High Grade Corporate Credit Research Commentary
August 9, 2017

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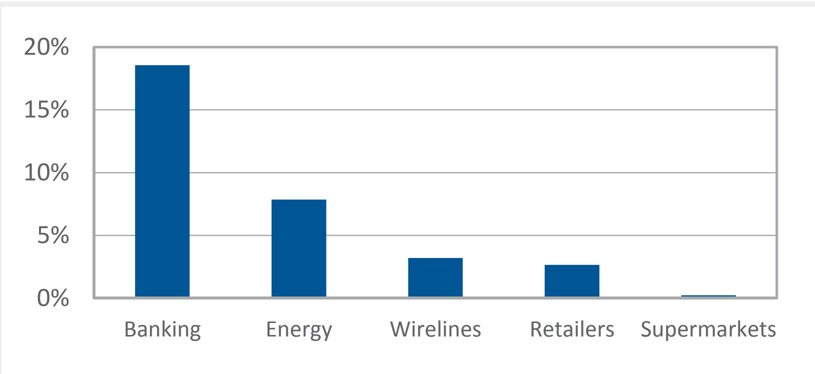
The corporate credit market has been resilient in 2017. While pro-growth policies were expected to boost the market, another quarter is behind us with no progress on healthcare, infrastructure and tax reform. The market has largely shrugged off reform expectations in the near term and the focus has been on underlying fundamentals.

Financials naturally takes center stage as the sector represents the largest constituent in the investment grade index, as seen in the chart below. During the quarter, financials faced a few headwinds including a lack of volatility in the market, which contributed to weakness in 2Q17 trading revenues across banks' and brokers' fixed income divisions. However, other business segments continued to exhibit strength which helped offset the weakness. Concerns about asset quality picked up recently largely related to credit card portfolios, but in the most recent quarter we saw an improvement in metrics.

There were also important political developments since our last update; the House passed the Financial Choice Act 2.0 and the US Treasury submitted their proposal for financial reform[1]. We are concerned that lighter regulation would generally be negative for credit quality given the increased potential for capital return. However, we do not anticipate any action on this front in 2017 given healthcare and tax reform priorities in addition to a lack of support for legislative change and lack of key leadership appointees at certain agencies needed to direct change. On a positive note, regulatory reform may increase lending capacity for banks which may stimulate growth. A testament to the strength of bank reforms post the financial crisis, all 34 US banks passed the annual Fed stress test and largely received approval of their capital return plans for 2017. We think this may be an inflection point in the credit strength of the banking sector and the prioritization of returning capital to shareholders alongside lighter regulation could signal a peak in capital generation. We continue to watch closely.

SELECT SECTORS, AS % OF INVESTMENT GRADE INDEX



Note: The above sectors do not represent the entirety of the Investment Grade Index.
Source: Bloomberg, as of June 20, 2017.

