Asset Management

3Q 2019 CREDIT STRATEGY THEMES

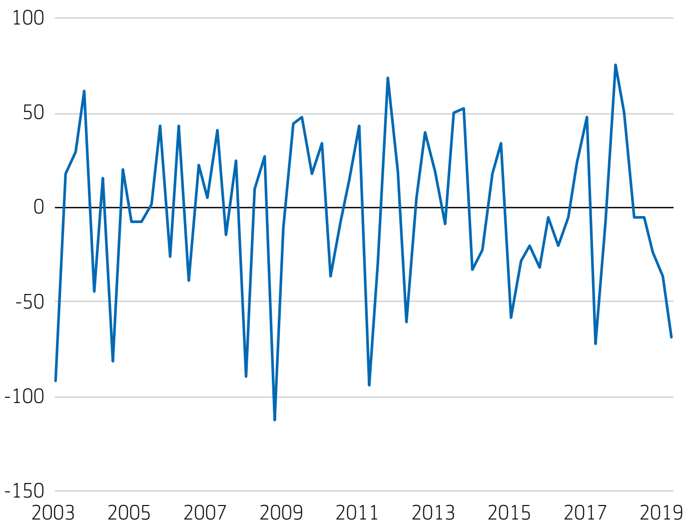
By Garry Creed, CFA, Chief Credit Strategist

Our third quarter outlook strikes a balance between the continued pivot toward easing central bank policies around the globe and the ongoing search for yield, with concerns about softer underlying company earnings, continued deterioration on economic fundamentals, and ongoing global uncertainties. This is not a call for an impending recession or default cycle, but rather a recalibration of risk pricing within the continued extension of the current business cycle. The strength of technicals from moderating supply, as well as the ongoing demand created by the search for yield amid expectations for aggressive central bank easing, keep us from taking a more cautious approach—especially when spreads have some room to improve within the context of longer term ranges. However, there are concerns on the horizon, which give us pause and lead to our caution for the coming quarter.

The US central bank's ability to engineer a soft landing

The key question is whether the US Federal Reserve can be effective in its ability to mitigate deterioration caused by the increasingly uncertain effects of trade wars and a softening economy. The dovish US central bank appears to be headed down the path towards cutting rates during the third quarter. Recent economic data continues to show a decidedly negative trend and the Citi Economic Surprise Index is at its lowest level in two years (Exhibit 1). Business activity is likely to remain subdued given the uncertainty surrounding the administration's ongoing negotiations with major trading partners related to trade and tariffs, particularly against difficult comps spurred by last year's tax cuts. This should provide an environment where the central bank can use this cover of softer data to cut rates to help compensate for the economic uncertainty created by trade and tariff negotiations. The market is currently trading as if it has confidence that the Fed, through these rate cuts, can provide a soft landing. While we agree that these cuts can help offset some of the uncertainties, we are less certain of its ability to engineer a smooth path on the return to stronger economic growth.

Exhibit 1: The Citi Economic Surprise Index

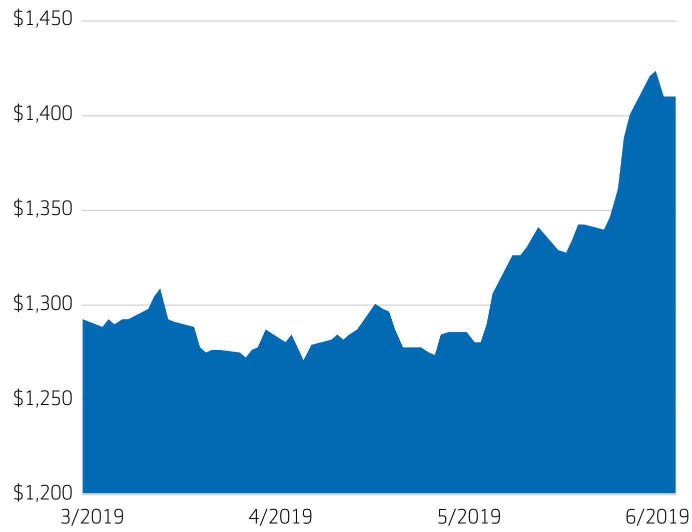


Source: Bloomberg, as of June 28, 2019.

