Three Credit Investment Ideas to Consider if Reflation Occurs

Loans, unloved corporates, and hard currency EM debt look tempting.

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KEY INSIGHTS

- Stabilizing economic data are likely to lead to some compelling opportunities within the fixed income sector.
- The floating rate bank loan market stands out as the potentially most interesting credit allocation.
- Opportunities are also likely to arise in specific corporate bond sectors, while hard currency emerging market (EM) bonds appear to be positioned to perform.

Recent economic data have been encouraging in the U.S., Asia, and, to some extent, Europe, which could be a sign that economic conditions have begun to stabilize. However, it is still too early to determine whether this represents merely a pause in the slowdown or the beginning of a late-cycle rebound. In our latest policy week meetings, the investment team discussed the potential impact of the improving data on fixed income markets, focusing in particular, on which parts of the credit market could benefit the most if the "reflation trade" story continues to gain traction. Below, Saurabh Sud, portfolio manager and member of the global fixed income investment team, highlights three credit investments to consider in a reflation scenario.

1. The floating rate bank loan market is attractive again.

The loan market has underperformed high yield over the past nine months as the market has priced in more rate cuts by the Fed, leading to significant outflows. Negative headlines have also hindered the asset class—particularly as the pace of rating downgrades has increased lately—and its impact on bank loan demand by collateralized loan obligations (CLOs). A more favorable economic environment would offer some respite for loans, which currently offer attractive valuations compared with conventional high yield. Demand could pick up at a time when the Fed is expected to remain on hold and there is strong interest in cash-related products. Overall, this looks like it may be a good entry point to allocate back to floating rate loans.

But not all parts of the loan markets are attractive: B issues launched in 2017–2019, for example, are expected to have a high risk of default and could see widening spreads even if the rest of the loan market performs well. Security selection remains key in this very technical asset class. In particular,

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Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme that was discussed.

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research team members highlighted discount loans with strong asset coverage and high visibility on the company's ability to pay down or refinance the loans in the next two to three years.

2. Unloved parts of the corporate bond market are worth a look.

Within investment-grade corporate bonds, the energy sector has suffered from low oil prices for a while now and would benefit from a reflation environment. If growth picks up in the U.S., energy names, either pipeline, or extraction-related, may offer value. The most interesting names are probably to be found in higher-rated high yield issuers, but distressed debt should continue to be avoided as the team still expects defaults to hit the sector as capital continues to recede from unsustainable business models and capital structures. Now may also be a good time to focus on the automobile sector, which has lagged the rest of the credit universe over the past two years amid low demand, a correction in valuations, and concerns over vehicles' environmental impact. It may be time to consider reallocation, particularly to short-dated bonds, where the valuation correction seems to have been overdone. Apart from certain companies such as Ford, the market is no longer expected to suffer downgrades, and a resurgence of consumer demand would boost the economic profile of these companies.

3. Emerging market hard currency bonds offer value.

Stabilizing growth and lower geopolitical risk may also prove to be positive for hard currency bond-issuing companies domiciled in emerging market countries, particularly Asian credit securities. A stronger outlook for global demand, improving U.S.-China trade relations, and a weakening U.S. dollar will make it easier for these companies to borrow in U.S. dollar terms and improve their ability to repay. In addition, investors allocating to EM companies now have the opportunity to capture income from companies that are for the most part investment grade-related, offering some protection should the reflation story not play out as expected.

The same can be said for hard currency sovereign bonds, where demand has started to increase. However, the higher duration profile of hard currency bonds could make them more vulnerable to a rise in interest rates, so our preference would be for shorter-dated bonds.

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