U.S. Investment Grade Credit Investor Update

3rd Quarter 2017

Market Review

Despite a bout of pronounced weakening midway through, investment grade credit spreads tightened once again during the third quarter. This makes eight quarters in a row of positive excess return – a winning streak that has only been surpassed once in the last 20 years. The option-adjusted spread on the Bloomberg Barclays Corporate Bond Index tightened 8 basis points (bps) to 101 over the three-month period ending September 30, 2017. This compares to 123 bps at the beginning of the year, and 138 bps at the end of 3Q2016. In the U.S. Treasury market, the benchmark 10-year yield increased from 2.301% to 2.326%, after having traded as high as 2.392% and as low as 2.060% during the quarter.

In what has become a familiar pattern, investment grade credit continued to rally during July as record-setting inflows combined with a supportive macro backdrop. Economic growth remained steady, corporate earnings came in strong, and the persistent lack of inflation pressures continued. During August, however, issuers began to front-load debt offerings to avoid the risk of higher interest rates later in the year. As a result, the investment grade market struggled to absorb the rapid increase in supply. This initial period of spread weakness was exacerbated by a sharp drop in Treasury yields resulting from escalating tension between the U.S. and North Korea, increased doubts as to the ultimate success of the Trump agenda -- as well as by uncertainty as to the impact of hurricanes Harvey and Irma. Credit spreads grew wider, causing new issue supply to slow dramatically. But as we have seen several times earlier this year, fears died down, and the seemingly overwhelming demand dynamic once again became evident. By quarter-end the investment grade market (helped by the dramatic reversal in Treasury yields) had more than retraced the widening.

There are a couple of other aspects of the investment credit market's behavior this quarter that should be noted. First, improved sentiment regarding commodity markets continued to provide a tailwind to spreads during the quarter. We expect this trend to continue, but recognize that should the market reverse its positive view of the energy and metals & mining sectors, a significant support for credit spreads would fade. Another point worth mentioning was the adverse impact of the sharp rally in Treasury rates. As rates dropped mid-quarter, and the Treasury curve flattened, the long-end of the credit market underperformed. One of the underpinnings of our constructive view of the investment grade corporate credit market has been our belief that long-end spreads are cheap vs. the rest of the curve, and that a shift toward higher Treasury yields will likely lead to increased demand for longer maturity corporate bonds – since all-in-yields may become more attractive for asset/liability-matched institutional buyers (such as insurance companies and pension funds). But this quarter's temporary weakness highlights that Treasury yields are close to being sufficiently low, and the Treasury curve close to being sufficiently flat, that credit spreads may once again widen and steepen should we experience a repeat of the sharp mid-quarter rally in Treasuries.

Outlook and Strategy

Looking forward, we continue to be broadly constructive on the investment grade corporate credit market, but with several caveats. We maintain a constructive view about economic growth and corporate earnings, and while we anticipate an increase in inflation pressures, we anticipate this to occur gradually. Additionally, while we expect a detrimental impact on the Treasury and Mortgage-Backed markets from the Federal Reserve (Fed) beginning to unwind quantitative easing (QE), we believe the impact will begin to take shape with a several-month lag. In other words, we anticipate an orderly increase in interest rates over the near-term, which is unlikely to prompt significant outflows from U.S. investment grade credit, and which may, at the longer-maturity part of the curve, prompt better buying. Not surprisingly, there are risks to this positive-credit-spreads, negative-Treasury-prices view.

From a fundamental standpoint, while the current economic expansion is getting long in the tooth, we do not foresee a near-term, dramatic deterioration in corporate profits or a resultant increase in concerns that companies will be able to service their debt. Despite the rapid increase in corporate indebtedness, interest coverage ratios have started to improve somewhat. Valuations, however, are approaching their post-credit crisis tights – leaving less room for error in a period of "risk-off". Finally, from a supply/demand perspective we continue to believe that the biggest risk to continued demand for U.S. investment grade credit is an increase in foreign inflation that leads to a more rapid withdrawal of foreign central bank monetary stimulus and QE. This would in turn likely lead to increases in overseas yields, thereby providing the steady foreign buyers of U.S. investment grade credit attractive domestic alternatives. While foreign rates of inflation have yet to accelerate, the current period of global synchronized growth means that this risk bears close watching.

From an interest rate perspective, we believe it all comes down to inflation. In addition to an ebbing of geopolitical concerns and renewed optimism on tax reform, the reversal back toward higher yields in the Treasury market was significantly helped by the August CPI report beating estimates, and thus breaking the string of five straight monthly inflation misses. This is one factor behind the market pricing in a high probability of a rate hike at the December Federal Open Market Committee (FOMC) meeting. Nevertheless, unless and until the data confirm that inflation is indeed finally trending upward, the more dovish members of the FOMC will continue to express doubts about the likely path of interest rate increases – thereby providing support for lower Treasury yields.

