FOURTH QUARTER 2018 CREDIT MARKET OUTLOOK

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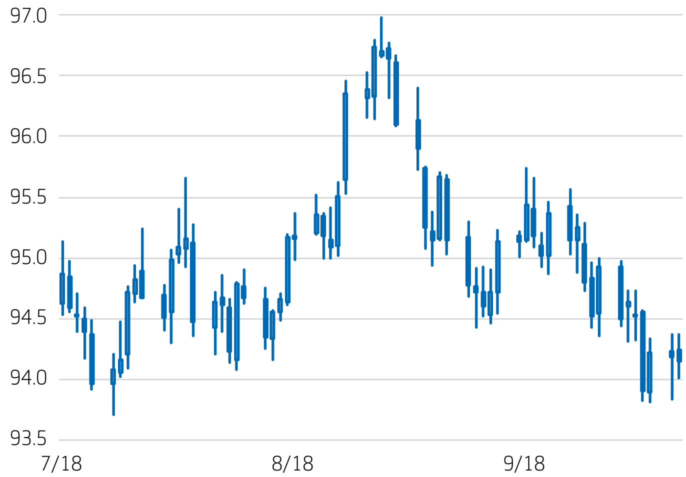
Heading into the fourth quarter, we continued the gradual move to upgrade portfolios and reduce exposure to credit risk—though we still favor remaining modestly overweight credit. The reason for this growing caution is twofold. First, we expect an uptick in idiosyncratic situations as we enter the quarter due to increased volatility across economic data, earnings results, central bank plans and politics. Second, the continued rally in credit reduces the risk-return trade-off of lower quality credit. Despite growing pockets of concern, economic conditions are still solid and supportive of company fundamentals. We see no signs of an increase in the default cycle or a near-term recession. Therefore, we reiterate our core views moving into the fourth quarter: a modest overweight to credit risk with a continued move closer to benchmark weights, a preference for domestic credit versus international, and a drift upwards in credit quality.

Third quarter in review

We entered the third quarter with a preference for investment grade and high yield credit over rates. Additionally, we favored US exposures and generally drifted closer to benchmark weights as the quarter progressed due to our expectation of an increasingly volatile market and a continued divergence in the relative strength of global growth rates.

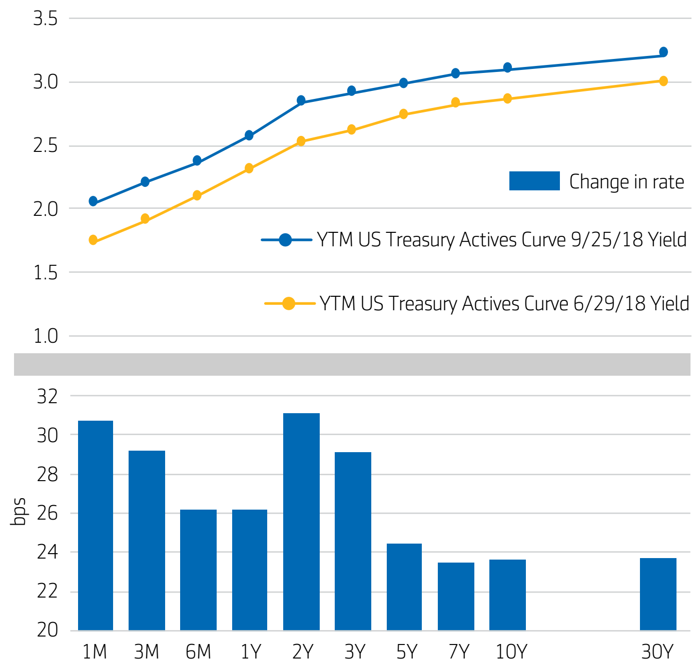
Third quarter markets saw a lot of action. The US dollar moved up sharply through mid-August only to be followed by a return to levels near where it opened the quarter (Exhibit 1). Emerging markets experienced increased volatility as events in Argentina and Turkey created concern but then stabilized as markets deemed these to be idiosyncratic moves. Exhibit 2 shows the fluctuations in US Treasury rates, but all within a 20-30 basis points range across the curve. Then, of course, there were the US equity markets, which reached new all-time highs (Exhibit 3). During all of this, US credit markets continued to grind tighter with investment grade and high yield credit generating positive excess returns.

