Credit Research

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# 2019 CREDIT STRATEGY OUTLOOK: PATIENCE IS A VIRTUE.

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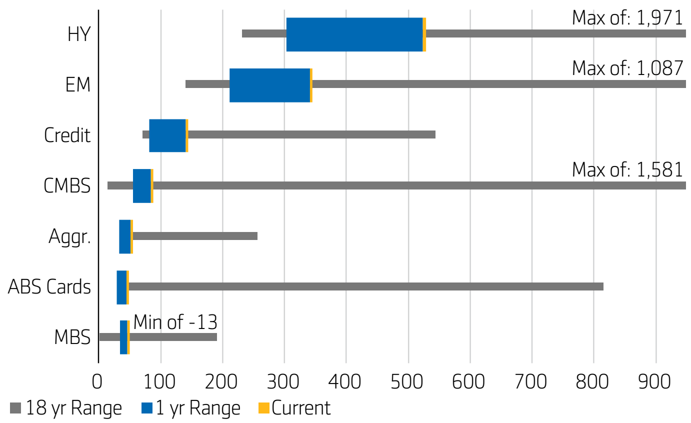
*The key word for our 2019 outlook is patience. Volatility and the associated downward pressure that hit the credit markets during the fourth quarter helped to create interesting opportunities. However tempting these opportunities may be, we expect patience to be rewarded. We generally maintain our defensive positioning as we enter 2019.*

*Through continued periods of market volatility, we believe there will be ample opportunities to take advantage of dislocations opportunistically by adding exposure as the year progresses. Primarily because credit spreads begin the year at more attractive levels than we have seen in some time (Exhibit 1), our expectations are for positive returns for most credit asset classes. In a year with expected recurring periods of significant volatility, patience should be rewarded as idiosyncratic situations or market overreactions occur.*

Exhibit 1: Asset Class OAS
High and Low for Previous 52 Weeks
High and Low Since August 2000




Source: Barclays Capital Indices, Barclays Live. ©2018 Barclays Capital Inc. Used with permission. As of 12/31/2018.

## A quick look back

We began 2018 favoring credit with a preference for high yield. As the year progressed, we generally reduced credit risk and took a more balanced approach between exposure to investment grade and high yield. As the year came to a close, general positioning was close to benchmarks for credit exposure while continuing to add exposure to structured assets.

In hindsight, we were not bearish enough on credit given the volatility that ensued as the fourth quarter progressed. The market volatility that erupted led to dramatic spread widening and underperformance of credit for the quarter. The rationale that drove our increasing defensiveness—interest rate increases by the Federal Reserve, uncertainty surrounding tariffs and trade, global politics, peaking economic growth, and less attractive valuations—were major contributors to what led the markets downward. Many of these risks will likely persist into the new year.

## The big picture

It is our belief that the economic environment has reached an inflection point. After two years of accelerating US GDP growth rates, we expect US economic growth to slow in 2019 and 2020. This slowdown will increase the ferocity of the debate regarding the end of the economic cycle. While we anticipate a slowing of economic growth, we are not forecasting an outright recession until after 2020. The combination of a transition in the economic outlook and the uncertainty created by shifting central bank policies and changes in the political climate will likely drive near-term volatility.

The Fed continues to raise short-term interest rates and has indicated its intention for two more rate hikes in 2019 alongside a continued reduction in quantitative easing (QE). A too aggressive pace of raising rates by the Fed could expedite the next economic recession.

Market participants are closely watching the shape of the US yield curve for inversion—viewed as a useful indicator in identifying potential recessions. Because it has such a large following, it could become self-fulfilling if it inverts and lenders tighten credit standards in anticipation of an impending recession. The curve has not yet inverted, but it is flattening.

The European Central Bank (ECB) is also at an inflection point and continues its QE tapering. The ECB anticipates raising rates for the first time in mid-to-late 2019. Markets are questioning whether the ECB will remain on that path given the soft economic performance for the eurozone and the overhanging uncertainty created by Brexit negotiations. Investors are starting to expect the ECB to become incrementally dovish given the slowing outlook for growth and the uptick in market volatility.

The Chinese economy has weakened leading central planners to take stimulative actions in hopes of stabilizing and turning the economy around. While they have had some success with this approach during recent years when the economy has exhibited periods of softness, these stimulative efforts have yet to take hold. Markets are still questioning whether they can successfully provide sufficient stimulus to stabilize and revive the economy while navigating the uncertain environment surrounding trade and tariffs. If they can succeed, that would support for the global economic outlook, and in turn, credit markets.

