Credit Outlook 2018

Are market expectations too good to be true?

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ALL APPEARS CALM ON THE SURFACE...

Consensus expectations for modest returns from credit markets in 2018 may well prove to be accurate. However, are investors underestimating the long-term risks posed by structural problems as central banks reverse their ultra-loose monetary policy?

Credit markets appear to be very well set up for 2018. Economic growth is robust, which is boosting corporate profitability, but not boiling over into accelerating inflation. The recently approved US tax reform is providing another tailwind for profits, while also reducing levels of bond issuance as a number of large US firms repatriate cash for buybacks and dividends, rather than asking corporate bond investors for money. While government bond yields could rise a little, this should be offset by credit spread tightening, which could lead to another year of positive total returns from credit markets.

...BUT ARE INVESTORS UNDERESTIMATING THE RISKS?

There are two potential problems with this outlook. The first is that it is very hard to find anyone with a different view. This is reflected in valuations, with spreads and yields both at very low levels (Figures 1 and 2 overleaf). With stretched valuations and crowded investor positioning, this scenario of modest positive returns is probably the best investors can hope for. Any deterioration of market conditions, however, could result in a destabilising stampede to the exit.

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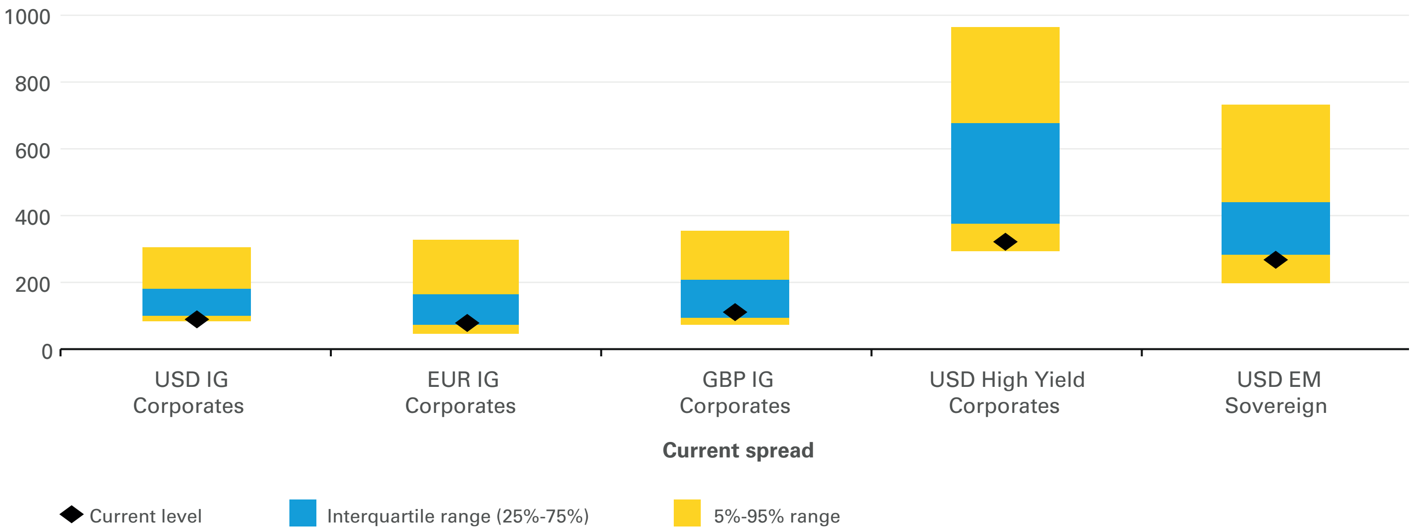
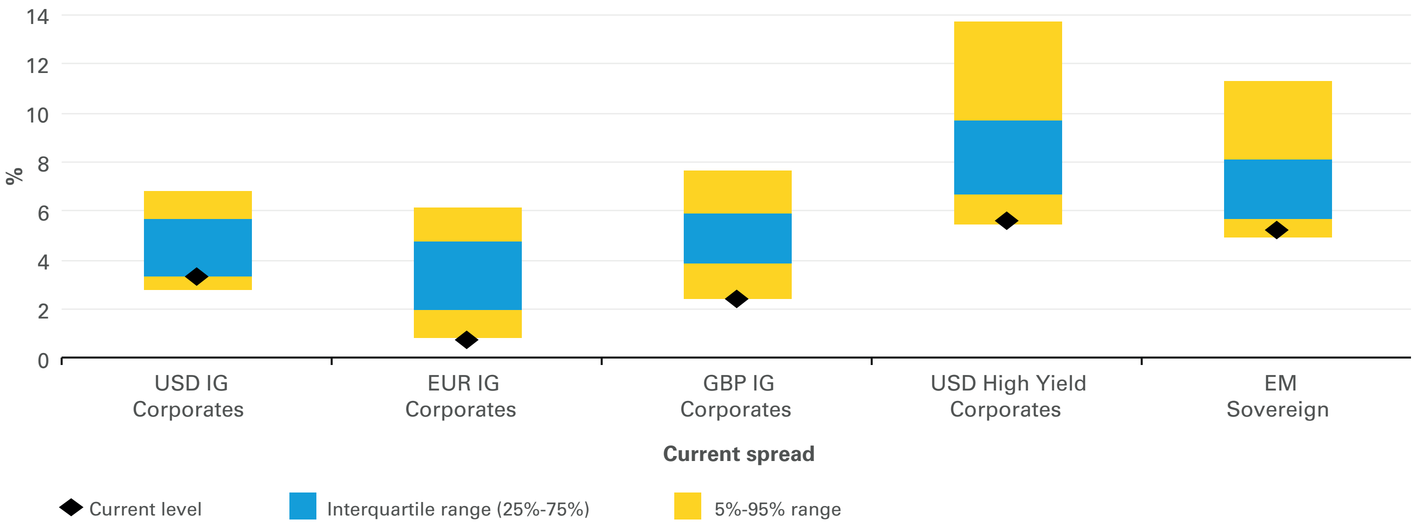
Figure 1: Comparing current credit spreads (bps) versus history



