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Revisiting the Global Credit Cycle

How New U.S. Policies Could Accelerate the Credit Cycle

After years of muddling along in an environment of ultra-low interest rates, slow economic growth, and low inflation, the U.S. business backdrop may be poised to accelerate, supported by President Donald Trump's pro-growth, pro-business agenda. There's little doubt that the administration's efforts to "Make America Great Again" may notch U.S. economic growth a bit higher, but to what degree, across what industries and sectors, and, to what effect on the current credit cycle?

As we explained in, "The Global Credit Cycle: What Inning Are We In (Or, What Game Are We Even Playing?)", published in July 2016, the current credit cycle has unique characteristics that stem from post-financial crisis regulation, the commodities bubble, and aging demographics, among other factors. The result is an asynchronous cycle in which different industries are moving through the cycle at varying paces. Last summer, for example, U.S. banks were not yet at the halfway mark in their cycle while global commodity companies were near the end of their cycle or at the beginning of the next.

So how will recent global events, including a new, pro-growth U.S. administration, rising political risk, and a bounce in commodity prices, affect this cycle? In this paper, we review:

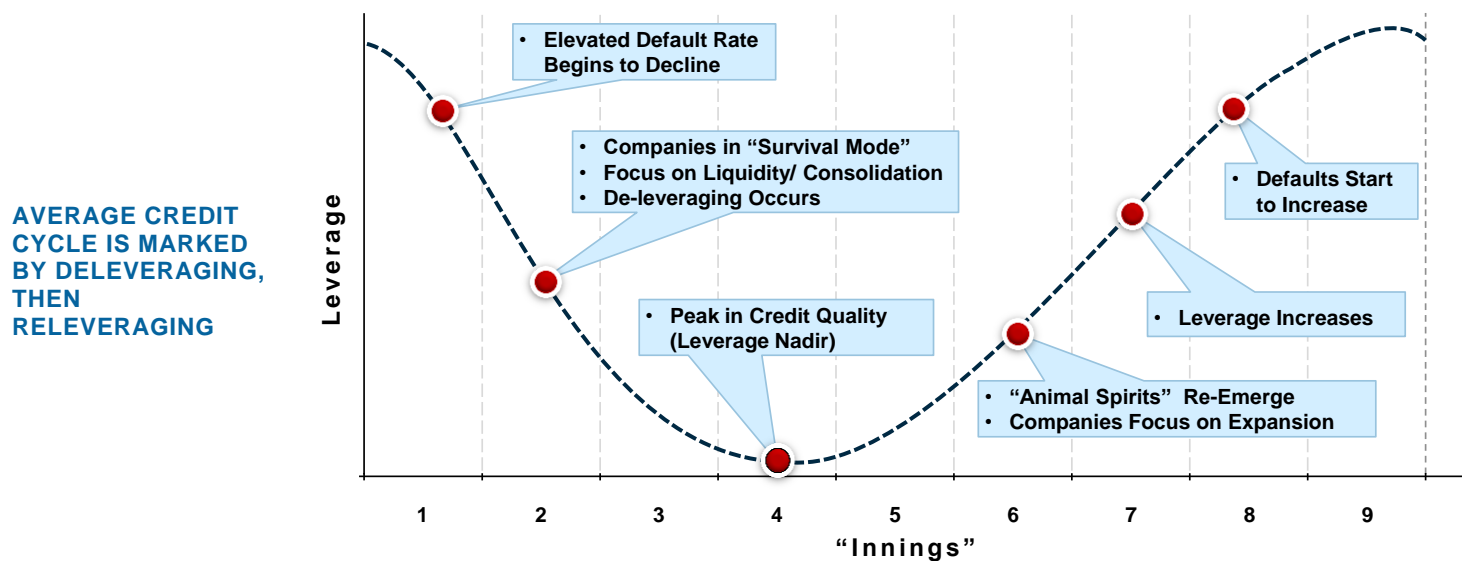
- *How regulatory and tax policy changes could accelerate the credit cycle*
- *Why an accelerated cycle and renewed investor optimism may sow the seeds of the next U.S. recession in three to five years*
- *Why these findings and the current market climate call for increased attention to tail risk in fixed income portfolio construction*

Animal Spirits: Friend or Foe?

