CREDIT MARKET OUTLOOK, THIRD QUARTER 2018

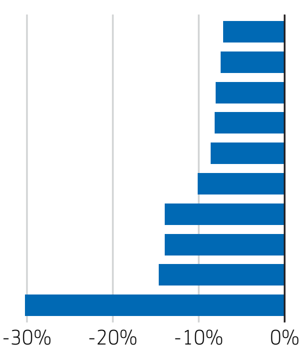
By Garry Creed, CFA, Chief Credit Strategist

The second quarter saw high yield credit outperform investment grade credit and US Treasuries. Within high yield, the lower quality components of the universe outperformed with CCCs leading the way. Meanwhile, investment grade credit struggled to keep pace. The primary drivers of the difference in performance were threefold. First, rising rates more negatively affected investment grade credit due to its longer duration. Second, supply-and-demand technicals were less favorable. Third, the sound credit fundamentals driven by the strength of the first quarter earnings season combined with the continued search for yield kept investors comfortable with lower quality credit.

Perhaps the biggest story of the quarter was the rebound in the US dollar. Beginning in January 2017, the dollar began an extended period of softness. Declining over 13% through the end of the first quarter 2018, the market reversed course sharply in the second quarter and rallied more than 5%. This unexpected reversal led to widespread weakness in currencies around the globe, hitting emerging market currencies the hardest (Exhibit 1).

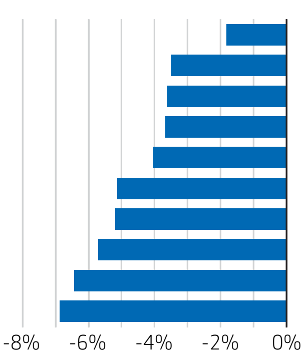
Exhibit 1: Currency depreciation versus the US dollar, second quarter 2018

Emerging markets



10 worst spot returns (%)		
Czech Koruna	CZK	-7.53
Chilean Peso	CLP	-7.71
Mexican Peso	MXN	-8.67
Polish Zloty	PLN	-8.71
Russian Ruble	RUB	-8.94
Hungarian Forint	HUF	-10.02
South African Rand	ZAR	-13.73
Turkish Lira	TRY	-13.88
Brazilian Real	BRL	-14.71
Argentine Peso	ARS	-30.37

Developed markets

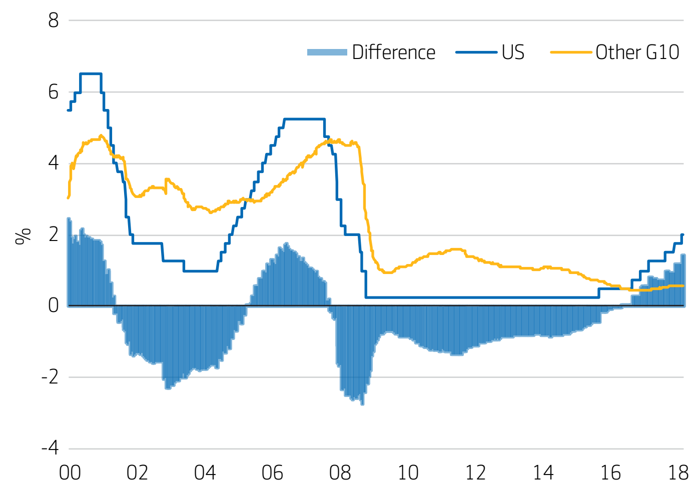


Spot returns (%)		
Canadian Dollar	CAD	-1.77
Australian Dollar	AUD	-3.57
Swiss Franc	CHF	-3.69
Norwegian Krone	NOK	-3.76
Japanese Yen	JPY	-4.04
Danish Krone	DKK	-5.15
Euro	EUR	-5.19
British Pound	GBP	-5.77
New Zealand Dollar	NZD	-6.48
Swedish Krona	SEK	-6.72

Source: Bloomberg

Entering the year, market consensus was for a continued period of synchronized global growth. This narrative started to shift as economic data in the eurozone, followed by other areas of the world, started to disappoint relative to expectations. By comparison, the US economic data continued to show strength. These diverging dynamics led to a more hawkish Federal Reserve reiterating plans for a total of four hikes in 2018. Meanwhile, the ECB became incrementally more dovish, pushing out the timeline for possible rate increases well into 2019. Exhibit 2 shows the changing dynamic of US policy rates versus average G10 policy rates.

Exhibit 2: US policy rates versus average G10 policy rates



Source: Bloomberg, Barclays Research

From our perspective, this dynamic likely will continue through the third quarter. We expect strong second quarter data to be reported in the US, including solid economic data, increasing yet controlled inflation, and favorable earnings from US companies driven in part by support from fiscal stimulus. Conversely, we anticipate global data to remain subdued as expectations recalibrate and the effects of these sharp currency moves are realized.

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July 2018

Third quarter 2018 outlook and themes

1. Retaining our preference for credit risk relative to rate risk

We entered the year with a preference for credit, particularly lower quality credit. Moving into the second quarter we continued an overweight call on credit with a more balanced view between investment grade and high yield. We continue to suggest a more balanced approach to the overweight, including a favorable view on adding to securitized asset classes.

