U.S. Investment Grade Credit Investor Update

2nd Quarter 2018

Market Review

Following a brief spread rally in early April, the US investment grade credit market was under steady pressure all quarter. An unexpected increase in large, merger & acquistion (M&A) driven new issues proved too much for a market facing reduced inflows. Retail demand was hampered by the sharp rise in interest rates, while higher currency hedging costs hurt overseas demand. This supply/demand mismatch resulted in wider credit spreads and negative excess return. The option-adjusted spread (OAS)[1] on the Bloomberg Barclays US Corporate Index widened 14 basis points (bps) to 123 over the three-month period ending June 30, 2018. This compares to 93 bps at the beginning of the year, and 109 bps at the end of 2Q2017. In the U.S. Treasury market, the benchmark 10-year yield increased from 2.74% on March 31, 2018 to 2.85% on June 30, 2018, after having traded as high as 3.108% and as low as 2.731% during the quarter.

Investment grade credit spreads initially improved as the quarter began, reaching an OAS of 105 bps, but could not hold that level as a surge in new issues set a new month-of-April record. May saw a further deterioration as credit failed to keep pace with the flight-to-quality US Treasury rally resulting from heightened concerns about Italian political risk. The spread weakness was further exacerbated by supply fears in the Cable sector arising from the bidding war for the 21st Century Fox assets, as well as from weakness in emerging markets (EM) spilling over into Metals & Mining credits. And while Italy concerns receded during June, EM weakness and trade fears intensified. The micro- backdrop was no less challenging as the Telecom and Media sectors were pressured on M&A speculation following regulatory approval of AT&T's acquisition of Time Warner Inc. Moreover, June saw yet another heavy new issue supply calendar – which, as was the case in April, set a new month-of-June record.

In sum, abundant supply, combined with adverse macro- (trade wars) and micro- (acquisition-related deals and shareholder rewards) developments, steadily pressured credit spreads over the course of the second quarter. The second quarter of 2018 ended with the index OAS at an 18-month high. The details behind this performance are not wholly surprising: the worst performers were the lowest rated, longest maturity issues, and most vulnerable to the economic cycle.

Outlook and Strategy

Looking forward, given the magnitude of spread widening in 2Q2018, we look for near-term improvement as supply will likely be light given the July 4th holiday week. Then, when supply picks up again, we anticipate that an understandably skittish buyer base will demand attractive concessions. We see this as an opportunity and intend to seek to exploit it. More broadly, we do not expect the torrid pace of new issuance to continue – though announcements of unexpected debt-financed M&A transactions continue to be a risk to this view. Nonetheless, our base case for the third quarter is a more manageable calendar, attractive new issue opportunities, robust 2Q earnings announcements, and a partial retracement of this year's spread widening.

Despite this positive nearer-term tactical view, however, we remain cautious on investment grade credit. From a fundamental standpoint, corporate credit remains strong. Profit growth should continue, albeit at a slower rate, and cash flow should remain robust. That said, the corporate sector has been aggressive in using its financial flexibility to fund share buybacks and M&A activity through debt issuance. As a result, we do not foresee a broad improvement in leverage metrics. For each company that has successfully delivered on their post-merger deleveraging promises, another one seems to take its place. And as we move further along in the economic cycle, this becomes increasingly concerning.