To begin, we first review the progression of the global credit cycle. The onset of the average cycle is marked by intensive deleveraging (typically during or after a recession) amid heavy defaults and serious soul-searching by corporate management teams as they shift from expansion to survival mode. Ultimately, deleveraging bottoms out, representing the apex in credit quality for the cycle.

Eventually, the natural animal spirits re-emerge and companies focus once again on growth and expansion. By this point, the financial markets and intermediaries (e.g. banks) are usually fully healed and actively seeking investment opportunities. Individuals, corporations, and even the banks themselves may embark on borrowing and re-leveraging binges. This aggressive, risk-seeking behavior almost always leads to the end of the cycle—credit losses, higher bankruptcy levels, and, typically, a recession.

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Source: PGIM Fixed Income

Trump Policies Could Lead to Better Growth Over the Next Two to Three Years...

The largest impact to the U.S. credit cycle may be the new U.S. administration's tax reform agenda. Reducing U.S. corporate tax rates and immediately expensing capital investments should bolster both large and small companies' bottom lines and encourage investment spending. The proposed sharp reduction of the tax rate applied to foreign profits held abroad should lead to the repatriation of offshore cash. While much of the cash will likely be used for capital investment, strategic acquisitions, share repurchases, or dividend payments, some may be used to pay down debt and/or reduce debt issuance.

Moreover, proposals to reduce or eliminate the tax deductibility of net interest expense bear watching; such a seemingly minor tweak to the tax code could have a profound effect on capital structure optimization, rendering debt financing to be less appealing for corporate treasurers and private equity firms (not to mention forcing a rewriting of many corporate finance textbooks). Just lowering the corporate tax rate itself should reduce the advantage of debt financing relative to equity financing.

The proposed deregulation of myriad industries—healthcare, energy, financial services, and autos—and general labor market and environmental deregulation should boost animal spirits and investments. The prospect of a less regulated business climate has already shored up business confidence, as exhibited by recent surveys, and pushed equity multiples higher, particularly for small companies. Finally, increased infrastructure and defense spending will likely be marginally positive for economic growth.

Notwithstanding the result of the U.S. election, economic and earnings momentum is already exhibiting positive trends, both in the U.S. and globally.

All in all, recent trends and the above pro-growth portion of the new administration's agenda has led us to shift our base case from secular stagnation to somewhat better U.S. economic growth (from 2.0% to 2.5% - 3.0%) and, accordingly, reduced recession risk over the next two to three years.

...But Sow the Seeds of the Next Recession

The abundant newfound optimism regarding the ostensibly pro-growth policies detailed above has to be balanced with the significant—both upside and downside—tail risks. Let's address the upside tail risk first.

The unleashing of animal spirits that have been kept largely at bay since the financial crisis could propel the economy to grow even faster than 3.0%. While higher growth seems like a valiant objective, we should be careful what we wish for.

We believe that the long-term, real potential U.S. growth rate remains about 2.0%. In fact, the independent Congressional Budget Office just reduced its expected potential growth rate over the next 10 years to 1.8% from 2.0%.¹

This muted "economic speed limit" is largely driven by multiple trends, including the brutal demographics of aging populations and shrinking workforce growth rates (e.g. U.S. labor force growth is expected to be less than 0.5% for the next few decades¹), burgeoning entitlement spending, and untenable, growth-dampening public sector debt burdens.

