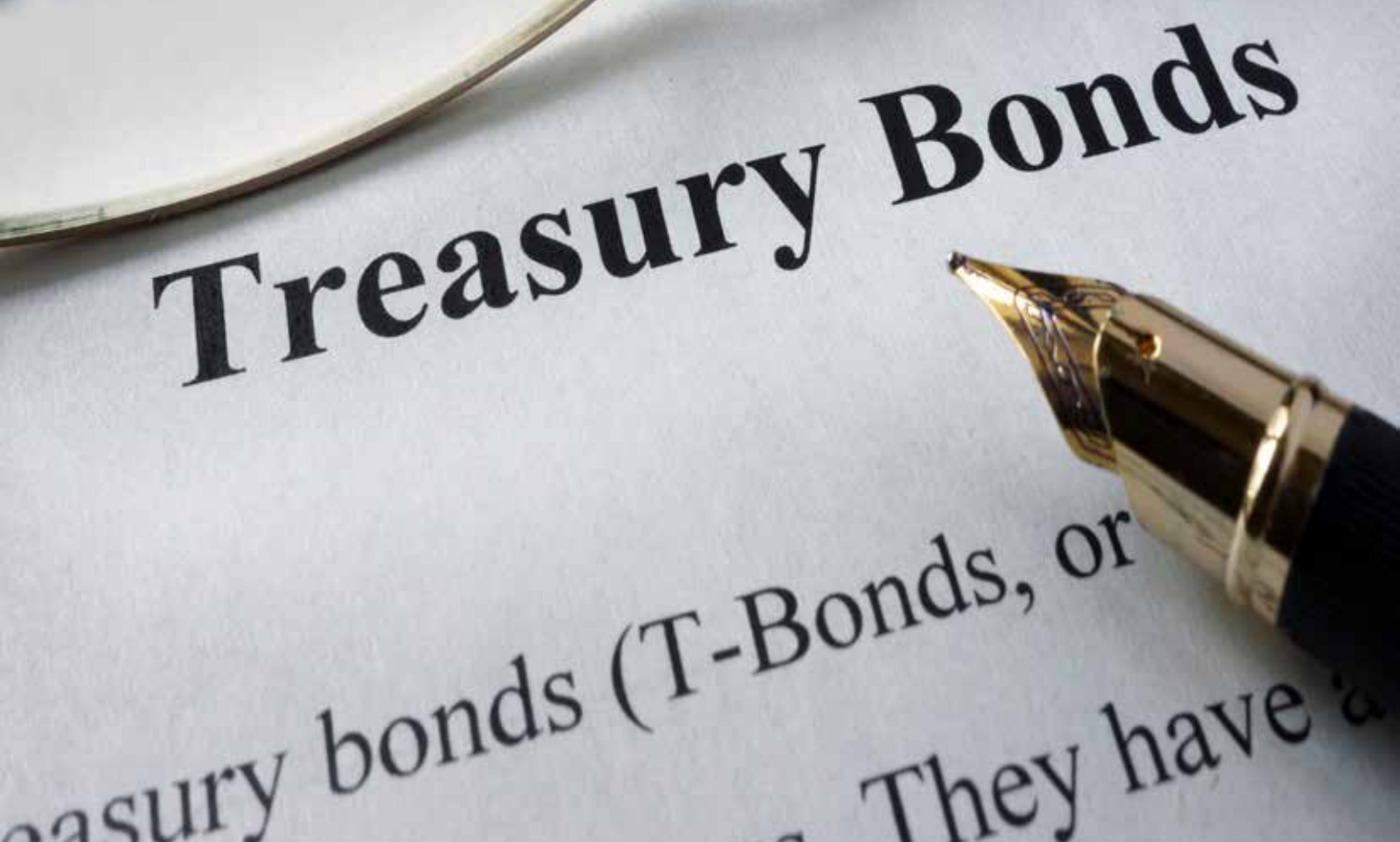




# CREDIT STRATEGY IN A RISING INTEREST ENVIRONMENT

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January 12, 2017



**Table of content**

Do not cut the cord as reality could be different ----- 3

Debt ceiling debate looms in March ----- 4

And the Fed should continue to favor prudent fiscal management ----- 4

Three rate hikes in 2017 not as hawkish as markets envisaged ----- 4

No major impact on corporate spreads ----- 5

Strong credit metrics and low refinancing risk----- 6

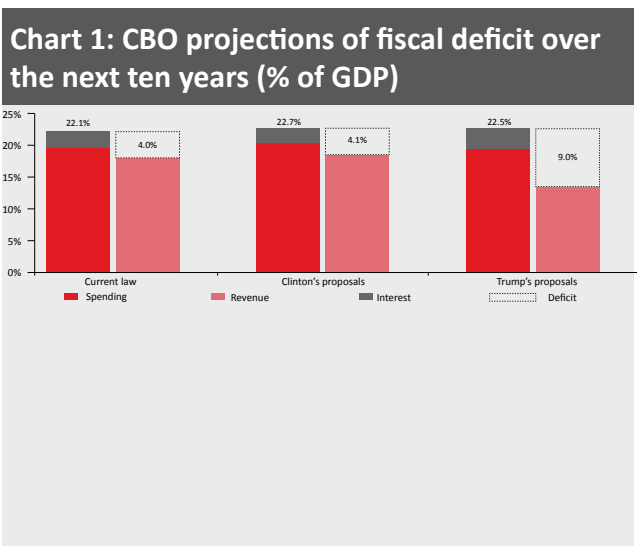
Shorter durations and higher-yielding bonds to gain increasing traction ----- 7

Conclusion ----- 7

