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News Release

For Immediate Release

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"Unique Credit Cycle" Stretching Longer Owing to Lower Risk-Taking

Credit Opportunities Harder to Spot, Western Asset Deputy CIO Says

(Pasadena, CA, March 31, 2017) – In a quarterly webcast entitled, "Credit Opportunities Are Still Out There – If You Know Where to Look," Western Asset Management Deputy Chief Investment Officer Michael C. Buchanan stressed that there continues to be credit opportunities, but it takes a keen eye to spot them.

"There are opportunities in the credit market," Mr. Buchanan said. "It's not as broad based; it's not as simple perhaps as buying indexed products or the market in general. You really have to know where to look. We rely on our fundamental research teams globally to deliver insight."

This points in fixed to the value of active management income markets, where many funds not bound by adherence to an index – as opposed to equities – have outperformed over market cycles.

Watch the replay from the Western Asset Management webcast, "Credit Opportunities Are Still Out There – If You Know Where to Look."

While Mr. Buchanan noted that the credit cycle is mature, he believes that caution on the part of corporate management teams has resulted in limited excess risk taking.

"Risks spirits with respect to corporations are still very much subdued," he said. "The feedback from our research team is we're not yet broadly seeing aggressive risk-taking by management teams."

"It's understandable to think about this just from a psychological perspective. For companies, 2007, 2008 was an extreme period unlike one that we have witnessed in our lifetimes. Companies saw their competitors, their suppliers, and their customers go out of business by not having control of their balance sheets."

"It would be only natural to expect that it's just going to take longer for those CFOs, those CEOs, those treasurers, to start pursuing those risk-taking behaviors that ultimately lead to a turn in fundamentals. So just that risk aversion alone, we thought, would be one of the factors that would contribute to a longer credit cycle this time around."

"This is a unique credit cycle," Mr. Buchanan concluded, addressing the larger shape of the market. "We need to recognize that. There are unprecedented forces at play that we think are going to create a longer cycle than what we've witnessed historically."

“This particular cycle is going to be unique, for three main reasons. One, regulatory. If regulators were too liberal going into the Financial Crisis, we felt it was likely that pendulum would swing, and we would see very stringent regulation that would favor bond holders.”

“Also, central bank accommodation. It was global, it was unprecedented, that we also believed would be a favorable backdrop for credit.

On the regulatory front, Mr. Buchanan pointed to dramatic improvement in the capitalization of both US and European banks, the result of stricter rules governing equity capital markets.

“One thing was very clear to us – and this came from our financials team – that regulators were going to do everything that they could to ensure the financial stability of our key banks,” Mr. Buchanan said. “You'll see that this trend has very much evolved. Banks clearly in 2007 and 2008, going into the Financial Crisis, had insufficient capital. It's even more glaring when you look at the prevailing standards, the Basel II standards back then, and you apply the more stringent Basel III standards of today. The tier one common equity ratios looked very shallow.”

“You can also see kind of a difference between how the U.S. handled this versus the European banks. The U.S took meaningful charges earlier on, as you see by drop in capital from 2007 to 2008. European banks chose to take a more gradual approach. But both ended up in the same place; very strong capital ratios and dramatic improvement in their balance sheets.”

“Virtually all of these major banks now have record capital ratios,” Mr. Buchanan summarized. “Again, this was a trend that we thought would unfold. Financials are a very big part of the investment-grade market, so to have a regulator forcing that fundamental improvement gave us quite a bit of comfort in our exposure, not only to financials but into corporates in general.”

“Central bank accommodation has helped prolong the favorable credit environment. Central banks have provided historic levels of liquidity. Balance sheets of the BOJ, ECB, Fed and BOC have grown by over USD$10 trillion since 2010. None of these central banks have given any indication they would look to start contracting their balance sheets any time soon. Rather, they remain engaged and focused on maintaining liquidity.”

