# FIXED INCOME WEEKLY

## JANNEY FIXED INCOME STRATEGY

AUG 8, 2016

Janney

Key issues that emerged at a financial industry retreat included knock-on Brexit effects, China growth, US high yield, and EM freedoms.

CONTENTS



## IN THIS ISSUE OF FIXED INCOME WEEKLY:

- An annual economists and strategists' retreat included four major investible themes: Brexit and its impacts, China and Yuan devaluations, US high yield and the prominence of ETFs, and the interaction between emerging market returns and political freedoms.
- The majority of second quarter earnings results have posted, and the average S&P 500 member firm's revenue fell 0.5%, and its earnings 4.4% versus the year-ago quarter.
- Muni investors are receiving decreasing compensation for taking credit risk, and despite low yields, we nonetheless recommend favoring higher quality over higher yielding tax-exempt debt.

## RECENT HIGHLIGHTS FROM JANNEY FIXED INCOME STRATEGY & RESEARCH:

- Jody Lurie's 2Q Bank Earnings analysis is available here; earnings were generally stronger, with 13 of 15 big US banks meeting or beating expectations.
- Alan Schankel discussed the intersection of transportation and pension issues in New Jersey in this Bond Buyer article (subscription may be required).
- Guy LeBas discusses the most recent action in The US Treasury markets in this Wall Street Journal article (subscription may be required).


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### Fixed Income Strategy & Research Recent Publications

| Publication | Sector | Date | Notes |
|---|---|---|---|
| 2Q Bank Earnings | Credit | 8/1/2016 | Benefitted from low YoY comps |
| Bankruptcy Primer | Credt | 7/28/2016 | Bondholder roadmap |
| Municipal Bond Market Monthly | Munis | 7/22/2016 | Appropriations, CT |
| FI Asset Allocation | Market | 7/20/2016 | Still cautious on risk |
| US Interest Rate Forecasts | Economics | 7/12/2016 | 1.60% year end ten year note |
| Employment Commentary | Economics | 7/8/2016 | Gains to reverse May slowing |
| Midyear Outlook | Market | 6/30/2016 | Quality over yield, prefer munis |
| Municipal Bond Market Monthly | Munis | 6/29/2016 | Demand continues |
| FOMC Commentary | Rates | 6/15/2016 | Dots declined, net dovish |
| FOMC Preview | Rates | 6/13/2016 | Low change of hike |
| Employment Commentary | Economics | 6/3/2016 | Worst result in 2yrs |


See page 8 for important information regarding certifications, our ratings system as well as other disclaimers.

CONTENTS



## Economics: Notes from Camp Kotok

- Camp Kotok is an annual economist, strategist, and portfolio manager retreat in Maine that affords the opportunity to understand the major economic and market issues of the day from a more distant perspective.
- For 2016's retreat, the most frequent issues to arise centered around China's economic reality, the long term equilibrium post-Brexit, and the risks that flows into and out of ETFs could cause more violent "flash crashes."
- Emerging markets outside of China were also a topic of frequent discussion, particularly as to how economic and civil freedoms do and will impact risk asset returns—a focus stimulated by the events still unfolding in Turkey.

For the last 25 years, economists and strategists have descended on the Maine woods for a retreat nicknamed Camp Kotok after its founder and host, Cumberland Advisors' David Kotok. The rules of the retreat are simple: be social, dress casually, speak freely, and don't reveal who else was there or what any individual attendee said. The attendees—from former Fed officials to hedge fund managers—and the discussion—from politics (LOTS of politics) to technical details of ETF creation and redemption processes—were extremely varied, but here are some of the highlights from the retreat.