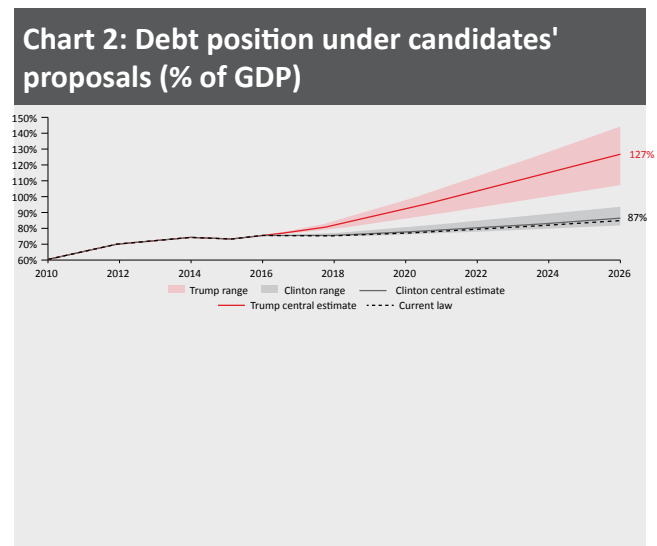
This whitepaper explores at the guiding theme for US credit markets in 2017 in the backdrop of the prevailing expectations of expansionary fiscal and tightening monetary policies. The policy combinations appear ambiguous, and the debate over macroeconomic policy dilemmas should hog the limelight this year. This whitepaper also examines the current state of the US economy and weighs the argument against any significant requirement of fiscal stimulus. We also dissect the credit cycle of the past, and how fixed asset managers can maximize their total return on their portfolios by shifting toward shorter duration and higher-yielding bonds in a rising interest rate scenario.

