

# Strange Things Happen When You Drive with Two Feet

---

*AAM's Investment Outlook Webinar*  
*Wednesday, February 7, 2018*



Insurance Investment Management

# Today's Presenters:

## Market Outlook



Reed J. Nuttall, CFA  
Chief Investment Officer

## Macroeconomic Review and Outlook



Marco Bravo, CFA  
Senior Portfolio Manager

## Corporate Securities



Elizabeth Henderson, CFA  
Director of Corporate Credit

## High Yield Sector



Scott A. Skowronski, CFA  
Senior Portfolio Manager

## Structured Products



Scott A. Edwards, CFA  
Director of Structured  
Products

## Municipal Market



Gregory A. Bell, CFA, CPA  
Director of Municipal Products  
and Municipal Bond Trader

## Convertible Market Overview



Tim Senechalle, CFA  
Senior Portfolio Manager

---

## Market Outlook

---



Reed J. Nuttall, CFA  
Chief Investment Officer

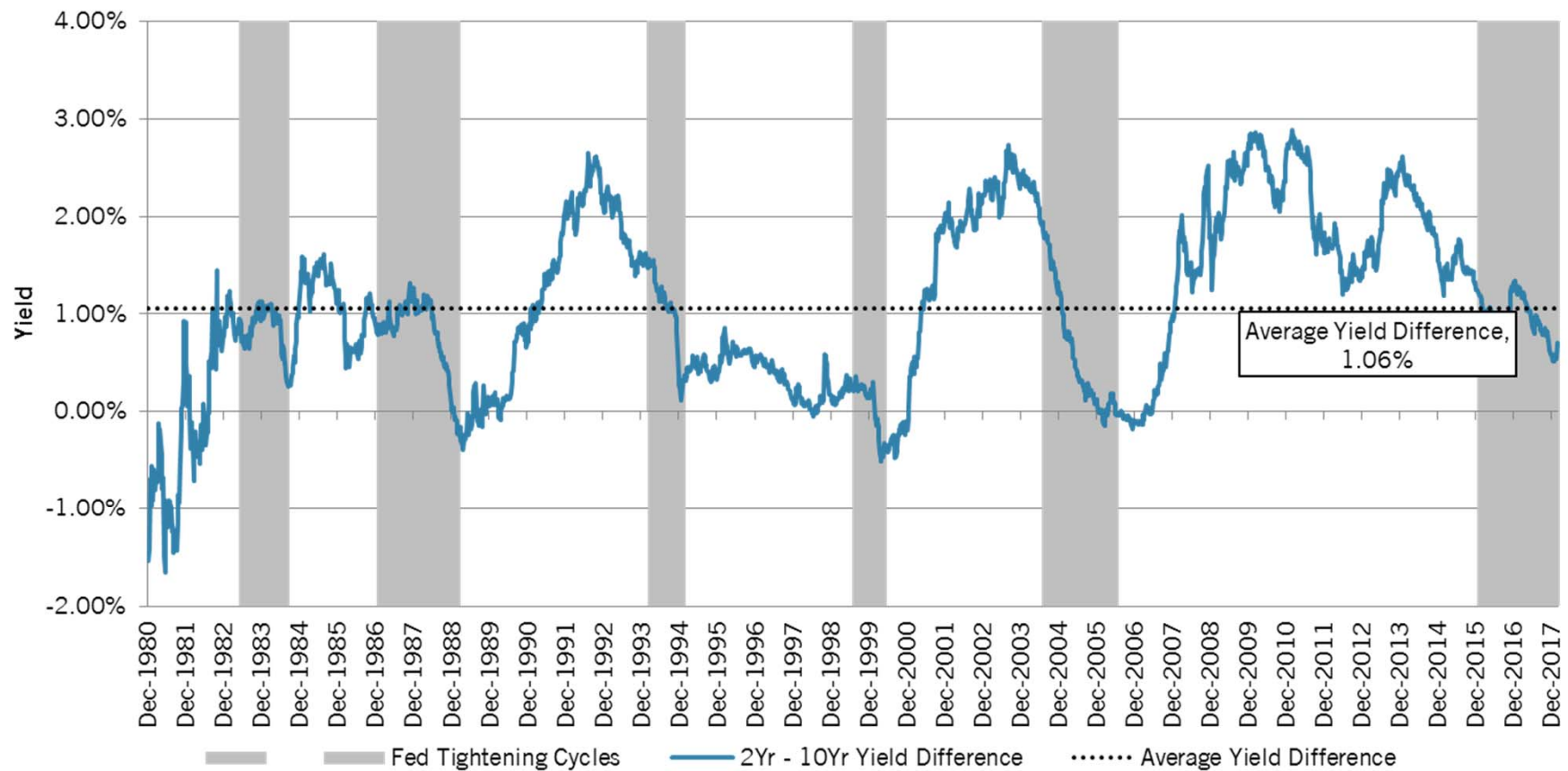
# Asset Class Returns

2017 Returns by Asset Class	
<b>Investment Grade</b>	
<b>Bloomberg Barclays US Aggregate</b>	3.07%
<b>Treasuries</b>	2.31%
<b>Corporates</b>	6.42%
<b>CMBS</b>	3.35%
<b>MBS</b>	2.47%
<b>Tax Exempt Municipals</b>	5.45%
<b>Surplus Growth</b>	
<b>High Yield</b>	7.48%
<b>US Equities</b>	20.48%
<b>Convertibles</b>	21.54%

Source: Bloomberg Barclays Index Series, S&P 500, Barclays Global High Yield Index, VOA0 (Merrill Lynch US Convertibles Ex-Mandatory)