### Brexit & Future of EMU

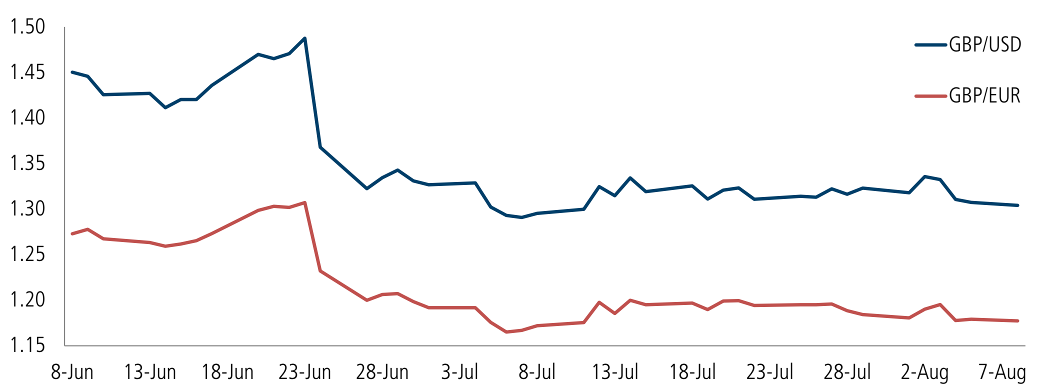
The United Kingdom's referendum to leave the European Union is a little more than one month old, but there's little professional agreement about what the vote even "means." A panel debate at Kotok, including two UK citizens, came to essentially no agreement on what UK citizens thought a leave vote would do. If anything, it appears to be a combination of, one stronger desire for self-determination; two, a belief that, for many, the economic outlook is perceived so bleak that any sort of change offers opportunity; and three, a rebellion against the elite who claimed an EU exit would be terrible. Regardless of the meaning of that vote, a survey of the panel indicated only a 1 in 5 chance that the UK would, through legal maneuvering, avoid actually leaving the European Union. It's basically a fait accompli, though the longer term outgrowths remain uncertain.

For all of the discussion, there was still no consensus about what Brexit implies for economic outcomes in the UK or Europe.

When it comes to the US, the overwhelming consensus was that, in and of itself, the Brexit vote would have low to zero long term impact. Most of any short to intermediate term impact would be felt via the currency handle, and the strengthening dollar that we've seen thus far isn't great for domestic manufacturing (then again, the US export sector is already about 20% in the hole from the last round of dollar rallies and oil price declines). When it comes to the UK economy, the broad consensus was that, in the short term, the degree of uncertainty posted by shifting tectonics of business regulation and trade agreements would restrict business investment for one to two years, causing a near-certain recession in the UK. Longer term, however, panel participants expressed the opinion that the economic equilibrium for the UK was fairly solid as an export-driven economy.

The real risks from Brexit come not from the UK's long term outlook, but for the potential deterioration of the Eurozone, and especially for the risk that members of the Euro currency elect to leave. As we noted in our pre-Brexit "what ifs," one of the key implications is a global shift towards "rebel-

**7% Drop in GBP/EUR Cheapens UK Exports & Protects Against Brexit Economic Pain**




Source: Janney Fixed Income Strategy; Bloomberg

**CONTENTS**



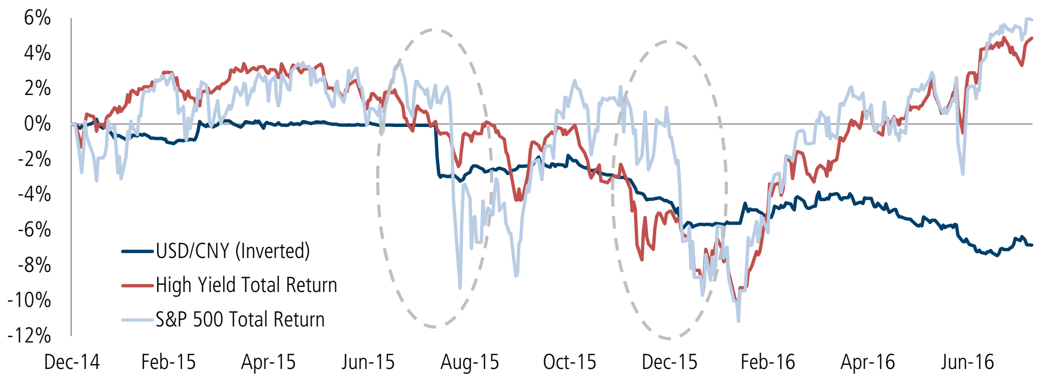
lion" voting whereby frustrated electors vote for change of any sort. Post-Brexit, there have been calls in nearly every Eurozone nation for internal referenda, and a leave decision of a Euro currency member could have profound effects on the global currency markets. Were Greece and Portugal, for example, to leave the Euro currency, we'd likely see the currency strengthen, which would impair Germany's ability to export profitably. While, that scenario helps the US long term, the adjustment period would likely prove far more problematic than the long term benefits would prove positive. While not specifically on Italeave, Italy is scheduled to hold a constitutional referendum in November that would increase the strength of Italy's central government. Failure of that referendum would result in Prime Minister Matteo Renzi's resignation, and could help spur a nationalistic movement that would put the country on a path to at least consider a Euro exit down the road.

