FIXED INCOME

LOOKING FOR A PLACE TO HIDE

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SUMMARY

RISING RATES POSE RISKS

Last year credit posted stellar total returns, and the beginning of 2017 has also started well. However, we expect US and euro sovereign yields to rise this year. This should in theory translate into upwards pressure on yields in US and euro investment grade (IG) and high yield (HY). But with other factors also at play, there may be places in credit for fixed income investors to hide in an environment of rising sovereign yields.

KEY METRICS ARE IMPROVING

Leverage ratios are declining among IG and HY companies, helped by recovering profits and a stabilisation of debt issuance. Potential US tax cuts and changes in rules on capital repatriation could benefit US IG spreads. Meanwhile, the recovery in oil prices and looser lending conditions should help default rates in US HY, which surged in 2016, to fall back again.

HIGH VALUATIONS SUGGEST CAUTION—FOR NOW

Credit spreads are tight according to different valuation metrics, especially in HY, which has strongly outperformed IG in terms of spread ratios. We expect credit spreads to tighten slightly this year, except in euro IG (which is likely to suffer as markets start to factor in the prospect of ECB tapering) and possibly US HY (which, with lower default rates and higher commodity prices already priced in, would likely require a major US fiscal stimulus to justify another leg of spread tightening).

TABLE 1: YIELD FORECASTS FOR 2017

		27.02.2017		Expected end 2017	
	Duration	yield	spread	yield	spread
10-year US Treasury	8.7	2.36%		3.00%	
10-year German Bund	9.8	0.21%		0.70%	
10-year Spanish Bond	9.3	1.64%		2.00%	
10-year Italian Bond	9.0	2.09%		2.70%	
BofAML US IG	6.9	3.29%	122	3.92%	122
BofAML Euro IG	5.2	0.84%	125	1.38%	130
BofAML US HY	6.5	6.00%	375	6.89%	400
BofAML Euro HY	4.0	3.65%	351	4.03%	340
JPM EMBI (USD)	6.6	5.43%	311	6.71%	375
JPM CEMBI Broad (USD)	4.8	5.28%	302	5.90%	300
JPM GBI (local currency)	4.6	7.05%		7.60%	

Source: Pictet WM - AA&MR, Factset, Bloomberg

MACROECONOMY
GEOPOLITICS
CENTRAL BANKS
ASSET ALLOCATION
ASSET CLASSES
WEALTH MANAGEMENT

INVESTMENT CONCLUSIONS

Due to the expected rise in sovereign yields and a lack of significant spread tightening, total returns from IG are likely to be low in 2017. Returns should be higher in HY, making HY a better place to hide than IG for fixed-income investors at a time of rising sovereign yields. However, with valuations particularly expensive at present, and political uncertainty likely to see periodic spikes in yields this year, we think investors should wait for a rise in spreads before adding exposure to HY, especially US HY.

RISING RATES POSE RISKS

The beginning of 2017 has started well for credit compared to last year, when recession fears during the first months of 2016 led to a negative performance of risky assets, such as equities and high yield bonds. Will this positive performance continue during the rest of the year?

Last year credit posted stellar total returns. For instance, the Bank of America Merrill Lynch (BofAML) US high yield (HY) index returned 17% and its euro counterpart 9%. Performances were slightly lower in investment grade (IG), as would be expected in a risk-on environment, at about 5% for the BofAML indices in USD and euro.

As already outlined in our sovereign bonds outlook for 2017 (Flash Note, Sovereign bond yields to rise as reflation takes hold, 10 January 2017), we think investors need to watch three main macroeconomic risk factors in 2017:

- **Inflation,** which will normalise, rising from its low levels of 2016 thanks to a rebound in oil prices and sustained economic growth.
- **Monetary policy,** which will continue to diverge. We expect the Fed to raise interest rates twice and the European Central Bank (ECB) to remain accommodative, not tapering its assets purchases until 2018.
- **Fiscal policy,** which will remain accommodative in both the US and the euro area–with the potential of becoming even more supportive in the US if President Donald Trump manages to rally Congress behind his expansionary fiscal plan.

