

Low-Hanging Fruit Perhaps Not So Sweet

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Sometimes it is okay to just step back, think, and assess. “Patience is bitter, but its fruit is sweet,” the philosopher Jean-Jacques Rousseau once advised. Although the immediate reach for yield may be tempting, now is not the time to be going for broke when investing for income across both sovereign and credit assets. Instead, we believe a more thoughtful approach to generating income and total return that may entail waiting for the right opportunities is warranted in the current investment climate, an unusual environment that is the result of being nine years into the slowest economic recovery we have seen, even with the unprecedented policies from global central banks (see [Charts 1 and 2](#)). Risks abound for investors—from lofty valuations to the unknown implications of the unwinding of Federal Reserve and European Central Bank (ECB) balance sheets, and from the normalization of interest rates to geopolitical risks in Europe, the Middle East, and the North Korean peninsula.

Chart 1: U.S. Real GDP Cumulative Growth Since Prior Peak*
Percent Change, As of 6/30/2017

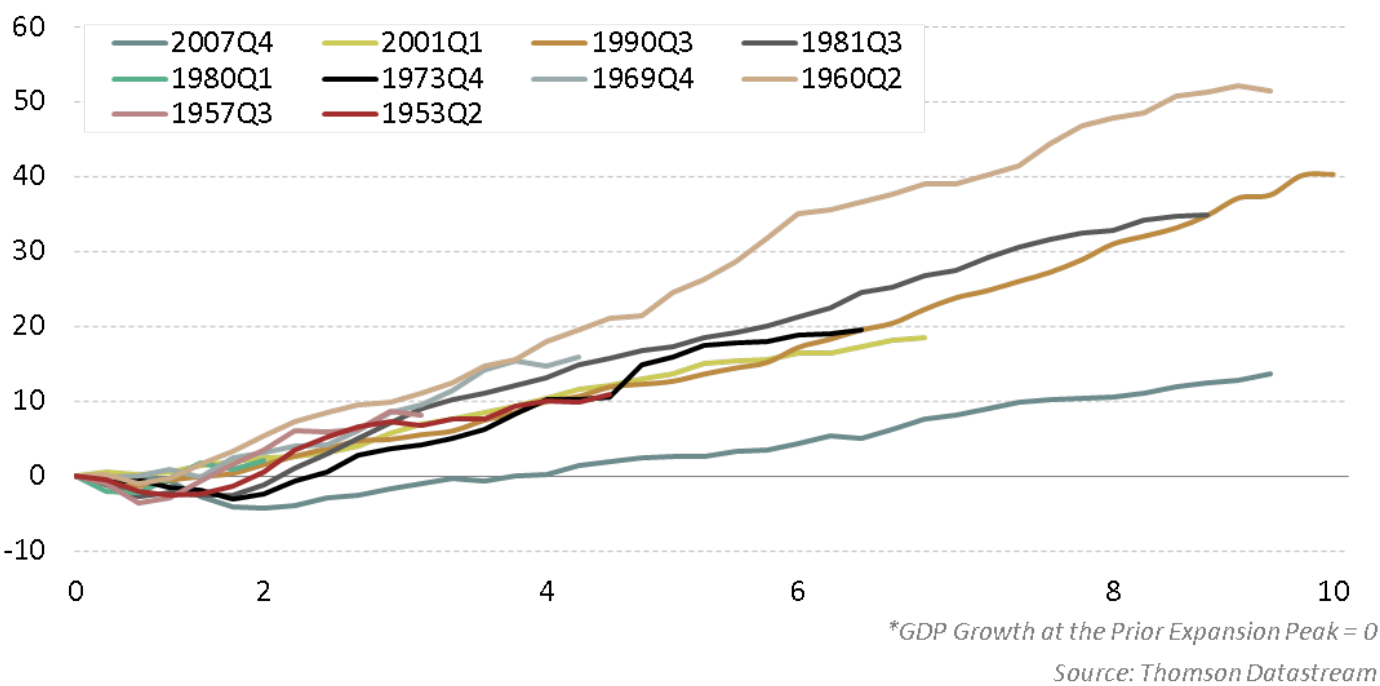
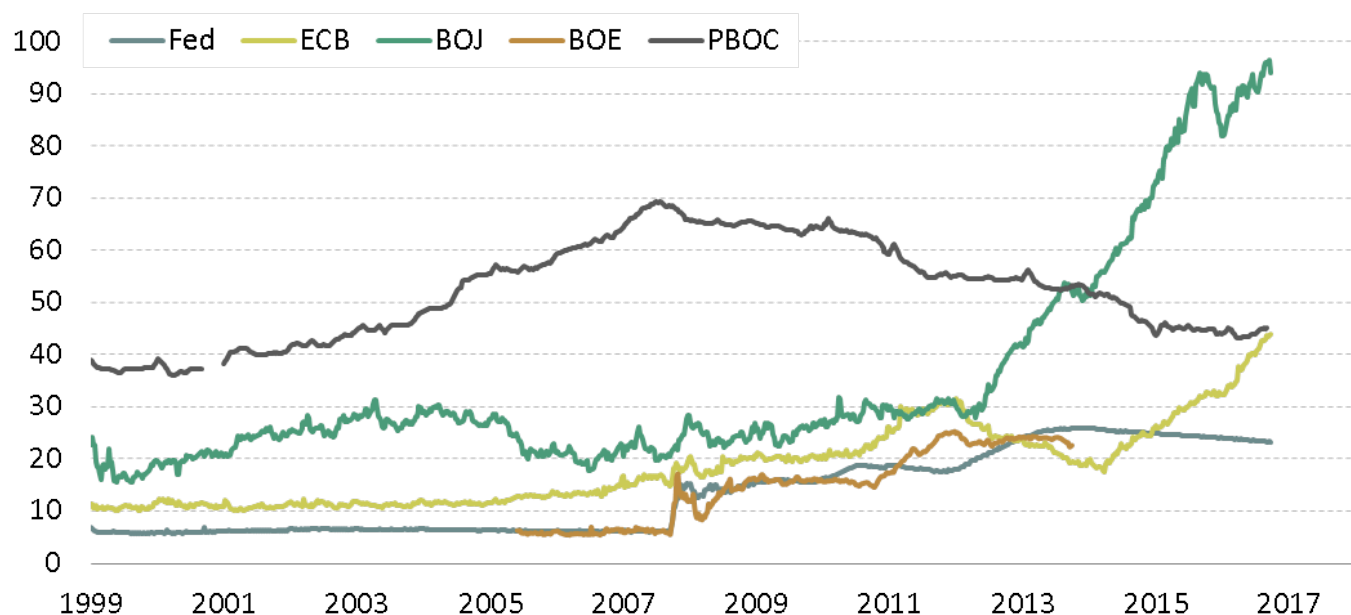


