Global credit economic summary and outlook

First quarter 2019

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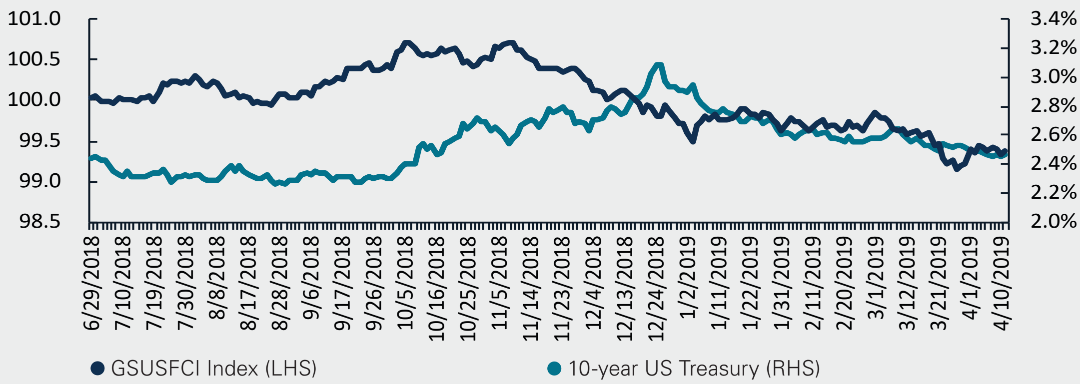
Domestic

Summary

As it turns out, Jay Powell and the U.S. Federal Reserve do listen to the markets. Recall that the Federal Reserve's December 19, 2018 forward guidance anticipated two federal funds rate increases in 2019 accompanied by continued balance sheet run-off described as "on cruise control." In response, investors voted with their feet, triggering a significant sell-off in risk assets, a tightening of financial conditions and a Treasury bond market rally. In essence, the market told the Federal Reserve that its stated monetary policy outlook represented a sizable policy error.

Goldman Sachs U.S. Financial Conditions Index and 10-year U.S. Treasury Yield



As of 4/10/2019. Source: Bloomberg

To their credit, the members of the Federal Open Market Committee (the FOMC) realized the error and began walking back guidance almost immediately through a series of public statements and interviews. This reversal of policy course has flipped investors' expectations regarding 2019 monetary policy to one of easing from one of tightening. After both the January 30, 2019 and March 20, 2019 FOMC meetings, Federal Reserve Chairman, Jay Powell, confirmed the reversal of the guidance that emerged with the December 18-19, 2018 meeting. At the March meeting, the Federal Reserve indicated it would cease shrinking its balance sheet in September 2019 and its new dot plot indicated no hiking of the federal funds rate this year and only one hike in 2020.

During the first quarter of 2019, the U.S. Bureau of Economic Analysis reported that gross domestic product (GDP) growth decelerated sequentially again, dropping from a seasonally adjusted annualized rate of 3.4% in the third quarter of 2018 to 2.2% in the fourth quarter of 2018. Inflation also decelerated as the core consumer price index (CPI) fell from a peak of 2.4% year-over-year in July 2018 to its most recent 2.0% year-over-year level in March 2019.

Notably, the 35-day government shutdown appears to have had little lasting effect on economic growth. In addition, business and consumer confidence surveys remain at healthy levels while the labor market continues to exhibit strength. Nevertheless, recent data and Federal Reserve guidance now suggest that the rate of economic growth has incrementally slowed.