Exhibit 1: US dollar, third quarter 2018



Source: Bloomberg

Exhibit 2: US Treasury yield curve



Source: Bloomberg

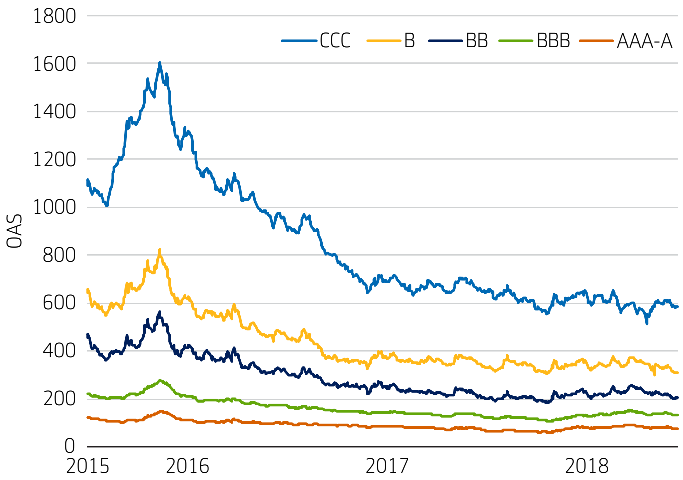
Exhibit 3: S&P 500 Index returns, third quarter 2018

Source: Bloomberg

Looking ahead

Our preference for credit risk relative to rate risk is a view we have held throughout the year. Our gradual move upward in credit quality continues as the ongoing rally in lower quality credit (Exhibit 4) makes the risk-return trade-off incrementally less compelling. Additionally, as we look at the upward movement in US Treasury rates in context of our outlook for the economy and rates, we think we are closer to the top end of the near-term range. This makes us less concerned about taking on the duration risk of a higher quality asset classes like investment grade credit.

Exhibit 4: US Corporate OAS by rating
(10/1/15 – 9/25/18)



Source: Bloomberg

Fundamentals remain sound with strong growth in earnings and cash flow. We have seen some deterioration on the margin as companies add leverage to grow business both organically and inorganically. Relatedly, the rating agencies are allowing some latitude to deviate from historical leverage targets giving companies time to work their way back to proscribed levels of debt. Given the strength of the overall economic environment, the rating agencies have been willing to provide fairly lenient timelines to work back to appropriate financial metrics. The leveraged loan market is also seeing signs of aggressive behavior as borrowers are pressing for increasingly generous terms and reduced covenant packages. It is too early to pass judgement on the full impact, but these types of activity could be sowing the seeds for future stress when the market turns.

The other factor that supports our willingness to stay overweight credit is the technical picture. The absolute yields in investment grade continue to attract investors, enabling the asset class to digest a heavy new issuance calendar. Meanwhile, the high yield net supply picture remains favorable and is expected to be negative for the fourth year in a row. When combined with relatively stable inflows the technical picture is attractive.

From a valuation perspective, we believe credit valuations are moderately rich but that spreads should hold reasonably well leading to an environment that favors carry. Credit curves are also relatively flat and we prefer to stay on the short-to-intermediate end of the curve since we don't believe investors are being adequately compensated to extend.

We see opportunities to pick up spread in private label structured products where fundamentals and technicals for most sectors remain supportive of a positive outlook on spreads. Similar to credit, given the lack of incremental yield to take on additional risk, we favor an up-in-quality strategy. Structured securities generally have retained their underwriting discipline to this point in the cycle and we view it as an attractive area to pick up high-quality assets and, if we see periods of volatility, we would look to add exposure.

In short, while drifting upward in credit quality, we generally view the environment as a carry trade in credit and structured. We believe that the best opportunities to add alpha in this environment can be provided through the identification of attractive idiosyncratic opportunities in these markets.

Risks to our 4Q credit outlook

Market optimism getting ahead of itself. This has occurred modestly on the economic front as global economic expectations have had to recalibrate as growth rates have slowed in many countries outside the US. While we are positive on third quarter data to be reported, the last few months of the year could see fourth quarter data start to soften. Headwinds like the rising dollar, rising interest rates, growing cost pressures, slowing global growth, and the impact from tariffs could flow through and hurt US companies earnings and, eventually, overall US growth.

Concern that the Federal Reserve (Fed) becomes too active, stifling growth and the business cycle. This remains a risk, but we do not think this reaches an inflection point until perhaps the Fed increases rates by another 50 to 75 basis points.

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. There have been a few signs of late-cycle behavior like the Comcast bid for Sky, more aggressive covenant packages on select leveraged loan issuance, and rating agencies providing increased leeway to companies that need to rebuild their credit profile following a leveraging event.

Volatility pushes through to credit spreads. This has occurred outside of the US credit markets, most notably in 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 are experiencing decelerating growth rates. While this trend has paused in the late third quarter, we continue to view this as a risk as the year progresses.

Political turmoil stagnating the US business-friendly agenda. The political turmoil has continued with trade and tariff news flow taking center stage. This has not had a material effect on the credit markets but we continue to monitor potential impacts. Additionally, should midterm elections give the Democratic Party control of the Senate or House, this could constrain the ability of the Trump administration to actively implement its business-friendly agenda.

Our preferences

We continue to favor credit risk relative to rate risk and maintain a balanced view toward investment grade credit and high yield credit. We also prefer US exposures in the credit and structured asset classes. As a result of the third quarter beginning a shift from optimistic expectations to more subdued expectations, we continue to stay closer to neutral in terms of risk.

We believe the fourth quarter will be a continuation of a multi-quarter period of transition from the globally-synchronized global growth to a more dynamic environment. In our view, this will create increased dispersion in performance and the best opportunity to add alpha will come through identifying idiosyncratic opportunities in credit and structured asset classes.