ANALYSIS

Credit Continuum

August 2018

We believe carry remains attractive

Is the worst of the US rate rise behind us with the US 10-year Treasury rate at close to 3% and the Federal Reserve (Fed) funds rate at 2%? The Fed recently stated it considered the US economy to be strong, based on a series of economic indicators.* It is generally expected that the Fed will increase rates in September and December, and three more times in 2019, provided that economic growth remains robust.

Quantitative tightening continues as the Fed limits its reinvestment activity. The US Treasury recently announced that it expects the US's borrowing needs in the second half of the year to increase to levels last seen during the financial crisis given reduced tax receipts brought on by tax reform. This means that rates may face upward pressure as supply is pushed through the market. It also remains to be seen what impact an escalating trade war will have on China's willingness to hold US Treasuries, as China is the largest foreign holder of US government debt.*

It is of course impossible to predict what rates will do. The European Central Bank, while committed to eventually ending their quantitative easing, has yet to officially begin, and the Bank of Japan remains committed to an easy monetary policy despite recent market pressure.

Meanwhile, geopolitical risks that have ebbed and flowed for much of the year remain, including the US/China trade tariff conflict, China's move to reduce borrowing leverage in its shadow banking system creating credit and currency uncertainty, the political situation in Italy and the uncertainty surrounding the outcome of Brexit.

The heightening of any of these risks could lead to periods of increased volatility and risk-off sentiment. A stronger US dollar would also put further pressure on the EMFX complex.

*Source: https://www.federalreserve.gov/monetarypolicy/files/monetary20180801a1.pdf

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Michael manages the Muzinich Global Tactical Credit strategy. Prior to joining Muzinich in 2012, Michael was president and Head of the High Yield Division at Seix Advisors, Inc. At Seix Advisors, he was the founding partner of the high yield strategy that grew to over $13 billion under his leadership. Previously, Michael served in various research and portfolio management capacities at American General Corp. and at Capital Holding Corporation. He earned a BA in Management Science from the University of California, San Diego and an MBA from Rice University.

Within credit markets, following a volatile first half of the year, where investors rotated their position from fixed income into equities, we believe valuations still remain overly bullish (albeit modestly off year-to-date tights). As a result, credit selection remains paramount given heightened idiosyncratic risks either due to M&A activity (leveraging) or sector-related pressures due to rising costs.

Nevertheless, given the rise in front-end risk free rates, the carry available in credit is now at or close to its highest since 2009 (1-5year).*

Excluding any large exogenous shocks, we believe credit spreads (especially front-end) should continue to be supported, or at least stay range bound, for some time.

*Source: ICE BoA Merrill Lynch CVA0(1-5y Corp), ICE BofA Merrill Lynch H1AV (1-5y BB US HY Index) as of 31 July 2018

Important Information