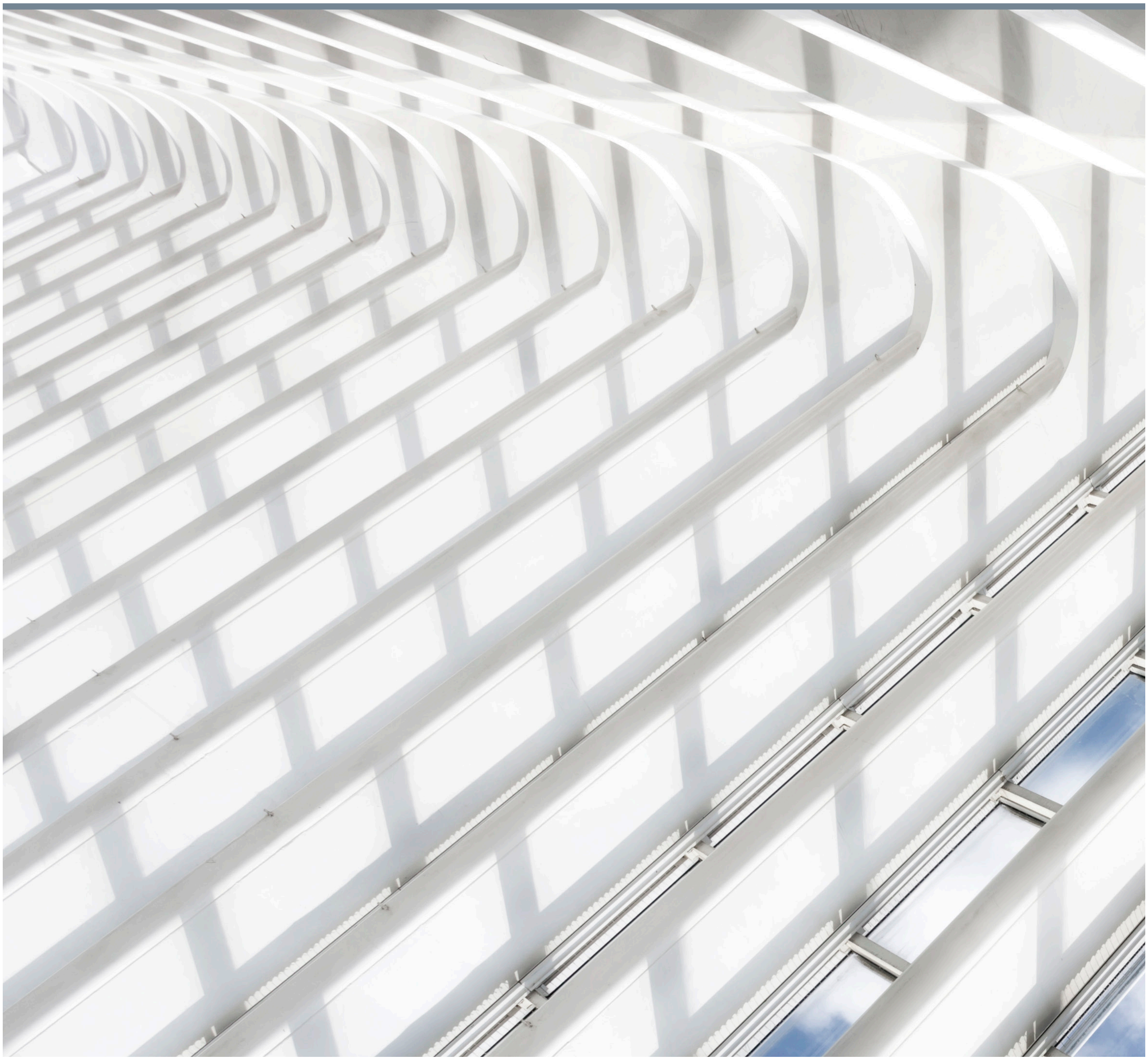
Investment Grade Corporates

Positioned for the New Reality



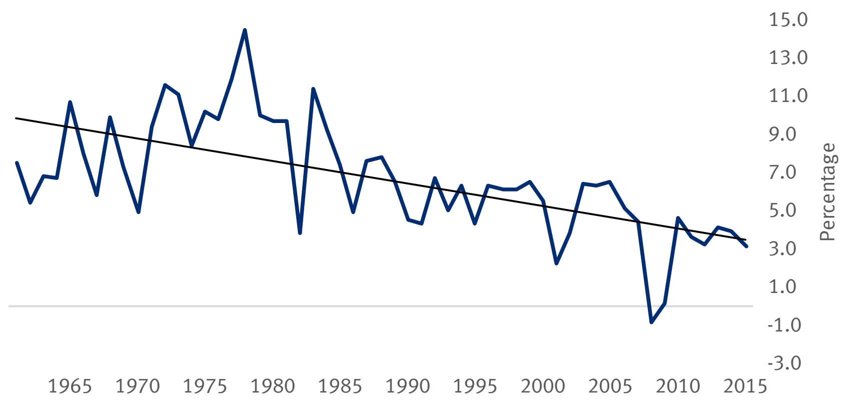
Global Asset Management

The global financial crisis altered the growth profile for the global economy, resulting in a new era of suppressed yields and weak growth, leading to lower-than-expected asset returns. The medium-term growth expectations continue to be anchored by the negative secular trends of aging demographics and lower productivity. Investors who are seeking more yield by moving into riskier asset classes should remain rational and continue to focus on prudent risk management to protect against downside risk. Investment grade corporates are ideally suited to provide investors with attractive risk-adjusted returns while protecting against downside risk to principal.

Following the global financial crisis, central banks have taken unprecedented actions of accommodating monetary policies (quantitative easing and low interest rates) in an effort to stabilize