# Treasury Curve Steepness

Yield Difference 10 Yr and 2 Yr Treasury



Source: Bloomberg weekly data

# Strange Things Happen...



---

## Macroeconomic Review and Outlook

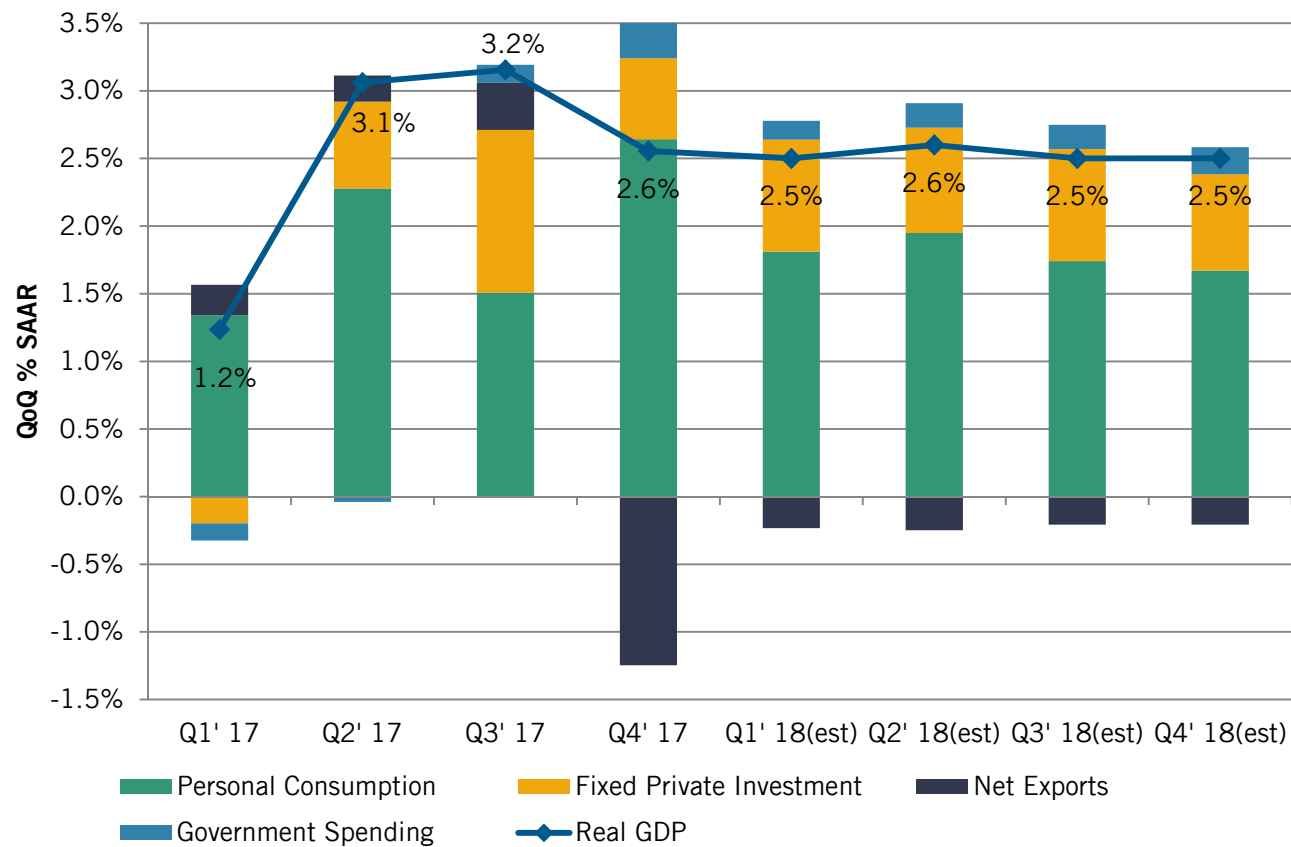
---



Marco Bravo, CFA  
Senior Portfolio Manager

# GDP Growth

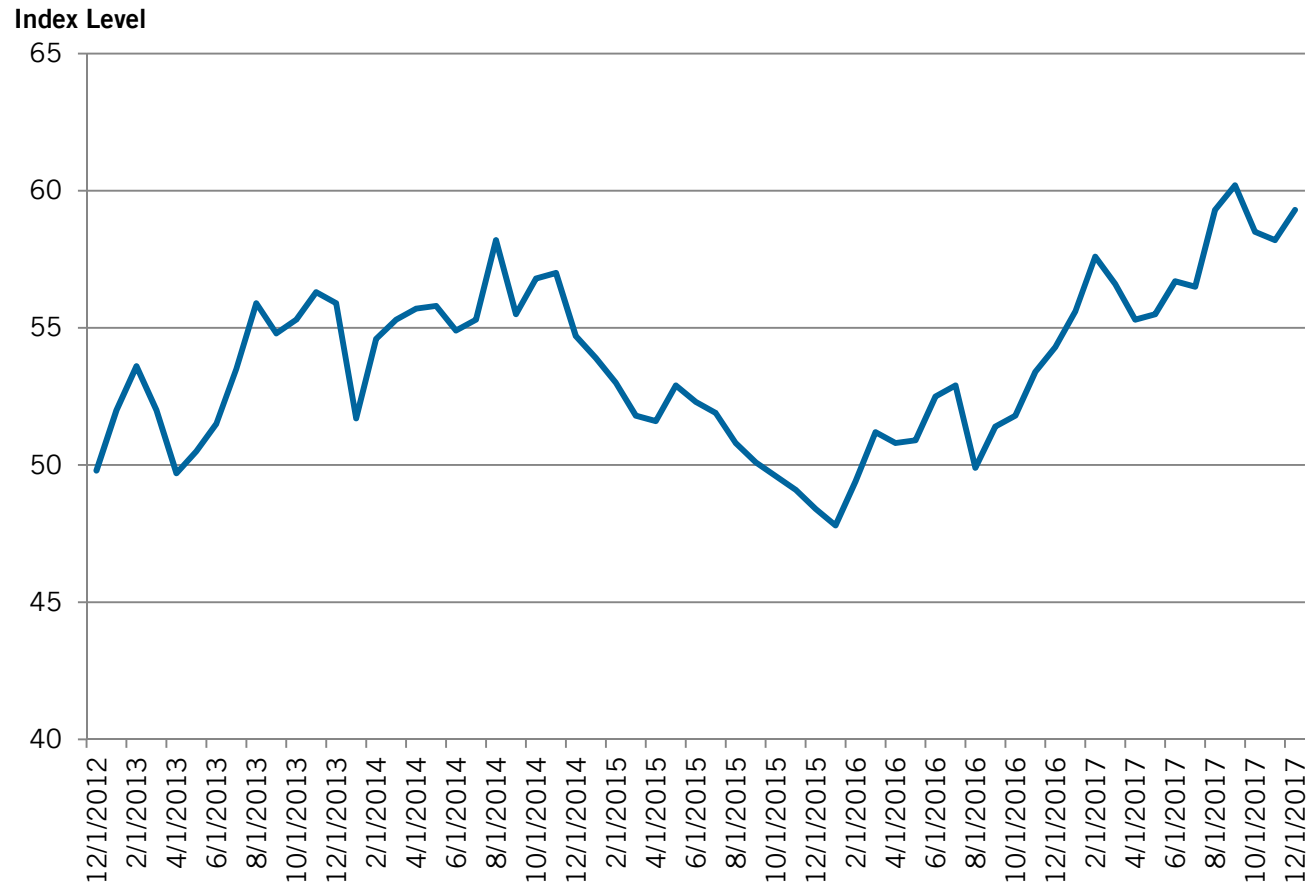
## Contribution to GDP Growth



Source: Bureaus of Economic Analysis, Bloomberg

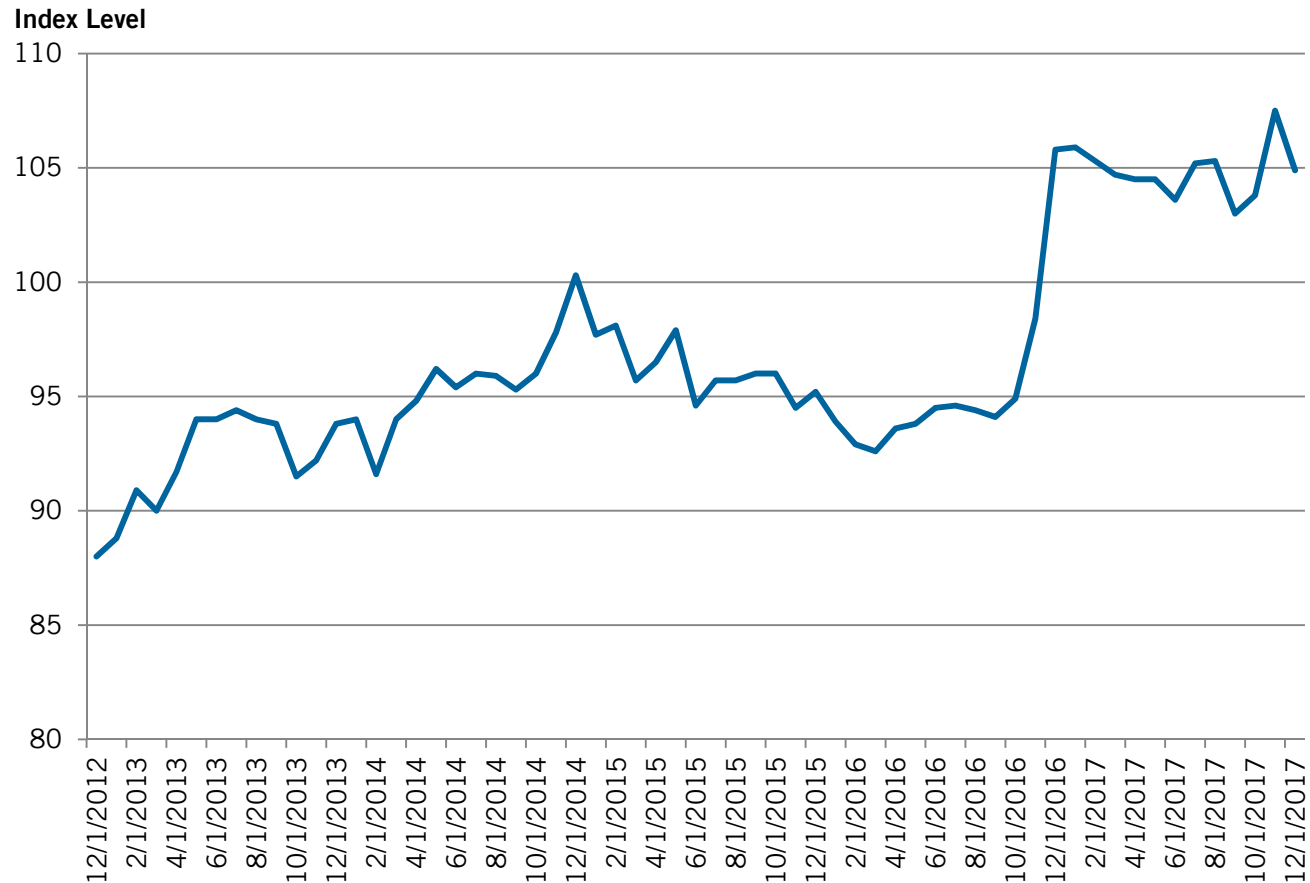


# ISM Manufacturing Index



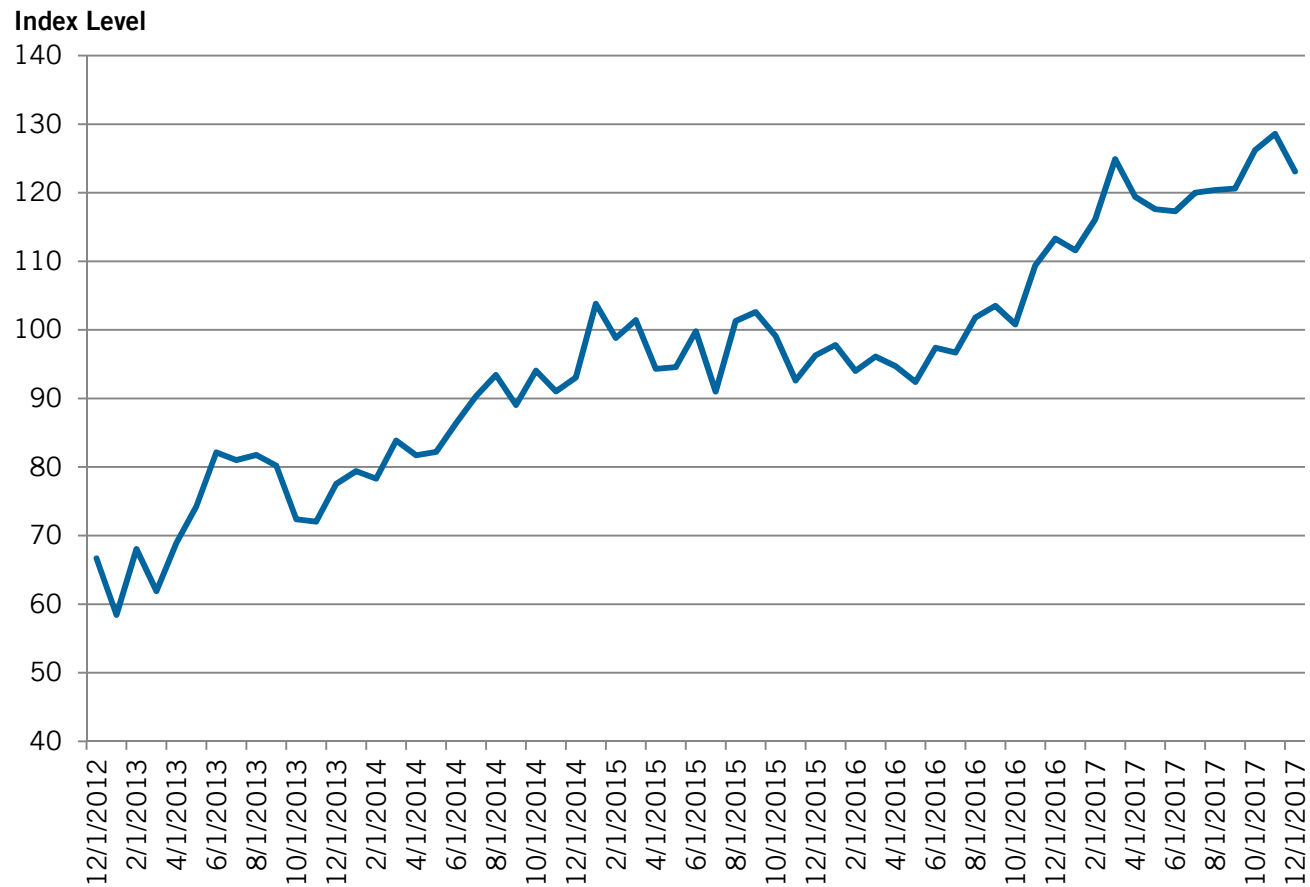
Source: Institute for Supply Management, Bloomberg

