Chilton Investment Services

Special Report

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Please feel free to reach out to us. We look forward to your phone call.

Timothy W.A. Horan

CIO-Fixed Income

646-443-7748

thoran@chiltontrust.com

Gregg Manjerovic, CFA

Taxable Portfolio Manager

646-443-7768

gmanjerovic@chiltontrust.com

Stephen Stowe, CFA

Head of Credit Research

646-443-7866

sstowe@chiltontrust.com

Eamon Marley

Credit Research Analyst

646-443-7745

emarley@chiltontrust.com

Xiaolei Guo

Credit Research Analyst

646-443-7776

xguo@chiltontrust.com

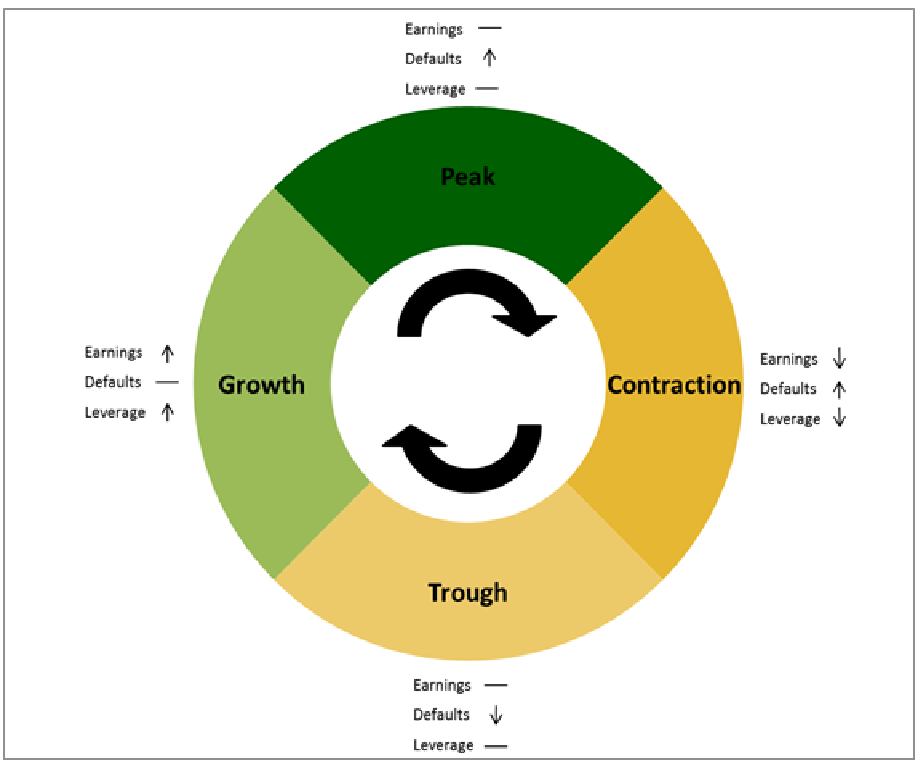
Where are We in the Credit Cycle?

"In nothing are appearances of greater moment than in whatever regards credit. Opinion is the soul of it and this is affected by appearances as well as realities"

- Alexander Hamilton, Report on Public Credit, 1790

As one of this country's foremost founding fathers knew so well, investor sentiment is critical in establishing a healthy credit market. The ebb and flow of this sentiment is determined by many factors including fundamental corporate credit quality, pricing of credit relative to alternative asset classes and investor risk tolerance. A way to conceptualize the market is utilizing a cyclic model in which the credit market repeatedly contracts and rebuilds (Chart 1). We believe US credit quality is currently at the "peak" phase of the cycle and that the current 4% high yield default rate is set to rise through 2016, exceeding the historical average of 4.3% from 1983-2015. We see potential catalysts for an extended period of above-average defaults through 2017 with comparison to the default cycle of the early 2000's perhaps most appropriate. However, the key unknown is the amount of time it will take for US credit markets to move into the "contraction" phase, a process which could be delayed due to strong global demand for the higher relative yields offered by US credit. Further ahead, we believe the "trough" and renewal of credit growth will be less influenced than in past cycles by Federal Reserve policy due to the expectation of a more limited range of movement in Fed rate-setting than in past cycles.

