

Equivocating Doves Deliver Credit Opportunities

Back in 2014, Janet Yellen stated that she is “doing this to help American families who are struggling in the aftermath of the Great Recession.” She was referring to her commitment—and by extension the Federal Reserve’s—to tackling unemployment and guiding the U.S. economy toward full employment. This mindset and policy stance must be considered when bearing risk in credit markets and emerging markets, particularly when denominated in local currency. Relative valuations and fundamentals also must be assessed. Looking at both considerations, we believe the current opportunity in high yield is compelling (see [Charts 1 and 2](#)).

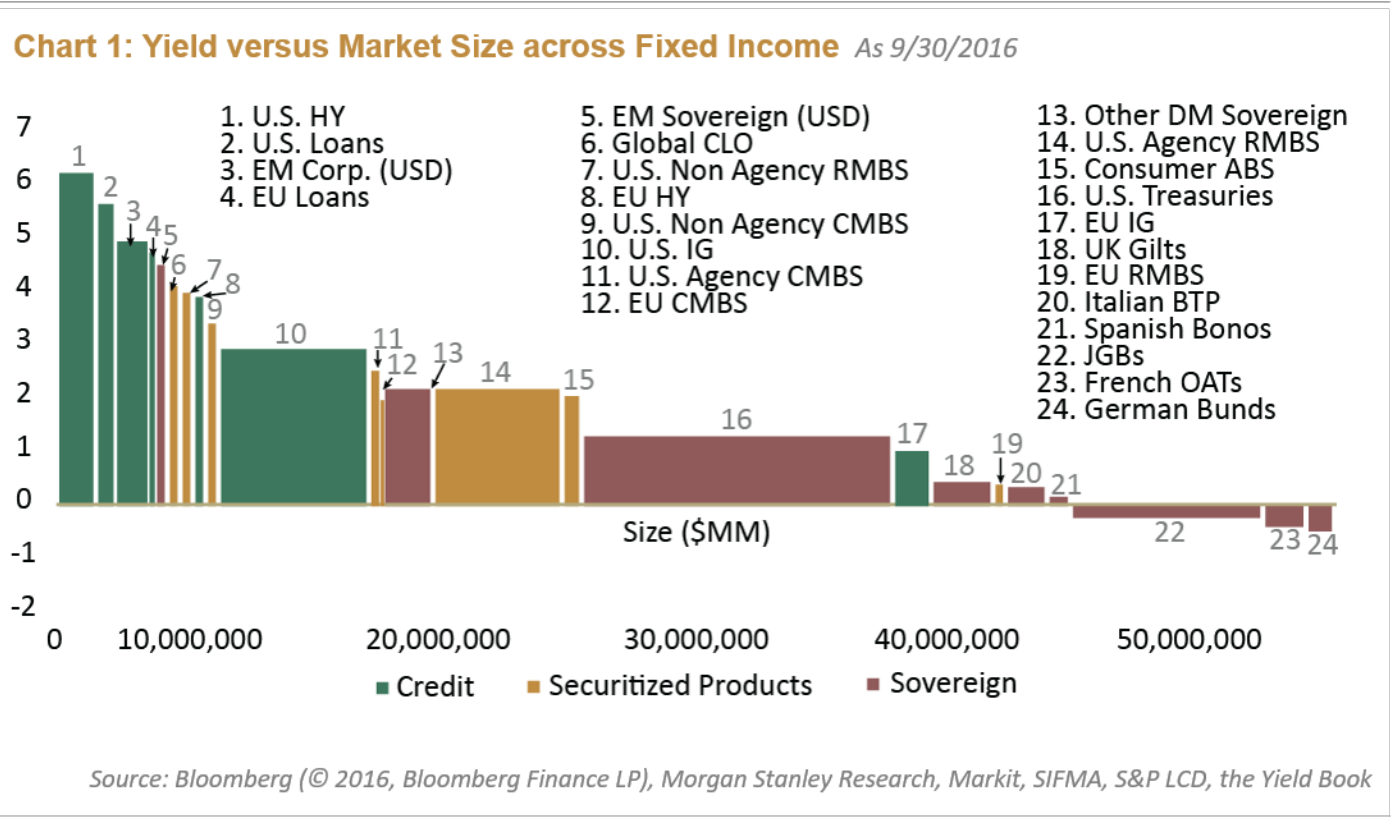
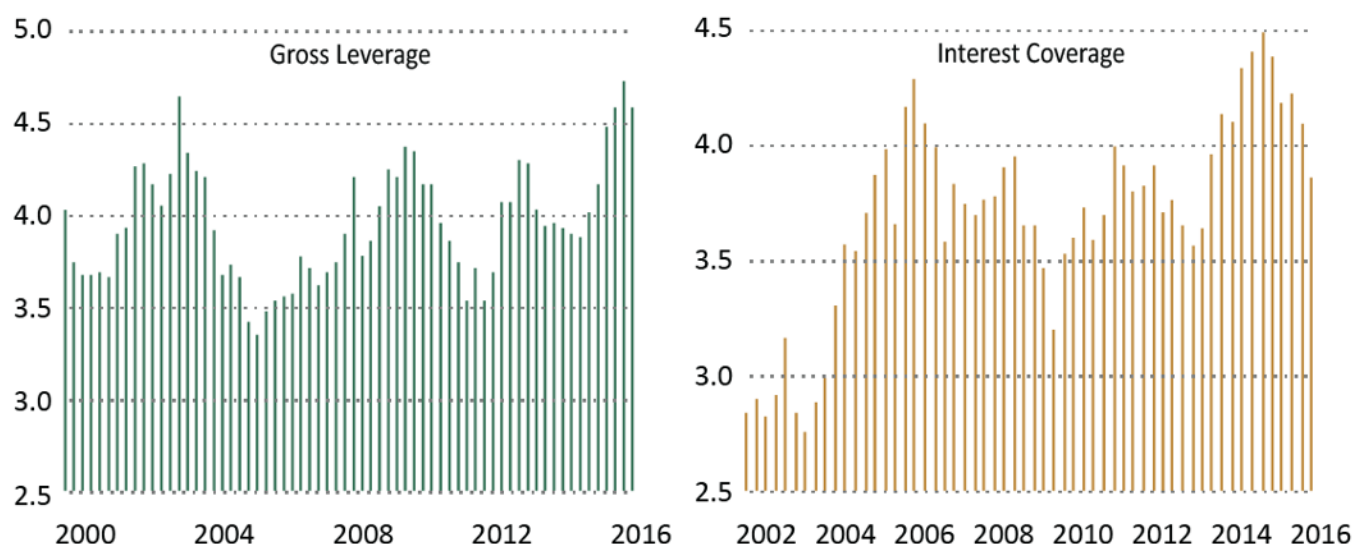


