CORPORATE BOND MARKET OUTLOOK

KEY DRIVERS FOR THE QUARTER

- Large companies involved in debt-funded mergers and acquisitions are now primarily focused on deleveraging.
- Solid operating results at large companies are more than offset by a less-constructive earnings outlook.
- Net corporate supply declined due to lower gross issuance, overseas cash repatriation and bond redemptions.
- Foreign purchases of U.S. corporate bonds slowed, based primarily on higher U.S. dollar hedging costs.
- Spreads gapped out on risk aversion, and higher-quality corporate bonds outperformed lower-quality bonds.

INVESTMENT OUTLOOK

Timing the Turn

Early signs of deleveraging are expected to expand during 2019. After several years of rapidly increasing corporate debt through a hyper focus on M&A and debt-funded shareholder enhancement activities, corporate financial flexibility has weakened to the point that some management teams are beginning to refocus on the balance sheet. Deleveraging is becoming a more popular management buzz word on earnings calls as investment grade (IG) industrial companies, particularly those saddled with high merger-related debt, focus more on debt reduction.

Not all IG companies have the willingness or ability to deleverage, so creditworthiness may continue to deteriorate as measured by the upgrade/downgrade ratio, the fallen angel counts and the proportion of BBB bonds in the IG corporate market. That said, if more IG companies credibly prioritize free cash flow for debt reduction, a serious balance sheet focus should eventually drive incremental credit improvement and narrow credit spreads. Getting to that point may take some time. And, record Industrial company leverage could move higher if an economic slowdown or a recession emerges. Management teams that refocus on balancing the long-term interests of shareholders with those of bondholders should be better positioned if capital markets volatility continues in 2019.

The Economy, Central Bank Policy and Geopolitical Risk

U.S. real GDP grew 3.4 percent in 3Q18, although the growth rate is expected to slow in 4Q18 and 2019. Economic growth has moderated in China and Japan, and Germany had weak 3Q18 GDP prints. The Fed sees a gradual approach to rate increases, while remaining flexible based on incoming data. Fed projections show two rate hikes in 2019 while the market is pricing in less than one. At the same time, the Bank of England and Bank of China are normalizing policy, and the ECB is expected to wind down quantitative easing (QE).

Meanwhile, the Bank of Japan is accommodative. The Chinese central bank (PBOC) responded to slowing economic growth in China by cutting the reserve ratio requirement by 1 percent for all banks in January.

Global foreign policy volatility and tit-for-tat threats to levy more tariffs on some products and sectors, for various trading partners and allies, may strain foreign relations and impact policy.

Multinational companies with global supply chains face unique challenges operating in such an environment. High geopolitical risks are viewed as a material headwind for corporate credit.

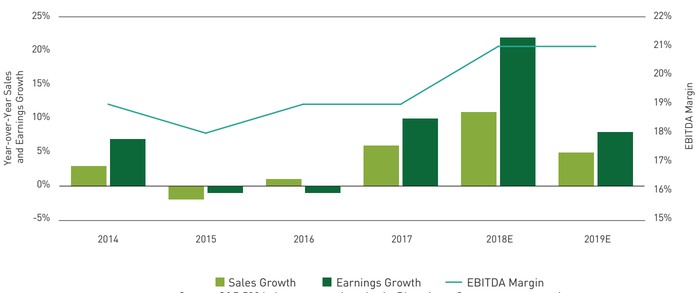
FUNDAMENTALS: SOLID PROFITS OFFSET BY HIGH LEVERAGE

Strength: Solid Operating Trends

S&P 500 Index companies reported sales and earnings growth of 8 percent and 9 percent, respectively, in 3Q18, and the outlook for 4Q18 results is solid. Margins have remained steady over the last several years, as companies have effectively managed costs through the cycle.

However, as the benefit of tax cuts rolls off and as some economies slow, operating trends may moderate (Figure 1). Deregulation in some industries is a focus for regulators and Materials, Energy and Utility sectors may benefit from less regulation while scrutiny is high in Media and Healthcare. U.S. bank regulations are likely materially softening for regional banks, but not as much for money centers. Federal tax cuts and foreign cash repatriation enhanced companies' financial and operational flexibility and drove a material reduction in corporate bond issuance in 2018. (So far, proceeds from repatriation have been relatively balanced among shareholder enhancements, debt reduction and capital expenditures.) Cybersecurity, data privacy, reputation and other ESG risks are increasingly relevant.

FIGURE 1: S&P 500 PROFIT GROWTH IS FORECAST TO SLOW



Source: S&P 500 Index on a per-share basis, Bloomberg, Street consensus estimates.

