Reflections on 2018…

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As we look to 2018, we see economic growth, both domestic and global, starting the year on a firm footing. A growing economy means corporate earnings growth will be strong, and act as a driver of positive equity performance. In addition, the tax reform legislation that seems almost certain to be heading for approval will provide additional stimulus in two ways. First, it will stimulate economic growth. Second, lower effective tax rates for many companies will boost after-tax earnings and bolster valuations. After several years of positive but disappointing growth, better times are likely.

At the same time, stronger growth means greater inflation risk and heightened concern from central banks. The accommodative central bank policy that has supported financial markets' confidence over the last several years will be gradually withdrawn. A combination of less central bank support and higher inflation will likely mean a more difficult environment for corporate credit, as market confidence will likely be reduced. Volatility in the credit markets is likely to increase against this backdrop.

While the outlook for equities in 2018 is positive, credit spreads are likely to widen, as we expect diminishing central bank support will start to become a meaningful issue, especially as we approach and enter the second half of the year. With economic growth accelerating and inflation risk rising, the risk to markets is that central banks reset "normalized" targets for short term interest rates higher. At present, the markets see the Fed setting a "normalized" Fed Funds rate of around 2.5%. If inflation rises, this target could also rise, and inject fear of restrictive policy into markets.

The withdrawal of central bank support presents the greatest risk to highly leveraged companies. The credit cycle is at an advanced stage, and warning signs are appearing. Money is flowing into leveraged credit markets in a manner creating an imbalance that favors the borrower at the expense of the investor. Loan underwriting standards are falling as "covenant-lite" loans become the norm, and credit spreads have continued to narrow, even while defaults have already started creeping higher. This cycle will not end well.

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Chart A: Unlike high yield, Convertible market is not dominated by leveraged companies

The convertible issuers' universe is dominated by high growth companies as can be seen by a rather low Net Debt to Enterprise Value (EV). Aggregate Net Debt to EV is 30% for the convertible universe vs. approximately 80% - 90% for high yield. The Healthcare and Technology sectors, both of which are very important to the convertible market, stand at an even lower 8% and 1%, respectively.

	Net Debt to EV			
GICS Sectors	Aggregate	25th Percentile	Median	75th Percentile
Consumer Discretionary	18%	7%	38%	45%
Consumer Staples	25%	17%	19%	33%
Energy	49%	31%	48%	66%
Financials	58%	35%	45%	68%
Health Care	8%	-3%	9%	27%
Industrials	36%	24%	31%	36%
Information Technology	1%	-10%	4%	21%
Materials	19%	14%	36%	46%
Real Estate	29%	27%	34%	44%
Telecommunications	46%	48%	48%	55%
Utilities	46%	40%	47%	88%
Whole Universe	30%	5%	29%	46%

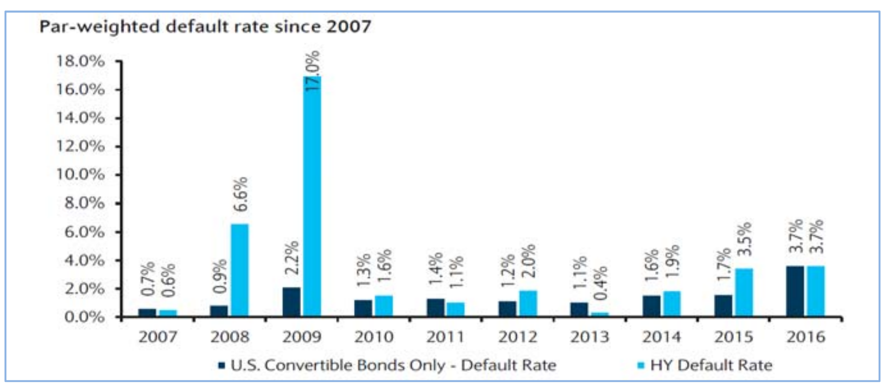
Source: Barclays Research

The convertible market offers investors insulation from this risk. The convertible market is not dominated by highly leveraged companies, as can be seen in Chart A above. For most issuers, balance sheets are strong, and earnings are growing. In many cases the convertible is the only publicly traded debt on the company's balance sheet. The benefits of lower leverage and stronger balance sheets benefitted convertible issuers during the 2008 financial crisis, with the vast majority of convertible issuers surviving the crisis unscathed, as reflected in the default rates' experience (see CHART B below).

Chart B: Lower default rates in Convertible Bonds vs. High Yield from 2007-2016

Over the period of 2007-2016, the average annualized default rate of convertible bonds-only universe was 1.6% vs. 3.8% for that of the high yield market

During the 2008 financial crisis, the default rate of convertibles of 0.9% was negligible as compared to 6.6% for high yield



Source: Barclays Research

Finally, while our general outlook is positive, we see market volatility rising from the unusually low levels of recent years, as greater fears of inflation and restrictive monetary

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policy emerge. Investors should be prepared to "play defense" if these risks rise, and the convertible market provides an excellent vehicle for defensive positioning while still being able to capture the benefits of economic growth and achieve long-term return objectives.

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