Is the economic cycle shifting?

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Steady global growth, with rising uncertainties
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Moving up in credit quality for better durability
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In this Issue

Many investors fear the economy may shift into recession, as all good things must come to an end. We don’t share their near-term pessimism. However, ten years into a US expansion, we do see rising market volatility on the global horizon. We think a cautious approach to inflation and the aging credit cycle can still be profitable for long-term investing. Stepping back to review the big picture in the third quarter, we see the following:

Top Down Views

- Positive US economic momentum should continue for another 18–24 months. Fears about inflation and trade tensions are overblown (for now), but require close monitoring.

- Global growth remains buoyed by consumer spending, though China and the eurozone have been decelerating slightly. We expect rising market volatility as more banks end quantitative easing.

Bottom Up Views

- Some investment-grade bonds are riskier than their ratings imply, while high yield enjoys positive technical tailwinds. Bottom-up credit analysis is key to our investment process at this stage in the cycle.

- A large number of bank loan agreements now favor borrowers over lenders. We explain the steps we’re taking to protect investors from potentially damaging changes to bank loan interest rates.

Steady global growth, with rising uncertainties

All in, we think global growth is still on track this year, although less synchronized across the world’s four largest economies. The United States has been outpacing the eurozone and Japan with 4.2% gross domestic product (GDP) growth in this year’s second quarter, driven largely by US consumer spending. We do not think a US recession is on the near-term horizon, given the momentum sparked by last year’s $1.5 trillion tax cut, deregulation and ongoing deficit spending. Instead, we see continued positive momentum for the next 18–24 months.

Global growth: Still on track but less synchronized


Europe and US switch places

We are neither surprised nor worried to see the eurozone decelerate slightly this year. In our view, it’s still a healthy growth rate. Last year’s GDP growth of 2.4% was the eurozone’s fastest since 2007. It even eclipsed the US economy’s 2.3% growth in 2017. We think the eurozone’s projected growth trajectory of 2.1% is achievable this year, given steady consumer demand. With very few signs that its economy is overheating, the European Central Bank (ECB) has the flexibility to keep monetary conditions very accommodative.

Our confidence in the eurozone’s forward momentum lies partly in Europe’s consumers. For investors who think of Europe (and especially Germany) as being an export machine, we like to highlight that 56% of the European Union’s (EU’s) GDP growth comes from domestic consumption. The majority of EU member states trade more goods with other member states than with non-EU countries, as shown in Exhibit 1. This affords Europe a level of economic self-sufficiency that export-driven economies like China don’t have.

China slows deliberately

In contrast to the EU, China has been slowing down its economy on purpose as it transitions away from investment and export-led GDP growth toward a consumer-driven economy. Why target slower growth? In our view, China envies the self-sufficiency that its consumer-oriented rivals enjoy. Yet China’s private consumption has been stuck below 40% of GDP since 2005. One hurdle has been convincing China’s newly minted consumer class to embrace a “premium-seeking” attitude. Beijing wants to see more of its middle class shopping online, and even indulging in western luxuries like cosmetic surgery.

As many economists expected, China’s GDP slowed to 6.7% in the second quarter of 2018, slightly behind the 6.9% it achieved in 2017. The World Bank expects China’s GDP growth will further moderate to 6.5% this year, and then average 6.3% the following two years. What makes this glide path toward consumption-led growth especially tricky is that Beijing is also cracking down on risky credit growth. Throw in escalating US trade tensions, and China’s Communist Party faces a delicate balancing act.

Exhibit 1: EU trade: member states, intra EU exports vs. extra EU exports

Source: Eurostat, Comext database, 2016. Eurostat is the statistical office of the EU.

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2. The European Commission reduced its 2018 growth forecast from 2.3% to 2.1% in July 2018, citing trade tensions and higher energy prices. We note this forecast came before European Commission President Jean-Claude Juncker met with President Trump in late July, where they agreed to work toward zero tariffs. There is no assurance that any estimate or projection will be realized.
Global uncertainties
China’s obstacles toward achieving more sustainable, consumer-driven growth overlap with a series of risks that confront all the world’s economies. To explain our thinking, let us briefly walk through our views on inflation, trade tensions and central bank policy.

