



US Credit Strategy: US credit feels the pressure of high commodity exposure

US credit markets have made a U-turn midway through 2015, as doubts began to surface with respect to issuer fundamentals, exposure to commodities and EM, and more recently even certain developed market names. The cavalier attitude that energy sector problems will remain contained has also seen defectors as oil prices set new lows during the course of the year and bonds came under even more pressure. At the same time, the expected pickup in consumer spending still takes time to materialize.

The US credit market reflects a much more realistic view of a potential for rising credit losses from here, with spreads in both HY and IG being at 3- to 4-year wides. Naturally, we like these levels better than those prevailing just a few months ago, and unless those credit losses start materializing soon, the market could be positioned for a strong rebound. Evidence we look at suggests that this is not the most likely outcome just yet, however.

At the core of our view is that the epicenter of this cycle will be in commodities and EM. These areas continued to show few signs of imminent turnaround at the time of this writing. A McKinsey study earlier this year estimated total of new debt created since 2007 at \$50trln, capturing all global sovereigns, corporates, and consumers. Much of it was raised with a belief in the commodity super-cycle. Today, we know that such a belief was wrong, and so it would only be logical to assume that meaningful debt write-downs are inevitable. The question really is whether they remain limited to commodity/EM areas, or spill over to a wider set of sectors.

We see three primary risks to the upside from here. The first one, least predictable but most relevant, is the Chinese economy turning the corner. The second, somewhat evident, is equities continuing to diverge in the face of commodity meltdown. The third, perhaps the most obvious, is more stimulus from central banks, at least outside the US. We discuss each of these in greater detail in our full year-ahead publication to be released soon. That they are listed here as risks, and not base case, gives readers a preview as to our assessment of their probabilities.

Overall, we expect the push-and-pull to continue, with those seeking more yield and those seeing signs of a cycle turn. We expect variable degrees of success to be claimed by each side at different points over the course of 2016. We find ourselves believing in moderate increases in ex-energy defaults to 3.2% next year, up from 1.9% today, and a continued pressure on HY spreads, where USD DM ex-energy index could widen by about 100bp.

Higher vulnerability of HY makes IG a more attractive alternative, in our eyes, especially in light of its current levels; we expect IG to widen only by about 10bps from here, or well inside of a normal 1:4 relationship to HY. European credit should remain better bid than the US, and loans should continue to quietly outperform HY, just like both of them did in 2015. We are not viewing 2-3 hikes by the Fed as being problematic to credit. In our opinion, their ability to hike multiple times would be proof that credit tightening concerns were overblown.

Also critical to our positive outlook on IG is the continued demand for 'safe yield' from overseas investors, particularly those in Asia. Non-U.S. investors absorbed roughly one-third of the net supply of U.S. issuer bonds in 2015 in a great rotation to developed-market debt markets, in flows that appeared to favor financial bonds, single-A corporates and 5-year and 30-year paper. The laggard, 10-year BBBs, look cheap on a relative basis and we like owning these bonds outright or through 2s10s flatteners.