Chart 2: Major Central Bank Balance Sheets

As Percent of GDP, As of 9/20/2017



Source: Thomson Datastream

In light of the numerous risks referenced above, investors should not bear credit and interest rate risk indiscriminately. We would argue that today's valuations are the most significant risk facing investors given the current economic backdrop, the potential for normalization of rates, and the looming reduction of central bank balance sheets. Looking back across historical data spanning over 20 years, on an option-adjusted spread (OAS) basis, spreads are at or near historical lows across essentially every credit quality and geographic segment (see [Charts 3 and 4](#)). Given the current levels of valuations and spreads, investors must take the time to search carefully for pockets of value and segments of the market that still offer the potential for further spread compression.

Chart 3: OAS by Credit Segments

25th-75th Percentile, As of 9/20/2017

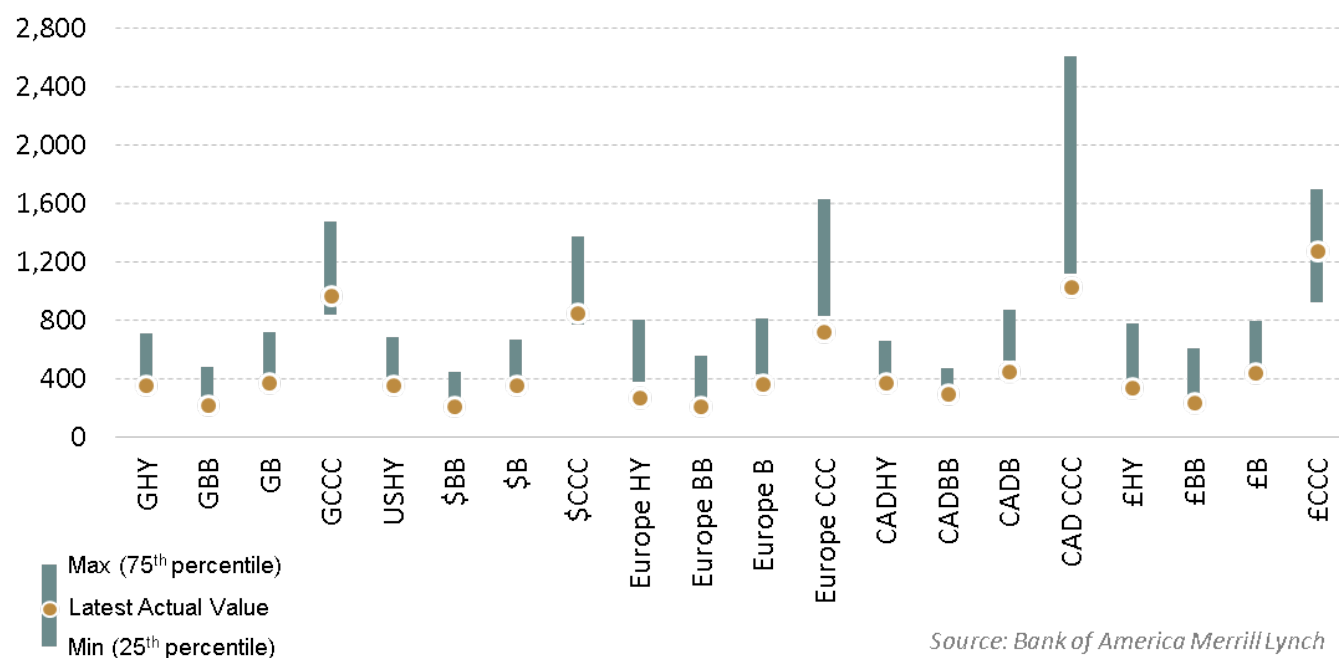
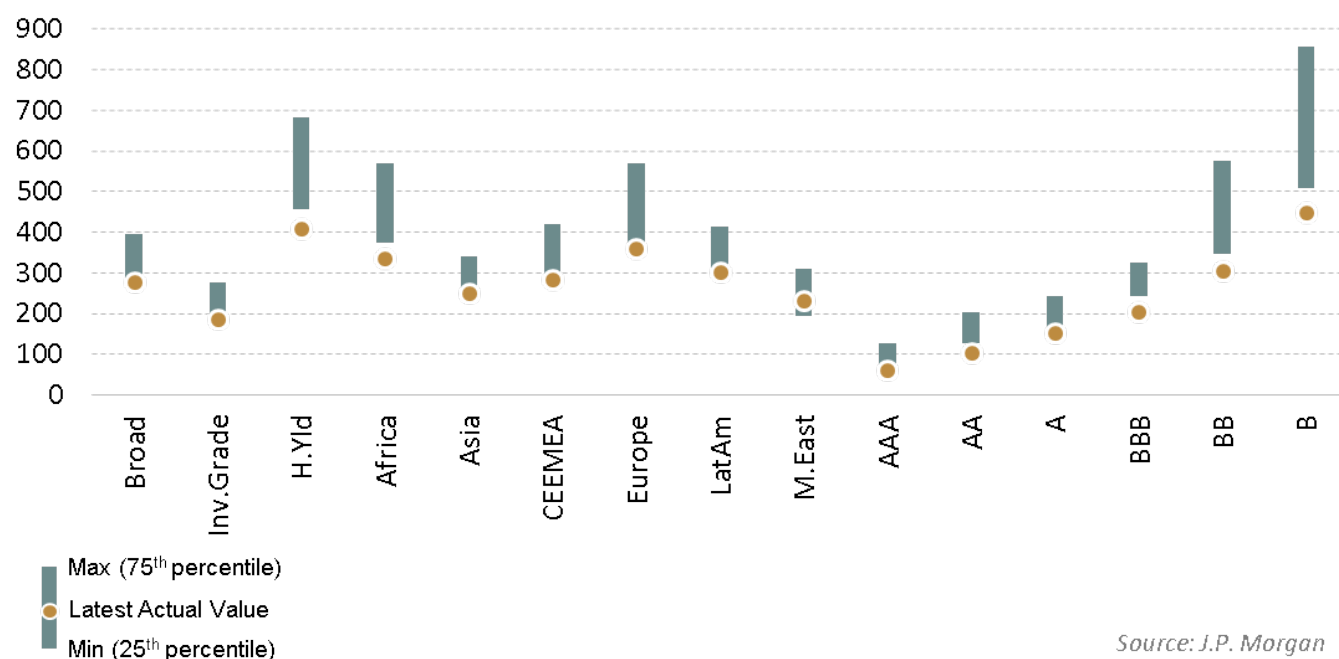


Chart 4: Corporate Emerging Markets Bond Index (CEMBI) by Regions and Credit Ratings

