U.S. Investment Grade Credit Investor Update

2nd Quarter 2017

Market Review

Investment grade credit spreads recovered from their March widening, improving each month during the second quarter of 2017. The option-adjusted spread on the Bloomberg Barclays Corporate Bond Index tightened 9 basis points (bps) to 109 over the three-month period ending June 30, 2017. This compares to 123 bps at the beginning of the year, and 156 bps at the end of the second quarter of 2016. The trend of lower credit quality issues outperforming higher credit quality issues resumed after pausing in March, with crossover credits (which still have a non-investment grade rating from one of the three major rating agencies) performing the best, while Aa+ credits performed the worst during each of the past three months. In the U.S. Treasury market, the yield on the benchmark 10-year Treasury declined from 2.388% to 2.305%, after having traded as high as 2.415% and as low as 2.126% during the quarter. Two sharp intra-month declines in yields were not able to hold against the backdrop of a market-friendly outcome in the French Presidential election, solid first quarter earnings, and increasingly hawkish global central bank posturing with regards to removing quantitative easing (QE).

Nonetheless, while investment grade credit spreads improved in aggregate, the dispersion across different sectors that contributed to March's spread hiccup accelerated during the second quarter. Continued oil price weakness caused energy issuer spreads to take another leg wider, while issues from the retail and supermarkets industries continued to struggle – first from disappointing earnings and then later in the quarter from Amazon's announcement of their planned acquisition of Whole Foods Markets. Conversely, sectors such as healthcare and pharmaceuticals saw credit spreads rally as fears regarding the potential for repealing the Affordable Care Act (ACA) and for sharply lower drug prices began to fade.

One of the reasons supporting our positive view on credit spreads has been the continued steepness of 10-yr/30-yr credit spread curves. We have believed that this value would ultimately be recognized by the market, and this is exactly what happened during the second quarter as the 25+ yr and 10-25 yr maturities strongly outperformed.

In looking back over the quarter, solid corporate earnings, decent global growth, along with tame inflation should have (and did) result in higher equities markets, tighter credit spreads, and lower interest rates. The question of whether this pattern can be expected to repeat, however, is of course much less straightforward. Consider, for example, that investment grade issues have now experienced seven consecutive quarters of positive excess return – a winning streak that has only been surpassed once in the last 20 years.

Outlook and Strategy

One of the major themes coming into this year was trying to anticipate how buoyant "soft" economic data (e.g., survey- and sentiment-based) would reconcile with much more muted "hard" economic data (e.g., employment, GDP, etc.). While the reality has been a strong downward adjustment in the "soft" data, the "hard" data has continued to show steady, albeit subdued, growth and a strong labor market. Wage gains, however, have been slow to accelerate, while inflation has moved downward. Nevertheless, the Federal Reserve (Fed) along with other major central banks have sounded an increasingly hawkish tone in regards to removing QE and normalizing their balance sheets. Synchronized global growth, along with a belief that labor market tightness will eventually cause wage pressure to feed into inflation, have made continued crisis-era monetary accommodation appear increasingly unwise. In the U.S., the Fed has increased rates four times so far since December of 2015 and has hinted that a fifth hike could be forthcoming by year end. At present, it appears to us increasingly likely that the Federal Open Market Committee (FOMC) will begin reducing the Fed balance sheet in September, with a December rate hike to follow, assuming the uptick in inflation that they anticipate materializes.

Should inflation continue to be muted, on the other hand, we would anticipate heightened risk that the hawkish narrative, that both hawkish as well as dovish FOMC members have lined up behind, could be called into question over the coming months. Tactically, this makes us more cautious on positioning for higher rates, while more positive on credit spreads. Strategically, however, we see the bigger risk to both the current level of interest rates and credit spreads as coming from the Fed starting to reduce their balance sheet. In other words, tactically, we are concerned that interest rates might decline in the near-term based on weak inflation numbers, which would exacerbate our longer-term strategic concern that the market is mispricing the potential adverse impact on interest rates and credit spreads of the removal of global QE.

We believe that the synchronized global growth which underpins our positive fundamental outlook for economic growth and corporate earnings will likely bring forward global monetary policy normalization. As such, while we remain positive on the investment grade corporate credit market over the near-term, we anticipate positioning more defensively as the third quarter progresses.