Keeping our eyes on inflation
If some investors are in a nervous sweat over looming inflation, the world’s central banks appear to be taking things in a cool, measured stride. ECB President Mario Draghi appears confident that inflation in the eurozone remains in check for now. We don’t expect to see any rate hikes from the ECB until 2020, as Draghi’s primary goal before stepping down as president in October 2019 will be ending the bank’s quantitative easing (QE) purchases by the end of this year. In contrast, the Bank of England (BoE) raised rates in August, and signaled more rate hikes to come if inflation looks to accelerate above 2%.

In the US, the US Federal Reserve (Fed) has signaled that while it may tolerate an overshoot of its 2% inflation target, inflation appears to be manageable. Fed Chair Jay Powell thinks wage growth will remain in check, as discouraged workers who stood on the sidelines are finally re-entering the workforce. With the US economy running hotter, the Fed has already signaled that two more rate hikes are coming this year, while forecasting 2.8% GDP for 2018. With the rising US dollar, the currency markets are clearly signaling that strong economic momentum combined with Powell’s steady march toward policy normalization make a compelling pair.

Twitter and trade tensions
So what could derail the US economy and global growth? Plenty. The escalating trade rhetoric between the US and China is arguably the biggest “known unknown” that concerns central banks, economists and investors alike.

If these tariffs take hold, more companies may put planned investments on hold and wait for the dust to settle. Consumer spending could also take a hit. When tariffs drive up the cost of goods, companies often pass along price increases to consumers. We think China’s economy is more vulnerable in the short term compared with the US, given its dependence on exports. In terms of trade, the US benefits from a remarkably self-sufficient economy, as 68% of its GDP comes from domestic consumption.5

Forecasting how these trade tensions may evolve is quite difficult, in large part because the Trump administration’s strategic trade goals remain somewhat opaque. For now, investors can take solace by looking at the EU’s recent tariff negotiations with President Trump. European Commission President Jean-Claude Juncker met with President Trump in late July and managed to kick off negotiations that may result in “zero tariffs” between the US and EU. It remains unclear if these negotiations will lead to substantive agreements that will prevent the re-emergence of tariffs down the road.

Brexit, soft or hard?
The EU has dodged the tariff bullet for now. But Brexit looms as another event that could destabilize the EU and United Kingdom (UK). Aiming to negotiate a soft Brexit, Theresa May’s Conservative party remains split between a hardline, Brexit-supporting wing, and moderates who want to strike a “soft” exit deal with the EU. If negotiations fail before the EU’s October 18 deadline, the UK could exit without a deal in March 2019.

We continue to think momentum is gradually building for a Brexit compromise despite the British pound dropping on fears the UK will crash out with no deal. After a soft Brexit, we expect the EU will finally embrace new fiscal spending. Within the European Parliament, the UK typically voted in lockstep with Germany’s desire to keep a tight fist on spending. Without the UK, Germany may finally acquiesce to member states like Italy that want to see looser purse strings.

But we’ll have to wait until October or perhaps November to see. That is when both sides are expected to unveil the proposed withdrawal treaty outlining terms of departure, including mutual financial commitments and managing Irish border access.

Ending QE as we know it
Perhaps a bigger “known unknown” facing the global economy in the medium term is understanding how markets will respond when more central banks move away from QE. As a refresh, the Fed kicked off QE in 2008 during the global financial crisis in a bold effort to drive down longer-term rates and boost growth.6 By purchasing massive quantities of bonds each month, the Fed passed along credit and more liquidity to US corporations and households in hopes of jumpstarting the economy. The Fed finally stopped increasing its stockpile of QE bonds in 2014, and is now gradually shrinking its balance sheet in an effort to “normalize” QE policy. Today, the Fed allows up to $40 billion of its QE bonds to mature each month without replacing them, and up to $50 billion a month starting this October.