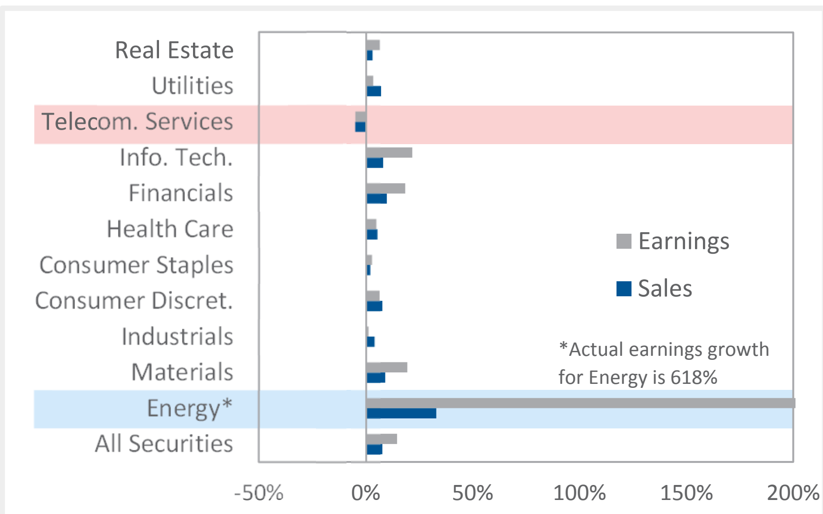
Shifting Landscape in Retail

As seen in the chart above, the retail sector represents a much smaller percentage of the Investment Grade Credit Index and continues to face mounting pressure given secular shifts. While our earlier concerns centered on the apparel and department store sub-sector, a major e-commerce disruptor shifted the focus to the grocer space after the company announced that it would be acquiring a natural and organic food supermarket, sending shockwaves across the industry[2]. The increased competitive environment with European discounters in the market and food price deflation has put pressure on the sub-sector. In a sign of the ongoing stress in the sector, one of the highest rated department stores is currently exploring taking itself private in a management led buy-out of the company[3]. The action could be indicative of a management team combating a difficult environment not visible to the public market. We have a negative conviction on retail as we expect these issues to persist with rating downgrades, defaults, store closures and bankruptcies continuing overtime.

Risks and Opportunities to Consider in Energy and Telecom Sectors

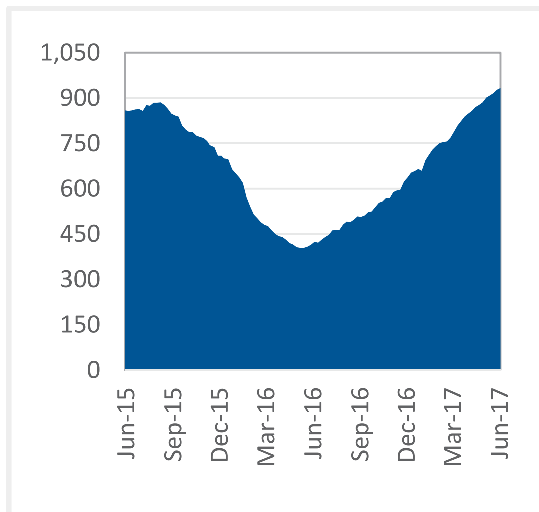
The energy sector, meanwhile, has seen the largest improvement in quarterly earnings[4] (see chart below), driven by the year over year recovery in energy prices off the lows. But energy prices have declined in 2017 amid increased production from Libya, Nigeria and non-OPEC players and rising stockpiles. The investment grade energy sector has been resilient with energy prices in the $40s as it has already gone through this playbook during the last downturn and is better positioned now. Break-evens for many oil producers have declined, allowing them to be profitable at lower prices. Many energy companies took actions to right size their balance sheets i.e.: asset sales, debt reduction, equity issuance, and dividend cuts. And rating agency action is largely contained given the aggressive actions taken during the last downturn.

2Q17 YOY SALES AND EARNINGS GROWTH



Source: Bloomberg as of June 30, 2017.

UNITED STATES OIL RIG COUNT, 2015-2017



Source: Baker Hughes as of June 16, 2017.

Telecom remains in focus as it includes two of the largest non-financial issuers in the investment grade market. While we are concerned about fundamental weakness driven by the competitive landscape, a few announcements during the quarter have been positive catalysts. One of the largest telecom operators came to the market to fund M&A[5]. This was the third largest corporate bond issuance to date and was well absorbed by the market after the company spread out its funding across international currencies which supported US dollar debt. There have also been bond tender announcements to help clean up high cost debt. In addition, a partnership announcement between two large cable operators reduced the risk of M&A in the near term. There are still potential M&A scenarios that could play out in the industry and we continue to watch closely.

Outlook

We continue to have a favorable view on the broader corporate credit market as corporate earnings continue to grow, M&A activity continues to decline with macro uncertainties, debt issuance expected to slow in the second half of 2017, potential for corporate tax reform remains and demand continues to be strong for corporate bond new issuance. Though less accommodative global central bank policies could impact the dynamic in the future, global investors remain one of the largest holders of corporate bonds, and continue to find the asset class attractive.

Sources
1. Huffington Post, *Financial Choice Act 2.0 Has Made Progress,* 6/27/2017
2. The New York Times, *Amazon to Buy Whole Foods for $13.4 Billion,* 6/16/2017
3. U.S. News & World Report, *Nordstrom Family Considering Buyout of Department Store,* 6/08/2017
4. Forbes, *Energy Sectors Are Coming Up With Oil Giants Reporting Later In The Month,* 7/10/2017
5. Reuters, *U.S. telecoms industry set for M&A negotiations frenzy,* 4/17/2017

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