U.S. Investment Grade Credit Investor Update

1st Quarter 2018

Market Review

> "If something cannot go on forever, it will stop."
> ~ Herbert Stein

Despite spreads initially rallying to post-crisis tights in January, the U.S. investment grade credit market experienced its worst 1Q performance since 1996, and gave back approximately half of 2017's credit spread tightening. In doing so, the U.S. investment grade credit market also broke its streak of nine consecutive quarters of positive excess return. The option-adjusted spread (OAS)[1] on the Bloomberg Barclays US Corporate Index widened 16 basis points (bps) to 109 over the three-month period ending March 31, 2018. This compares to 93 bps at the beginning of the year, and 118 bps at the end of 1Q2017. In the U.S. Treasury market, the benchmark 10-year yield increased from 2.406% on December 29, 2017 to 2.740% as of March 31, 2018, after having traded as high as 2.940% during the quarter.

Investment grade credit spreads continued their 2017 tightening rally during January, reaching an OAS of 86 bps -- a level not seen since before the financial crisis. A strong beginning-of-the-year rally in the equity market, combined with cheaper yields resulting from a selloff in the Treasury market, provided a powerful tailwind to corporate credit spreads. But it was not to last, as demand for investment grade credit failed to successfully absorb an unexpectedly heavy new issue calendar. This supply/demand imbalance induced weakness was exacerbated by a continued selloff in Treasuries that, unlike the case for much of 2017, credit spread tightening was unable to offset. Sentiment was additionally hurt by increased volatility in the equity market, and its adverse impact on VIX-based products during the quarter. Finally, credit spreads were hurt during the first quarter by the repatriation of overseas cash by U.S. corporations resulting from tax reform. Specifically, U.S. corporations, which have been one of the largest buyers of front-end (shorter maturity) corporates, stopped buying, and in certain cases began selling, as overseas cash was shifted back to the U.S. now that the onerous rate at which such repatriation had been previously been taxed has been reduced.

In many ways it was an unusual quarter in that several relationships broke down. For one, despite the weakness in credit spreads, BBB-rated credits outperformed A-rated credits within the Bloomberg Barclays US Corporate Index. We attribute the underperformance of A-rated credits to the financials sector being the source of the supply increase in investment grade credits, and believe this underperformance offers an attractive opportunity since the improved fundamentals for the financials sector should help at least a portion of this quarter's underperformance reverse. Another development worth noting is the positive excess return from the telecommunication sector. Given the large amount of debt outstanding from Verizon and AT&T, and the heightened liquidity this provides, telecom traditionally underperforms in a selloff due to it being an easily replaced, liquid means of shedding risk. This quarter, however, both issuers were strong performers since the improved cash flow arising from tax reform is a significant credit positive – more so given that a portion is being used for debt reduction. In contrast, the electric utility sector underperformed the Bloomberg Barclays US Corporate Index, as it is one of the primary losers from tax reform because the tax savings will be removed from their rate base, thus negatively impacting cash flow. Finally, this quarter's credit spread curve flattening is somewhat unusual since credit spread curves tend to steepen during periods of spread weakness. However, during the first quarter front-end credit spreads widened much more than longer-maturity spreads as overseas cash repatriation put severe pressure on bonds in the 1-3 year maturity range. Here too, we see the widening as overdone, though given what we believe is a permanent supply/demand shift, we do not expect the front-end selloff to fully reverse.

In sum, then, an adverse shift in supply/demand, negative total return arising from increasing Treasury rates, and repatriation-induced stress in shorter-maturity corporate bonds combined to keep the investment grade credit market under pressure right into quarter-end.

Outlook and Strategy

Looking forward, we anticipate a near-term reversal of the spread selloff given both its severity and given our expectation for the new issue calendar to slow somewhat as the second quarter begins. Additionally, we believe credit fundamentals remain strong and we expect the upcoming earnings season to deliver robust results. Earnings should be strong, with the positive impact of a lower corporate tax rate providing an additional boost.

