



ANALYSIS

Credit Continuum

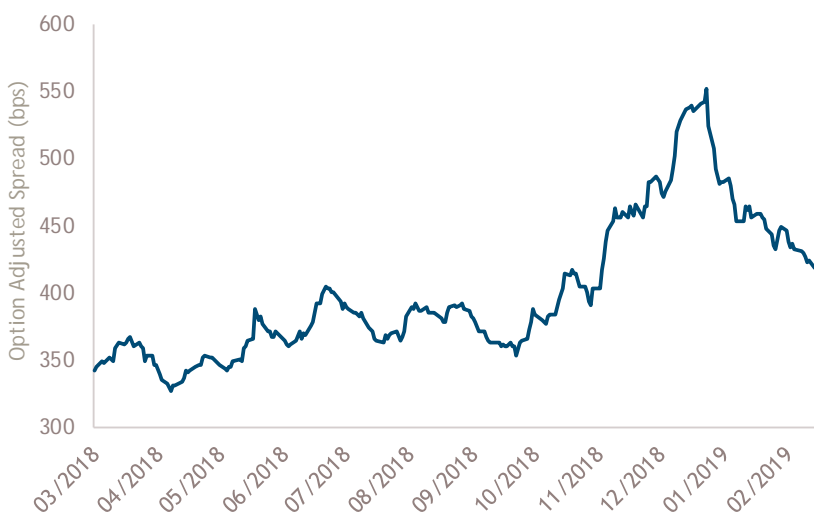
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Where next for credit spreads after the recent strong performance?

Credit valuations have rebounded notably during the first two months of the year, recovering most of their fourth-quarter losses.

While we anticipated a correction, its speed is somewhat surprising, as is the fact that, while corporate fundamentals remain stable, they are misaligned with the still fragile global macroeconomic backdrop.

Fig. 1 - Performance of Global High Yield



Source: ICE BofA Merrill Lynch Global High Yield Constrained Index (HWOC), as of 28 February 2019. Past performance is not indicative of future results.



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Michael manages the Muzinich Global Tactical Credit strategy. Prior to joining Muzinich in 2012, Michael was president and Head of the High Yield Division at Seix Advisors, Inc. At Seix Advisors, he was the founding partner of the high yield strategy that grew to over \$13 billion under his leadership. Previously, Michael served in various research and portfolio management capacities at American General Corp. and at Capital Holding Corporation. He earned a BA in Management Science from the University of California, San Diego and an MBA from Rice University.

On the positive side, certain data points (service sector, consumer confidence indicators) show strength in some areas of the global economy. However, manufacturing continues to weaken and we believe the sharp fall in US retail sales in December has not been sufficiently compensated by January's small rebound. Meanwhile the risk of trade tensions is continuing to impact trade which is, in turn, hurting global capital expenditure.

As a result, we have seen central banks begin to deploy a new range of stimulus measures to reignite growth. Following the Federal Reserve's decision to leave rates on hold, the European Central Bank has postponed its forwards guidance on its first rate hike and announced a new Targeted Long Term Refinancing Operation (TLTRO) to support bank lending for the next few years. Muted levels of inflation are also helping central banks postpone further rate hikes and are creating an environment that could possibly lead to further easing in the next few months.

China's economic deceleration is also being addressed by the government via fiscal and monetary stimulus, although we believe more will be needed to stabilise growth around the 6-6.5% internal target and lowering official rates has become a plausible scenario.

Against this backdrop, we believe credit spreads are now close to fair value, given the macroeconomic and political uncertainties.

The technical picture for high yield has been supported by a combination of limited supply and increasing demand as investors return to the market following the heated sell off during the final quarter of 2018. However, we expect supply to resume in the near term, capping the relative attractiveness of high yield versus loans or investment grade bonds. In contrast, supply in the investment grade market has been much more significant but matched by renewed institutional demand.

The next few weeks are likely to bring further insight into several issues including a potential trade agreement between the US and China and whether Europe could be the next target for Trump to reduce the US trade deficit. We are also likely to gain some clarification on the outcome of the end-March Brexit deadline, the recovery momentum in the eurozone and how China will intensify its growth stimulus policy.

In this context we believe it is difficult to see credit repeat its recent robust performance, given current valuations. However, we believe there is a good chance for spreads to stabilise while we wait for the macroeconomic and political picture to clear.

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