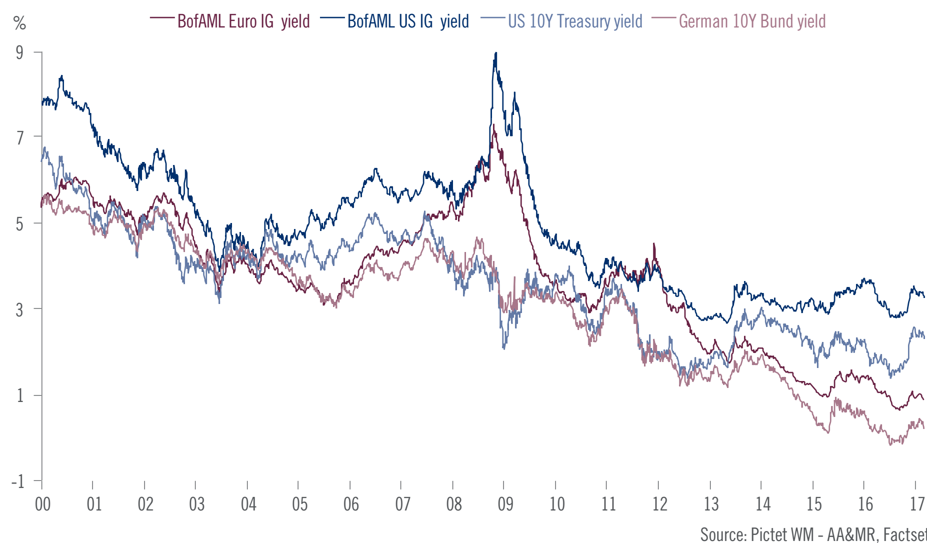
HY OFFERS MORE OF A CUSHION

Credit yields depend on two components, the sovereign yield on the respective currency (often called the risk-free rate), and the credit spread, which determines how much more yield investors require in order to accept the liquidity and credit risk that comes with investing in corporate bonds. We expect the benchmark 10-year US Treasury yield to rise further this year, to 3% by the end of 2017. For euro credit, we think the benchmark 10-year Bund yield (a proxy for the risk-free rate) will also rise, albeit only to 0.7%. This should translate into a similar upward move in credit yields, assuming that spreads are stable and that the slope of the respective sovereign yield curves remains constant. In reality, that is never the case. Could fixed income investors hide in credit in order to obtain positive total returns in an environment of rising sovereign yields?

> We expect the benchmark 10-year US Treasury yield to rise further this year, to 3% by the end of 2017

As seen in Charts 1 and 2, IG yields are more strongly influenced by sovereign yields than their HY counterparts. This is due to their smaller credit spreads, as the high-grade segment is more liquid and has no default rate, so is less risky. Thanks to wider spreads, HY should offer a better cushion for investors in times of rising sovereign yields. Moreover, with higher coupons, bonds of shorter duration and a higher exposure to small and medium sized companies, which are more exposed to regional economic growth, HY should outperform IG in terms of total return in 2017.

CHART 1: BOFAML US AND EURO IG YIELDS WITH THE BENCHMARK 10-YEAR US TREASURY AND GERMAN BUND YIELDS



Source: Pictet WM - AA&MR, Factset

KEY METRICS ARE IMPROVING

There are also other concerns for investors in credit. A key metric is the leverage ratio–essentially debt divided by profits. When leverage rises, a company is increasing its debt level by more than growth of profits, which could end up being unsustainable. As Chart 3 shows, since 2014, leverage ratios have risen sharply for US firms in the BofAML US IG

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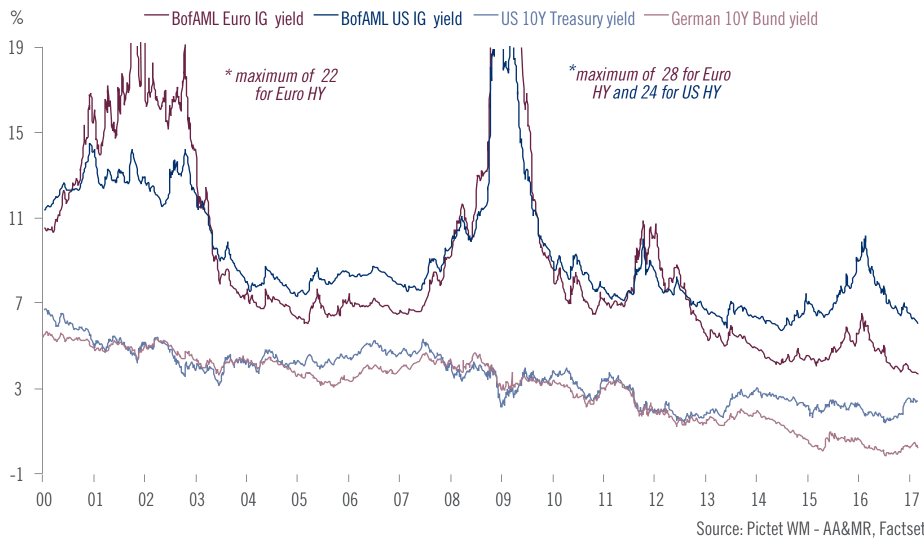
CHART 2: US AND EURO HIGH YIELD YIELDS WITH THE BENCHMARK 10-YEAR US TREASURY AND GERMAN BUND YIELDS



