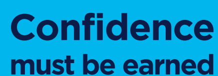


Thematic paper | CROSS ASSET Investment Strategy

January 2018

US credit: don't worry about the macro, focus on technicals

RESEARCH
STRATEGY
& ANALYSIS

Document for the exclusive attention of professional clients, investment services providers and any other professional of the financial industry

US credit: don't worry about the macro, focus on technicals

VALENTINE AINOUZ
Credit Strategy

Finalised on 17/01/2018

The essential

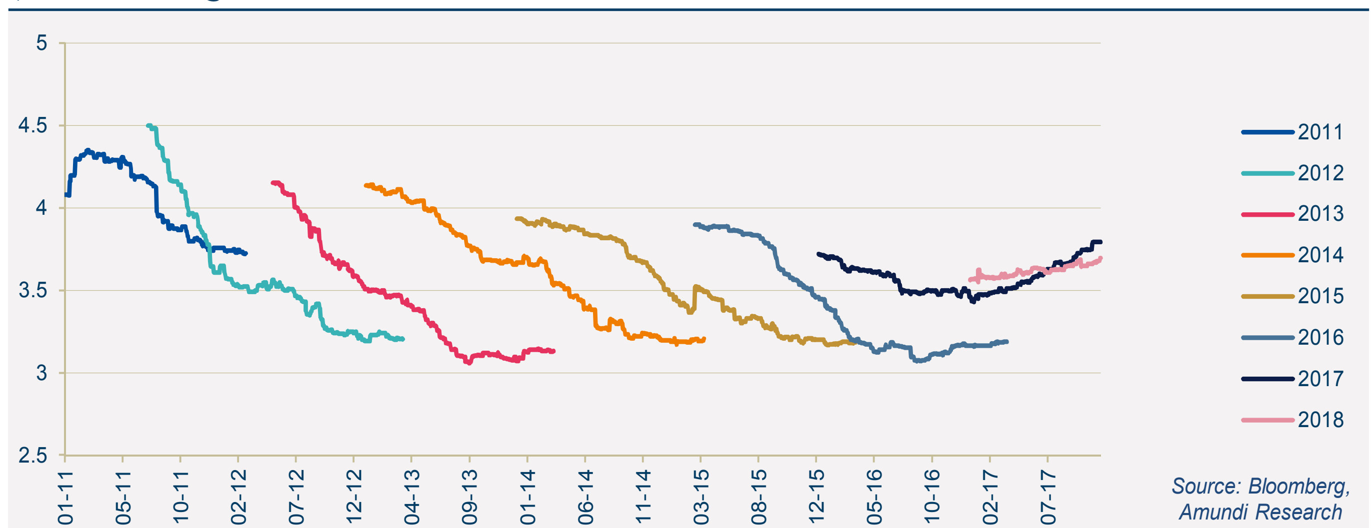
What should we expect for US credit in 2018, in a context where spreads and volatility are closing in on cycle lows? We are already in the late phase of the cycle. However, we remain upbeat on US Investment Grade as some positive surprises can be expected. We are more cautious on US High Yield as the investors are now not rewarded for the risks taken on fundamentals.

What developments can we expect on the US Corporate bond market?

US IG and HY delivered excess returns vs Govts of 3.8% and 6.1% in 2017. The combination of a broad synchronised upswing in the world economy, highly accommodative monetary policies and very low volatility led to another year of very good performance.

- The global economy enjoyed its strongest upturn for more than five years. Upward revisions to growth were made across the board. All advanced economies performed better than expected, with the exception of the UK. Growth was strong in China and India, while Brazil and Russia also confirmed their exit from recession.
- At the same time, the global inflation outlook remained subdued. Underlying inflation measures were especially weak in developed economies. Core inflation in the US and the Eurozone stayed well below central bank targets.

1/ **World GDP growth forecast**



Source: Bloomberg, Amundi Research

Document for the exclusive attention of professional clients, investment services providers and any other professional of the financial industry
Amundi
ASSET MANAGEMENT

- Monetary policy was very accommodative. The major central banks continued to expand their balance sheets. Central banks were a key buyer on the fixed income market.