## China

While there were no events based on China, the fact that the country is world's second-largest economy (according to official data, at least), and one of the greatest sources of economic and financial markets volatility meant that there were a number of informal discussions on the topic. There's a small industry of clandestine data gatherers who attempt to produce statistics more accurate than the government's official GDP numbers. It seems that "true productive" economic growth in China is likely running about half the pace the government reports. While GDP growth is probably in the 6 – 7% range, in line with official figures, much of that growth is forced malinvestment at the province and city level; hence the construction subsidized ghost towns of buildings with no one living in them.

A China Yuan devaluation is far less likely than the very vocal shorters argue.

### Yuan Has Been Trigger of Two Major Market Rebellions in Last 13 Months




Source: Janney Fixed Income Strategy; Bloomberg; Citi Indices

More significantly for the global markets, the broad consensus was that the Chinese government has far more power to fight off reserve outflows than the naysayers give the government credit. Prominent hedge fund managers, especially Kyle Bass, have argued that the Chinese banking system needs to write off billions of loans, which will force the Peoples Bank of China to recapitalize the banking system and cut rates. Simultaneously, a flight of capital from the country will force the PBoC to print money to do so and devalue the Yuan in order to dissuade further outflows. The problem with this analysis is that China's government is essentially on both sides of the bad loans: partially state-owned banks made the loans to fully and partially state-owned entities, so there's no need to write off the loans, and the domino effect to lead to currency devaluation is far less likely to happen.

US investors should care because devaluation of the Yuan, or the risk thereof, spurred two major market rebellions in the last year. The first, in August 2015, was a roughly 1% cut in the Yuan awkwardly-timed when Chinese central bank officials happened to be on vacation. That cut was mis-communicated, and many market participants assumed that the deval was the first in a string. It wasn't. The second rebellion came in early-2016, when a stronger dollar caused fears China would have to accelerate a deval timeframe. The Kotok consensus suggests we should be aggressive buyers of risk assets if there's another China-deval-related freak out in the coming months.

## High Yield ETFs

Your author participated in an informal debate about the impact of high yield corporate bond exchange traded funds. While the conversation used HYG and JNK as examples of funds, the same principles apply to all ETFs, and the real discussion wasn't about performance of ETFs, but about impact on the high yield and other financial markets. Essentially, the inflows and outflows of high

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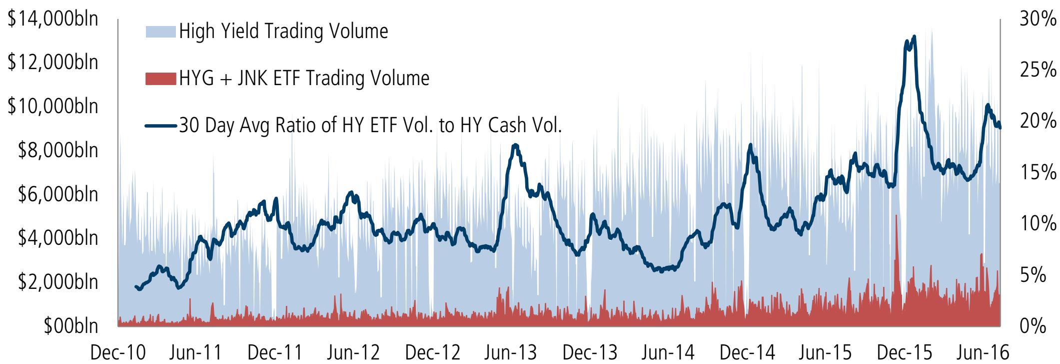
CONTENTS



