INDOSUEZ WEALTH MANAGEMENT

MONTHLY HOUSE VIEW

MARKETS, INVESTMENT & STRUCTURING – AUGUST 2019

FOCUS

FALLEN ANGELS: RISKS AND OPPORTUNITIES

EQUITIES

CENTRAL BANKS: READY TO ACT?

This is an excerpt of our Monthly House View. Should you wish to receive the full version, please contact us.

EDITORIAL

VINCENT MANUEL

Chief Investment Officer,
Indosuez Wealth Management

ON THE SUNNY SIDE OF THE STREET

Dear Reader,

Over the past month, Wall Street and other markets abandoned the cautious attitude adopted in May on the back of concerns regarding the trade war and its potential impact on GDP growth. Expectations of additional monetary easing on both sides of the Atlantic worked their magic and caused the one-way bull trade which pushed the S&P 500 to a new all-time high on 15 July above 3'000 points.

Can the sun shine on all sides of the financial planet at the same time? Normally not. What is abnormal is to have such stunning equity performance while treasuries and gold are also outperforming. This is typical of markets driven by central banks, a trade which lifts all boats simultaneously.

Listen to the markets' song today: it is as if there is a Pied Piper playing the following refrain, pushing bear investors into early hibernation:

- *"Afraid of lower earnings growth? Central banks will deliver!*
- *Afraid of lower GDP growth? Central banks will deliver!*
- *Afraid of resuming trade war? Central banks will deliver!*".

The central banks' put has probably never been as strong as today. Under these circumstances, it is very risky to fight the trend and question central bankers' commitment. However, you may well wonder whether market prices do not already reflect all this potential good news which is yet to be confirmed.

Even if available macro-economic data does not fully justify more easing from the Federal Reserve today, there is now a high probability that the policy interest rate will be cut this month, and if not, at the September FOMC meeting. A preventive rate cut by the Fed logically means that the macro-economic route ahead of us will be darker. Yet, so far, everyone is looking only at the sunny side of the street: a nice rate cut by the Fed, and more quantitative easing in Europe.

In this context, there is a real risk of a technical market correction, should the Fed disappoint, or should corporate earnings and the Q2 US GDP release come in below estimates. Under a historically low volatility regime, and with unusual market correlations, investors would do well to keep a balanced exposure to risk assets, or add diversification and protection in order to safeguard year-to-date performances.

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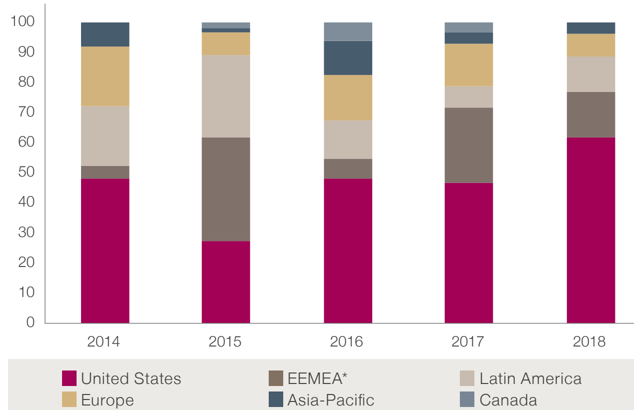
FALLEN ANGELS: RISKS AND OPPORTUNITIES

Potential fallen angels are corporates on the cusp of investment grade and high yield, i.e. rated BBB- with negative outlooks or negative rating watches. Thus, movements in ratings on this category can be price sensitive and disconcerting for investors.

Given the size of the US bond market at USD 7.1 trillion (issued by non-financial corporates), it is likely to have the highest number of fallen angels in 2019. The US has had the highest proportion of fallen angels globally in four out of the past five years (61.5% in 2018, see chart below). In the first half of 2019, the eight fallen angels globally include six in the US, one in Canada and one in China. By sector, a large majority are utilities and homebuilders.

