CREDIT MARKET INVESTING:
STOP WATCHING THE CLOCK. THE FUNDAMENTALS MATTER MORE.

Following the lows of the global financial crisis, risk assets have broadly enjoyed a strong and sustained eight-year ascent. Already appearing extended at least by some measures, investors are questioning how much longer the current credit cycle has to run. However, to assume that each and every cycle must follow a predefined, finite timeline does not reflect reality, never mind the fact that cycle position can vary so much by industry, sector and geography. As a result, cycle position can be very difficult to decipher; that’s why we monitor a wide range of fundamental metrics to guide us in our assessment. Some of those factors are highlighted in (FIGURE 1), with the direction and strength (or weakness) of a metric providing an indication of where we may be in the credit cycle.

More broadly, across the entire credit cycle, we think investors will make better long-term investment decisions if they focus on the fundamentals—how companies and countries are managing their respective balance sheets—rather than the absolute length of the cycle.

**FIGURE 1: FUNDAMENTAL METRICS CAN INDICATE CREDIT CYCLE POSITION**

<table>
<thead>
<tr>
<th>LEVERAGE</th>
<th>RECOVERY</th>
<th>EXPANSION</th>
<th>DOWNTURN</th>
<th>REPAIR</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEBT</td>
<td>—</td>
<td>↑</td>
<td>—</td>
<td>↓</td>
</tr>
<tr>
<td>EBITDA</td>
<td>↑</td>
<td>peaking</td>
<td>↓</td>
<td>—</td>
</tr>
<tr>
<td>DEFAULTS</td>
<td>↓</td>
<td>bottoms</td>
<td>↑</td>
<td>peak</td>
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<tr>
<td>CAPEX</td>
<td>—</td>
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<tr>
<td>CREDIT SPREADS</td>
<td>↓</td>
<td>—</td>
<td>↑</td>
<td>stabilizing</td>
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</tbody>
</table>

**SOURCE: BARINGS.**

What are the fundamentals telling us?

Based on our market observations, the assumption that we are in the very late stages of the credit cycle may be premature. While there are certainly signs of late-cycle behavior in some parts of the market, other segments of the market appear to be exhibiting characteristics more commonly associated with the early or mid stages of typical credit cycles.

The historically low interest rates observed in this cycle have undoubtedly incentivized corporate issuers to borrow, but uninspiring GDP growth has also contributed to more conservative balance sheet management than in past cycles. Companies have tended to focus more on managing costs than on generating top-line growth, which is music to a credit investor’s ears—but not so much for an equity investor.

As a result, high yield leverage levels, for instance, have remained relatively stable. Default rates are also running very low—around 1% in Europe for the past few years, and roughly the same in the U.S. when you strip out the uptick in the commodities, energy, and metals and mining sectors (FIGURE 2). This contrasts with leverage levels in the investment grade market, which have been trending somewhat higher. This has been driven primarily by a small number of large transactions by mega-companies, particularly in the pharmaceutical and telecommunications sectors, who would be expected to have enough financial flexibility to meet their obligations, even if their credit profile were to deteriorate.
BOTTOM LINE—For market participants looking for a single, blanket statement on where we are in the credit cycle that they can apply equally to all situations, it unfortunately doesn’t exist. Much depends on the asset class, sector and region. Broadly speaking, here’s how we see things standing at the moment:

**HIGH YIELD**

Overall, fundamentals in high yield remain broadly stable with leverage levels still in reasonable territory [FIGURE 3]. Credit spreads have tightened since the wide levels of early-2016 but are only back to 2014 levels, and corporate defaults remain at low levels relative to history. Broadly speaking, issuers have managed their balance sheets conservatively this cycle, suggesting that a continuation of the current environment may be possible for an extended period. One deviation from that trend is the energy sector, which, due to the oil price weakness of 2014 and 2015 underwent a mini credit cycle, including a rise in corporate defaults, followed by balance sheet repair.

