

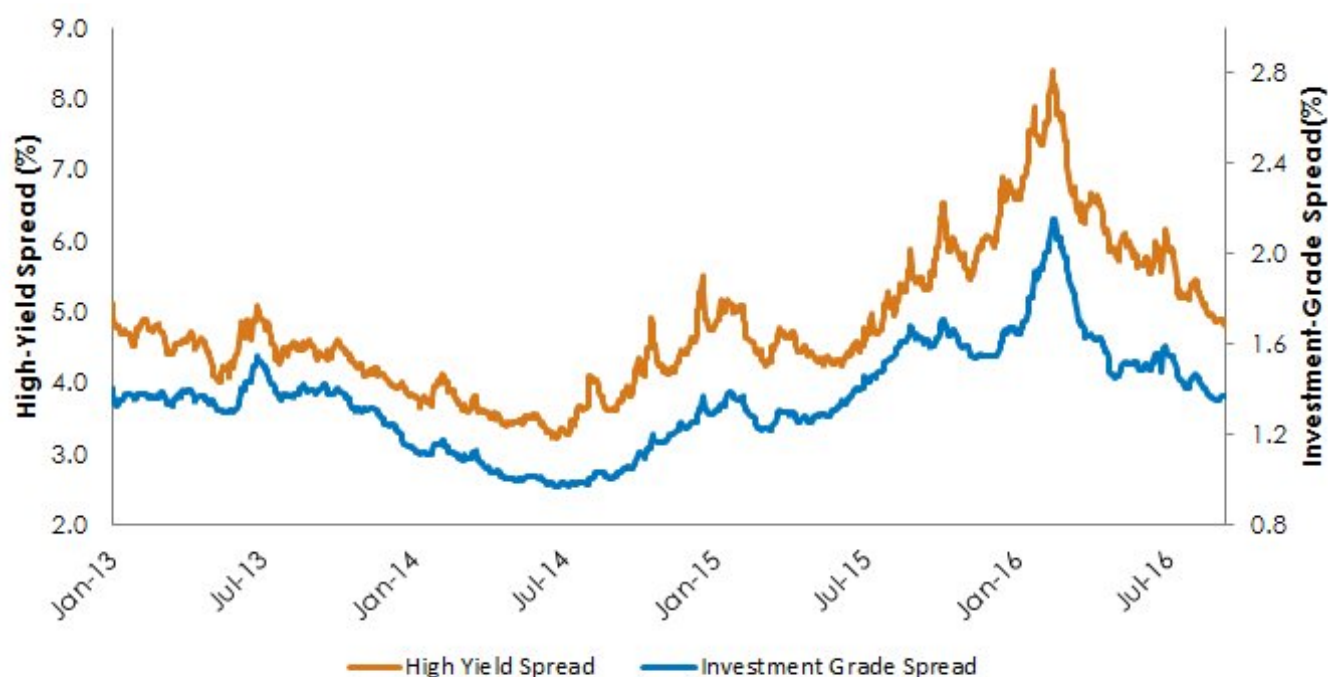
U.S. Fixed Income: Giving Credit Where Credit Is Due

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With the third quarter coming to a close in a few weeks, fixed income investors have had a lot to cheer about thus far in 2016. Indeed, essentially every major asset class has posted positive returns up to this point, with some groupings registering double-digit gains. Certainly, one of the more notable positive performances has come in the area of U.S. corporate bonds, both high yield (HY) and investment grade (IG). As of this writing, according to the Bloomberg Barclays U.S. Corporate High Yield Total Return Index Value Unhedged, HY corporates have produced a rather robust positive reading of +14.72%, while IG (Bloomberg Barclays U.S. Corporate Total Return Value Unhedged Index) has registered a solid showing of +9.56%. These vigorous performances have been the by-product of both declining interest rates and considerable spread tightening throughout the year. **Investment-Grade Spreads (RS) vs. High-Yield Spread (LS)**



Sources: Bloomberg, Barclays, as of 9/7/2016. Past performance is not indicative of future results.

Clearly, when an asset class produces such results, investors can become a bit more cautious in their outlook, and rightfully so. From a rate perspective, unless a global risk event were to produce another

significant flight-to-quality effect and/or the U.S. economy was to lose further steam from its already soft +1% real GDP figure during the first half of the year, it is difficult to envision yield levels falling to new lows. With that in mind, we'll look at the spread part of the equation. Let's put into perspective the narrowing that has transpired from the end of 2015. Through the first week of September, IG spreads (Bloomberg Barclays U.S. Aggregate Corporate Index) have contracted by nearly 30 basis points (bps) and reside at their lowest levels since June of last year. For HY Bloomberg Barclays U.S. Corporate High Yield Index), there has been a more sizable decline of almost 180 bps, once again pushing the spread down to a 14-month low watermark. The year-to-date results mask what has truly occurred in 2016. As the reader will recall, the current calendar year got off to a rather inauspicious start, as global growth worries, plunging commodity prices and the ensuing [risk-off](#) trade had pushed both IG and HY spreads to levels not seen in the last four to five years. From the "peak risk-off" day on February 11, IG and HY differentials have plummeted by roughly 80 bps and 360 bps, respectively. So, what is the scope for additional spread tightening as we look ahead? Admittedly, the aforementioned moves are truly exceptional, and investors should not expect a repeat performance. However, if one takes a step back and observes what has occurred since the beginning of 2014, it becomes apparent that current spread levels are not excessively low. For example, the average spreads for IG and HY over this time frame come in at +136 bps and +493 bps, respectively, or basically where they are as of this writing. In addition, they reside visibly above the "tights" (IG: +97 bps; HY: +323 bps) that were printed during this period. This is not to say that spreads will narrow to these low watermarks, but it does show there is more room for some potential contraction. **Conclusion** The markets have seen an uptick in default rates this year: as the latest Moody's Investors Service report revealed, the U.S. speculative-grade reading rose to 5.5% in July versus 2.2% a year earlier. It is interesting to note that, thus far, the corporate bond market has appeared to have discounted this news. Periods of risk-off are also often difficult to predict, but the upcoming U.S. presidential election could be a wild card for the credit markets. Nevertheless, from a broader fixed income investment strategy perspective, in an environment of moderate economic growth, a cautious, deliberate Fed (one that could even raise rates this year) and a range-bound UST market, we continue to favor credit, specifically IG, versus the interest-rate-sensitive sector. ***Unless otherwise noted, data source is Bloomberg, as of 9/7/2016.***

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.