the financial system and to stimulate weak economic growth. To date, these actions have proven largely ineffective. Instead, trillions of dollars in assets with negative yields were created.

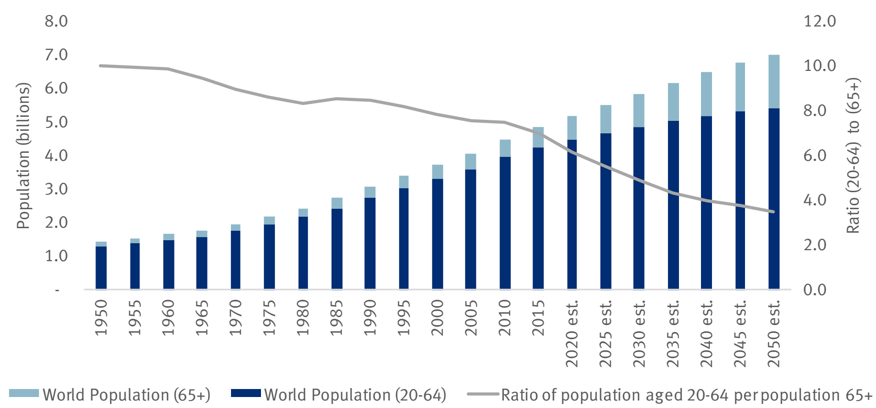
The latest International Monetary Fund outlook projects global growth to be 3.1% in 2016 and 3.4% in 2017. Advanced economies are projected to grow by only 1.8% in 2017. In particular, GPD growth has been steadily declining (Exhibit 1). We expect slow economic growth over the medium term to persist primarily due to aging demographics (Exhibit 2) combined with low labor productivity (Exhibit 3). The most recent increase in rates and improvement in the short-term growth prospects are due to anticipated fiscal stimulus and tax reforms in the US, which likely will have only a near-term growth effect in our opinion. The fact remains that growth has slowed and it is projected to remain slow over the medium term which will limit investment returns across nearly all asset classes.