# NFIB Small Business Optimism



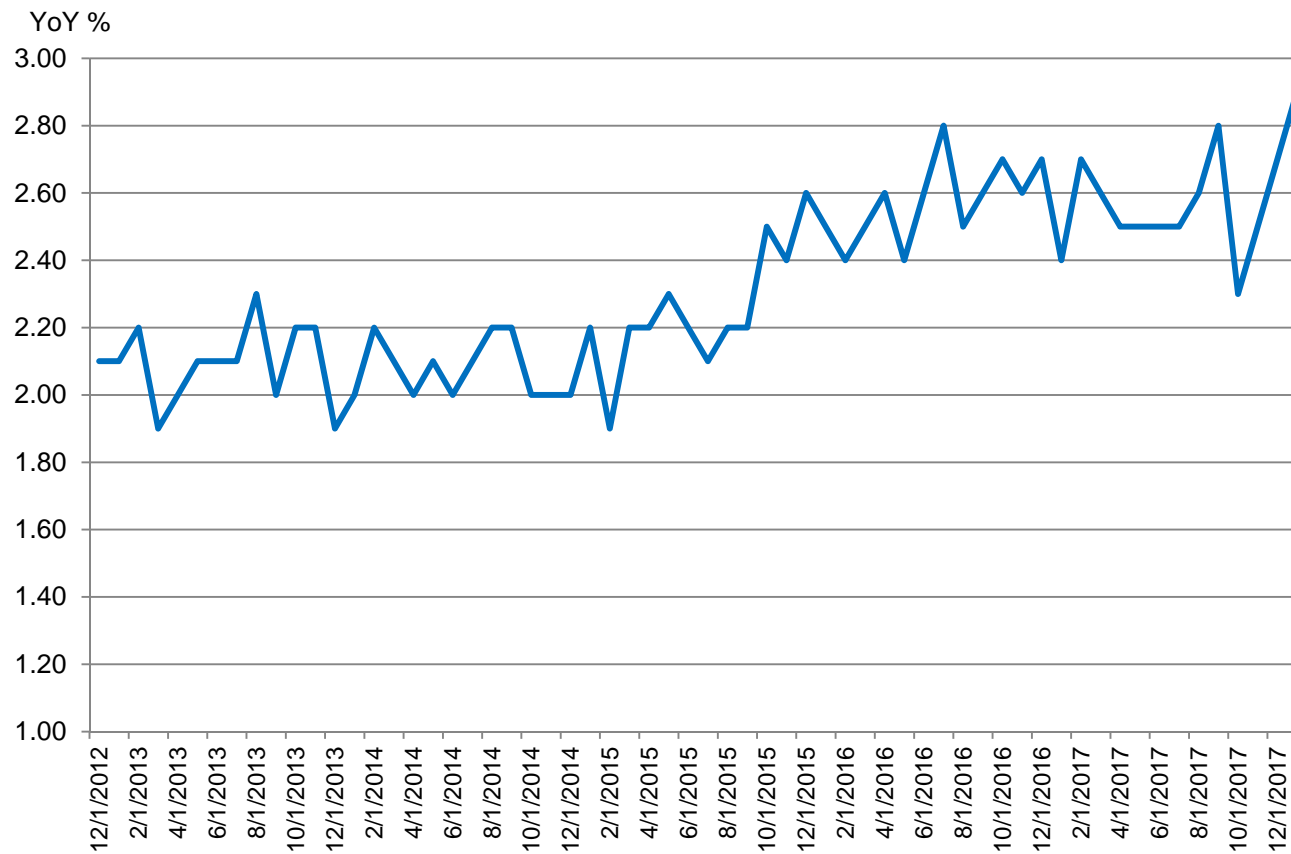
Source: National Federation of Independent Businesses, Bloomberg

# Consumer Confidence



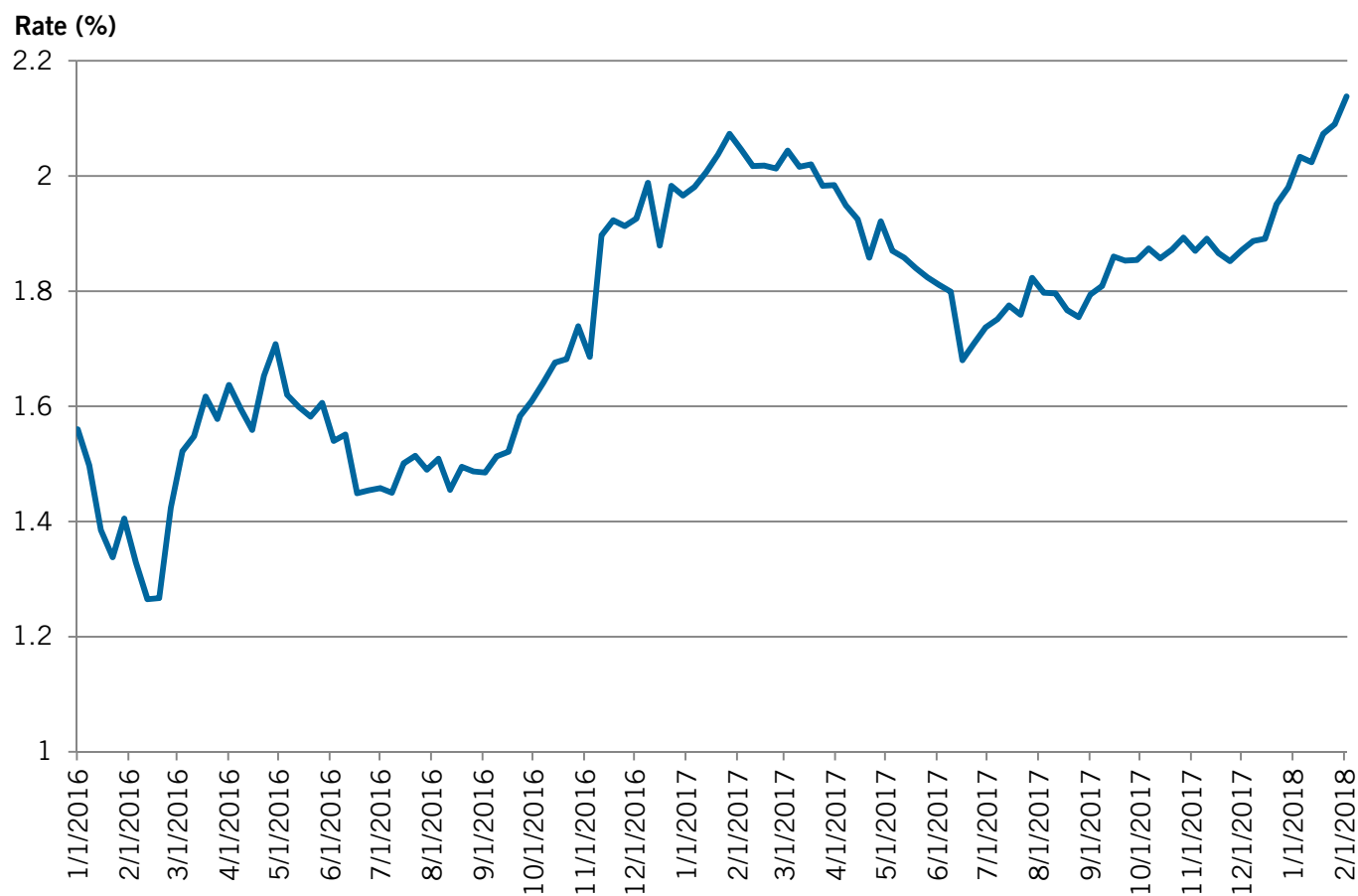
Source: Conference Board, Bloomberg

# Average Hourly Earnings



Source: Bureau of Labor Statistics, Bloomberg

# 10 Year Inflation Expectations



Source: US Treasury, Bloomberg.

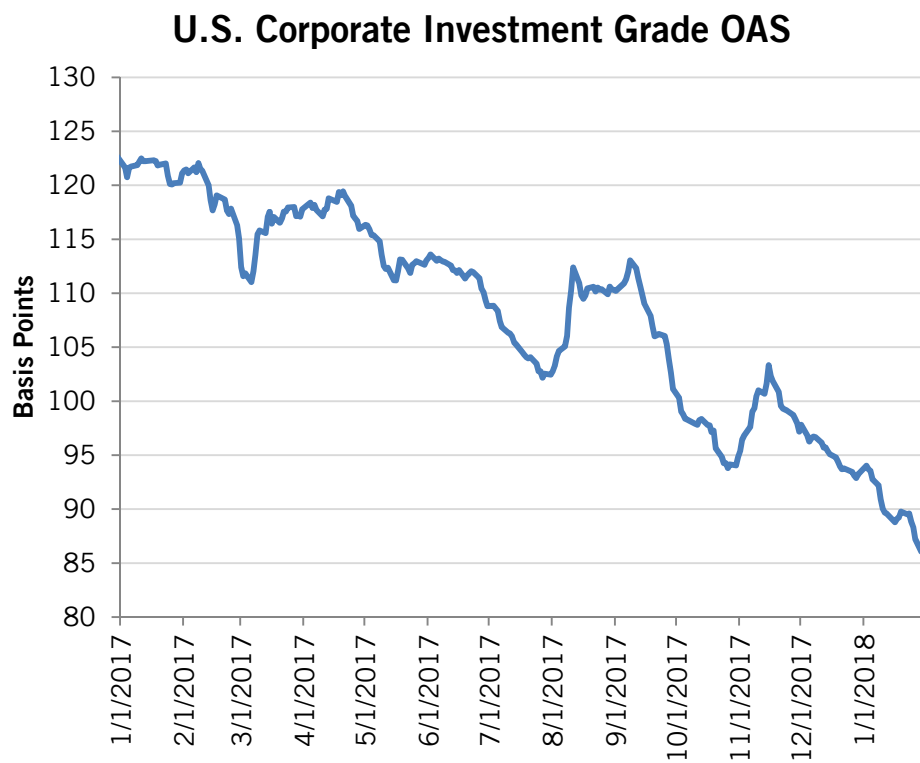
## Corporate Securities



Elizabeth Henderson, CFA  
Director of Corporate Credit

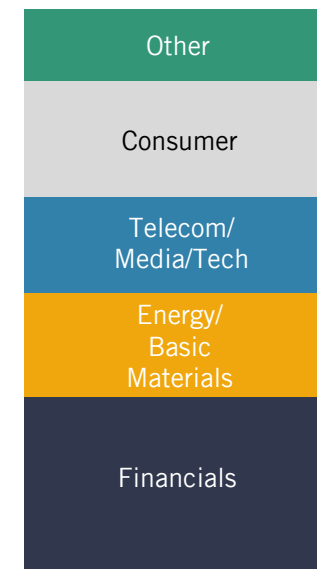
# Corporate Sector

Credit spreads tightened and all sectors contributed in 2017



Source: AAM, Bloomberg Barclays (as of 2/1/2018)

