

Where Do Credit Spreads Go from Here?

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The minutes from the Federal Open Market Committee's January meeting were recently released, confirming that central bank officials have grown more confident about reaching its 2% inflation target, and potentially putting a fourth rate hike on the table for 2018. As investors, our job is to think and process the latest economic data to position our portfolios for the future. Right now, the latest information ties back to inflation, and now we're tasked with its potential impact on credit assets. The last several weeks have been trying for investors as equity markets entered correction territory. But for credit investors, is it time to worry about widening spreads?

Inflation and Monetary Policy

In the U.S., wage inflation may finally be taking hold as Average Hourly Earnings exceed expectations. This reading coincided with a significant increase in volatility, specifically around several exchange-traded notes (ETNs) linked to volatility indices. In our opinion, this acceleration in wage growth should increase the probability of a fourth Federal Reserve (Fed) rate hike this year, just as long as economic growth registers at or above expectations. As we reassess the pace and number of interest rate hikes that the Fed will make in 2018, we need to understand the implication on credit assets.

As shown in [Chart 1](#), the 10-year U.S. Treasury yield bottomed in September 2017 and has been steadily rising since, and even accelerating after the turn of the year as the world experienced synchronized global growth.

Chart 1: U.S. Generic Government 10-Year Yield Index

As of 2/21/2018



Source: Bloomberg (© 2018, Bloomberg Finance LP)

Global Growth Is an Important Factor

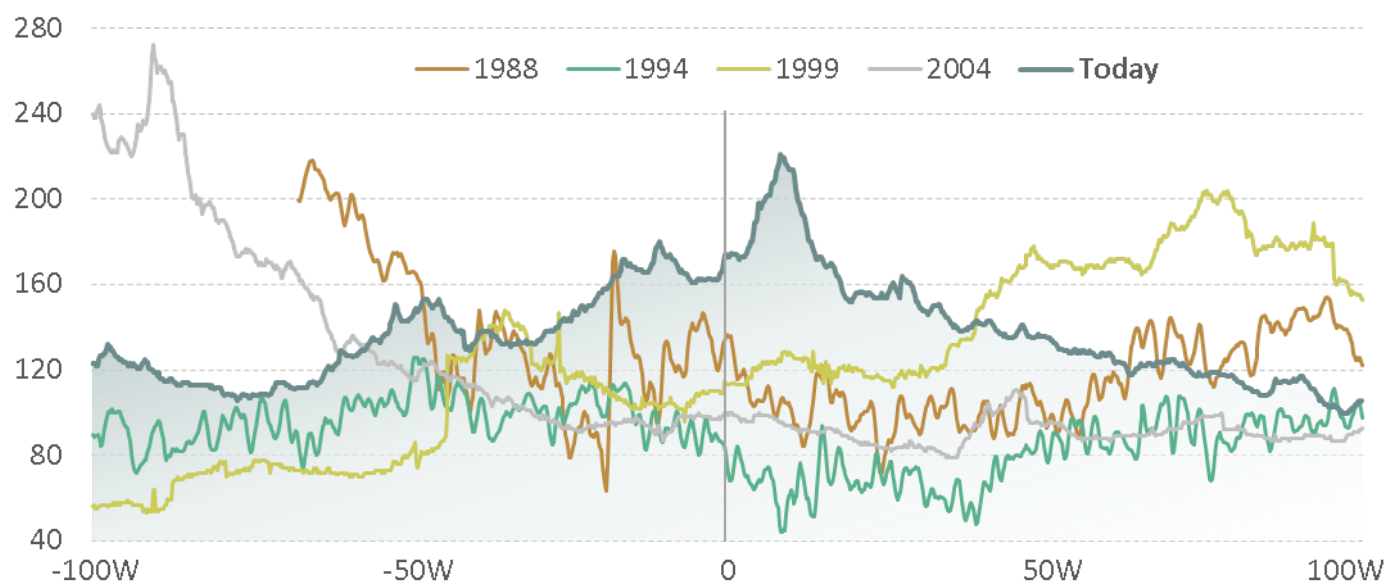
We are constructive on both U.S. and global growth. Europe continues to exceed growth expectations while China remains stable. In the U.S., the recent tax reform coupled with the budget agreement will provide additional fiscal stimulus which should allow growth to surpass forecasts. We believe that “risk-free” rates like U.S. Treasury yields are finally starting to reflect not only optimism, but actual solid economic fundamentals. We also think that synchronized global growth will allow the Fed to continue on its path of hiking interest rates in 2018 as well as normalizing its balance sheet.