### Do not cut the cord as reality could be different

The theme about the ‘great rotation’ from bonds into stocks has resurfaced although the underlying cause this time around is different, with US President-elect Donald Trump’s fiscal policies taking the driver’s seat. However, the Republicans’ fiscal stimulus and resulting economic growth target appear unrealistic, especially given the fact that the economy is running at close to full-employment, coupled with growing fiscal deficit. The Republicans have set a sustainable growth target of 4%, which is an ambitious goal. This level of growth has never been achieved over the past four decades. The size of new expenditure and tax cuts are expected to add USD 5.3tn. in new debt over the next ten years, more than double the baseline projections of the Congressional Budget Office (CBO). As a result, the overall fiscal deficit is expected to reach 9% if the plans are executed, as compared to the base case of 4% over the next ten years, and 3.2% in FY16.



Source: Committee for a responsible federal budget, CBO projections



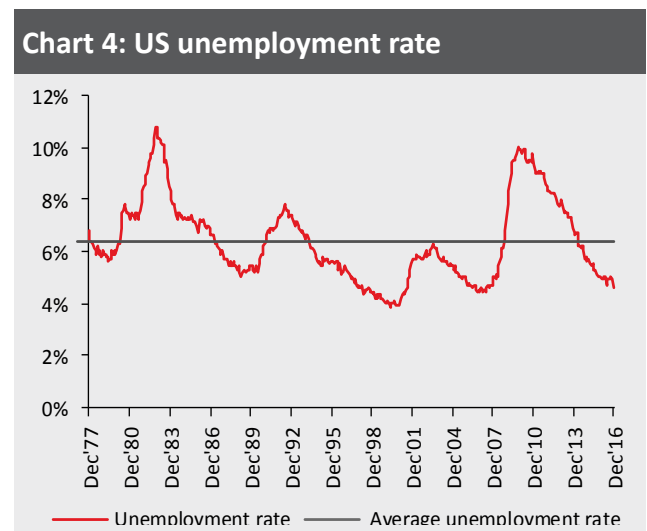
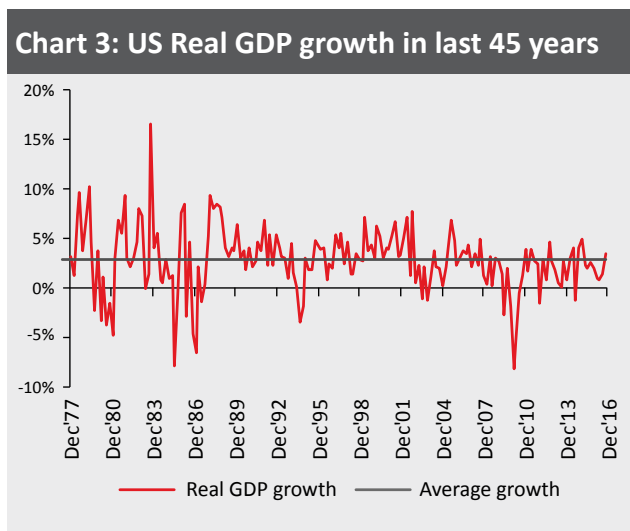
Source: Committee for a responsible federal budget

## Debt ceiling debate looms in March

The above charts indicate expectations of a sharp rise in debt levels, which should support the immediate sell-off in US treasuries. However, the majority of market participants now believe that the Republicans' mega stimulus plans are easier said than done. The scenario indicates that the debate over tax cuts and spending increase would be healthy and protracted, despite the Republicans holding a majority in both the Houses. There are many conservative Republicans, who were once vocal against increasing spending and raising the debt ceiling. For instance, Mick Mulvaney, a Congressman from South Carolina, had voted against raising the debt ceiling in 2013. He has now been appointed as the new budget director under Donald Trump's administration. Critically, the debate (which was suspended in 2015) on debt ceiling resumes in March 2017, which is likely to put pressure on the new government to step up fiscal responsibility measures and curtail the debt at sustainable levels.