Conversely, the market cannot ignore the risk that inflation, possibly through wage pressures resulting from increasingly tight labor markets, may begin to behave more in line with what the FOMC has been expecting – and with a magnitude that may cause concern that the Fed has gotten behind the curve. Such periods have in the past resulted in significant market disruption as the market is forced to quickly reprice a much more aggressive path of interest rate increases. Examples would include the 2013 "Taper Tantrum" or the Fed's catching the market by surprise with its February 1994 rate increase.

Finally, an additional factor that cannot be overemphasized is that any discussion of U.S. monetary policy is even more speculative than normal given the upcoming end of Janet Yellen's term as Federal Reserve Chair. Depending upon who President Trump chooses, be it reappointing Yellen or naming a replacement, the market may be faced with adjusting to the post-QE reality against the backdrop of a significantly different Fed reaction function. As a result, we anticipate that we may position more defensively both in terms of credit exposure, as well as duration, over the upcoming quarter.

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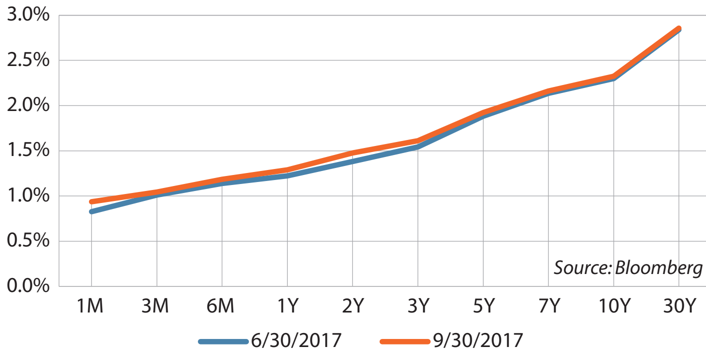
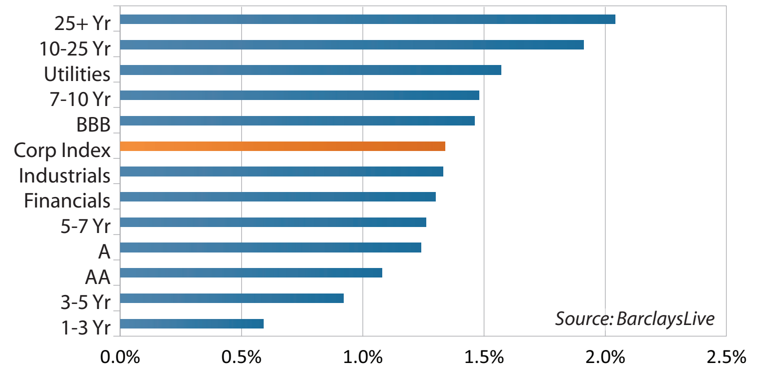
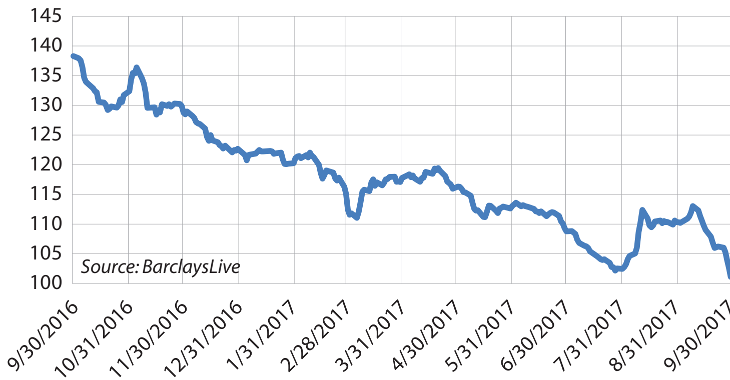
U.S. Treasury Curve