6. The Bank of Japan pioneered the use of QE back in 2001 once it discovered that lowering short-term interest rates to zero no longer produced the economic stimulus it was seeking.
The Bank of Japan (BoJ), ECB and BoE eventually followed the Fed’s lead with their own QE programs. Since their economies are years behind the US in terms of recovery, the BoJ and ECB continue buying bonds today, though they have been quietly tapering their purchases. For example, the BoJ effectively cut its purchases in half from 2016 to 2017.

To understand the scope of this tapering, the G-3 central banks’ combined QE balance sheet increased by $703 billion in the second half of 2017, then grew by only $76 billion in the first half of 2018. The ECB expects to end its QE purchases entirely by the end of this year, while we expect the BoJ will continue its purchases for the foreseeable future. After averaging nearly $150 billion in new QE bond purchases per month in recent years, monthly net asset purchases are set to reach zero within a couple years. That is a transition from around $1–$2 trillion annually in QE asset purchases over the past five years, to nearly zero. We do not expect the ECB to start unwinding its balance sheet for many years, and well after interest rates are back above zero.

How the market may respond to the end of QE remains unclear. However, it appears to be a safe bet that market volatility will increase. We take some comfort knowing that the banks are well aware that the process must be gradual, and that they will take notice of market reactions.

Bottom up views

Moving up in credit quality for better durability

As long-term investors, our credit research broadly focuses on determining if companies can service their debt throughout a credit cycle. In today’s crowded investment-grade (IG) space, our research also helps us distinguish overly leveraged companies from ones with manageable debt loads and durable business models. Within high yield, we are seeing a different dynamic compared to the enormous IG universe. Given shrinking supply, high-yield bonds are enjoying positive tailwinds that can benefit investors.

It’s quite a different story for the bank loan market, which now rivals high-yield in terms of size. With investor demand outstripping bank loan supply, we are seeing more investors relinquishing control over credit terms. That could spell trouble down the road when the credit cycle finally shifts.

Below we explain how our credit research and long-term orientation helps us discern cash flow durability in the companies we analyze, and how we negotiate for better terms in credit agreements.

INVESTMENT-GRADE BONDS

The IG seal of approval often conveys a status of safety that some investors might misinterpret. From our experience, we know these bonds can still be volatile if broader economic conditions deteriorate, or for company-specific reasons. To better gauge the risks of one IG bond in comparison to another, some investors look at credit ratings from agencies like Moody’s and Standard & Poor’s. The vast majority of IG corporate bonds historically carried the highest quality ratings, like S&P’s AAA, AA and A designations.

Exhibit 2: Credit quality deterioration in investment-grade credit

7. Source: S&P Global Market Intelligence data, May 2018, shows the US syndicated leveraged loan market tops $1 trillion.
The quality of the IG universe, however, has steadily declined in recent years. On the back of low interest rates, many companies issued more debt to fund projects, acquire new companies, and even buy back equity shares. As more companies overindulged in borrowing, leverage levels rose, and credit metrics fell. BBB rated bonds (the lowest rating in the IG universe) now make up nearly half of IG securities, up from 25% in the 1990s, as shown in Exhibit 2 on the previous page.

Given the late nature of today’s credit cycle, some investors might think exiting the BBB rated universe entirely and moving up the credit rating scale is a good idea. We think moving up in quality makes a lot of sense. However, we don’t need to exit the vast BBB rated universe entirely, given our deep credit research. Through our own analysis, we look to pinpoint BBB rated companies that we believe have the potential to generate reliable cash flows, even within competitive and rapidly evolving industries.

Survival of the fittest

One high-profile theme that brings secular industry changes and aggressive competition to life is the disruptive power of Amazon. Amazon’s purchase of Whole Foods in June of last year cast a dark cloud over the US grocery landscape. Overnight, markets reacted by indiscriminately driving down grocery retailing shares while spreads widened for bonds.

In the case of Kroger, the largest traditional US supermarket chain in terms of revenues,8 we thought the bond market was over-reacting. Kroger’s scale gives it tremendous cost advantages over smaller rivals. But it also sends off giant, well-resourced discounters like Wal-Mart and Germany’s Aldi, which decimated incumbent grocers in the United Kingdom. As a highly efficient operator, Kroger has an enviable reputation for generating strong cash flows despite strong competitors.

