How Low Can We Go?

July 2019 Commentary

Executive Summary

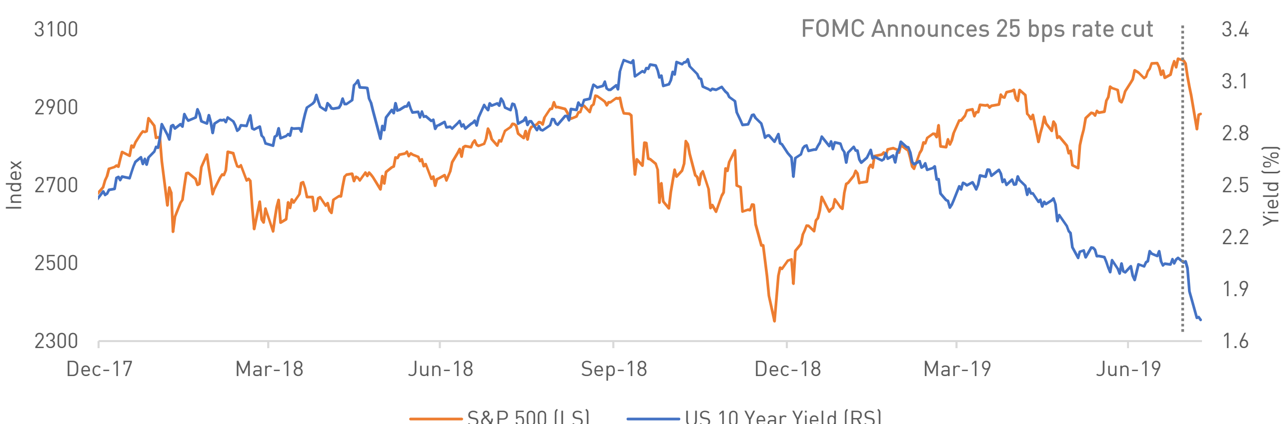
- The Fed delivered it's first rate cut in 10 years...perhaps it wasn't low enough
- With no guarantee of future Fed stimulus, investors had little incentive to increase holdings in risk assets
- With these dynamics, quality and defensive securities (including corporate bond spreads) may look expensive relative to longer-term averages
- However, we think there are fundamental and technical factors that can push spreads lower, especially in the BBB space

NOT LOW ENOUGH

The Fed delivered a 25 bps rate cut in July for the first time since December 2008. In addition, the Fed announced it would halt the sale of the assets it had accumulated on its balance sheet. This stimulus was intended to reassure participants, leading them to take on more exposure knowing the Fed stood ready to support risk assets. However, the market reaction clearly showed that participants were underwhelmed. Powell's comments around "midcycle adjustments" hinted that there was no guarantee of further rate cuts after July despite the market's expectation for three more cuts in 2019. Equities sold off and interest rates plunged to even lower levels suggesting that the market was pricing in much more future stimulus than was delivered.

We think this speaks to the growing disconnect between the outlook for global growth priced in by market participants versus the Fed's need to maintain policy tools to fight a possible recession in the future. This "gap" in expectations has created heightened uncertainty around future policy direction and, combined with Trump's surprise increase in tariffs, has led to a 'risk-off' tone from the market despite having received our first cut in over 10 years. This goes to show that the market had overpriced the support that would be available from the Fed and discounted the weaker macroeconomic data we have been seeing across global economies.