yield ETFs have become the elastic variable in the high yield markets, absorbing and giving off supply. Traditionally, that role had been reserved for dealers that traded in and supported the high yield markets. Other participants were particularly concerned that this elasticity could create some problematic liquidity event if sellers in high yield in the institutional market coincided with retail liquidations of HYG and JNK ETFs. Your author's conclusion, however, was a bit different, however. There's less leverage involved in ETF-provided liquidity, since ETFs can't be margined as aggressively as can be individual bonds. ETF leverage is at most 1.5 to 1 (and many holders don't leverage at all), whereas dealer leverage in high yield inventories was functionally closer to 5 or 10 to 1. As a result, there's an argument to be made that the expansion of ETFs actually decreases knock-on effects from a sell-off in high yield, since losses to any individual market participant aren't as likely to wipe out that investor's capital base or counterparty losses.

**High Yield ETF Trade About 20% As Much Dollar Volume As Cash High Yield Markets**




Source: Janney Fixed Income Strategy; Bloomberg

High yield ETFs have partially replaced dealer balance sheets for high yield liquidity, creating a pro-trend trading bias in high yield.

While the growth and prominence of ETFs reduces potential contagion effects from the high yield markets, it does introduce a source of uncertainty within the high yield markets. That uncertainty is created by the feedback loop in the pricing services. Independent pricing services evaluate every bond in a high yield ETF every day and estimate these bonds' market values. One of the inputs into evaluations is TRACE trading levels of these bonds, but another of the inputs is trading levels of the ETF itself. That feedback loops injects a pro-cyclical valuation and trading theme into the high yield markets which is precisely the inverse of the traditional counter-cyclical "cushion" that dealer market making in high yield used to provide. As a result, high yield spreads are more likely to trend, and more likely to move aggressively. The primary impact of high yield ETFs coming to prominence is more volatile spreads in the high yield markets, an impact in evidence several times in the last two years. Each high yield sell-off or rally had a traditional narrative (such as falling oil prices) behind it, but the speed and persistence of the spread widening and tightening has been faster than we've typically seen in the prior decade.

## Emerging Markets

In the immediate aftermath off the Turkey coup—or, for the skeptics, faux coup—we penned a note commenting on political risks of Emerging Market investing, and how those risks are essentially non-diversifiable. There were several participants at Kotok whose primary business lies in evaluating political and civil freedom across the globe and investing, either rules-based or actively, based on those freedoms. The group of these EM-freedom investors was too small to draw broad conclusions, but the nature of their work and research was one of the most unique and intriguing aspects of the weekend discussions. Historically, emerging market countries that have instituted democratic reforms and improved civil rights protections have generated above-average positive returns, yet there is no evidence that investing in countries that already have strong democratic and civil right institutions produce higher returns. The conclusion is that a large portion of Emerging Market investing needs to be about predicting these reforms and investing in advance of them as well as divesting in countries at risk of reversing these reforms.

Not all themes in heavy evidence at Camp Kotok's annual retreat were investible, but at least four—Brexit, China, HY ETFs and emerging market freedoms—have exactly the sort of long-term implications that we try to bring to our investors' attention.