**INVESTMENT GRADE**

Sectors also play a key role in determining the credit cycle phase in the investment grade market. We view financials as fairly early in the cycle, because of the regulatory-driven structural changes they have made to their business models and the resulting changes to their financial profile. We also view the energy sector as being early in the cycle, for the same reasons experienced in high yield. At the other end of the scale, however, we consider industrials to be much later in the cycle.

**EMERGING MARKETS**

Emerging markets are currently in a very different phase of the economic and credit cycle. Many were in a slowdown or recession in the second half of 2016. We’re now seeing the start of a potential bottoming out.
The ubiquity of volatility events—and how investors are learning to embrace them

Regardless of where investors believe we are in the credit cycle, volatility events (potential or actual) are likely to be somewhere in the frame. The most recent and notable are the Brexit vote of June 2016, and the U.S. presidential election in November. There have been plenty others like that over the last decade, and there are more on the horizon, including:

**China growth**: Just how sustainable, over the long term, is China’s purported growth rate? Many believe it is not, which would have major repercussions for many economies.

**Expansionary U.S. fiscal policy**: The new U.S. administration appears set to spend big on updating the country’s aging infrastructure. Such an expansionary fiscal move could have significant implications for U.S. debt and interest rates, which could have knock-on effects globally.

**Trade war/protectionism**: What could be the potential impact globally if leading economies adopt more protectionist trade policies—as the U.S. is indicating it could do?

**EU Elections**: Europe has multiple elections coming up—most notably in France, the outcome of which could have serious ramifications for the European Union’s future.

**Brexit negotiations**: The 2-year countdown to Britain’s exit from the European Union starts this month. Over those two years, it would be reasonable to expect multiple volatility events as the negotiations wax and wane.

While volatility events can cause concern among investors, in recent years many have increasingly embraced the potential opportunities these events can create. This is particularly true in high yield where investors have witnessed a continuous risk-on/risk-off loop in the asset class. Indeed, investors seem to have become so familiar with the loop that they are now looking for the sell-off to jump in—but that can be hard to time or simply may not materialize. Post the Brexit vote, if you blinked you missed the entry point; while post Donald Trump’s November win, the entry point never came.

In other words, a crystal ball would be required to predict when such volatility events will happen, the precise nature of what will happen, and the impact (if any) it will have on markets. Remember—the actual Brexit referendum and U.S. presidential election weren’t the volatility triggers, per se. It was the unexpected outcomes from both events, which (as far as we are aware) no mainstream political or economic pundit predicted.

This cloud, however, has a silver lining. Headline events like we’ve just described can contribute to technical weakness/sell-offs i.e. sell-offs not based on the underlying credit-worthiness of the security or issuer but on supply dynamics and inflows/outflows within the asset class. And such sell-offs can often generate compelling opportunities for active managers. At Barings, we are long-term, fundamental investors but in the short term we track technicals very closely—aiming to lean into, rather than away from, the opportunities they can create at the individual issuer/issue level.
What does all this mean for investors?

With the relatively high probability of some kind of volatility event in 2017, it’s only natural that investors are asking how they can best position their fixed income portfolios. Each investor obviously has to make a decision that best serves their needs, but here are some broad principles they might like to take into account in their approach.

BALANCING CREDIT RISK AND INTEREST RATE RISK

An investor needs to consider the appropriate balance between credit risk and interest rate risk in their fixed income allocation. In making their decision, it might be wise for the investor to take into account what markets are currently indicating:

• In developed markets, the environment would seem to favor credit risk, given that defaults remain below historical averages and that the path of least resistance for rates seems to be higher (in the case of the U.S.) or at least likely doesn’t have much further to fall (in the case of Europe).

• In emerging markets, however, interest rate exposure may provide investors with a more attractive risk/reward profile, as many emerging markets need an accommodative rate environment so they can continue to recover from the fallout of the 2014 energy crisis.

DON’T TRY TO TIME THE MARKET

Trying to time entry or re-entry into any market is challenging at the best of times for the average investor, but even more so if there are potential volatility events on the horizon. Also, regardless of where we are in the credit cycle or the general economic environment, there are always niche “relative value” opportunities to be found and exploited throughout the cycle. An active manager, who is continuously invested in and monitoring the market, is best-positioned to identify those niches, and capitalize on them for the investor.