Exhibit 1
US Nominal GDP Growth



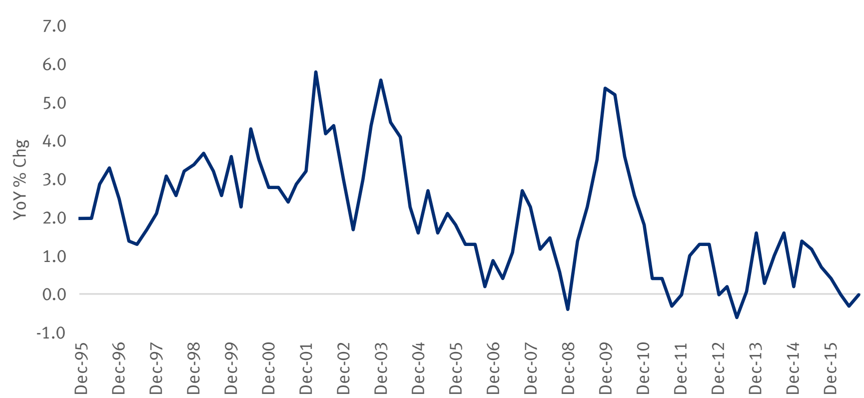
Source: Bloomberg and US Bureau of Economic Analysis as of 12.31.15

Exhibit 2
Aging World Population



Source: United Nations (Department of Economic and Social Affairs) as of July 2015

Exhibit 3
US Labor Productivity



Source: US Bureau of Labor Statistics as of 9.30.16

While returns have fallen and are likely to remain subdued, investors must remain diligent in risk management and principal protection. Investment grade corporates provide an attractive fixed income option for those looking to improve returns while minimizing risks.

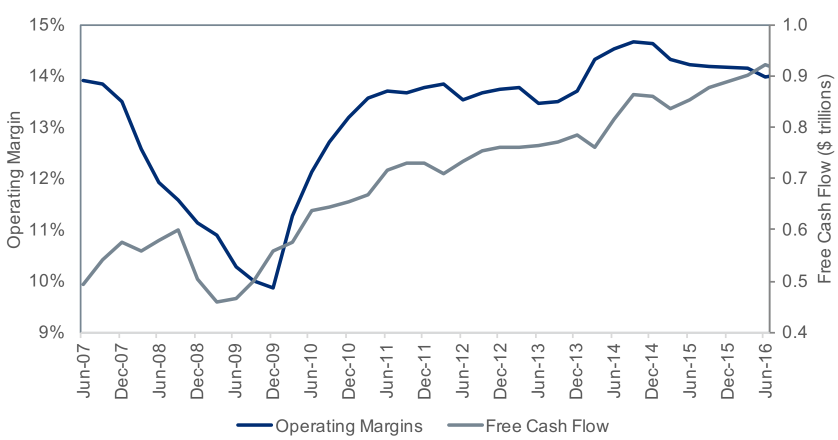
Investment grade corporates historically provide an income advantage (currently around 1.30%) in excess of Treasury yields. The extra income, or spread, compensates investors for incremental risk over risk-free assets. This extra income provided by investment grade corporates can be especially helpful during periods of rising interest rates as it softens the price impact of rising rates. Investment grade corporates have outperformed Treasuries by an average of 2.50% in periods of rising rates (Appendix 1).

Exhibit 4
30 Year Correlation Matrix through 6.30.16

	Bloomberg Barclays US Investment Grade Corporate Index	Bloomberg Barclays US Treasury Index	BofA Merrill Lynch US High Yield Index	S&P 500 Index
Bloomberg Barclays US Investment Grade Corporate Index	1.00	0.73	0.53	0.27
Bloomberg Barclays US Treasury Index	0.73	1.00	-0.02	-0.06
BofA Merrill Lynch US High Yield Index	0.53	-0.02	1.00	0.58
S&P 500 Index	0.27	-0.06	0.58	1.00

Sources: Bloomberg, Bank of America Merrill Lynch, Standard & Poors, Bloomberg Barclays