## And the Fed should continue to favor prudent fiscal management

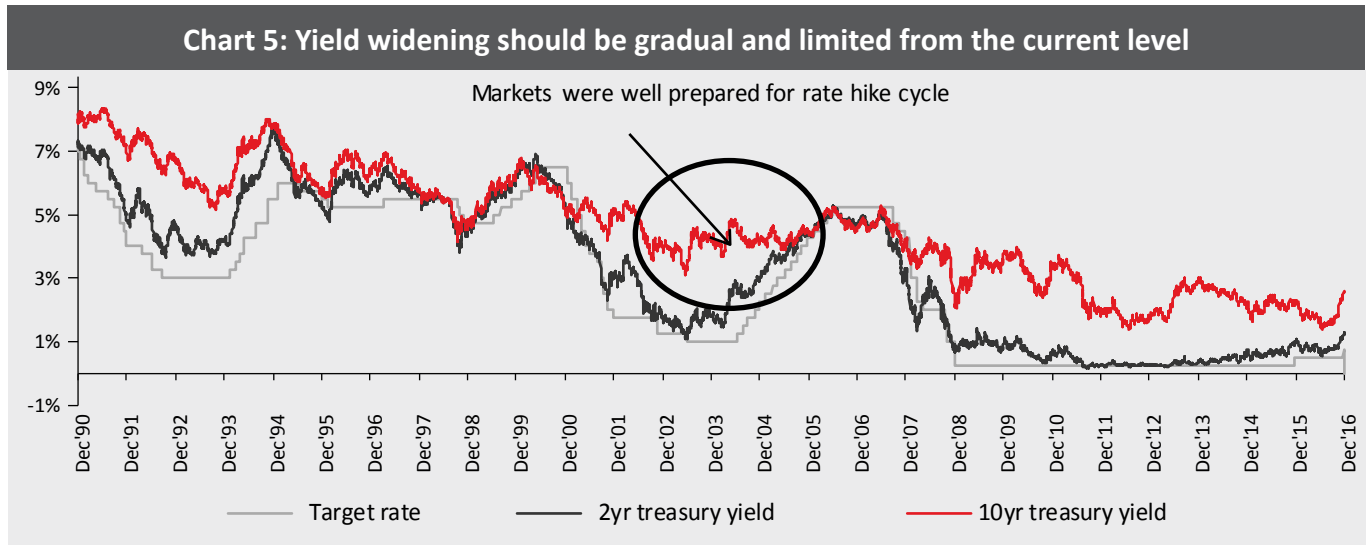
As US lawmakers were looking to fix the fiscal issues over the years, the Fed took the lead in steering the economy to a level where the output gap now appears limited. The economy is close to full-employment level and the real GDP growth of 3.5% in Q316 is above the 45-year historical average of 2.8%. Yet, the Fed in its latest projections, raised its 2017 growth outlook for the US to 2.1% (from 2%), while keeping its 2018 and 2019 growth forecasts unchanged at 2% and 1.8%, respectively. Until 2019, the unemployment rate is expected to stay at 4.5%, which is at the lower end of the natural rate of unemployment expected by the Fed. Given this backdrop, we do not see any significant need for fiscal stimulus, which may actually have an undesired effect of economic overheating. Instead, the new government must focus on fixing the growing fiscal deficit and debt.



## Three rate hikes in 2017 not as hawkish as markets envisaged

Most of the Fed members, including Janet Yellen, appear unsure about the Republicans' fiscal policy plans and have not considered new fiscal expansion measures into their economic forecasts. The central bank now expects to hike the Fed funds rate three times (~75bps) in 2017, as against expectations of two hikes foreseen in the September 2016 meeting. The prospect of three hikes is not as hawkish as markets had perceived, especially given the improving consumer confidence, higher oil prices and upside risks to growth stemming from fiscal plans. After the FOMC meeting, Treasuries sold-off, adding to the selling pressure already fueled by Trump's fiscal policies.