FALLEN ANGELS BY REGION, %



*EEMEA: Eastern Europe, Middle East and Africa

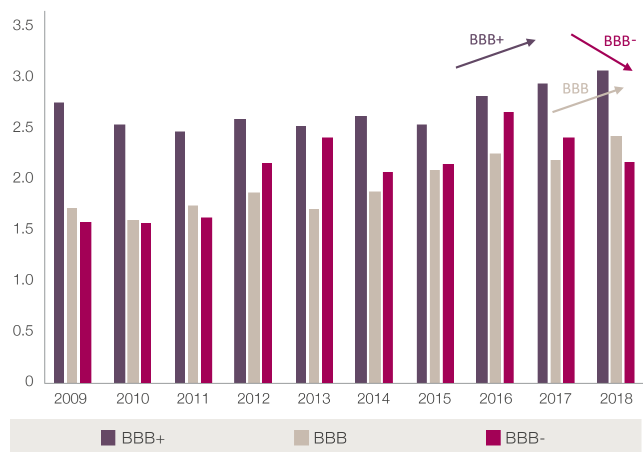
Source: S&P, Indosuez Wealth Management
Past performance does not guarantee future performance.

Although the EEMEA (see brown bar in the chart above) had a lower amount of fallen angels in 2018 compared to 2017. The European investment grade segment of the fixed-income market currently offers little return as spreads are at historically tight levels at 65 basis points (0.65%). Better opportunities can be found elsewhere particularly in the GCC (Gulf Cooperation Council), in the US, and in China such as Chinese investment grade bonds, and specifically perpetual bonds with a high coupon reset. It provides high incentive for issuer to call the bond at call date and to repay bondholders a price above par.

Selective GCC credits denominated in USD also offer better risk-reward and have proved to be resilient during the market sell-off in December 2018, thanks in part to a stable investor base.

In the US, the fear of fallen angels has made the low-investment grade segment more attractive. When we compare credit fundamentals among all BBB rated non-financial corporates, we can see more reassuring signs at the weakest rating category of BBB-. The BBB- category has been deleveraging since 2016, in contrast with the re-leveraging trend of BBB+ and BBB rated segment (see chart below).

NET LEVERAGE OF US NON-FINANCIAL BBB RATED CORPORATES 2009-2018



Source: S&P, Indosuez Wealth Management
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While we are not forecasting or expecting an imminent recession in the US, we see spread widening pressure at the BB level rather than the BBB categories at this late point in the cycle. The current yield differential between BB and BBB categories is 84 basis points, 32 basis points below the 5-year average of 116 basis points (see chart on the next page). Arguably, this implies downside risk for BB spreads to widen and an upside potential for BBB to tighten. During times of economic stress and flight-to-quality, that is when investors move capital away from risky assets to safer assets, BB bonds are more vulnerable to a market correction. Looking back at January 2016, when the oil price plunged to below USD 30 per barrel, US BB spreads spiked at 537 basis points while US BBB spreads rose to 273 basis points; the BBB-BB spread differential was 3 times wider than its current 84 basis points level.

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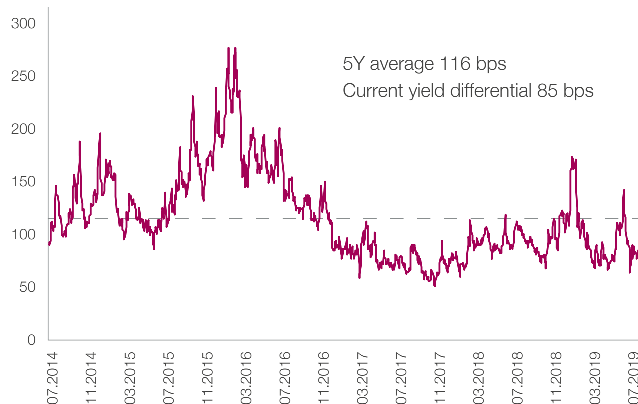
FALLEN ANGELS: RISKS AND OPPORTUNITIES

