

Choosing Sides: Corporate Credit View 1Q 2019

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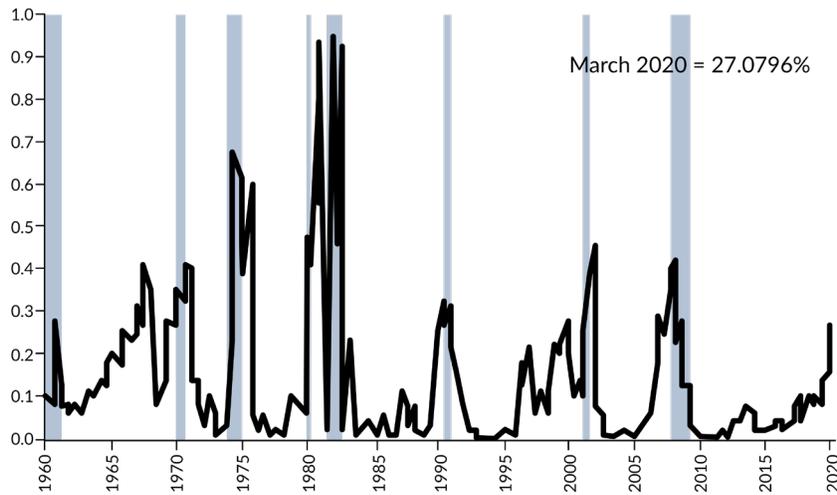
Market summary and outlook

The Investment Grade (IG) Corporate bond market (per Bloomberg Barclays Index) returned to positive territory in the first quarter, delivering a 5% total return, with spreads tightening 34 basis points (bps). The IG market underperformed the S&P Index, which returned 14% and High Yield (per Bloomberg Barclays Index) 7%. Worldwide equity markets are very optimistic, while the Treasury market continues to reflect caution. Which market will prove to be correct?

Risk premiums have fallen this year in the equity and credit markets. Investors expect: (1) the Fed to be more apt to cut rates, (2) a China trade agreement and resumption of growth, driving a second half 2019 earnings recovery and (3) the avoidance of a hard Brexit and/or European recession. The Treasury curve reflects the expectation for lower growth, predicting a 27% probability of a recession next year per the NY Fed (see Exhibit 1).

Corporate spreads have tightened more than we expected for the year. We remain comfortable investing in the sector given improved financial conditions and our outlook for 2%+ GDP growth. However, lackluster valuation and our expectation for heightened volatility and margin pressure causes us to build liquidity and flexibility to add at more attractive levels.

Exhibit 1: Probability of US Recession Predicted by Treasury Spread* - Twelve Months Ahead (month averages)