So is Kroger also equipped to battle the likes of Amazon? We think it is. Kroger has over 1,000 click-and-collect stores, where shoppers can order groceries online, with plans to double that footprint this year. It is also pushing into home food delivery and testing pre-made meal kits. Management also takes full advantage of its deep reservoir of customer data analytics, amassed over decades. By understanding customer behaviors, needs and patterns, it tailors its marketing promotions to increase repeat visits.

Kroger has all the fundamental qualities we look for in an attractive bond issuer—a defensible competitive position, proven cash flow generating capacity, and a smart, forward-looking management team that’s ready to take on Amazon.

HIGH-YIELD BONDS

Tight spreads in today’s high-yield market don’t offer much comfort this late in the credit cycle. And yet, high-yield bonds have broadly outperformed IG credit so far this year. That’s partly because high-yield durations are generally shorter compared with IG corporates, and less sensitive to rising Fed rates. But we’ve found another reason to like high-yield—shrinking supply.

Positive macro tailwinds

Unlike the steady rise in new IG issuance, net new high-yield issuance has been negative in recent years,9 as more high-yield entities are choosing to raise capital through leveraged loans. That means fewer high-yield bonds are coming to market than are being retired. The shrinking supply should give high-yield bonds a positive technical tailwind that can support valuations—a trend that IG bonds are not enjoying. The lowest spectrum of IG bonds (BBB) now tips the scales at over $3 trillion, compared with just $569 billion for BB high yield, as shown in Exhibit 3.

Another potential tailwind for high-yield valuations is relatively low default rates—currently running below the historical average.10 The collapse of commodity prices in 2015 nurtured this, along with the dramatic crash in oil prices in February 2016. Like a healthy cleanse, the commodity correction helped purge over-leveraged players in the energy sector, in our view, setting the stage for more stability today.

Regardless of these positive macro tailwinds, our credit research capability remains indispensable as we seek to avoid company-specific meltdowns, and to uncover opportunities that others may overlook. Another example where exaggerated headlines and careful research revealed different stories is Bausch Health Companies (Bausch).

Previously known as Valeant, Bausch is a pharmaceutical and consumer health company. Back in 2015, as many pharmaceutical companies were producing record profits, the market applauded Valeant by driving its equity shares to extreme valuations. When Valeant appeared before the US Congress to discuss drug prices, it came under scrutiny by a high-profile short seller. Soon, rumors of large-scale fraud and potential bankruptcy swirled, and its shares nose-dived. Although the pricing concerns were valid, we thought the media and certain vocal stakeholders had overly exaggerated Valeant’s risks.

Our healthcare credit analyst ignored the market noise and dove into Valeant’s product portfolio and pipeline. Two

10. Source: JP Morgan data.
segments of Valeant, Bausch & Lomb and Salix, immediately grabbed his attention. Both segments had attractive products, robust cash flows, and peers with enterprise valuations that far exceeded what the market had assigned to Valeant. Bausch & Lomb gave Valeant some financial stability and revenue diversification, since it didn’t face patent expirations like a typical drug company. Bausch & Lomb’s main strength was its well-known consumer brand, and the repeat sales of staple products like contact lenses and saline solution. Valuations for industry peers like Cooper Cos and Alcon were also far higher than investors gave Bausch & Lomb. Evaluating Salix, we felt the market didn’t fully appreciate its upcoming expansion into the large gastrointestinal market with an existing product that faced few competing treatments. Doing a sum-of-the-parts valuation, we concluded that even with very little contribution from Valeant’s 1,500 other products, the valuations and cash flows of Bausch & Lomb and Salix alone could nearly cover Valeant’s debt.

What’s the main lesson from Bausch and Kroger? Markets and investors occasionally overreact to headlines. Investment managers with a long-term orientation and a willingness to do their own credit analysis can find investment opportunities that others may miss due to shortsightedness.

