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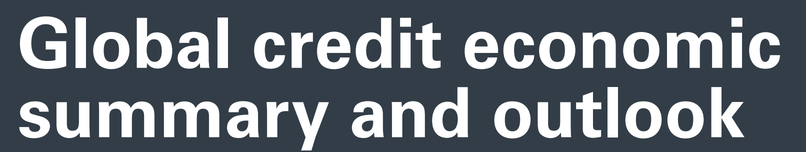


Second quarter 2019

Global credit economic summary & outlook

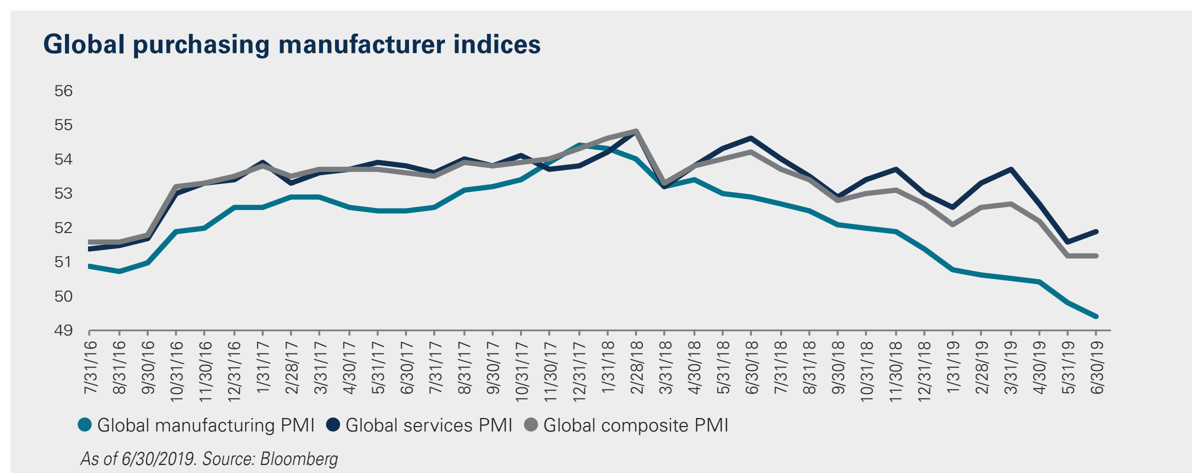
Domestic

Summary

U.S. GDP growth in the second quarter of 2019 appears to have softened from a stronger-than-anticipated first quarter seasonally adjusted annual rate of 3.1%. While the most recent rate of economic growth appears slower, the composition of growth appears healthier, as personal consumption expenditures will likely contribute more than inventory growth and net exports.

Notably, in the first quarter of 2019, the growth in personal consumption expenditures (which comprises approximately 70% of U.S. GDP) declined to a seasonally adjusted annual rate of 0.9%, versus 2.5% and 3.5%, respectively, in the fourth and third quarters of 2018. However, according to the Federal Reserve Bank of Atlanta's most recent GDPNow forecast, the growth in personal consumption expenditures in the second quarter of 2019 should rebound to a much healthier 2.5%. That said, the Federal Reserve Bank of Atlanta's most recent forecast expects U.S. GDP to grow only 1.4% in the second quarter of 2019, suggesting that other primary components of GDP growth (likely net exports and inventories) will make relatively modest contributions to overall economic growth in the period.

The slowing of the industrial sector featured prominently in economic data and news flow during the second quarter of 2019, and many headlines connected the trend to business uncertainty caused by the tariff war being waged by the U.S. on multiple fronts, the most significant being the trade tension with China. Notably, however, we see evidence of a general slowing of global economic trends (see chart below) and don't believe these all result from U.S. trade tensions.



As of 6/30/2019. Source: Bloomberg

Outlook

The U.S. Federal Reserve appears focused on the possibility that domestic economic growth appears poised to decelerate in the coming quarters. In addition, the Federal Reserve appears increasingly concerned with the persistence of low inflation. We currently expect the Federal Reserve to cut its federal funds target rate by 25 basis points at the FOMC meeting on July 31, 2019; however, some strategists expect the cut could be as large as 50 basis points.

