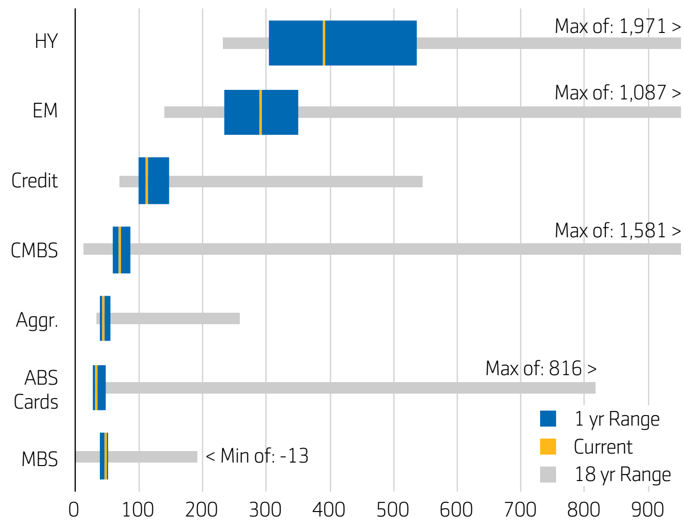
2Q 2019 CREDIT STRATEGY THEMES

By Garry Creed, CFA, Chief Credit Strategist

1Q 2019 in review

As we entered the year, we urged patience and sticking through whatever volatility the market sent our way. The Fed's pivot to a more dovish stance during the quarter was cheered by the markets with a sharp bounce in risk assets as well as US Treasuries. This was also accompanied by a softer political tone as progress was made on many of the market's big picture concerns—namely, trade and tariffs—while Brexit uncertainty remains. It also reduced investor uncertainty, which helped bring down volatility levels and lead Treasury yields even lower. Throughout the current business cycle, we have repeatedly seen the credit markets react favorably to a less restrictive Fed. We believe that this most recent Fed meeting moved the markets toward a turning point between where a more accommodative Fed can support strengthening and extending the cycle, to a point where the economic and business cycle outlook becomes weak enough that market participants become increasingly concerned that it needs Fed stimulus to sustain it. We are now dancing on that fine line, although market views on a near-term recession appear to be overdone.

Exhibit 1: Asset class option-adjusted spread



Source: Barclays Capital Indices, Barclays Live. As of date 3/29/19.

Concerns remain

Softening US economic growth. It is still our belief that the US economic environment has reached an inflection point as confirmed by the dovish pivot made by the Fed. After over two years of accelerating quarterly US GDP growth rates, we expect the US economic growth rate to slow in upcoming quarters. This slowdown will increase the veracity 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 through at least late 2020, though the risk of a late 2020 roll-over is gradually increasing. The Fed has come to the realization that additional hikes will likely be viewed as a policy mistake, and has expressed a view toward continued patience. The markets have also flattened/inverted certain parts of the yield curve, which has historically been a leading indicator of a recession. For example, the 10-year/2-year Treasury yield curve was at a positive 14 basis points on March 31, 2019—down from 20 basis points at the start of the year. The combination of this transition in the economic outlook and the uncertainty created by an increasingly concerned central bank, lead us to believe that markets will recalibrate risk premiums over upcoming quarters as we await additional data confirming whether concerns over weakening US growth are overdone. As I mentioned, other parts of the yield curve have inverted, which would historically be a leading indicator of a recessionary environment, although the timing of the recession has historically been multiple quarters or years after an inversion. This would not be inconsistent with our view toward no near-term recession. For additional insight on our thoughts of the implications of an inverted yield curve, you can read our piece here.

Decelerating corporate profit growth. Corporate profit growth reached an inflection point in late 2018 when we saw a slowing rate of change in quarterly corporate profit growth on a year-over-year basis. The combination of slowing economic growth and the more difficult comps resulting from strong tax reform in 2018 are key drivers in 2018. Additionally, we believe that fundamentals will also start to see pressure as companies compete harder to secure their share of the less rapidly growing economy, which will make it more difficult to sustain peak margins for the cycle. Exhibit 2 shows that expectations are for an 8.1% growth rate, down significantly from the 26% in 2018. The key question during the upcoming earnings season is whether investors have fully discounted the severity of this slowing. Full year estimates are back-end loaded and the risk of further downward adjustments remains. We think the deceleration in the earnings growth rate will impact investment grade companies more than high yield companies since they benefitted more from tax reform by nature of having more positive net income.

