ANALYSIS

Credit Continuum

October 2018

We believe credit remains supported by solid fundamentals, despite increasing signs of late-cycle behaviour in the macroeconomic backdrop

In our view, the combination of macro and credit events that have occurred so far this year have increased the odds of the global credit cycle nearing its final phase. Divergence in fiscal and monetary policies and the changing international trade landscape are increasing downside risk.

In the US, the tax cuts programme has proven beneficial to corporates in the short term and has boosted domestic demand. However, a lack of supply-side response (long-term productivity) is preventing a prolonged extension of the US cycle.

While we are currently witnessing growth-beating forecasts, in our view we could see a major economic slowdown in the US in 2020/2021, as the positive impacts of the tax cuts fade away. Moreover, aggressive US trade tariffs – particularly against China – could begin to weigh on the global economy in 2019, with the US also partially affected by slowing global demand, therefore bringing forward the chances of an economic slowdown.

However, we believe current momentum in US domestic demand offers protection against what could become a sudden slowdown in the global trade cycle.

Market participants are questioning how far the Federal Reserve will tighten monetary policy. The recent progression of wages and inflation in the US, and the Federal Open Market Committee Chair's recent statements, indicate that the rate cycle is still some way from maturing.[1] This suggest that another hike in December is on the agenda, unless there are dramatic developments in financial markets.

Michael McEachern, MBA

Portfolio Manager & Head of Public Markets

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.

1. https://www.federalreserve.gov/newsevents/pressreleases/monetary20180926a.htm

In Europe, the macro picture appears weaker than the US and economic growth is on a decelerating path, probably to below 2% in 2018.[2]

Uncertainty around Italy's budget and debt path is also a concern, particularly in how it relates to the wider European periphery and the eurozone financial sector, which has traditionally been more exposed to domestic sovereign risk. US/European trade relations, while currently steady, also remain a risk.

European yields are low and, in our view, the spread widening witnessed during the first half of 2018 does not fully compensate investors for the risks we see developing in the Euro area.

While elevated hedging costs between the euro and US dollar should keep euro-based investors focused on European credit, we see only inflows into very short duration high quality credit. The unknown impact of the end of quantitative easing by the European Central Bank is also adding to the general uncertainty.

Moving to the emerging markets, lower US dollar liquidity and rising US short rates have challenged the most vulnerable countries, which cumulated in high foreign currency debt and too loose fiscal policies (e.g. Argentina and Turkey).

Other countries, like Brazil, which are not suffering from high external imbalances, are going through their election calendar and therefore have limited policy responses to international pressure.

Although the succession of idiosyncratic stories has resulted in a reassessment of the fundamentals of emerging market economies by some investors, we believe recent events have created more attractive valuations which should see more recognition from global portfolios, after the political uncertainties have passed.

Overall, from a credit perspective, we do not anticipate negative credit-specific event risk. Defaults remain historically very low and leverage ratios are also at or below cycle levels. However, we believe end-of-cycle psychology is likely to create increasing bouts of volatility as well as liquidity concerns.

2. https://www.focus-economics.com/countries/eurozone

Important Information