Aegon Asset Management

2018 CREDIT THEMES & OUTLOOK

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2018 Credit market outlook: Stay long credit risk

In 2018, we believe credit spreads will continue grinding tighter and, therefore, intend to remain overweight credit risk relative to interest rate risk, with a modest preference for high yield over investment grade corporate bonds. Here's why: The outlook for US economic growth is favorable, inflation remains in check, and we expect the global search for yield will support the domestic credit market. Meanwhile, as the economy continues expanding, we anticipate the Federal Reserve will follow-through with policy normalization, which should keep upward pressure on interest rates.

However, we expect only a modest spread tightening, with limited upside. As a result, meaningful investment results will likely have to come from finding idiosyncratic opportunities, as opposed to relying on the broad market performance for returns. As the year progresses we believe it will become prudent to reduce beta-type overweights to credit risk, and increasingly focus on opportunistic strategies. In our view, the recipe for credit asset classes to outperform in 2018 will be driven by current yields plus modest spread movement, avoiding the idiosyncratic bombshells, and taking advantage of opportunistic situations that arise in the stressed parts of the market.

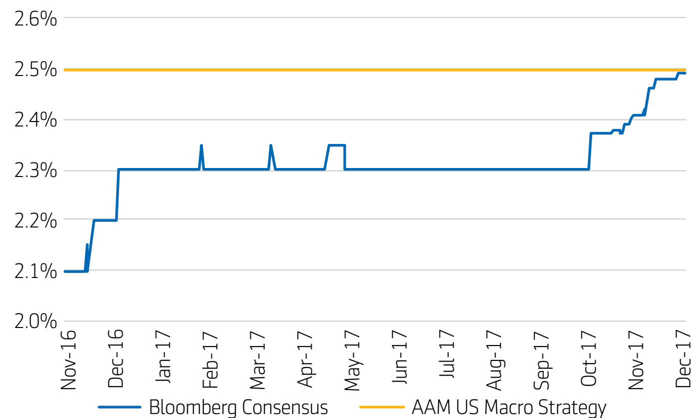
2018 Credit themes

1. The macroeconomic and financial market environments remain in a Goldilocks scenario, which should support modest spread tightening over the year.
2. Pro-growth policies, like tax reform and reduced regulatory burdens, will likely continue to extend the business cycle.
3. The US consumer's strength continues to boost domestic economic growth. While long-term structural challenges continue to affect some consumer-related segments (e.g., retail and autos), the consumer remains healthy.
4. Idiosyncratic risk will likely grow as the markets increasingly punish individual companies that disappoint relative to expectations, or that have business models facing secular headwinds.

Theme 1: Not too hot, not too cold

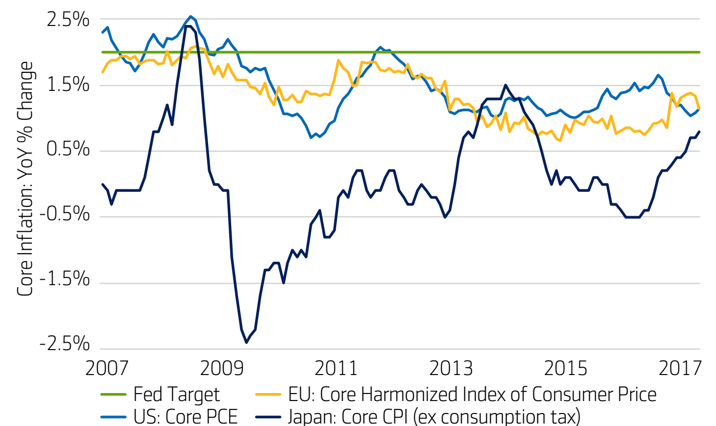
The global economic environment remains favorable for further asset price appreciation. Economic growth is steadily increasing and consensus projections are trending upwards (Exhibit 1). Overall, central banks continue to be more dovish than hawkish, and appear committed to market-stabilizing policies meant to keep volatility from spiking. We think both factors will continue for the foreseeable future, leading to a Goldilocks environment where the economy is not too hot, and not too cold. Inflationary pressures continue to remain under control domestically and globally, but require close monitoring (Exhibit 2). While there will always be bumps along the way, our view is that this amenable economic environment and continued macro stability remains supportive of investing in risk assets.

