U.S. Investment Grade Credit Investor Update

1st Quarter 2017

Market Review

Investment grade credit spreads improved during the first quarter of 2017, with the option-adjusted spread on the Bloomberg Barclays Corporate Bond Index tightening 5 basis points (bps) to 118 over the three-month period ending March 31, 2017. This compares to 163 bps at the end of 1Q2016. Significantly, however, credit spreads widened in March after tightening during both January and February. Moreover, the eight-month credit spread compression trend came to an end during March as crossover credits (which still have a non-investment grade rating from one of the three major rating agencies) underperformed higher-rated credits for the first time since June 2016. U.S. Treasury performance was likewise muted, with the yield on the benchmark 10-year Treasury falling from 2.445% to 2.388% during the quarter.

While sentiment toward corporate credit fundamentals remained positive during the quarter, other headwinds worked against credit spreads and caused U.S. Treasury yields to fall: a Federal Reserve that aggressively prepared the market for a March tightening in a very narrow timeframe, weakness in oil prices, and increasing doubts about the ability of the Trump administration to rapidly accomplish its objectives of deregulation, fiscal stimulus, and tax reform. The financial market's overly optimistic expectations regarding both the timing and ultimate likelihood of enactment of the Republican agenda was starkly highlighted by the failure of the vote to repeal and replace Obamacare in late March.

The quarter was significant from a supply/demand perspective as well. While robust new issue supply set a new 1Q record, it was absorbed surprisingly well as inflows to investment grade mutual funds and ETFs were pronounced. While a portion of the positive sentiment toward high grade fixed income (as evidenced by strong inflows) may reflect a degree of uncertainty about equity valuations following the rapid post-election rally, a more important factor is likely the more skeptical view as to the odds of the U.S. economy upshifting into a new period of significantly higher growth. While this sentiment seems broadly accurate in our opinion, it is not without risk – as well as opportunity.

Outlook and Strategy

Over the near term, the ongoing challenges of low labor force participation rates and anemic productivity growth suggest that the recent, more sober assessment of the chances for U.S. growth to rapidly accelerate seems much more appropriate than some of the euphoria following last fall's U.S. presidential election. As such, credit fundamentals should be supported by improved corporate earnings against a backdrop of steady, albeit unremarkable, economic growth. The recent gap between strong sentiment-based economic measures and more subdued "hard" economic data should, in other words, end up meeting somewhere in the middle. This should be constructive for credit spreads -- both in terms of fundamentals, as well as in terms of supply/demand technicals. The risk to this positive scenario, therefore, is less likely to be from the growth side than from the inflation side – and so inflation measures, especially those involving wage pressures, should increasingly be the focus of market attention, in contrast to the primary focus on employment for the past several years.

In terms of valuations, the spread decompression witnessed in March is likely to be a harbinger of what is to come. Absent an inflation-induced selloff resulting in sharp outflows, the current level of investment grade credit spreads suggest that further moves will be more "bottom-up", sum-of-the-parts moves than "top-down" credit spread market beta driven. For example, money-center bank spreads will likely be primarily impacted by the outlook for a rollback in financial regulation, higher interest rates, and a steeper yield curve. These factors will likely have much less impact on spreads in the energy sector, to use another example, where focus will be on whether OPEC extends their production cuts when they meet later this year, and on possible disruptions in Libyan production, in our view. While focus on such micro-factors might sound obvious, they have, in fact, taken a back seat to more macro-based beta drivers since the middle of last year. As such, seeking to benefit from such sector and issuer cross-currents will be one of our primary areas of focus over the next quarter.