**BANK LOANS**

Quite unlike the shrinking high-yield market, bank loan supply has doubled since 2010, now reaching over $1 trillion, according to S&P Global Market Intelligence. Yet investor demand is outstripping this supply, given strong relative performance in today’s rising-rate environment. With so much capital chasing bank loans, we have seen a steady erosion in bank loan standards, favoring borrowers over investors, in our view. Importantly, lenders are now losing their voice regarding changes to benchmark rates, which has important implications for future returns. We take a closer look at these troubling changes to credit agreements.

**Rising rates accelerate demand**

One of the main attractions of bank loans are their floating rates. Unlike fixed rate bonds, bank loan coupons adjust in rising-rate environments because they are pegged to the London Interbank Offer Rate (LIBOR). This “benchmark rate” represents the average interest rate that a panel of leading banks charge each other for loans. This flexibility is attractive for investors looking to benefit from rising income or to avoid the negative interest rate exposure that fixed rate bonds may carry.

So far this year, this flexibility has paid off. On the back of two Fed rate hikes this year, bank loans generated attractive returns relative to some fixed rate counterparts.
As bank loan demand has risen, we’ve noticed a steady decline in lender protections within credit agreements. Borrowers are modifying or eliminating protections that lenders considered sacrosanct—often creating greater risk for lenders. For example, bank loan issuers are incorporating provisions that allow them to issue more debt, pay out dividends to equity shareholders, and even put collateral out of lenders’ reach. Then, on the heels of news last July of LIBOR’s likely termination, a fresh wave of credit agreement amendments got our attention. We think more investors should sit up and take notice.

Due to a string of LIBOR pricing scandals, banks will no longer be required to quote LIBOR, starting in 2021. Many observers believe the banks will continue supporting LIBOR in the coming years, though no official comparable replacement exists yet. In response to these expected changes, borrowers started inking new provisions in credit agreements that take away lenders’ rights to opine on future LIBOR benchmark replacements.

Specifically, an issuer’s administrative agent can now identify future LIBOR benchmark replacements, but without giving lenders any say, or giving them just five business days to decline it. In the latter case, unless a majority of lenders in a syndicated loan reject the proposed LIBOR replacement in writing, the new benchmark rate becomes effective at the agent’s discretion.

Borrowers break an essential rule

In our view, this practice breaches a fundamental rule of bank loans: any proposed reduction or change in the interest rate that lenders receive, may not move forward without the lenders’ affirmative consent. In our view, it is inappropriate to place the onus on lenders to respond negatively (i.e., opt out) within five business days. Lenders typically don’t know other lenders in the syndicate, nor have time to discuss the merits of a particular LIBOR alternative in just five days. We feel these actions will place investors at a possible disadvantage of having their expected income change, without any say in the matter.

We do not believe these provisions in new or amended loan documentation are in the best interest of our clients. That’s why one of our conditions before investing is that credit agreements give lenders the right of prior consent to any LIBOR changes. In several instances where we’ve seen unfavorable provisions regarding LIBOR introduced in loans we currently own, we have either eliminated or dramatically reduced our exposure to these borrowers. By par value, only 17% of our current bank loan holdings have objectionable LIBOR replacement language. By comparison, we currently estimate that 50% of the broader loan market contains this language.

The loosening of credit agreements combined with record issuance levels should warrant more, not less, vigilance by investors. And yet, many investors are passively accepting these changes, and signing away one of their fundamental rights. We are encouraging more asset managers to join us in negotiating for the removal of unfavorable LIBOR replacement language in credit agreements. In our view, LIBOR replacements in syndicated bank loans should not be able to move forward without the affirmative consent of a majority of lenders.

12. Given the flood of new bank loan issuance, we estimate over 50% of bank loans currently carry LIBOR replacement provisions that we consider unacceptable. Our estimate derives from knowing that about 98% of YTD 2018 loan issuance has this LIBOR replacement language, per the Loan Syndications & Trading Association. And 60% of the Credit Suisse Leveraged Loan Index has an effective date after July 2017, when the FCA ruling came into effect.
Franklin Templeton Thinks: Fixed Income Markets highlights the team’s ongoing analysis of global economic trends, market cycles and bottom up sector insights. Each quarterly issue spotlights the team’s thinking on different macro forces, and particular sector views that drive our investment process.

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