



AMHERST  
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# Rates and Risk Premiums

The APS Insurance Portfolio Strategy Conference  
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**Steven Abrahams**

Head of Investment Strategy

[sabrahams@apsec.com](mailto:sabrahams@apsec.com)

1 (646) 776-7864

**Mary Beth Fisher**

Strategist

[mfisher@apsec.com](mailto:mfisher@apsec.com)

1 (646) 776-7872

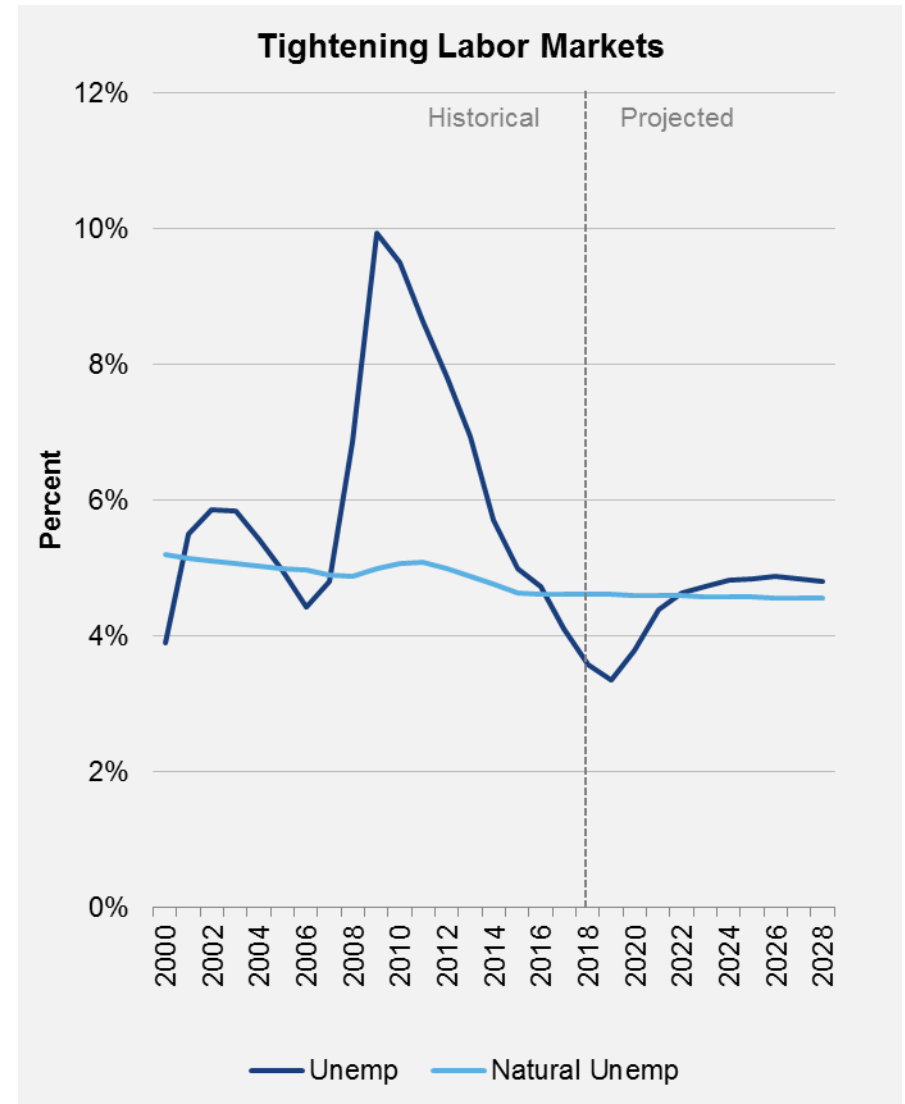
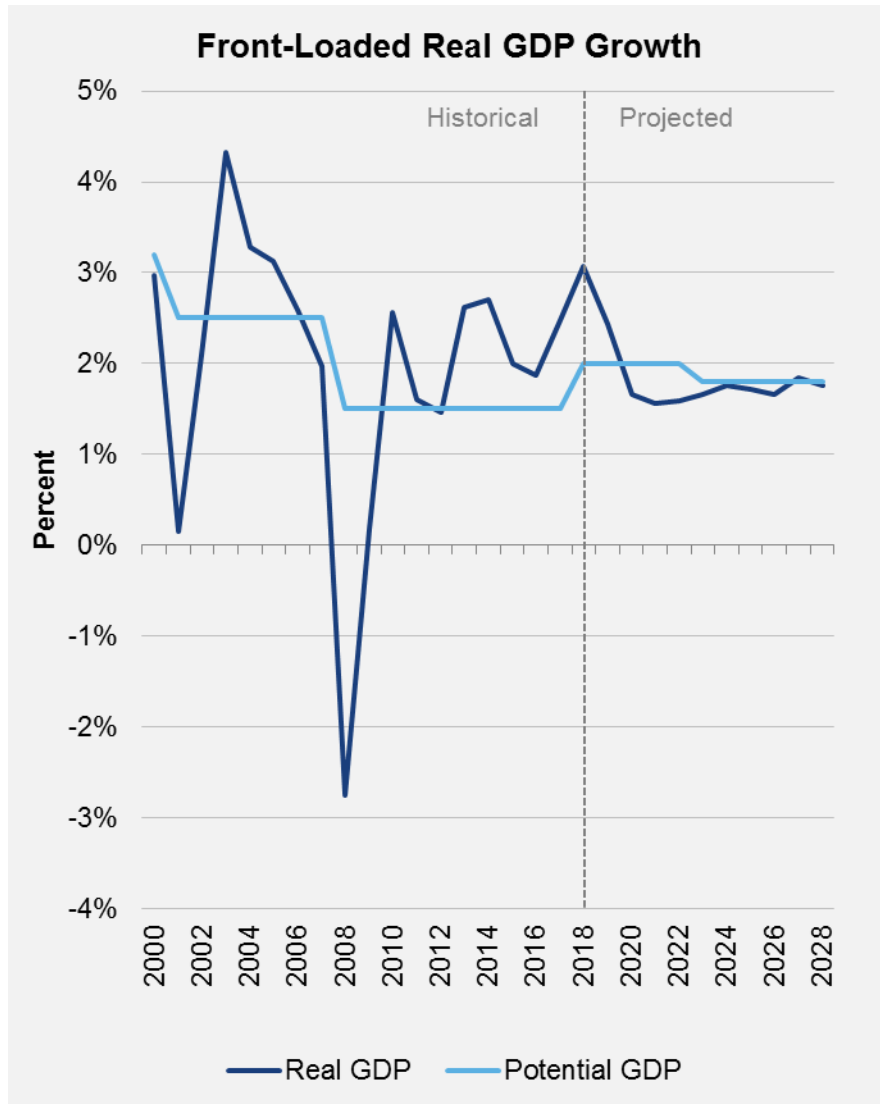
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# SUMMARY