The underlying defensive rotation in equities

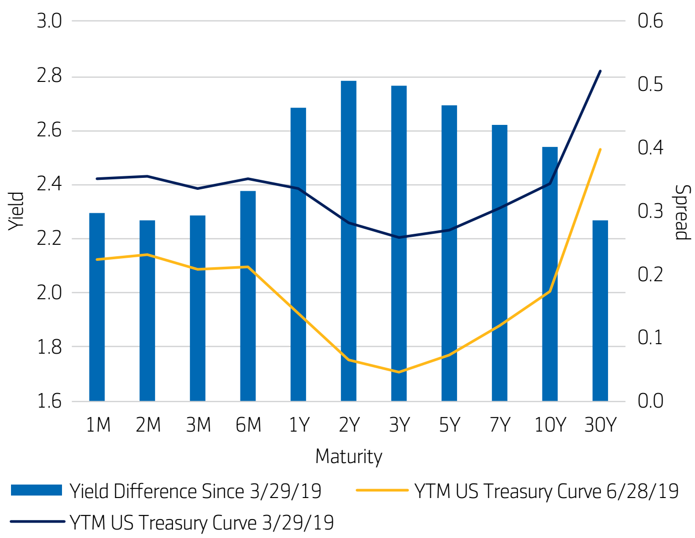
Underneath the rally in risk assets, particularly within equities, we have seen a rotation to more defensive sectors like utilities and REITs as well as a broader rally in other lower risk assets like US Treasurys, investment grade credit and gold. This indicates that while investors are willing to take risk as the central bank eases, they are not ready to move to an aggressive risk on position in anticipation of a recovery. They are in effect hedging their bets, and we think their caution is warranted. One way to see this is to look at the style factor performance where we have seen the equities of low debt, low beta companies outperform during the quarter. Another way is to look at the decline in US Treasury yields and the sharp recent upward move in gold (Exhibits 2 and 3).

Exhibit 2: Gold returns, second quarter 2019



Source: Bloomberg, as of June 28, 2019.

Exhibit 3: US Treasury returns, second quarter 2019



Source: Bloomberg, as of June 28, 2019.

Earnings complacency and earnings recession

Heading into second quarter's earnings season, we think the softness from the first quarter will continue and likely accelerate. During the first quarter, companies managed to eke out a modestly positive year-over-year growth rate and beat estimates that had been significantly reduced coming in at a mere positive 1.37% rate of EPS growth for the quarter (albeit better than the estimates for a decline). Because first quarter results were better than reduced expectations, we think investors are somewhat complacent heading into this earnings season. According to a recent Bloomberg article,[1] 82% of companies that have revised their profit data have cut estimates. We believe that we could see an earnings recession in second and third quarters with negative rates of growth. Granted, much of this decline is due to the extremely strong results and difficult comps in the prior year when tax cuts stimulated results.