Moreover, our near-term positive view on credit spread valuation will, if born out, be self-correcting. Should credit spreads recover to levels closer to fair value, the market will be left looking for a catalyst for further improvement – which we do not see arising from either of the other broad market drivers: fundamentals or technicals. As such, we believe the investment grade credit market has entered a new phase where both spread wides and spread tights will be wider. The good news, however, is that we do not expect the path to be straight – but instead filled with fits and starts that should provide attractive tactical opportunities. We continue to believe, furthermore, that the unwarranted spread compression witnessed over the past several years will 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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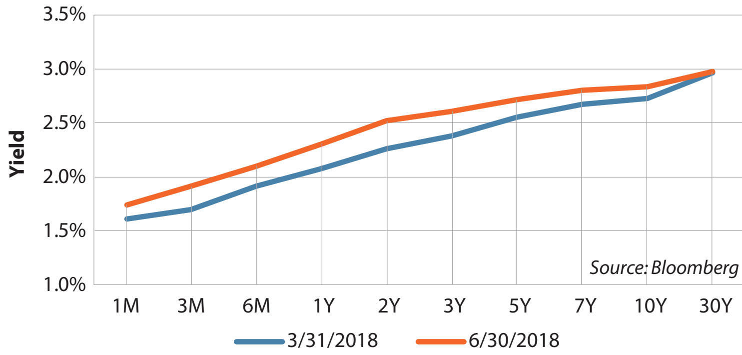
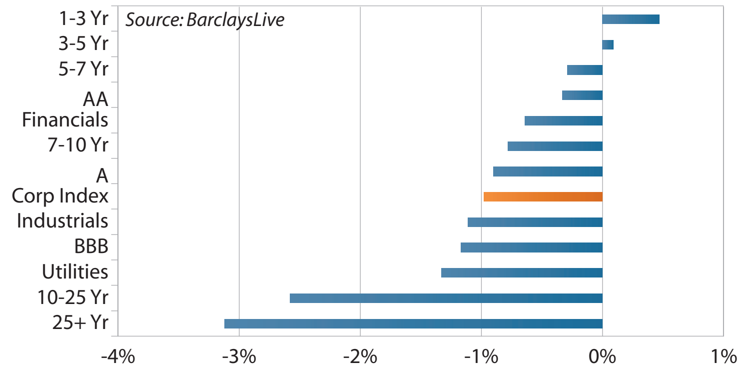
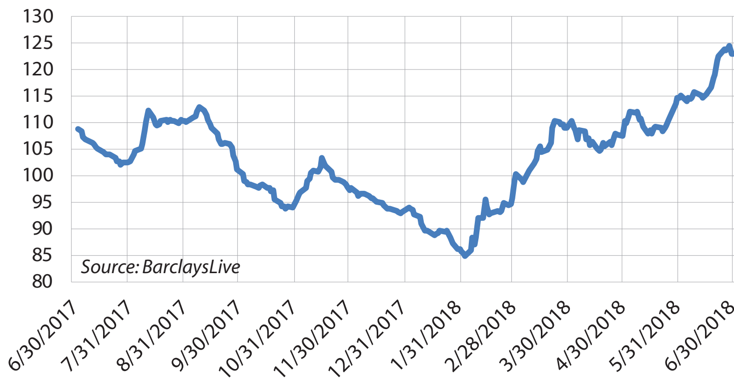
U.S. Treasury Curve



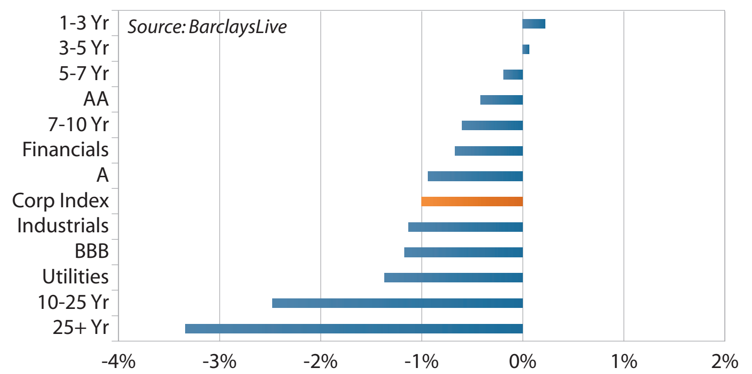
Bloomberg Barclays U.S. Corporate Index Segments 2Q 2018 Total Return*



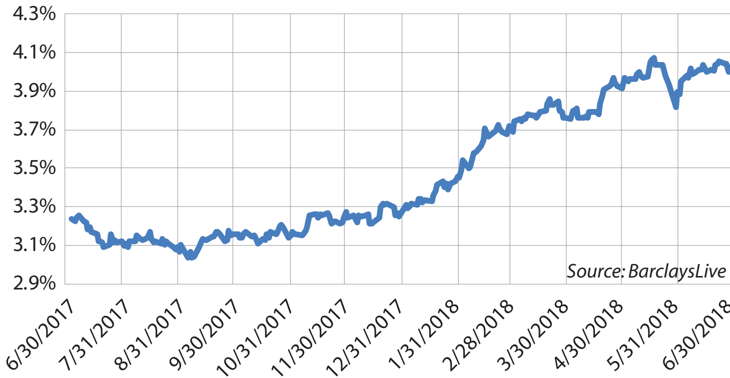
Bloomberg Barclays U.S. Corporate Index: Option-Adjusted Spread[1]



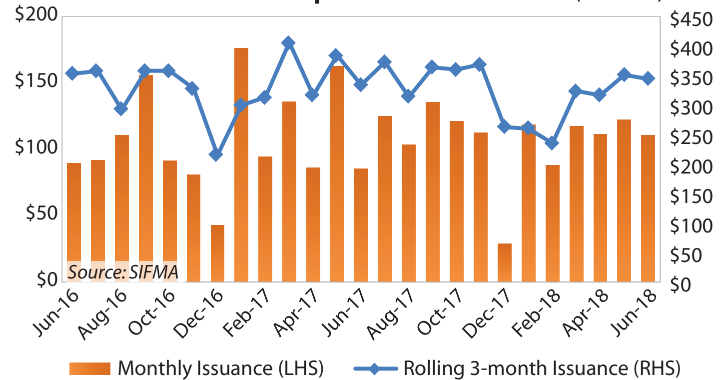
Bloomberg Barclays U.S. Corporate Index Segments 2Q 2018 Excess Return*



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).

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.