The Market Reaction to the Fed Cut Was Distinctly Risk-Off



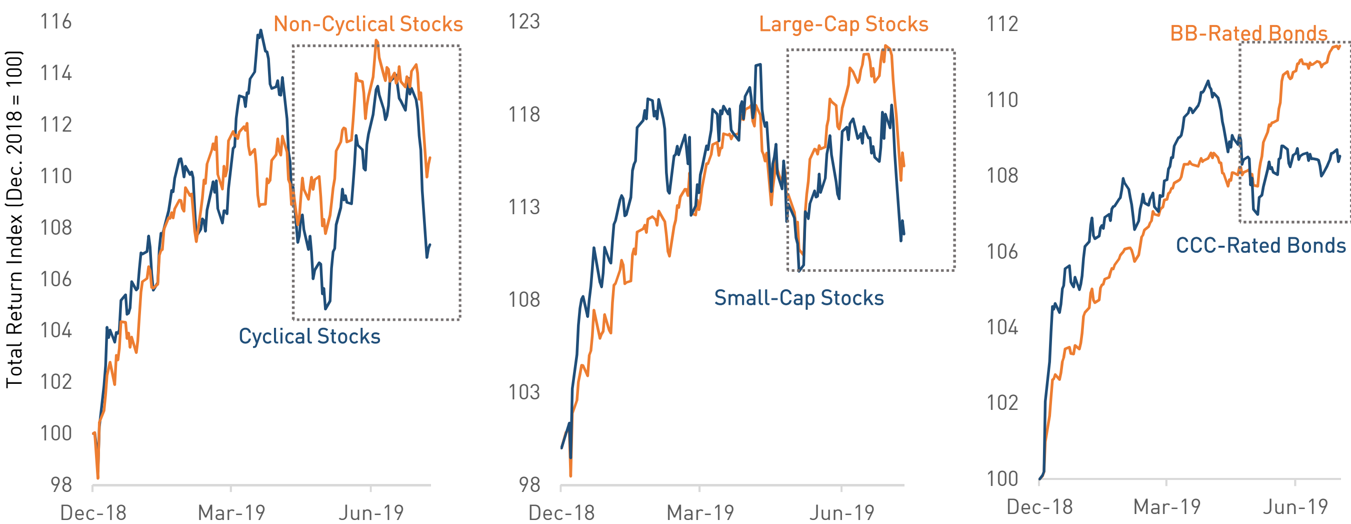
Source: Bloomberg

RPIA Global Fixed Income Experts

CAN SPREADS GO LOWER?

Given our view that the Fed's actions were not enough to overcome weakening economic data, it is worth discussing how to invest in a world where demand for safer assets is growing, pushing valuations higher and spreads lower. This preference is epitomized by the stellar returns we have seen in investment grade markets so far in 2019, with investors choosing the relative safety of corporate bonds over equities. U.S. investment grade's year-to-date total return (as of the end of July) is one of the highest we have seen in nearly 10 years. The market's predilection for quality exposures has also been expressed across other asset classes with defensive equities outperforming more cyclical stocks, large-cap issuers outperforming small-cap and higher rated bonds outperforming lower-rated issuers.

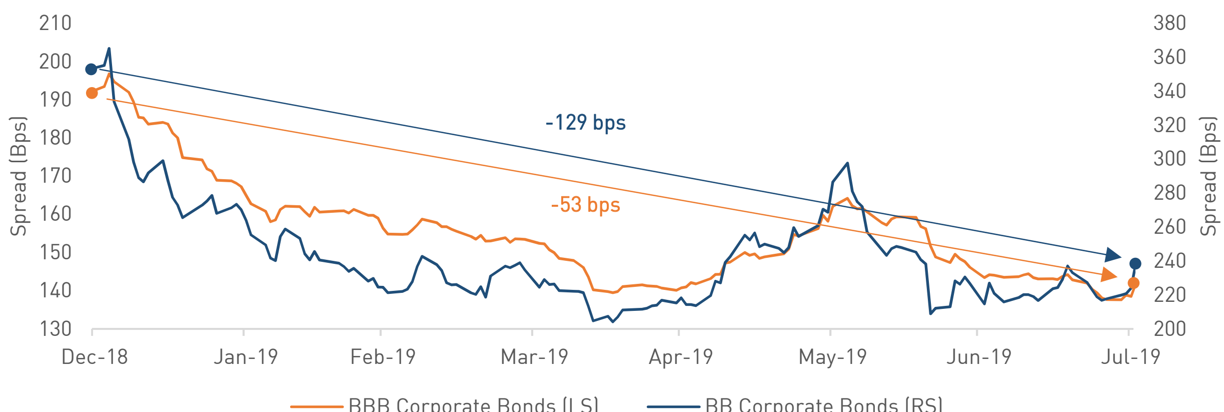
Quality, in all its formats, has outperformed Non-Defensive Asset Classes in 2019



Source: Bloomberg

So is the price of quality too high given these dynamics? We would argue no. With uncertainty around future economic growth, the infinite unknowns of Trump's trade war and a 2020 election, we think that quality, while not cheap by some standards, is still the right place to be in terms of our portfolio positioning.