Source: Pictet WM - AA&MR, Factset

index (a sample of 354 firms) and HY index (380 firms). This was due to both a strong acceleration of firms' indebtedness and a fall in profits. The deterioration in leverage ratios was a concern for credit markets at the beginning of 2016, as investors thought profits would fall further due to lower oil prices (especially damaging for the energy sector, a large component of US HY) and slower US economic growth. However, since then, US IG leverage has fallen back a little thanks to a slowdown in indebtedness and a rebound in profits. In euro IG the picture is similar, with the difference that the peak in the leverage ratio reached in 2015 was lower than during the financial crisis–which suggests less concern over financial health for companies issuing debt in euro.

In US HY the fall in the leverage ratio has been more impressive (see Chart 3), as the overall index was strongly impacted in 2015 by losses incurred by companies linked to the fall in the oil price, and firms have also boosted their debt level since 2014. However, in 2016 companies have seen their profits grow again, partly due to the rebound in the oil price, and have reduced their indebtedness.

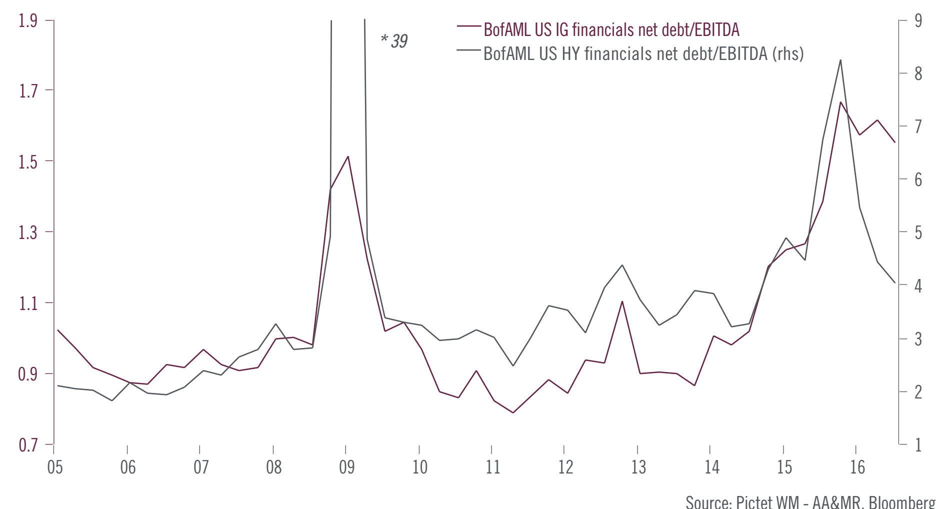
CORPORATE DEBT ISSUANCE HAS STABILISED

Gross corporate debt issuance broadly stabilised in 2016 according to gross issuance data from UBS. It rose only slightly compared to 2015 in the US IG segment, to USD1,291bn (admittedly a record year), while in euro IG, the introduction of the ECB corporate debt purchase programme did not incentivise companies to issue more debt, and gross issuance remained stable at around EUR525bn. In US HY, gross issuance fell drastically at the beginning of 2016, as higher yields made companies less inclined to finance themselves on the capital market; but as yields fell during the year, gross issuance caught up to the 2015 level, at USD290bn. In euro HY, issuance halved to EUR58bn.