## Contribution by Sector to IG Corporate Excess Returns



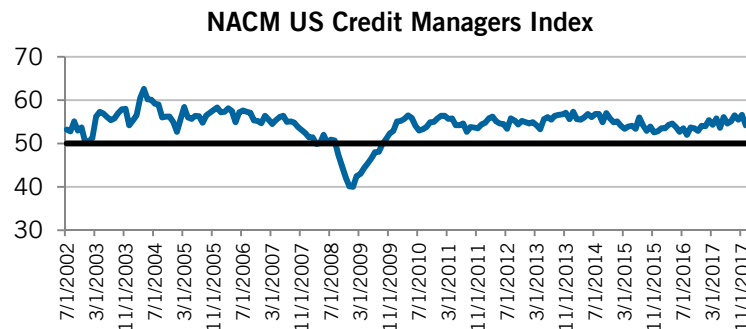
346 basis points

Source: AAM, Bloomberg Barclays as of 12/29/2017

# Corporate Sector

## *Credit cycle indicators remain supportive*

- ✚ Fewer banks tightening standards
  - Indicators indicate stability:
    - SLO survey remains favorable (standards are loose)
    - Financial Conditions Index trending positively
    - Credit Managers Index remains above 50 (expansion) and trended positively in 2017

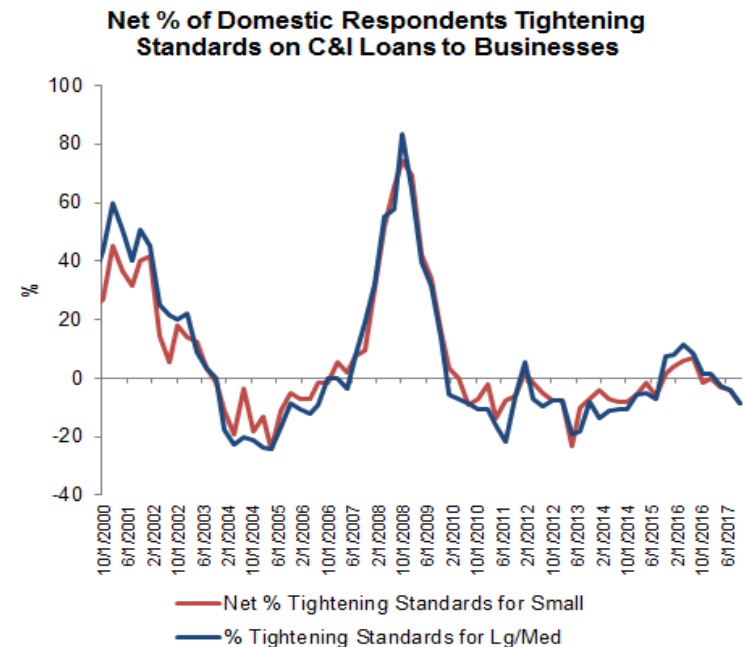


## ▬ Yield curve remains upward sloping

- Fed in tightening mode
- Flattening slowly

## ✚ Capital markets are wide open

- IPO, leveraged loans, high yield, emerging markets

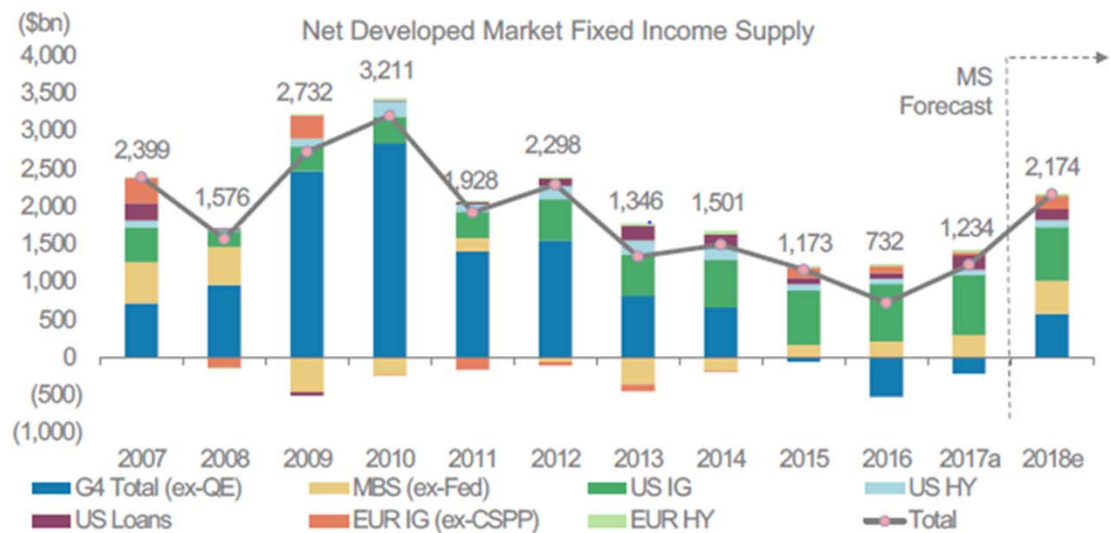


Source: AAM, Barclays, Fed



## *Modest excess returns expected in 2018*

- Fundamentals expected to remain stable
- Technicals remain favorable but expected to soften in 2018
- Valuation is not compelling as spreads are historically tight



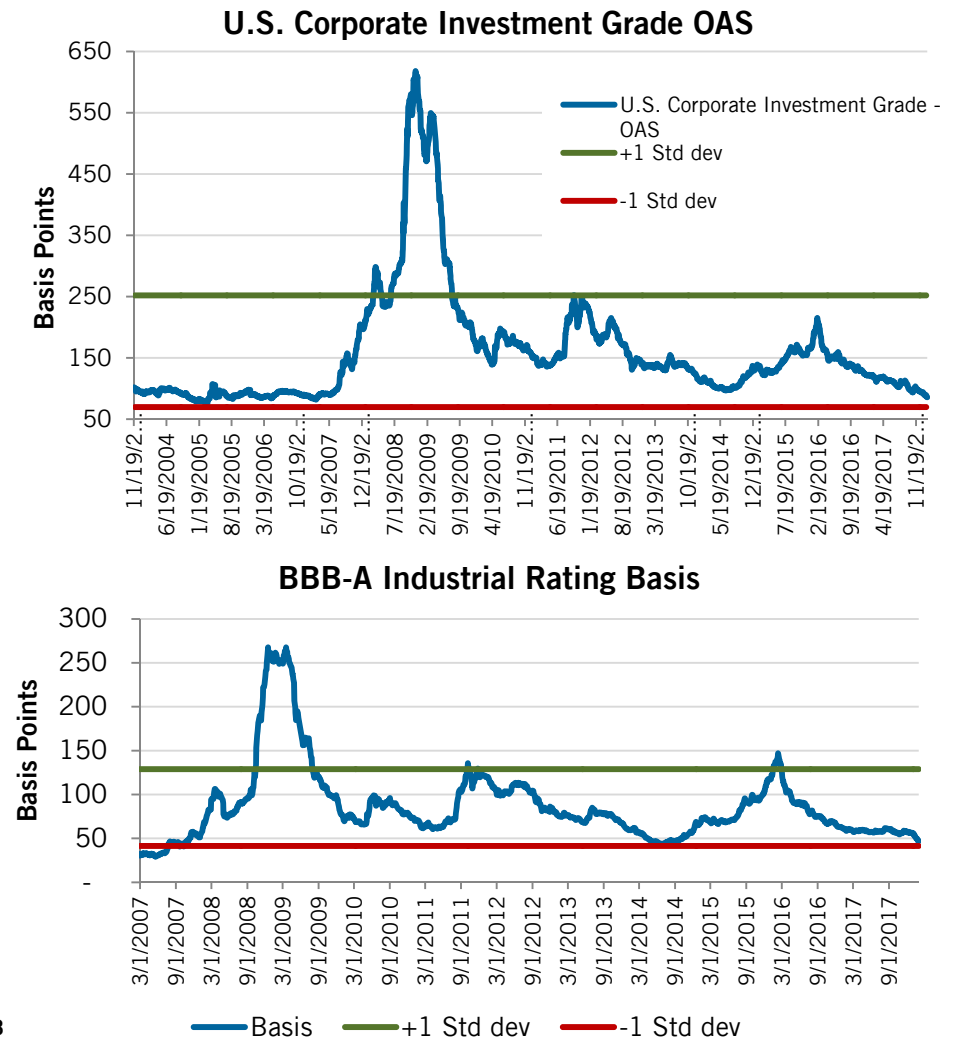
Source: Morgan Stanley Research, Dealogic, S&P LCD, Federal Reserve, Bank of Japan, Bank of England, ECB

# Corporate Sector

*Modest excess returns expected in 2018, continued*

- Fundamentals expected to remain stable
- Technicals remain favorable but expected to soften in 2018
- Valuation is not compelling as spreads are historically tight

