



The Late Innings of the U.S. Credit Cycle

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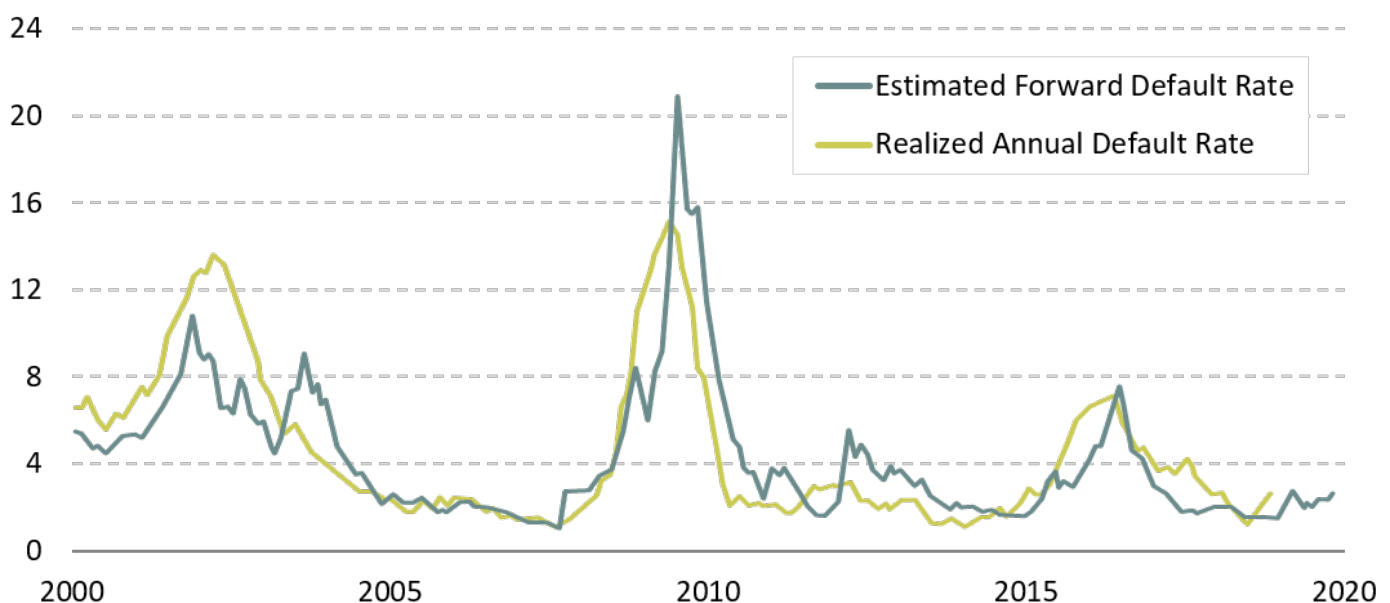
Using the proverbial American baseball analogy, the U.S. credit cycle is in the late innings of the game, but there are still some good plays left. Managing these later stages requires skill, and it becomes a game of careful security selection in certain asset classes. Investing in a mature credit cycle also means that managers should look for end-of-the-cycle signals like a rising default rate, weighing the benefits of defensive characteristics versus attractive valuations, and anticipating monetary and fiscal policy responses.

Defaults

We find that looking at forward default rates provides insight into the potential for risks within the U.S. credit market. Although the model as shown in [Chart 1](#) below does not forecast a significant uptick in defaults, we suggest that investors be mindful of increasing distress ratios. In the short term, defaults will remain muted as the volume of debt that matures in the next year is reasonably manageable since companies have termed out their debt and loose covenants provide these borrowers with flexibility in managing their balance sheets. The absence of a looming debt maturing wall and lighter covenants signal that the end of the credit cycle may still be a couple innings away.

Chart 1: Estimated versus Realized U.S. High Yield Default Rates

Percent, As of 8/31/2019



Source: Bank of America Merrill Lynch, Brandywine Global

Valuations

Given that we are in a mature U.S. credit cycle, valuations across this asset class have not necessarily offered significant value, although there are select sectors and quality strata that do. In particular, we believe there is relative value in U.S. high yield versus investment grade credit, as illustrated by the option-adjusted spreads in [Chart 2](#):