IG = Investment Grade EM = Emerging Market

Source: Barclays, JP Morgan, Bloomberg L.P., historical ranges from January 2001, current level as at 12 January 2018

Figure 2: Comparing current yields (%) versus history



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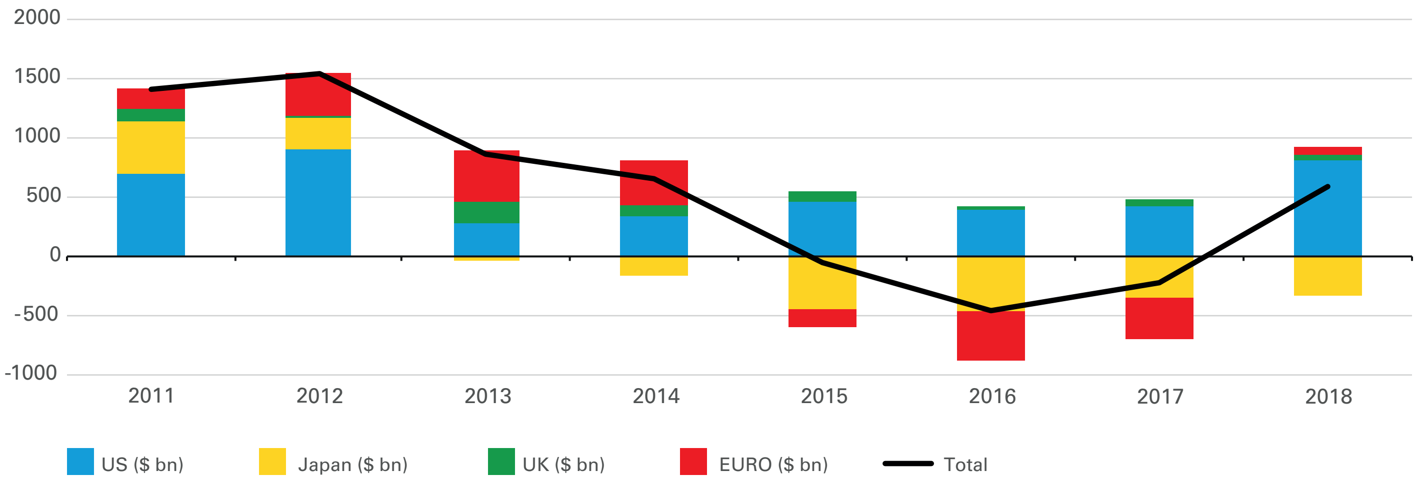
But why would market conditions suddenly weaken? We think the removal of quantitative easing is crucial in this regard, and represents our second problem with the consensus positive outlook. As discussed in our recent **CIO Outlook**[1], 2018 is set to see a dramatic increase in the volume of government bond issuance that needs to be absorbed by investors (Figure 3). This is in contrast to recent years when central banks have absorbed all the net government bond issuance, which in turn has kept yields suppressed and displaced existing investors into alternative markets such as credit. However, this 'trickle down' demand is now reversing.

