AllianceBernstein®

GLOBAL CREDIT STRATEGY

A LENGTHY RECOVERY AHEAD, BUT STILL POSITIVE ON CREDIT

Yield spreads have declined, but we still see carry opportunities in credit. And while our overall view is constructive, the economic recovery is likely to take some time. We're monitoring risks closely, including credit migration.

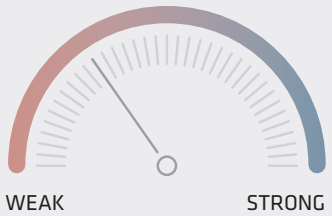
MACRO TRENDS

The global economy rebounded in the third quarter, but it is now entering a more difficult phase as COVID-19 infections rise and policymakers gradually withdraw emergency policy measures. These factors will likely limit the rebound, translating into a more modest US expansion and a temporary contraction in Europe. In China, where output is back above precrisis levels, a sustained recovery seems likely.

We think the economic damage from the COVID-19 pandemic will linger for a few more months—and more policy support will be needed. With monetary policy near the end of the road, fiscal policy will need to shoulder the burden. If it does, the recovery should accelerate again in the second quarter of 2021, barring a major public-health deterioration and renewed economic restrictions. For central banks, their main role right now is to keep interest rates at ultralow levels for the foreseeable future, facilitating fiscal expansion.

DISPLAY 1: GLOBAL FORECASTS

Economic Growth



+ Despite a strong initial rebound, the road to a full recovery is likely to be long and uneven.
+ For many countries, output may not return to precrisis levels until well into 2022.

KEY RISKS

+ Downside: second lockdown
  Upside: early vaccine
+ Rising geopolitical tensions between China and the West

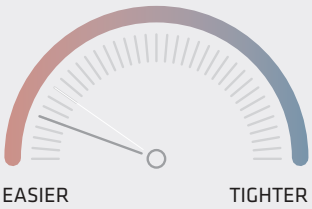
Inflation

+ Elevated debt and a major shift in the underlying policy regime point to higher inflation in the medium term.
+ But dislocations caused by COVID-19 suggest that near-term inflation risks are skewed to the downside.

KEY RISKS

+ Oil prices
+ Policy effectiveness

Monetary Policy



+ With interest rates at or below zero in many countries, monetary policy is close to the end of the road.
+ But central banks still have a vital role to play by anchoring bond yields and supporting fiscal policy.

KEY RISKS

+ Fiscal dominance/monetization
+ Are we sowing the seeds of an even bigger future debt crisis?

Source: AllianceBernstein (AB)

ISSUANCE HAS BEEN HIGHER

We started the year anticipating that credit issuance would be below 2019's levels, but the opposite has taken place: US issuance is running about 71% ahead of last year's, a record pace.

Traditionally, when issuance surges this way, it weighs on credit markets, so we've been pleasantly surprised that the increased supply has been met with strong demand at wider spread levels. Demand has been driven primarily by elevated valuations, strong retail and institutional flows into credit markets globally—specifically technical flows in both the US and Euro—and lower currency hedging costs that support foreign investment. Heavy supply stemmed from the pandemic's effects, which forced issuers to focus on liquidity and debt-maturity management, and from accommodative central bank stimulus initiatives in March and April. Mergers and acquisition debt funding has also been high.

Looking ahead, we expect central bank policy to remain supportive and government yields to stay low. Given this backdrop, we expect demand for credit to remain robust, while supply should normalize as we head into year end. This scenario is likely to sustain longer-term positive technical factors in credit markets.

LEVERAGE METRICS ON THE RISE

Fundamental leverage metrics deteriorated meaningfully in the first half, creating a negative tailwind as net leverage increased across nonfinancial issuers. Following second-quarter business lockdowns in a low-interest-rate environment, corporates flexed their liquidity cushions with new and refinanced debt. Higher leverage, along with lower earnings in sectors hit hardest by the pandemic, have caused debt metrics to weaken.

Both gross and net leverage hit all-time highs in the second quarter, and the decline in economic activity reduced EBITDA for investment-grade (IG) companies. At the same time, debt growth accelerated, rising by about 12% for the quarter. Although gross and net leverage have risen, net leverage has risen by less, as issuers built balance-sheet liquidity. As a result, the cash-to-debt ratio has also risen to a near-term high.

Given that our macro outlook calls for a prolonged recovery period before the global economy returns to its pre-COVID-19 output, our base-case expectation is that credit leverage metrics will remain elevated.