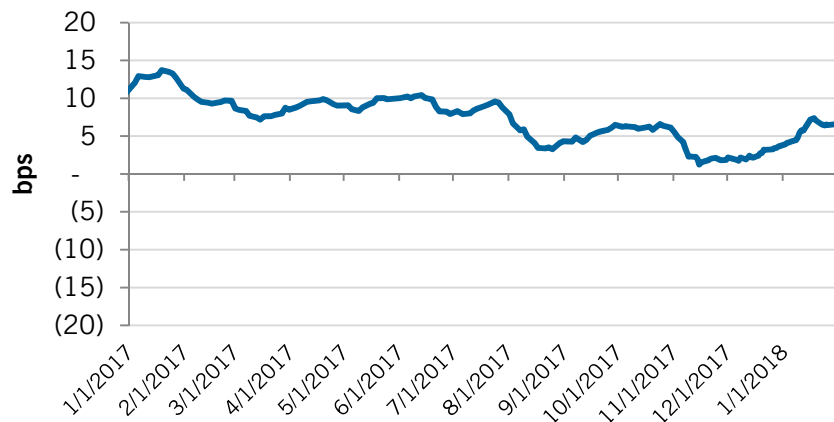
Source: AAM, Bloomberg Barclays (OAS data)



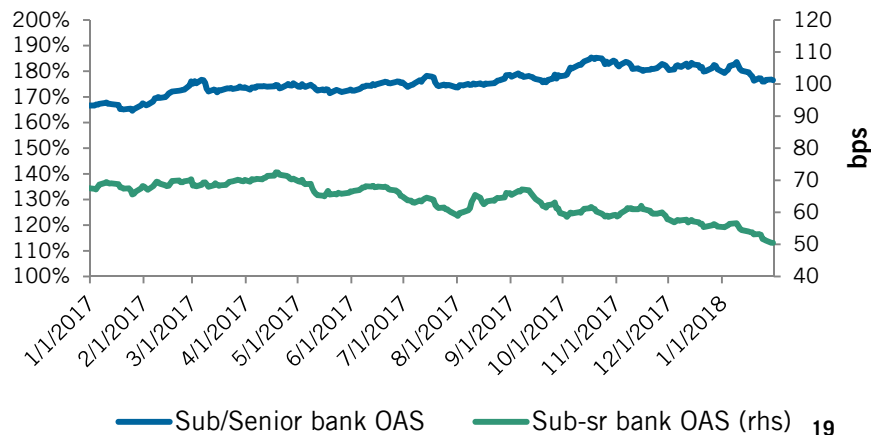
# Corporate Sector

*Prioritize risk adjusted income – Opportunities in Financials*

**Finance – Industrials OAS**



**Sub/Senior bank relationships**



## AAM comments:

- Financials are fairly valued given outperformance
- Prefer domestic banks (money center, legacy bonds), P&C and Life Insurance and insurance brokers
- Remain selective in REITs and managed care
- Community banks remain interesting but must be selective and disciplined with pricing
- Continue to avoid:

## Inadequate risk adjusted return

Australian banks	Asset managers
Reinsurers	Small REITs
BDCs	Broker dealers

# Corporate Sector

*Prioritize risk adjusted income – Opportunities in non-Financials*

## AAM comments:

- BBBs offer more value but must be selective at lower end of quality spectrum especially as spreads have compressed with higher quality
- Investment themes:
  - Technological disruption in TMT:
    - Pros: Semiconductors, Software, Telecom, Towers
    - Cons: Cable, Hardware, small Media networks
  - Growth challenged/cost focused:
    - Pros: M&A related new issue funding
    - Cons: Highly rated Consumer Products, Food/Beverage, Healthcare, IT Services
  - Balance sheet focused
    - BBB Pharma, Energy, Metals & Mining, Utilities

Outperform		
Metals & Mining	Diversified Manufacturing	Wirelines
Supermarkets	Pharmaceuticals	Tobacco
Independent Energy	Midstream	Railroads
Electric Utilities	Natural Gas	

Underperform		
Healthcare	Technology	Integrated Energy
Consumer Products	Food/Beverage	Chemicals
Auto	Cable/Satellite	Media

---

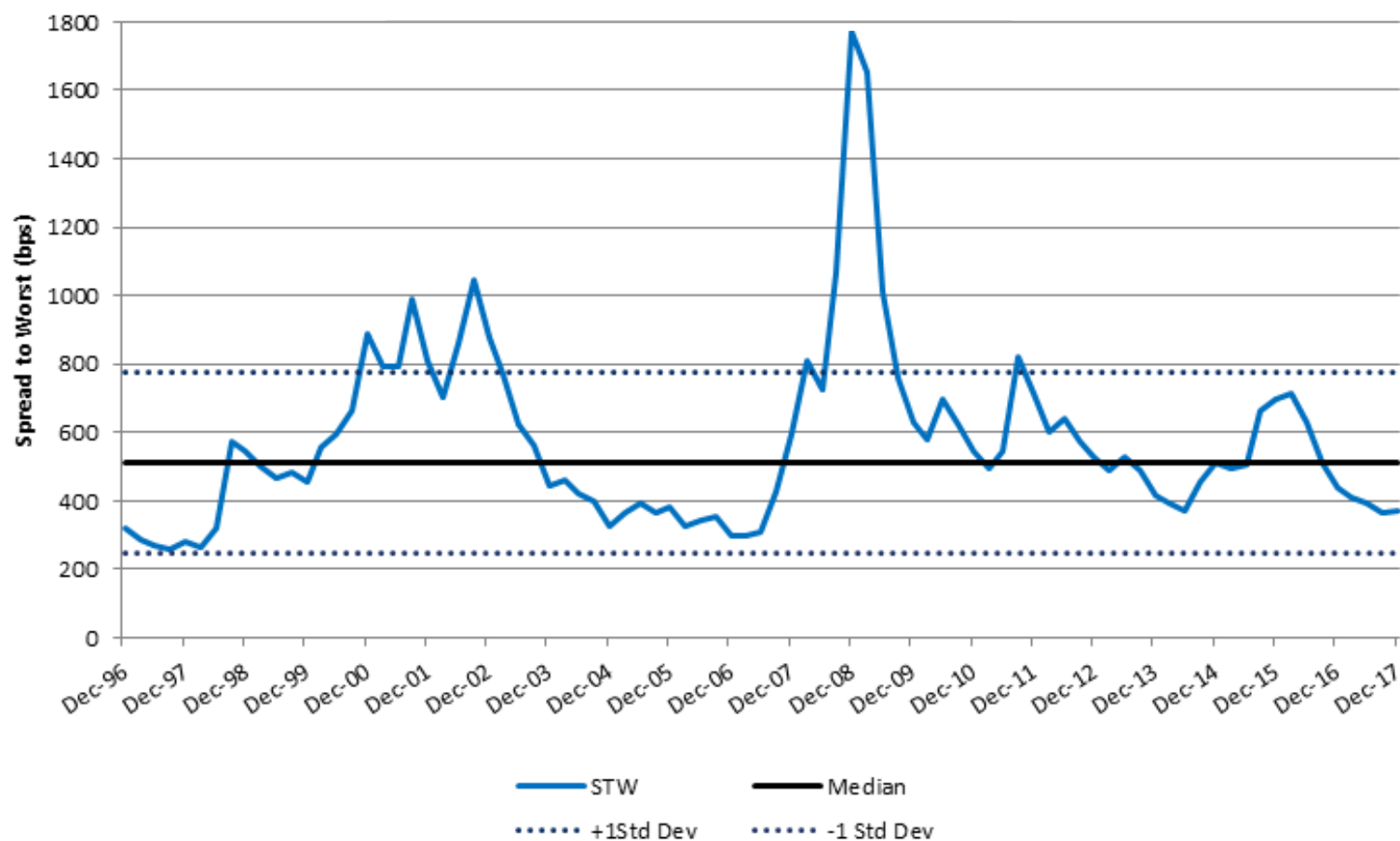
## High Yield Sector

---



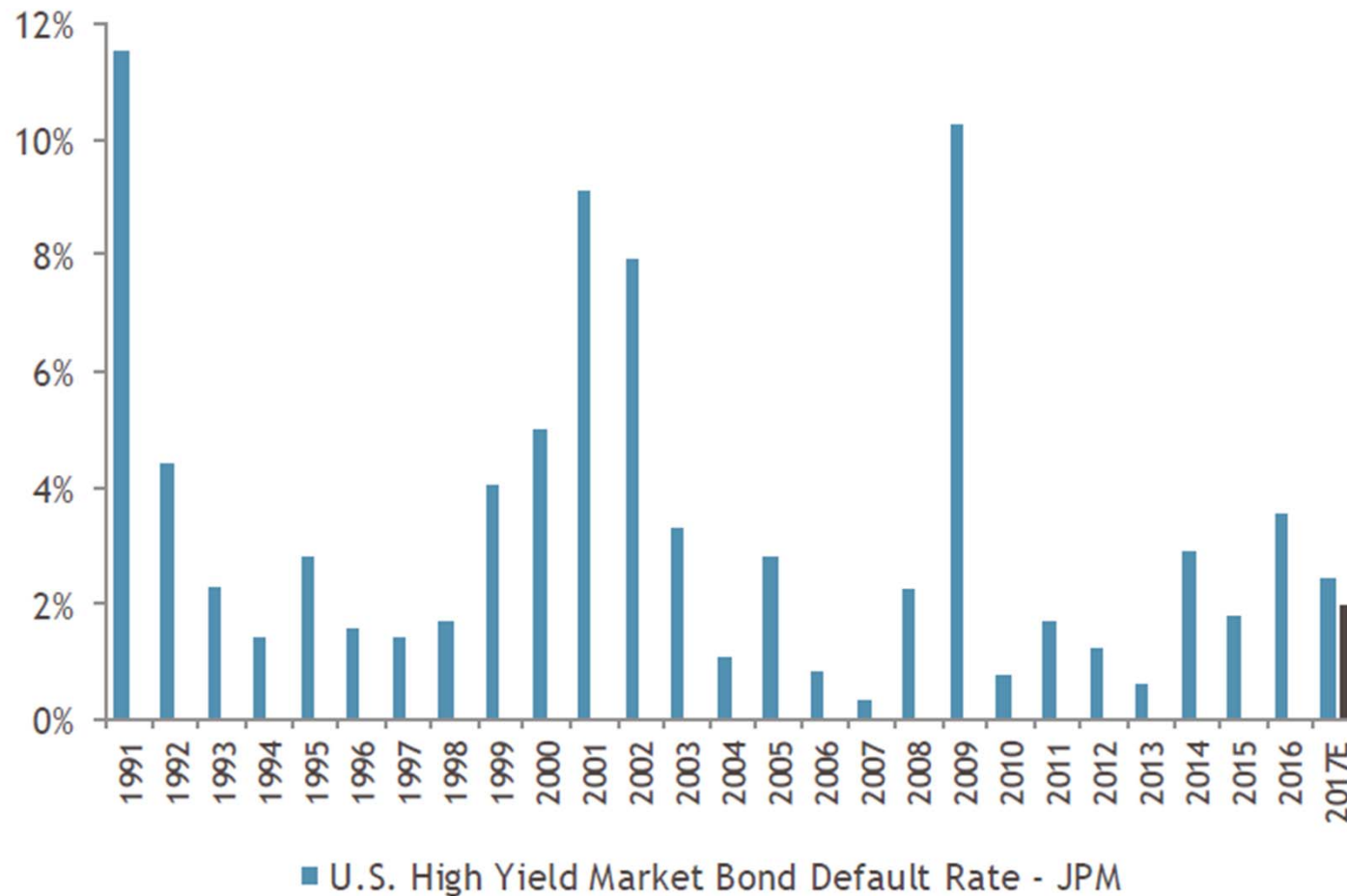
Scott A. Skowronski, CFA  
Senior Portfolio Manager

