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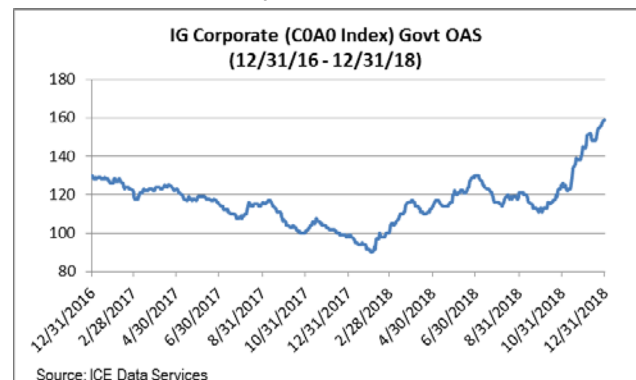
Peak Credit?

January 2019

Financial market performance during 4Q surprised many in large part because it occurred in a benign economic environment. In fixed income, credit markets experienced fierce and relatively sudden spread widening commensurate with event-driven panics in the past such as Worldcom's default in 2002, the U.S. sovereign debt downgrade in 2011 and the oil market crisis in early 2016. The anomaly in 4Q 2018 is the absence of a triggering crisis. With the severe spread widening, observers predicted the end of the credit cycle, citing the abundance of corporate leverage and the damaging implications of the looming recession. Always respectful of information contained in market prices, we do not believe the market has it right. On the contrary, we believe the credit cycle has not peaked and the widening presents an excellent opportunity.

Investment Grade Credit

Investment grade credit prospects started 2018 on an optimistic note after the passage of the corporate tax reduction in December 2017. Spreads were tight relative to historical levels, but were likely justified by prospects for earnings and cash flow. Spreads narrowed further in January, but adjusted after February's equity jolt and moved higher when the Fed raised rates in March and June. Overall, they oscillated in a relatively narrow range until September.

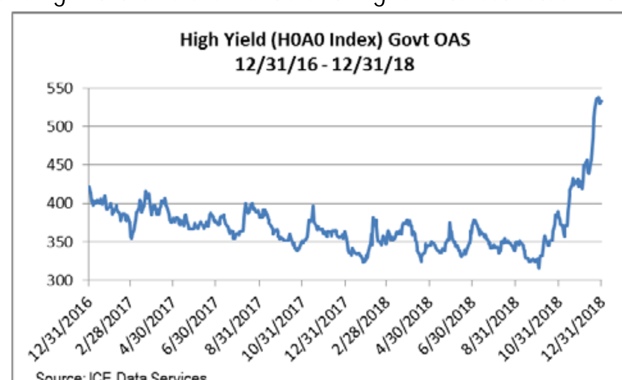


In its third quarter earnings release GE made various announcements, including a dividend cut and further restructuring, that put a spotlight on the company, with both equity and credit analysts questioning the strategy and illuminating its credit risk. As a highly indebted company, investors worried about a downgrade to junk and its ability to finance an ambitious plan. Predictably, the market began to focus on other highly indebted investment grade companies, especially those with recent sizeable M&A transactions, like AT&T, Bayer, CVS, AB Inbev and others. All of these companies promised quick deleveraging after their deals that a weaker economy might stall, leaving them exposed to significant ratings risk. That conversation grew louder during the quarter despite the companies insisting their plans were on track. The focus on some of these companies affected sentiment and led to outflows from credit funds that, combined with poor year-end liquidity, propelled the sector's underperformance. But reviewing investment grade credit fundamentals suggests a different picture:

- Investment grade non-financial leverage peaked in 2017 after three elevated years of issuance to take advantage of low interest rates. In 2018, leverage started declining as earnings improved and borrowing subsided. Most of the companies that took on transaction related leverage are on track in their debt reduction plans;
- After six record years of issuance, investment grade borrowers issued fewer bonds in 2018. According to Barclays, investment grade issuance in 2018 totaled $1.2 trillion, about $230 billion less than 2017. Most credit strategists expect borrowers to reduce their issuance again in 2019, in part because they expect higher interest rates;
- An important support for investment grade credit came from foreign investors. As rates rose in 2018, the cost of hedging increased making the investment proposition less compelling. The pause in rate increases and the higher spreads restores some of the attractiveness of the sector to foreign investors;
- Opinions amongst economists and strategists became more divergent on the pace of global economic growth and the likely direction of interest rates. Even the most hawkish observers, trimmed their expectations for Fed rate hikes and levels of U.S. interest rates in 2019. Assuming the lower rate assumptions prove correct, more favorable financial market conditions support a benign outlook for investment grade credit.

High Yield

In our September 2018 quarterly letter we wrote, "High yield bonds seemed to defy gravity with another impressive quarter despite noticeable worries in emerging markets, continuing withdrawals of funds and higher interest rates in the U.S." The sector's high wire act ended forcefully during the quarter with spreads widening the most in a single quarter since 2011. Fund withdrawals accelerated during the quarter, nearly doubling the sector's outflows during the first nine months of the year. The negative performance was led by lower rated credits, specifically CCC and low B rated names. Pressure in these rating categories started with energy and the decline in oil prices, but expanded to other weakly rated industries like telecom and retail.