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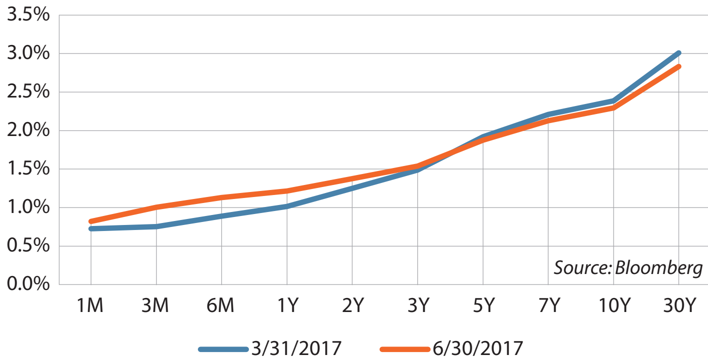
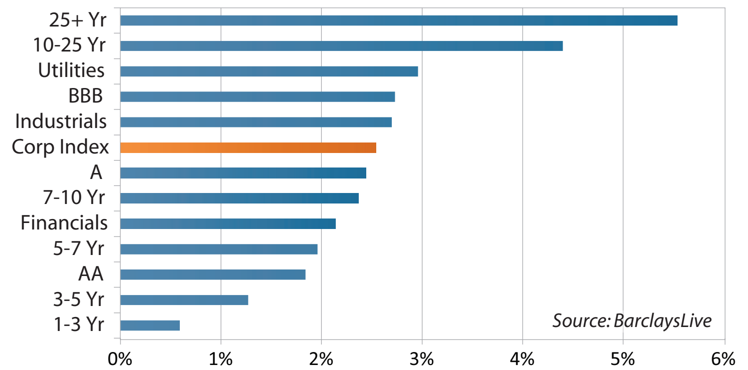
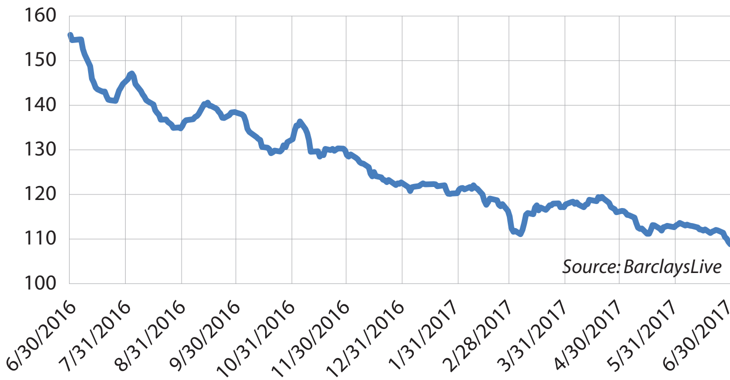
U.S. Treasury Curve



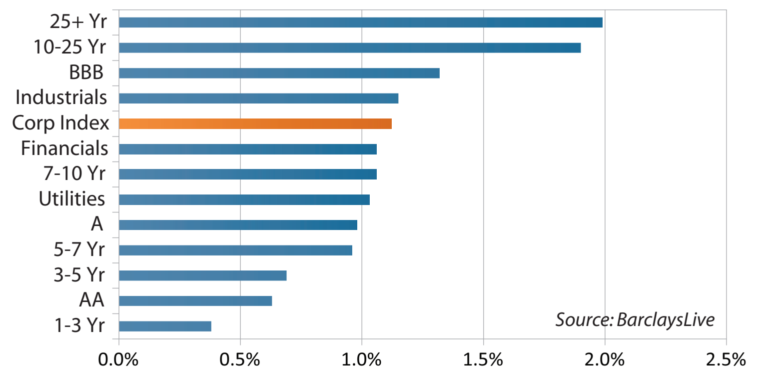
Bloomberg Barclays U.S. Corporate Index Segments 2Q 2017 Total Return* *(12/31/16 to 6/30/17)*



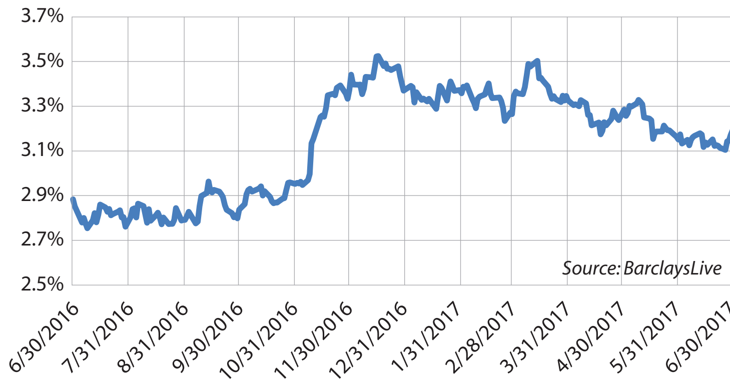
Bloomberg Barclays U.S. Corporate Index: Option-Adjusted Spread[1]



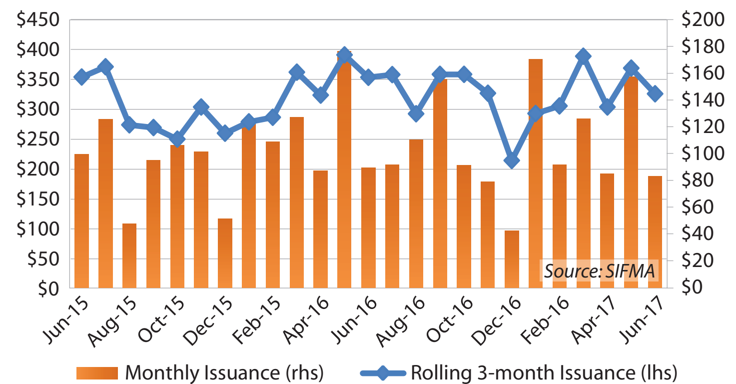
Bloomberg Barclays U.S. Corporate Index Segments 2Q 2017 Excess Return* *(12/31/16 to 6/30/17)*



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.*

***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).