Chart 2: U.S. High Yield versus Investment Grade Option-Adjusted Spread

Percent, As of 8/31/2019

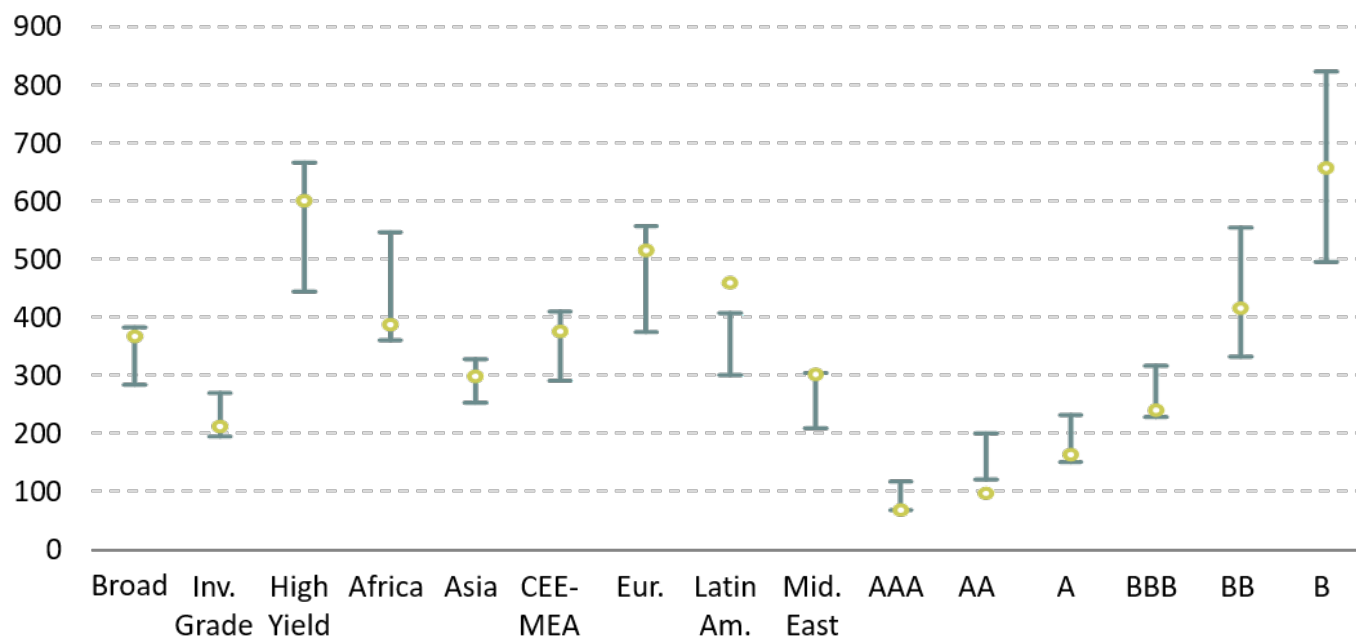


Source: Bank of America Merrill Lynch, Brandywine Global

Credit investors can therefore have more defensive positioning within the high yield sector and pay a smaller premium relative to investment grade corporate bonds. Nevertheless, valuations across the corporate quality spectrum, using historic metrics, appear to be fully valued. With many global spreads at or near all time highs (see [Chart 3](#) below), we suggest that investors focus on better credit quality within the high yield sector and also manage duration through rolling down the yield curve.

Chart 3: CEMBI By Regions and Ratings

CEMBI Spreads, 25th Percentile – 75th Percentile – Current, As of 9/5/2019



Source: Bank of America Merrill Lynch, Brandywine Global

Based on [Chart 3](#), we believe there are opportunities in the single-B credit quality segment of the U.S. high yield market. As mentioned earlier, this is a game about prudent security selection. Therefore, shorter-duration credits issued by companies that are refi-eligible should benefit from easier Federal Reserve (Fed) policy. In this environment, investors may be also contemplating whether to fully allocate to more defensive positions or also consider positions in higher-yielding opportunities that have more attractive valuations. We don't think there should be a tradeoff between the two, as there are also opportunities in emerging market sovereigns on a country-country basis.

Opportunities

We expect many central banks around the world to participate in broad-based easing, as the global inflationary backdrop remains relatively benign. Weak inflation in most developed markets has been offset by stable-to-modestly higher inflation in emerging markets. As monetary policy potentially shifts, an emerging market allocation might be the appropriate complement to defensive U.S. credit positioning. Furthermore, several governments have also announced plans to earmark parts of their budgets for fiscal stimulus. The increase in government spending to help offset any potential decreases in business investment in the face of flagging global growth. The Fed's slow tilt toward dovishness should also foster a more constructive environment for emerging markets. We will be looking for countries with improving current account and fiscal balances and that offer local-currency bonds with an attractive carry. Given the factors outlined, we believe this stage of the game warrants careful security selection in both emerging market sovereign bonds as well as the U.S. high yield credit market.

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