July 2017

Investment Grade Credit Insights:

Credit Markets Grind Tighter In The Face Of Oil Price Volatility

A decline in oil prices caused energy credit spreads to widen and troubled central bankers who are struggling to meet inflation targets, but were largely shrugged off by the rest of the market.

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Macroeconomic Backdrop for Credit:

Volatility returned to the energy markets in June with oil prices falling over 13% from the beginning of the month until June 21st before rebounding 10% at the end of the month to close only 5% lower than where they started. The primary cause of the decline was additional concerns regarding oversupply. Despite recently extending its output cuts to March 2018, OPEC's oil output reached a year-to-date high during June. This was largely due to greater than expected volumes from both Libya and Nigeria who are each exempt from compliance with the cut since their oil production was negatively affected by non-market factors prior to the agreement. Libya, for example, is now producing approximately 900k barrels per day compared to just 550k barrels per day in April 2017. This additional supply along with an increase in production from US shale producers caused oil inventories to rise unexpectedly in June which caught the market off guard. In response to these moves, energy related spreads were wider on the month, but betas were significantly lower than in previous periods of significant oil price disruptions. One of the reasons for the more muted response is because the fundamentals of investment grade energy credits have improved dramatically since 2015/2016 as management teams have aggressively cut capital expenditures, suspended dividends and sold assets in order to reduce leverage and improve their balance sheets.

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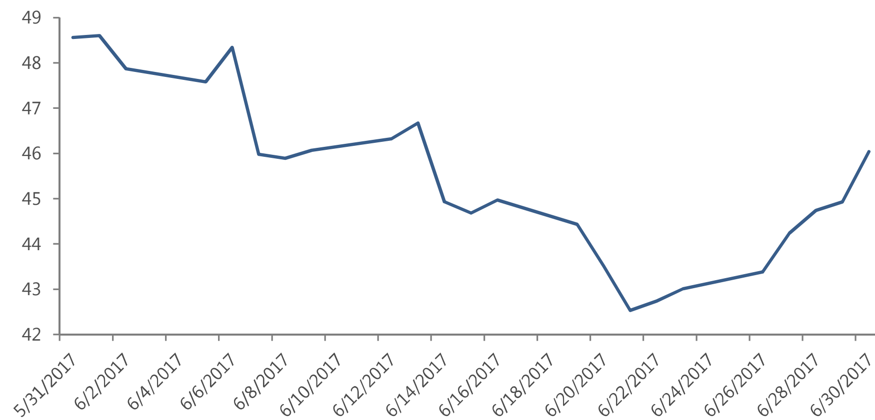

Source: Bloomberg as of June 30, 2017

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The oil markets continued to exhibit a fair amount of volatility during the month.

Investors were not the only group keeping a close eye on energy markets. The recent decline in oil prices is also a concern for central bankers, many of whom are anxious to reduce the historically high degree of monetary policy accommodation, but are conflicted due to the persistent lack of global inflation. In fact, inflation is below long-term targets in 80% of countries, a trend that has been in place since 2010. Despite persistently low inflation prints, the Federal Reserve increased short-term interest rates by 25bps during the month citing labor market strength and economic activity that has been "rising moderately" this year. This hike marked the third in the last six months with one additional increase expected before the end of the year. The Fed also discussed its plans for balance sheet normalization during the month. While they did not specify a date, many are speculating that the unwind process may begin as early as September. The expectation is that the Fed will allow treasuries and mortgages to roll off without reinvestment at a gradual pace as to not upset the market. Following the Fed, the European Central Bank appeared more hawkish than previously thought when President Draghi characterized recent deflationary pressures as transitory during comments at a conference in Sintra, Portugal. The market interpreted these comments as a signal that the ECB was ready to begin tapering sooner than expected which caused German bunds to back up 22 basis points in just three days.

Not only was the ECB busy determining the appropriate level of monetary policy accommodation during the month, but it was also exerting its control over the European Union's banking system. On June 7th, the ECB in conjunction with Europe's banking resolution authority, the Single Resolution Board (SRB), exercised resolution powers under the Bank Recovery and Resolution Directive (BRRD) for the first time. The SRB determined that Banco Popular is "failing or likely to fail" after identifying a EUR9.1 billion provision and capital shortfall. As a result, it subsequently wrote down all common equity tier 1 and additional tier 1 capital and converted tier 2 securities into new equity which was then sold to Santander for EUR1. Senior bonds were not touched as Banco Popular had not yet issued senior bail-inable debt. Then, on June 23rd, the ECB determined that both Banca Popolare di Vicenza and Veneto Banca were also failing. However, in this case the SRB determined that the potential risk did not warrant resolution, but instead directed that both banks be unwound under Italian insolvency law. While the equity and subordinated debt of both entities were wiped out, senior bonds and deposits were not touched as Italian Banks have not yet issued senior bail-inable debt. Intesa agreed to acquire the deposits and certain performing liabilities of both banks while the Italian government provided support in the form of cash and government guarantees. In general, spread reaction to both events was orderly as investors were impressed with how well this process worked.