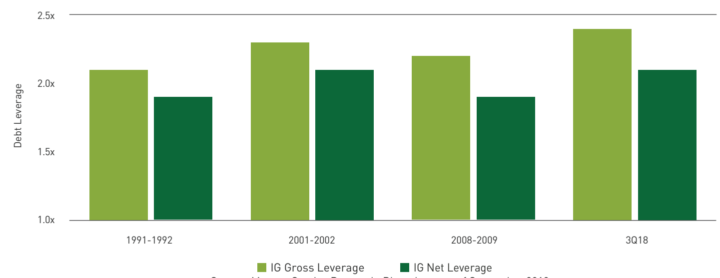
Risk: Record High Gross Leverage Is a Key Risk

It's well documented that the average credit quality of the IG corporate bond market has been declining for decades. In the ICE Bank of America Merrill Lynch Corporate Index, 50 percent of issuers were BBB at the end of 2018, versus 38 percent in 2011. While there is no one reason for this, rising indebtedness has certainly been a factor.

Furthermore, accommodative monetary policies, tax reform and low financing costs have sustained merger activity—much of it debt-financed—at a high level for the last few years. Company efforts to maintain a strong IG rating (A minus or better) have waned during this cycle, as the low after-tax cost of debt incentivized management to borrow heavily and quality spreads were very tight.

High debt leverage has weighed on creditworthiness (Figure 2) and we expect agency credit downgrades to outnumber upgrades. For instance, at S&P, global corporate bond potential rating upgrades (e.g. issuers with positive outlooks or on CreditWatch with positive implications) numbered 339 in November, lagging 544 potential corporate bond downgrades, for a potential upgrade-downgrade ratio of 0.6:1. However, larger IG companies involved in debt-funded M&A are now primarily focused on deleveraging. And, as financial conditions have tightened and financing costs have risen, merger activity may moderate going forward.

FIGURE 2: GROSS LEVERAGE EXCEEDS PRIOR RECESSIONARY PEAKS



Source: Morgan Stanley Research, Bloomberg, as of September 2018.

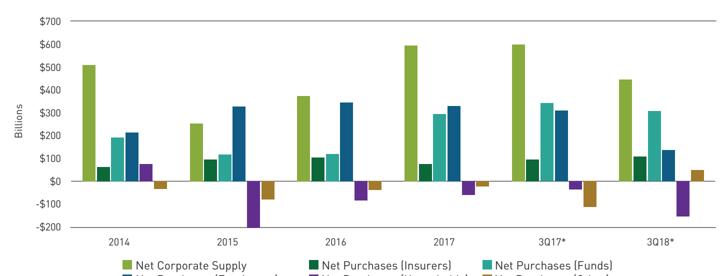
TECHNICALS: NET ISSUANCE AND FOREIGN FLOWS SLOWED

Mutual Fund Outflows Offset by Steady Institutional Buying

Gross IG corporate bond supply was just $210 billion in the fourth quarter of 2018, down from $280 billion in 4Q17. And, more significantly, on a net basis after redemptions, fixed rate IG corporate issuance was just $4 billion in the fourth quarter, down from $56 billion a year ago, per Barclays estimates. For the full year, IG corporate fixed rate net supply was just $277 billion, versus $490 billion in FY17. This is the lowest net supply since 2007.

In terms of demand, foreign purchases of corporate bonds have slowed primarily due to higher U.S. dollar hedging costs. Purchases by mutual funds and ETFs have also slowed notably. IG bond mutual funds reported $40 billion of outflows in 4Q18, as compared to $40 billion of inflows in 4Q17. Inflows were $20 billion in FY18, as compared to $138 billon of inflows in FY17, per ICI. However, private and public pensions, as well as insurers, have been steady buyers of corporate bonds (Figure 3).

FIGURE 3: SUPPLY AND DEMAND



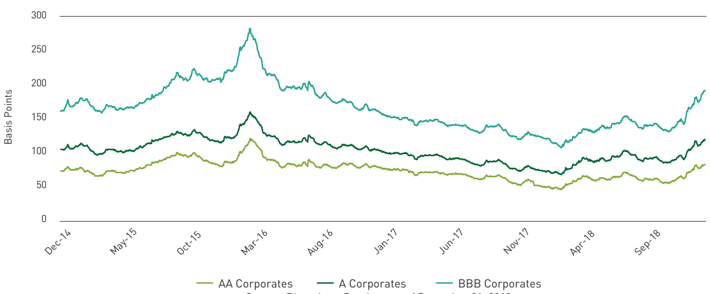
* Note: Quarterly figures are seasonally adjusted annual rates. Seasonal adjustments are made to remove the seasonal components of time series graphs. Source: Federal Reserve Flow of Funds, as of 3Q18.