That said, our long-running constructive view on investment grade credit has shifted. As mentioned, the fundamentals remain strong, but the tailwind of aggressive demand that we have seen for the past few years has lessened. As the Federal Reserve continues to hike short-term interest rates and to reduce its balance sheet, we expect front-end rates to continue to move higher. The need to fund fiscal stimulus is likely to only exacerbate this effect – as the increased fiscal deficit will be funded primarily at the front end. As a result, despite our expectation for longer-term interest rates to outperform (curve flattening, in other words), we believe more attractive front-end yields should reduce the pressure to reach for yield by extending duration, meaning that the long-end will not be immune to upward rate pressure. Consequently, we expect demand to be challenged as buyers come to terms with negative 1Q total returns. Moreover, higher U.S. short-term interest rates, combined with negative sentiment toward the U.S. dollar, have increased hedging costs for overseas buyers, further reducing demand.

On the other hand, with interest rates higher and credit spreads wider, valuations have become more attractive. We believe increased equity market volatility should also temper investor desire to dramatically reduce allocations to fixed income. Nonetheless, we see the broad-based credit spread rally of the past few years as having largely run its course. Going forward, we see opportunity in remaining underweight duration -- as well as in relative value plays between sectors, industries, and individual credits. The unwarranted credit spread compression witnessed over the past several years appears to us to offer fertile ground for sorting out the winners from the losers as the investment grade credit market becomes much more discriminating going forward. As such, the focus of our efforts will be in exploiting such opportunities.

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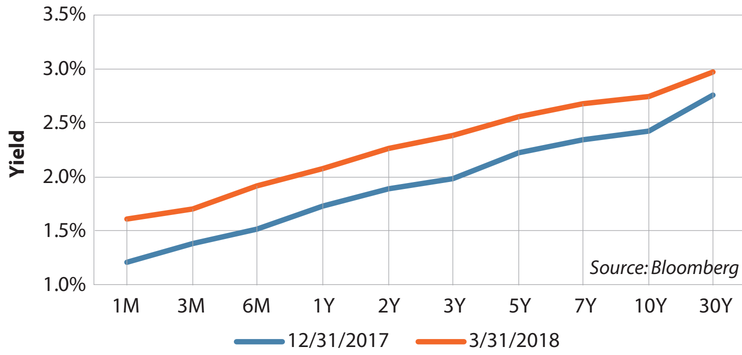
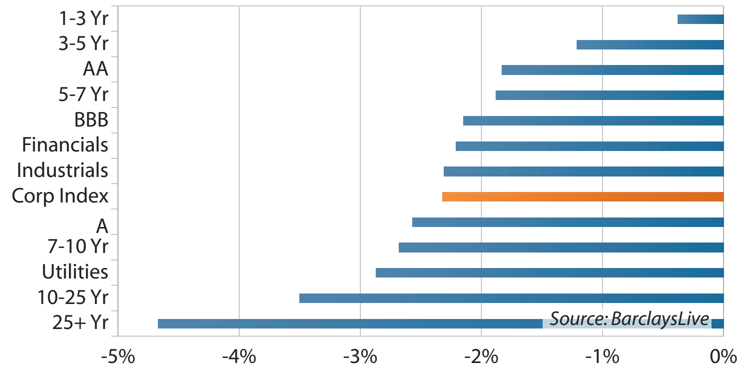
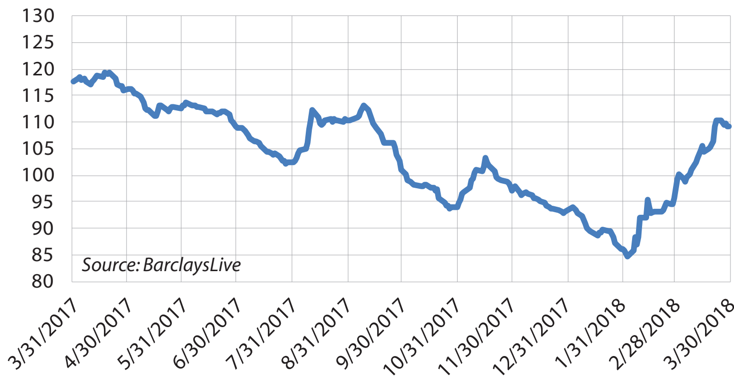
U.S. Treasury Curve