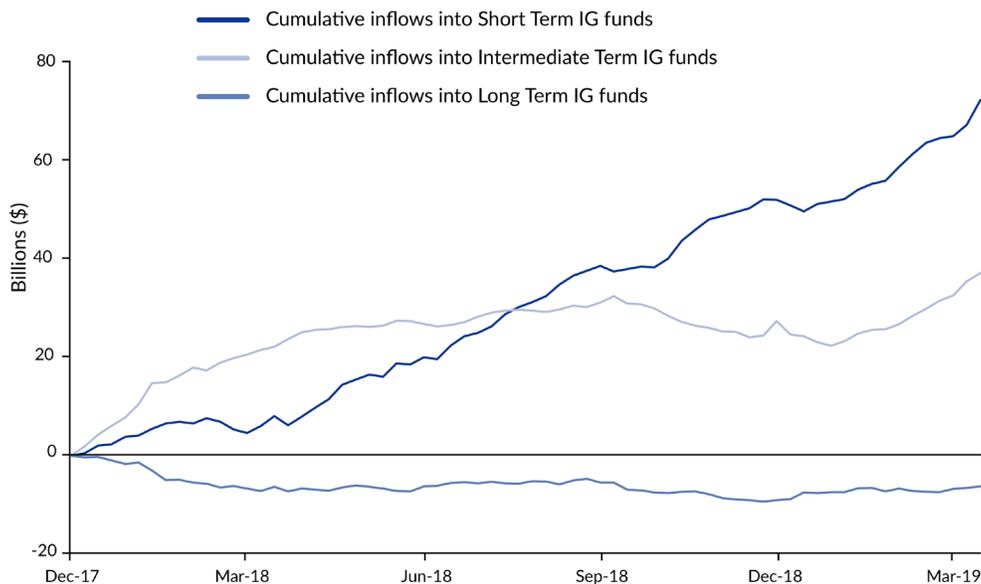


*Parameters estimated using data from January 1959 to December 2009, recession probabilities predicted using data through March 2019. The parameter estimates are $\alpha=0.5333$, $\beta=-0.6330$. Source: Bloomberg as of 4/2/2019

Performance summary

The year started with more attractive valuations and a heightened level of concern regarding economic growth (China in particular). Since that time, Chinese economic data has surprised to the upside and trade related tensions have eased. Importantly, the Fed has pivoted to a more dovish position, and US economic data seems to support that view. An outlook for lower yields and economic growth around 2% increased the demand for fixed income. As shown in Exhibit 2, shorter maturities have benefited, and credit curves have steepened.

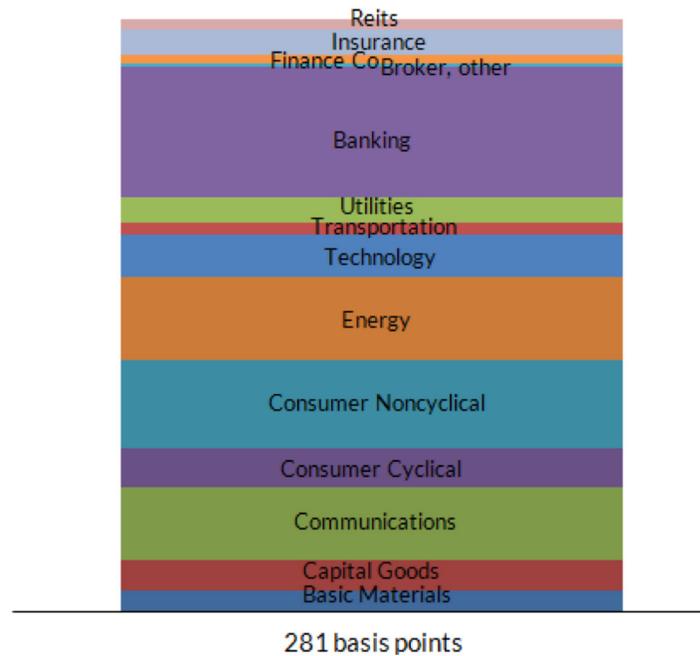
Exhibit 2: IG Cumulative Flows Across Tenors



Source: EPFR, Goldman Sachs Global Investment Research

The Energy, Communications and Banking sectors outperformed, which we would expect in a high beta rally given the liquidity in these sectors. BBB rated securities also outperformed. The basis between BBB and A-/higher rated non-Financial credits has narrowed modestly but remains around its historic average which is fair. Debt issuance has tracked last year’s pace.