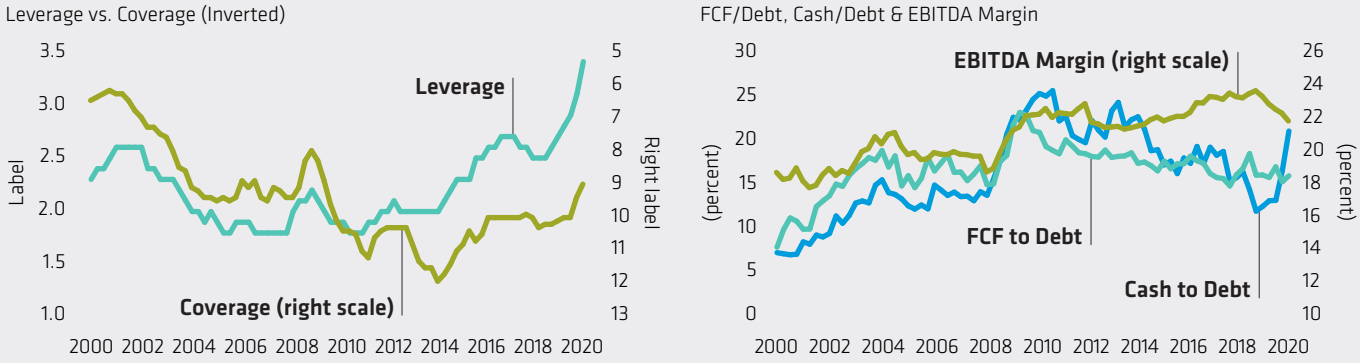
LOOKING AHEAD: RATINGS MIGRATION

Our worries about a wave of fallen angels from a large volume of rating agency downgrades have abated, for now. Rating agencies have slowed the pace of downgrades considerably so far this year, but the number of issuers on negative watch is rising.

As the global pandemic continues to drive the risk of more downgrades, AB's economic forecasts are slightly more conservative than market consensus. This leaves us slightly more negative on the volume of potential downgrades, though we're bullish based on our fundamental research and are taking advantage of attractive BBB valuations. With downgraded companies likely to face a substantially higher weighted average cost of capital, issuers are incentivized to remain IG to the extent they can.

We expect downgrades to outpace upgrades in the credit market, leading us to conclude that there will be continued risk of negative credit migration. For that reason, we remain conservative: as we see it, we're not out of the woods yet with agency rating downgrades.

DISPLAY 2: LEVERAGE METRICS



Note: ex-Fins. Data represents ~90% of ex-Fin USIG in Market Value. Metrics data is calculated using median.
As of June 30, 2020
Source: AB

VALUATION

Even though we've already seen credit spreads decline globally so far this year, we're still optimistic overall and maintain our positive recommendation on the sector. Our thesis, however, has shifted from expecting material spread compression to only modest compression, but with a positive yield carry. As a result, we've gone from a substantial credit overweight to a more moderate overweight.

From a portfolio beta perspective, we've been very content to allow beta to drift lower as spreads have tightened, while still maintaining an overweight risk position.

Given global central banks' support of credit markets, we continue to expect credit to perform well. And when coupled with low government bond yields, we think positive flows into credit will persist and perform within our forecast range. With spreads having declined meaningfully, our expectations are centered around achieving positive carry.

On the new issuance front, a disciplined market has prevailed, with more balanced supply/demand technicals. We had been seeing higher new-issue demand than issuance, but that relationship has started to wane in August and into September.

DISPLAY 3: ASSET-CLASS UNIVERSE

Asset Class		Yield %	Hedged Yield %				OAS	OAS % Change	
			USD	JPY	GBP	EUR		1 Month	YTD
EUROPEAN CREDIT CORPORATES	Index	0.58	1.38	0.80	1.20	0.58	114	(11%)	23%
	A	0.34	1.13	0.56	0.96	0.34	90	(13)	18
	BBB	0.85	1.65	1.08	1.48	0.85	141	(10)	26
	1–5 Years	0.37	1.16	0.59	0.99	0.37	100	(13)	28
	7–10 Years	0.77	1.57	0.99	1.40	0.77	126	(9)	15
	10+ Years	1.07	1.87	1.30	1.70	1.07	134	(6)	14
US CREDIT CORPORATES	Index	1.95	1.95	1.38	1.78	1.15	129	(3)	39
	A	1.61	1.61	1.03	1.44	0.81	97	(1)	39
	BBB	2.33	2.33	1.75	2.16	1.53	167	(3)	39
	1–5 Years	0.88	0.88	0.30	0.71	0.08	69	(10)	30
	7–10 Years	1.95	1.95	1.37	1.78	1.15	136	(2)	39
	10+ Years	3.02	3.02	2.45	2.85	2.22	184	1	35
TAXABLE MUNICIPAL BONDS	Index	2.65	2.65	2.07	2.48	1.85	164	(4)	46
SECURITIZED ASSETS	US ABS	0.59	0.59	0.01	0.42	(0.21)	45	(24)	2
	US CMBS	1.48	1.48	0.90	1.31	0.68	111	(8)	54
	US MBS	1.23	1.23	0.65	1.06	0.43	58	(5)	49
EUROPEAN HIGH YIELD	Index	5.04	5.83	5.26	5.66	5.04	443	(11)	51
	BB	2.51	3.31	2.73	3.14	2.51	302	(10)	59
	B	4.93	5.73	5.15	5.56	4.93	523	(11)	58
	CCC	9.79	10.59	10.01	10.42	9.79	1020	(13)	26
US HIGH YIELD	Index	5.36	5.36	4.78	5.19	4.56	484	(2)	44
	BB	3.87	3.87	3.30	3.70	3.08	334	(2)	83
	B	5.52	5.52	4.95	5.35	4.72	503	0	55
	CCC	10.34	10.34	9.77	10.17	9.54	987	(3)	14
EMERGING-MARKET DEBT	IG Corporates	2.81	2.81	2.23	2.64	2.01	246	(6)	28
	HY Corporates	5.84	5.84	5.27	5.67	5.05	555	(5)	24
	IG Governments	2.88	2.88	2.31	2.71	2.09	196	(4)	21
	HY Governments	8.12	8.12	7.54	7.95	7.32	743	(6)	47
COLLATERALIZED LOAN OBLIGATIONS	AAA	1.76	1.76	1.18	1.59	0.96	143	(14)	11