2. Staying closer to home

The theme of staying closer to home covers two separate concepts. First, a preference for domestic credit versus international credit. Second, a view toward moving portfolio risk closer to neutral.

When putting these themes in the context of our research framework, which considers fundamentals, sentiment, technicals and valuation, we see how it reinforces our outlook.

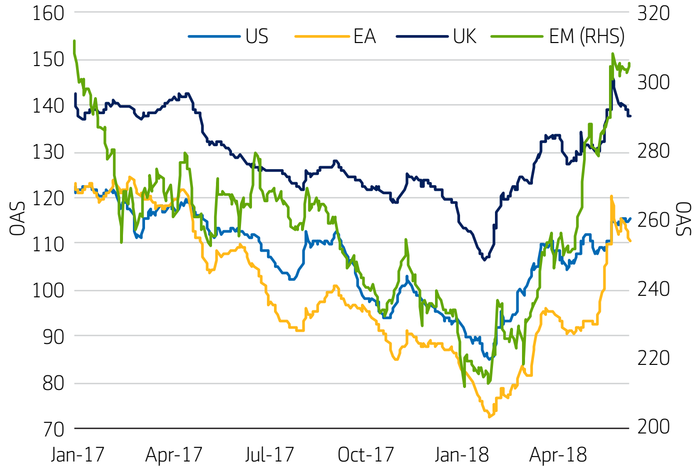
Fundamentals. We expect a strong second quarter earnings season for US issuers, which should provide a sound backdrop for corporate fundamentals. This is particularly true for US-focused companies. Though we could see some modest pressure on multinationals given the rally in the dollar and slowing growth in some overseas economies, our forecast is for a favorable earning season as a whole. Given the sharp moves in some currencies, we will closely watch reported results and any changes in guidance from companies with non-dollar exposure for signs of concern.

Sentiment. Sentiment has become less favorable for US investment grade and high yield credit as the year progressed, but it has changed sharply for international credit. Fund flows have generally been negative for credit, with the exception of leveraged loans, but outflows in emerging markets and Europe have become notably more negative.

Technicals. The technical picture for investment grade has seen modestly reduced supply relative to last year, but that comes off of a very high 2017. When combined with the reduced demand, investment grade has had difficulty digesting new issuance. Conversely, high yield has seen a more significant decline in issuance, and while demand has fallen, it has not been as material on a relative basis. Recent shifts in the global markets have led to declining issuance internationally as well.

Valuation. Investment grade valuations have improved modestly as the asset class has underperformed year to date, both on an absolute and relative basis. High yield valuations have become moderately more expensive given its relative performance this year. US investment grade and high yield have outperformed their European market counterparts, but Europe continues to look rich relative to the US (Exhibit 3).

Exhibit 3: US versus non-US credit spreads



Source: Bloomberg, Barclays Research

Risks to our 3Q credit outlook

Market optimism getting ahead of itself. This has occurred modestly on the economic front with global economic expectations recalibrating as growth has slowed. While we are positive about the second quarter, the last few months of the year could see this risk spread. Headwinds like the rising dollar, rising interest rates, growing cost pressures, and slowing global growth could flow through and hurt US companies' earnings relative to current consensus estimates.

Concern that the Fed becomes too active, choking off growth and the business cycle. This remains a risk but there is little to suggest we have reached the inflection point. The flattening yield curve could be a signal that the markets are concerned the Fed is approaching that point.

Pick up in late-cycle behavior negatively affecting credit. We have seen continued examples of late-cycle behavior like an increase in M&A and growing share buybacks, but so far most M&A has been disciplined. The recent bidding war for Twenty-First Century Fox may indicate how aggressively buyers are willing to be in terms of credit profile deterioration.

Volatility pushes through to credit spreads. This has occurred outside of the US credit markets with movements in European credit and emerging markets, but US credit markets have remained under control. As central banks end quantitative easing, and the rate of US growth begins to slow, we anticipate US credit markets becoming more volatile.

A shift in the global growth dynamic (Europe slowing, China slowing). This has begun to play out but we believe there is more to come. The period of globally synchronized growth has transitioned to a period of diverging global growth. The US continues to perform well while many other developed and emerging economies see decelerating growth rates.

Political turmoil stagnating the US business-friendly agenda, leading to a risk-off trade. The political turmoil has continued and few days go by without a notable headline. Until recently, most did not ripple through the markets. However, the latest actions surrounding tariffs and trade war talks have caused some concern. This topic will likely move in waves of news, and cause bouts of uncertainty. Ultimately we think this is yet another example of the transactional negotiating style of the US administration under President Trump and will play out in a more moderate fashion over time.

The markets adjust more quickly than anticipated, and begin discounting our concerns for a recalibration of market expectations. If the markets start to look further into the future and begin to price in reduced economic and earnings expectations, valuations could soften sooner than expected. We view the third quarter as the beginning of a multi-quarter period of transition from optimistic to realistic expectations.

Our preferences

We continue to prefer credit risk relative to rate risk, and maintain a balanced view toward investment grade credit and high yield credit. We also favor US exposures in the credit and structured asset classes. With the third quarter being the beginning of a period of transition from optimistic expectations to more realistic expectations, we are also considering staying closer to neutral in terms of risk.

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