Figure 3: Contributors to IG Corporate Excess Returns 1Q2019



Source: Bloomberg Barclays, AAM

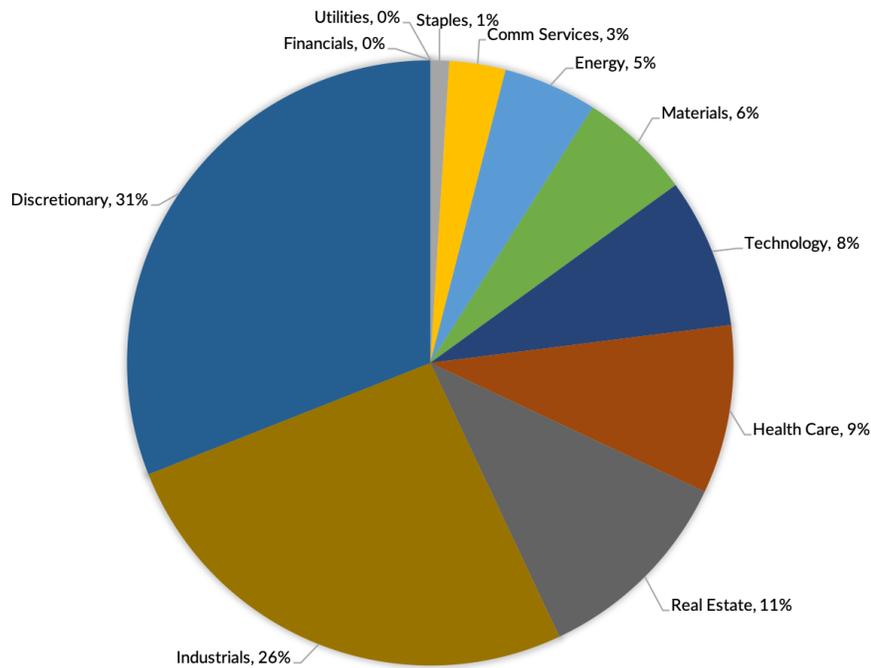
Credit market fundamentals

We anxiously enter the first quarter reporting season, expecting weak first quarter results to be outweighed by optimistic outlooks. Sectors that were impacted by China trade tensions and/or economic deceleration are expected to rebound sharply in the second half (Materials, Technology). Consumer sectors are also expected to benefit as confidence improves. However, the trajectory of growth has shifted lower and wage pressures are rising. That earnings pressure coupled with low interest rates increases event risk. Companies that have pursued this have been rewarded by equity holders. We expect increased event risk to place more pressure on spreads in the upcoming quarters.

In regards to the expectation for an earnings recession in the first half of 2019, a number of factors are driving this. First, revenue declines are anticipated in sectors like Technology and Energy that are more closely tied to global growth and China in particular. Foreign exchange is a headwind for companies on a revenue and/or cost basis. Lastly, higher wages and labor costs are becoming more problematic. The unemployment gap (difference between actual unemployment rate and long-run natural rate) has been negative since 2017, placing pressure on wage growth. An increasing number of industries are experiencing above-trend wage growth (Morgan Stanley, “Wage Pressures: Risks from Labor Costs Rising,” 04/15,19) and citing labor as their most important problem (NFIB survey). This is an issue as top line growth slows. For fixed income investors, this is especially problematic given the degree of

debt leverage at corporations. Despite this, we do not expect material deleveraging this year, and with this margin pressure, leverage may rise. Only those companies that are forced to reduce debt because of their very large capital structures will do so. The cost of debt is simply too low for the majority of companies.

Figure 4: Earnings Transcript Mentions of Labor Cost - 4Q2018 Breakdown



Source: Alphasense, Morgan Stanley Research as of 3/31/2019

Liquidity has fallen, with companies maintaining the lowest cash balance relative to debt since 2008. Repatriation was one driver of this, but the trend was not isolated to those companies. This may reflect the confidence companies have in the markets, or the pressure management teams face from activist investors. Debt leverage remained broadly stable in 2018 vs. 2017, as additional debt incurred due to M&A and share repurchases offset the reduction in debt driven by changes in the tax law or industry pressures. In regards to capital spending, we expect very modest growth this year and next. We expect this to largely track economic growth expectations.

Elizabeth Henderson, CFA is a Principal and the Director of Corporate Credit at AAM with 23 years of investment experience. She is responsible for the Corporate sector, in addition to the analysis of investment grade Telecommunications, Media and Technology credits. Additionally, Elizabeth is a member of AAM's "Outsourced CIO" Committee. Prior to joining AAM, Elizabeth was a Director at Fitch Ratings with responsibility for following public and private telecommunications and media companies. She is a CFA Charterholder as well. Elizabeth graduated from Indiana University with a BS in Finance and earned a MBA in Finance, Analytical Consulting, and Marketing from Northwestern University's Kellogg School of Management.



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