Exhibit 5
IG Corporate Operating Margins and Free Cash Flow



Source: FactSet as of 6.30.16

In addition to income advantage, investment grade corporates also provide lower volatility relative to other asset classes. The Bloomberg Barclays Investment Grade Corporate Index has shown a strong correlation to US Treasuries (Exhibit 4). This correlation, coupled with the excess spread, provides investors with a strong risk-adjusted return profile. Investment grade corporate securities also exhibit a lower correlation to equities and can offer a compelling hedge as the asset class has provided average annual returns of 6.33% in years of declining equity markets (Appendix 2). In contrast non-investment grade securities have a higher correlation to equities. The Bank of America Merrill Lynch US High Yield Index tends to track equity performance more closely and does not provide the same risk profile as the investment grade corporate asset class.

The low volatility of returns may continue due to the asset class currently featuring stable credit fundamentals. The present era of low economic growth is resulting in weak revenue growth for companies. This is concerning for most investors, especially equity investors, as low growth tends to limit price appreciation for equity securities. However, we view the current low growth environment as being positive for credit investors, particularly those in investment grade corporates.

Most investment grade companies are currently focusing on lowering costs, improving margins and generating cash. Focusing on efficiency gains is the primary method for growing earnings given stagnant revenue growth. Firms have also become more stringent on capital allocation, particularly capital expenditures due to the low growth environment. The combination of low capital expenditures and high operating margins creates an environment for strong cash generation (Exhibit 5). A company's ability to generate cash flow is a primary consideration for corporate credit investors as it demonstrates a company's ability to pay back its obligations. Investment grade-rated corporations are ideally situated in the current environment due to their strong credit profiles and modest leverage.

Finally, the investment grade corporate credit market features breadth, diversification and liquidity versus other fixed income classes. The Bloomberg Barclays Investment Grade Corporate Index market value amounts to $4.9 trillion and includes almost six thousand issues, giving investors a broad range of securities and liquidity to construct and manage portfolios for clients. The US investment grade market also benefits from a steady supply of new debt offerings; there have been over $1 trillion of new issuance in each of the last four years, providing a deep and abundant source for constructing diverse portfolios.

The US investment grade asset class provides a strong risk-reward investment option. In today's world of weak growth and low yields, investors do not need to take unnecessary risks to achieve return objectives. As companies focus on strong operating margins and cash flow, investment grade corporates provide an opportunity to add attractive risk-adjusted returns while gaining exposure to a stable asset class. Investors should consider US investment grade corporate strategies in the current low growth environment.

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Appendix 1
Years of Rising 10-Year Treasury Rates

	Change in 10-Year Treasury Yield from Previous Year	Bloomberg Barclays US Investment Grade Corporate Index Return	Bloomberg Barclays US Treasury Return	Corporate vs. Treasury Return
1987	1.64	2.56	2.00	0.55
1988	0.28	9.22	6.99	2.23
1990	0.13	7.05	8.54	-1.49
1994	2.03	-3.93	-3.38	-0.55
1996	0.85	3.28	2.70	0.59
1999	1.79	-1.96	-2.56	0.60
2003	0.43	8.24	2.24	6.00
2005	0.17	1.68	2.79	-1.12
2006	0.31	4.30	3.08	1.22
2009	1.62	18.68	-3.57	22.25
2013	1.27	-1.53	-2.75	1.21
2015	0.10	-0.68	0.84	-1.53
Average	0.89	3.91	1.41	2.50

Source: Bloomberg, Barclays

Appendix 2
Asset Class Returns During Negative Equity Markets (Since 1986)

	1990	2000	2001	2002	2008	Average
S&P 500	-3.10	-9.10	-11.89	-22.10	-37.00	-16.64
Bloomberg Barclays US Investment Grade Corporate Index	7.05	9.08	10.31	10.12	-4.94	6.33
Bloomberg Barclays US Treasury Index	8.54	13.52	6.75	11.79	13.74	10.87
BofA Merrill Lynch US High Yield Index	-4.36	-5.12	4.48	-1.89	-26.39	-6.66

Source: Bloomberg, Barclays, Bank of America Merrill Lynch, Standard & Poors

Global Asset Management

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