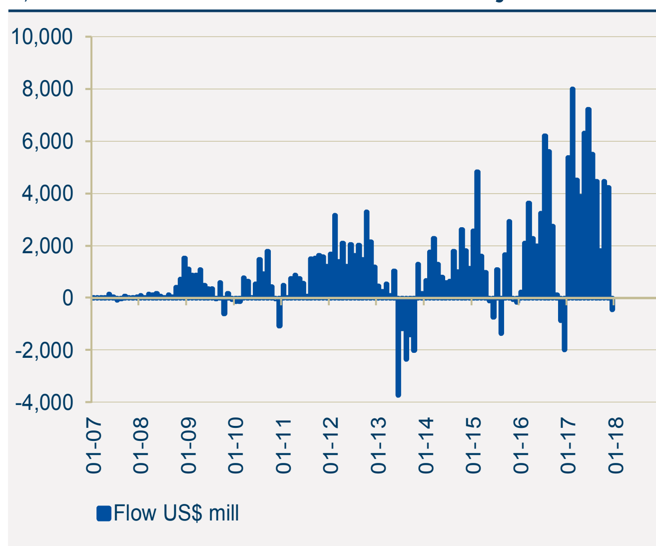
In a context where spreads (and volatility) are closing in on cycle lows, what should we expect for 2018?

Several trends have characterised the US Corporate bond market in recent quarters:

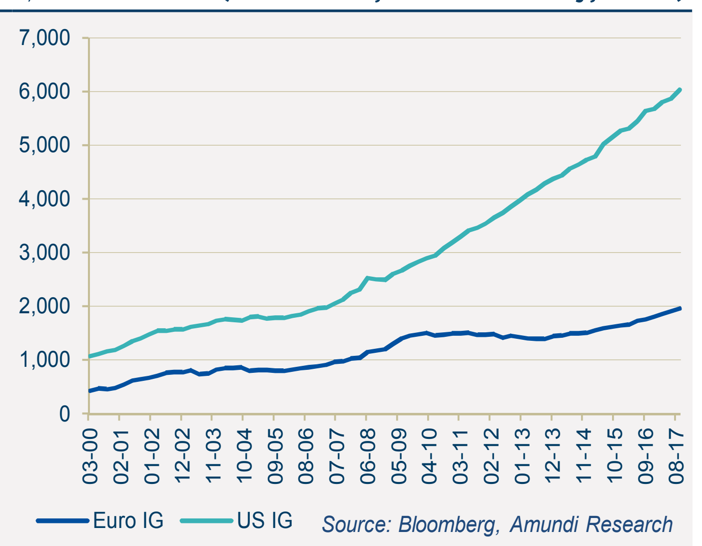
- **Strong demand for US IG**. Demand has increased at an unprecedented pace in recent years. In a low yield environment, foreign investors have been motivated by the search for yield: US credit has been treated as a rate product. USD corporate securities held by foreign residents have increased by 45% since 2012 and foreign investors currently account for 40% of the USD corporate bond market.
- **Strong supply in US IG.** American companies have raised record amounts on the US IG market, primarily to fund M&A and share buy-backs. This market has virtually doubled in size since 2008.
- **Flat net supply on US HY.** Demand for this asset class has remained limited but at the same time net supply has been negative in the last two years. Companies prefer to borrow on the loan market, as covenants have weakened. This trend is expected to continue in 2018.

> "Demand from foreign investors has been a huge support for US IG."

2/ **Investment Grade - USA monthly flows**



3/ **Market size (face value, local currency, in bn)**



Source: Bloomberg, Amundi Research

- **Huge rise in the leverage of American companies.** The rise in leverage has been considerable. Leverage is today high, especially if we take into consideration the fact that the economy is in an extended expansion phase. Previous peaks were recorded following a recession against a backdrop of depressed profits. In the IG universe, the interest coverage ratio remains adequate, but is disappointing considering that interest rates are historically low. However, the number of HY firms with very low interest coverage ratios remains high. Currently, one-third of companies seem to be in a challenging situation.
- **Fall in the junk bond default rate.** The default rate reached a peak of 6% in Q1 2017 and then fell back to around 3% by year end 2017.

