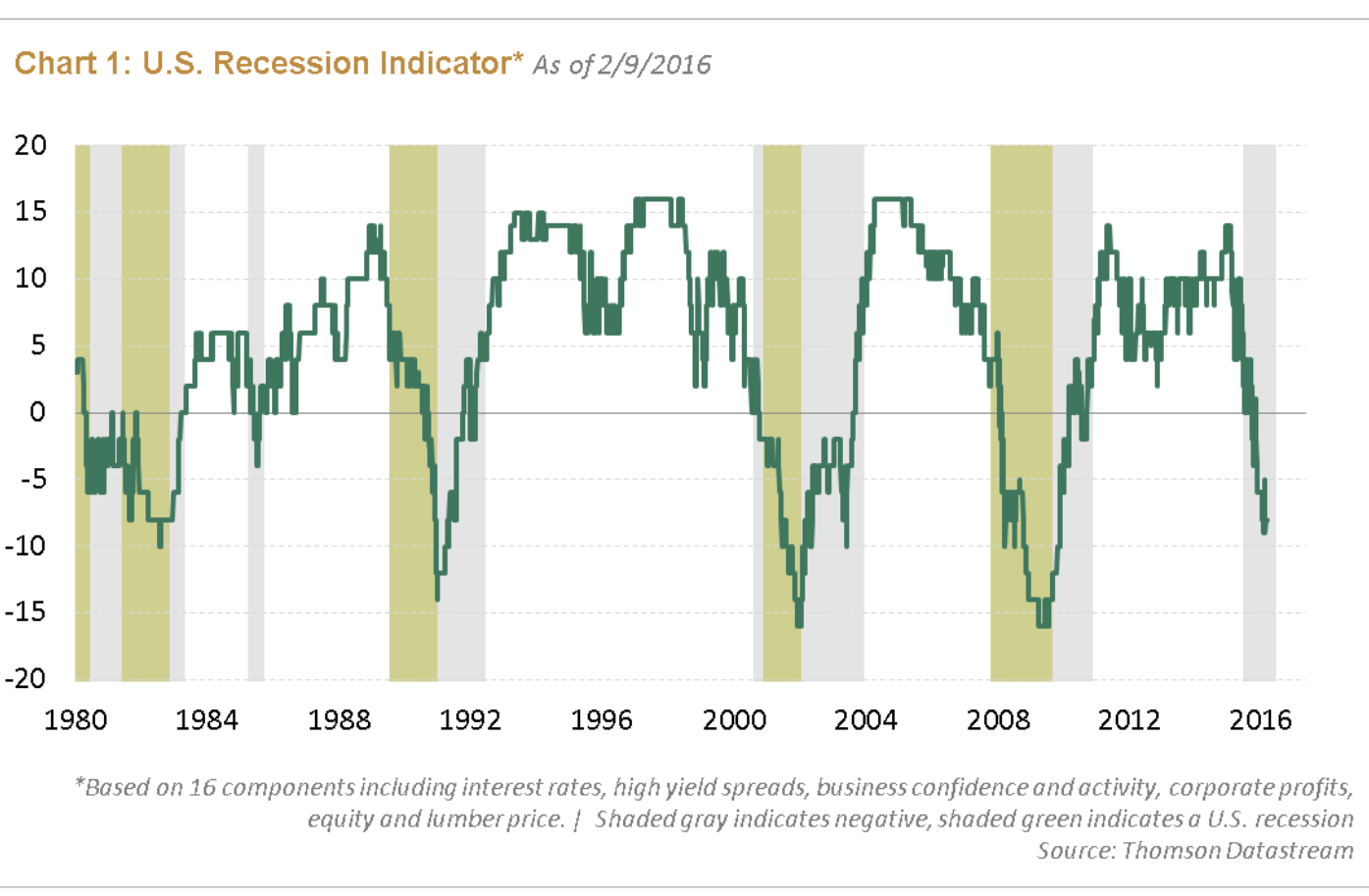


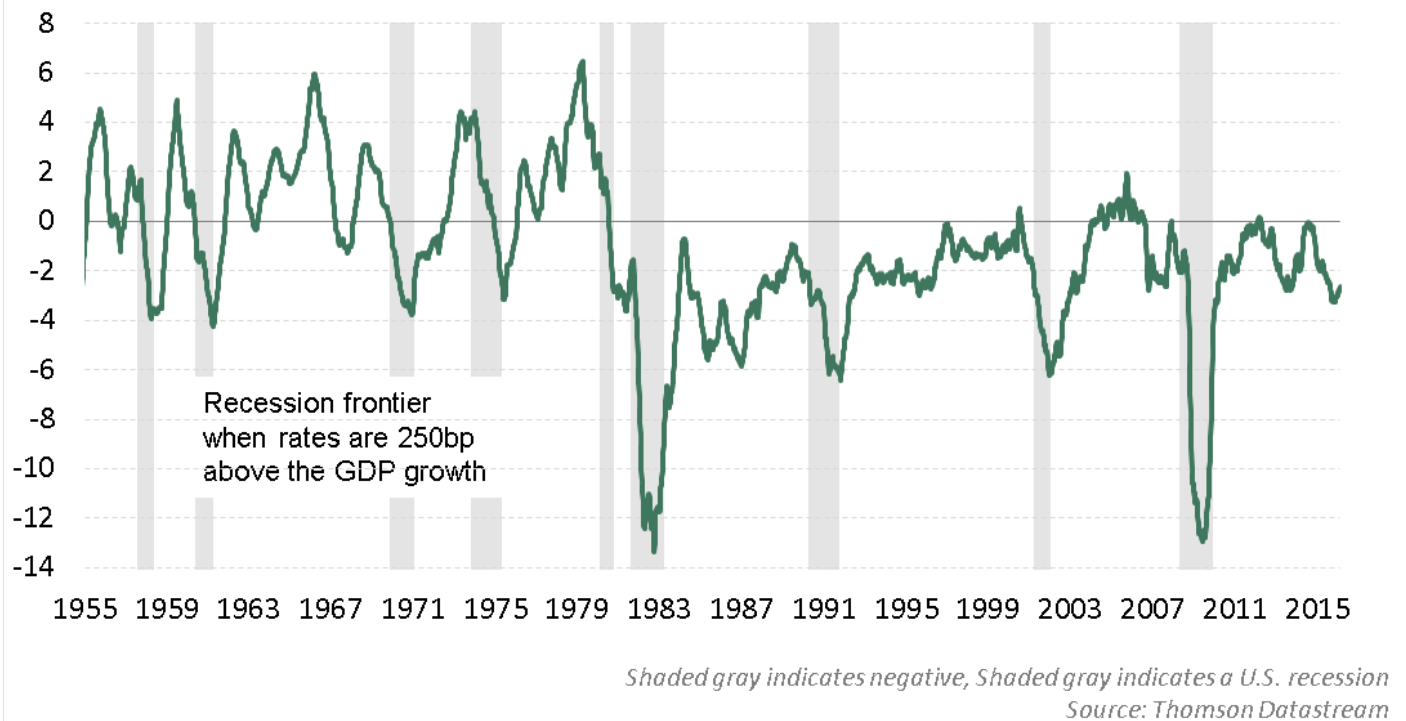
Time to Go Up in Global Credit Quality?

We believe credit markets are warning of a recession; in our opinion, these warning signs are worth paying attention to. In fact, our own proprietary models indicate the probabilities are elevated. According to our research, significant economic weakness is evident in top line revenues, margins, and credit costs. Our first indicator warns that the U.S. economy is decelerating and recession will become reality if the Federal Reserve (Fed) continues on the path toward raising rates after tapering its asset purchases.



Our second indicator compares real gross domestic product (GDP) to real longer-dated BBB bond yields. When the risk premium moves more than 250 basis points (bps) above real economic growth, the cost of incremental leverage to finance investment—or even refinance existing debt—for the majority of corporations becomes very cost prohibitive. The increased expense creates further challenges for economic growth.