June Market Performance:

US corporates outperformed in June with spreads 4bps better, resulting in excess returns of 0.50% and total returns of 0.31%. Financials continued their strong run highlighted by sub banks which tightened another 7bps in June bringing excess returns to 2.49% over the first half of the year. Industrials were 4bps better on the month driven by outperformance across the board with the exception of Energy which clawed its way back to end the month only 4bps wider (+11bps going into the last week). Autos were 9bps tighter after three consecutive months of underperformance and other top performers included Pharma (-8bps), Healthcare (-8bps) and Media (-9bps). The curve flattened slightly with the long end 6bps tighter vs. 7-10YR bucket only 4bps better. European corporates also outperformed in June as financials continued to rally, Insurance tightened another 21bps on the month to bring year to date excess returns to 5.76%. Overall the index was 7bps tighter, resulting in excess returns of 0.47% and total returns of -0.56% for the month.

Supply Update:

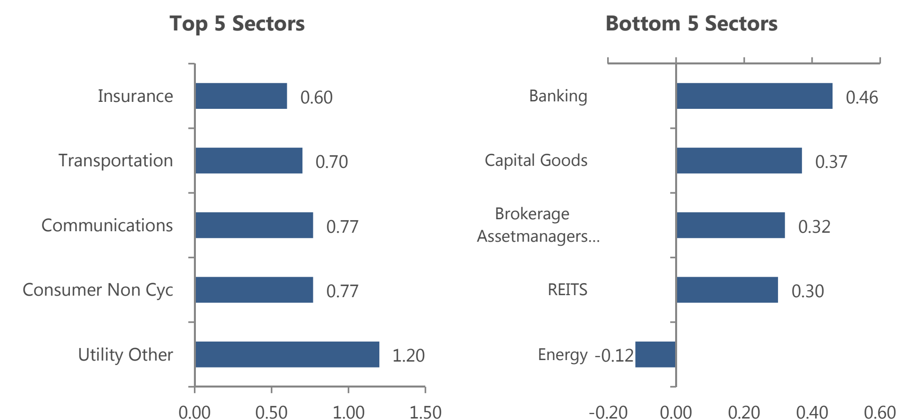
In the US, new issue volumes declined to $78 billion in June which is consistent with the June average from the previous 4 years. Despite a noticeable slowdown in US Bank issuance, financials still came in at $28 billion during the month as both insurance

companies and yankee banks were active in June. Year to date, issuance is consistent with last year's record breaking pace. In Europe, issuance was €52.9 billion in June which represents the busiest June since 2009. Supply was led by non-financials which set a new June record at €35.2 billion. Year to date, issuance is now level with last year's pace.

The elevated issuance was well absorbed as money continued to flow into both markets.

We anticipate some modest spread tightening, but given current valuations, we believe the majority of the return over the next 6 months will come from carry.

Top and Bottom 5 U.S. Corporate Sectors by One-Month Excess Returns



Source: Barclays POINT as of June 30, 2017

Outlook:

We anticipate some modest spread tightening, but given current valuations, we believe the majority of the return over the next 6 months will come from carry.

Technicals: We continue to believe technicals will remain supportive for IG credit, particularly in the U.S., as the asset class remains attractive to both yield sensitive domestic buyers as well as foreign investors.

Fundamentals: U.S credit fundamentals have improved year to date. 1Q17 earnings improved materially with 78% of companies exceeding expectations and benefitting from a weaker U.S. dollar. Revenue growth was +7.8% and earnings growth was +14.6% as Materials, Energy and Technology led the way. While expectations for consensus earnings for the S&P 500 for 2017 is $128.23, an increase of 17.8% year-over-year, this forward earnings figure is negative 1% over the last three months. The S&P 500 price level increased 8.2% year to date, as the outlook for forward earnings has moderated. The forward P/E on 2017 earnings has increased to 18.9x. Events that could negatively impact earnings include the delay of tax package, impact of China's debt financed GDP growth, the related impact on commodity prices, Brexit, and emerging market growth. Gross leverage increased 0.13x year-over-year to 3.0x with the primary driver being Technology issuance to fund stock buybacks. Interest coverage decreased 1.1x year-over-year to 10.1x as corporate debt at high rated companies increased, while overall earnings improved. Capital expenditures declined 9% year-over-year due to slower spending by Energy/ Materials companies. Excluding Energy/Materials capital expenditures are +2% year-over-year. Cash payments to shareholders are negative 6% year-over-year primarily due to a 17% reduction in stock buybacks as dividends were stable. M&A activity has slowed this year given high stock valuations and uncertainties on tax policy. If forward earnings do not materialize, while companies continue to spend on dividends, stock buybacks, capital expenditures, and M&A the high leverage trend will likely become a greater concern to credit investors.

Valuation: We believe investment grade credit valuations continue to be moderately attractive given our views on technicals and fundamentals.

Potential Risks:

1. U.S. policy uncertainty; we believe valuations at the moment are pricing in many of the credit-constructive policies Trump has discussed (tax reform, infrastructure spending, etc.) and few, if any, of the negative ones (tariffs, strict immigration policies, protectionism, etc.).
2. Geopolitical instability.
3. Monetary policy mistake.

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