He also noted that regulations limiting investment banks' ability to underwrite leveraged buyouts (LBOs) has reduced the risk of a steep rise in defaults in the near future.

Corporations generally remain committed to conservative balance sheet management. In the investment grade market an increase in leverage is primarily attributable to two forces. One of these relates to higher quality companies making “like-for-like” acquisitions. These types of acquisitions tend to have fairly predictable and reliable deleveraging characteristics over time. High quality companies with virtually no debt have chosen to take advantage of the low rate environment and add some debt to their balance sheets. These companies remain very high quality and defensive.

In the high yield market, weak commodity prices resulted in a high degree of stress in the energy and the metals & mining industries. These sectors witnessed a very high level of defaults during 2016. But now, with a recovery in commodity pricing, and weaker, vulnerable companies already defaulted, the default rate for the remaining cohort of credits is dropping rapidly. The remaining sectors in high yield have experienced no change in their leverage over the past 5 years and defaults are at historically low levels.”

Mr. Buchanan discussed those areas where Western Asset was sourcing opportunities including the subordinated bank debt and energy markets in investment grade credit and issue specific examples in the high yield and emerging market sectors.

Mr. Buchanan noted the Fed's impact on credit markets.

"Credit has historically done well in a gradually rising rate environment," he reported. "We still think that will be the case. There's room for spread compression. As rates go higher, if they're going higher for the right reasons, if the economy is generally doing better, we expect corporates to do better. They will absorb some of that rate impact, higher rates, with tighter spreads."

Asked about Western Asset's duration bias, Mr. Buchanan explained, "Our longer duration bias, if you want to call it a bias, is definitely the result of two things. We're always looking at the overall risk profile of our portfolio and we think of duration in that context. So typically, if we're going to have elevated levels of risks via spread sector exposure, we tend to balance that with our true interest rate duration. Throughout a cycle, those two tend to work well together. We have brought some of the risks down over the last year and a half, as valuations have gotten tighter."

"You're obviously going to own less corporate credit today than you did a year ago, because valuations have changed so much," Mr. Buchanan continued. "So, at the margin you'd expect, as we brought risks, the bias might be not to have as much duration in our portfolios. You could see our duration coming down just as a result of how we've managed risk in our portfolio."

"But our durations are always going to be reflecting our overall macro view," he said. "At the margin, we're going to be making changes or shifts to our duration to our curved positioning based on our overall macro view. As portfolio managers, we are going to be thinking about how that works within the context of a diversified portfolio that has a broad array of risks assets."

Asked about expected moves by the U.S. Federal Reserve, Mr. Buchanan said Western Asset expected the rate hike announced March 15, but was more concerned with the Fed's reasons.

"What's really changed is financial conditions," he said. "Financial conditions have improved, whether it's what you see in equity pricing, what you see in spread markets in general, what you see with the U.S. dollar. It gives the Fed a little more of a perspective, and we don't think you're going to hear a very different message beyond that. We don't expect the dots to move much from where they were. We do think that the Fed certainly is aware of some of the pro-business initiatives and policies that are being talked about by the Trump Administration."

"But the Fed has always been clear that they want to rely on the actual data," Mr. Buchanan said. "So, until they see more clarity, we don't expect them to move to a clearly more hawkish stance. Three hikes this year, in 2017, seems reasonable. That's what the market's generally pricing in."

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About Michael C. Buchanan CFA
The Deputy Chief Investment Officer of Western Asset Management Co., Mike Buchanan is a specialist in high yield, having headed the Global Credit team. Prior to joining the firm in 2005, Mr. Buchanan served as Managing Director and Head of U.S. Credit Products at Credit Suisse Asset Management, and as Executive Vice President and Portfolio Manager at Janus Capital Management. He also worked at BlackRock Financial Management as a managing director and portfolio manager, and at Conseco Capital Management as a vice president and portfolio manager. A Certified Financial Analyst, Mr. Buchanan earned his B.A. from Brown University.

About Western Asset Management

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About Legg Mason
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