Chart 2: Leverage Is Still Elevated, but Coverage Is Solid U.S. High Yield, As of 9/30/2016



Source: Bloomberg (© 2016, Bloomberg Finance LP), Morgan Stanley Research

Trading Inflation for Full Employment

It appears that the central bank is poised to act “responsibly irresponsible” with respect to monetary tightening, to use a term from Paul Krugman’s 1999 essay *Thinking about the Liquidity Trap*. If the Federal Reserve (Fed) continues to be extraordinarily reticent in confronting inflation proactively, remains overly concerned that underemployment is firmly entrenched, and stands prepared to let the economy run a little hot, tolerating some inflation in exchange for extended, low unemployment, then we believe a material change in both perspective and positioning is warranted for credit portfolios.

Protecting against Interest Rate Risk

Both emerging market credit—hard assets and especially local currency—and higher real-yielding sovereigns may offer better protection against a dovish monetary policy stance. As well, low-quality credit, including fallen angels, single Bs, and even select CCCs, may afford the most attractive opportunities in the global fixed income markets (see [Charts 3 and 4](#)). When analyzed using a historical perspective, these credit and emerging market opportunities are particularly apparent.

Chart 3: Option-Adjusted Spreads for Global High Yield Markets

OAS: 25th %TILE – 75th %TILE, As of 10/03/2016

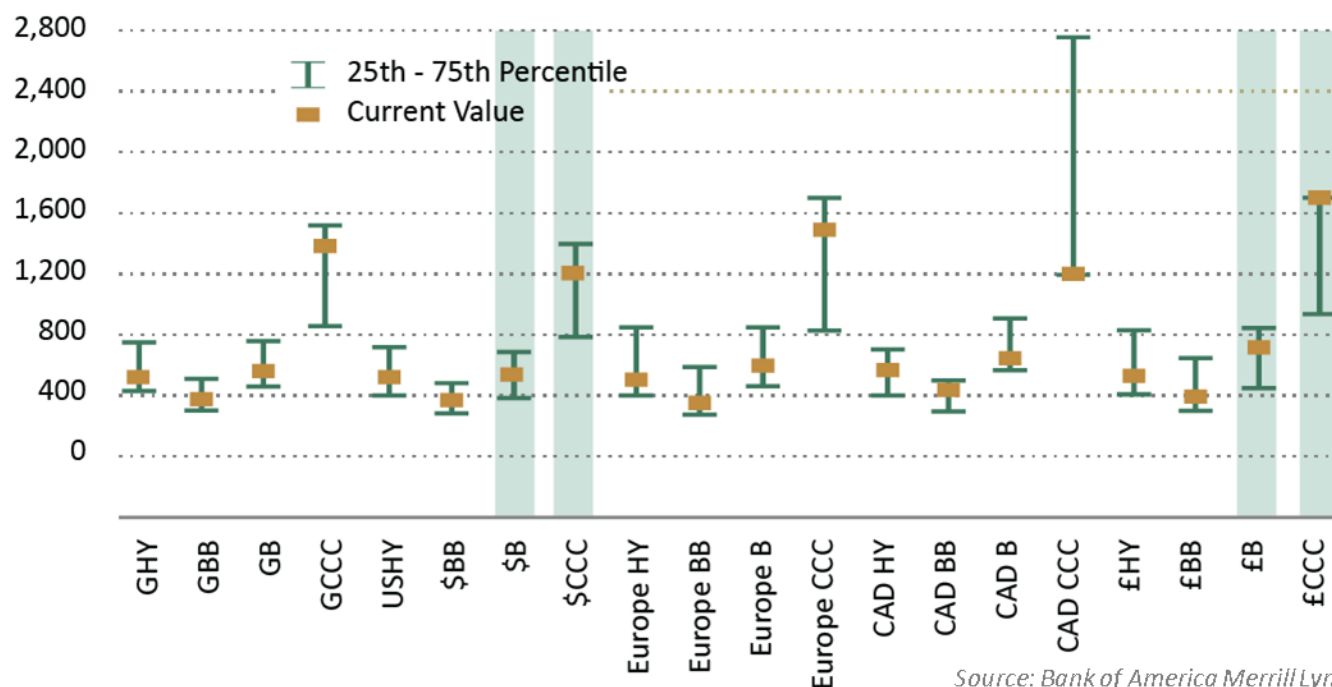
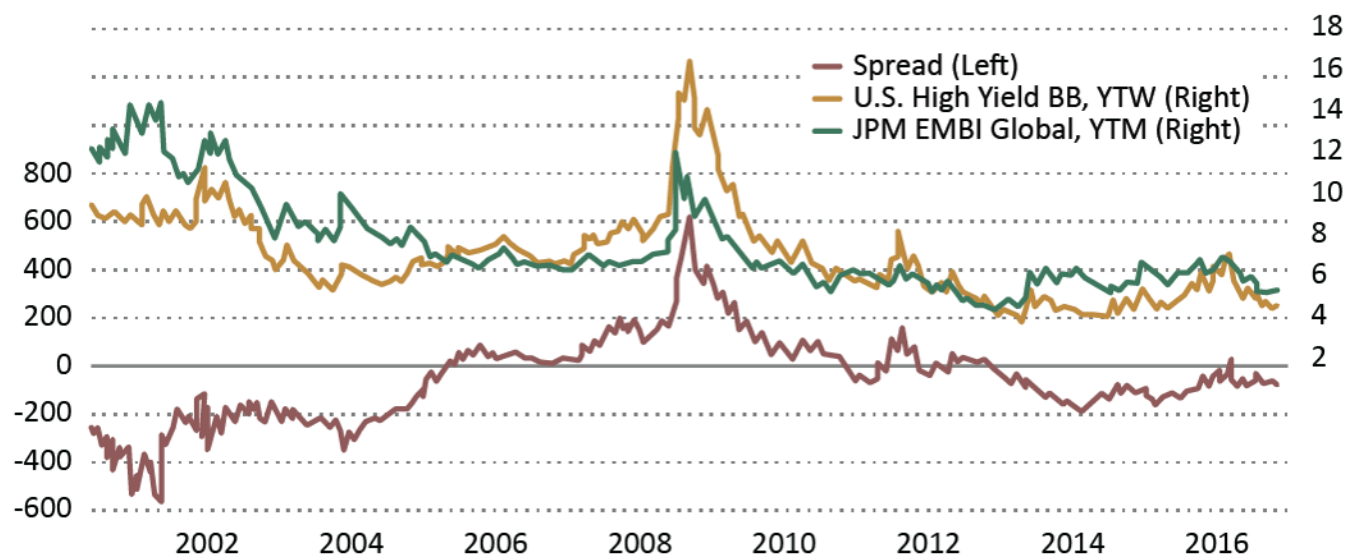


Chart 4: Select Emerging Markets Offer Value Relative to Credit

Basis Points, (%), As of 10/03/2016



Source: Bloomberg (© 2016, Bloomberg Finance LP), Bank of America Merrill Lynch

All of these positions—emerging market and single B credit—can reduce the sensitivity of a fixed income portfolio to a central bank that wants to act “responsibly irresponsible.” We believe minimizing this key risk—monetary policy “irresponsibility”—in credit portfolios is best achieved through shorter duration, mid-tier credit and select non-dollar sovereign exposure. However, further steps may need to be taken to reduce interest rate sensitivity, such as using short positions in developed market sovereign bond futures to further remove

interest rate risk while bearing select emerging market high, real-yielding local currency risk. Given these exposures, our credit portfolios will have a decidedly non-benchmark orientation. This benchmark-agnostic approach also happens to be a Brandywine Global philosophy and hallmark.

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