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INCOME RESEARCH + MANAGEMENT

IR+M UPDATE

US Investment Grade Credit Market: 2020 Vision

December 5, 2019

Over the course of 2019, the Federal Reserve lowered the federal funds rate three times. Yields were down across the maturity spectrum, leading to a flat – and, at times, inverted – yield curve. The low rate environment and flat yield curve pushed investment grade supply out to the long-end where it was met with great demand, particularly from foreign investors searching for positive yielding assets. Entering 2020, we continue to monitor the late stages of the credit cycle and while leverage remains high, coverage is strong and fundamentals are relatively healthy.

Depth Perception: Lower for Longer

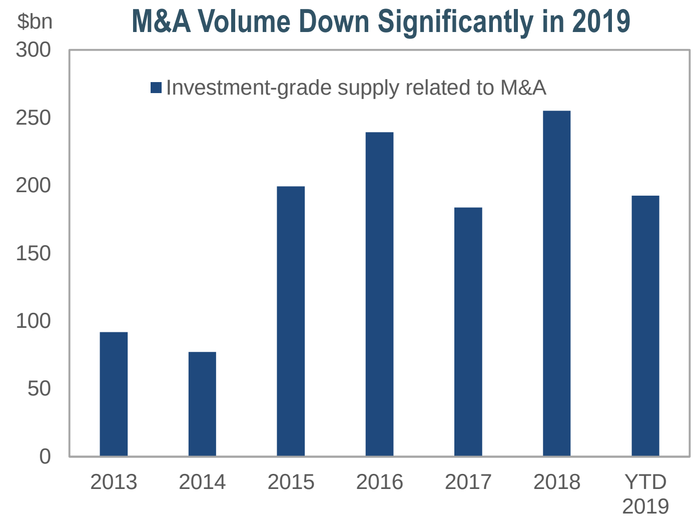
As we approach year-end, valuations continue to appear rich across the corporate bond market relative to recent history.

- Spreads on the Bloomberg Barclays Corporate Index reached 104bps, the tightest level in 20 months, well below the 5-year average of 127bps and 10-year average of 142bps.

Spreads were driven lower by capital flows from overseas investors, demand from pension funds, and a decrease in supply.

- The global hunt for additional yield continues with negative yielding bonds totaling over $11 trillion.
- Equity markets continue to reach new highs, providing an additional tailwind for corporate bond demand as pension plans look to de-risk and lock in asset gains.
- Investment grade issuance used to fund corporate M&A is down 30% year-to-date, while overall supply is down 4% year-over-year.

M&A Volume Down Significantly in 2019



Trade wars, tariffs, and political tensions add uncertainty, but we continue to see stable economic indicators and credit fundamentals.

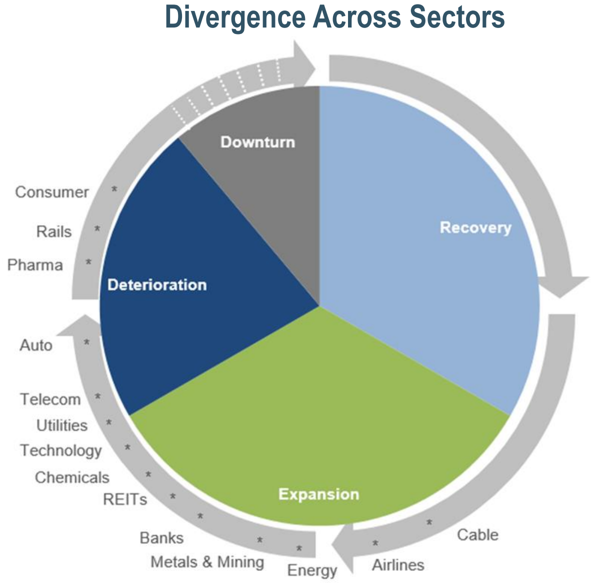
- 2019 earnings are estimated to be flat, but expected to improve to the low single digits during the first half of 2020.

Beyond the Horizon: The Late Stages of the Credit Cycle Keep Going…and Going…

Late stage signals have been present for years; several months ago, the focus was the slowdown and the next recession, yet fundamentals have appeared to stabilize and we continue to experience the longest credit cycle in modern history.

- We are entering the 11th year of the cycle; most cycles average between four and seven years.

Divergence Across Sectors



Where we are in the credit cycle depends on the industry. As opposed to prior years, we see more sector concentration in the expansion and deterioration phases. We still continue to find divergence among sectors, allowing for investment opportunities.