VALUATIONS: IG CORPORATE BOND SPREADS WIDENED

Quality Spreads Gapped Out on Risk Aversion

Looking back, 4Q18 was a risk-off period for IG corporate bonds. For instance, the yield spread differential between the Bloomberg Barclays IG Corporate Bond Index and duration-matched U.S. Treasuries widened by 47 basis points (bps), finishing 2018 at an average spread of 153bps. In addition, lower-quality corporates, specifically BBB-rated bonds, gapped out 60bps, underperforming higher-quality counterparts such as A-rated corporates, which were 34bps wider. As expected in a risk-off environment, higher-quality AA-rated corporate bonds outperformed the IG corporate market with spread widening of 27bps in 4Q18. At 73bps, the A-rated corporate to BBB-rated quality spread moved 26bps wider in 4Q18 and is currently at its widest since August 2016 (Figure 4).

FIGURE 4: SPREADS WIDENED IN RISK-OFF ENVIRONMENT



Source: Bloomberg Barclays, as of December 31, 2018.

SUMMARY OF KEY PERSPECTIVES

Today's challenging corporate credit environment offers opportunities for long-term IG investors. Recent spread widening should create attractive entry points during 2019 as valuations have improved. While price and ratings risk have ticked higher, default risk for IG corporates remains near zero.

To manage volatility, deleveraging plans from large acquirers should be heavily scrutinized, and companies and sectors should be analyzed independent of the ratings agencies to determine which ones can best ride out any uncertainties in macro trends. In such an environment, we continue to focus on investing client funds in what we believe to be creditworthy corporate borrowers with solid business profiles, good financial flexibility, credible leverage and/or rating goals and balanced ESG risk profiles.

Credit Trends Dashboard

In our Credit Trends Dashboard, we capture our views of the key drivers of IG corporate credit.

TRENDS	Weakness				Strength	
Operating Trends				X		S&P 500 companies reported growth in sales and operating earnings of 8% and 24%, respectively in 3Q18, as well as solid outlooks for 4Q18 results.
Economy				X		U.S. GDP is solid, but the growth rate is challenged by ongoing trade tensions and declining oil prices.
Regulatory			X			Materials, Energy and Utility credits may benefit from less regulation, while regulatory scrutiny is high in Media and Health Care.
Central Bank Policy			X			Fed sees a gradual approach to rate increases, while remaining data dependent; developed central banks are normalizing policy.
Event Risk			X			Accommodative monetary policies, tax reform, economic growth and low financing costs have sustained merger activity at a high level.
Management/ESG		X				Federal tax cuts and overseas cash repatriation enhanced financial flexibility. Cybersecurity, data privacy, and reputational concerns are increasingly relevant.
Financial Leverage		X				Industrial gross debt leverage could move higher if a slowdown emerges. Companies that performed debt-funded M&A are now focused on deleveraging.
Rating Trends		X				At S&P, potential global corporate rating upgrades lagged downgrades, for a potential upgrade-downgrade ratio of 0.6:1.
Flows/Technicals		X				IG funds reported -$40B of outflows in 4Q18 and $20B of inflows for FY18 compared to $41B of inflows in 4Q17 and $138B for FY17.
Geopolitical Risk	X					U.S. government tensions with China, Russia and/or Saudi Arabia may increase geopolitical risks.

Source: Breckinridge Capital Advisors, Bloomberg, FactSet, Standard & Poor's Financial Services, LLC, as of December 31, 2018, and ICI, as of December 26, 2018 and January 2, 2019.

Statistical Summary

	As of 12/31/18		OAS Change (bps)		
	YTW (%)	OAS (bps)	MTD	QTD	YTD
Bloomberg Barclays U.S. Corporate Index	4.20	153	16	47	60
Corporate Quality Spreads					
AAA Corporate	3.54	78	7	21	25
AA Corporate	3.47	83	7	27	34
A Corporate	3.86	120	10	34	47
BBB Corporate	4.60	192	20	60	71
BBB-A Corporate	0.74	72	10	26	24
Corporate Sector Spreads					
Basic Industry	4.55	185	16	51	70
Capital Goods	4.09	142	13	51	65
Communications	4.55	183	16	41	50
Consumer Cyclical	4.18	153	19	53	68
Consumer Non-Cyclical	4.16	147	17	48	61
Energy	4.58	188	17	63	69
Financial Institutions	4.09	147	16	45	63
Technology	3.90	124	11	43	46
Transportation	4.14	139	18	39	54
Utility	4.21	144	13	39	53
Supply/Demand ($Billions)					
	3Q18*	**3Q17***	**2017**	**2016**	**2015**
Net Corporate Supply	446	600	596	374	253
Net Purchases (Foreigners)	136	311	329	345	327
Net Purchases (Funds)	307	342	295	119	118
Net Purchases (Households)	-155	-37	-60	-85	-206
Net Purchases (Insurance)	108	96	76	104	95
Net Purchases (Other)	50	-112	-24	-38	-81

Sources: Bloomberg Barclays, ICI, Fed Flow of Funds. * Note: Quarterly figures are seasonally adjusted annual rates. Seasonal adjustments are made to remove the seasonal components of time series graphs.