Outlook

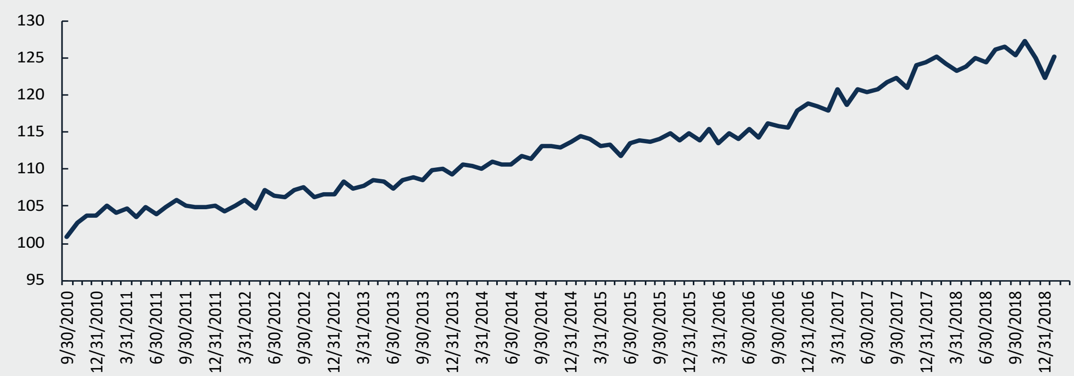
U.S. GDP grew 3.0% in 2018; in 2019, we expect modest slowing from that level as the effects of the Trump tax cuts fade and global economic growth slows. We currently forecast U.S. GDP growth to slow to 2.4% in 2019. While our forecast implies a deceleration in the rate of growth, it remains above trend. We also expect inflation to remain well contained in 2019. Consumer spending will continue to comprise the primary driver of U.S. economic growth, as the strong labor market should continue to exert upward pressure on wages. Business spending may slow as gross private domestic investment fades after growing 6.8% in 2018. We believe the subdued growth picture combined with benign inflation will keep the U.S. Federal Reserve on hold this year.

International

Summary

In April 2019, citing worsening trade friction, the IMF downgraded its 2019 world economic growth forecast to 3.3% from 3.5% as forecast in January 2019. We believe the slowdown in the global economy has likely bottomed out, based on partial data, which suggests that global stimulus efforts may be having a positive effect. Indeed, world trade activity appears to be increasing after a brief lull (see chart). In a boost to emerging market economies, oil and other commodity prices trended gradually higher in the first quarter of 2019.

CPB Netherlands Bureau for Economic Policy Analysis - World Trade Volume Index

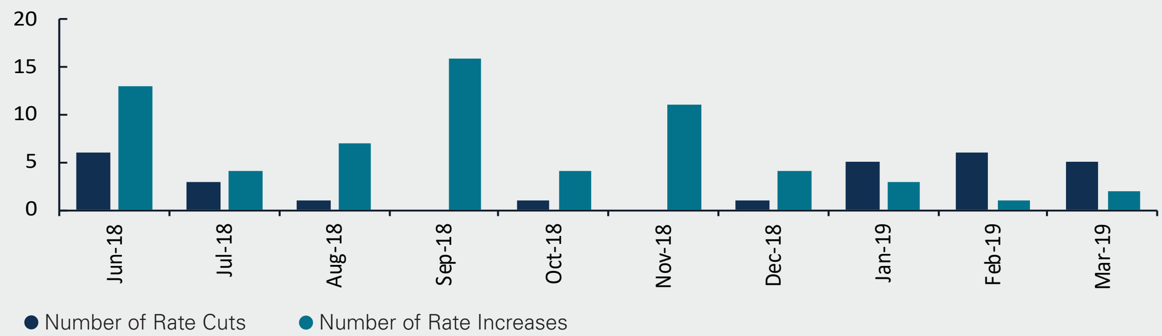


As of 1/31/2019. Source: Bloomberg

Recent economic data from France, Germany and Italy appears somewhat positive and points to a second half 2019 recovery. Nevertheless, Europe remains a serious area of concern as a recession takes hold in Italy following two consecutive quarterly periods of negative economic growth (i.e., GDP growth of -0.14% and -0.11% in the third and fourth quarters of 2018, respectively). Currently, Italian government projections predict flat economic growth for 2019. Additionally, a sharp drop in German exports represents another area of focus. Because a significant quantity of European government bonds currently offer negative yields, many investors fear that fiscal stimulus comprises the only effective tool that remains for European governments to influence economic activity. High debt-to-GDP ratios compound those fears, as they limit the ability of many European countries to implement significant fiscal stimulus programs.

A summary of worldwide central bank rate increases and cuts provides some evidence that global stimulus is increasing (see chart). While the data isn't GDP-weighted, the simple tally of global central bank rate increases and cuts shows that, since January 2019, interest rate cuts outpaced increases. This trend appears to coincide with a marked change of sentiment by the U.S. Federal Reserve, which significantly reduced its resolve to continue increasing its federal funds rate target throughout 2019.

