



Finding Opportunities in Investment-Grade Credit

With corporate fundamentals weakening, security selection is key.

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KEY INSIGHTS

- With corporate fundamentals generally weakening as global economic growth slows, the opportunity to generate gains through broad allocations to investment-grade corporate bonds has diminished.
- We think that short-maturity Asian investment-grade corporates denominated in U.S. dollars offer an attractive risk/reward trade-off and diversification away from the elevated leverage in BBB rated U.S. credits in particular.
- Our credit analysts are also finding pockets of opportunity in select U.S. investment-grade credits that appear to be mispriced across a range of sectors; the automotive and tobacco sectors, in particular, appear attractive.



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Strong security selection matters more than ever in investment-grade corporate bond portfolio management in the current late-cycle credit environment. With corporate fundamentals generally weakening as global economic growth slows, the opportunity to generate gains through broad allocations to the asset class has diminished. Relying on the insights of our team of global credit analysts, we are finding select opportunities that offer relative value and fundamental strength within investment grade, particularly in Asian credits as well as the automotive and tobacco sectors.

Late-Cycle Economic Conditions

The current U.S. expansion, which began following the end of the global financial

crisis 10 years ago, is already lengthy by historical standards, and U.S. economic data softened noticeably late in 2018. European growth appears to have stagnated at a very low level, and the Chinese government may not be willing to add enough stimulus to allow China to lift the global economy. The Federal Reserve has noted these late-cycle conditions and shifted toward a much more dovish stance since the end of 2018, likely putting rate hikes on hold for the remainder of this year. Corporate fundamentals have broadly weakened from their midcycle strength as revenue and earnings growth slows. For example, corporate leverage, as measured by debt-to-EBITDA,¹ is lofty.

Against this backdrop, we generally favor exposure to shorter maturities in investment-grade corporate bonds.

¹ Earnings before interest, taxes, depreciation, and amortization.

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This relatively defensive posture would allow portfolios to better withstand a widening of credit spreads² in the asset class, which we expect as investors increasingly price in deteriorating corporate fundamentals.

Asian Credits Offer Attractive Risk/Reward Characteristics

Select non-U.S. credits also provide defensive characteristics relative to the broad U.S. investment-grade corporate debt asset class. For example, we think that short-maturity Asian investment-grade corporates denominated in U.S. dollars offer an attractive risk/reward trade-off. Our exposure to the segment adds diversification away from the elevated leverage in BBB rated U.S. credits in particular. Asian investment-grade bonds also have historically demonstrated more attractive Sharpe ratios³ than U.S. investment-grade corporate debt and currently provide more spread relative to their volatility.

Asian technology is a particularly attractive sector. For example, we favor A rated Asian tech companies over BBB rated U.S. telecommunications issuers, a more volatile segment characterized by high leverage and challenged growth. The A rated Asian tech credits have little to no net debt and strong growth profiles, yet they offer wider spreads than BBB rated U.S. telecom companies.

Pockets Of Opportunity In Automotive And Tobacco Sectors

Among U.S. issuers, our credit analysts are finding pockets of opportunity in select investment-grade credits that appear to be mispriced. The automotive and tobacco sectors, in particular, appear attractive, but we have also identified idiosyncratic relative value opportunities across a range of sectors.

Slowing global auto sales, lingering trade war concerns, and a slow industrywide transition toward electric vehicles have created attractive valuations for some of the higher-quality credits in the automotive sector. While we anticipate that negative news headlines will continue to impact the sector, we believe that some automotive credits (particularly some high-quality European issuers) have strong, well-managed balance sheets that should allow them to withstand volatility from negative headlines. However, our positions in the sector are mostly short-maturity to moderate our exposure to negative credit news.

Select Tobacco Credits Offer Strong Cash Flow, Robust Balance Sheets

The tobacco sector has suffered from weak investor sentiment, but we believe that the problems that have been weighing on sentiment apply more to equities than debt. Recent large mergers and acquisitions in the sector worried investors, and an overhang of regulatory uncertainty and declining consumption has further dampened enthusiasm for tobacco companies. However, we think that some tobacco companies present opportunities because of their strong free cash flow and balance sheets that are robust enough to withstand negative news and maintain their investment-grade credit ratings. In fact, we are comfortable with exposure to longer maturities in these select tobacco credits.

In the automotive and tobacco sectors as well as Asian issuers, we rely on the insights of our credit analysts to find credits with dislocated prices that do not reflect their fundamentals. This analysis is essential for success in a late-cycle environment where the entire asset class is not benefiting from the broad improvement in fundamental credit quality that characterizes the early stages of the economic cycle.

² Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

³ The Sharpe ratio is a measure of return relative to risk, calculated as an asset's return above the risk-free rate, divided by the standard deviation of the asset's excess return. Sharpe ratios for Asian investment-grade corporate bonds as measured by the Bloomberg Barclays Emerging Market Asia USD Investment Grade Corporate 1–5 Year Index and for U.S. investment-grade corporate bonds as measured by the Bloomberg Barclays U.S. Corporate Investment Grade Index.

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