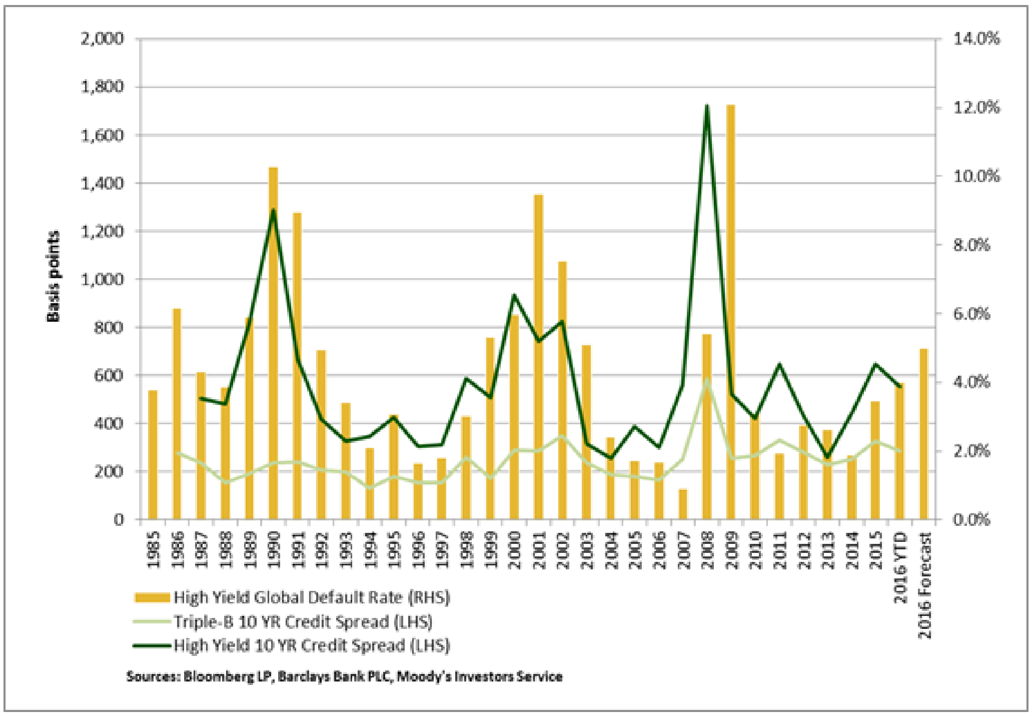
Chart 1: Credit Cycle Phases



Historical Credit Cycles

By way of historical comparison, 3 recent credit cycles are instructive - the early 1990's, early 2000's and 2008-2009. While the specific circumstances of each cycle are unique, we believe a focus on investor sentiment is illustrative in understanding the timing of each cycle. The chart below illustrates the evolution of annual high yield default patterns and high yield and investment grade credit spread levels through each cycle.

Chart 2: Recent Credit Cycles



1986-1991 – Extended period of default build-up; timely recovery - Following a multi-year bond bull market and the birth of the modern high yield market, the Federal Reserve began tightening from 1986 through mid-1989 due to inflation concerns. This triggered a relatively long period of above-average defaults, starting in 1986 and running through 1991. Contributing to the duration and magnitude of this default cycle was the government-directed sale of the junk bond portfolios of failed savings & loan associations, the failure of many leveraged buyouts and the collapse of investment banking firm Drexel Burnham Lambert. As inflation came under control, Fed easing led to a dramatic improvement in economic expectations by the end of 1990. In 1991, fund flows into bond mutual funds surged, outpacing equity flows. High yield bond returns easily exceeded equity returns for the year as investors came to view bond yields as attractive relative to declining money market yields.