World Wide Central Bank Rate Cuts and Increases



As of 3/31/2019. Source: ww.cbrates.com

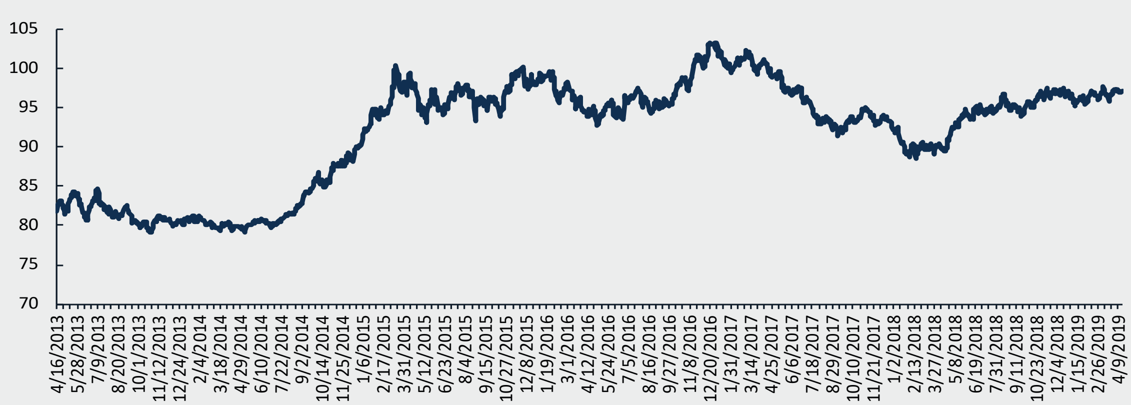
Outlook

As authorities acknowledge the recent slowing in global economic growth, policy steps to counter this are slowly taking effect. China put into place a combination of tax cuts and government programs equivalent to an estimated $300 billion. Recent positive Chinese economic data, especially in the housing sector, provide evidence that the economy has turned the corner. Japan also introduced tax cuts in the face of slumping consumer sentiment. As suggested above, Europe may consider more aggressive action as its core economies feel the effects of a global economic slowdown. As a result, we expect global economic activity to increase in the second half of 2019. Finally, we note that ongoing trade negotiations in many countries represent a potential but currently unquantifiable additional variable to the global outlook.

Currencies and commodities

The U.S. dollar index spot rate remains in an upward trend (see chart) and we continue to see no sign of a weaker dollar. The U.S. economy continues to grow at a respectable pace versus other developed countries and, as a result, it should attract global capital investment. Technical analysis still suggests a slightly firmer U.S. dollar for the near term. Ex-energy, mainstream commodity prices firmed in recent months, but in our opinion, present little threat to global inflation going forward.

U.S Dollar Index Spot Rate



As of 4/9/2019. Source: Bloomberg

Sector analysis

U.S. interest rates

U.S. Treasury rates declined considerably during the first quarter of 2019. The yield curve continued to flatten, with the spread on 2-year and 10-year U.S. Treasury Notes declining to 14 basis points at the end of the quarter. The belly of the curve led the decline as 5-year U.S. Treasury Note yields declined 28 basis points while 7-year note yields declined 27 basis points. The 10-year U.S. Treasury Note yield declined 28 basis points, ending the quarter at 2.41%. The short end of the yield curve inverted as 2-year and 5-year U.S. Treasury Note yields ended the quarter at 2.26% and 2.23%, respectively. In summary, the flattening trend continues and the curve has inverted on the short end. However, the inversion has lasted only for a brief period, and has reversed itself on several occasions. With regard to duration, our portfolios are broadly positioned neutral relative to their benchmarks.

Securitized products

The securitized products sectors participated in the first quarter 2019 risk-on rebound, but unfortunately not to the extent seen in the credit markets. The CMBS sector ranked as the best-performing sector and it posted an excess return over U.S. Treasuries of 133 basis points, followed by ABS at 46 basis points, and agency MBS at 41 basis points. Fundamentals for the securitized sectors remain favorable and include positive underlying trends in residential housing, commercial real estate, and consumer finance. We believe the housing market, which had been showing signs of slowing, should benefit from the recent decline in mortgage rates. Commercial real estate and consumer finance fundamentals directly benefit from continued robust labor markets. In general, securitized sector valuations leave little room for improvement after recovering much of the underperformance generated in the fourth quarter of 2018. In the short term, we prefer to allocate in a selective and cautious manner within the securitized products sectors. We favor an underweight in agency MBS, where poor valuations and negative supply and demand technicals should weigh on returns. We maintain a modest CMBS overweight in most portfolios while targeting higher credit quality and shorter maturities. Finally, in the ABS sector, we recently reduced our targeted overweight and upgraded quality.

