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GLOBAL CREDIT MARKET OUTLOOK 2017

Global credit markets added another good year of performance in 2016. Despite rising rates in Q4, returns across different markets remained positive. The main drivers of outperformance were some of the investment themes that we highlighted previously, such as the focus on high yielding bonds:

Global Credit Outlook for 2016
https://en.nikkoam.com/articles/2016/04/global-credit-outlook-201604

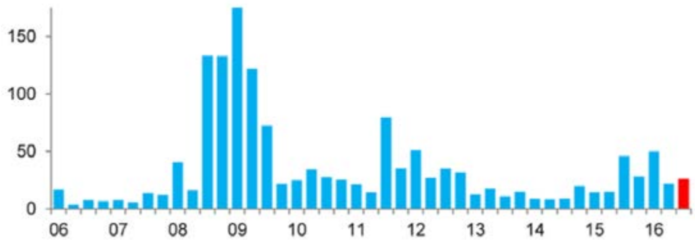
Despite soaring default rates, US High Yield experienced a particularly strong performance recovery from negative returns in 2015. This boosted global indices, but also, the imbalance between supply and demand in fixed income markets helped to boost returns, greatly due to three major central banks' (Bank of England (BOE), Bank of Japan (BOJ) and European Central Bank (ECB)) active participation in the corporate bond market over the course of the year.
Looking further ahead into 2017, some important questions need to be answered for a clear view on how credit markets will unfold throughout the year.

Firstly, it will be important to evaluate if the paradigm of central bank action driving yields and spreads lower comes to an end. The market wobbled in Q4 and this could suggest that we are moving to a new regime, in which the adoption of a fiscal stimulus path will take over from accommodative monetary policy. During his electoral campaign, President-elect Trump laid out plans to spark GDP growth by increasing fiscal stimulus. The latter would drive the Fed to turn more hawkish and aggressively normalize rates. Nevertheless, the BOE, BOJ and ECB are likely to continue to buy bonds in the open market for some time and will weigh against the trend of higher rates. However, the continuation of these three QE programs should not be taken for granted and any hints about tapering or termination of central bank-induced bond purchases will negatively impact bond markets. Citigroup points out, however, that even after tapering of monthly purchases from EUR 80bn to EUR 60bn, the ECB will buy more bonds in 2017 than they did in 2016.

We do not see a paradigm shift yet, but being outright long rates and credit risk based on central bank support is no longer guaranteeing outperformance either. Markets will likely become more volatile, as was already observed in the last quarter, which will require more flexible trading-based investment strategies for portfolios.

Secondly, should a portfolio manager rely on top-down or bottom-up focused strategies? When asked how to enhance performance going forward, Lorenzen & Faith (2016) claimed that most investors *cited* selection as the main source of alpha. However, Citigroup showed (Figure 1), that even with perfect foresight, portfolio managers were not be able to outperform the market by a significant margin over the last few years. The results are not a major surprise, as default rates were globally below the historical average in most markets. Therefore, avoiding default will not likely be a major source for outperformance yet. We prefer to minimize idiosyncratic risk by implementing a diversification strategy that focuses on key top-down investment themes to achieve risk adjusted outperformance. Compensation for idiosyncratic risk is globally low, as global yields trade around there historic lows. Some European credits are even trading with a negative yield.

Figure 1 iBoxx Euro IG Corp index, in bps



Source: Citi Research, Markit. *: The excess return investors would make if they knew in advance which two sectors would be the best and which two would be the worst performing in the subsequent quarter and positioned accordingly by a 5% over-/underweight in each.

Thirdly, if global default rates remain low, does it mean we no longer have to do credit research anymore? We would argue that such a scenario is certainly not the case! Although investment strategies mainly focused on selection should struggle to outperform, we expect credit quality divergence, which should offer opportunities to generate alpha for investors.

One market that we would be more cautious on is US credit. Corporate leverage in the US has increased to an all-time high, as more than half of operating cash flows are now spent on dividends and share buy backs. The announcement of more aggressive share buybacks of US corporates, for example, could lead to seriously negative excess returns. In contrast to this, in Europe CFOs are still much more focused on increasing internal efficiency than on shareholder value.

The fourth question to consider is how will credit markets react if the upward movement of rates continues into 2017? We would argue it is not the direction which matters, but more so the level of interest rate volatility. An orderly sell off would probably lead to tighter spreads, as treasury yields will increase faster than credit yields. But if interest rate volatility spikes (like during the taper tantrum) the perception of panic will also impact credit markets and could lead to wider spreads. Even if the sell-off in rates is orderly, however, highly rated corporate bonds might struggle to fully earn the coupons. Therefore, we would argue that it will be much easier for High Yield issuers to generate total returns next year.