# Long Term High Yield Spreads



Source: ICE Bank of America Merrill Lynch High Yield US High Yield Index

# Default Rate Expectations Are Lower



Source: JP Morgan, as of November 2017. 2017 blue line - actual default rate, dark line - expected

---

## Structured Products

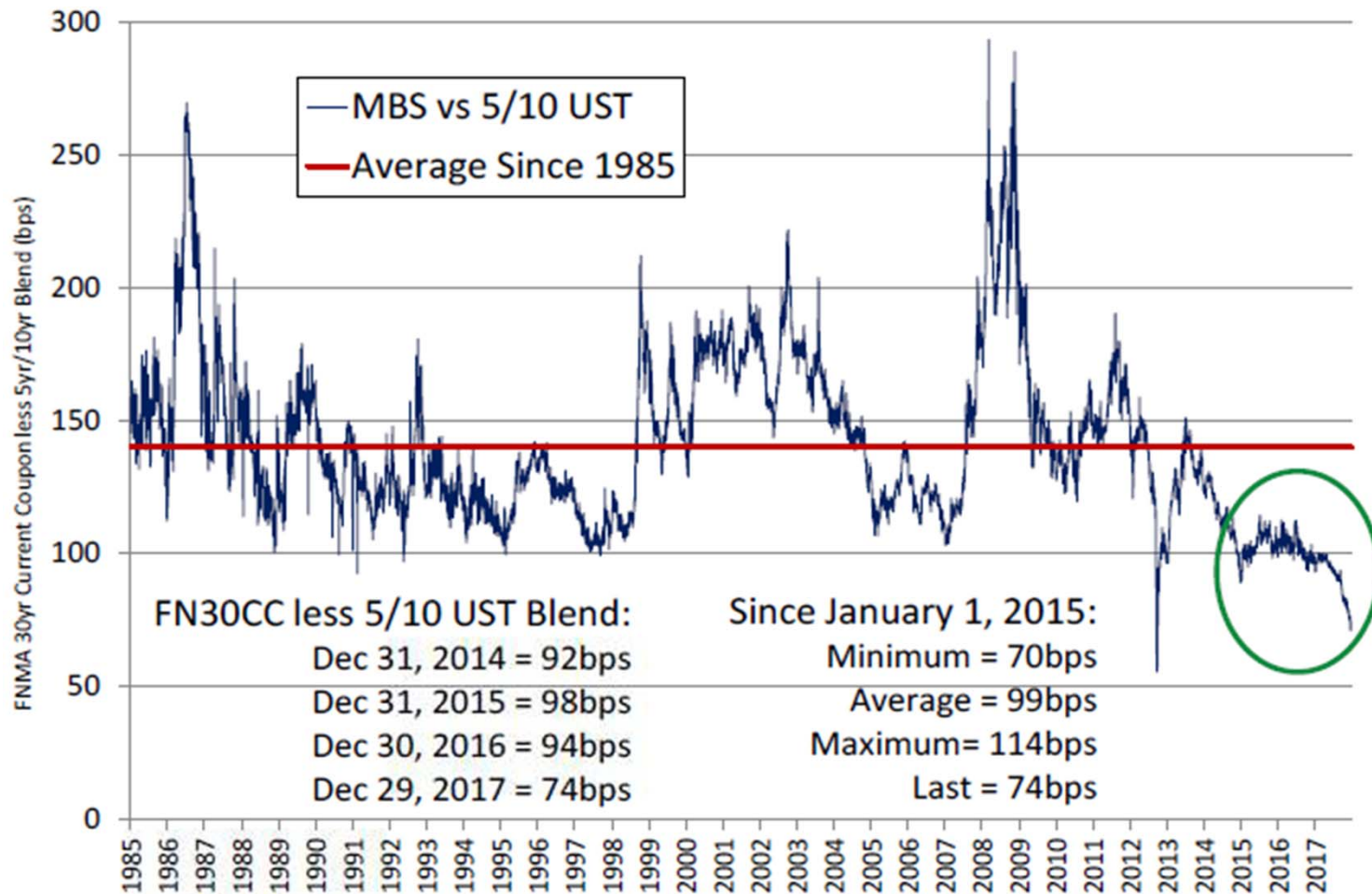
---



Scott A. Edwards, CFA  
Director of Structured Products



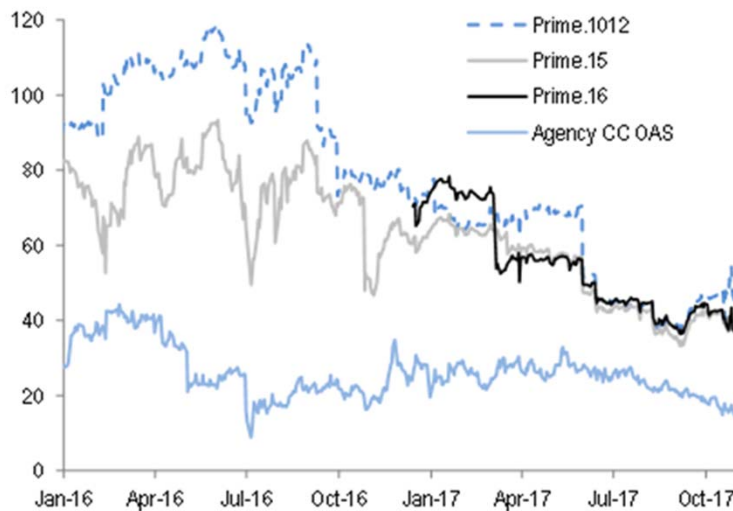
# 30yr Mortgage Backed Security Spreads



Source: Stifel, Bloomberg

# Non-Agency Residential Mortgage Backed Securities

**Prime Non-Agency 2.0 MBS Spreads (bps)  
Compared with Agency MBS is attractive**

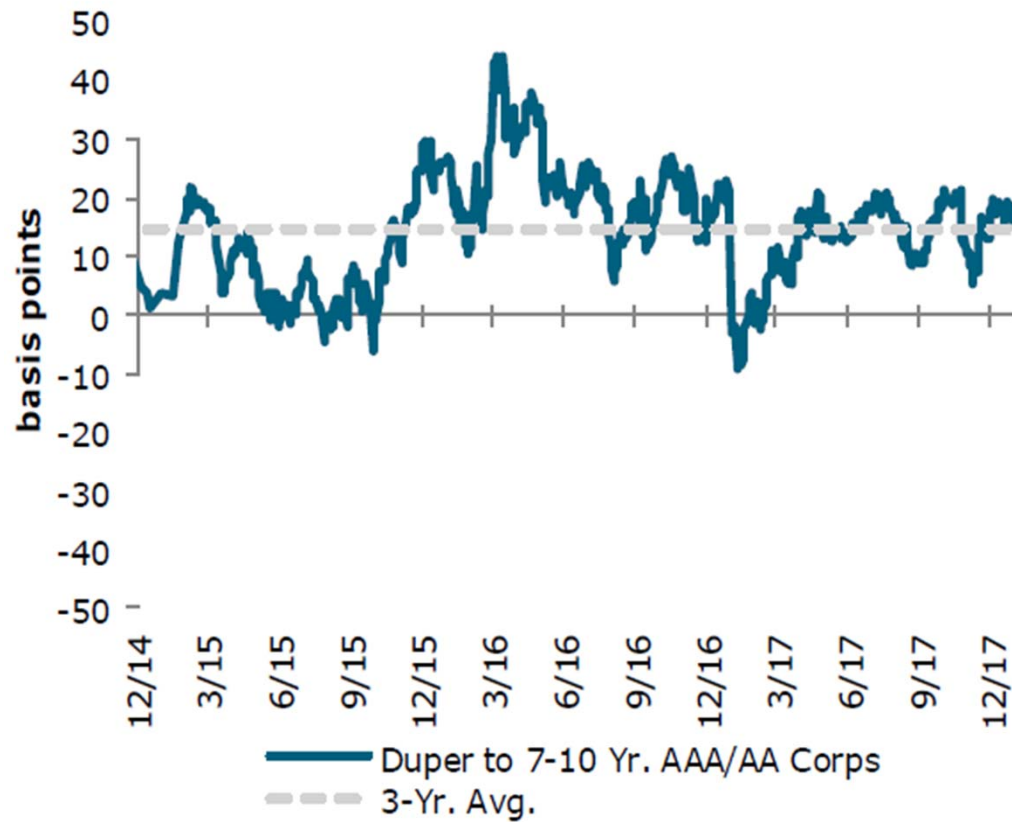


**Mortgage-Backed Security (MBS)  
Issuance (\$ billions)**

Year	Agency MBS	Non-Agency Prime MBS
2009	1,734	0
2010	1,420	0
2011	1,240	1
2012	1,757	3
2013	1,643	13
2014	980	9
2015	1,323	12
2016	1,607	5
2017	1,712	12