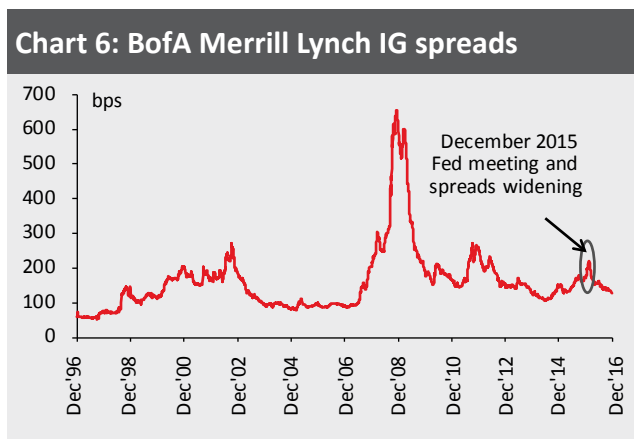
The unexpected hawkish tone from Fed officials seems to have largely priced in. As a result, it is possible that the 10yr treasury yield could widen to some extent from the current level of 2.4%. The data-dependent Fed should keep a close watch on macro indicators and global events, before making a rate hike decision. Accordingly, the lagged impact of fiscal expansion, if significant, would be visible only toward the latter part of 2017. Consequently, it does appear that the markets are prepared for monetary policy actions in 2017, as was the case in 2004, when markets had largely priced in the monetary tightening cycle. As part of the monetary policy, the market should not rule out unwinding the Fed's bloated balance sheet if inflation picks up strongly.



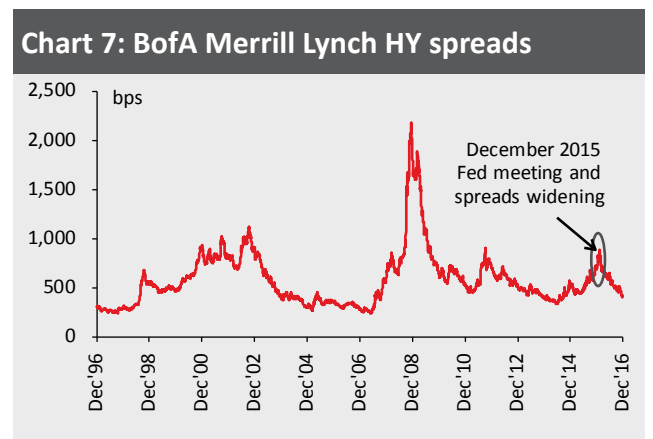
Source: Bloomberg

### No major impact on corporate spreads

Unlike December 2015, when spreads spiked after the Fed hinted at four rate hikes, this time around corporate spreads have remained surprisingly resilient. This implies that US corporate credit fundamentals are now on a strong footing and maturities over the next twelve months are manageable. Interestingly, spreads remained tight even during the previous credit tightening period of 2004-2006. This probably means that corporate credit demand should remain intact at a time when the growth outlook appears promising.



