Credit Continuum

ANALYSIS

November 2019

With credit dispersion highlighting some late-cycle behaviour, can investors continue to find value and yield?

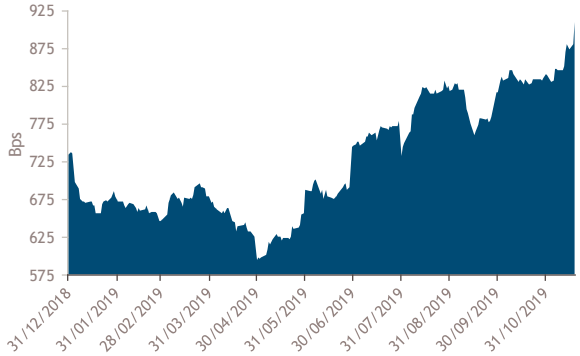
The health of the global economy remains front and centre of investors' minds. While macroeconomic data has struggled for much of the year, recent data points indicate it appears to be stabilising, albeit at low levels.[1]

Central banks meanwhile are providing support and economic stimulus, with rate cuts across developed and emerging markets.[2]

We have also seen increasing prospects of a Phase 1 trade deal between the US and China. While we believe this reduces tail risks for the US economic outlook for 2020, it falls short of being a strong positive for the manufacturing and export sectors and is unlikely to reverse the fall in capital expenditure that has dominated these sectors for the last two quarters.[3]

We are already seeing signs of dispersion in the performance of the lower-rated segment of the US high yield market (Fig. 1), with CCC rated bonds displaying what we believe to be recessionary behaviour.

Fig. 1 – Spread Widening in Lower-Quality High Yield



Source: ICE BofA ML. Difference in Spread to Worst vs Govt. of the ICE BofAML CCC & Lower US Cash Pay Index (J0A3) vs. the ICE BofAML BB US Cash Pay High Yield Index (J0A1). As of 19 November 2019

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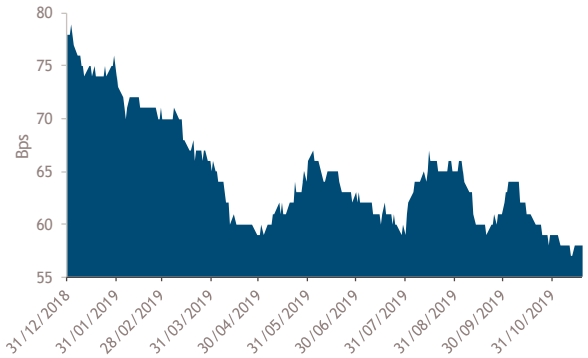
Michael manages the Muzinich Global Tactical Credit strategy. Prior to joining Muzinich in 2012, Michael was president and Head of the High Yield Division at Seix Advisors, Inc. At Seix Advisors, he was the founding partner of the high yield strategy that grew to over $13 billion under his leadership. 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.

In our view, this spread widening reflects persistent weakness in the energy and metal and mining sectors which comprise a significant portion of the lower-quality segment of the market.[4]

In contrast, spreads within the investment grade segment (Fig. 2) have tightened and the lower-quality end of the investment grade segment has outperformed the higher quality end. We believe this highlights that market participants are not concerned for the health of the US economy and are happy with bond-holder-friendly measures (such as the deleveraging) taken by highly-leveraged BBB rated companies in the US investment grade market.

In addition, other indicators that would add further weight to the late cycle argument, such as distress ratios, are around their long-term average (Fig. 3), providing us further comfort.

Fig. 2 – Investment Grade Spreads Have Tightened



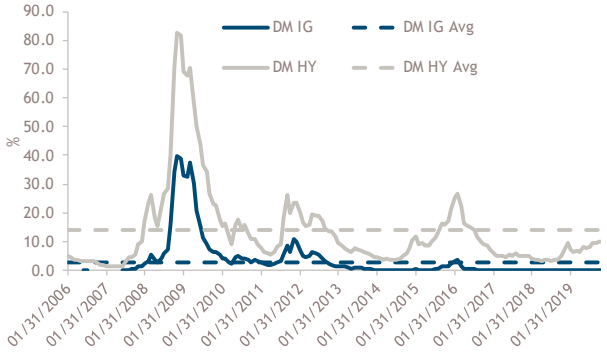
Source: ICE BofA ML. Difference in Spread to Worst vs Govt. of the ICE BofAML BBB US Corporate Index (C0A4) vs. the ICE BofAML Single-A Corporate Index (C0A3). As of 19 November 2019

Looking ahead, we believe future performance is likely to depend on the spill-over risk from manufacturing sectors to the rest of the economy, although US employment trends appear strong and therefore we believe this scenario currently appears less likely. Meanwhile central banks continue to be accommodative and we do not expect rates to rise any time soon.

In our view, abundant international liquidity and lower short rates are forcing investors into the high yielding segment of fixed income and creating an overall positive technical backdrop for credit markets.

As we are late cycle however, we maintain a strong focus on diversification, fundamental credit analysis and security and sector selection.

Fig. 3 – Distress Ratios at Long-Term Averages



Source: BAML EM Corporate Chartbook, as of 31 October 2019. Developed market high yield (DMHY) long term averages date from 31 October 1990. Developed market investment grade (DMIG) long term average from 31 January 1999.

For multi-asset credit strategies, we believe it prudent to retain a greater weighting towards investment grade bonds in the current environment.

Within high yield, we would advocate a bias for higher-quality credits as we believe yields do not currently have the potential for compensating investors for long-term risk.

We continue to find opportunities in sectors where fundamentals are improving, and in highly-rated credits in emerging markets, whilst being more selective in cyclical areas such as retail and energy.

1. https://tradingeconomics.com/euro-area/manufacturing-pmi; https://tradingeconomics.com/euro-area/gdp-growth; https://tradingeconomics.com/united-states/gdp-growth
2. https://www.federalreserve.gov/monetarypolicy.htm; https://www.ecb.europa.eu/mopo/decisions/html/index.en.html; https://www.reuters.com/article/us-emerging-rates/down-down-they-go-emerging-central-banks-deliver-most-rate-cuts-in-a-decade-idUSKCN1VN1J2
3. https://www.ft.com/content/28ecd00a-c1b8-11e9-a8e9-296ca66511c9; https://tradingeconomics.com/world/composite-pmi
4. Source: ICE BofAML CCC & Lower US Cash Pay Index (J0A3)
5. https://tradingeconomics.com/united-states/unemployment-rate

J0A3 – The ICE BofA ML CCC & Lower US Cash Pay High Yield Index is a subset of the ICE BofA ML US Cash Pay High Yield Index (J0A0) including all securities rated CCC1 or lower. J0A1 – The ICE BofA ML BB US Cash Pay High Yield Index is a subset of the ICE BofA ML US Cash Pay High Yield Index (J0A0) including all securities rated BB1 through BB3, inclusive. C0A4 - The ICE BofA ML BBB US Corporate Index is a subset of the ICE BofA ML US Corporate Index (C0A0) including all securities rated BBB1 through BBB3, inclusive. C0A3 - ICE BofAML Single-A US Corporate Index is a subset of ICE BofAML US Corporate Index including all securities rated A1 through A3, inclusive.

Important Information