CONTENTS



## Credit: Expected the Worst, Hoped for the Best

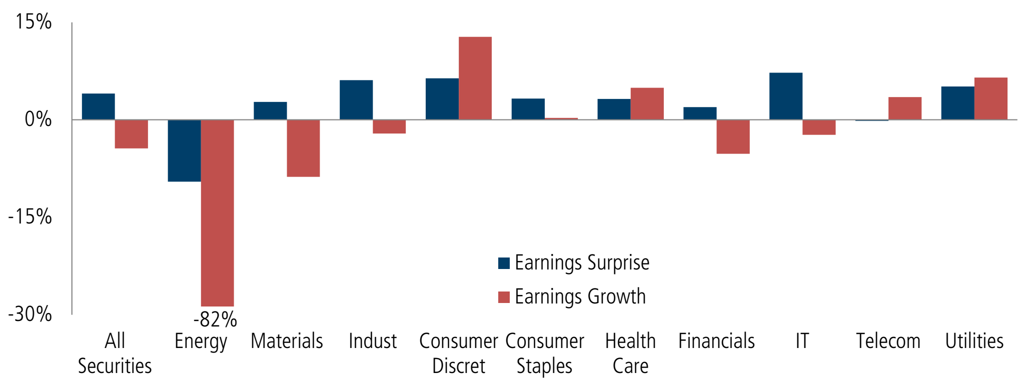
- Earnings for 2Q 2016 followed the lead of the prior two quarters in showing a beat percentages below the prior ten quarters' median (4.1% vs. 4.7%). Despite some optimism in this versus last quarter, performance still came in on the lighter side.
- For the eighth consecutive quarter, energy recorded the weakest top line growth, and the softest bottom line growth for the seventh consecutive quarter. Telecom experienced the highest revenue growth for the fourth consecutive quarter, while consumer discretionary the biggest earnings growth for the second consecutive quarter.

As of writing, 87% of S&P 500 companies have reported 2Q 2016 results. The average firm's revenue fell 0.5%, and earnings 4.4% YoY, compared to declining 2.0% and 8.1% in 1Q 2015, respectively. This quarter marked the sixth consecutive to record shrinking average sales, and the fifth consecutive to exhibit decreasing average earnings. Nonetheless, companies managed to exceed Street expectations for both the top and bottom lines at beat percentages of 0.6% and 4.1%, respectively. As we have noted in the past, management teams are quite adept at under-promising and over-delivering, particularly for earnings, which can be shaped in various ways. To help the quarter were improving macro factors, despite the volatility brought on by Brexit at the end of June, so management teams communicated modest, albeit cautious, optimism for the remainder of the year.

This quarter, we saw a repeat for the weakest sectors: energy, materials, and industrials. Although factors like energy and commodity prices improved from the lows recorded in 1Q, the comparison over a year ago second quarter came in soft and these industries were still far from healthy in terms of supply/demand dynamics. Average revenue and earnings for the energy space showed double-digit declines YoY. Comparatively, for materials, the two metrics registered high single digit drops YoY. Other industries that demonstrated some weakness were financials at the bottom line, utilities at the top line, and information technology for both top and bottom line, though none of the changes YoY were as severe as for the more commodity-sensitive spaces.

Earnings relied on the expectations game this quarter, as the average S&P 500 firm beat, despite seeing falling revenues and earnings versus the same quarter last year.

**Only Energy and Telecom Underperformed Street Expectations for Earnings**




Source: Janney Fixed Income Strategy; Bloomberg; Company Reports

On the positive, the telecom sector experienced its fourth consecutive quarter with the highest revenue growth YoY among all industries. Despite this feat, telecom slightly underperformed analysts' guesses for both top and bottom line. Because the industry has the smallest number of companies in the S&P 500, each firm's performance more dramatically moves the needle either which way compared to other sectors. Consumer discretionary demonstrated healthy average revenue and earnings expansion YoY, and the latter was the largest average growth among sectors for the second consecutive quarter. What's more, because the industry showed spottiness across subsectors last quarter, Street expectations for the space were mixed, allowing companies on average to outperform at the top and bottom. How the third quarter trends remains to be seen, though exogenous factors are more muted than in the first half, which may help firms in their quest for both organic growth and margin improvement.