1998-2003 – Average default build-up period; extended recovery - On the heels of a period of strong growth in the mid-1990's, financial crises in Asia, Russia and Argentina ignited an increase in defaults beginning in 1998, a trend which accelerated as the Federal Reserve tightened monetary policy from mid-1999 to mid-2000 in order to restrain U.S. inflation. Debt-fueled overcapacity in the telecommunications industry resulted in a number of high profile bankruptcies and sentiment improved more slowly than 1991 as concerns over corporate fraud, economic growth and the telecom bubble lingered into 2002. However, by the end of 2002, investor sentiment began improving due once again to Fed easing, as well as stronger technical factors including lower corporate bond issuance. **Notably, throughout this extended default period (2001-2002), investment grade bond returns strongly outperformed high yield bonds and equities.**

2007-2009 – Accelerated default build-up; accelerated recovery - The most notable aspect of this cycle was the much more rapid rise and fall of default activity, due almost entirely to unprecedented government intervention (e.g. monetary easing, asset purchases & debt guarantees). **This resulted in a much shorter default cycle with defaults peaking in 2009 while simultaneously a huge bond market rally was already underway.** High yield bonds ended up one of the top-performing global asset classes on the year, with fund flows and total return exceeding equities in a manner similar to 1991. Once again, a primary reason was the relatively attractive yields offered when compared to money market and U.S. Treasury rates at unprecedented lows. Moreover, the investor base for distressed debt had significantly broadened since the late 1980's.

So how does the current credit cycle differ from the recent past? What is the likely magnitude and duration of this default cycle? And what does it mean for investor sentiment and credit appetite? Credit market investors focus on some combination of economic outlook / corporate profits, monetary policy and defaults to ultimately assess value.

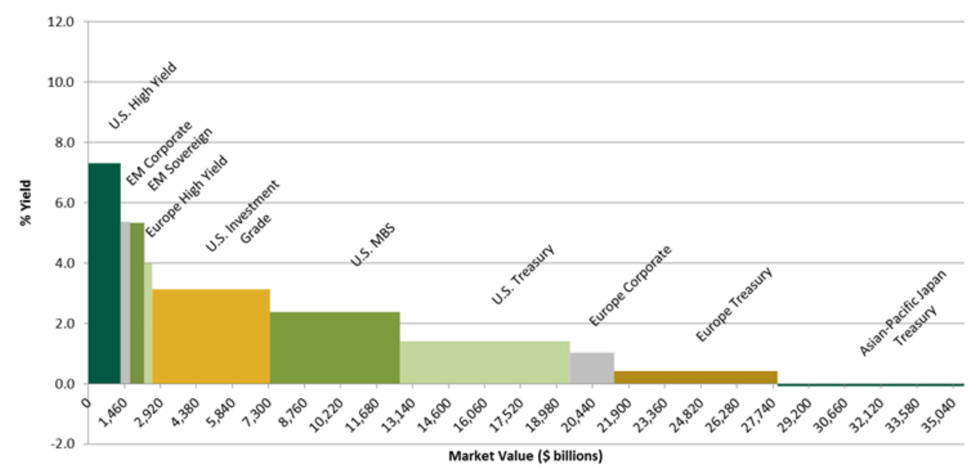
<u>Possible signs we are entering the "contraction" phase of the credit cycle:</u>

- Commodity price declines have exerted a downward pull on earnings and cash flow for the past 2 years. However, this remains largely an energy and basic materials story. Stripping out the commodity sectors, we note that cash-flow growth remains positive. However, first quarter 2016 earnings per share for non-commodity companies did decline, the first such move this cycle.
- Leverage for non-financial firms is now at multi-decade highs, exceeding pre-crisis levels. Notably, the trend is not limited to commodity names but applies to the broader corporate investment grade market. The only exception is the financial sector, which continues to maintain leverage well below pre-crisis levels.
- Defaults have increased, driven by the commodity-linked sectors. The high yield default rate is expected to hit ~5% at the end of 2016 with energy and mining companies expected to post 10-20% default rates over the next few quarters.
- As a result of the commodity price collapse and generally slower economic growth, risk sentiment has become more negative since mid-2014 when credit spreads appear to have bottomed.