Chart 2: U.S. Real GDP Minus Real BAA Bond Yields %; As of 2/9/2016

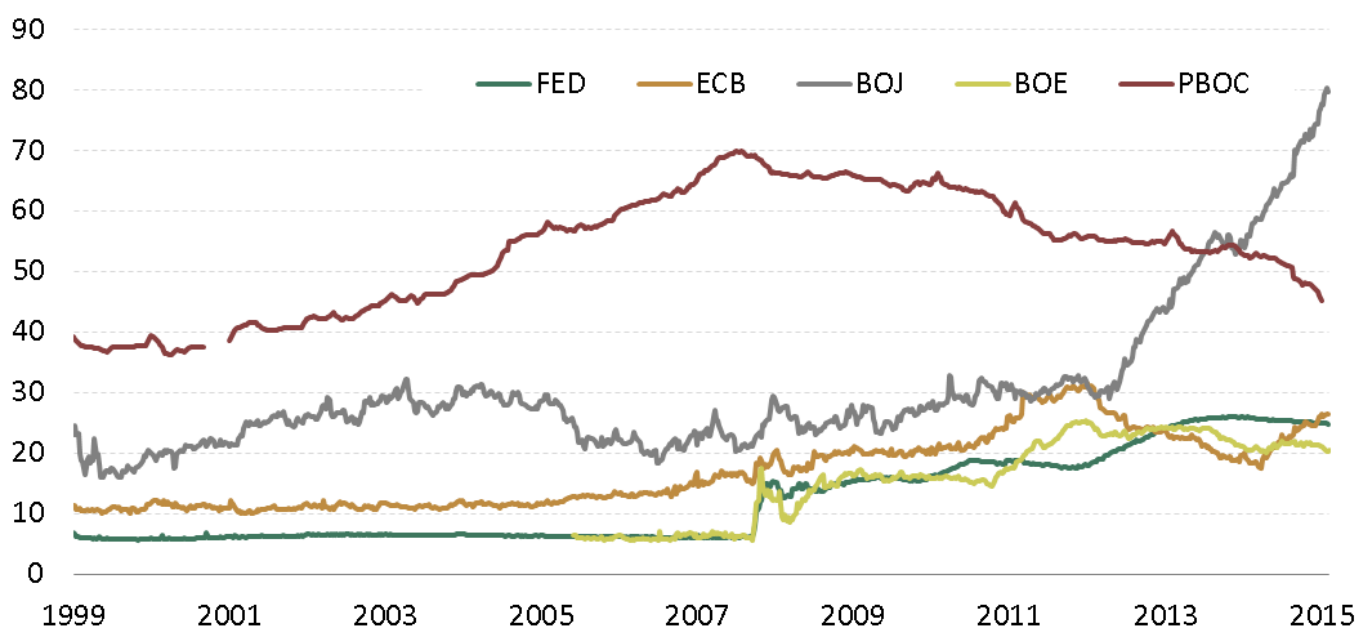


The recent 25 bps increase in federal funds rate didn't cause all these challenges. In fact, it's our view that central bank balance sheet contraction, or tapering of asset purchases, created a tighter monetary policy environment prior to the Fed's December hike.

Just as asset purchases served to tighten risk premium, suspension of these asset purchases has caused risk premia to widen as the U.S. now enters the late stage of the credit cycle.

Meanwhile, the central bank balance sheets of the remaining two G3 economies are expanding; however those expansions have done little to hamper the increasing risk premia in Japan and the euro zone. Importantly, the European Central Bank (ECB) is simply returning its balance sheet to the previous peak percentage of GDP, while Japan is desperately trying to create inflation to offset productivity improvements and demographic declines. Meanwhile, the U.S. and U.K. central bank balance sheets are stable, while the Chinese central bank balance sheet is in a continued, steady contraction.

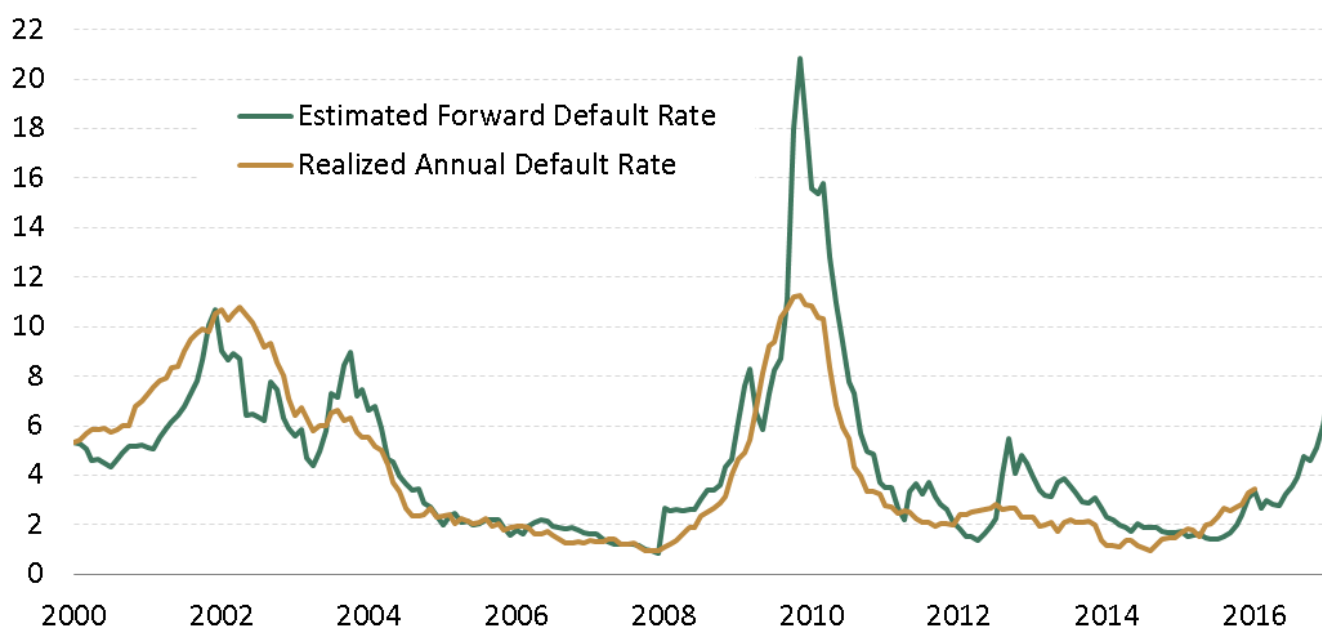
Chart 3: Central Bank Balance Sheet *As % of GDP; As of 1/27/2016*