+ Cable remains stable with strong cash flow profiles.
+ Banks continue to show better than expected earnings, particularly given the low rate environment.
- Although rails continue to improve operational efficiency, they showed some weakness as tariffs and consumer demand impacted the sector.
- Autos have seen declining sales but these remain at healthy levels.

Corporate balance sheets are highly levered across industries, but we believe fundamentals on the whole are stable.

- The cost of servicing debt is at historical lows; interest coverage is strong.
- The majority of new issuance is opportunistic, as issuers take advantage of low rates to term out debt maturities.

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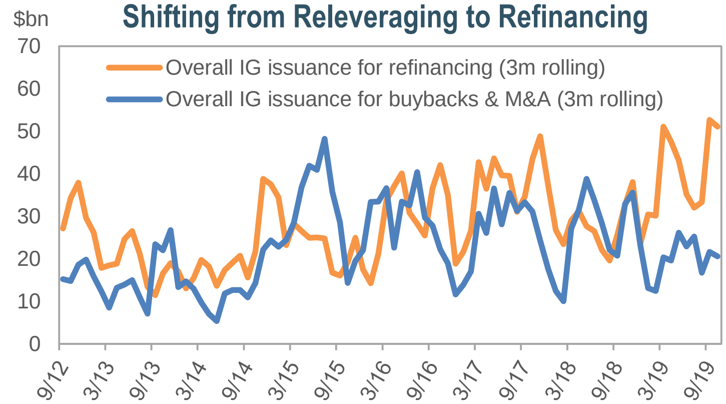
The Supply Lens

While overall gross investment grade fixed income issuance is down 4% year-over-year, we remain at healthy levels led by the long-end.

- 2019 gross supply in the long-end has already exceeded 2018 totals, accounting for 27% of issuance versus an average of 19% since 2010.
- Total net issuance is down 10% year-over-year as companies focused on their debt levels, decreased M&A activity, and looked to refinance existing debt. Most expect further decreases in 2020.
- $342 billion of net issuance has also been skewed heavily toward the longer-end, while the net supply of bonds maturing in less than five years was negative.
- The flat yield curve and general low rate environment allows companies to lock in these low yields for longer.

Shifting from Releveraging to Refinancing



Note: There is overlap between categories as each new issue deal may have several UOPs

BBB-rated securities continue to dominate the investment grade space. Both gross (45% BBB) and net (70% BBB) new issuance reflect the tilt toward BBBs.

- Despite the elevated risk of fallen angels, rising stars have been prevalent throughout 2019.
- Year-to-date fallen angels total $9 billion versus $40 billion of rising stars; since 2017, we've seen $59 billion of net upgrades.

2019 Gross Investment Grade Fixed Income Issuance ($ Thousands)

	3yr		5yr		7yr		10yr		30yr		Total
2016	219,725	19%	312,325	26%	89,183	8%	357,803	30%	201,651	17%	1,180,687
2017	274,075	22%	281,900	22%	139,675	11%	290,838	23%	267,316	21%	1,253,804
2018	279,131	25%	218,689	19%	118,489	11%	245,946	22%	265,060	24%	1,127,315
2019 YTD	184,187	18%	178,687	18%	90,910	9%	274,382	27%	269,888	27%	998,054

Note: YTD through 10/31/2019; shading highlights significant changes in the 5-year and 30-year space as a percentage of overall total issuance

IR+M's 2020 Vision

- We are entering another year of uncharted territory with an extended credit cycle, easy monetary policy, and negative yielding assets globally. As such, we are cautious in our outlook, but see stable fundamentals that keep us from panicking.
- While we don't predict interest rates or when the next recession will hit, we do remain positioned to capitalize on any market dislocations.
- The political landscape will be important to watch as we head into an election year with potentially dichotomous results and significant impacts on several industries, particularly health care, energy, and banking.
- We continue to monitor liquidity within the market overall.
- If rates stay low, spreads remain tight, and demand for 30-year bonds remains high, we may see corporations continue to term out their debt but still expect a continued decrease in gross and net issuance.

The US Investment Grade Credit market is characterized by tight spreads, which leads us to favor shorter- and intermediate-term, high quality issues. Given the late phase of the credit cycle, we believe that security selection is paramount. We continue to closely monitor companies' debt levels and commitment to their de-leveraging plans. While many issuers have used the low rate environment to term out their debt, others may be hanging out at the punchbowl too long. We remain focused on the limited dispersion between sectors and individual companies. If spreads widen, we feel that we are well-positioned to take advantage of what the market gives us.

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