> "One-third of US HY companies now seem to be in a challenging situation."

How can we position in 2018?

We are in the late phase of the cycle. Looking ahead to 2018, we believe it will be difficult to deliver solid returns similar to 2017. The potential for further spread tightening is limited. We expect returns to be primarily driven by carry.

We remain upbeat on US IG as some positive surprises can be expected:

- **Technical factors could remain positive.** We expect US IG to continue to be supported by positive foreign flows and the rise in sovereign debt yields to be limited. With rate staying low, US IG will remain attractive. At the same time, we expect the slowdown in net supply to continue in the coming quarters. After the peak of 2015, net supply declined slightly due to lower requirements for new financing (slowdown in M&A and share buyback activities).
- **The leverage of US companies could decline.** Most companies have recently managed to stabilize/decrease their leverage thanks to (1) a positive trend in profit growth and (2) more cautious behaviour. This is quite unusual at this stage of the cycle.
- **The tax reform desired by Trump could have a positive impact** on:
  - # Technical factors. The repatriation of cash held abroad could reduce IG issuance.
  - # Corporate fundamentals. First, the lowering of taxes could have a positive impact on profits. Second, the non-deductibility of interest could encourage US companies to further reduce their leverage. In this new context, it would be much less attractive for companies to issue debt to finance share buybacks.

We have a more cautious stance on US HY for fundamental reasons:

- **One-third of companies now seem to be in a challenging situation**. US corporate debt has reached historic highs. The number of firms with very low interest coverage ratios is high. A slowdown in growth would inevitably cause difficulties for these companies.
- **We expect the default rate to continue decreasing next year to very low levels** (between 2.5% and 3% forecast). Defaults will continue to fall because of very supportive financing conditions.
- **The decrease in the default rate is already priced in by the market.**

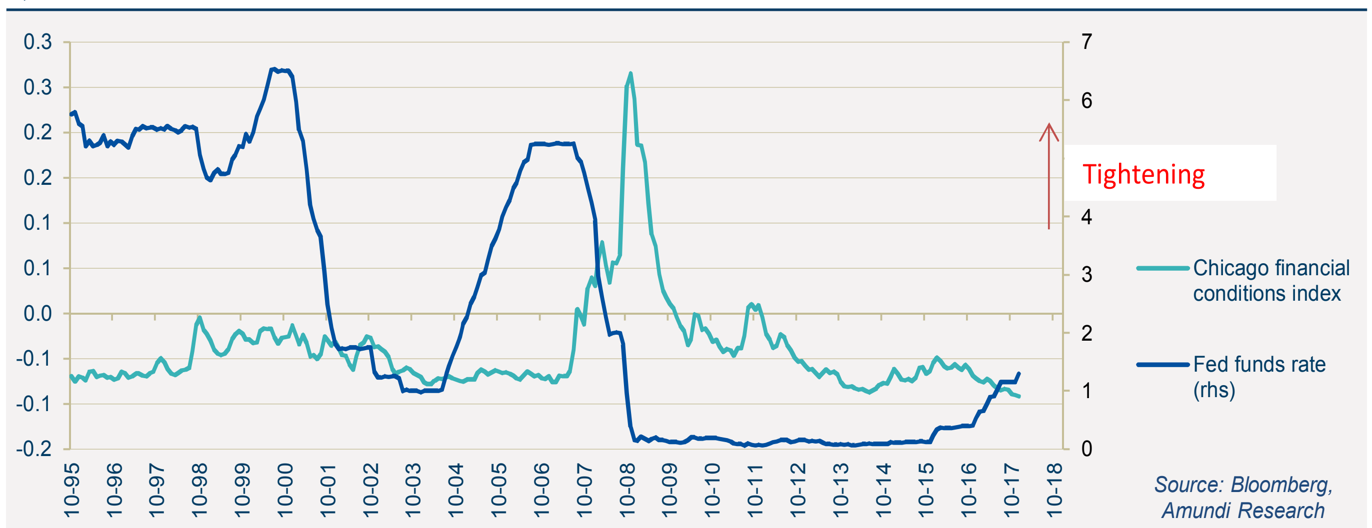
> "US HY default rate are very low because of very accommodative financing conditions."