**Jody Lurie**

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CONTENTS



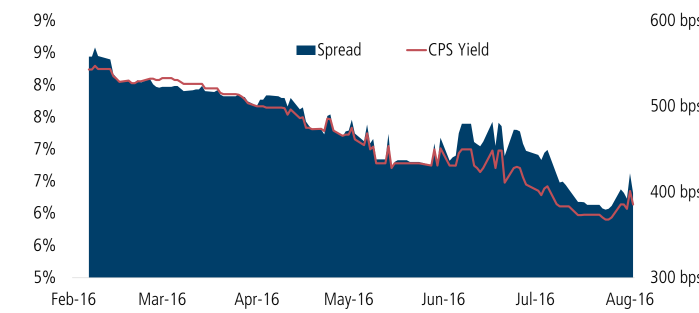
## Municipals: Quality Over Yield

- With the relentless drive for yield as background, credit spreads continue to tighten placing into question the risk reward proposition of higher yielding tax free bonds
- Although Puerto Rico yields rose after the record $3.5 billion 2014 bond sale, as the territory moved towards massive default, most high yield issues, including Chicago Public Schools, saw yields fall and spreads narrow.
- We believe municipal bond investors should consider upgrading portfolio quality, talking advantage of narrow spreads, and adding insulation against future economic downturn.

There is much investor and media focus on the lowest yields in a few generations, but as is often the case, as yields fall, credit spreads also compress. While our forecast is that longer term interest rates will range around current levels for at least the next year or so, the same may not be true for today's tight credit spreads. Compared to a 200 basis point differential between yields of Baa rated bonds and Aaa benchmark yields in early 2012, the Aaa-Baa spread has resumed its contraction, falling below 80 basis points in recent months (based on MMD data).

### Credit Spreads Continue to Tighten Post-Recession


### CPS Yields Fell 150BPS More Than Gen Mkts Since Feb




Source: Janney Fixed Income Strategy; MMD; Bloomberg

While it's tempting to chase yield in the muni markets, there are a number of reasons why we favor quality in this market.

The hunt for yield is relentless. In the municipal world, Puerto Rico, tobacco bonds, and more recently several Chicago names comprise large portions of the muni high yield universe. With the July 1st, $1 billion payment default, Puerto Rico moved from high yield to default. Investors who bought Puerto Rico 8% of 2035 at 93 (8.28% ytm) when the $3.5 billion issue was first marketed in March 2014 saw prices fall to as low as 63 (13.41% ytm) as the Ba1/BB+/BB rated deal was ultimately downgraded to today's Caa3/D/D ratings.

Of course high yield bonds do not always fall in price. Chicago Public Schools came to market in February with a $725 million issue and ended up needing an 8.50% yield to sell the 28 year maturity. Rated NR/B+/B+ (Moody's rates CPS at B2 but did not rate the February issue), the issue started moving up in price almost immediately. Although general market yields have fallen by about 50 basis points since February, the frenzy for yield generated a drop exceeding 200 basis points for the high yield Chicago school bonds.