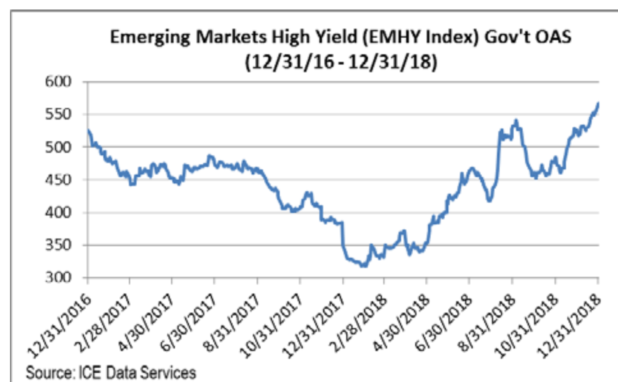
The high yield market always has companies facing financial peril. However, aside from a few well-known names in challenged industries, we believe the financial outlook continues to look good for the sector. With reasonable credit fundamentals, the quarter's performance seems particularly surprising.

- The default rate in 2018 was 1.81%, which included a long anticipated default of I-Heart Radio. Without that, the default rate would have been 1.08% compared to a historical average of 3.46%. The default rate is the lowest since 2013, and is forecast to remain well below the historical average for the next two years;
- High yield borrowers reduced their public debt borrowing by a staggering 43% compared to 2017. For the first time since November 2008, there were no new issues in the high yield market in December. The annual borrowing of $287.4 billion was the lowest since 2009 ($180.7 billion) and well below the annual average of $307 billion since the crisis. While some borrowers shifted their financing needs to the leveraged loan market, issuance in that market declined by 28% in 2018;
- Fears attributing the increase in spreads and the reduction in annual issuance to a cycle turn or recession indicator appear premature. Most companies in the high yield market were not challenged finding financing options. In fact, indicators like pricing, size of issuance, covenant constraints all point to the opposite. We believe two other factors are playing a more significant role: 1) earnings and cash flow are robust enough to reduce financing needs, and 2) the new corporate tax law is shifting the balance of leveraged capital structures in favor of equity;
- Year-end spread levels discount default rates near 5%, which would exceed every annual rate since 2009. Given the trajectory of corporate earnings, financing availability and direction of leverage, we think this outcome would be surprising. The upgrade/downgrade ratio was 1.3 for 2018, including a 2.1 reading in the fourth quarter, and 1.4 in 2017. These succeeded two years of more downgrades than upgrades, suggesting the favorable markets (or interest rates) have not been fueling a steady increase in gross leverage.

Emerging Markets Corporate Credit

During the second quarter of 2018, markets adopted a narrative regarding the deleterious impact tightening financial conditions would have on emerging markets. The narrative focused on financing challenges for highly indebted countries. The strengthening U.S. dollar featured prominently and led to immediate devaluations in countries running large current account deficits. Chief among these were Argentina and Turkey, although other indebted countries were not spared. Corporate spreads widened dramatically because, although not directly targeted, they cannot fully escape the fate of their sovereign domicile. While that narrative softened during the summer, credit spreads did not return to their earlier levels.

During the fourth quarter, spreads widened again, but relative to investment grade and high yield, they were well-behaved. In fact, value indicators turned against emerging markets credit because both investment grade and high yield began to look cheap. Like other credit sectors, however, we believe emerging markets look attractive when considering fundamental characteristics of the sector.



- The emerging market high yield default rate declined in 2018 to about 1.6%. Measured by names included in J.P. Morgan's CEMBI Index, the rate was only 1.2%, below the level for U.S. high yield. Regionally, defaults were concentrated in Asia and Latin America, with no defaults reported in Emerging Europe, Middle East or Africa. Forecasts for 2019 are for a modest increase in defaults, although given recovery rates, market prices discount substantially higher defaults;
- While relative spreads compressed between emerging market credit and high yield credit, spreads for BBB rated securities widened to the highest levels in two years. The absolute level of investment grade spreads also suggests a high risk of downgrade, which appears premature considering the more favorable direction of corporate ratings in 2018;
- Leverage amongst emerging market corporate borrowers declined in 2018. Driven by higher revenue and cash flow, leverage metrics improved for both investment grade and high yield rated borrowers. Both high yield and investment grade borrowers in emerging markets boast better leverage metrics than their U.S. counterparts.
- Despite meaningful increases in new external borrowing during the last seven years, new issuance declined in 2018 by about 23% compared to 2017. Gross external debt increased marginally in 2018 for all emerging markets, but it declined in Latin America and Emerging Europe.
- While investors remain legitimately concerned about China's growth rate and its ongoing impact on commodity prices, forecasts improved for significant economies like Brazil, India and South Africa. Many economies will benefit from improvements in domestic consumption aided, to some extent, by lower oil prices and more competitive currency levels.

Historically, credit cycles began to get stressed when leverage was increasing, financial conditions tightened, credit availability lessened and events challenged a few industries. Financial conditions tightened during 2018 and energy related entities confronted lower oil prices, but credit availability remained ample and leverage was not stretched across most industries. When considered from a macro perspective, the evolution of leverage metrics is consistent with the economy's trajectory and changes in monetary policy. Unlike prior credit cycle peaks, conditions do not seem to support the pessimistic interpretation of the spread widening. More likely, in a December punctuated by poor liquidity, market deterioration exceeded levels that would be justified by underlying creditworthiness, generating attractive opportunities for credit investors.

Sources: J.P. Morgan, Bank of America Merrill Lynch, Barclays, Wells Fargo

January 15, 2019

GIA Partners, LLC

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We have a thorough understanding of fixed income investments and their role in a globally diversified portfolio, which has rewarded our clients throughout market cycles.

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