Exhibit 1: 2018 Real GDP Growth Forecasts



Source: Bloomberg, Aegon Asset Management US (Aegon AM US) Macro Strategy, as of December 2017

Exhibit 2: G3 (Dis)Inflation



Source: Haver Analytics as of 12/12/17

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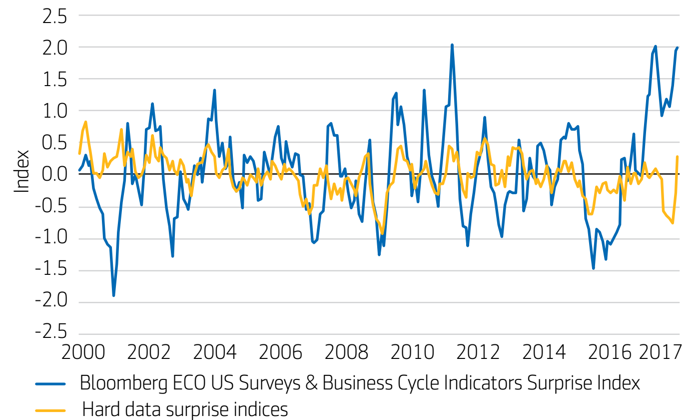
Theme 2: Extending the business cycle

Pro-growth policies, like tax and regulatory reform, should support business growth and help sustain fundamental company performance. By providing support for asset prices and keeping default rates low, we expect these factors would mitigate the risk of a near-term turn in the business cycle.

Already, markets have responded favorably to policy changes, as hard and survey-based economic data illustrate (Exhibit 3). The new corporate tax regime should bring the US more in line with global peers (Exhibit 4). Based in part on expectations for these reforms, corporate earnings momentum has been positive and strong in recent quarters. While the policy changes will affect companies differently, we expect lower tax rates will ultimately increase after-tax cash flows. Kinder tax treatment of repatriated cash should also lead to an increase in financial flexibility for some firms. When combining these factors with an improved tax treatment of capital spending, we think there will be an increase in domestic business investment.

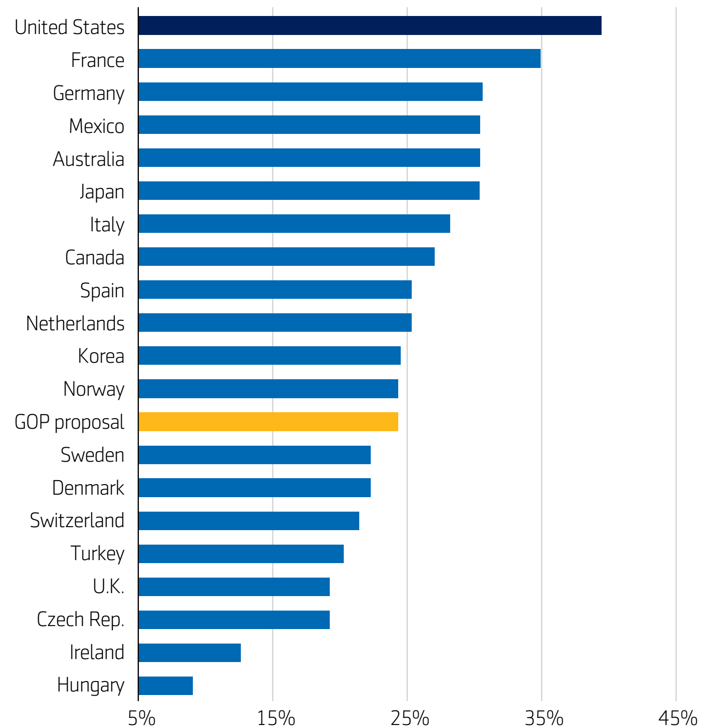
Further extending the current cycle should promote continued risk appetite in a yield hungry world. As long as inflation remains under control, and central banks can avoid a policy mistake, we continue to favor a long credit risk position.

Exhibit 3: Aggregate surprise indices: Soft vs Hard data



Source: Bloomberg, as of November 2017

Exhibit 4: US and global statutory corporate tax rates



Source: BEA, Compustat, OECD, Goldman Sachs Global Investment Research. As of December 4, 2017. Note: Tax rates include federal and local taxes. White House and GS estimate data points include the current 4% average state & local tax in excess of the 35% federal rate. 2017's "Tax Cuts and Jobs Act" fixed the effective US corporate tax rate at 21%.