<u>However several factors remain in favor of prolonging the "peak" phase:</u>

- US fixed income yields are superior to yields available in equivalent global markets. As shown in Chart 3 below, US high yield offers an approximately 7% yield, higher than emerging market and European high yield credit which offer yields in the 4-5% range. And US investment grade corporate markets offer a similarly attractive advantage at ~3% yields versus just ~1% for European investment grade. Notable as well is depth and scale of US markets when compared to those of Europe and Asia. This is a function of the relatively greater reliance on public capital markets by American companies, making US fixed income the primary playing field for global bond funds.

Chart 3: Global Fixed Income Market Relative Yields



Source: Barclays Bank PLC

- This attractive relative value is reflected in good mutual fund inflows with high yield funds reversing last year's outflows and registering inflows of $9.7 billion year-to-date compared to 2015 outflows of $16.6 billion. Meanwhile, investment grade corporate bond funds continue to attract money, $8.0 billion year-to-date, on pace to comfortably exceed last year's total $8.5 billion[1].

- Not surprisingly, issuance activity and capital market access has improved. Year-to-date investment grade issuance is within 10% of last year's record level and there has been a noticeable rebound in high yield issuance which, though volatile, has increased every month year to date. Reflecting stronger 1H15 issuance before a collapse in issuance in the second half of 2015, high yield new issue is still down 27% year to date 2016[2].

<u>Catalysts</u>

Economic outlook / profits - **We anticipate slow global growth for the near term, making further significant price appreciation for corporate credit unlikely.** The caveat of course is that the U.S. economy enjoys a relatively more positive growth outlook compared to the global economy. A risk is that investors perceive greater opportunities in an alternative market such as equities. However, slowing or flat earnings growth will likely keep equity returns contained in the near term. We note equity fund flows are slightly negative year to date, the S&P price / earnings ratio approximates the

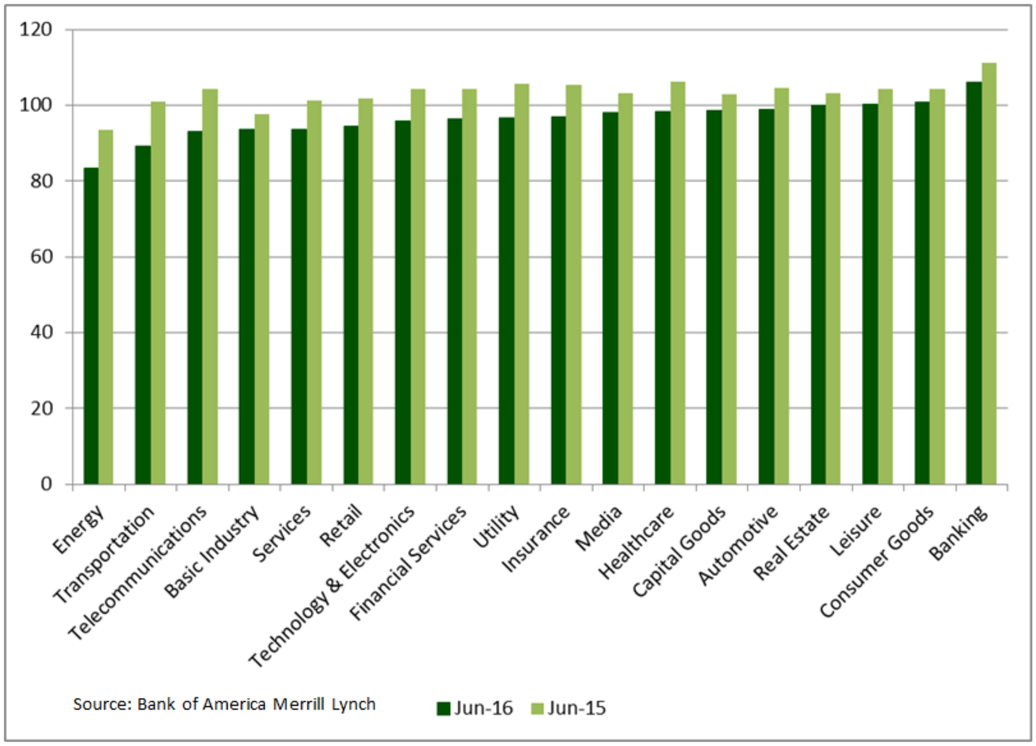
[1] JP Morgan, "JPM Daily Credit Strategy & CDS/CDX am update"; June 3, 2016
[2] JP Morgan, "Credit Strategy Weekly Update", 20 May 2016.