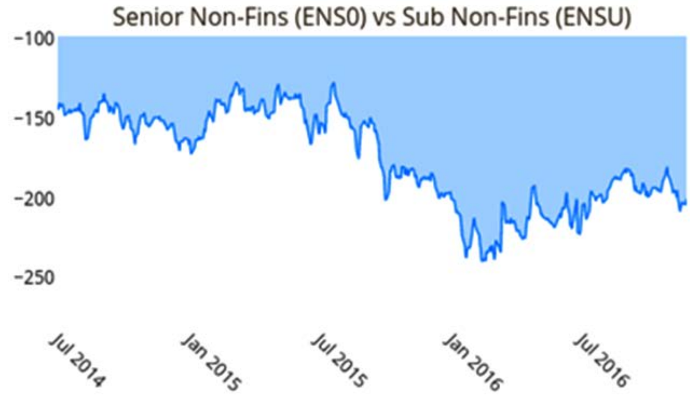
The last question to ponder for 2017 would be how to position in Emerging Markets. Over the last twelve months, emerging market corporate bonds have generated solid performance and we expect that investments outside the developed world could also generate alpha in 2017. A broad range of countries are experiencing solid growth, supported by recovering commodity prices and easing inflation pressure, with the latter factor giving hope for more accommodative monetary policies. Nevertheless, performance will vary by region and country. One of the important factors to consider will be the attitude of the Trump administration towards certain topics, such as the future trade relationship with Mexico. Developing a clear view on this critical question is mandatory to identify the important investment themes and to build a return forecast for the coming year ahead. Currently the level of uncertainty with regards to the critical questions is still high, as the new administration is just coming in. Therefore, we prefer to invest in countries, which are less involved in trading with the US, i.e. Brazil.

Overall, we expect 2017 to be another positive year for global credit markets. Nevertheless, hoping for the continuation of central bank support and a reliance on a buy and hold approach will not likely deliver desirable returns. Indeed, we think that next year, portfolio income needs protection from an increased level of volatility sparked by reduced central bank support and political uncertainties. As mentioned above, a flexible trading-driven approach to systematic risk factors, like rates and credit risk is required, and derivatives offer the most efficient way to implement these strategies.

Equally important next year, besides flexibility, will be the identification of the correct top-down investment themes. Some of the key themes we are looking at are hybrid bonds, financials, oil/Emerging Market and High Yield.

Hybrid bonds pose an interesting investment opportunity, as they trade with an attractive spread gap vs. senior bonds (Figure 2). Most hybrid bonds are issued by European corporates and offer a cheap way to access a market in which senior spreads are heavily repressed by the central bank's corporate bond purchasing programs. Indeed, Investment Grade-rated hybrid bonds currently offer spreads of 253bps (Libor OAS) vs. senior spreads of 68bps.

Figure 2 Senior vs. Subordinated Non Financials, in bps



Source: BofA ML Research

We expect the financial sector to continue its recent outperformance vs. non-financials, especially as higher rates and steeper yield curves since the US election should help banks to improve profitability. Additionally, we should experience a global push against stricter bank regulation. In the US, the incoming administration wants to overhaul the Dodd-Frank Act and in Europe, governments are equally pushing against overly tight Basel 4 rules. Furthermore, unlike financials, non-financials continue to weaken their credit ratios with share buybacks. Within the financial sector, we like banks as well as insurance, although attractive valuation for the latter leaves us slightly more in favour of insurance companies.

Oil prices have recovered significantly in 2016, largely driven by the OPEC agreement to cut production volume, which should lead to more balanced supply and demand in the oil market and support higher prices. Some of the main beneficiaries of this can be found in Emerging Markets. Brazil's corporate sector offers attractive relative value opportunities combined with a strong focus on deleveraging. Russia could also offer value, as its commodity producers benefit from a low-cost position and moderate leverage.

Global High Yield has outperformed Global Investment Grade in four out of the last five years. Only in 2015 did the High Yield market underperform, as oil producers and basic material companies were hit hard by the slump in commodity prices. In 2016, the market recovered and neither Brexit nor the aftermath of the US election could derail the rally. Indeed, since Trump's election, the market has generated more than 1.5% of total return and offered a good shield against rising rates and declining prices of Investment Grade bonds.

Regardless of our expectations of what top-down themes will drive the market in 2017, we are still mindful of idiosyncratic risk. As pointed out above, the credit health of US companies is currently declining, with an increasing number of CEOs trying to support share price performance with the help of debt-financed share buybacks and dividend increases.

Lastly, while full protection of the income might become difficult, as rates could rise further in 2017, we expect that a broad range of investment themes will help generate enough alpha performance to offset the rates impact.

References

Lorenzen, H. & Faith, H,L. (2016). Diversification is the spice of life – European Credit Outlook. *Citi Research*

Important Information