November 2017

*Investment Grade Credit Insights:*

# Carry On

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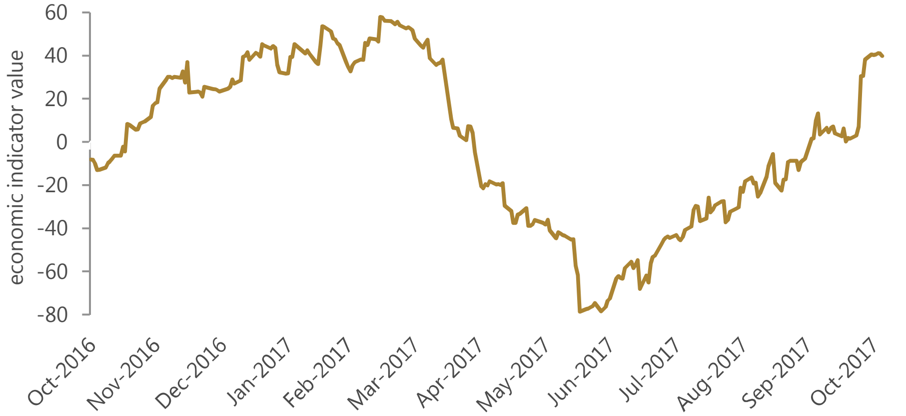
**Market Focus:**

Credit spreads rallied in October due to a combination of improving economic data, low inflation and the prospect of US corporate tax reform.

Economic data came in much stronger than expected in October. The Citi Surprise Index which measures data surprises relative to market expectations, increased to +40.90, a dramatic reversal from June 2017 when it was at -78.60 (see chart below). Most encouraging was the fact that, unlike earlier in the year, the improvement was not just limited to the "soft" survey data like consumer confidence, Institute for Supply Management surveys and regional Fed surveys. "Hard" indicators like auto sales, industrial production and GDP were also strong during the month with the hurricane recovery efforts providing a bit of a tailwind. The one area that continued to come in below expectations was inflation.

Inflation continues to be stubbornly low, confounding most economists given tight labor markets usually lead to wage pressures. However, the lack of inflation has given both the ECB and the Fed the flexibility to only gradually remove their historically accommodative monetary policy stances despite strong economic growth, creating an environment that is very supportive of credit spreads. To this end, the ECB delivered a dovish message during its meeting on October 26th when it extended its monthly purchases until September 2018 at €30bn/month and guided towards a negative policy rate beyond the end of QE. Furthermore, Draghi remained committed to the corporate bond purchase program. Similarly, the Fed continues to be slow and deliberate in its tightening cycle, leaving rates unchanged this month, but signaling that a December increase is likely. While a newly appointed Fed Chairman Powell is likely to be somewhat less dovish than his predecessor, a low inflation environment will likely continue to dictate a gradual path of monetary policy tightening in the first half of the year.

**Citi Surprise Index**




Source: Bloomberg as of November 6, 2017

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As the nomination for Fed Chairman was well telegraphed in the days leading up to the announcement, the market seemed to me more focused on the details of the House GOP tax proposal. The provisions that have the most impact on the corporate credit market are as follows. 1) The federal corporate tax rate is cut from 35% to 20%. 2) Capital expenditures can be expensed immediately for the next five years. 3) Existing un-taxed foreign earnings are subject to a one-time tax of 12% for cash and 5% for invested capital (up from 8.75%/3.5% in an earlier plan). 4) Net interest deductibility is limited to 30% of EBITDA. The credit market's reaction to this proposal was limited as the only significant point of clarity was related to the interest deductibility. Prior to the announcement, many market participants were speculating that in order to pay for the tax cuts, interest deductibility would be eliminated entirely thereby reducing the financial incentive to issue debt and improving the quality of balance sheets. However, setting a 30% threshold means this provision in and of itself will have a limited impact on the issuance patterns of investment grade companies because only 5% of the companies in the investment grade corporate universe have an interest/EBITDA ratio above 30%.

### Market Performance:

US corporates outperformed in October with spreads 6bps tighter, resulting in excess returns of 0.52% and total returns of 0.40%. BBB-rated bonds and longer duration continued to outperform during the month. The top performing sectors were commodity related with Energy 14bps tighter and Basics 10bps tighter. The worst performing sectors were Pharmaceuticals (1bp wider), Health Insurance (3bps tighter) and Wirelines (3bps tighter). Year to date, US corporate spreads are 28bps tighter resulting in excess returns of 2.97% and total returns of 5.61%.

Despite concerns about tapering, the European corporate index also performed well in October, tightening 9bps on the month, resulting in excess returns of 0.68% and total returns of 1.10%. The top performing sectors were Insurance (20bps tighter), Automotive (18bps tighter) and Wirelines (13bps tighter). The bottom performing sectors were Pharmaceuticals (6 tighter) and Construction Machinery (8 tighter). Year to date, European corporate spreads are 36bps tighter which translates into excess returns of 3.33% and total returns of 2.88%.

### Supply:

The new issue market continued to be extremely busy during October. In the US, there was $135bln of supply, representing the busiest October on record. The majority of issuance came from financial borrowers, but industrial issuers like Northrop Grumman, Wal-Mart, Broadcom and PepsiCo also came to the market with large transactions. Year to date, the market has priced $1.305 trillion which is only 1.5% below last year's record setting pace. In Europe, unsecured €-IG issuance totaled €28.9bln in October, down from €57.9bln the previous year. Unlike the US, non-financials accounted for the majority of the European issuance. Year to date, the market has price €448 billion which is 7.5% below last year's pace. Looking forward, we would anticipate the new issue pipeline to continue to be busy as issuers look to access the market before year-end. Expectations are for approximately $95bln which is consistent with the November monthly average.

### Outlook:

**Technicals:** Technicals should remain strong given the ongoing central bank accommodation as the asset class remains attractive to both yield sensitive domestic buyers as well as foreign investors.

**Fundamentals:** U.S credit fundamentals have continued to improve year to date with earnings growth outpacing debt growth.

**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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