YIELD SPREADS BETWEEN US BBB AND US BB CORPORATES 2014-PRESENT, BPS



Source: S&P, Indosuez Wealth Management
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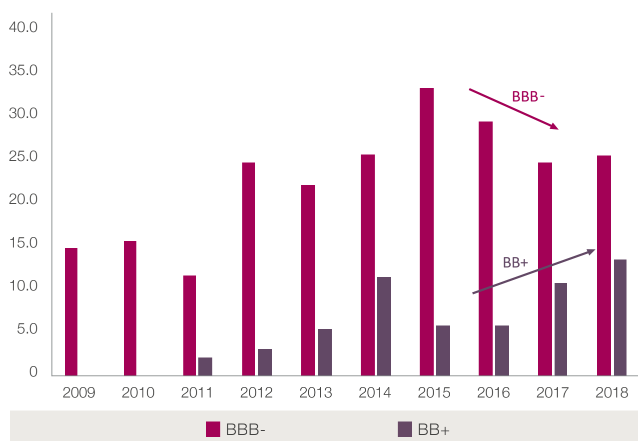
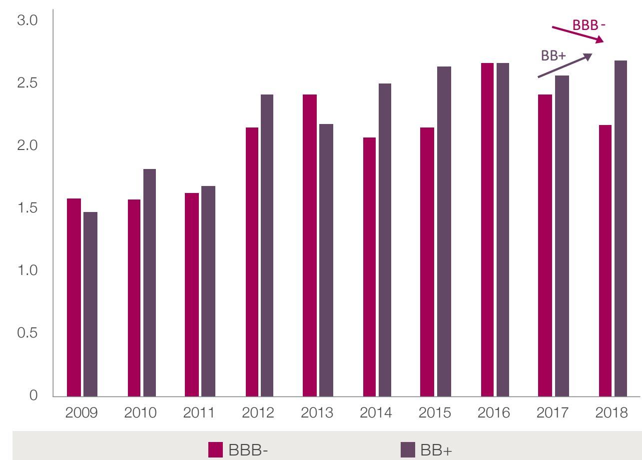
From a fundamental perspective, during the high market volatility in 2018, BBB- corporates demonstrated their willingness to strengthen their balance sheets by reducing dividend pay-outs in contrast to BB+ corporates' more generous pay-out levels, albeit at a lower level (see charts below). In general, BBB- corporates have more leeway to defend their ratings (can cut share buybacks and pursue asset disposals, in addition to dividend reductions).

MEDIAN DIVIDEND-PAYOUT RATIO OF US NON-FINANCIAL BBB- VERSUS BB+ RATED CORPORATES 2009-2018, %



Source: S&P, Indosuez Wealth Management
Past performance does not guarantee future performance.

MEDIAN NET LEVERAGE OF US NON-FINANCIAL BBB- VERSUS BB+ RATED CORPORATES 2009-2018



Source: S&P, Indosuez Wealth Management
Past performance does not guarantee future performance.

While the median BBB- corporates have more leverage than they did a decade ago, the BBB category usually has better financial strength and flexibility to weather economic downturns than the BB category. BBB rated corporates are substantially larger and often more profitable and less burdened by the cost of servicing of their debt.

From a markets technical perspective, BBB bond spreads have lower correlation to macroeconomic conditions and would fare better in times of market sell-offs. During the market sell-offs in December 2018, global fund flows to investment grade corporates continued to be positive while fund flows to high yield corporates quickly turned negative. Above all, BBB corporates have a clear advantage from their unsecured debt structures that give them an ability to sell assets or issue secured debt to shore up liquidity if needed.

However, the risks associated with fallen angels should not be taken lightly given the size of the total global debt issued by this segment, USD 220 billion at end-2018 using data from Moody's. However, predicting the timing of the fallen angel trend is difficult since it is not highly correlated with macroeconomic cycles but rather driven by industry-specific or idiosyncratic risks related to that specific company. Rigorous monitoring and fundamental analysis remain crucial for high-conviction trade ideas to take advantage of the market volatility.

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Edited as per 19.07.2019.