Rising political uncertainty and conflict

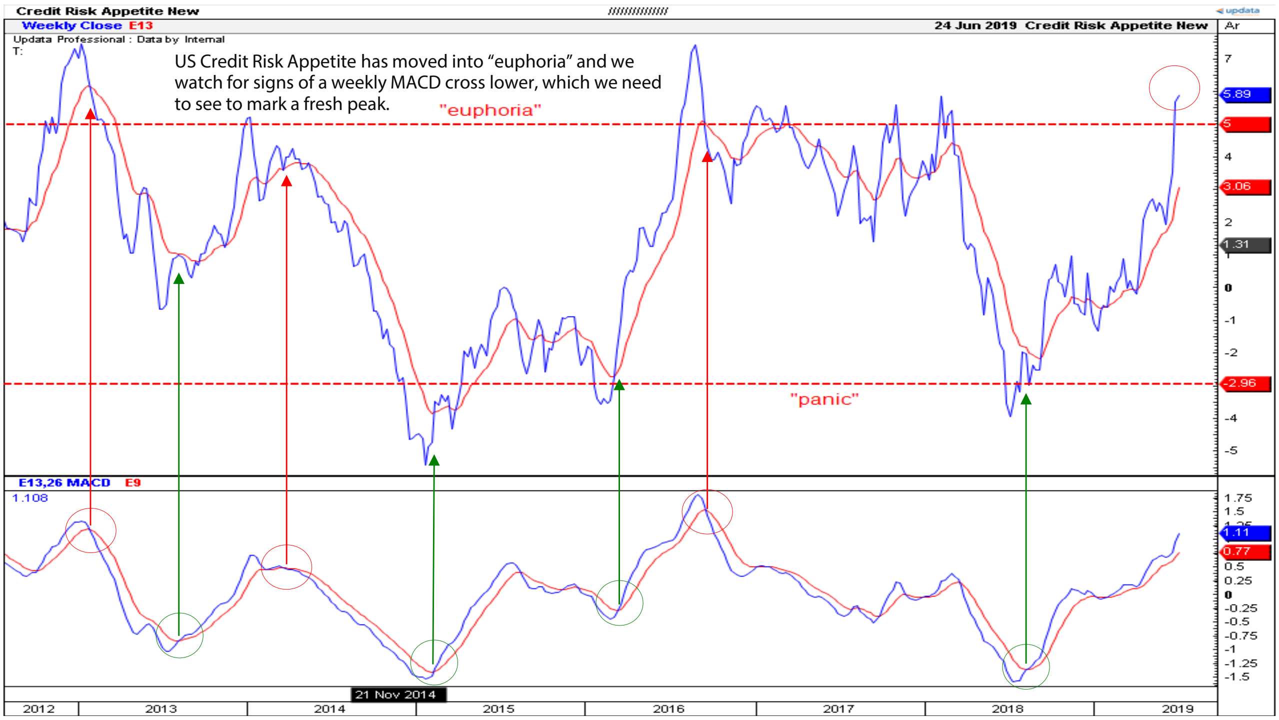
The on again/off again trade discussions with China, and the uncertainty surrounding the addition and removal of tariffs is making it challenging for companies to execute on their business plans. This is said to be affecting expansion plans, capital spending decisions, and overall business confidence. In addition, the ebb and flow of the countries included in these various unilateral trade discussions is creating challenges for companies around the globe to manage their global supply chains and spending plans. We expect this uncertainty to continue to manifest itself in softening economic data, weakening underlying earnings trends, and increased market volatility. We have also seen continued strain in the UK where Prime Minister May resigned following her inability to execute an acceptable path toward Brexit, and increased tension with Iran related to nuclear development activity.

[1]Ponczek, Sarah. "Grim Earnings Forecasts are Getting Worse by the Week." Bloomberg. July 2019.

Overdone risk appetite

According to Exhibit 4, credit risk appetite has moved into “euphoria” which suggests limited additional support from future increases in credit risk appetite. However, given that credit asset classes are trading outside of their tights, we think there is still room for incremental tightening before investors look to aggressively reverse their positions.

Exhibit 4: US credit risk appetite moves into “euphoria”



Source: Multi Asset Macro Pack, Key Market Themes dated June 26, 2019 by Technical Analysis Team of Investment Solutions & Products Department of Credit Suisse. ©2019 Credit Suisse. Reprinted with the permission of Credit Suisse.

Summary

In review, global estimates for economic growth have continued their downward slide. This has been met with a more synchronized move toward central bank policy easing globally and over the past few months, the Fed has continued an increasingly dovish pivot as the US growth outlook becomes more uncertain. Recent history indicates that typically when the Fed has ended a tightening cycle, asset markets have reacted favorably. Central bank policy has overwhelmed economic fundamentals as stock indexes are approaching all-time highs while yields and spreads continue to decline.

We believe that the combination of this policy shift with the ongoing global search for yield has created a situation where the market has gotten ahead of itself. We now think that the risks to credit assets outweigh the potential reward. We see value in a modestly more defensive tactical position within credit assets with a view toward a repricing of risk. This includes retaining our favorable positioning towards more defensive securitized assets, followed by a neutral-to-modestly cautious position in investment grade credit and moving to a modestly, slightly more cautious position in high yield. The downward trajectory in rates and associated performance risks for leveraged loans due to their floating rate nature keep us cautious on loans as well. This is not a call on the end of the credit cycle or an anticipated spike in defaults, but rather, a view that a number of pending catalysts will serve to trigger a repricing of credit risk in the near-to-intermediate term.

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