Any sustained growth rate much above potential will likely be marked by one or more of the following: a sharp cyclical rebound, a permanent surge in productivity, or a debt-fueled re-leveraging of the economy (even if it's primarily via the public sector) accompanied by speculative excesses. Arguably, the U.S. has already experienced a significant, albeit steady, cyclical recovery with the unemployment rate diving to under 5% from 10%, and auto sales and housing starts almost doubling from recession lows. Attempts to "juice up" the economy via more fiscal stimulus and/or ambitious capital investments may be mistimed at this stage of the cycle.

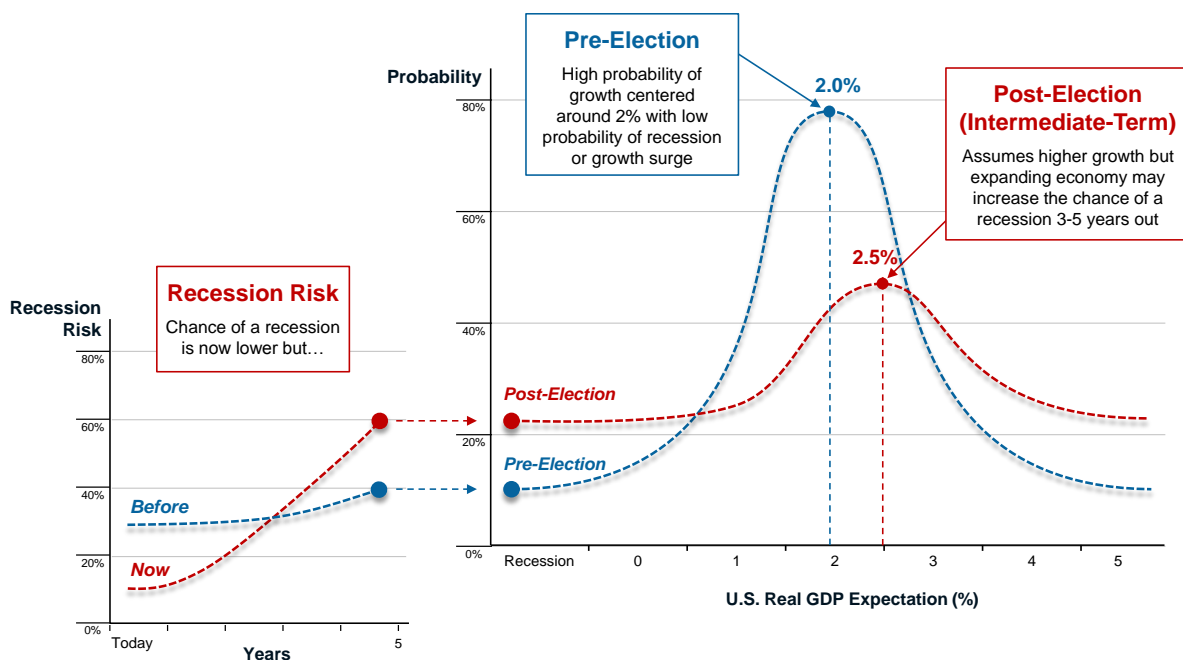
Moreover, pushing for job creation amid a tightening labor market (even the dovish Federal Reserve Chair Janet Yellen now admits we are approaching full employment) may accelerate already rising wage growth, possibly shifting the stance of the Fed from one of "removing accommodation" to that of outright tightening. We fear that pushing growth significantly above the potential rate will bring about a reversion to the traditional boom-bust economic cycles.

Then there are the downside tail risks, including slower global economic growth brought on in part by geopolitical policy risks, either initiated globally or domestically. Clearly, the inflation of the enormous credit bubble in China is unsustainable, although the catalyst for popping the bubble is not obvious. Political risks in Europe are growing and becoming more imminent with the onset of Brexit negotiations and looming elections across the continent. And, of course, the potential for policy miscues from the new U.S. administration regarding international diplomacy, trade, tax, and immigration has hardly been greater. Even the border adjustment tax as outlined by congress could create enough confusion to slow economic activity significantly in the near term.

All in all, the risk of recession within the next three to five years, whether it emanates from the U.S. or overseas, has increased significantly. And, tail risks have become elevated amid the uncertain environment.

