Investment Grade Credit Insights:

Potential Tax Reform Trumps Other Uncertainty

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Global Macro

September was an extremely strong month for investment grade credit as the market seemed to focus on all the positives (tax reform and the rebound in oil) and looked through the negatives (geopolitical tensions, central bank tapering, somewhat surprising German election results and natural disasters). While we certainly welcome the positivity, which feels particularly important in this day and age, the asymmetry of the bond market leads us to start with the negatives.

Geopolitical tensions continued in September as President Trump and Kim Jong-un exchanged threats throughout the course of the month regarding North Korea's nuclear ambitions. Traditional diplomacy was replaced with personal insults. North Korean missile tests were met with additional US economic sanctions. This was followed by North Korean threats to test a hydrogen bomb in the Pacific Ocean and a statement from a North Korean foreign minister that the US had declared war and therefore intended to shoot down any US airplanes even in international airspace. Despite the escalating rhetoric, there was little reaction in credit spreads as most market participants believed that cooler heads would prevail and viewed a nuclear conflict as an unlikely tail risk.

Central bankers were also busy during the month laying out their plans to unwind the unprecedented monetary policy experiments referred to as quantitative easing. As expected, the Federal Reserve announced that it would start to normalize its $4.5 trillion balance sheet in October gradually reducing the reinvestment of proceeds from maturities. While the European Central Bank has yet to make its plans officially known, it is expected to announce tapering of its own during its next meeting on October 26th. We believe the ECB announcement has the potential to have more of a negative impact on spreads since the corporate bonds were included in the purchase program. However, our base case is that the spread impact will be limited as both central banks have adequately prepared the markets for these announcements. The risk is that the ECB comes out much more hawkish than anticipated which would cause both government yields and spreads to sell off. Provided the ECB maintains their dovish tone and tapers in a gradual manner, the market should be able to absorb the announcement without significant volatility.

With its focus on balance sheet normalization, the Federal Reserve left policy rates unchanged this month. However, the market interpreted the changes to the Summary of Economic Projections as hawkish which was only reinforced when Chairwoman Yellen stated the "Fed should be wary of moving too gradually." As a result, the rates markets are now pricing in a 70% chance of a rate hike in December, which is consistent with the Standish view.

There was also series of devastating natural disasters during the last several weeks (first Harvey and then Irma and Maria). While Hurricane Irma ravaged the Florida Keys and resulted in significant damage across Florida and the Southeast, the most dire projections of losses have not materialized. Prior to the storm making a landfall in the U.S. some catastrophe modelers estimated worst-case insured losses approaching $130 billion, assuming a repeat of the 1926

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Miami hurricane or 1-in-100 year FL hurricane event. Actual damage was significantly lower and estimates of insured losses from Irma now range from $20-40 billion in the U.S. and $5-$15 billion in the Caribbean. The credit impact has been limited because Florida's homeowners' insurance market is concentrated with smaller state-specific insurers and mutual insurers that maintain large reinsurance programs. The top US homeowner insurers have significantly reduced their exposure to Florida in the past decade.

The Five Costliest US Meteorological Events Since 1980

Year	Event	Overall loss (USDbn)	Insured loss (USDbn)	Insured / Overall loss
2005	Hurricane Katrina, storm surge	125	60.5	48%
2012	Hurricane Sandy, storm surge	68.4	29.2	43%
2008	Huricane Ike	37.8	18.5	49%
1992	Hurricane Andrew	26.8	17	63%
2004	Hurricane Ivan, storm surge	22.5	11.8	52%
	Average			**51%**

Source: Munich Re's NatCatSERVICE as of October 4, 2017

Now for the good news. The Republicans announced their much anticipated tax reform proposal. The latest version calls for a reduction of the current federal corporate tax rate from 35% to 20%. The plan also allows for the immediate expensing of non-structure capital expenditures. It should be noted that higher capital expenditures often result in a short term decline in credit fundamentals as the additional spending lowers free cash flow and encourages borrowing. However, longer term this mild deterioration is more than offset by an improvement in economic growth and future profitability. In order to offset the loss of revenue from lower rates and the expensing of capital expenditures under this plan, lawmakers are considering making interest deductibility "partially limited" when calculating their tax bills. Not only is it unclear what "partially limited" means, but the question still remains as to whether existing debt would be grandfathered. To the extent companies think existing debt will be grandfathered, the market may see a flood of supply which could pressure spreads in the short term. However, longer term, the elimination of interest deductibility would be a positive for credit. From a fundamental standpoint, it would make debt issuance a less attractive form of funding and therefore leverage should decline and balance sheet quality should improve. Furthermore, less new issue supply would also be a supportive technical as the same dollars would be competing for fewer bonds. Also offsetting the loss of revenue is a one-time involuntary tax on accumulated foreign earnings. Since this tax would be applied to accumulated earnings and not just overseas cash, lawmakers are proposing two rates: 8.75% on liquid assets/3.5% on other earnings. While several details still need to be worked out before this tax reform proposal can even be brought to a vote, (the first step is passing a joint budget resolution by mid-October), the market viewed it as significant progress and spreads tightened as a result.

