U.S. FIXED INCOME: WHAT'S YOUR CREDIT SCORE?

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With all the headlines following the recent jobs report, the primary focus in the fixed income arena has been squarely on the U.S. Treasury (UST) market. However, somewhat lost in the shuffle have been the developments, or lack thereof, in the U.S. corporate bond market. This is certainly a change of pace from earlier this year, when credit concerns were front and center among fixed income investors. Certainly, the overarching sentiment for U.S. corporates has experienced a rather welcome change, as anxieties surrounding potential downgrades and defaults have been replaced by investors searching for value and relative yield enhancement in a fixed income universe devoid of any glaring opportunities. As a recap for how 2016 got started, both investment-grade (IG) and high-yield (HY) spreads ballooned to levels unseen in the last four to five years—a period that corresponded with the eurozone crisis—as investors were responding to renewed fears regarding global growth, plunging crude oil prices and an overwhelming risk-off mentality. **Investment-Grade Spread (RS) vs. Baa Spread (RS) vs. High-Yield Spread (LS)**

Sources: Bloomberg, Barclays, as of 6/7/16.

With global economic data not validating recession-like fears and crude oil prices rebounding to the $50-per-barrel threshold, the market's worst fears were obviously not realized, and investors looked to U.S. corporates as an opportunity from both a total-return and an income vantage point. As we wrote in our June 1 blog post "Global Fixed Income: Let's Go to the Videotape," IG and HY have now registered solid performances on a year-to-date basis, no doubt reflecting the visible drop in spreads that has transpired since the peak readings of mid-February. To provide some perspective, as measured by the Barclays U.S. Aggregate Corporate Bond and the Barclays U.S. Aggregate Baa Index, overall IG spreads have contracted by 65 basis points (bps), with the Baa sector narrowing even more, at nearly 90 bps. On the HY side, much as we saw on the way up, the spread for the Barclays U.S. Corporate High-Yield Index has come down in a very visible fashion, declining by roughly 275 bps during the same time frame. For both IG and HY, spreads have now recouped all of the widening that was witnessed during early winter, and then some. Indeed, IG is now back to levels seen last summer, while HY has returned to November readings. The natural question is whether there is scope for any additional spread tightening in the months ahead. Since about mid-April, IG spreads have traded in a rather narrow range of only about 10 bps. The HY market has been a bit more volatile but has lately seen spreads decline by 50 bps. It is interesting to note that in each sector of the corporate bond arena, neither

has displayed much of a reaction to the Fed's "will they or won't they" debate, which has been such a fixation since the FOMC minutes were released on May 18. In terms of perspective, the spread levels as of this writing for IG and Baa were still 10 to 20 bps above the average tallies over the last two to three years. As expected, for HY the differential versus the two-to-three-year average is higher, coming in at more than 60 bps. **Conclusion** The potential for actual downgrade and/or default news in the corporate bond market lingers, as such announcements by the ratings agencies can tend to lag. However, unless some unwelcome surprises develop on this front, we feel the market has, for the most part, moved on, as illustrated by current spread levels. Periods of risk-off are often difficult to predict, but a "yes" vote to Brexit on June 23 could result in such a knee-jerk move in the credit markets. Nevertheless, from a broader fixed income investment strategy perspective, in an environment of moderate economic growth, a cautious, deliberate Fed and a range-bound UST market, we continue to favor credit versus the interest rate-sensitive sector, with IG offering relative value in the U.S. corporate market.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

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Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Investment Grade : A rating given to a municipal or corporate bond. It is a relatively favorable rating by either Moody's or Standard & Poor's indicating a higher chance an issuer performs interest and principal obligations as promised by the terms of the debt issuance.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

Baa : Moody's credit rating that implies the borrower has capacity to meet financial commitments, but may be more vulnerable to adverse economic conditions. This rating includes the lowest level of credit risk while still being investment-grade.

Barclays U.S. Corporate Index : is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers that meet specified maturity, liquidity, and quality requirements.

Basis point : 1/100th of 1 percent.

Barclays U.S. Corporate High Yield Index : Covers the universe of fixed-rate, non-investment-grade corporate debt.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Ratings Agencies : nationally-recognized statistical ratings organizations who perform analysis on the credit worthiness of bond issuers.

Brexit : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.

Interest rates : The rate at which interest is paid by a borrower for the use of money.