In the near term, we do not expect that the U.S. economy will slow to the point of recession. Nevertheless, a slowdown in economic growth seems highly possible, given the recent negative trend of purchasing manager indices and other economic data. Significantly, any continued weakness in economic data and GDP growth will likely trigger the U.S. Federal Reserve to begin a rates easing cycle.

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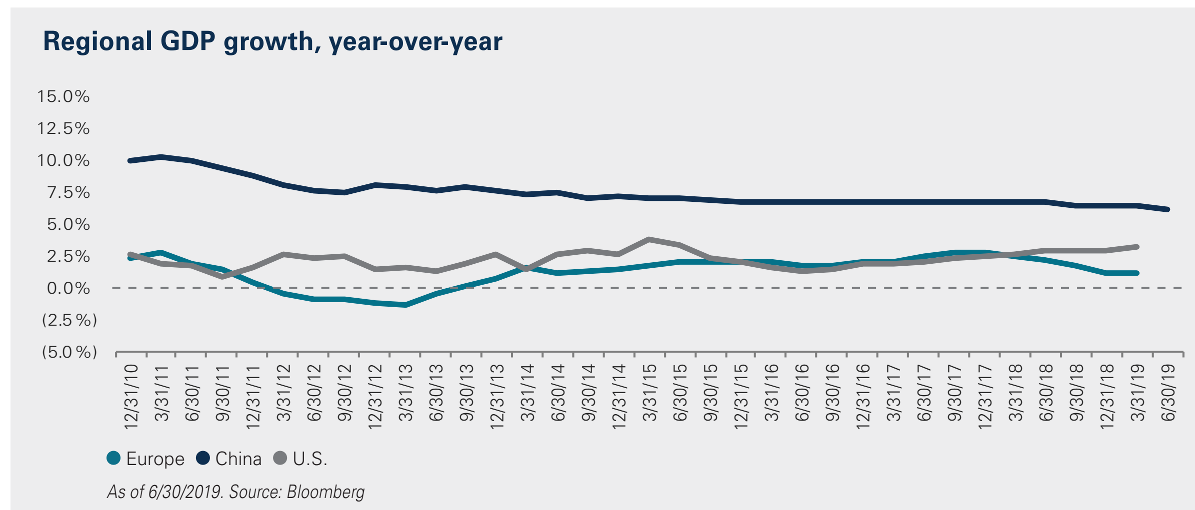
International

Summary

Global monetary policy continues to become more accommodative as central bankers react to a global slowdown in industrial and trade activity. Although trade and tariff concerns weighing heavily on economic fundamentals, other significant cyclical and idiosyncratic headwinds continue to pressure various regional economies. Ongoing structural limitations of the European Union limit the European Central Bank's ability to effectively deal with macro-economic cycles, and address challenges such as financial crises or decelerating global growth. In the Asia-Pacific region, economies face the reality of slowing economic growth in China, which can have a pronounced effect on the area's business and industrial trends.

Regional GDP growth data (see chart below) reveals a divergence in worldwide economic growth trends. During the second half of 2017, GDP growth in both Europe and China began to decelerate, while U.S. economic growth continued to accelerate. We attribute this divergence largely to fiscal policies. In the U.S., following the 2016 Presidential election, tax and regulatory reform provided a significant late cycle boost to the economy. Conversely, while authorities in Europe and China have enacted policies aimed at sustaining economic growth, their efforts have been less effective.



As of 6/30/2019. Source: Bloomberg

In the near term, U.S. year-over-year GDP growth appears poised to begin decelerating as last year's performance, the strongest of the current cycle, rolls off. Notably, in January 2016, China and the G-7 countries enacted the "Shanghai Accord" which sought to stimulate global economic activity. More recently, China has begun to re-stimulate its economy, and it seems likely that it will begin to benefit from such efforts by the end of this year. The ECB, on the other hand, possesses limited tools at its disposal, although it seems to realize that the faltering European economy requires stimulus. We believe these divergences may significantly impact bond and currency markets in the coming quarters.