Current analysis does not guarantee future results.
As of August 31, 2020
Source: AB

CURRENCY

US-dollar hedging costs have been very stable and are at their lowest since 2015. We continue to view US credit spreads as cheap from a global perspective, and yields offered in the US market—after accounting for currency hedging costs—are compelling. That's why we recommend an overweight to US credit.

Since our last update, the US credit market has outperformed euro credit. Based on that development, we advocate for adding euro credit exposure in the front end of the yield curve while taking advantage of the relative yield advantage US credit offers in the long end of the curve.

We've recently seen positive domestic demand in the US and European credit markets. Foreign investor demand has also been positive and stable, which should provide added support. We expect Asian demand for US credit assets to remain robust. In addition, US institutional demand remains strong and euro-denominated credit investors have been eagerly buying European credit, which is another positive. (*See Displays 4, 5 and 6, below*).

SUMMARY

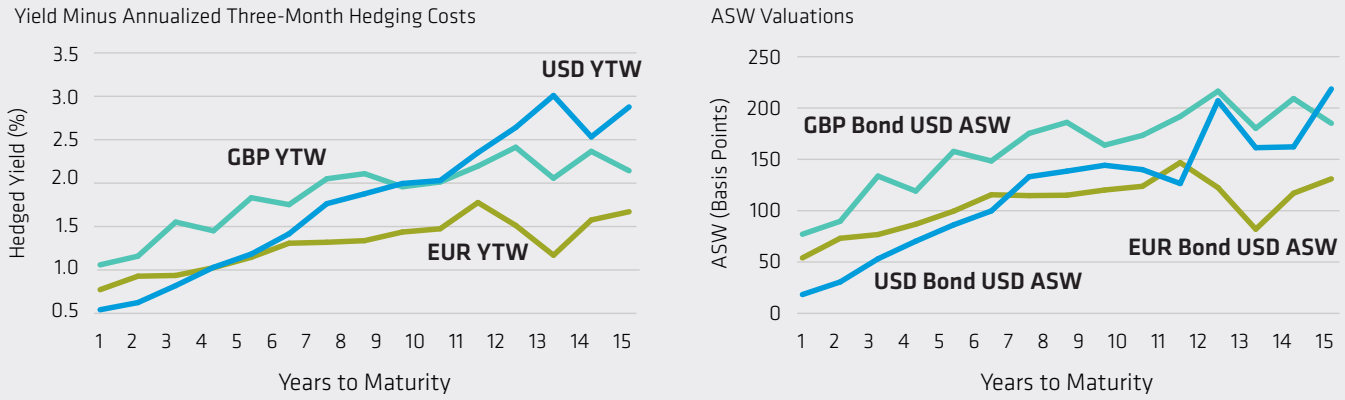
We're very constructive on risk-taking, continuing to recommend an overweight position in US credit portfolios. We've allowed our overall risk position to drift lower, though—driven by moderately deteriorating fundamentals, the risk of negative ratings migration and uncertainty surrounding the upcoming US presidential election.

We continue to like BBB credits, running our portfolios with a slightly more bulleted maturity profile and a focus on the seven- to 10-year part of the yield curve. We remain focused on avoiding negative ratings migration, and, given the spread compression we've seen already, the expected potential is centered on achieving a positive carry.