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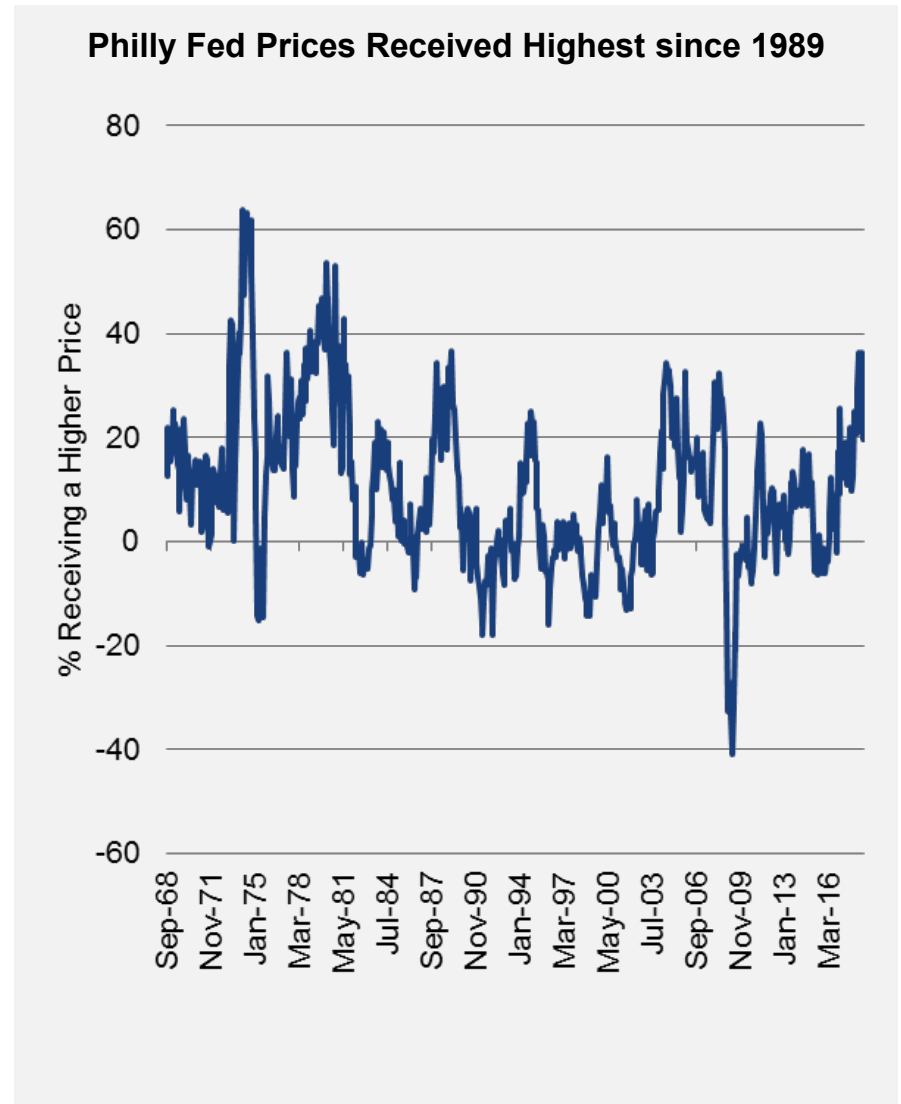
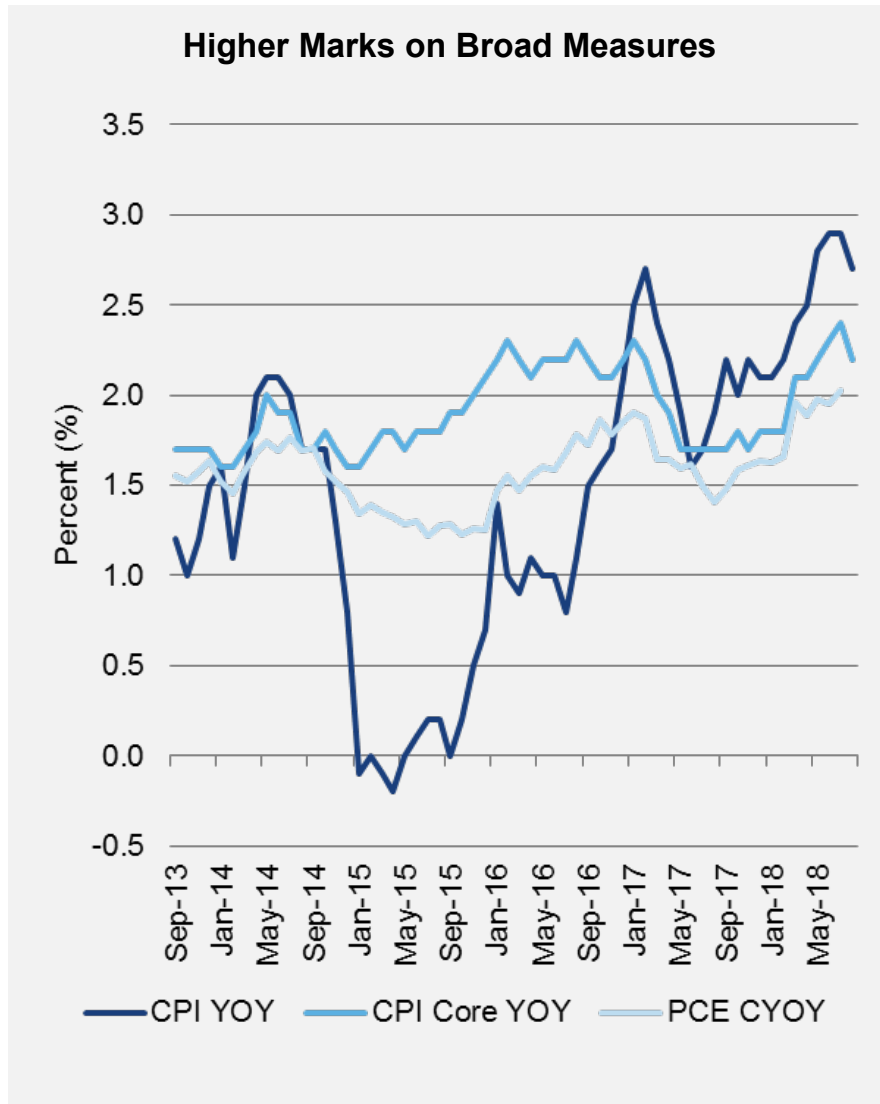
- **The government balance sheet: mainly fair value**
- The corporate balance sheet: caveat emptor
- The household balance sheet: opportunity knocks
- Thoughts on leveraged loans