Outlook

Certain emerging economies and those in Asia will likely benefit from any rate easing efforts the Federal Reserve deploys to sustain economic growth in the U.S. Importantly, the effect of U.S. Federal Reserve policy likely won't immediately register on the macro economic and business cycle trends in those regions. The effect on currencies, however, will be felt much sooner. A softening dollar will create a tailwind for economic growth and risk asset prices in emerging economies. This, combined with an anticipated turnaround in the Chinese economy, should significantly benefit emerging markets.

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We believe that European economic fundamentals will likely remain in a relative malaise. Christine Lagarde will take control of the ECB when Mario Draghi's term as President ends on October 31, 2019. As a result, the ECB's responsiveness may suffer somewhat as it adjusts to the impending leadership change, as it's not yet clear how Ms. Lagarde will prioritize the use of the ECB's policy tools. We view deeper negative interest rates as a risk and burdensome to the region's banking system; and asset purchases appear to have largely run their course. Interestingly, and mirroring the background of the new U.S. Federal Reserve Board Chairman, the new ECB President will not be an economist; in fact, they are both lawyers by training. We observe that Ms. Lagarde's profile could usher in a more pragmatic approach to monetary policy compared to that employed by her economist predecessors. Regardless, given the impending change in leadership at the ECB and the continued uncertainty surrounding the U.K.'s Brexit, we believe risk assets and both sterling and the euro currencies will face headwinds.

Currencies and commodities

Within the near-term horizon, the strongest days of the dollar are likely behind it. The U.S. Federal Reserve has signaled the beginning of a new easing cycle as growth is poised to decelerate from its peak in 2018. With respect to currencies, we expect the primary beneficiaries of this shift in policy will be those viewed as safe havens, such as the Swiss franc and the Japanese yen, along with selective emerging market currencies. Until China begins to realize the effects of its recent stimulus efforts, we do not expect commodity prices to move meaningfully higher. We anticipate that a softening dollar will benefit oil prices, despite softer global demand.

Sector analysis

U.S. interest rates

During the second quarter of 2019, ongoing concerns regarding a decline in global growth and ongoing trade battles fueled a rally in U.S. interest rates. We began the quarter with rates slightly higher, however the breakdown in trade negotiations with China reversed the trend and U.S. interest rates began a steady decline. Yields on the short end of the curve ended the second quarter of 2019 approximately 30 to 50 basis points lower than the beginning of the period, while the longer end of the yield curve saw a decline of approximately 30 to 40 basis points.

Specifically, during the second quarter of 2019, the yield on the 3-month U.S. Treasury bill declined 29 basis points, ending the period at 2.10%. The U.S. Treasury 5-year note yield declined to 1.80%, down 43 basis points in the quarter. The 10-year note yield ended the quarter at 2.0% and the 30-year bond yield declined to 2.50%. The 3-month T-Bill versus the 10-year note yield spread began the quarter nearly flat at 0.88 basis points but ended the quarter inverted at 99.46 basis points.

Securitized products

The overall fixed income market registered another strong result, as the Bloomberg Barclays U.S. Aggregate Bond Index returned a robust 3.08% in the second quarter of 2019. Securitized products experienced difficulty keeping pace with the rally, as both the ABS and CMBS sectors modestly outperformed U.S. Treasuries, but agency MBS returns lagged by 39 basis points. The ABS and CMBS sectors benefited from strong demand for high quality yield and lower than expected new issue supply. Strong fundamentals for consumer finance and commercial real estate, driven by healthy labor markets, helped support both sectors. Unfortunately, the agency MBS sector continues to face headwinds from increased volatility, elevated refinancing risk, and the continued runoff of mortgages from the Federal Reserve's balance sheet. The agency MBS sector is the only fixed income category that generated negative year to date excess returns versus U.S. Treasuries. During the second quarter of 2019, we made only modest changes to our securitized portfolio strategy, including a reduction to our allocation to the ABS sector from 10% to 8% as valuations returned to recent highs. We maintain a modest overweight to CMBS with a focus on seasoned, high quality bonds in the four to seven year maturity range. Lastly, we see no reason to change our long-standing underweight to the agency MBS sector. We believe mortgages will eventually return to favor, which will likely coincide with the end of the rally in the credit markets.