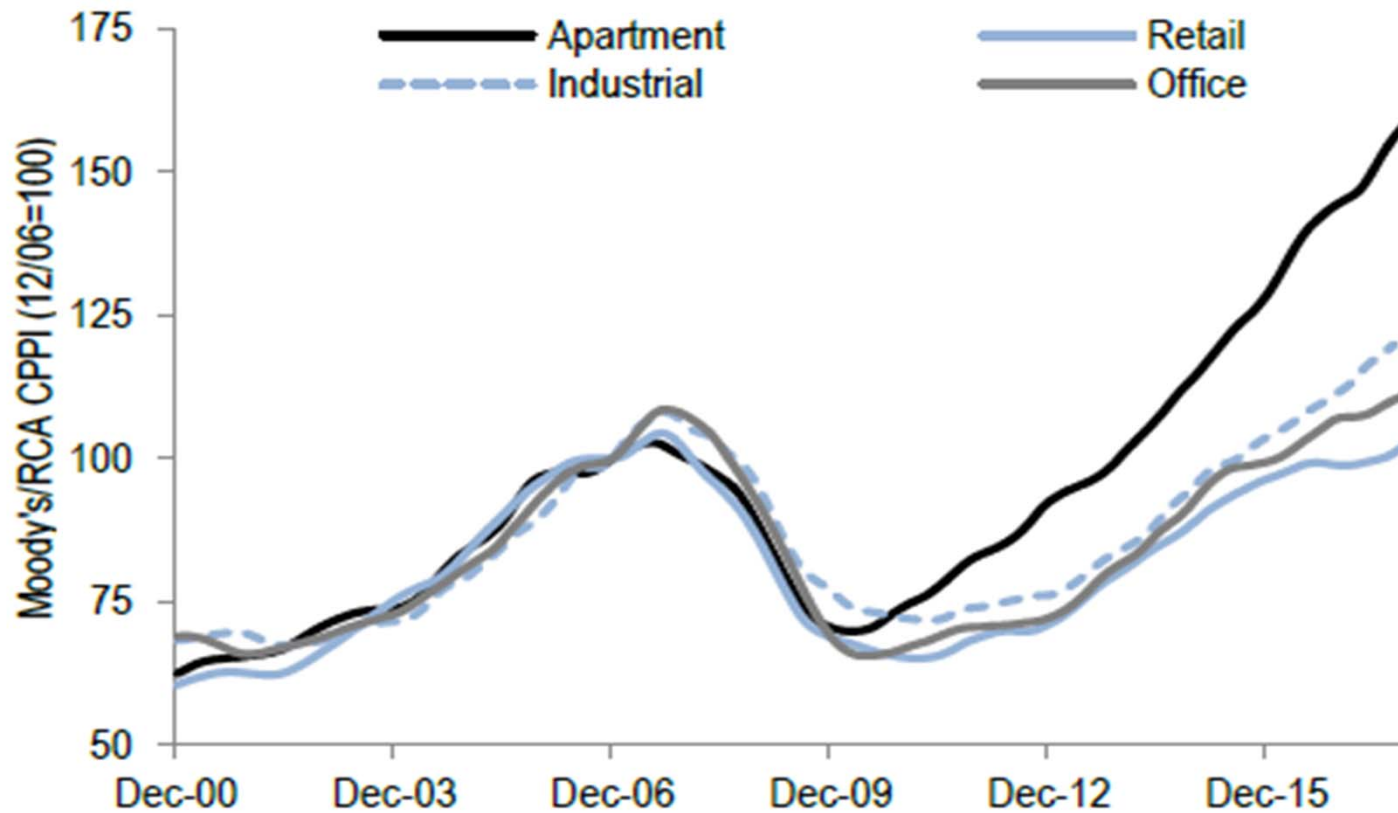
- Prime Non-Agency RMBS offer compelling carry versus Agency MBS and are expected to outperform
- Limited issuance relative to Agency RMBS provides opportunities for managers who can accumulate meaningful exposure
- Credit performance has been excellent in Non-Agency Jumbo 2.0 given stringent mortgage underwriting standards**
  - 17 defaults out of 76,426 loans securitized (0.02%) since 2012**

# 'AAA' CMBS Spreads vs. 10yr 'A' Corporate Bonds



Source: Wells Fargo Global Securities

# Commercial Real Estate Price Appreciation By Sector



Source: Bank of America Merrill Lynch Global Research

---

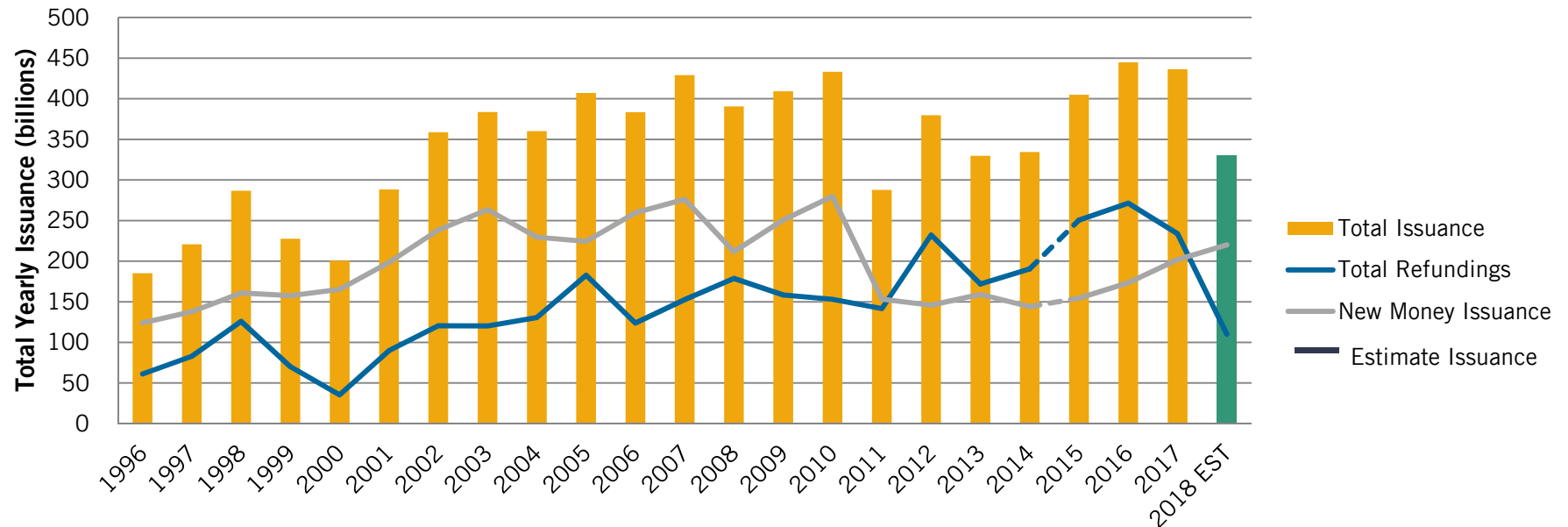
## Municipal Market

---



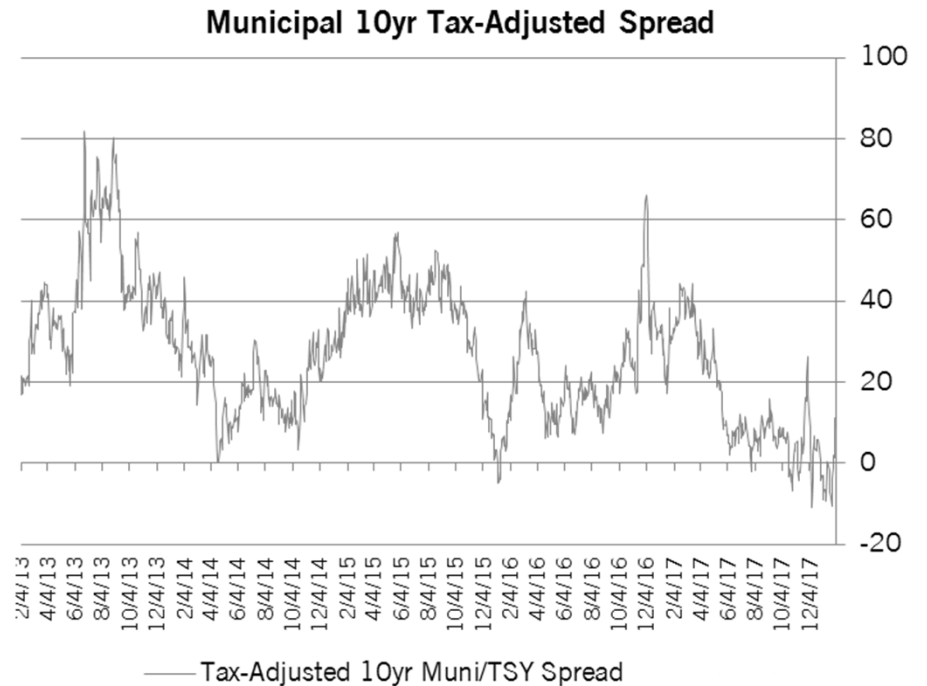
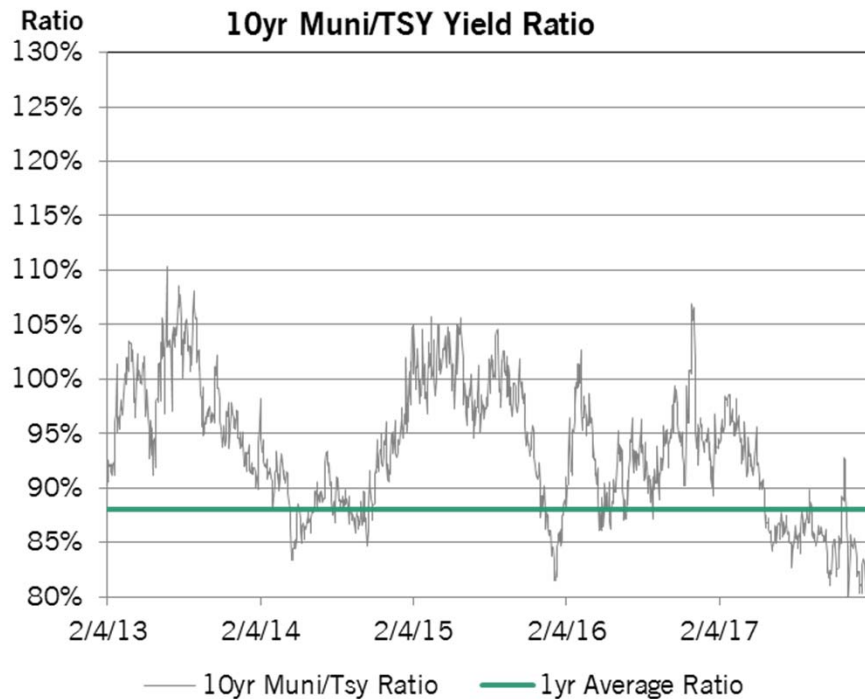
Gregory A. Bell, CFA, CPA  
Director of Municipal Products and Municipal Bond Trader