That being said, we understand that staying invested can be challenging when markets seem to lose their way. However, (FIGURE 4) illustrates the value of staying invested in high yield bonds. Specifically, European high yield bonds posted almost identical performance as the S&P 500 for the period just prior to the financial crisis through last month.

STAY FLEXIBLE

In current markets, very different drivers will push the yield opportunity at different times, and in different geographic regions, so investors need to be in a position to reallocate in as close to real time as possible. For some investors, that may mean delegating the reallocation decision to an investment manager if they can’t realistically execute real-time reallocation.

STAY GLOBAL

To the extent that you can, because that boosts your flexibility and ability to pursue relative value as its location shifts over time. For example, the current divergence in monetary policies of the U.S. and Europe could be effectively exploited by taking a global stance. But if global is not possible, consider some form of multi-asset strategy as a way of exploiting cross-market inefficiencies and potentially enhancing returns.
Where do we see the opportunities?
As an active, global manager, we seek relative value opportunities across geographies and sectors. In that context, we currently see the following opportunities:

**Single-B securities over BBs.** For the investor favoring credit risk, Single-B rated high yield bonds appear to offer value vs. BB-rated credit. For instance, European single-Bs currently offer a roughly 175 basis points\(^1\) spread premium to BBs. In our opinion, that is significant compensation for taking some additional credit risk, especially with European default rates at roughly 1%. Single-Bs, may also appeal to the interest rate-sensitive investor, as they offer lower duration than BBs because they are, for the most part, much shorter maturity instruments.

**Global senior secured bonds.** For investors more concerned about credit protection but still in need of yield, global senior secured bonds, part of the high yield universe, are a potentially attractive option. As of February 2017, global senior secured bonds had an average duration to worst of just 2.9 years\(^2\). In addition, the asset class offers attractive yields, global diversification—and importantly, capital structure seniority. That means senior secured bondholders sit first in line for repayment, greatly improving the probability that they will recover the majority of their money in the event of an issuer defaulting. An additional bonus, at least at the moment, is that investors are not paying a premium in the market for that downside protection.

**Select sectors in investment grade credit.** While corporate fundamentals have weakened somewhat, we expect that lower issuance going forward should contribute to a modest tightening in credit spreads. We see opportunities in the energy sector—particular in the pipeline space—which continues to trade at spread levels that are wider than the overall investment grade index. Specifically, we are investing in names with diversified business models and strong balance sheets. We are also currently finding opportunities in the metals & mining sector with a focus on large diversified businesses with competitive cost structures. Finally, we see value in the banking and insurance sectors—sectors that are well-capitalized, screen well on risk-based metrics and may benefit from potential regulation rollbacks under the Trump administration.

**Emerging markets local currency debt.** Emerging markets local debt—issued in the local currency of the issuer as opposed to a hard currency like the U.S. dollar or the euro—appears cheap relative to historical measures. The asset class looks poised to benefit from currency valuations near 15-year lows and likely accommodative monetary policy across many countries. As a result, we see local currency debt as having the potential to significantly outperform hard currency debt over the next 12 months.

**When in doubt—come back to the fundamentals**
It is all too easy to get distracted from what really matters when the market is watching the clock rather than focusing on the fundamentals. At Barings, however, fundamentals are always the bottom line. Of course, headline events matter too—but only to the extent that they impact fundamentals, which for us comes down to the issuer’s ability to repay the money we have invested. If that has not changed, then we will look to take advantage, where appropriate, of technical weakness to bolster returns for our investors.

In every industry or geography, no matter what dynamics they are facing at a given point in time, there are going to be select investments that do well. You just have to dedicate the resources to find those opportunities and invest with an appropriate risk-reward tolerance. At Barings that means using our relative value focus to buy assets at attractive valuations and avoid defaults. To serve that objective, and our investors, we have built one of the largest, global fixed income investment platforms, comprising teams of investment professionals, dedicated by asset-class, with focused expertise and an in-depth knowledge of every issuer and issue we select.

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