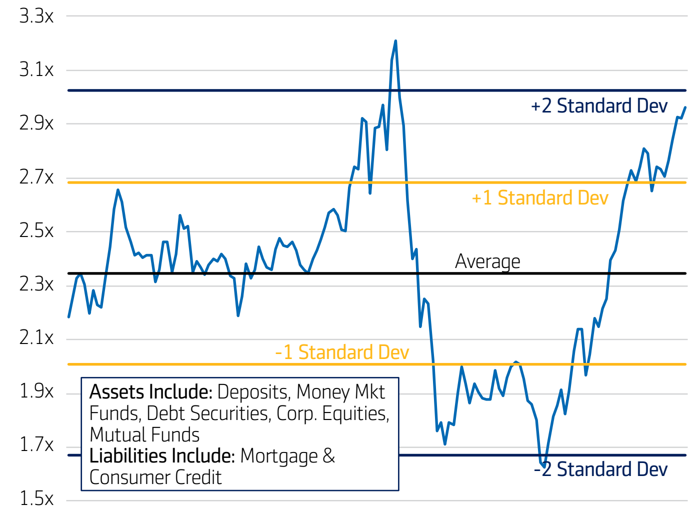
Theme 3: The discretionary consumer

Historically low unemployment, a strong housing market, steadily improving access to consumer credit, easy financial conditions, limited inflationary pressures, and robust wealth effects bode well for the US consumer (Exhibit 5). As one might expect in such an environment, consumer confidence is soaring and aggregate consumer spending should continue moving higher. We don't envision these trends will reverse anytime soon, and investors will likely find plenty of opportunity to benefit from consumer strength.

The housing sector has some of the best fundamental prospects in today's environment. In addition to increases in housing starts, housing permits, and single family home sales, prolonged periods of economic strength have historically translated into increased household formation. While Millennials initially bucked this trend, that may be starting to shift. Research from Fannie Mae suggests that Millennial home ownership may be picking up as the economic recovery continues (Exhibit 6). If true, it could provide an incremental boost to housing demand, benefitting the sector.

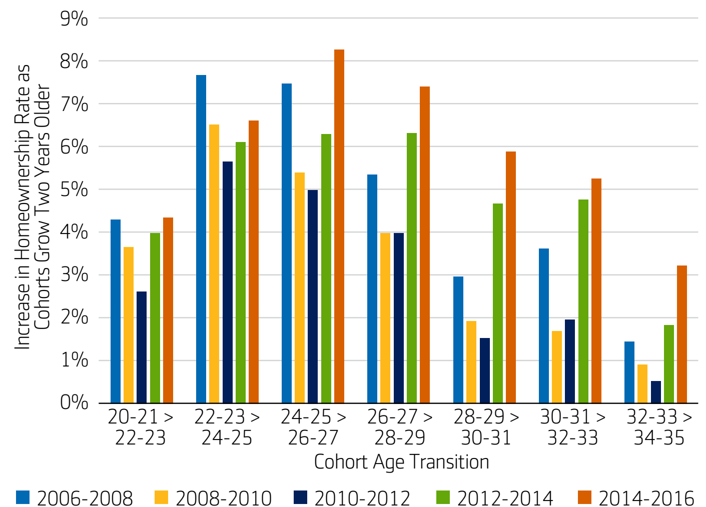
Changing demographics aren't the only trend driving consumption patterns. Technology is rapidly changing behavior, providing consumers more information, more choices, and more convenience. Amazon has been a particularly disruptive force, increasingly affecting competitors' business models, and driving a larger wedge between winners and losers in the consumer space. Some sectors may continue to suffer (e.g., retail), while others are likely to face a swiftly evolving competitive landscape (e.g., drugstores, supermarkets). Still, some businesses, like those involving a high degree of human interaction or a distinct consumer experience, may retain a degree of protection from the Amazon model.