¹ Source: Congressional Budget Office, "The Budget and Economic Outlook 2017-2027," January 2017

PRO-GROWTH POLICIES MAY INCREASE CHANCE OF RECESSION IN THREE TO FIVE YEARS



Source: PGIM Fixed Income. Represents conceptual depiction of market environments. Not based on actual data. For illustrative purposes only.

Below, we take a look at how recent global events and rising political risks may affect a variety of fixed income sectors.

U.S. Banks

In mid-2016, we characterized the U.S. financial sector, and the large U.S. money center banks in particular, as being in the 3rd inning of their credit cycle. Since the financial crisis, most banks have substantially de-levered by building large capital bases. Moreover, they have de-risked their business models and improved their liquidity buffers. Of course, practically all of this fundamental improvement has been required by regulators. To their credit, many banks have exhibited more conservative underwriting standards since the financial crisis, bolstering their asset quality. In recent quarters, bank earnings have improved noticeably as their diversified business models—underwriting, advisory, trading, lending, and asset management—gained traction. Given better earnings, solid loan growth, and the fact that an increasing portion of their earnings is now being distributed to shareholders in the form of share repurchases and slowly increasing dividends, we believe U.S. banks have advanced to the 5th inning of their cycle.

“We still favor U.S. money center banks despite potential deregulation.”

Going forward, the U.S. administration could relax certain regulations that were enacted to boost the bank sector’s stability following the financial crisis. Some investors are questioning whether deregulation of the banks will undermine our positive, fundamental thesis on the U.S. bank sector. In our view, some policies may be tempered on the margin, but the regulations that require more stringent capital levels—some of which are governed by international standards—should remain in place, providing a solid foundation. In fact, there are calls by some regulators and politicians for even higher capital levels. But, if capital investment across the U.S. economy picks up and lending standards moderate, the banks should continue to move through the “middle innings” of their cycle.

A nuance that bears watching is the potential elimination of the tax deductibility of net interest expense for corporations. While banks would likely be exempt from such a tax change, the new rule could result in a decline in loan demand and corporate debt issuance, which in turn could negatively impact the banks' businesses. Even so, we still hold a favorable view on the large money center banks relative to industrials.