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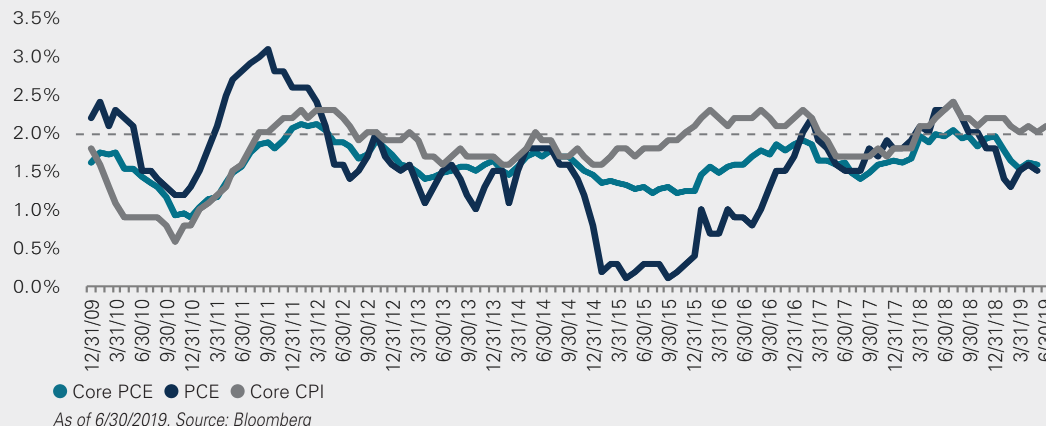
Credit Spotlight

Where is Inflation?

Congress mandates the U.S. Federal Reserve to manage monetary policy in a manner consistent with 1) price stability, and 2) maximum sustainable employment. Since 2012, the FOMC, which sets the Federal Reserve's monetary policy, defined its stable price objective as being represented by a 2% rate of inflation, as defined by the Personal Consumption Expenditures Price Index ("the PCE Index").

U.S. inflation, year-over-year



As of 6/30/2019. Source: Bloomberg

The FOMC first publicly defined price stability in January 2012 as being equal to a 2% level on the PCE Index. Since that date, headline inflation, as measured by the PCE Index only briefly exceeded the 2% target and has averaged only 1.4%. Similarly, the core PCE Index (i.e., excludes food and energy prices) only briefly exceeded the 2% target during the first quarter of 2012 and has averaged only 1.6% since 2012. Clearly, FOMC policies have failed to achieve the stated goal of "price stability" and a 2% level on the PCE Index.

So, what has gone wrong? Simply put, the "non-accelerating inflation rate of unemployment" (NAIRU) comprises a major input to the FOMC's inflation models. NAIRU represents an estimate of the lowest sustainable rate of unemployment the economy can bear without putting consistent upward pressure on prices, thus causing inflation. Understanding NAIRU requires consideration of two critical issues.

First, we consider the thesis that lower unemployment causes inflation. The mechanism for the transmission of this inflationary pressure is either 1) that higher employment levels increase the wealth of workers, thus providing the means to pay more for the goods they purchase; or, 2) that low unemployment forces wages higher and thus increases the cost of goods or services sold, again, causing inflation. However, this rationale focuses only on the demand side of the economy and completely ignores the supply side. In reality, however, price pressures may wane if capacity exists to provide more of the goods that consumers want to buy, or more people enter the workforce. Arguably, globalization has significantly increased manufacturing capacity and the supply of workers, thereby breaking down the demand side of the unemployment / inflation relationship. As an aside, some evidence suggests that local shortages of workers exert upward price pressures in the service sector. The effects are local, however, and have not impacted prices nationally.

