May 2018

THE END OF GOLDILOCKS?
NAVIGATING TIGHT CREDIT VALUATIONS AND RISING YIELDS

INVESTORS HAVE HAD A GOOD RUN OVER THE PAST FEW YEARS INVESTING IN FIXED INCOME MARKETS, THANKS TO A SECULAR DECLINE IN INTEREST RATES AND A CYCLICAL COMPRESSION IN CREDIT SPREADS. HOWEVER, THE ENVIRONMENT IN 2018 AND BEYOND MAY FAVOR MORE SOPHISTICATED ACTIVE APPROACHES, SUCH AS FLEXIBLE 'BEST IDEAS' STRATEGIES.

'Goldilocks' was the byword for credit markets in 2017. The first synchronized global economic expansion since the financial crisis underpinned a strong rally in credit spreads. Economic growth and inflation ran 'just right' to support asset prices. It also resulted in the lowest average levels of volatility in equity market history (as measured by the VIX index).

The first signs that the Goldilocks regime may be coming to an end came in February 2018 when concerns about rising inflation and rates contributed to the largest ever one-day spike in the VIX. The Goldilocks narrative has also come under fire given the recent trade-related talk with China.

Nonetheless, credit spreads still trade at some of their richest valuations since the 2008 crisis, being justified by an economic backdrop that remains strong. In our view, this should translate into robust corporate earnings growth. Indeed, a forecast for continued low default rates in 2018 is justified. Given the expectation of higher interest rates, we believe a shorter-duration exposure is appropriate and economic fundamentals do not yet justify being short credit risk. However, current tight valuations, a potentially normalizing volatility backdrop, the threat of inflation and the reversal of monetary stimulus warrant an 'index agnostic' approach to portfolio construction. Prudent security selection is mandatory.

We believe one thing is clear – this is not the type of straightforward environment in which passive investors or active index-constrained 'benchmark huggers' tend to feel most comfortable. This environment might be better suited to active and dynamic 'best ideas' approaches, where sector and security selection can exploit the most value.

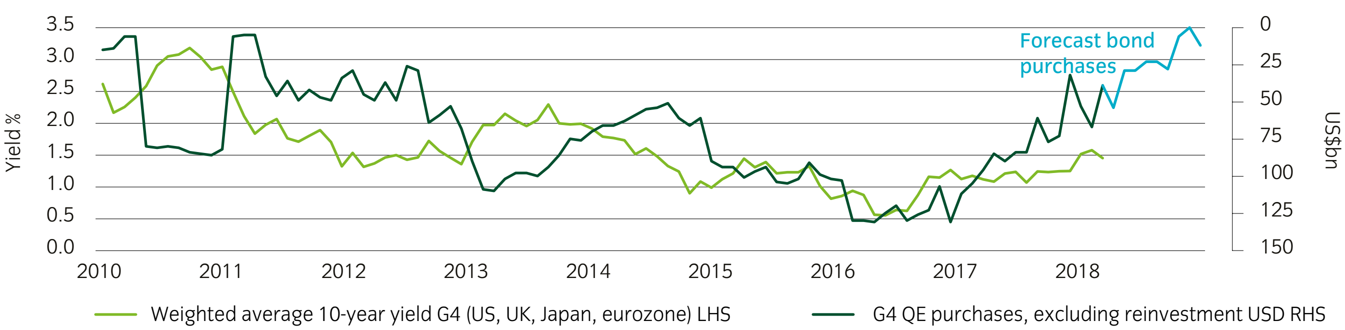
THE END OF EASY CREDIT RETURNS?

There are a number of reasons to believe that the Goldilocks era is unsustainable.

Global growth is increasing towards its potential, likely the highest point at which current level of inflation can be sustained. US unemployment at 4.1% (as of March 2018) is one of the lowest on record. According to the Phillips Curve, unemployment and inflation have an inverse relationship as tight labor markets force companies to compete for existing workers through higher wages. Inflation pressures are therefore likely to build.

The Federal Reserve is normalizing monetary policy and reducing its balance sheet while central bank support elsewhere is peaking (Figure 1).

Figure 1: Will the withdrawal of central bank stimulus drive yields higher?[1]



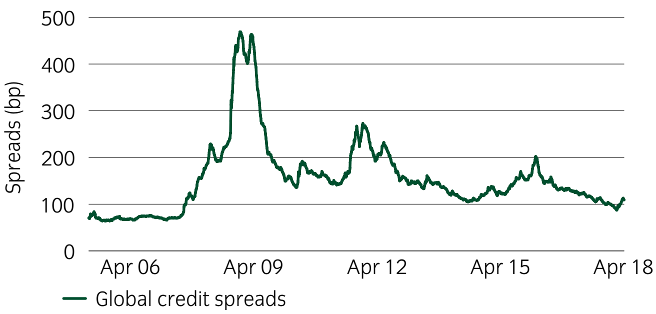
[1] Source: Bloomberg, Atlanta Federal Reserve, data to end March 2018 and forecast for remaining period.

WHERE NOW FOR CORPORATE BONDS?

Credit markets should not react too unfavorably to inflationary impulses or rising yields if they are orderly and contained, but sharp rises would be a concern.

This adds to the challenges facing credit investors. Credit spreads are at some of their tightest since the global financial crisis (Figure 2), potentially exposing investors to market corrections.

Figure 2: Credit spreads reach their narrowest levels since before the financial crisis[2]



A 'BEST IDEAS' APPROACH FOR A COMPLEX CREDIT MARKET

In our view, not all segments of the global market are in sync and active management is better positioned to capture the value from that nuanced reality. Strategies that can look across the full spectrum of US and global investment grade credit markets, regardless of a benchmark, are best positioned to extract better returns. Freedom to take advantage of relative-value opportunities across diffferent issuers and up and down the capital structure, across sectors and/or global credit regions is also important. This index-agnostic approach can also add additional diversification from areas such as high yield, secured loans, emerging market debt, asset-backed securities and/or more esoteric investments. Secured finance, for instance, offers a complexity premium above comparably-rated corporate credit, which is attractive for sophisticated investors. Managers can also hedge interest rate risk or adopt a short duration exposure.

GENERATING 'BEST IDEAS' FOR CREDIT INVESTING

The difficulty of investing in credit strategies on a 'best ideas' basis is that it requires considerable resources and expertise. Not having a benchmark to hide behind requires diligent bottom-up credit expertise that seeks to identify future rising stars as opposed to just avoiding future fallen angels.

Those with access to the required skills are well-placed to overcome the flaws of traditional index-based approaches in the current environment.

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Gautam joined Insight's Fixed Income Group as a senior portfolio manager in January 2015, following BNY Mellon's acquisition of Cutwater Asset Management (Cutwater). He initially joined Cutwater in 2003 and has worked in the financial services industry since 1999. Gautam's responsibilities include leading the management of Insight's flagship US core plus strategy, as well as its US high yield and global strategic income strategies in addition to other discretionary total return products. Gautam is also the lead portfolio manager of the US select income strategy. Prior to Cutwater, Gautam was a high yield analyst with Times Square Capital Management, where he focused on credit management for CBOs as well as high yield total return accounts. He holds a BS (Hons) from the Rochester Institute of Technology and an MBA degree (with distinction) from Cornell University. He is a CFA charterholder, a Certified Public Accountant (CPA) and a member of the New York Society of Security Analysts.

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[2] Source: Bloomberg, Bank of America Merrill Lynch, April 9, 2018.

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