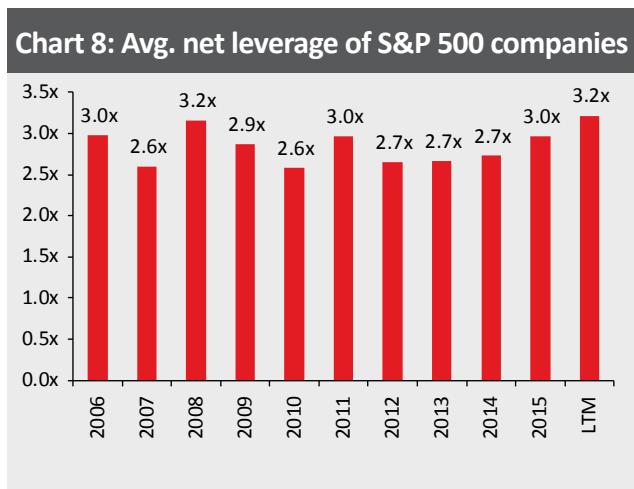
Source: fred.stlouisfed.org



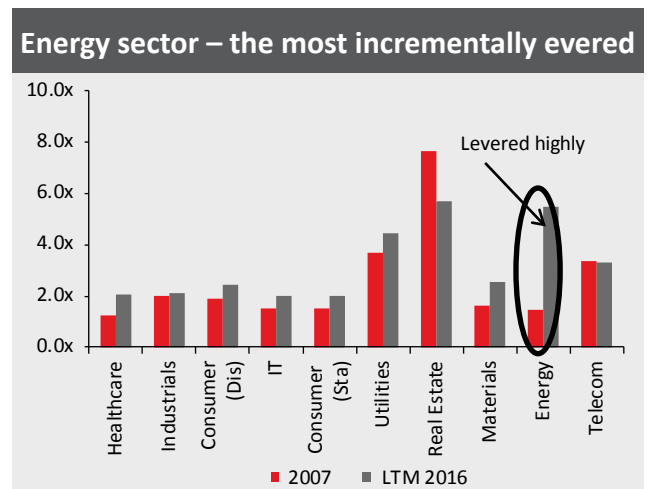
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### Strong credit metrics and low refinancing risk

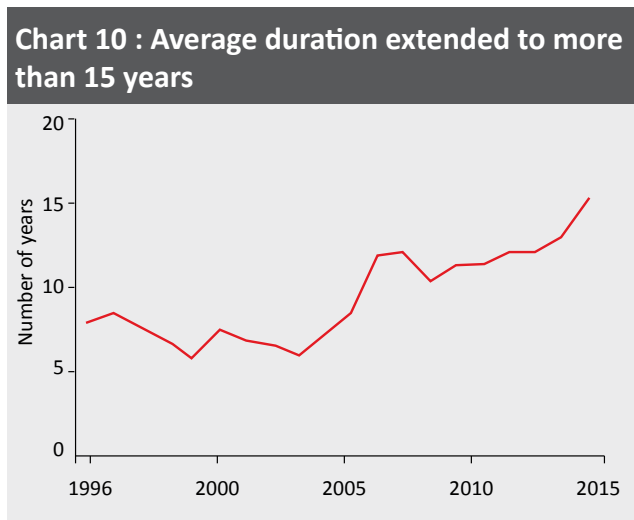
US credits should continue to entice investors as long as credit fundamentals are healthy and refinancing risks remain low. We have analyzed S&P 500 companies (excluding financials) and found that the average net leverage has not increased significantly, except for energy companies, during the low interest rate era. Supply risk also appears low, given the refinancing needs in 2017. We expect c. USD 700bn of new US IG supply from non-financials in 2017, compared to USD 1.2tn in 2016. Our expectations of new debt supply do not include M&A funding needs. Refinancing risk is low, with over 15 years of average extended maturity at the end of 2015, according to data released by the Securities Industry and Financial Markets Association.