In addition, extraordinary monetary policy has been unable to solve the global structural problems of deteriorating demographics and weakening productivity, something about which we have written on a number of occasions as part our **Long-term Thinking**[2].

1 http://www.lgim.com/uk/en/insights/our-thinking/market-insights/cio-investment-outlook1.html
2 http://www.lgim.com/uk/en/insights/our-thinking/long-term-thinking/

Figure 3: Net of redemptions and quantitative easing, government bond issuance is set to soar in 2018



Source: Morgan Stanley, LGIM estimates

TWO SCENARIOS FOR 2018

Against this backdrop, we see two main possible return scenarios for credit markets in 2018, as shown in Figure 4. The first is the consensus expectation for moderately higher government bond yields being offset by spread tightening and broadly resulting in low, positive returns for credit.

In our second scenario, we would also expect government bond yields and inflation pressure to rise at the start of the year. Central banks would continue to remove liquidity and companies would remain focused on shareholder returns and leveraging their balance sheets. But as ultra-easy liquidity is drained and bond investors become concerned that rising yields are wiping out their returns, we expect demand to reduce and spreads to head higher. Emerging markets would be particularly vulnerable if this monetary tightening is associated with a rising dollar, and some stressed high yield sectors could be facing higher defaults as funding conditions tighten.

While we agree that the first scenario is very possible, the removal of quantitative easing in the context of significant global structural problems suggests to us that the probability of our second scenario is underestimated. Indeed, it may even be more likely.