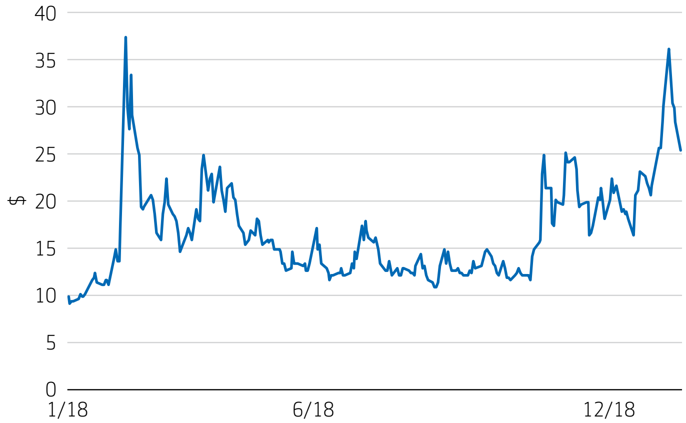
Global politics increased uncertainty in the markets over recent quarters. Unexpected gyrations in Brexit negotiations have created uncertainty for the UK and eurozone. We have seen populist fiscal measures as governments look to shift policy. The most recent example being the yellow vest protests in France that resulted in changes to policy in France to appease protesters. Meanwhile, we are seeing the ongoing trade and tariff policy changes driven by the US cause recurring bouts of market volatility. We think these types of risk will remain and continue to garner headlines.

## Volatility

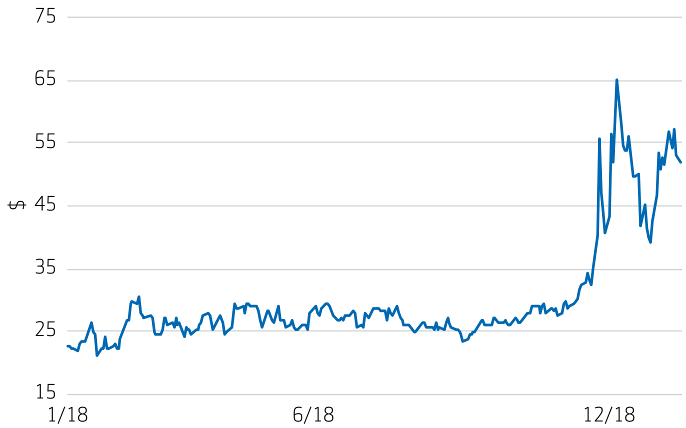
The fourth quarter saw volatility ripple through many areas of the markets (Exhibit 2). Equity volatility, as measured by the CBOE Volatility Index (VIX), ramped up throughout the quarter. Crude oil prices fell sharply, with WTI crude declining nearly 40% in the fourth quarter while the CBOE Crude Oil Volatility Index (OVX) spiked upwards. Fixed income volatility, as measured by the Merrill Lynch Option Volatility Estimate (MOVE) Index, increased late in the year as well.

Exhibit 2: Volatility rippled through the markets in the fourth quarter

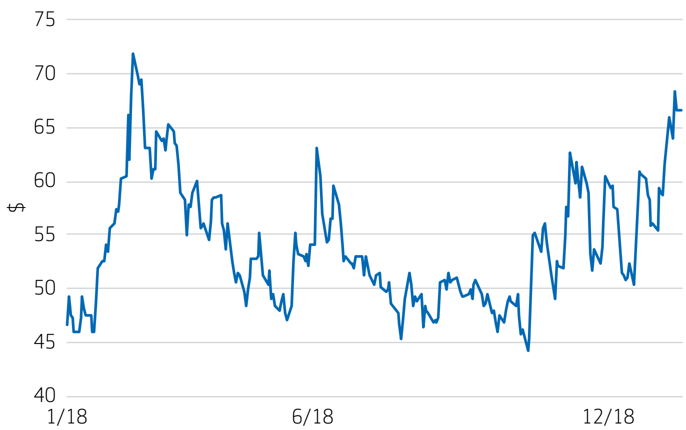
CBOE Volatility Index (VIX)




CBOE Crude Oil Volatility Index (OVX)




Merrill Lynch Option Volatility Estimate (MOVE) Index




Source: Bloomberg. Data as of 12/31/2018.

## Credit markets

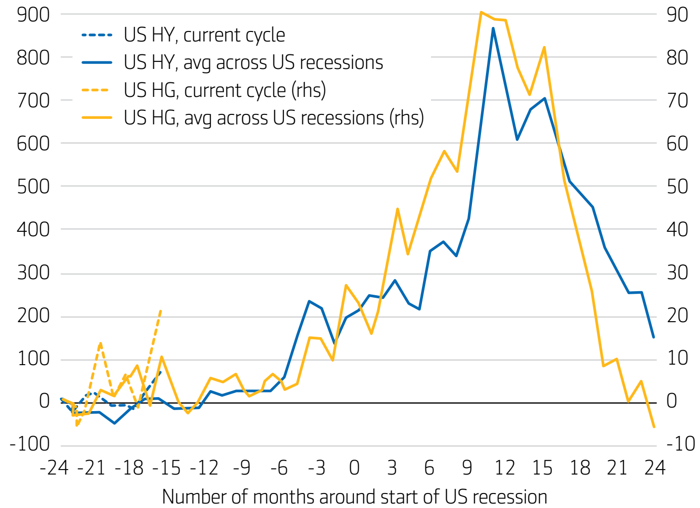
Aggregate credit statistics have seen some modest deterioration and while recent quarterly earnings were strong, we believe that expectations are likely to come under pressure as the market works through this transitional phase.