What are the risks associated with this scenario?

1) A lower growth environment:

- **The default rate would increase sharply.** Financing conditions have remained accommodative for years. As we have said above, the default rate is today at low levels mainly because of very accommodative financing conditions. This scenario could come about in 2019 and we have to bear in mind that the market will price in downgrades at least a year before they occur.

4/ Financial conditions index versus fed funds rate



Source: Bloomberg, Amundi Research

Amundi ASSET MANAGEMENT

- **Fallen angels volumes would rise significantly.** 30% of the US IG index would already carry a high yield rating if the rating was only based on leverage. The weight of BBB ratings has increased significantly in recent years.

2) An increase in the global yield environment

- **Higher sovereign bond yields could change the game**. The lack of yield has made the US IG asset class very attractive. Demand from foreign investors has been a huge support.
- **The drop in demand for US IG products would occur in a context of rising refinancing requirements.** US companies will have to refinance the huge debt incurred in recent years. The positive point is that companies will not face "a wall of maturities". Indeed, companies took advantage of exceptional financing conditions to extend the average maturity of their debt.

"No maturity wall but structurally huge refinancing needs over the next years."

We expect growth of 2.6% in the US in 2018 and a very gradual and contained rise in inflation. Liquidity injections by central banks are approaching their inflection point but will remain positive in 2018 despite the Fed's reduced balance sheet. Macroeconomic and monetary policy conditions will continue to support credit markets in 2018. The main risk is an abrupt end to the current environment. A surprise upward inflation could be a trigger.

CROSS ASSET
INVESTMENT STRATEGY

January 2018 | Thematic paper

DISCLAIMER

In the European Union, this document is only for the attention of "Professional" investors as defined in Directive 2004/39/EC dated 21 April 2004 on markets in financial instruments ("MIFID"), to investment services providers and any other professional of the financial industry, and as the case may be in each local regulations and, as far as the offering in Switzerland is concerned, a "Qualified Investor" within the meaning of the provisions of the Swiss Collective Investment Schemes Act of 23 June 2006 (CISA), the Swiss Collective Investment Schemes Ordinance of 22 November 2006 (CISO) and the FINMA's Circular 08/8 on Public Advertising under the Collective Investment Schemes legislation of 20 November 2008. In no event may this material be distributed in the European Union to non "Professional" investors as defined in the MIFID or in each local regulation, or in Switzerland to investors who do not comply with the definition of "qualified investors" as defined in the applicable legislation and regulation. This document is not intended for citizens or residents of the United States of America or to any «U.S. Person» , as this term is defined in SEC Regulation S under the U.S. Securities Act of 1933.

This document neither constitutes an offer to buy nor a solicitation to sell a product, and shall not be considered as an unlawful solicitation or an investment advice.

Amundi accepts no liability whatsoever, whether direct or indirect, that may arise from the use of information contained in this material. Amundi can in no way be held responsible for any decision or investment made on the basis of information contained in this material. The information contained in this document is disclosed to you on a confidential basis and shall not be copied, reproduced, modified, translated or distributed without the prior written approval of Amundi, to any third person or entity in any country or jurisdiction which would subject Amundi or any of "the Funds", to any registration requirements within these jurisdictions or where it might be considered as unlawful. Accordingly, this material is for distribution solely in jurisdictions where permitted and to persons who may receive it without breaching applicable legal or regulatory requirements.

The information contained in this document is deemed accurate as at the date of publication set out on the first page of this document. Data, opinions and estimates may be changed without notice.

You have the right to receive information about the personal information we hold on you. You can obtain a copy of the information we hold on you by sending an email to info@amundi.com. If you are concerned that any of the information we hold on you is incorrect, please contact us at info@amundi.com

Document issued by Amundi, a société anonyme with a share capital of €1,086,262,605 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris www.amundi.com

Photo credit: iStock by Getty Images - baona

Find out more about
Amundi research team
research-center.amundi.com

Amundi
ASSET MANAGEMENT