The second issue involves the method of estimating NAIRU itself. The so-called natural rate of unemployment represents an unknown quantity and attempts to estimate it have proven difficult, if not impossible. NAIRU is an explicit input to the widely used Taylor Rule model that the Federal Reserve considers as it sets monetary policy. Since the 2008 financial crisis, the FOMC has consistently lowered its estimates of NAIRU via forward guidance statements. It has become clear that the concept of NAIRU has broken down. This breakdown in concept draws into question traditional policy tools such as the Taylor Rule, and is likely a contributor to the Federal Reserve's consistent miss to the low side on inflation.

Inflation dynamics have changed significantly since the 2008 financial crisis and we believe monetary policy should adjust to accommodate the change. Specifically, we believe the concept of NAIRU needs to be reexamined. Moreover, the social safety net and social norms have changed significantly over time. Even a very simplistic evaluation of employment slack using labor participation rates reveals how the employment situation in the U.S. has changed. Overall labor participation in the U.S. has declined 3% from pre-crisis levels, to 63% versus 66% previously. Some of that change is due to aging of the population, but even the so-called working age participation rate (those aged 25-54 years) only started improving in 2016 and has yet to fully recover. We believe that the bottom line for monetary policy is that the FOMC should re-evaluate its approach to the dual mandate. Indeed, Chairman Jay Powell has indicated a more pragmatic approach that would tolerate a stronger economy for longer, deemphasizing a focus on excessively low unemployment statistics.

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Investment grade credit

Despite a volatile and bumpy ride during the month of May, investment grade corporate credit continued to produce positive excess returns during the second quarter of 2019, outperforming U.S. Treasuries by 91 basis points. Underperformance during May was quickly reversed as the market posted its second best performing month of the year in June on an increased expectation for near term Federal Reserve rate cuts. The best performing industries and sub-segments of the Bloomberg Barclays U.S. Credit Index, on an excess return basis, comprised telecommunications, food, beverage and tobacco, media-cable / satellite and life insurance. The worst performing industries and sub-segments during the quarter included foreign agencies, utilities, packaging, oil field services and refining.

We remain modestly underweight investment grade credit due to deteriorating credit fundamentals and stretched valuations, partially offset by improving supply and demand technicals. From a fundamentals perspective, corporate earnings growth is decelerating, U.S. and global growth appear slowing, and the negative effect of tariffs creates margin pressure for many industries. Corporate balance sheet leverage remains a concern as it hovers near its post-crisis peak, while interest coverage remains weaker over the last several years for the investment grade corporate credit market as a whole. At the same time, shareholder enhancement at the expense of debt holders remains pervasive in the corporate market via transformational M&A deals and share buy backs. Given the recent sharp move lower in interest rates, such corporate behavior will likely to continue, simply due to cheaper financing costs coupled with persistent demand for higher quality issues among global investors.

Investment grade corporate bond demand technicals benefit significantly from the dovish central bank policy shift in the U.S. and Europe. The increase in the amount of negative yielding global debt is reigniting the crowding out effect and pushing global investors into the highest yielding developed market bonds; that being those of the United States. The dovish pivot from the U.S. Federal Reserve combined with potential rate cuts on the horizon has and will continue to decrease currency hedging costs for many investors in Europe and Asia. Although a declining yield differential between the U.S. and several developed countries offsets some of the improvement in currency hedging costs, we believe foreign demand for U.S. investment grade corporate bonds should increase in the near term.

From a supply standpoint, we expect near term issuance to pace slower than that of 2018, although longer term we believe supply will increase simply as a result of lower interest rates. Credit spread valuations continued to snap back during the second quarter of 2019, despite some intra-quarter volatility, and appear modestly expensive from a historical perspective at approximately one-half standard deviation rich versus the average when compared to the last 5 and 25 years, according to the Bloomberg Barclays U.S. Investment Grade Corporate Bond Index. However, investment grade corporate bond spreads have modestly lagged the rally year to date, versus both the S&P 500 Index and the high yield bond market in general, largely due to the sudden decline in U.S. Treasury rates and yield shock experienced by many investor groups. While a 3.2% yield for the Bloomberg Barclays U.S. Corporate Bond Index as of the end of the second quarter of 2019 isn't especially inspiring, it remains attractive for many foreign buyers relative to their local market alternatives.