Exhibit 5: Wealth effect in action
Household asset-liability ratio



Source: Aegon AM US Macro Strategy, FRB Flow of Funds, as of Q3 2017

Exhibit 6: Cohort perspective reveals acceleration in millennial homeownership attainment during the economic recovery



Source: US Census Bureau, American Community Survey, as of 2016

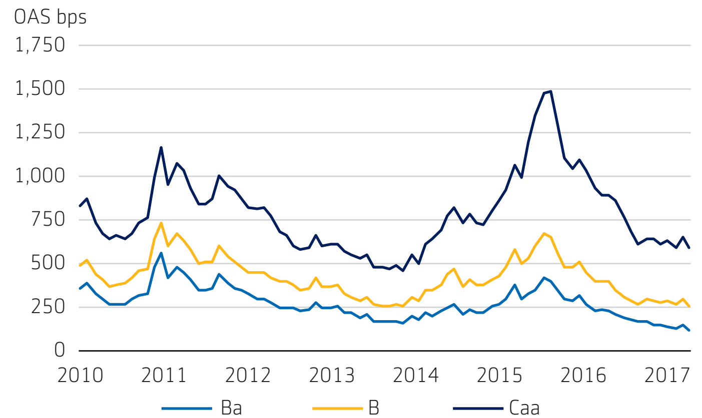
Theme 4: Growing idiosyncratic risk, particularly in high yield credit

As an asset class, high yield corporate debt looks relatively expensive. Whether its Ba or Caa-rated, junk bond spreads have compressed inside long-term averages (Exhibit 7). For some, these spreads are taken as a sign that the high yield market is fully valued, and devoid of investment opportunities. But despite the steady, low volatility, and persistent drive towards tighter credit spreads and lower yields, there is meaningful turbulence beneath the surface.

That turbulence, also referred to as idiosyncratic risk, is creating opportunity. Sector and company specific issues (like the Amazon effect discussed above) are causing more divergence in individual company performance in some segments of the market. We believe that in 2018, managers can enhance performance by successfully taking advantage of these idiosyncratic opportunities.

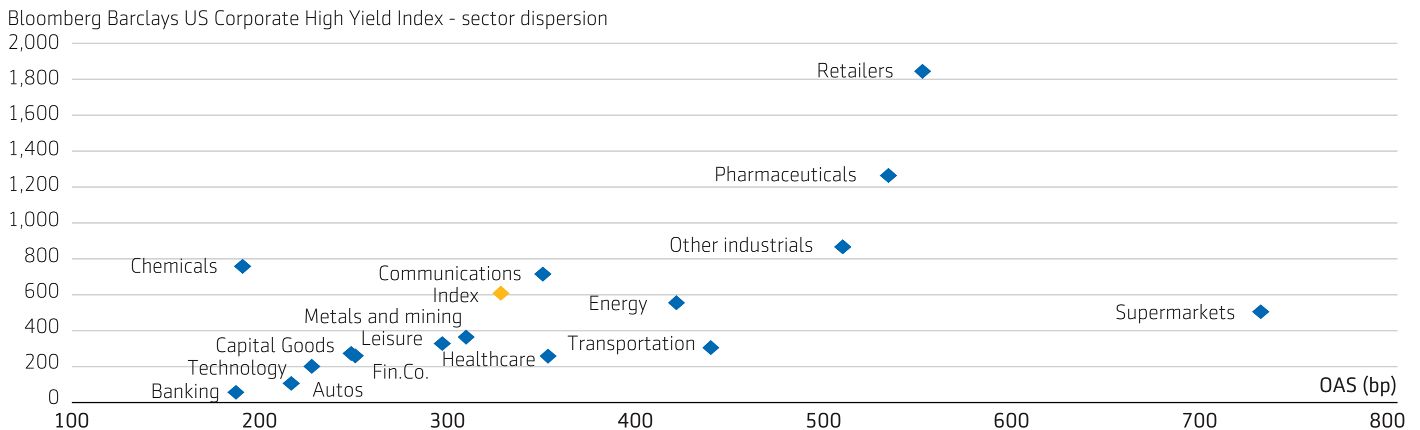
Even now, the market is more acutely differentiating between winners and losers, penalizing those companies that miss earning targets or that face sector-specific or company-specific risks (Exhibit 8). At present, the greatest dispersion is in the retail sector, though individual issuers in the pharma space have also been under pressure. Relative to the absolute low level of high yield spreads, we also see a substantial gap between the non-distressed and distressed segments of the market. The ability to avoid non-distressed names that are at risk for significant underperformance, or to identify those names in the distressed segment of the market that present opportunity, will be where active managers can add value.