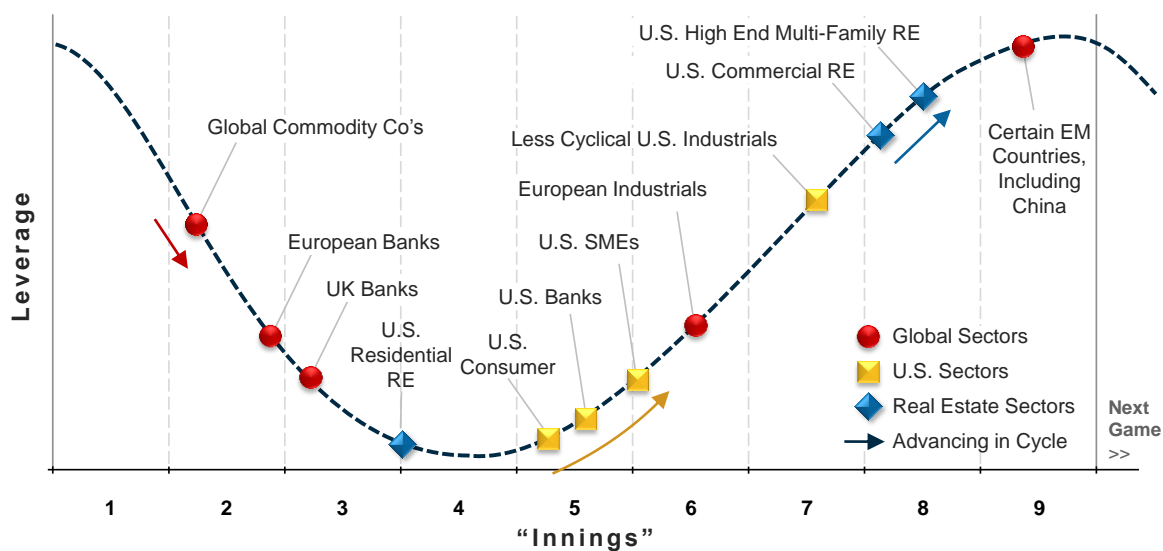
U.S. Industrials

The U.S. industrial sector is a broad category with many unique credit trends across dozens of subsectors and thousands of issuers. In recent years, there has been a significant re-leveraging across the sector as companies issued record levels of debt to fund large, strategic acquisitions and other shareholder-friendly activities, such as share buybacks and dividend payments. This increasing level of credit risk led us to place the category, as a whole, in the 7th inning of the cycle last summer. Given still healthy fundamentals, potentially stronger U.S. growth, ongoing demand for the relatively higher yields of U.S. corporate bonds, and a tailwind from potential corporate tax policy changes—which could boost earnings, temper re-leveraging, and reduce supply—we believe the credit quality of many industrial companies will improve or stabilize in the near term, keeping the category as a whole in the 7th inning of the game (like a rain delay in baseball). In fact, some companies may actually take a step or two back in the cycle—to the 5th or 6th inning—if new corporate tax policies incent them to reduce leverage.

U.S. Consumer

The outlook for the U.S. consumer is still a mixed bag. On the one hand, wage growth has picked up and is now running slightly above the rate of inflation. Consumer confidence is also up. And, if new stimulus policies are successful at increasing the volume of higher-paying jobs, consumer spending could increase. On the other hand, changes to trade policies could lead to retaliation and/or raise consumer prices, resulting in lower real wage growth and less spending. Also, if deregulation of the financial sector eases the restrictive lending standards implemented after the financial crisis, consumers may borrow more money to finance or improve their homes—although with mortgage rates now 100 bps higher, on average, than a year ago, mortgage loans may still be out of reach for some borrowers.

INDUSTRIES AND SECTORS ARE MOVING THROUGH THE CREDIT CYCLE AT DIFFERENT PACES



Source: PGIM Fixed Income as of February 2017. For illustrative purposes only.

European Banks

Last summer, we placed the broad European financial/banking sector an inning or two behind the U.S. banks' de-leveraging cycle. European banks have been slower to recapitalize than their U.S. counterparts due to nascent economic growth across the continent, rolling peripheral financial crises, and a general resistance to write-off bad assets. Some banks in core and northern Europe have made progress since the financial crisis with a number of them reaching settlements regarding crisis-era litigation. However, many other banks are still undercapitalized, primarily those in the peripheral countries, such as Italy.

As such, we would still place the sector, in general, in the 2nd or 3rd inning of the cycle. There have been some modestly encouraging signs of economic momentum across parts of Europe. And a weaker euro should further bolster growth. However, political risk is on the rise, which could stifle growth at any time.

European Industrials

Low interest rates, the European Central Bank's non-financial corporate bond buying program, generally conservative management, and a weak euro have all helped to support the credit quality of many diversified European industrial corporate issuers. Moreover, Europe has less exposure to the volatile energy sector than the U.S. market, especially in the high yield bond market, which has kept default rates low across the region.

However, European economic growth remains challenged with a projected rate for 2017 of just above 1.0%—albeit a notable uptick from several years ago. European companies have generally been less aggressive than their U.S. counterparts to increase financial leverage, partly due to an uncertain economic and political backdrop. Even so, leverage has begun to inch higher given softer earnings growth. At present, we would categorize this broad sector as being in the 5th or 6th inning. On a more cautionary note, the Brexit vote and momentum of populist, nationalistic parties across Europe could hamper trade, reduce productivity, and be a headwind for corporate earnings going forward. The ECB's eventual tapering of its bond buying program will also stoke volatility.