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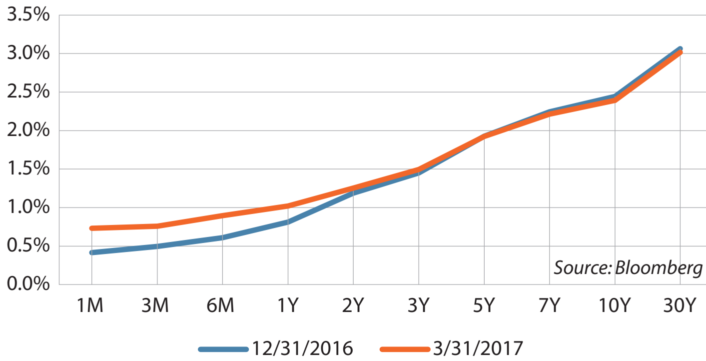
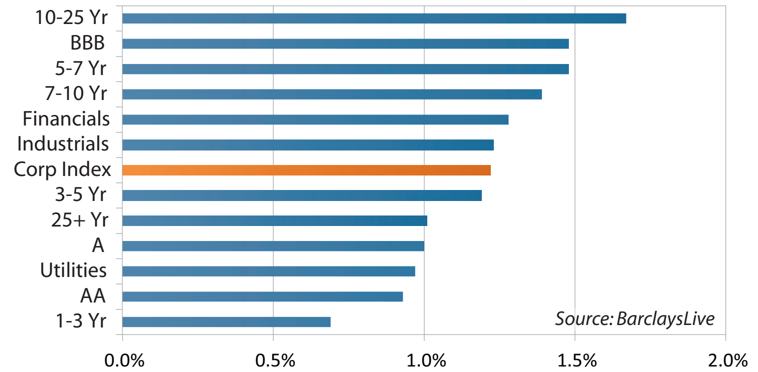
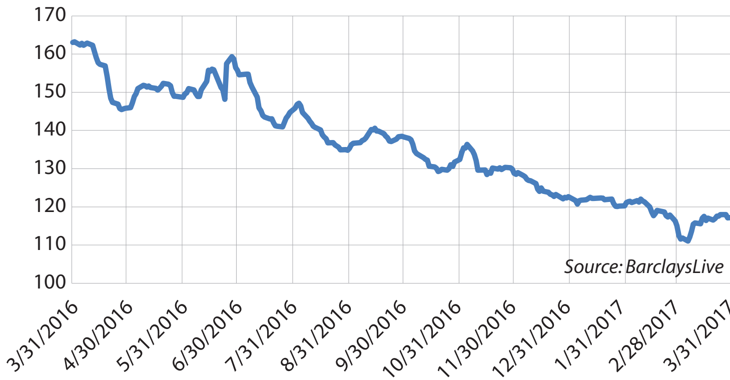
U.S. Treasury Curve



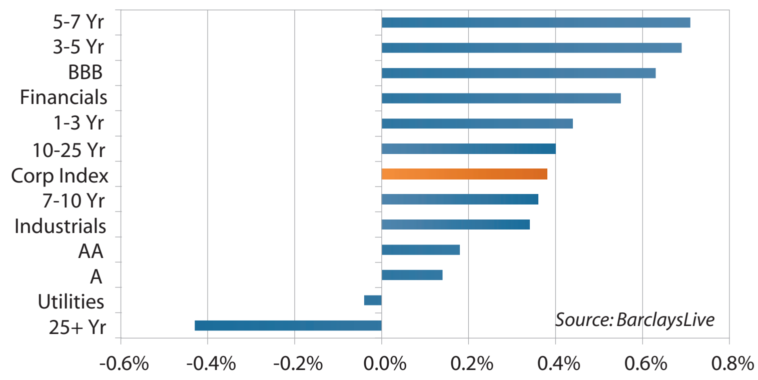
Bloomberg Barclays U.S. Corporate Index Segments 1Q 2017 Total Return* *(12/31/16 to 3/31/17)*



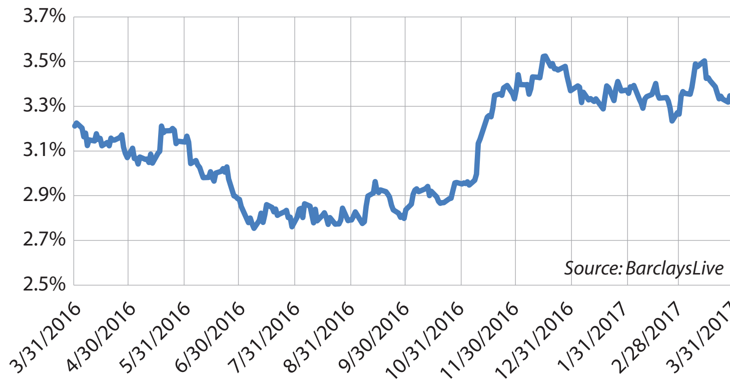
Bloomberg Barclays U.S. Corporate Index: Option-Adjusted Spread[1]



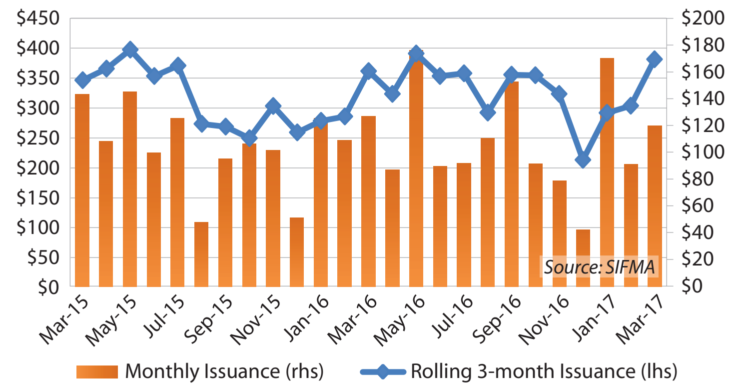
Bloomberg Barclays U.S. Corporate Index Segments 1Q 2017 Excess Return* *(12/31/16 to 3/31/17)*



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.*

[2] *Interest coverage ratio is a company's pretax operating income or cash flow divided by its interest obligations for a given period.*

***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).

Yuan-Peg - China's currency is not freely tradeable, but is instead managed by the government through being fixed, or "pegged", to the U.S. dollar.