In the near term, we expect technical demand tailwinds should outweigh fundamental credit headwinds and potentially cause modestly expensive valuations to become more expensive. From an intermediate to longer term basis we can't lose sight of the reasons for more accommodative central bank policy: slowing global growth, the trade war, and below trend inflation. These, combined with stretched corporate leverage, decelerating earnings growth, and modestly rich valuations leave us marginally underweight from a longer-term perspective with an intense focus on industry allocation and issuer selection.

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High yield

Against a lower-yield backdrop and hope for Federal Reserve stimulus later in the year, the high yield market bounced back from May's sell-off to post a 2.3% total return in June 2019 (Bloomberg Barclays U.S. Corporate High Yield Bond Index), the second-strongest month of the year (behind January's 4.5% return). June's performance brought high yield total returns in the second quarter of 2019 and the year to date period to 2.5% and 9.9%, respectively, with spreads now approximately 150 basis points tighter on the year (i.e., spreads reached +377 basis points as of June 30, 2019). The collapse of the front end of the U.S. Treasury yield curve drove a particularly strong quarter for rate-sensitive BBs (which returned 3.1% in the second quarter of 2019), while high yield investors remained shy of embracing more credit risk, as CCCs lagged in particular (Bs returned 2.7% and CCCs returned 0.3%). For the quarter, sectors benefitting from lower rates or relatively immune from trade concerns outperformed (e.g., supermarkets returned 5.4%, wireless returned 4.7%, banking returned 4.6%, and homebuilders returned 4.5%), while energy comprised the only industry to post a negative return (-0.9%) as oil traded off. Although retail flows slipped in the second quarter of 2019, the year to date inflow of $12 billion leaves technicals balanced. However, fundamentals pose a risk after credit metrics trended negatively in the first quarter of 2019 (latest available, per JPMorgan data): top line revenue growth slowed to 2.4% year over year and EBITDA declined 4.3% year over year, the weakest readings since the third quarter of 2016, causing leverage to climb for the first time in ten quarters. Although a dovish U.S. Federal Reserve should support risk assets such as U.S. high yield corporate bonds, valuations appear tight on both a yield and spread basis.

Leveraged loans

Despite a credit-friendly tone, the leveraged loan market posted a lackluster gain in June 2019 of 0.22%, per the Credit Suisse Leveraged Loan Index, meaningfully underperforming the high yield market. Loans returned a modest 1.58% in the second quarter of 2019 and 5.42% year to date, trailing the high yield market by a healthy margin, as demand for floating rate products wanes with the U.S. Federal Reserve looking to cut rates soon. Loan spreads (3-year discount margin) retreated, ending the second quarter of 2019 at +460 basis points, 7 basis points tighter in the second quarter of 2019 and 90 basis point tighter year to date, but approximately 80 basis points wide of the post-crisis low of +380 basis points in early October 2018. Performance across ratings buckets generally favored up-in-quality during the second quarter of 2019, as BBs modestly outperformed Bs (1.7% return, versus 1.6%, respectively) while CCCs lagged returning only 0.6%. At the sector level, outperformers in the second quarter of 2019 included more stable industries (broadcasting returned 2.7%, utilities returned 2.1%, diversified media returned 2.1%), while metals and mining comprised the only sector to post a loss (-1.6% total return). Technicals remain challenged by retail outflows and tepid CLO demand, but reduced primary market activity partially offset the effect of these trends. On the fundamentals side, default rates remained low at approximately 1%, but leverage on new deals is climbing and indicative of late-cycle behavior. The relative value between loans and high yield bonds appears more balanced again after June's diverging performance, although headwinds persist for loans in the form of anticipated Federal Reserve easing and related expectations regarding reduced levels for LIBOR.

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