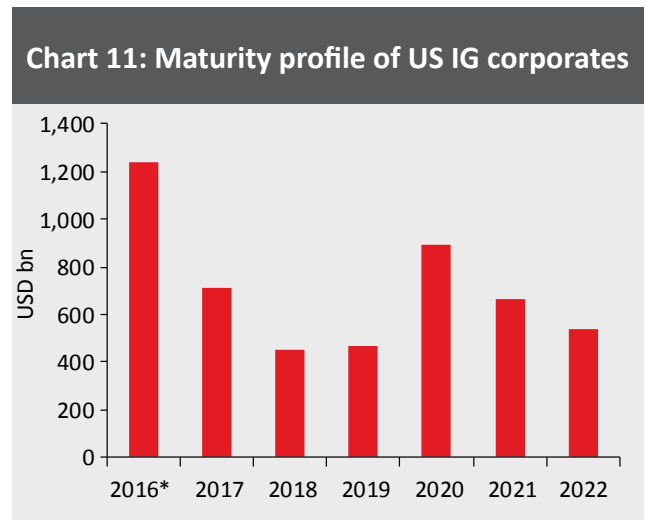
Source: Thomson Reuters



Source: Thompson Reuters



Source: Financial Times

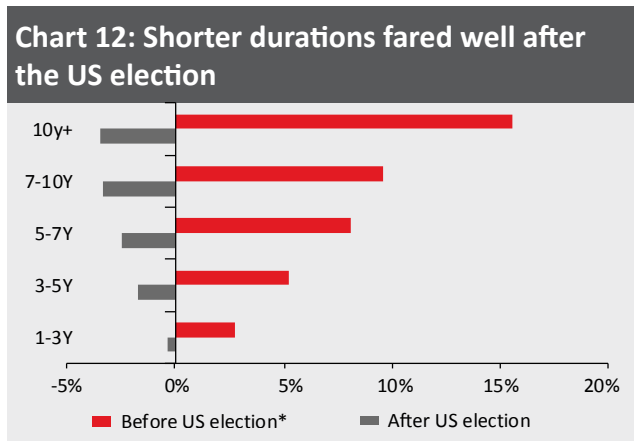


\* total IG issuance in 2016

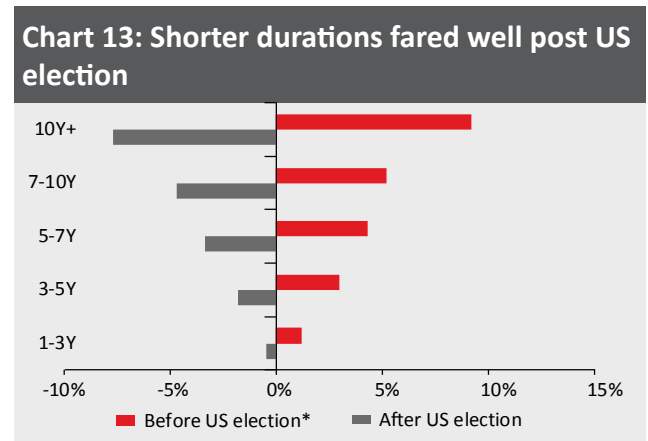
Source: Thomson Reuters,

### Shorter durations and higher-yielding bonds to gain increasing traction

However, as we inch toward a rising interest rate scenario, longer duration bonds are likely to suffer more. In such cases, shorter durations and higher yielding bonds have proved to be the most successful strategy. Shorter durations have outperformed, after the US election results and on expectations of monetary tightening cycle, with minimum losses in both Treasuries and USD-denominated corporate bonds. Shorter durations are likely to outperform in 2017, mirroring the case of the previous tight credit period (2004-2006).