> A cut in the US corporate tax rate should benefit US IG more than HY

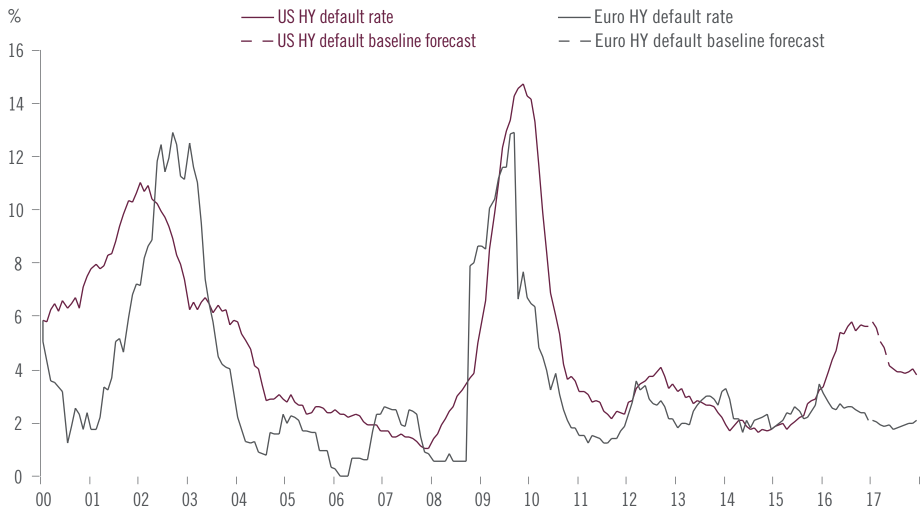
In 2017 issuance should be similar to 2016, with the exception of US IG, which could be impacted by potential measures aimed at incentivising companies to repatriate cash held overseas and at reducing US corporate

CHART 3: BOFAML US INVESTMENT GRADE AND US HIGH YIELD FIRMS EX-FINANCIALS LEVERAGE RATIO



Source: Pictet WM - AA&MR, Bloomberg

CHART 4: US & EURO HY DEFAULT RATES WITH MOODY'S FORECASTS

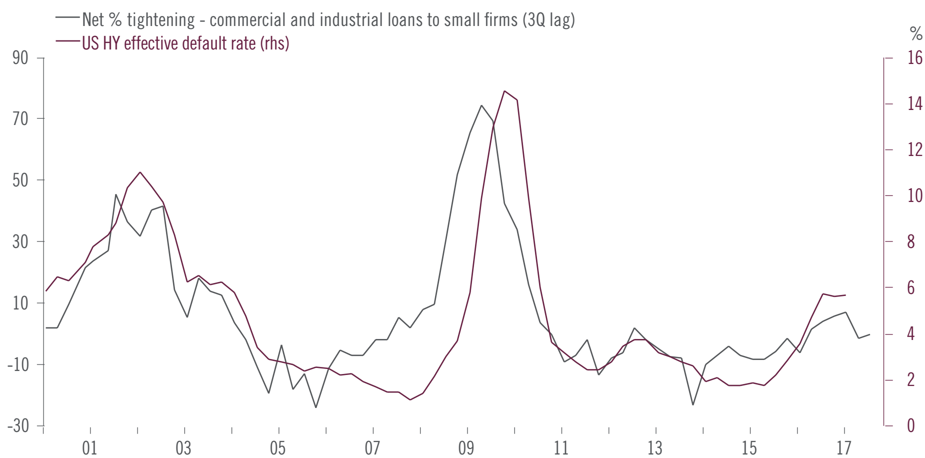


Source: Pictet WM - AA&MR, Moody's

tax. If implemented, repatriation measures could reduce US IG firms' need to borrow on the capital market, as they could use overseas cash for investment and share buybacks. CreditSights, an independent credit research provider, anticipates a roughly 15% reduction in gross issuance. This reduced supply could be positive for US IG spreads, assuming that demand remains stable. Such an effect would be more subdued in HY, where companies are generally smaller and less multinational.

A cut in the US corporate tax should also benefit US IG more than HY. According to our calculations, based on the same sample used for the leverage analysis, about 11% of US HY firms posted losses in Q3 2016 against only 2% in US IG, which suggests IG companies will save more in taxes.

CHART 5: US HY DEFAULT RATE AND BANK LENDING TO SMALL FIRMS



Source: Pictet WM-AA&MR, Moody's & Bloomberg

SMALLER EXPECTED LOSS IN HY

Default rates in HY are also important as, with recovery rates, they determine the expected loss for investors. In December 2016, the default rate stood at 5.6% for US HY, and at 2.4% for its euro counterpart, according to Moody's (see Chart 4). The strong divergence in default rates that appeared in 2015 was due to the high exposure of US HY to the energy and metals & mining sectors–both were badly hit by the fall in commodities prices. The US HY default rate should fall to around 4% by the end of 2017, while remaining stable for euro HY. The expected loss will therefore be larger in US high yield in 2017 at around 2.4%, compared to 1.2% for euro HY.

