquisition"). Based in Detroit, FPT is among the largest processors and distributors of prime ferrous scrap in the United States, representing approximately 15% of the domestic merchant prime scrap market. FPT currently processes approximately three million tons of scrap per year, approximately half of which is prime grade.

- On September 30, 2021, Advantage Metals Recycling (AMR), a subsidiary of The David J. Joseph Company, completed the purchase of Grossman Iron and Steel located in St. Louis, Missouri. This acquisition brings AMR's total number of recycling facilities to twelve. We view this acquisition as positive and recently upgraded Grossman Iron to reflect the financial strength of its new ultimate parent, Nucor.

- On October 5, 2021, All Star Auto Lights, a specialty distributor of alternative automotive lighting parts and a portfolio company of Atlantic Street Capital, announced its expansion into the remanufactured and aftermarket wheel category with the acquisitions of Jante Wheel and Perfection Wheel.

- Neenah Enterprises, Inc. agreed to acquire all assets of US Foundry & Manufacturing Corporation on October 14, 2021. The Department of Justice's Antitrust Division requires Neenah Enterprises Inc., U.S. Holdings Inc., and U.S. Foundry and Manufacturing Corporation to divest certain gray iron municipal castings assets in order to proceed with NEI's proposed acquisition. NEI and US Foundry are two of only three significant suppliers of gray iron municipal castings in eleven eastern and southern states.

- Icahn Enterprises L.P. (IEP) has announced plans to sell 100% of its interests in Mayfield Heights, Ohio-based PSC Metals LLC to Orange, California-based SA Recycling LLC for about $290 million. PSC operates scrap metal processing facilities across North America in Ohio, Pennsylvania, Indiana, Illinois, Missouri, Kentucky, Georgia, and Alabama. Icahn Enterprises reports that it had PSC Metals on its balance sheet at a value of $141 million as of June 30. The transaction is expected to close by the end of the year.

- On October 18, 2021, SyBridge Technologies ("SyBridge), a global industrial technology company, announced that it completed the acquisition of Pyramid Mold and Tool ("Pyramid"). This transaction further expands SyBridge's customer base and footprint in the life sciences end-markets. New York based private equity firm Crestview Partners established SyBridge Technologies in 2019. Pyramid is SyBridge's fifth acquisition in the last ten months. Pyramid manufactures plastic injection molding tools.

- On November 1, 2021, Concentric AB ("Concentric") announced the completion of its acquisition of Engineered Machined Products, Inc. ("EMP"). The company reached an agreement to acquire EMP for $147 million on a cash and debt-free basis. For the 12-month period ending December 2021, EMP forecast revenues of about $127 million and adjusted EBITDA of about $17 million.

Covenant-Lite Deals

According to LCD Daily data, more than 90% of U.S. leveraged loans issued this year have been covenant-lite, a new record. Overall, we view this as credit positive for borrowers because these loans do not include maintenance covenants, which require borrowers to meet regular financial tests. In absolute terms, year-to-date covenant-lite volume has already exceeded every full year on record. In 2000, covenant-lite loans represented roughly 1% of the market.

Metal Pricing

In late October, the U.S. and European Union agreed to end Trump-era steel and aluminum tariffs, averting a spike in EU retaliatory tariffs. Commerce secretary Gina Raimondo told reporters that the deal would maintain U.S. section 232 tariffs of 25% on steel and 10% aluminium, while allowing "limited volumes" of EU-produced metals into the U.S. duty free. The deal will likely reduce costs for steel-consuming U.S. manufacturers, as steel prices have more than tripled over the past year.

Additionally, S&P Global Ratings recently updated its metal price assumptions, reflecting currents of unsteady market conditions for various metals:

S&P Global Ratings Metal Price Assumptions
Revised assumptions (as of Oct. 6, 2021)

	2021	2022	2023	2024
Aluminum ($/mt)	2300	2100	2100	2100
Copper ($/mt)	9000	8500	8300	8300
Nickel ($/mt)	17000	16000	15000	15000
Gold ($/oz)	1800	1600	1400	1400
Iron ore ($/dmt)	120	100	80	80
Metallurgical coal ($/mt)	250	160	140	140

mt--Metric ton (1 metric ton = 2,205 pounds). oz--Ounce. dmt--Dry metric ton.

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