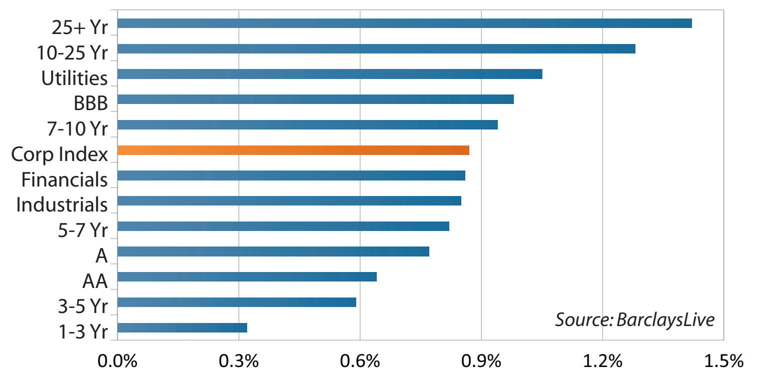
Bloomberg Barclays U.S. Corporate Index Segments 3Q 2017 Total Return*



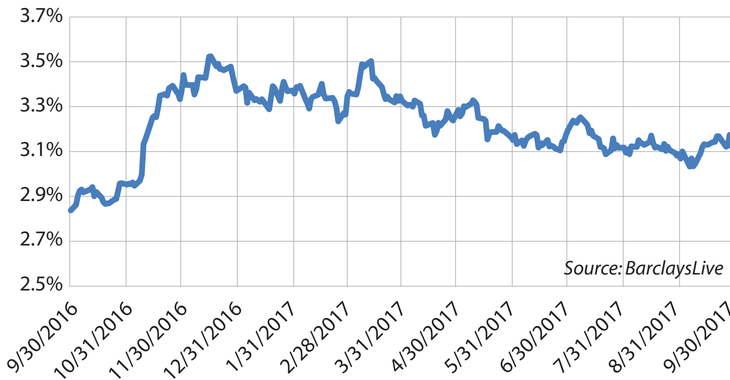
Bloomberg Barclays U.S. Corporate Index: Option-Adjusted Spread[1]



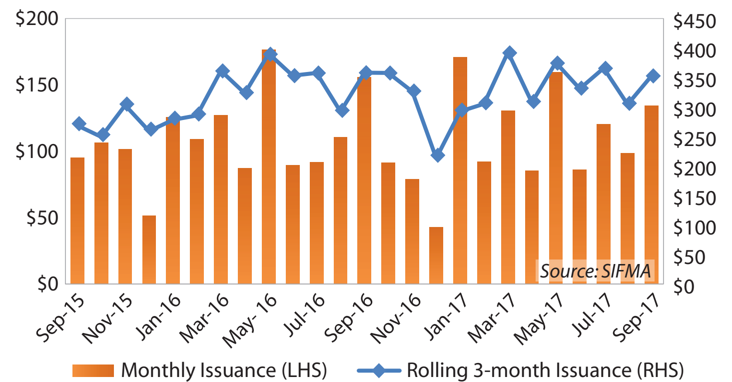
Bloomberg Barclays U.S. Corporate Index Segments 3Q 2017 Excess Return*



Bloomberg Barclays U.S. Corporate Index: Yield to Worst*



Investment Grade Corporate Bond Issuance *(billions)*



[1] *Option-adjusted spread is the spread relative to a risk-free interest rate, usually measured in basis points (bp), that equates the theoretical present value of a series of uncertain cash flows of an instrument to its current market price. OAS can be viewed as the compensation an investor receives for assuming a variety of risks (e.g. liquidity premium, default risk, model risk), net of the cost of any embedded options. A larger OAS implies a greater return for greater risks.*

***Definitions**

Bloomberg Barclays U.S. Corporate Investment-Grade Index - Measures the performance of investment grade U.S. corporate bonds. The index includes all publicly issued, dollar-denominated corporate bonds with a minimum of $250 million par outstanding that are investment grade-rated (Baa3/BBB- or higher). The index excludes bonds having less than one year to final maturity as well as floating rate bonds, non-registered private placements, structured notes, hybrids, and convertible securities.

Credit Spread - The yield spread, or difference in yield between different securities, due to different credit quality. The credit spread reflects the additional net yield an investor can earn from a security with more credit risk relative to one with less credit risk. The credit spread of a particular security is often quoted in relation to the yield on a credit risk-free benchmark security or reference rate, typically either U.S. Treasury bonds or LIBOR.

Yield to Worst - The lowest possible yield on a bond that may be called in the future. This metric is used to give an investor a worst-case scenario (short of a default by the issuer) when purchasing a bond. By using the yield to worst metric, bond investors get a more realistic view of a callable bond's yield.

Excess Return - Return rate on an investment relative to the return rate on risk free investment, for example the excess return for a corporate bond relative to a like-maturity U.S. Treasury. The excess return of an investment may exceed its total return.

Total Return - The overall return on a bond that includes both the excess return as well as the return from the like-maturity risk-free bond (such as a U.S. Treasury).