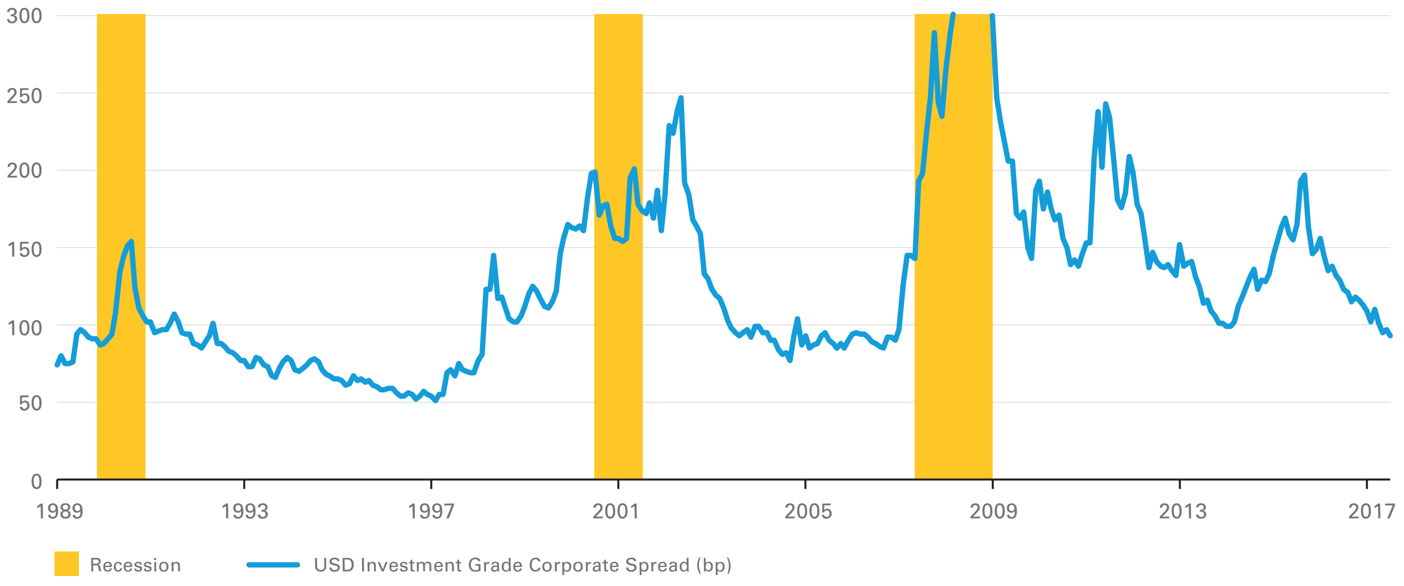
Figure 4: Fixed income return forecasts for 2018 under different scenarios*

Total returns	Scenario 1	Scenario 2
Global investment grade credit	0.9%	-0.5%
US dollar investment grade credit	1.4%	-0.2%
Euro investment grade credit	-0.1%	-1.7%
Sterling investment grade credit	-0.1%	-0.9%
US high yield	4.8%	-1.5%
Emerging market sovereign debt (EMBI)	4.7%	-1.0%

Excess returns	Scenario 1	Scenario 2
Global investment grade credit	1.2%	-2.2%
US dollar investment grade credit	1.2%	-2.6%
Euro investment grade credit	1.2%	-1.4%
Sterling investment grade credit	1.1%	-2.3%
US high yield	3.7%	-3.6%
Emerging market sovereign debt (EMBI)	4.3%	-3.4%

Source: LGIM. *Returns figures are forecast only and are not guaranteed

Figure 5: Credit spreads tend to rise before recessions



Source: Barclays, Bloomberg L.P.

This scenario does not involve the global economy slipping into recession in 2018, something we consider to be unlikely given the current economic momentum. However, a recession is not a necessary condition for credit spread widening. In reality, the relationship is more the reverse of this, with Figure 5 showing that credit spread widening often precedes economic problems.

If this pattern repeats, tightening credit conditions could start to weigh on growth towards the end of the year. But central banks may be constrained in their policy response by full employment or inflation pressure as a result of the long historic period of easier monetary policy. Investors could then worry about recession prospects, with longer-dated government bond yields falling as a result. This 'upper bound' to bond yields and economic growth thanks to the global debt overhang is what we call 'secular strangulation'.

There are also more specific downside risks for 2018 such as ballooning Chinese debt, geopolitical tensions and rising anti-globalisation policies. Many are symptoms of global structural problems, which are heightened by the withdrawal of the comfort blanket of ultra-easy policy support. Given today's low starting point for yields and spreads, it is hard to argue that upside return scenarios could have anything like the same magnitude.

BOTTOM LINE – MANY CREDIT INVESTORS ARE UNDERESTIMATING STRUCTURAL RISKS

We believe that many credit investors are underestimating the combination of stretched valuations, the withdrawal of easy monetary policy and the weight of global structural problems. For us, the benign consensus outlook for 2018 smacks of complacency, arguing for cautious credit portfolio positioning.

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