Looking at Past Cycles

With Fed tightening underway, let's look at past hiking cycles that may shed some light on potential outcomes today. In order to understand the impact each previous cycle had on both investment grade and high yield credit spreads, we created [Chart 2](#) and [Chart 3](#) that look at the past four rate-hiking cycles relative to the current cycle. Today's cycle looks similar to both 1994 and 2004; both periods provided credit investors with attractive returns. Looking at these two charts, the “0” on the x-axis serves as the starting point for a new Fed tightening cycle and is measured in weeks. Unsurprisingly, credit spreads were wider at the start of this current cycle, as there was a fair amount of skepticism factored into asset prices. We've already seen credit spreads compress after the Fed finally achieved its tentative liftoff in 2015.

Chart 2: Investment Grade Spread (Past Rate Hiking Cycles)

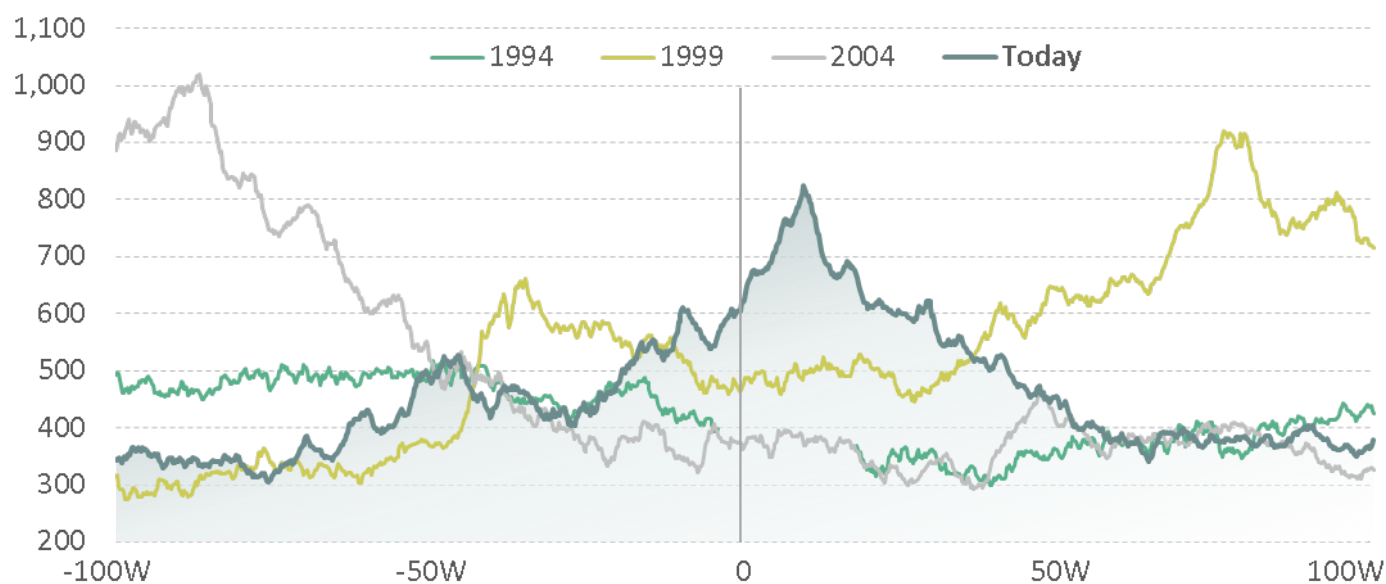
Basis Points, As of 1/1/2018



Source: Bank of America Merrill Lynch

Chart 3: High Yield Spread (Past Rate Hiking Cycles)

Basis Points, As of 2/20/2018



Source: Bank of America Merrill Lynch

Is there room for further spread compression? Yes, there is potential, especially if you look at '94 and '04 where both investment grade and high yield spreads traded within a tight range throughout the duration of a Fed hiking cycle. This same scenario could play out again because like these two instances, this tightening cycle began at the tail end of a crisis, when the energy sector crashed in 2015. Monetary tightening in '94 and '04

occurred at the end or shortly following unique market crises as well, with the Savings and Loan crisis and bursting of the technology stock bubble in the 1990s and 2000s, respectively.

Relative Value

Given the favorable global economic back drop, we believe U.S. investment grade and high yield credit can still perform well over the next year. Of course, there are investors who interpret these optimistic headlines through the lens of skepticism, anticipating that highly leveraged companies are going to get squeezed by the rising rate environment. We don't disagree with them. These companies will find it difficult to manage increasing interest expenses, and yes, defaults may slowly tick higher. However, it's not time to panic. U.S. corporate credit is still cheaper relative to European issuance, and of course to ultra-high quality sovereign bonds like Bunds or Japanese Government Bonds. More importantly, we think the Fed's cycle and the overall U.S. business cycle have been slower and longer than perhaps any other preceding cycle. We've been bullish on global growth for over a year now, and this environment should be constructive for risk assets in general. Perhaps it's easy to maintain our contrarian outlook sitting here in the City of Brotherly Love, where we can focus on our tactical allocations and patiently wait for our long-term outlook to continue unfolding.

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