US real growth should accelerate from 1.6% in 2016 to 2% in 2017, and if Trump's election pledge for fiscal easing is implemented, US growth could start to receive an extra boost later in the year, further reducing HY default rates. In the euro area, growth should decelerate slightly from 1.7% to 1.5% in 2017–not particularly supportive for default rates. We expect earnings growth to improve in 2017, to 6.7% for S&P500 composite companies and to 7.7% for STOXX Europe 600 ones. Profits should rise by a similar magnitude in the credit universe.

Moreover, banks in the US have eased their lending conditions in the second half of 2016–this corroborates Moody's projections for a lower path in US HY default rates, as lending conditions are a good leading indicator (see Chart 5). As long as the Fed stays dovish by hiking rates only twice this year, as we anticipate, lending conditions should remain a support for lower default rates. A risk would be if an acceleration in monetary tightening renews fears of the Fed derailing the economic recovery, leading to tighter

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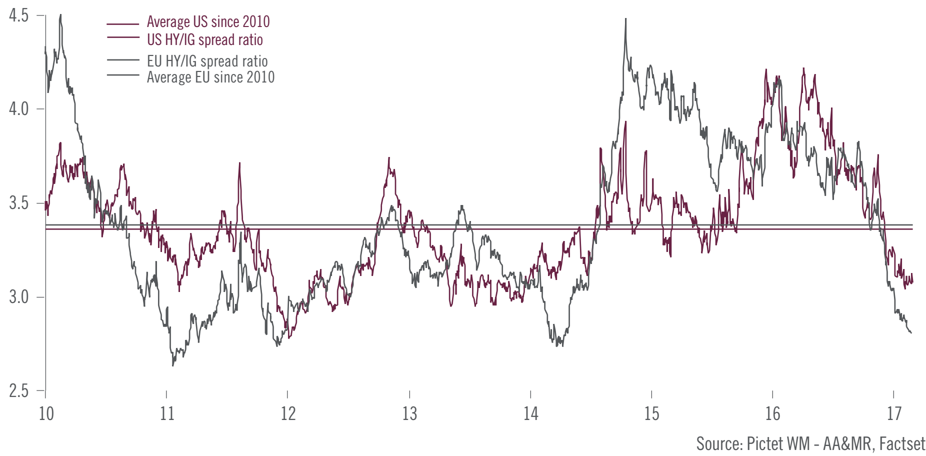
CHART 6: US AND EURO HY AND IG SPREAD RATIOS



Source: Pictet WM - AA&MR, Factset

Compared to ratios since 2010, US and euro HY underperformed from autumn 2015 onwards, but have outperformed since December 2016 (see Chart 6). However, spreads have not yet reached the lows attained between 2004 and 2007 (see Chart 7), when economic growth was buoyant in both the US and the euro area.

We expect credit spreads to tighten slightly this year, except in euro IG and possibly US HY

We expect credit spreads to tighten slightly this year, except in euro IG and possibly US HY. The former has benefited from ECB purchases, and spreads are likely to widen once the ECB signals its intention to taper its QE in 2018–probably in September, in our view–as the market anticipates reduced buying by the ECB. Regarding US HY, valuation metrics show that spreads have already discounted lower default rates for 2017 and the rebound in commodities prices. So only the implementation of aggressive fiscal easing could justify another

lending conditions and higher default rates. In the euro area, banks should not tighten lending conditions this year, as we expect the ECB to remain highly accommodative and not to taper QE before 2018.

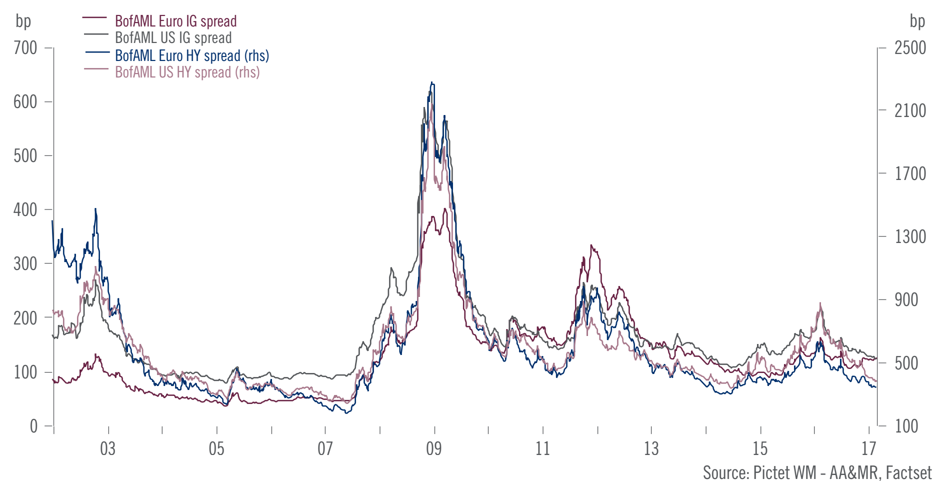
A risk would be if an acceleration in monetary tightening renews fears of the Fed derailing the economic recovery