25th-75th Percentile, As of 9/21/2017

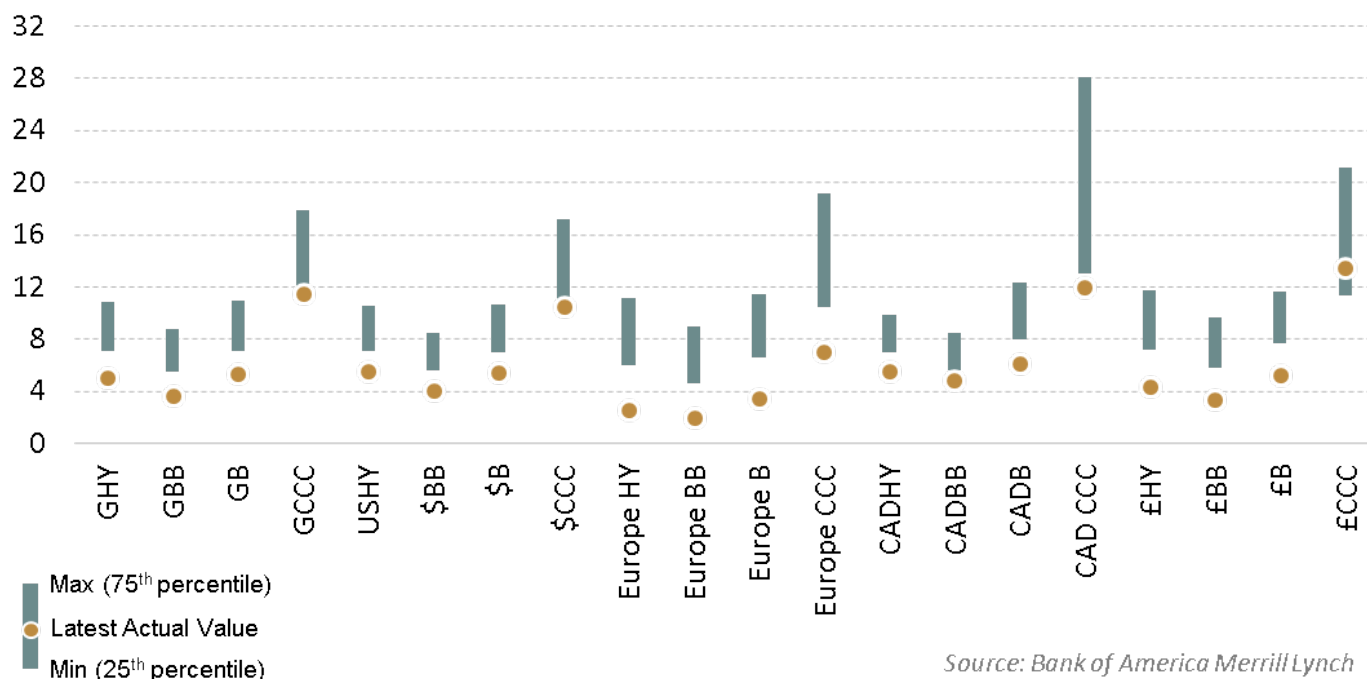


In addition to spreads, investors also must consider the coupons and current yields on their investments. In our view, the coupon and the annual return of those payments based on the bond's current price, or the current yield, are critical to protecting investors during periods of volatility and rising default risk. Theoretically, these semi-annual interest payments help provide investors with some downside protection, as each payment reduces the cost basis and leaves a diminishing amount of principal at risk. Unfortunately, yields today are at even more

extreme levels than spreads, thus not providing the same level of protection as seen in previous cycles (see Chart 5).

Chart 5: Yield-to-Worst (YTW) by Credit Segments

25th-75th Percentile, As of 9/20/2017



Conclusion

Given the valuation extremes and tight credit spreads we are seeing currently, it is not the right time to be reaching for yield and income indiscriminately. We would argue that a more prudent approach to generating income is necessary, one that centers on flexible or less constrained access to broad global fixed income markets and segments. Furthermore, to more accurately assess risk, determine value, and weigh the potential impact of changing monetary policies and economic conditions on various fixed income asset classes, we advocate utilizing both top-down, strong macroeconomic research coupled with thorough bottom-up fundamental analysis in portfolio construction.

The challenge for credit investors is how best to position for a scenario where economic activity continues to improve but valuations in certain sectors already fully incorporate this positive information risk. For example, global credit remains well supported by synchronized global growth, but risk-adjusted return potential appears constrained. Valuations are expensive with credit spreads at or near historical lows. Developed market central bank policy is poised to become less accommodative, and credit fundamentals could deteriorate as a result, particularly if growth stalls and stimulative fiscal policy, like tax reform, fails to materialize. Furthermore, covenant quality has reached an all-time low according to Moody's proprietary measure. Instead of reaching arbitrarily for yield and coming back with a handful of unintended consequences, we believe current conditions require adroit and patient maneuvers to achieve more palatable outcomes. We suggest decreasing the interest-rate sensitivity of credit holdings, increasing credit quality, and searching carefully for the pockets of value that we believe remain in corners of emerging markets, U.S. structured credit, and higher-quality corporate credit.

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