BARINGS **CONVERSATIONS**

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HEAD OF BARINGS' MULTI STRATEGY FIXED INCOME GROUP

"To me, what's happening with the yield curve is analogous to a low-grade fever; it's something to be aware of and keep an eye on, but it's probably not going to make you (or in this case, the economy) deathly ill tomorrow."

THE CHANGING FACE OF INVESTMENT GRADE CREDIT

*This piece was adapted from an interview with David Nagle. The full audio podcast can be found here.**

IN A RECENT INTERVIEW, DAVID NAGLE, CFA, HEAD OF BARINGS' MULTI STRATEGY FIXED INCOME GROUP, DISCUSSED THE INVESTMENT GRADE CREDIT MARKET, INCLUDING SOME OF THE ISSUES GARNERING HEADLINES RECENTLY AND HOW THE MARKET HAS EVOLVED THROUGH THE YEARS.

There's been a lot of talk recently about the yield curve and what it might be telling us about the economy. What's your take?

There are a number of ways to interpret the yield curve and the signals it's sending about the economy. Personally, I would be cautious, for a couple of reasons, about reading too much into it.

Many industry veterans like myself will point to the yield curve as one of the best leading indicators of slowing economic growth or a potential looming recession. While it's true that there has often been a historical correlation, the problem is—and I believe the academic literature will support this—that the timing of the signal from an inverted yield curve can be off, or it could even be just a coincident indicator rather than a reliable predictor of slowing growth or recession.

Also, some people are less than precise when discussing the yield curve. It's important to define exactly what maturities you're talking about. The 3-month/10-year curve is the one the Fed tends to focus on and the most relevant, in my view. A lot of folks today are overly focused on the very short yield curve because it's inverted for the first time in a long while. Other curves have been approaching zero but haven't quite gotten there yet, and as we've seen in the past, these curves can stay *near* zero for quite some time—so what's the signal when they don't actually invert?

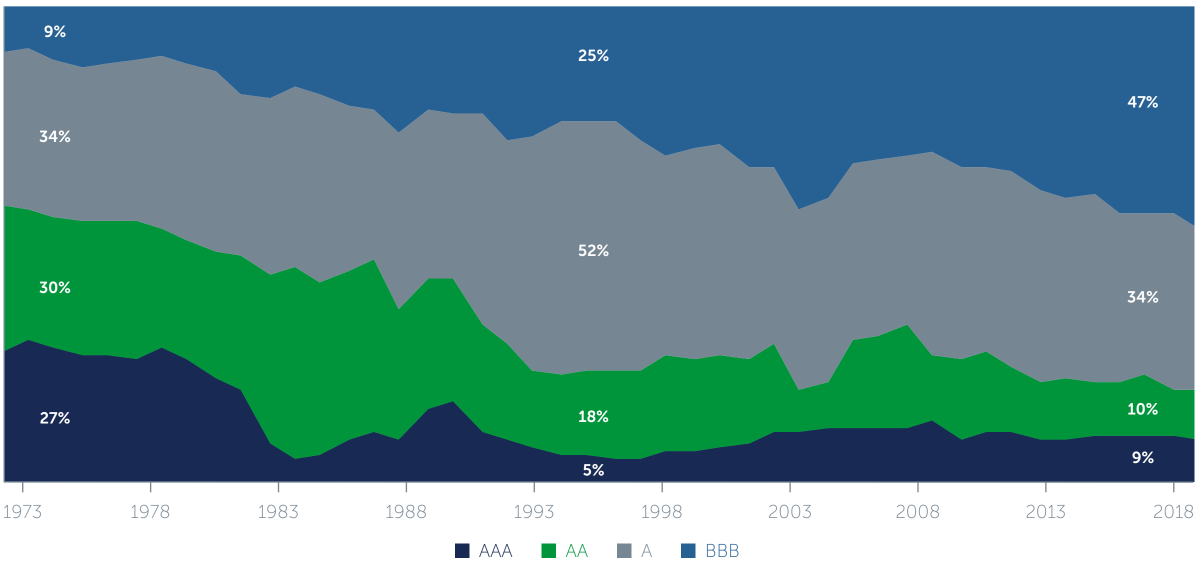
So to me, what's happening with the yield curve is analogous to a low-grade fever; it's something to be aware of and keep an eye on, but it's probably not going to make you (or in this case, the economy) deathly ill tomorrow.

*Full podcast URL: https://www.barings.com/gb/individual/podcast/investment-grade-credit-rates-bbbs-and-abs

Another issue that's grabbed headlines recently is the growth of the BBB segment of the investment grade corporate credit market. What are your thoughts there?

First, let's briefly define what BBB is. It's the lowest investment grade category, meaning bonds rated BBB sit right at the edge of the investment grade universe and the high yield (non-investment grade) universe. Historically, BBBs represented a fairly small portion of the investment grade market, but that slice has grown meaningfully over the past 10 or 15 years—to the point that the BBB segment now comprises roughly 50% of the total investment grade corporate credit market (FIGURE 1).

FIGURE 1: THE BBB SEGMENT OF THE MARKET HAS GROWN DRAMATICALLY THROUGH THE YEARS



SOURCE: *BARCLAYS. AS OF DECEMBER 31, 2018.*

So what used to be mostly a market of AAAs, AAs and As is now heavily occupied by the BBB space. That's one reason BBBs have received so much negative attention and press coverage in recent years. But the reality is that most BBB issues are not "low quality" companies per se. In fact, a large percentage of them are well-known Fortune 500 companies with strong earnings and cash flows—names that many investors would recognize and be willing to buy.