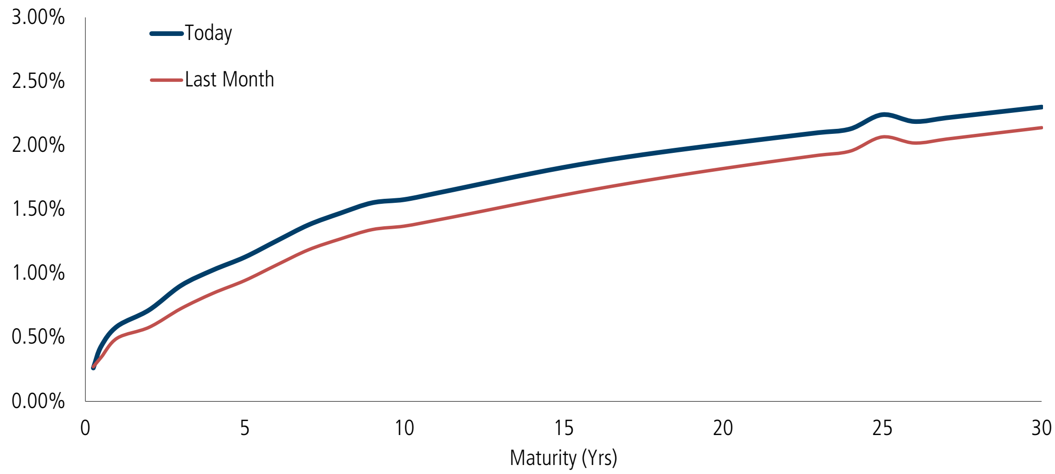
As the Puerto Rico and Chicago Board of Education examples illustrate, yields do not always move in the same direction, and volatility may be more pronounced in the high yield section. But as yields remain low, and credit spreads generally continue to compress, investors should consider if the risk reward proposition of investing high yield bonds is as compelling as it was in past years. Despite the sunny employment numbers for July, data continues to indicate sluggish economic growth. The post-recession recovery is long in the teeth. Lower quality municipal issuers remain challenged with tax growth anemic and fixed expenses (pension and debt) on the rise. We suggest that investors review portfolios and where appropriate consider upgrading quality (at the expense of yield) while spreads remain tight.

**Alan Schankel**

CONTENTS



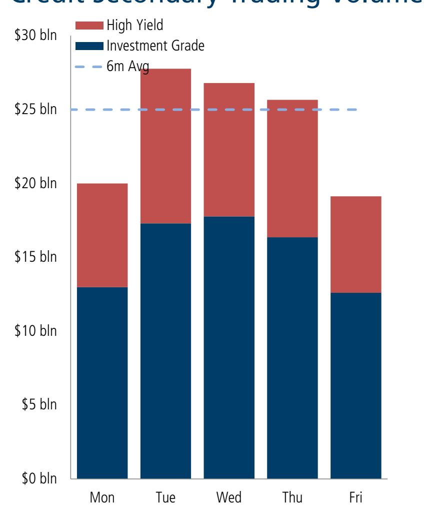
## Treasury Yields



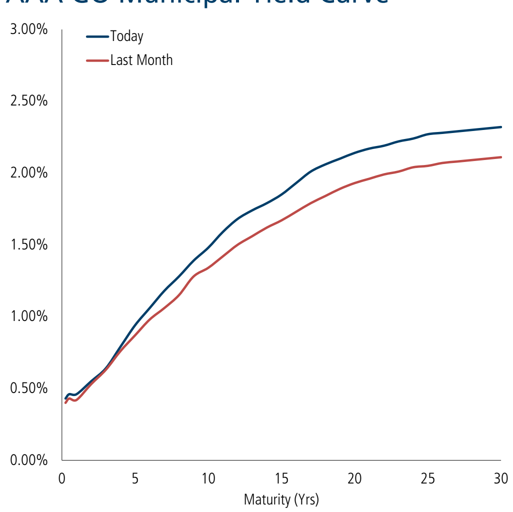

Yields moved to close to their post-Brexit highs following last week's strong July employment report.