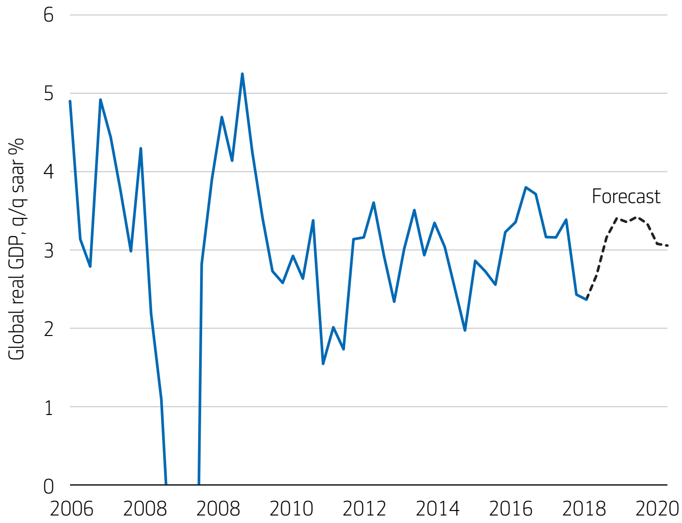
Exhibit 2: S&P earnings estimates

	2018	% Change	2019 (E)	% Change
S&P 500	**$156.89**	**26.0%**	**$169.61**	**8.1%**
Communication Services	$11.78	15.7%	$8.88	-24.6%
Consumer Staples	$29.59	8.3%	$30.92	4.5%
Consumer Discretionary	$40.02	13.6%	$43.12	7.7%
Energy	$28.98	118.1%	$28.22	-2.6%
Financials	$35.43	33.2%	$37.72	6.5%
Health Care	$52.93	17.4%	$67.45	27.4%
Industrials	$37.55	24.0%	$39.98	6.5%
Basic Materials	$22.02	28.2%	$22.91	4.0%
Real Estate	$5.89	5.2%	$5.09	-13.6%
Technology	$65.71	29.9%	$70.05	6.6%
Utilities	$15.88	9.3%	$16.68	5.0%

Source: Bloomberg. As of March 31, 2019.

Global economic growth remains under pressure but may be easing. European growth continues to be soft; Japan is not showing signs of strength; and while China has been attempting to stimulate their economy, it has yet to take hold. This broad economic softness combined with a less robust US growth outlook is going to make it difficult for the global economy to resume a favorable trajectory without additional stimulus. Resolution of some of the key trade and tariff conflicts could provide a boost to sentiment, but an observable turnaround in actual growth will need longer to take hold. If the Chinese stimulus takes hold as anticipated as the year progresses, this would likely be the catalyst for stabilization in the European industrial economy. The combination of these two regions stabilizing would stem the tide in global growth slowing, and potentially leading to improvement as we move past 2019 (Exhibit 3).

Exhibit 3: Global GDP growth set to improve imminently



Source: Credit Suisse, Thomson Reuters, Datastream.

Outlook

We retain our view of positive returns for most credit asset classes for the full year, though most of that performance may have already been generated during the first quarter. We do not expect a significant pick up in the default cycle in 2019, and do not anticipate a recession through 2020—though late 2020 recession risk is growing. We also remain alert on credit fundamentals with an anticipated slowdown in earnings growth whether certain companies, especially BBB corporates, can sustain their somewhat stretched credit profiles as growth slows. Our current base case is that we will not see a wave of BBB downgrades in the near-term, though as the cycle continues to soften, this risk increases in 2020 and 2021. The combination of the rally in risk assets and what we believe will be ongoing uncertainty related to the outlook for the US business cycle leads us to use this latest round of market strength to continue marginally reducing risk to earnings disappointments in our credit portfolios. We are also shifting our view away from a US-centric preference toward a more balanced global view on positioning as the divergence between accelerating US growth and decelerating global growth starts to reverse course. This should also lead to a more stable or even softening US dollar.

Given our view that much of the return for the remainder of 2019 will come from coupon as opposed to spread tightening, we remain neutral on high yield credit and the leveraged loan market, while we are slightly cautious about investment grade credit, and we continue to prefer higher quality structured asset positions.

High yield. We believe that high yield will benefit from the ongoing search for yield, support from stronger oil prices, and the reduced risk of a Fed policy mistake triggering a near-term recession. We believe the single-B space looks cheap as shown in Exhibit 4. Our focus remains on idiosyncratic security selection within high yield. For example, even though we are seeing strength in oil prices, we will be very selective in the energy sector names we favor. Additionally, we will avoid companies with secular problems like certain parts of the communications space.

Exhibit 4. Single B's look cheap compared to BB's on a five-year basis

Source: Barclays Live. As of April 2019.

Investment grade. While current technicals remain strong, the stabilizing global growth picture could reduce demand for the investment grade asset class as other countries become more attractive. There is also the higher risk of earnings pressure to consider. Within investment grade, we continue to find opportunities within As and BBBs, with a keen focus on bottom-up research driving our security selection. Yes, there are longer-term concerns over the BBB space, but we believe there are still opportunities there. While we are somewhat cautious of investment grade as a whole, we do not advocate making a significant upgrade trade out of BBB's at this point as valuations still provide some relative value.

Securitized. Securitized assets continue to benefit from disciplined underwriting, and fundamentals within most sectors remain healthy. Sentiment has remained somewhat favorable even in light of trade tensions and politics uncertainty. Supply and demand remain in reasonably good shape providing a solid technical backdrop. While valuations are expected to be range-bound, we anticipate the asset class should provide relatively stable performance during any bouts of volatility.

Disclosure