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2017: A Most Interesting Time

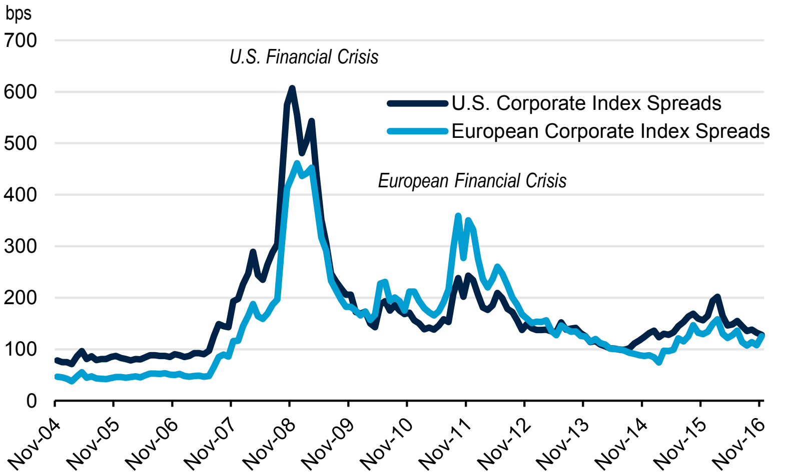
Adding Value in Global Investment Grade Corporate Portfolios

Looking ahead to 2017 I am reminded of an old expression, *"May you live in interesting times,"* and global corporate bond investors certainly weathered plenty of *interesting times* in 2016: divergent monetary policies, rising geopolitical risks, Brexit, Trumponomics, and Chinese policy reform, to name a few.

Boon or headwind?

As much as these factors have spurred market volatility, we would note that they have also provided attractive entry points, especially considering still favourable fundamentals and a host of stabilising technical tailwinds. The most notable game changers in 2016 were the negative interest rate policies of the European Central Bank and Bank of Japan, which sent investors in search of yield, and the ECB and Bank of England's corporate bond purchase programs, which removed about €46 billion and £4 billion of bonds, respectively, from the market through November 2016. Despite a year of record new issuance, investor demand combined with central bank purchases resulted in European corporate spreads tightening sharply—before political uncertainty sent spreads wider again in November.

Corporate Spreads Still Above Historical Tights



Source: Bloomberg Barclays as of 30.11.2016.

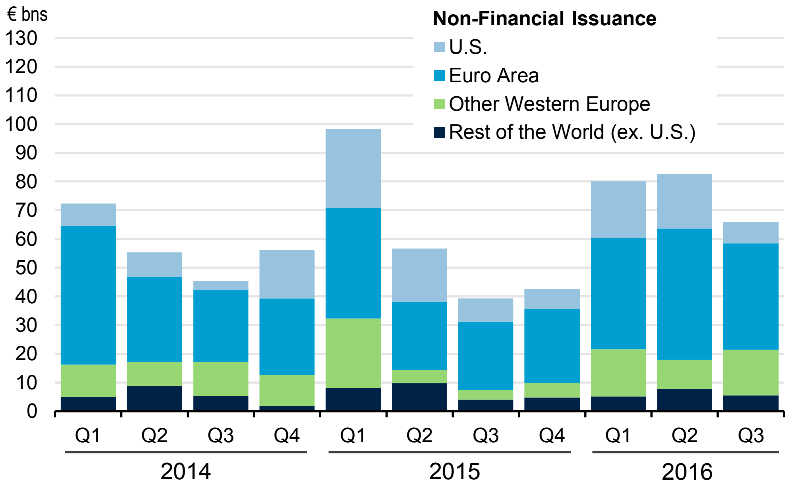
In the U.S., meanwhile, the Federal Reserve is signaling a series of short-term rate hikes and President-elect Trump is expected to initiate a potential inflation-fueling economic stimulus package. Considering these cross-currents, where can investors find value in global corporate portfolios?

Exploit cross-border inefficiencies

Depending on the backdrop, adding exposure to fundamentally-sound credits following a period of spread volatility can add value as the markets are typically inefficient at pricing, especially across regions and currencies. By leveraging cross-border relative value opportunities in the Euro, Sterling, and USD corporate bond markets investors can take advantage of price discrepancies for the same or similar credits caused by different economic and market conditions, technicals, and lack of name recognition. Add to that varying political and regulatory backdrops and eligibility for central bank purchase programs, and the opportunity set multiplies.

These opportunities became even more pronounced in 2016 given the volume of U.S.-based and non-Euro companies issuing in the lower-yielding European markets. As is illustrated in the following chart, more than €107 billion of reverse Yankee and non-Euro debt was issued last year in the European market through September alone. These credits are often priced at discounts to where they trade in U.S. dollars and offer a generous spread pick-up over similar-quality Euro debt. Over time, we would expect the market to price these issues more efficiently as technical unwinding can lead to attractive, long-term opportunities.

Non-Eurozone Issuers Represent a Large Portion of Euro Bond Market



Source: Dealogic as of 30.09.2016.

A recent example: Mylan, a U.S.-based, multinational pharmaceutical company, issued debt in the Euro market in mid-November at spreads 100 basis points wider (on a cross-currency adjusted basis) than a similar-maturity Mylan bond in the U.S. secondary market. In this case, the issuer appears to have been more rate sensitive than spread sensitive—the "all in" of the cheaper Euro bond outweighed spread valuation.

Managing a global corporate portfolio's risk exposures based on technical shifts, including politically-driven technical fallouts, can also add value. For example, reducing Sterling and Euro exposure pre-Brexit, then adding it back after the subsequent sell-off. Likewise, shifting risk to U.S. issuers when the ECB and BoE corporate bond purchase programs compressed Euro spreads to less attractive levels.

Expect the unexpected

We look for ultra-accommodative monetary policies to continue apace in Europe and Japan in early 2017, setting the stage for a still favourable technical. The themes of rising populism and heightened political risk will also resonate, leading to temporary risk-off appetites and liquidity limitations.

If market behavior surrounding Italy's referendum is a barometer, we would expect the upcoming elections in the Netherlands, Germany, and France, as well as the UK's plan to invoke Article 50 by the end of March, to stoke volatility.

But given still cautious corporate management in Europe and the UK, modest economic growth, and negative interest rate policies that drive the search for yield, we believe intensive research and relative value analysis can uncover value. Security selection is key, especially now that fundamentals are near or past their peak and leverage is inching higher due to lower EBITDA in Europe and M&A/share buyback activities in the U.S.

Overall, we hold a constructive view on global investment grade corporates, acknowledging that spreads are narrow but may have room to grind tighter across various regions, currencies, industries, and individual issuers. Shifting risk between U.S., Euro, and non-Euro issuers, discerning value in the same or similar credits across regions and currencies, and holding longer-term, fundamentally-based trades, such as overweighting U.S. money center banks relative to European banks and Northern European vs. periphery country debt, should continue to add alpha to global corporate portfolios in what should be another *interesting* year.

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