30 year average and total returns have been essentially flat over the past year.

The Fed - When considering the globalization of financial markets over the past decades, it makes sense to view the Fed's decision-making process as having evolved compared to the early 90's and even the early 00's default cycles. With the U.S. dollar's status as a leading reserve currency and the increased magnitude of global capital flows, the Fed effectively has help from global investors in controlling U.S. inflation. This policy-making evolution was apparent in the aftermath of the 2008-09 default cycle in which economic recovery and low inflation obviated the need for tightening, presenting the novel situation of a Fed now considering tightening just as the business cycle is believed to be maturing. A risk is that an unexpected inflation scare forces the Fed to tighten faster than desired, upsetting an increasingly leveraged corporate sector. However, with capacity utilization and commodity prices remaining low, the expected policy of Fed "gradualism" is highly supportable. **Going forward, this more limited range for rate-setting makes it seems unlikely that the Fed will be as able to catalyze credit cycle recovery compared to prior cycles.**

Defaults - currently expected to rise, driven by the commodity-related sectors. **But we cannot rule out contagion to other industries due to factors which could include – broadly weaker earnings, tighter bank credit standards and a sharp increase in high yield debt maturities in 2018-2020**. Forecasts differ but the rating agencies generally estimate default rates of around 5-7% in 2017 while market-implied indicators such as high yield bond pricing imply rates between 7-10%. As shown on Chart 4 (HY index pricing), over the past year, there has been some erosion of pricing in high yield sectors other than energy and basic industry (a.k.a. mining & metals). Pricing levels are still relatively healthy overall with no industries evaluated below $80. However, it is worth noting that pricing a year in advance of the 2001 and 2009 default peaks was also relatively sanguine with only three industries priced below $80 at the start of 2000 and one industry below $80 at the beginning of 2008. By comparison, a year later, industries evaluated below $80 had soared to almost 50% in 2001 and every industry in 2009.

Chart 4: Bank of America Merrill Lynch High Yield Index Pricing By Industry



Summary

As noted previously, credit market investors focus on some combination of economic outlook / corporate profits, monetary policy and defaults to ultimately assess value. Our view is that we are close to the end of the current credit cycle and the most significant risk is deterioration in earnings combined with a rise in defaults and tightening lending standards. In terms of severity and timing, we see similarities to the early 2000's default cycle with a handful of industries driving default rates higher leading to an overall risk-off sentiment in the credit markets. In terms of valuation, both triple-B and single-A corporate bond spreads are currently cheap to their historical averages while high yield spreads are in-line. Furthermore, we believe investment grade fixed income markets should remain supported by low global yields and perform well relative to high yield, in line with past default peaks. We believe that US investment grade credit warrants a 30% allocation for accounts in our crossover strategy, down from 40% a year ago. Meanwhile our corporate strategy targets ~50% in single-A credit and 45% in triple-B credit, roughly in line with the benchmark.