President Trump's Current Tax Plan

	Current	Proposed
Corporate Rate	35%	20%
Treatment of Capital Expenditures	Depreciation	Immediately Expensed
Treatment of Interest Expense	Deductible	Partially Limited
Foreign Earnings	Not Taxed	Involuntary Tax at Lower Rate

Source: U.S. Congress Ways and Means Committee as of 9/27/17

Market Performance:

US corporates outperformed in September with spreads 9bps tighter, resulting in excess returns of 0.87% and total returns of -0.17%. Subordinated banks spreads were 13bps tighter on the month in a reversal of the widening we experienced in August. Industrials outperformed with spreads 10bps tighter with Energy (-13bps) and Communications (-12bps), driven by a strong cable reversal, leading outperformance. Pharma (-14bps) also took a turn for the better, tightening substantially from prior month while lower beta Utilities (-5bps) and REITs (-5bps) both remained stable. The credit curve flattened with the long end outperforming (12bps tighter) while intermediates and the front end were only -10bps and -6bps, respectively. Year-to-date, US corporate spreads are 22bps tighter resulting in excess returns of 2.42% and total returns of 5.19%.

European corporates were also tighter in September led by strong performance in Energy (-7bps) and Consumer Cyclical (-6bps). Overall the index was 3bps tighter, resulting in excess returns of 0.28% and total returns of -0.20% for the month. Year-to-date, European corporate spreads are 27bps tighter with excess returns of 2.63% and total returns of 1.76%.

Supply:

The new issue market was busy in September with $146 billion pricing during the month. This is below last year's record of $156 billion, but roughly in line with the 4 year average for September. Unlike July and August, M&A issuance was nonexistent in September and should be quiet for the remainder of the year as several big M&A transactions were either cancelled or postponed. The majority of the supply was attributed to issuers looking to take advantage of tight spreads and pulling forward issuance plans in anticipation of higher rates. Year to date, the market has priced $1.170 trillion which is only 2% below last year's record setting pace. In Europe, unsecured €-IG issuance totaled €51.7 in September, up from €47.9 the previous year. Issuance was evenly split between financials and non-financials. Year to date, the market has price 418.3 billion which is also 2% below last year's pace. Looking forward, we would anticipate the new issue pipeline to slow down in October due to earnings blackouts.

Outlook:

Unless a comprehensive corporate tax reform bill appears all but certain, we believe spreads will trade in a range for the remainder of the year with the majority of return coming from carry.

Technicals: The technical picture is mixed for the next couple of months as

uncertainty surrounding tapering could impact demand.

Fundamentals: U.S credit fundamentals have continued to improve year to date. S&P 500 companies reported second quarter sales growth of 5.3% and earnings growth of 9.6%. More importantly, the earnings outlook for the balance of the year remains solid despite the fact that meaningful tax reform and/or fiscal stimulus seems unlikely to occur before 2018. 3Q17 earnings estimates are for 4.4% revenue and 14.7% earnings growth. As of the end of 2Q17 Gross leverage decreased 0.2x YoY to 2.9x, which is the first decrease in three years. Interest coverage decreased 0.1x YoY to 10.6x as corporate debt at high rated companies increased, while overall earnings improved. The rate of debt growth slowed in the period ended 2Q17 given less debt financed M&A. CapEx declined 6% YoY due to slower spending by Energy, Materials, Diversified Media, and Chemical companies. Excluding Energy/Materials capex was +1% YoY. Cash payments to shareholders was flat at +0.4% YoY primarily due to a +3.5% rise in dividends offset by a (4.5%) reduction in stock buybacks. Equity valuations remain elevated.

Valuation: Despite being on the lower end of the historical range, we believe valuations are fairly valued given our constructive view on fundamentals.

Potential Risks:

1) Geopolitical instability
2) Monetary policy mistake
3) U.S. policy uncertainty

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