## Credit Market Spreads

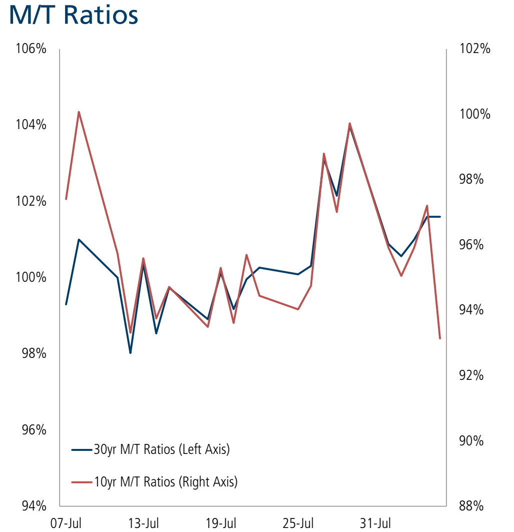

## Credit Secondary Trading Volume




## AAA GO Municipal Yield Curve




## M/T Ratios

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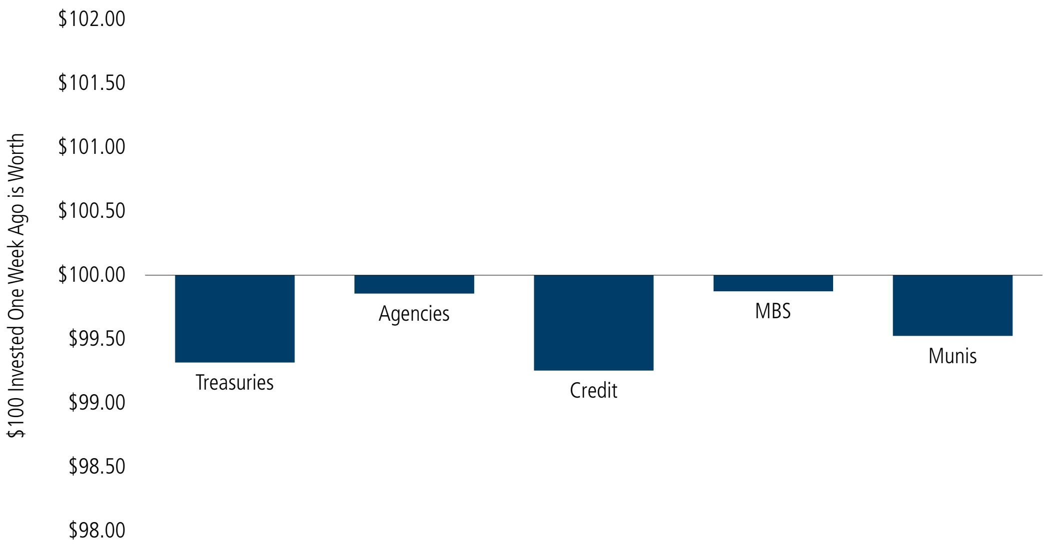
CONTENTS



## Market Sector Performance




Higher interest rates overwhelmed the benefits of tighter credit spreads in most US markets last week.

CONTENTS



## Analyst Certification

We, Alan Schankel, Guy LeBas, and Jody Lurie, the Primarily Responsible Analysts for this report, hereby certify that all of the views expressed in this report accurately reflect our personal views about any and all of the subject sectors, industries, securities, and issuers. No part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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Positive: Janney FIS believes there are apparent factors which point towards improving issuer or sector credit quality which may result in potential credit ratings upgrades

Stable: Janney FIS believes there are factors which point towards stable issuer or sector credit quality which are unlikely to result in either potential credit ratings upgrades or downgrades.

Cautious: Janney FIS believes there are factors which introduce the potential for declines in issuer or sector credit quality that may result in potential credit ratings downgrades.

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Marketweight: Janney FIS expects the target asset class or sector to perform in line with the comparable benchmark (below) in its asset class in terms of total return

Underweight: Janney FIS expects the target asset class or sector to underperform the comparable benchmark (below) in its asset class in terms of total return

## Benchmarks

Asset Classes: Janney FIS ratings for domestic fixed income asset classes including Treasuries, Agencies, Mortgages, Investment Grade Credit, High Yield Credit, and Municipals employ the "Barclay's U.S. Aggregate Bond Market Index" as a benchmark.

Treasuries: Janney FIS ratings employ the "Barclay's U.S. Treasury Index" as a benchmark.

Agencies: Janney FIS ratings employ the "Barclay's U.S. Agency Index" as a benchmark.

Mortgages: Janney FIS ratings employ the "Barclay's U.S. MBS Index" as a benchmark.

Investment Grade Credit: Janney FIS ratings employ the "Barclay's U.S. Credit Index" as a benchmark.

High Yield Credit: Janney FIS ratings for employ "Barclay's U.S. Corporate High Yield Index" as a benchmark.

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