SHENKMAN

2018 Global Credit Insights: Central Banks, Currencies & Opportunities

January 2018

A Good Year for Credit in 2017

In 2017, global leveraged finance markets benefitted from economic growth while interest rates generally moved up. As has happened in the past, credit gains outweighed increases in interest rates and credit spreads tightened with economic expansion. Developed global high yield returned 7.84% on a US Dollar (USD) basis[i]. Shenkman Capital's global bond performance benefitted from industry and regional rotations during the year, as outlined on page 2.

Many central banks appear to be shifting their rate stances in anticipation of inflation. We believe the drivers of inflation are different than in the past, which may frustrate central bank efforts.

We expect an extension of the global expansion and general credit improvements. However, markets have become used to a decade of central bank-induced stability, allowing shocks to be shrugged off. If central banks are truly going to beat the drum of tighter money, the riskiest parts of the markets may show greater vulnerabilities to surprises.

Central Banks, Currencies & Opportunities

Volatility in most global markets remained low in 2017. The same cannot be said for currencies. The trade-weighted USD declined by 6.55% in 2017 and saw volatility move above its three year average[ii].

Currency moves impact returns and levels of supply and demand. In the developed high yield index (USD hedged) currency moves added about +40 bps of return in 2017[iii].

Tightening actions by the Fed in 2015-16 appeared to strengthen the USD. As policy became clearly telegraphed, the impact of more recent actions seemed to be ignored by the currency markets. However, traders seem ready to react to any shift in policy by other major central banks. In the leveraged finance market, this currency volatility and differences in economic cycles should continue to create opportunities for regional rotations.

A temporary pop in USD may occur from repatriation under the new tax code, but there are predictions of more weakness. Many central banks are in flux. The European Central Bank said it will begin its QE unwind, but its President, Mr. Draghi, has become the "King of the Caveat". In Norway and Sweden, economic growth appears to warrant higher rates. Bank of England Governor Carney hinted of more hikes. Australia has had no recent rate increases, but consumer activity and commodity prices may force rates higher. South Korea has just moved its short term rates higher. Even the Bank of Japan's Governor Kuroda has talked of reversal rates, a possible signal of plans to move away from stimulus policies. These moves should make for an intriguing 2018.

Economic Factors

Growth seems relatively intact in the G10, even if countries are in different cycles. This growth appears independent of recent central bank actions. Consumer demand has remained healthy in the US and is improving elsewhere. There are signs of increased corporate spending as well. US tax legislation will undoubtedly have many unintended consequences and adds complexity to an already difficult tax structure. However, the new tax law coupled with deregulation should lend support to the US economy and corporate earnings. This all may produce a paradigm shift where the Fed and central banks matter significantly less, or not at all, to markets.

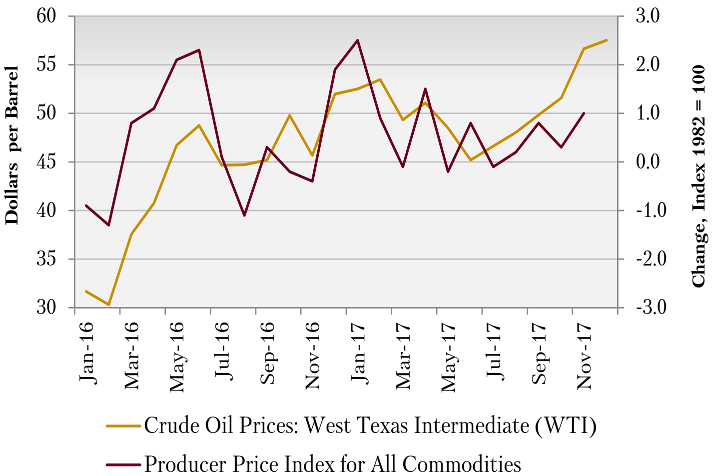
China's growth has been "relatively" absent from economic news in 2017. Neither published numbers nor political events have led to surprises. However, investors should take note of December comments from Governor Zhou of the People's Bank of China, showing concern about debt levels on individuals and corporations. This may be a harbinger of a credit-induced slow down.