# Strong Technicals should Support Relative Valuations



- New issuance supply expected to reach \$330billion, down 24% from 2017
  - Substantial drop in refinancing activity will be the largest driver
  - Infrastructure-related issuance of \$220 Billion expected to be the highest in 8 years
- Demand expected to remain strong in rising rate environment
  - Very heavy reinvestment flows from call proceeds should be very supportive
  - High marginal tax rates should continue to attract retail investors
  - Mutual fund redemptions expected to be a drag on demand flows as rates rise

# Tax-Adjusted Relative Valuations are Unattractive for Insurers



Source: Bloomberg

---

## Convertible Market Overview

---

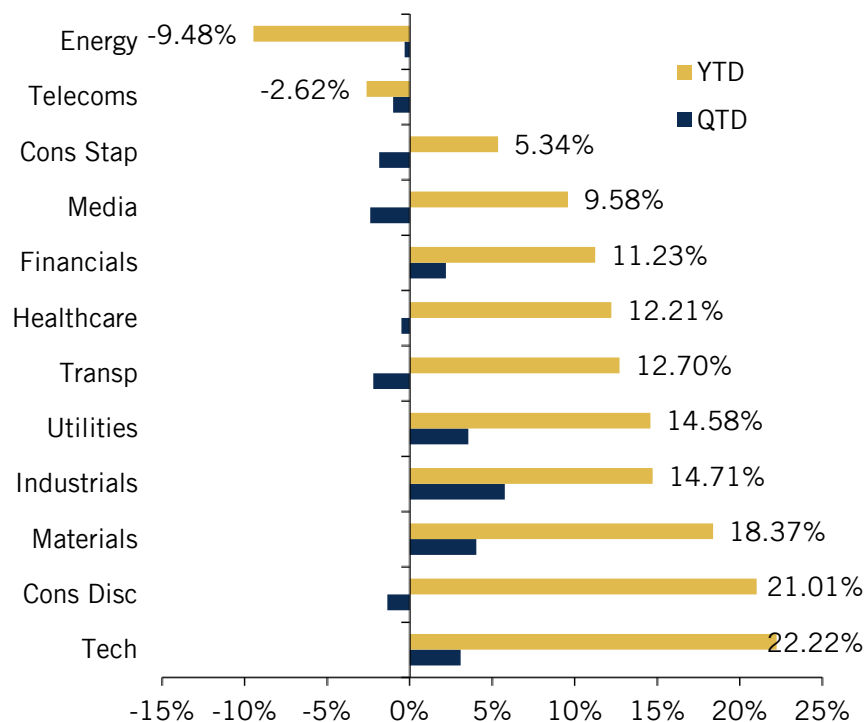


Tim Senechalle, CFA  
Senior Portfolio Manager

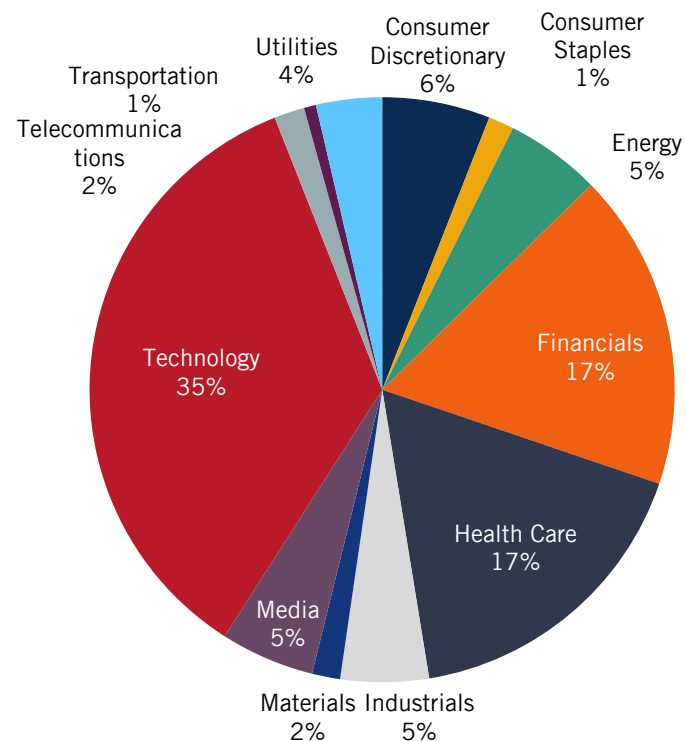


# Convertible Market Performance & Sector Distribution

4<sup>th</sup> Quarter & 2017 Full Year Performance – By Sector

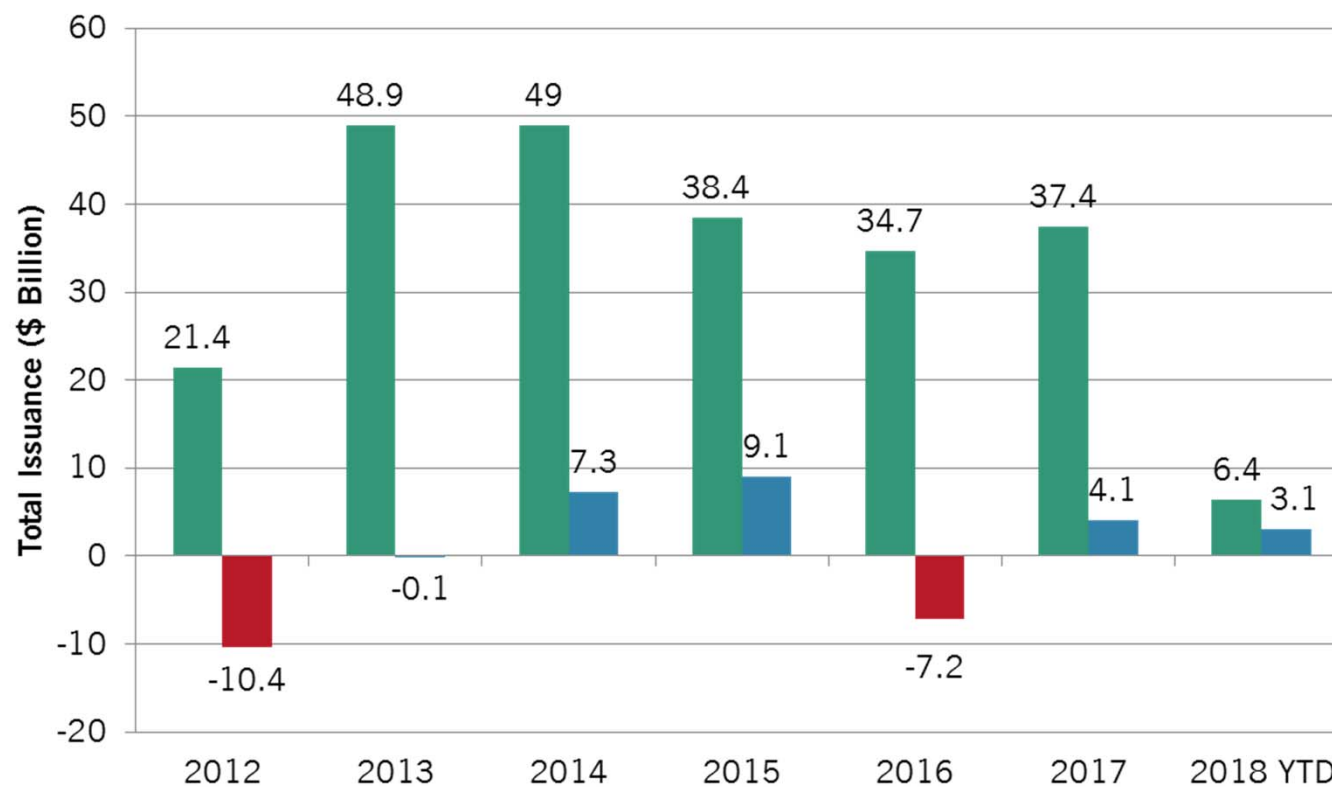


U.S. Convertible Market Sector Breakdown – 12/31/2017



Source: Bank of America Merrill Lynch Global Research, Data as of 12/31/2017

## U.S. Convertible Issuance – Gross & Net



Source: Barclays Capital Global Research Through 1/31/2018

## Summary and Questions

---

*Strange Things Happen When You  
Drive with Two Feet*

# Today's Presenters:

## Market Outlook



Reed J. Nuttall, CFA  
Chief Investment Officer

## Macroeconomic Review and Outlook



Marco Bravo, CFA  
Senior Portfolio Manager

## Corporate Securities



Elizabeth Henderson, CFA  
Director of Corporate Credit

## High Yield Sector



Scott A. Skowronski, CFA  
Senior Portfolio Manager

## Structured Products



Scott A. Edwards, CFA  
Director of Structured  
Products

## Municipal Market



Gregory A. Bell, CFA, CPA  
Director of Municipal Products  
and Municipal Bond Trader

## Convertible Market Overview



Tim Senechalle, CFA  
Senior Portfolio Manager

Please enter any questions on the top right  
hand of your screen