Exhibit 7: High yield spreads by credit quality



Source: Barclays Live, as of October 2017
Note: US Corporate High Yield Index Ba, B, and Caa components

Exhibit 8: Mapping sectors by dispersion and overall sector spread



Source: Barclays Live, as of October 2017

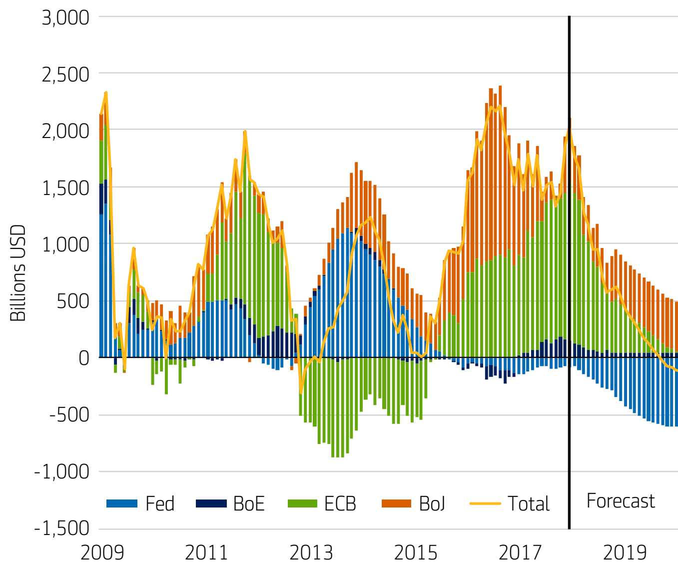
Managing Risks

We maintain our positive outlook for credit, but see the market facing a number of potential risks as the year progresses. As professional managers of risk, we regularly evaluate how these types of scenarios might impact our view. Here are our top three.

#1: Central Bank policy mistake

Market prices remain heavily influenced by exceptionally accommodative central banks in Japan, Europe, and the US. Based on the banks' own guidance, the market expects accommodative policies to remain largely in place, but to begin ever-so-gradually moving towards more historically normal stances (Exhibit 9). The Federal Reserve leads the way as they continue to raise short term rates and gradually shrink the balance sheet. A mistake by the Fed, in either direction, could be negative for credit markets. Tighten too fast and choke off growth, adding stress to credit markets. Remain too accommodative and risk higher inflation, leading to demand for increased risk premiums (i.e., wider spreads).

Exhibit 9: Global issues – Central Bank tightening on the horizon



Source: Deutsche Bank, Haver Analytics, Federal Reserve, Bank of Japan, Bank of England, Aegon AM US Macro Strategy, as of December 2017

#2: Deteriorating credit fundamentals

With our view that the markets will increasingly punish companies that don't meet their earnings guidance, any underperformance relative to market expectations is a growing cause for concern. In this way, deteriorating fundamentals could create turbulence in the credit markets. While we will be searching for signs of underlying fundamental weakness, it is also the case that strong earnings over the past several quarters mean companies will find it harder to continue beating increasingly difficult comps.

The market's reaction function will be crucial. Individual companies that disappoint will likely underperform. If the underperformance is spread widely enough across credit markets, equity markets may become increasingly concerned about companies' ability to grow earnings. This could lead to softness in equity prices, and a shift in the market's willingness to take risk, potentially widening credit spreads.

Companies are also increasingly susceptible to late cycle behavior. When comps become more difficult to achieve through continued fundamental improvements, companies look for increasingly aggressive ways to stimulate growth; mergers, acquisitions, aggressive changes to their business plan, increasing their use of leverage, and financial engineering. Many of these late cycle behaviors like aggressively financed M&A can ultimately be problematic for credit investors and investors should closely monitor this type of activity for signs of excess.

#3: Political uncertainty

Even though the current political environment may seem chaotic, financial markets have not flinched as asset prices regularly set record highs. However, the status quo could easily be up-ended by a political event. In our view, the primary risk is that the current pro-growth policy agenda is derailed. The catalyst could come from anywhere, but prominent flashpoints include Russian investigation bombshells, internecine strife among Congressional Republicans, and the mid-term elections. With narrow margins in both the Senate and the House, a shift in the party balance would very likely spell the end to further legislative action. Regardless of one's partisan leanings, anything that substantively shakes the market's belief in pro-business policy could lead to increased volatility and decreased risk appetite.

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