Emerging Market Countries

There are so many idiosyncratic political, economic, and market trends among emerging market countries that it is nearly impossible to generalize. Many countries have been mired in recession, or at least below-potential growth. The global commodity recession of the last year or two and a stronger U.S. dollar are partly to blame. But self-inflicted policy errors are as much to blame. Some countries (e.g. Argentina, Brazil), have made political changes. Others (e.g. India, Mexico) are trying to reduce regulations, open up their markets, and enhance the competitiveness of domestic companies. China, on the other hand, seems to be focused on growth at any cost; its debt-fueled growth and secularly declining potential GDP may continue to be a headwind for many emerging markets.

Following the U.S. election, there has been much speculation as to whether the new administration will impose trade restrictions on specific countries or goods. Policies that restrict trade, or otherwise increase geopolitical risk, could certainly have a negative effect on certain emerging market countries. On the other hand, if the new administration successfully boosts U.S. economic growth, there could be positive repercussions for many developing and developed countries.

Global Energy and Commodity Companies

Last summer, we noted that many global energy and commodity companies were aggressively shoring up their balance sheets, placing them at the end of the cycle or in the early innings of "next game." Since then, most commodity prices have stabilized or increased. The latest agreement from OPEC to reduce oil supply on the margin has further bolstered oil prices. Importantly, many companies have been focused on increasing free cash flow, reducing debt, and improving liquidity. As a result, many larger, more diversified (mostly investment grade) commodity companies are now much better positioned to withstand

commodity price fluctuations. The new administration certainly seems friendly toward the energy sector, as evidenced by the quick approval of the Keystone and Dakota Access pipelines.

However, as oil prices have drifted higher, we have already begun to see a supply response from the increasingly efficient U.S. "fracking" community, with rig counts moving higher. Many smaller, more levered companies (mostly non-investment grade) will likely require even higher oil prices in order to justify their debt levels (i.e. grow into their balance sheets). Accordingly, we remain cautious with regard to many below investment-grade companies.

Any energy-related deregulation would likely result in better growth prospects for certain companies. The likelihood that commodity companies resume more growth-oriented practices should quickly advance the sector to the 2nd or 3rd inning of the cycle.

Conclusion

Against a backdrop of potentially stronger U.S. economic growth over the next two to three years, rising political risks globally, and a potential hard landing in China, we continue to see an array of fixed income opportunities as industries and companies move through the credit cycle at varying, and, in some cases accelerated, paces.

The new U.S. election notwithstanding, a global economic climate characterized by aging demographics, high debt burdens, moderate global growth, and relatively muted inflation should continue to keep developed market government bond yields low and range bound.

While the policy changes ultimately implemented by the new U.S. administration remain far from certain, the prospect of more pro-growth, pro-business policies has generated renewed investor optimism. At present valuations, it appears the market has already priced in a significant uptick in growth and earnings via higher interest rates and equity valuations, and tighter credit spreads. But, it has not fully priced in the likelihood of higher volatility and the significant tail risks.

As such, it may be appropriate to consider pruning exposure to spread sectors that appear to be fully valued and gravitating to more attractive and/or defensive sectors that are in the early-to-middle innings of their credit cycle.

Even with deregulation looming, we continue to favor U.S. money center banks for their strong capital positions and relative immunity to event risk. We also like high-quality structured product, including top-of-the-capital structure asset-backed securities (ABS), commercial mortgage-backed securities (CMBS), and CLOs, as they can provide attractive spreads and cyclically-defensive characteristics.

We see value in select investment grade commodity companies—with the commodity recession so recent, we believe many of these companies will be reluctant to re-leverage any time soon. We also see pockets of value in sovereign debt, including parts of the U.S. Treasury yield curve. Regardless of the environment over the next few years, however, we believe there will still be ample opportunities to generate alpha through bottom-up, fundamental analysis and by identifying price discrepancies among countries, industries, individual issuers, and across all global fixed income sectors.

"The market has not fully priced in higher tail risks."

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