Our global macro view is that an economic recovery is likely to be long, lasting through all of 2021 and into 2022. With global central banks continuing to funnel support to credit markets, our outlook balances both positive and negative factors, leaving our ultimate outlook slightly skewed to the positive.

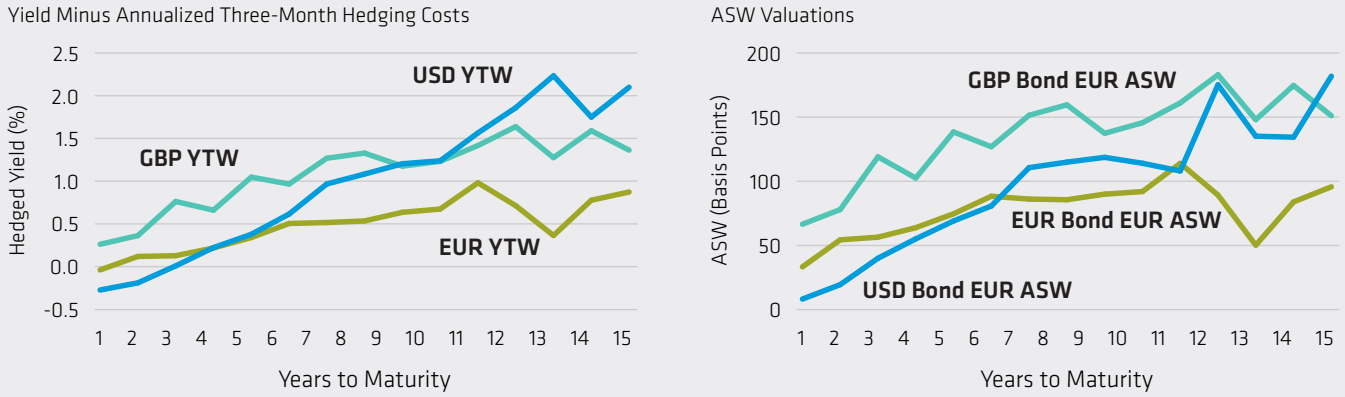
GLOBAL CORE PORTFOLIOS STILL OFFER VALUE VERSUS SINGLE-CURRENCY PORTFOLIOS, WHILE FRONT-END, HEDGED EURO OFFERS A RELATIVE YIELD ADVANTAGE TO THE US DOLLAR, AND LONG-END US DOLLAR OFFERS EURO INVESTORS HIGHER RETURNS

DISPLAY 4: USD HEDGED



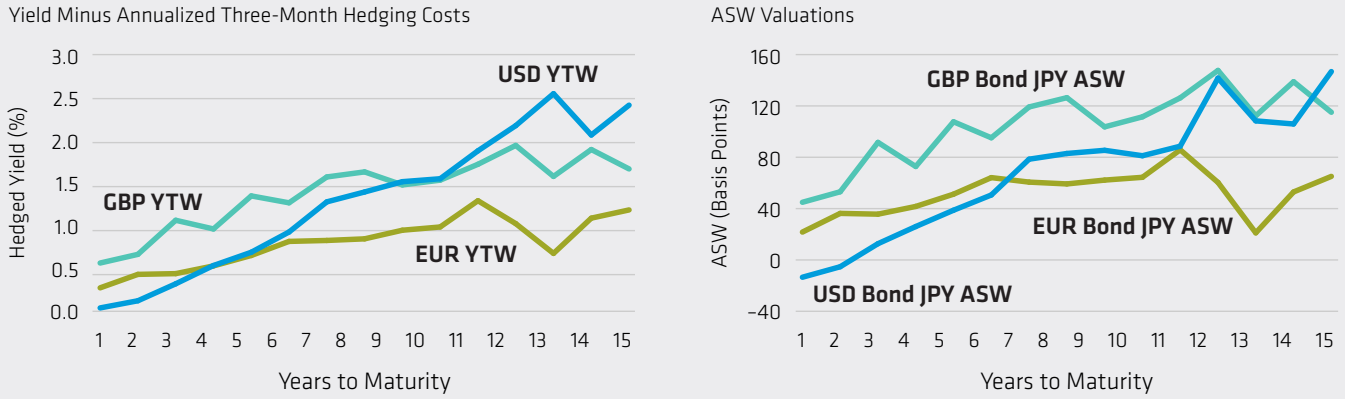
YTW: yield to worst; ASW: asset swap
As of August 31, 2020
Source: Bloomberg Barclays, J.P. Morgan and AB

DISPLAY 5: EUR HEDGED



YTW: yield to worst; ASW: asset swap
As of August 31, 2020
Source: Bloomberg Barclays, J.P. Morgan and AB

DISPLAY 6: JPY HEDGED



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Source: Bloomberg Barclays, J.P. Morgan and AB

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