Investment grade credit

Investment grade credit strongly rebounded during the first quarter of 2019, outperforming U.S. Treasuries by 252 basis points, offsetting almost 90% of the underperformance generated in the preceding quarter and marking the best quarterly excess return since 2012. On the basis of excess returns, the best-performing industries and sub-segments of the Bloomberg-Barclays U.S. Credit Index comprised refining, bank preferreds, energy E&P, gaming, and midstream energy. The worst performers during the quarter included supranationals, packaging, consumer products, supermarkets, and foreign local governments (i.e., taxable municipals and universities).

In late December 2018 and early January 2019, we tactically reduced our underweight within investment grade credit as a result of improved valuations heading into year end and an anticipated relief rally early in 2019. Nevertheless, we remain modestly underweight investment grade credit due to weakening credit fundamentals, decelerating earnings, and currently modest valuations, all partially offset by improved technicals. We expect broadly supportive yet decelerating revenue and earnings growth, some margin pressure, and a continuation of the predisposition of corporations to return cash to shareholders at the expense of the debt holder. Further, balance sheet leverage and corporate debt remain near cyclical peaks, although this phenomenon appears concentrated in a handful of industries and issuers. Valuations snapped back during the first quarter of 2019 as investment grade credit spreads retraced roughly half of the spread widening experienced since reaching the post financial crisis cyclical spread tights on February 1, 2018. Credit spreads currently reside approximately three-quarters of a standard deviation tighter than the average 2010-to-present spread and roughly one-half a standard deviation tighter than the average spread over the last 25 years. Demand technicals improved in the first quarter of 2019, largely due to renewed retail inflows which we expect to continue in the near term. Further, a modest decline in foreign currency hedging costs as well as lower foreign yields increased foreign investor demand for U.S. investment grade credit, especially out of Asia. Despite increased U.S. deficit funding, the phasing out of quantitative tightening later in 2019 should reduce some cross-asset supply pressure, thereby lessening the crowding out of credit demand. A continued modest decline in new issue supply should also continue to support technicals in the near term.

As anticipated, given the rapid sell-off that occurred during the fourth quarter of 2018, investment grade credit spreads improved early in 2019. However, we continue to expect an increase in volatility and wider spreads later in the year. Slowing U.S. and global economic growth, despite potentially more accommodative monetary policy, should eventually result in a handoff of market control from favorable supply demand technicals to weakening fundamentals. Further, given currently uninspiring valuations, we are treading cautiously and focusing on industry allocation and issuer selection.

High yield

In March 2019, a rally in U.S. Treasuries underpinned a 0.94% total return for the month by the Bloomberg-Barclays U.S. High Yield Corporate Bond Index (the High Yield Index). On a more impressive note, the High Yield Index generated a 7.26% total return in the first quarter of 2019, the strongest start to a calendar year in at least 25 years. Although higher-quality bonds outperformed in March as rates rallied, returns were notable for their consistency across the ratings spectrum (BBs and Bs returned 7.21% while CCCs returned 7.15%). On that basis, BBs significantly outperformed on a risk-adjusted basis. Spreads tightened 158 basis points in the quarter and now reside at levels equivalent to early November 2018, while the average yield-to-worst is now below 6.5% versus approximately 8% at the end of 2018. Every industry sector posted a positive return in the first quarter of 2019, with gains led by oilfield services (returned 11.1%), pharmaceuticals (9.3%), and supermarkets (9.1%), offset by lagging returns in automobiles (5.5%) and media (5.9%). Fundamentals remain on solid footing, as the high yield default rate resides under 1% and leverage continues to decline (i.e., through the fourth quarter 2018 financial reporting period (latest available data)). As a result of solid year-to-date inflows totaling $12.2 billion, technicals appear significantly more balanced than in 2018, allowing the new issue market to regain its footing and take share back from the leveraged loan market. The spread rally in the first quarter of 2019 left valuations on the rich side again, particularly for BB-rated bonds, and further tightening appears contingent on whether or not investors 1) gain general comfort in lower-rated issuers and / or 2) find the resolve to bid up prices for issuers in the energy sector, possibly on continued strength and stability in oil prices.