BB-Rated Bonds Have Tightened More Than BBB Counterparts



Source: Bloomberg

Within the quality trade, the North American U.S. dollar BBB market is the sweet spot for our strategies, despite relatively tight spreads and continued headlines espousing the risks in the space. While we are cognizant of these risks (exponential growth in the size of the market, higher leverage amongst issuers, etc.), we also think BBB credit continues to be a bond pickers market where managers can find issuers taking the necessary steps to improve their balance sheets.

We also believe that, despite BBB spreads appearing more expensive than prior periods, this part of the market is experiencing technical trends that support further spread compression, even from these relatively tight levels.

DEBT FRIENDLY ACTIONS = INCREASED MARGIN OF SAFETY

From a fundamental perspective, a large amount of BBB rated issuers are showing encouraging signs in terms of taking actions that are beneficial for bond holders, much to equity investor's chagrin. This is a welcome reversal from the past decade of borrowing to fund stock buybacks and dividend increases. Since 2018 we have seen a multitude of debt-friendly changes put into action by BBB issuers. In fact, the companies taking these debt friendly actions represent ~20% of the total BBB market, showing that a material subset of issuers are taking decisive steps to improve credit quality and shore-up their balance sheets prior to any possible recession. These actions give us comfort maintaining our exposure in select BBB rated issuers.

"Debt Friendly" Actions by BBB Rated Issuers

Issuer	Sector	Debt Friendly Action	Size of BBB Bonds Outstanding	Date of Action
Vodafone	Telecom.	Cut dividends 40% & sold portions of business to raise cash	$20.6B	May 2019
Kellogg	Food & Bev.	Asset sales to deleverage balance sheet	$5.4B	April 2019
Constellation	Food & Bev.	Asset sales to deleverage balance sheet	$9.3B	Mar. 2019
Kroger	Retail	Asset sales to deleverage balance sheet	$10.9B	Mar. 2019
Kraft Heinz	Food & Bev.	Cut dividends by 36%	$23.7B	Feb. 2019

Source: Bank of America Merrill Lynch

DEMAND FOR YIELD CAN PUSH SPREADS EVEN LOWER

Beyond the improving fundamentals amongst some BBB issuers, we also find technical aspects which support our case that spreads can move even tighter from here. Foreign investment flows continue to find their home in USD credit markets as the "only game in town" for yield versus foreign jurisdictions which are seeing an increasing number of near-zero or even negative yielding bonds enter their universe. While foreign demand has been increasing throughout 2019 the recent Fed cut should only continue to stoke demand by reducing the cost of hedging USD holdings back to local currency. We have even seen an increased appetite for foreign investors to leave currency risk unhedged to maximize the yield they receive from buying U.S. credit.

While U.S. fixed income represents roughly half of the total global fixed income marketplace in terms of bonds outstanding it represents an astonishing 88% of the yield available to global investors. This is an increase from approximately 82% in May and much higher than the paltry 50% the U.S. represented back in 2013.[1] Thus, an international investor looking across the global landscape for any and all sources of yield will find there are few options at hand outside of U.S. corporate bonds - specifically BBB rated bonds.

HIGHER QUALITY MAY MEAN HIGHER RISK

While BBB bonds are not cheap compared to long-term historical standards, we believe that investors should view the corporate bond world through the lens of relative value considering that risk assets of all types have been pushed to artificially low spreads/high prices thanks to monetary stimulus. While late cycle dynamics may entice investors to move higher up the quality spectrum towards AA and A rated bonds, we would argue you may not be receiving enough compensation for the risks embedded in this part of the bond market.

1 Source: Bank of America Merrill Lynch

In fact, from a relative value perspective, BBB's offer some key benefits versus their A rated counterparts despite the lower credit rating. This includes the lack of demand for A rated corporates by foreign buyers versus the BBB complex, less "debt-friendly" actions by A rated companies who seem to be resting on their laurels as opposed to taking action ahead of a slow down in global growth and a higher concentration in cyclical sectors which exhibit a higher correlation to the business cycle versus more defensive sectors to be found in BBB markets. Thus, despite their higher rating, some A rated companies may not offer enough spread compensation versus the future credit risks embedded in these companies. This a relative value equation we prefer to avoid.

With these factors in mind we believe that a more defensive position is prudent within all RPIA strategies. However, although quality assets may look relatively expensive at this point in time, there are some areas where prices can continue to rise and spreads continue to compress. For us, this means finding select opportunities amongst BBB issuers who are exhibiting improving fundamentals and debt friendly actions, making them (in our opinion) higher quality than the rating agency 'rubber stamp' may imply.