HIGH VALUATIONS SUGGEST CAUTION—FOR NOW

While key metrics are improving, another key point to bear in mind is that valuations are high. Thanks to the rebound in the oil price to above USD40 per barrel and the disappearance of US recession fears, US HY spreads rallied massively in 2016. The energy sector spread, after peaking at 2,000bp, fell back to 400bp, equivalent to the spread level for the full HY index. In the euro segment, ECB purchases of corporate bonds announced in March 2016 helped to tighten IG and to a certain extent HY spreads. The rise in sovereign yields since the autumn of 2016 and the recapitalisation of Italian banks gave an extra boost to the euro HY spread, due to its high exposure to banks' subordinated debt.

For these reasons, credit spreads are tight according to different valuation metrics, especially in HY, which has strongly outperformed IG in terms of spread ratios.

CHART 7: US AND EURO HY AND IG SPREADS



Source: Pictet WM - AA&MR, Factset

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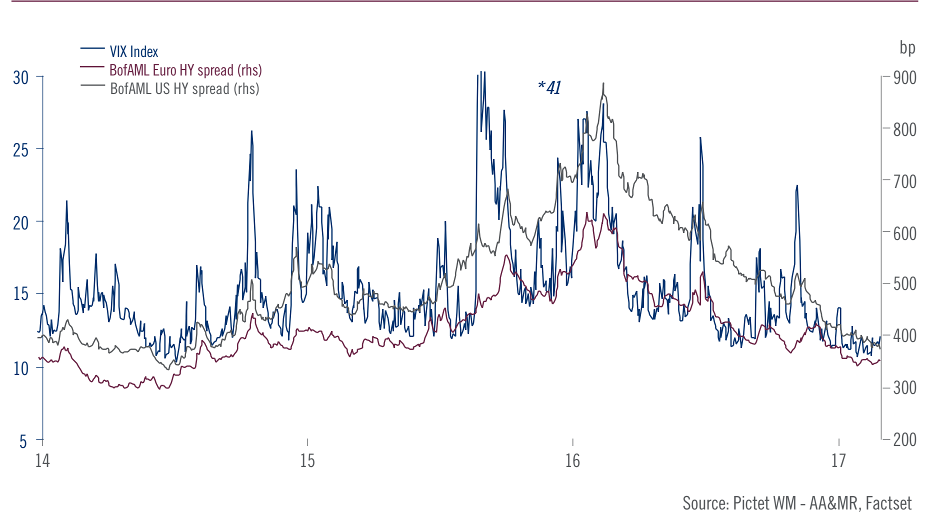
leg of spread tightening, which is not currently our central scenario–although it does appear a realistic possibility, so that could change.

HY LOOKS A BETTER BET FOR 2017

Due to the expected rise in sovereign yields and a lack of significant spread tightening, total returns from IG are likely to be low in 2017. Returns should be higher in HY, making HY a better place to hide than IG for fixed-income investors at a time of rising sovereign yields.

There is, though, a question of timing. Valuations are particularly expensive at present (i.e. spreads are already tight), and we think investors should wait for a rise in spreads before adding exposure to HY, especially US HY. As with other risky assets, HY spreads are positively correlated to the VIX, the implied volatility of the S&P 500 (see Chart 8). When the VIX rises, HY spreads rise as well. The VIX has been particularly low since the beginning of the year owing to the improved economic and earnings climate. However, we expect periodic spikes in volatility on political uncertainty in 2017. A rise in the VIX could provide a better entry point into HY. •

CHART 8: US AND EURO HY SPREADS AND VIX INDEX



Source: Pictet WM - AA&MR, Factset

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