Leveraged loans

The U.S. bond market's newly tempered rate outlook and continued retail outflows brought the loan market rally to a halt in March 2019 as the Credit Suisse Leverage Loan Index (the CSLLI) lost 0.12% in the month. Even so, the CSLLI's 3.78% total return in the first quarter of 2019 represents the best start to a year in a decade, although it lagged the High Yield Index's 7.26% total return by a wide margin, due in part to weaker technicals characterized by continued outflows thanks to the Federal Reserve's new dovish stance on rates and a relatively tepid start to CLO issuance in 2019. Whereas gains within the High Yield Index were spread evenly across ratings buckets thus far, higher-rated loans outperformed in the first quarter of 2019 as investors focused on the BB-segment which returned 4.2% in the period, versus 3.6% for Bs and 2.2% for CCCs. Every industry sector in the CSLLI generated a positive total return in the first quarter of 2019, with the food and drug, and metals and mining sectors leading the way with total returns of 5.5%, while the consumer non-durables sector trailed with a 0.1% total return. While the leveraged loan default rate remains low at approximately 1%, leverage metrics exhibited by new loan issuers is climbing and indicative of late-cycle behavior. Due to the weaker technical backdrop in the loan market, issuers began shifting new issue dollars to the high yield bond market (including to secured bonds), where demand is stronger. Following the High Yield Index's strong outperformance in the first quarter of 2019, loan yields, which currently reside near 7%, appear particularly attractive on a relative value basis.

Non-dollar

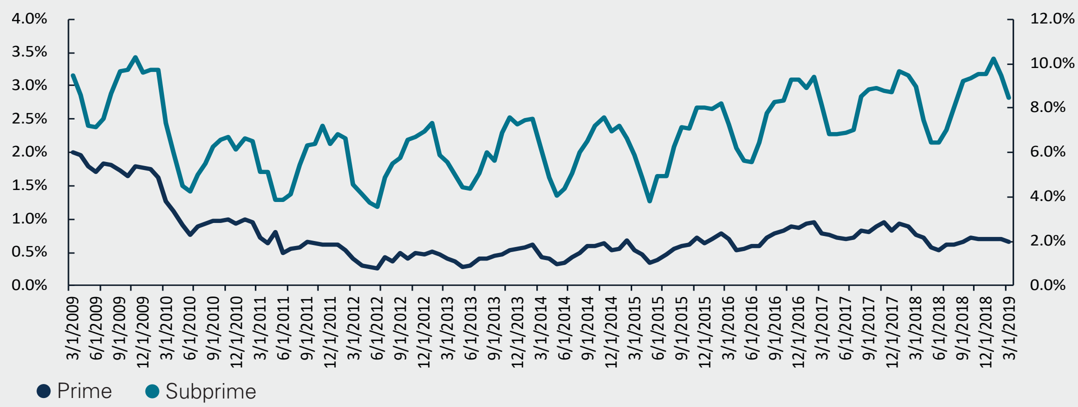
Rates remain low worldwide, creating little opportunity for non-dollar returns to surpass those offered by U.S. Treasuries.

Credit Spotlight

Auto ABS- Still rolling along

Despite negative headlines, especially for subprime borrowers, the auto ABS sector keeps rolling down the highway. Prime borrowers continue to exhibit very steady and strong credit performance (see chart). Prior to the financial crisis, prime auto ABS annualized net losses averaged approximately 1.5% compared to only 0.75% today. Prime auto ABS comprises loans originated by well-known issuers such as Ford Credit, GM Financial, Nissan Motor Acceptance Corporation, and Toyota Motor Credit Corporation.

KBRA Prime and Subprime Auto Loan Indices - Annualized Net Losses



As of 3/1/2019. Source: Knoll Bond Rating Agency

Notably, however, subprime ABS loan losses increased in recent years, with each successive annual peak moving slightly higher. Subprime ABS loan loss performance exhibits a strong seasonality, with losses peaking around year-end and then improving at tax refund time. While it appears that subprime ABS loan losses have almost returned to crisis levels on an aggregate basis, we observe that much of the credit deterioration is attributable to a change in the index composition due to the inclusion of new issuers that focus on deep subprime borrowers. Some prime auto ABS issuers, such as GM Financial, also issue subprime ABS. Additional subprime issuer include lesser-known names such as DriveTime Automotive Group, Santander Consumer USA and Westlake Financial Services.

Auto ABS loan loss performance continues to benefit from strong U.S. consumer fundamentals, including robust labor markets, gains in household net worth, and solid consumer balance sheets. We carefully monitor the decline in subprime ABS performance, but current loan losses remain within the underwriting expectations of the ABS structures. Lastly, we highlight that auto ABS structures are well tested over time, and both prime and subprime auto ABS securitizations have held up extremely well during the even the most stressful financial crisis environments.