Source: Thomson Datastream

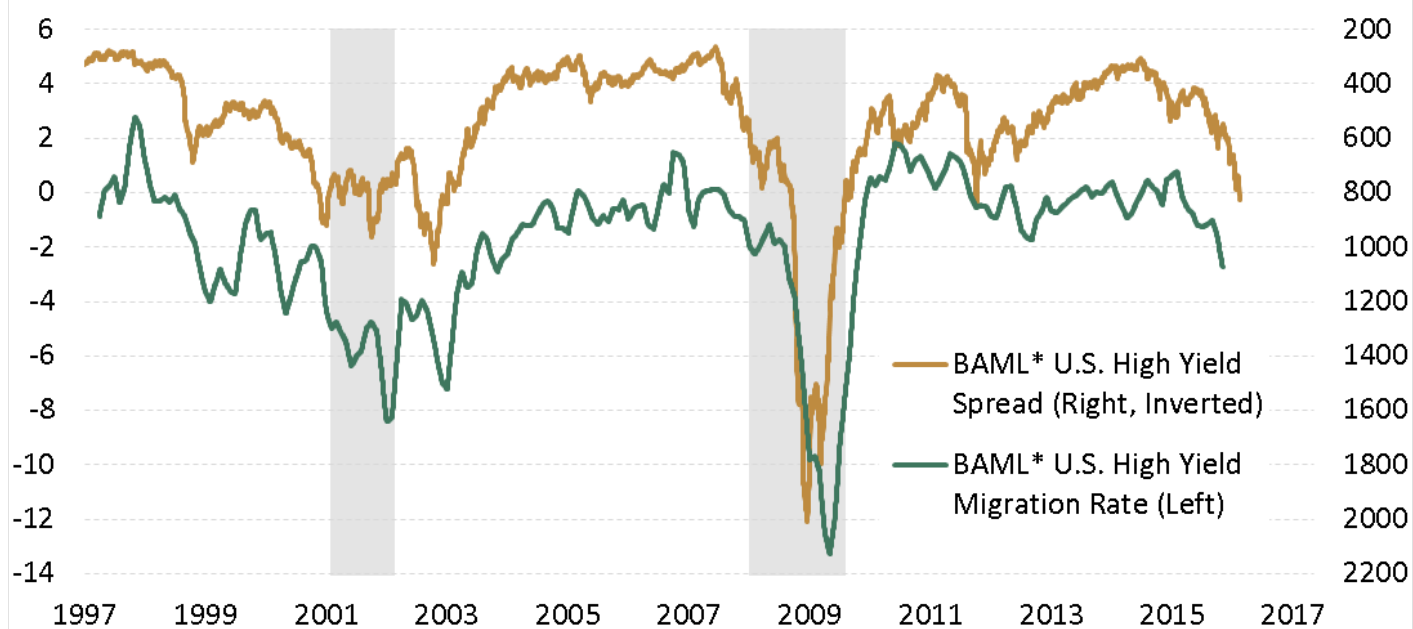
Given this environment, we believe a high-quality focus in investment grade and high yield credit portfolios is in order, at least until the U.S. and global default cycles peak and the credit downgrade/upgrade ratios stabilize. Both indicators historically signal for entry into lower-quality global credit; using the 2000-2002 recession as a guidepost, we think the high-quality focus will remain in effect for the next 6-18 months.

Chart 4: Estimated Forward & Realized Annual Default Rate %; As of 12/31/2015



Source: Thomson Datastream

Chart 5: High Yield Rating Change & High Yield Spread %; As of 2/9/2016



*BAML = Bank of America Merrill Lynch
 Shaded gray areas indicate U.S. recession
 Source: Bank of America Merrill Lynch

While the U.S. credit cycle is at a relatively mature stage compared to other regions, we believe the focus on

higher-quality credit should extend to global credit markets as well. In our opinion, going up in credit quality serves as a buffer against slowing global growth and widespread disinflation.

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