Inflation Uncertainty

Central banks are still searching for evidence of inflation and cannot seem to find enough. This seems to be a major factor slowing down rate hikes. As we wrote in May 2017, given many changes in the economy, central banks may be missing dramatic changes to inflation drivers. We do not see any wage push inflation and believe corporate pricing power is limited. However, the return of commodity prices may produce some inflation – especially in Europe and the US.

Energy is so ubiquitous in the economy that prices tend to influence almost all measures of inflation – price changes just take time to transmit through the economy. Low oil prices have likely pushed inflation down over the last 2.5 years and now energy prices are likely to have the opposite effect. The price of oil and inflation are not always meaningfully correlated but Exhibit 1 shows that they follow similar trends and have had periods of high correlation in the US.

Exhibit 1: Oil and Inflation Correlations



Source: FRED, Federal Reserve Bank of St. Louis

Fourth Quarter and 2017 Performance

The full year and latest quarter results for global leveraged debt are in Exhibit 2. By rating tier, CCC performed better than BB and B. On the year, USD outperformed Euro markets, but in the fourth quarter the opposite was true. Sterling lagged in both periods. From an industry perspective, Oil & Gas was a top performer in all markets. The rest of the top and bottom industry performers varied greatly by region, creating opportunity for performance differentiation.

Exhibit 2: Global Leveraged Debt Performance

Total Return	Q4	FY17
Shenkman Capital Global High Yield Bond Composite (Gross)*	**0.79%**	**7.66%**
Global High Yield Bonds (HYDC)*	0.60%	7.84%
US High Yield Bonds (H0A0)	0.41%	7.48%
European High Yield Bonds (HP00)**	0.76%	6.92%
S&P LSTA U.S. Leveraged Loan Index	1.11%	4.12%
S&P European Leveraged Loan Index**	0.47%	3.64%

*USD Hedged **Returns in local currency
Source: ICE Data Indices, Bloomberg, S&P

Strategic Shifts in Our Global Strategy

Over the quarter, we increased our Euro exposure slightly but remained underweight compared to the broader market represented by the HYDC. This was achieved by increasing and overweighting single B Euros, which outperformed the HYDC benchmark. We also shortened our Euro duration. For much of the year, we had strategically been longer duration in Euros. We kept an underweight in GBP, given the Brexit volatility and high concentration of retailing credits. We increased cyclical segments of the market – Oil & Gas, Industrial and Packaging – while decreasing Healthcare and Telecom.

Within single Bs, potential spread tightening from a credit rating upgrade is now more significant in Euros than USD. With careful selection, we believe this can be a performance enhancement.

Exhibit 3: Spread to Worst Difference in US BB-B and Euro BB-B (bps)

2017	January	December
ICE BofAML European BB (HP10) | B (HP20) Index	197	246
ICE BofAML US BB (H0A1) | B (H0A2) Index	133	153

Source: ICE Data Indices, Bloomberg

Outlook and Conclusion

We expect a continued expansionary cycle in the G10 countries. At this stage, some corporations may pursue more aggressive growth, thus increasing risks in the markets. Shifting interest rate regimes will likely increase vulnerabilities and opportunities.

Investors want exposure to credit for its predictable income and to benefit from the economic expansion. We believe that over the next year, fears of rising interest rates hurting credit are overblown, as long as the economic expansion continues.

The US has been the most aggressive in tightening monetary policy for the last two years. During 2016-17, the 5 year & 10 year US Treasury yield increased 45 bps and 14 bps, respectively, and the global high yield index annualized return was still 11.76%[iv.]

While spreads are tighter to start 2018, we believe there are still significant opportunities for select spread tightening. The ability to rotate to different global leveraged finance markets should prove to be an advantage.

[i] ICE BoAML Developed Markets High Yield Constrained Index, USD hedged (HYDC)
[ii] Using the Federal Reserve trade weighted index for the USD
[iii] ICE BoAML Developed Markets High Yield Constrained Index, USD hedged (HYDC)
[iv] Shenkman Capital, Bloomberg

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