U.S. Investment Grade Credit Investor Update

3rd Quarter 2018

Market Review

Given the magnitude of credit spread widening during the 2nd quarter, it should not be too surprising that the investment grade credit market recovered during 3Q2018. However, given ongoing concerns about rising interest rates, trade tensions, Italian sovereign risk, and the growth of the BBB-rated segment -- the magnitude of the recovery was somewhat unexpected. The option-adjusted spread on the Bloomberg Barclays US Corporate Index tightened 17 basis points (bps) to 106 over the three-month period ending September 30, 2018. This compares to 93 bps at the beginning of the year, and 101 bps at the end of 3Q2017. In the U.S. Treasury market, the benchmark 10-year yield increased from 2.85% on June 30, 2018 to 3.057% on September 30, 2018– after having traded as high as 3.101% and as low as 2.82% during the quarter.

Most of the spread retracement occurred during July, as strong earnings combined with solid economic data to foster a “risk on” tone. Interest rates moved higher, leading to increased demand as all-in-yields (UST rate plus credit spread) become more compelling. This positive technical was helped by a muted new issue calendar. Not surprisingly, given the rally, the best performing sectors tended to be those with higher spread beta and lower credit ratings. The July snapback was the strongest monthly excess return performance for the Bloomberg Barclays U.S. Corporate Index since April 2016, though total returns were hurt by the selloff in Treasuries.

August saw some spread weakness as expectations grew for a strong new issue calendar post-Labor Day, and as heightened concerns about trade and emerging markets hurt sentiment, but during September spreads retraced the August weakness before rallying further. We believe that the announcement of a trade agreement between the US and Mexico was an important impetus for this additional leg of the third quarter spread tightening. Although September did, in fact, see a large new issue calendar, it was met with solid demand – helped in part by an increase in Treasury yields.

One additional factor that we believe has played a role in the positive supply/demand technical during the third quarter was demand from pension funds. Not dissimilar to how individuals have until April 15 to make an IRA contribution for the previous calendar year, corporations had until September 15 to make pension contributions that could still be deducted at last year’s (pre-tax reform) corporate rate. This tax aspect, combined with the ability to monetize equity market gains by “de-risking” pension assets into fixed income (which better matches the duration of pension fund liabilities), appears to have provided an additional tailwind to the credit spread tightening seen during the quarter.

In sum, then, investment grade credit spreads rallied during 3Q2018 following the sharp second quarter spread widening despite concerns about a heavy post-Labor Day new issue calendar, trade tensions, and emerging market weakness. Strong demand was underpinned by robust corporate earnings and rallying US equity markets, along with Treasury rates that were higher, but not disorderly.

Outlook and Strategy

Looking forward, our outlook for the fourth quarter is in many ways a mirror image of how we saw the third. As mentioned above, while we expected a recovery in spreads during the third quarter, we were surprised by the magnitude of the spread snapback. As a result, we enter the fourth quarter with a cautious outlook. We suspect that spreads have rallied too far and are now at risk given the many hurdles the investment grade corporate credit market will face through the end of the year.

We continue to be broadly constructive on corporate credit fundamentals, but as we have discussed in prior commentaries, companies have used the leeway provided by robust earnings and cash flow to sharply ramp up borrowing. How the market reacts to margin pressure from higher input and labor costs, from the apparent slowing of economic growth outside the US, from ongoing removal of stimulus from the Federal Reserve and the fading of the fiscal stimulus bump – not to mention the likelihood of a Democratic takeover of the House in the mid-term elections – are all open questions. While the answers are not yet certain, it does seem likely that we are entering a period of heightened volatility.

