

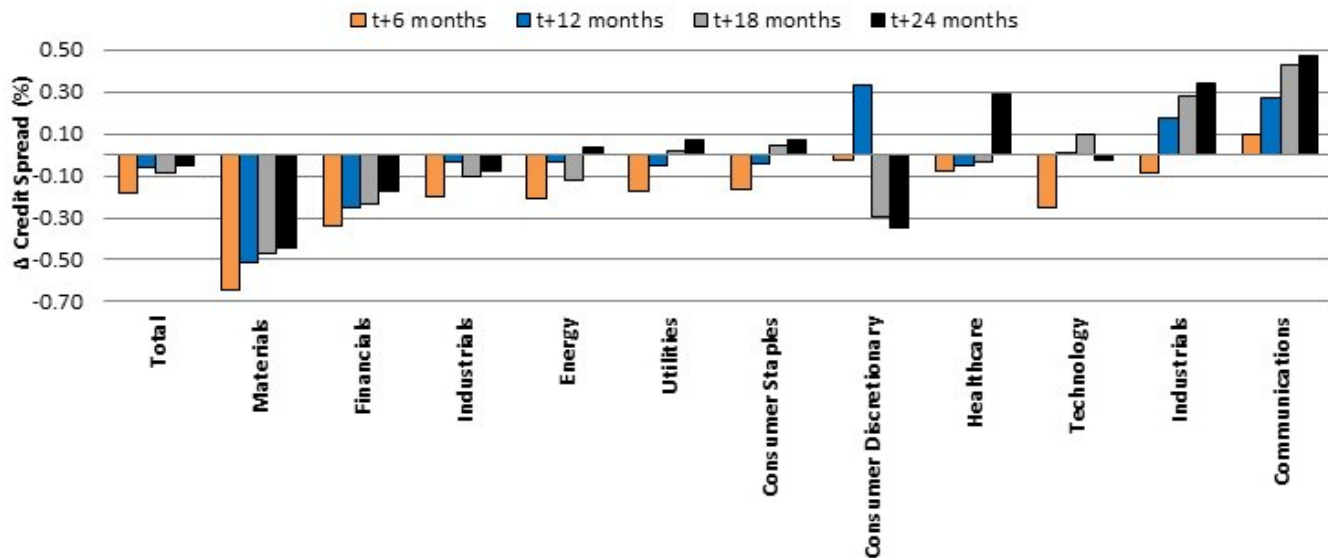
The Impact of Fed Tightening on U.S. Investment Grade Credit

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After nearly two and a half years of debate, the Federal Reserve (Fed) finally lifted the Federal Funds Rate target by 25 basis points (bps) on December 16, 2015. While investors continue to grapple with what impact this might have for markets and the economy, we thought it could be instructive to understand what impact a tightening cycle has historically had on the cost of credit for investment-grade corporations. While each tightening cycle is different, we chose to examine the most recent cycle from 2004. A primary reason for our focus on this period is that it represents liftoff from the second lowest period of rates in U.S. history (1.00%) and also shares some of the benign inflation characteristics seen today. Overall, credit tends to perform well in the first six months of a tightening cycle. As more hikes occur, the economy eventually slows, injecting additional costs and risks into markets. Below, we outline our key thoughts on how tightening from the Fed ultimately impacts the various sectors of investment-grade credit. **Macro Impact on Credit** As we show below, the immediate impact from Fed tightening is a general decline in credit spreads across nearly all sectors. In our view, this makes sense for several key reasons. First, it is extremely unlikely that any change in Fed policy would come as a dramatic surprise to borrowers and / or investors. Additionally, investors can generally view any Fed rate hikes as a vote of confidence from policy makers that the overall health of the economy is strong enough to necessitate higher rates. This boost in confidence appears to persist across sectors for at least the first six months, as evidenced by 2004 data. Finally, during periods of rising rates, many investors seek out corporate credit as one way to help dampen the impact of rising nominal interest rates. Historically, bonds with credit risk have tended to outperform U.S. Treasuries in rising rate environments given their higher incremental income (credit spread), as lending to risky borrowers can help dampen losses from higher nominal rates. Overall, credit spreads tended to tighten by approximately 18 bps over the first six months following the 2004 rate hike. Among major sectors, bonds from communications companies were the only ones that saw credit spreads widen. **Impact on Credit Post-Fed Rate Hikes Investment-Grade Credit Performance by Sector**



Source: Barclays. Period t represents 6/30/04, the date of the first Fed rate hike. Subsequent periods represent the end-of-month values for the Barclays U.S. Corporate Investment Grade Index and its underlying sectors. Past performance is not indicative of future results.

Sector Impact over Time With the exception of the Technology and Consumer Discretionary sectors, the trend in credit from 2004 shows that spreads initially tighten, then gradually widen back to around unchanged at the peak of the interest rate cycle. Additionally, Materials, Financials and Industrials were previously the strongest performers. For Financials, rising rates often translate into wider net interest margins, ultimately helping banks drive earnings. For the Materials sector, commodity prices generally rose over this period on the back of strong growth from emerging markets. Overall, credit across sectors tended to correlate over time, albeit with varying degrees of magnitude. Finally, while the trend in credit spreads is important from a positioning perspective, investors should also be aware of the all-in level of spreads. A primary reason the Communications sector appears to underperform over this period is that it had initially been trading at some of the lowest spread levels (78 bps over Treasuries) of any sector at that time. Today, credit spreads are materially wider than 2004 levels across all sectors (+55 bps). In fact, spreads currently average 155 bps over Treasuries across all sectors, ranging from a low of 121 bps for capital goods to a high of 268 bps for basic materials. **Pace of Hikes** Now that the Fed has announced its first hike of this cycle, the debate among market participants will ultimately begin to shift to the pace of rate hikes and the terminal level of interest rates for this cycle. During the 2004 tightening cycle, the Fed hiked rates at one of the most consistent paces in history. Over the first six months, the Fed hiked rates five times. Over the next 18 months, it increased rates by 100 basis points every six months. Ultimately, the target of the Federal Funds Rate rose to a high of 5.25%. Today, the Fed is forecasting four hikes for 2016 and a peak in the Fed Funds Rate of 3.5% in the long run. With a slower pace of tightening and a lower terminal rate, we believe that the net impact on credit has the potential be more subdued than in previous periods. While the impact of changes in Fed policy will continue to be hotly debated in the coming months, we don't currently view this initial shift as particularly troubling for U.S. investment-grade credit. For borrowers, this incremental shift in policy is hardly a surprise. For lenders, credit spreads have already

widened materially in advance of this move. In our view, investment-grade credit could continue to offer value over at least the next six months as investors and markets digest the shift in policy.

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