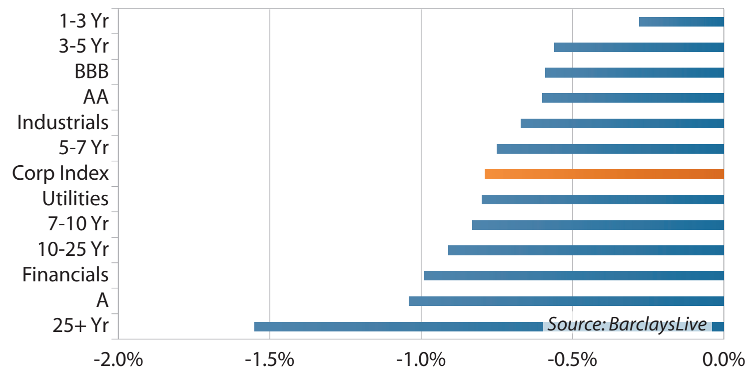
Bloomberg Barclays U.S. Corporate Index Segments 1Q 2018 Total Return*



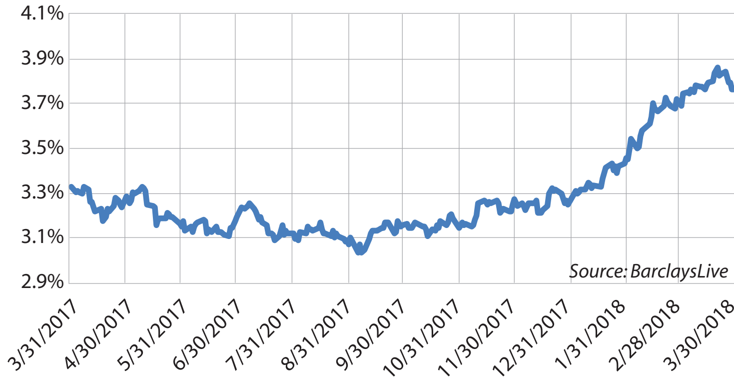
Bloomberg Barclays U.S. Corporate Index: Option-Adjusted Spread[1]



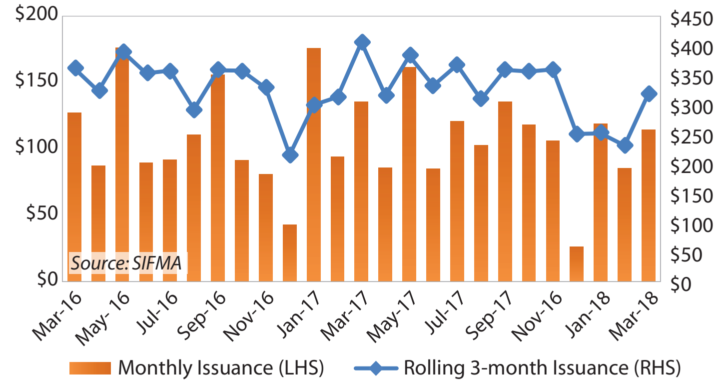
Bloomberg Barclays U.S. Corporate Index Segments 1Q 2018 Excess Return*



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).

VIX - Chicago Board Options Exchange SPX Volatility Index. The Chicago Board Options Exchange Volatility Index reflects a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of strike prices.

All charts shown herein are for illustrative purposes only and not indicative of any investment. The performance illustrations exclude the effects of taxes and brokerage commissions or other expenses incurred when investing. Past performance is not indicative of future results and there can be no assurance past trends will continue in the future.