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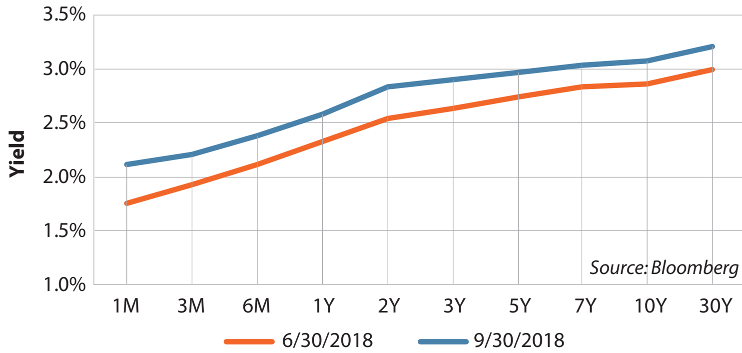
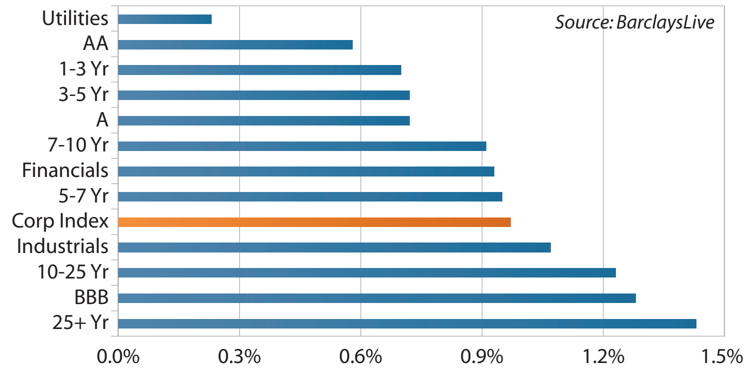
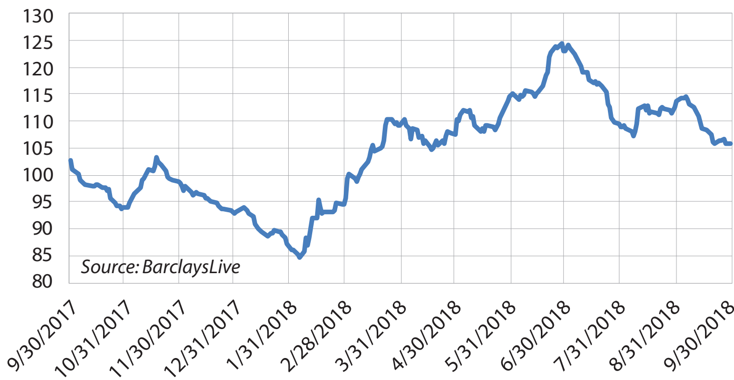
U.S. Treasury Curve



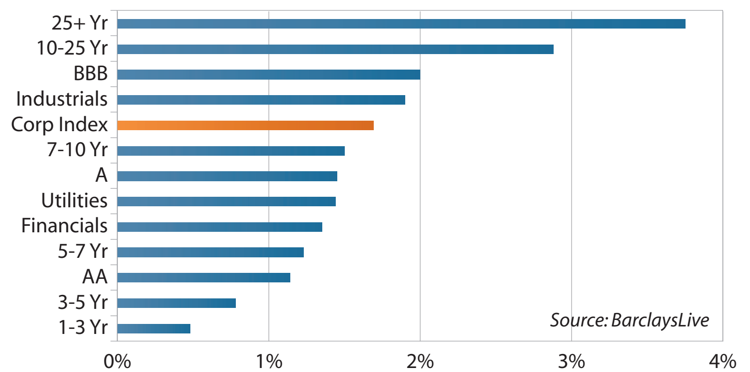
Bloomberg Barclays U.S. Corporate Index Segments 3Q 2018 Total Return*



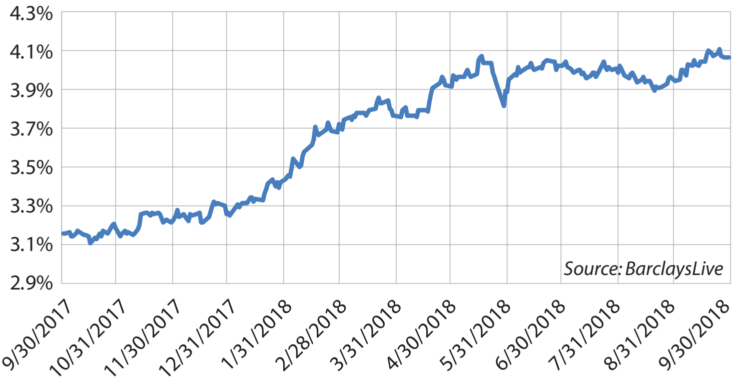
Bloomberg Barclays U.S. Corporate Index: Option-Adjusted Spread[1]



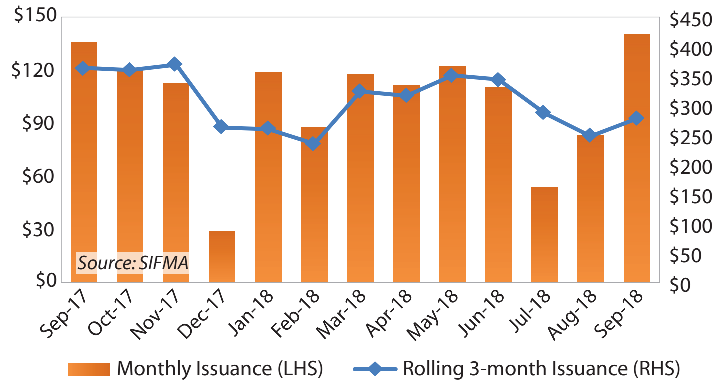
Bloomberg Barclays U.S. Corporate Index Segments 3Q 2018 Excess Return*



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



Investment Grade Corporate Bond Issuance *(billions)*



[1] *Option-adjusted spread (OAS) 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 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).

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