Another reason BBBs have been in the spotlight is that there have been more ratings downgrades from A to BBB in recent months than we've seen since 2015. That has fueled investor concerns, but again, it's important to remember how large and stable many of these BBBs are. They're incentivized to stay in the investment grade realm or even go higher, and many have the ability to do just that. So I certainly wouldn't expect a sustained flurry of downgrades going forward.

In that context, our view is that investors' fears about the BBB space may be overblown.

So the growth of BBBs is one way in which the investment grade market has evolved over the past decade or so. Can you speak more broadly to that evolution? How else has the market changed?

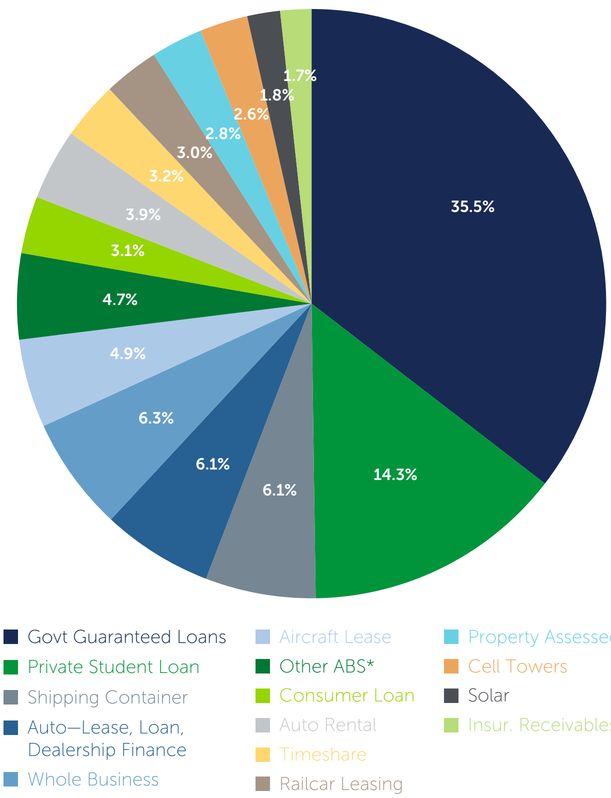
The investment grade credit market has changed markedly through the years and continues to do so. For starters, the market has grown and expanded significantly, with the number of bond indexes and types of securities having proliferated from just a handful in the 1980s and 1990s.

> *"Freedom from the constraints of a benchmark gives the manager the latitude to pursue what he or she sees as the best relative value opportunities across asset classes, sectors and geographies."*

If we limit the discussion to just the past 10 years, one of the big changes we've seen post-2008 has been in the securitized space. That includes commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS), but mainly I'm talking about the world of asset-backed securities (ABS)—both consumer and commercial. Consumer ABS could be personal loans (secured or unsecured) or student loans, while commercial could be anything from aviation or airplane-backed deals to medical receivables or whole business franchise receivables (FIGURE 2). Virtually anything can be securitized nowadays if it generates a steady cash flow.

ABS is an area where we at Barings have worked very hard to build out our team and capabilities because we saw opportunity there in the wake of the financial crisis. That opportunity has in fact materialized much as we had envisioned it would, to the point that ABS are now much more mainstream than they were even just a few years ago. Investor participation in the market is much broader and the dealer base is larger and more in depth, as is the issuer base. This, of course, gives us a much wider and deeper investment grade universe from which to construct diversified client portfolios. Having the resources to perform the bottom-up credit analysis is also key.

FIGURE 2: BARINGS DRAWS ON A WIDE RANGE OF ABS SECTORS FOR OUR PORTFOLIOS



SOURCE: *BARINGS. AS OF DECEMBER 31, 2018.*

And with this expanded investment grade market, we've seen the emergence and growth of so-called 'opportunistic' or 'multi-credit' strategies. What's your stance on those?

We think they make a lot of sense for many investors. Unlike traditional fixed income strategies, most of these strategies are benchmark-agnostic, meaning the portfolio manager is not required to adhere to a benchmark when creating the portfolio. Freedom from the constraints of a benchmark gives the manager the latitude to pursue what he or she sees as the best relative value opportunities across asset classes, sectors and geographies. The result is a more diversified approach to credit that can potentially deliver more attractive risk-adjusted returns versus a traditional benchmark-relative or single-sector strategy.

If managed appropriately, multi-credit or opportunistic strategies can also provide considerable flexibility to help investors navigate periods of interest rate volatility—in both rising and declining markets. A rules-based approach to duration management based on the slope of the short end of the yield curve is something Barings has done successfully since the early 1990s. With this type of strategy, the manager can seek to mitigate interest rate risk by, for example, adjusting the portfolio's target duration and/or favoring less rate-sensitive sectors of the market.

Bottom line: We think there are a variety of good opportunities to be found across the investment grade fixed income landscape, especially given the tremendous growth of the market (as we discussed), and these types of strategies can be an effective means of harnessing that opportunity set.

Of course, as with any investment, multi-credit, opportunistic strategies also involve risks that investors should consider carefully before committing capital.

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