Aggregate market statistics have raised some concern. Much has been written about the growing proportion of BBB credits in the investment grade market. As discussed in our piece titled, "Is the BBB Credit Bubble Ready to Burst?" we agree with market concerns about the growth in BBB credit, but do not think that current fundamentals warrant a substantial wave of rating migration. Similarly, we have observed some deterioration in leverage ratios, but do not expect a near-term default cycle.

From an individual company perspective, third quarter results saw a revenue increase of approximately 8% for S&P 500 companies and a more than 25% increase in earnings on a year-over-year basis.  However, the periods of easy comparables supported by the substantial tax reform package are coming to a close. Going forward, expect more difficult comparables, a slowing rate of economic growth, and overall market uncertainty to weigh on fourth quarter results and 2019 estimates. Even so, expectations from our credit research team are still for positive, albeit slower, earnings growth. This coincides with our top-down view for slower but still positive economic growth. This, combined with our view of no recession through 2020, are key reasons we think that once markets have recalibrated to the current environment, we will see positive returns in 2019.

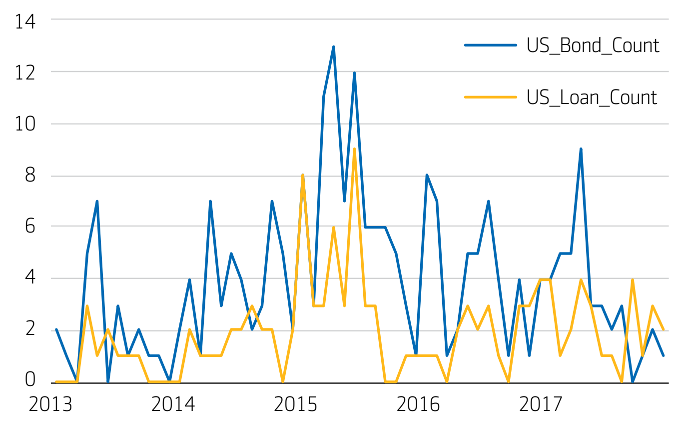
We recognize that the spread widening is reflective of the uncertain environment. However, markets should not discount credit market pricing to compensate for a recessionary environment today, in our view. Markets historically begin to reprice credit markets 12-24 months in advance of a recession and we do not think it is time for that clock to begin ticking (Exhibit 3). Nor do we believe, other than select idiosyncratic situations, that markets are primed for a significant default cycle (Exhibit 4). In our view, even with slower growth, fundamentals can still sustain the current business cycle.

Exhibit 3: Change in US HG and HY credit spreads two years before and after start of US recessions*




*US HG sample covers 1973 to 2007 (6 episodes); US HY covers 1990 to 2007 (3 episodes); Current assumes recession begins in spring 2020. Source: JPMorgan. Data as of 11/2018.

Exhibit 4: Defaulted US bond/loans issuer counts 12/2013 – 11/2018




Source: Moody's. As of 11/1/2018.

## Opportunities within credit

Based on our research, opportunities exist in certain areas within credit and structured markets—specifically, short duration investment grade credit is where something as simple as time may be the catalyst. Given the flat yield curve, unless an investor needs duration for structural purposes, shorter-term credit risk is currently providing modestly lower yields. As these shorter-term exposures move toward maturity, the credit risk premium will lessen, and the potential for what we believe will ultimately be a more dovish Fed should help limit interest rate risk by keeping the short end of the curve relatively anchored. Combined with our more sanguine outlook for fundamentals, companies should remain well positioned to repay or refinance these obligations.

Similarly, we are increasingly comfortable with higher-quality high yield. The recent repricing of credit risk has provided more attractive entry points and created an opportunity to acquire good companies at more attractive prices. Additionally, given that these credits typically have a higher degree of interest rate sensitivity than lower-quality high yield, we believe that upward pressure on rates is mitigated in the near-term by the combination of global uncertainty and the prospects for the Fed to continue softening the glide path of its rate increases.

The US structured credit asset classes are a consideration to weather anticipated market volatility. The combination of continued discipline in underwriting standards combined with limited risk of contagion to the repricing of other risk assets lead us to view structured credit favorably. We prefer private label structured assets where fundamentals for most sectors remain supportive.

## Summary

As we move into 2019, many of the uncertainties entering the year are macro in nature with binary outcomes. This is counterbalanced by our view that we do not expect a recession or default cycle, and that earnings and company fundamentals will soften, but stabilize. We expect positive returns for many asset classes for the year, and do not anticipate a recession through 2020, nor do we expect a significant pickup in the default cycle. Therefore, our baseline view is to enter the year cautiously until the market can appropriately digest all of the uncertainty and changing dynamics. Patience will likely be rewarded.