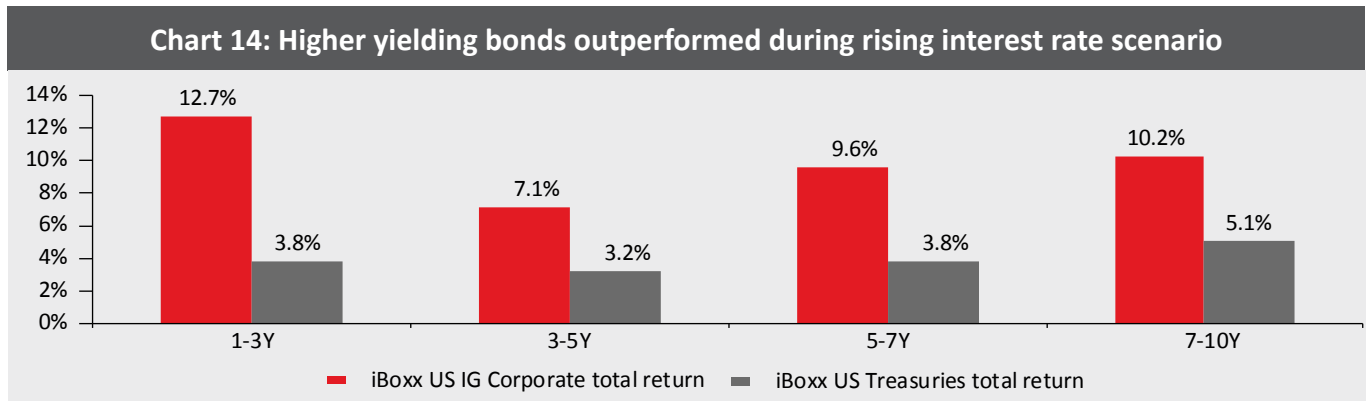


\* data from January 2016 to November 8  
Source: Reuters



\* data from January 2016 to November 8  
Source: Reuters

Another observation from the below chart is that higher-yielding bonds had performed better than lower yielding bonds. This could be mainly due to the yield cushion offered by corporate credit spreads, which helps offset price declines. Further, riskier assets ideally get support in a rising interest rate scenario, which typically accompanies periods of economic expansion.



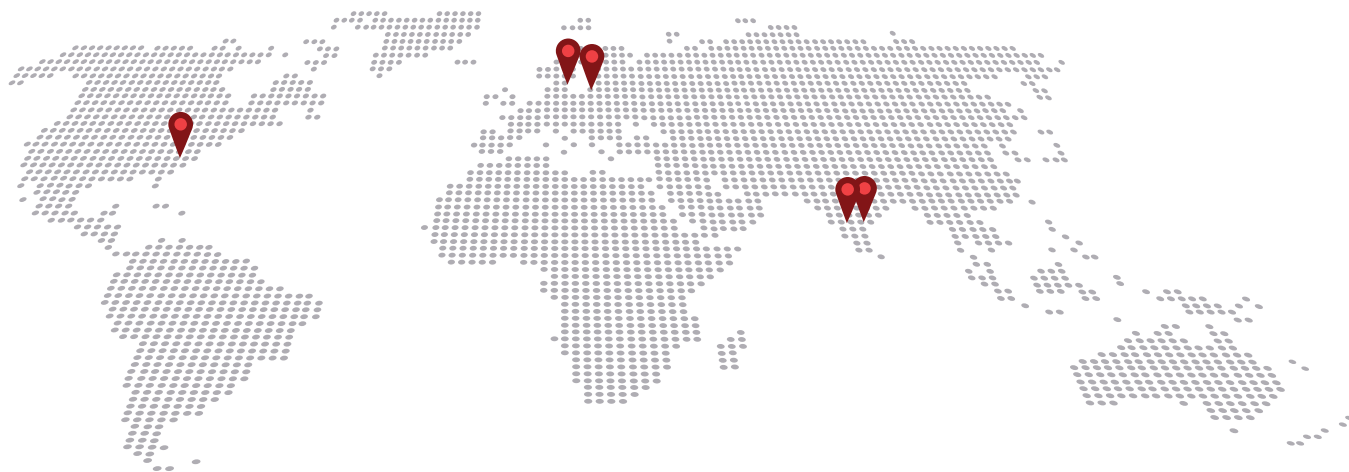
Source: Thomson Reuters

### Conclusion

Credit markets have evolved even stronger this time around, given the resilient credit spreads. This is despite expectations of faster-than-expected pace of monetary tightening by the Fed, amid aggressive fiscal stimulus plans outlined by the new US government. Unlike December 2015, the initial exodus from high-yield bond funds had fully recovered in a short span of time at the end of 2016. During the rising interest rate scenario, we saw that IG bonds with lower duration outperformed longer duration ones, thereby generating attractive returns. US corporate credits should witness strong demand and deliver at least high single digit return in 2017, if investors shift their strategy from longer duration to opportunistic buying, including higher yielding and shorter durations.

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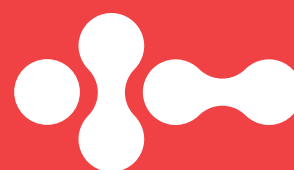
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