# CONVENTIONAL ANALYSIS SEES TAX REFORM AND FISCAL SPENDING ACCELERATING GROWTH AND TIGHTENING LABOR



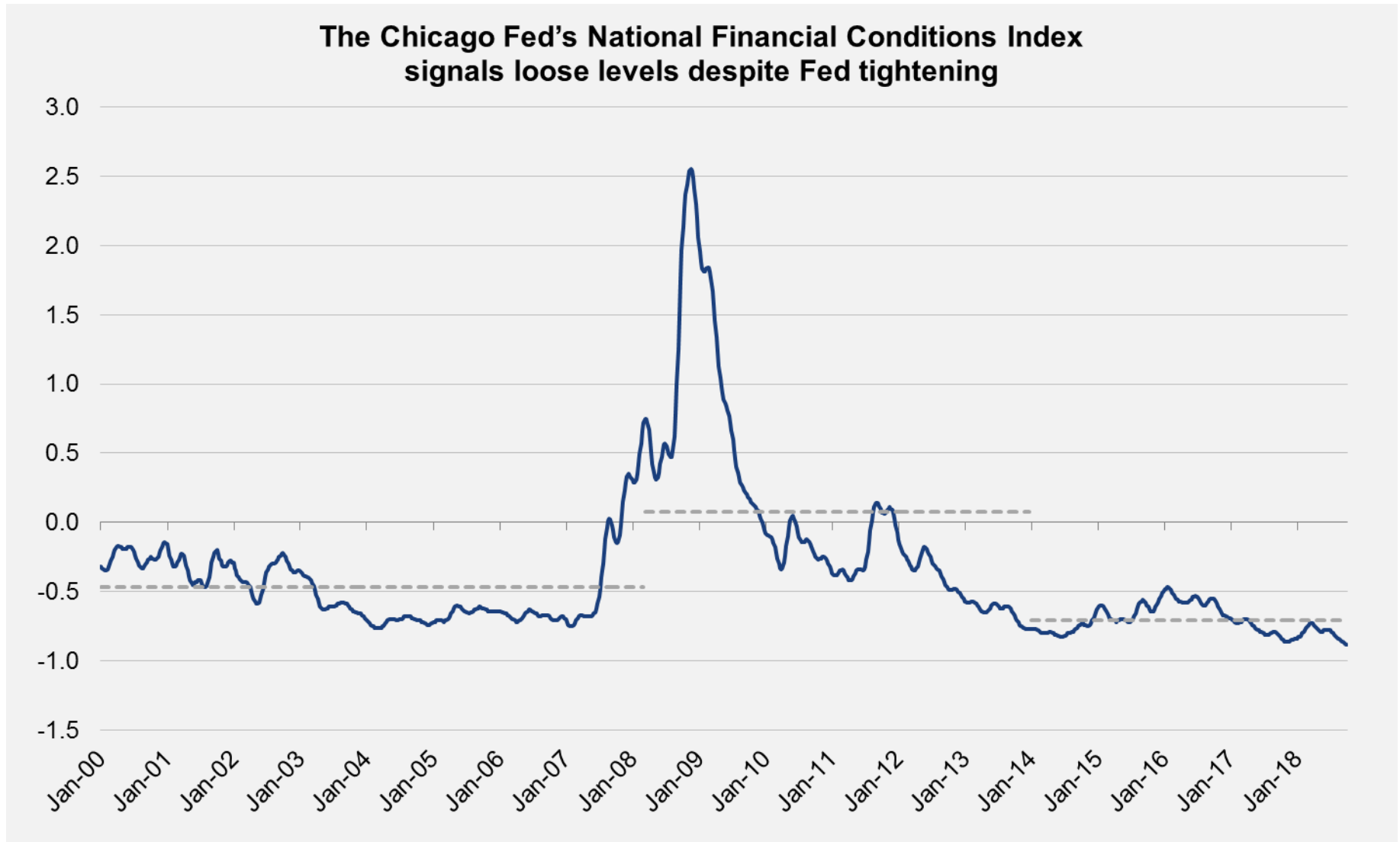
Source: Congressional Budget Office, An Update to the Economic Outlook: 2018 to 2028, August 13, 2018

# INFLATION CONTINUES TO NORMALIZE



Source: Bloomberg, APS as of Sep 30, 2018

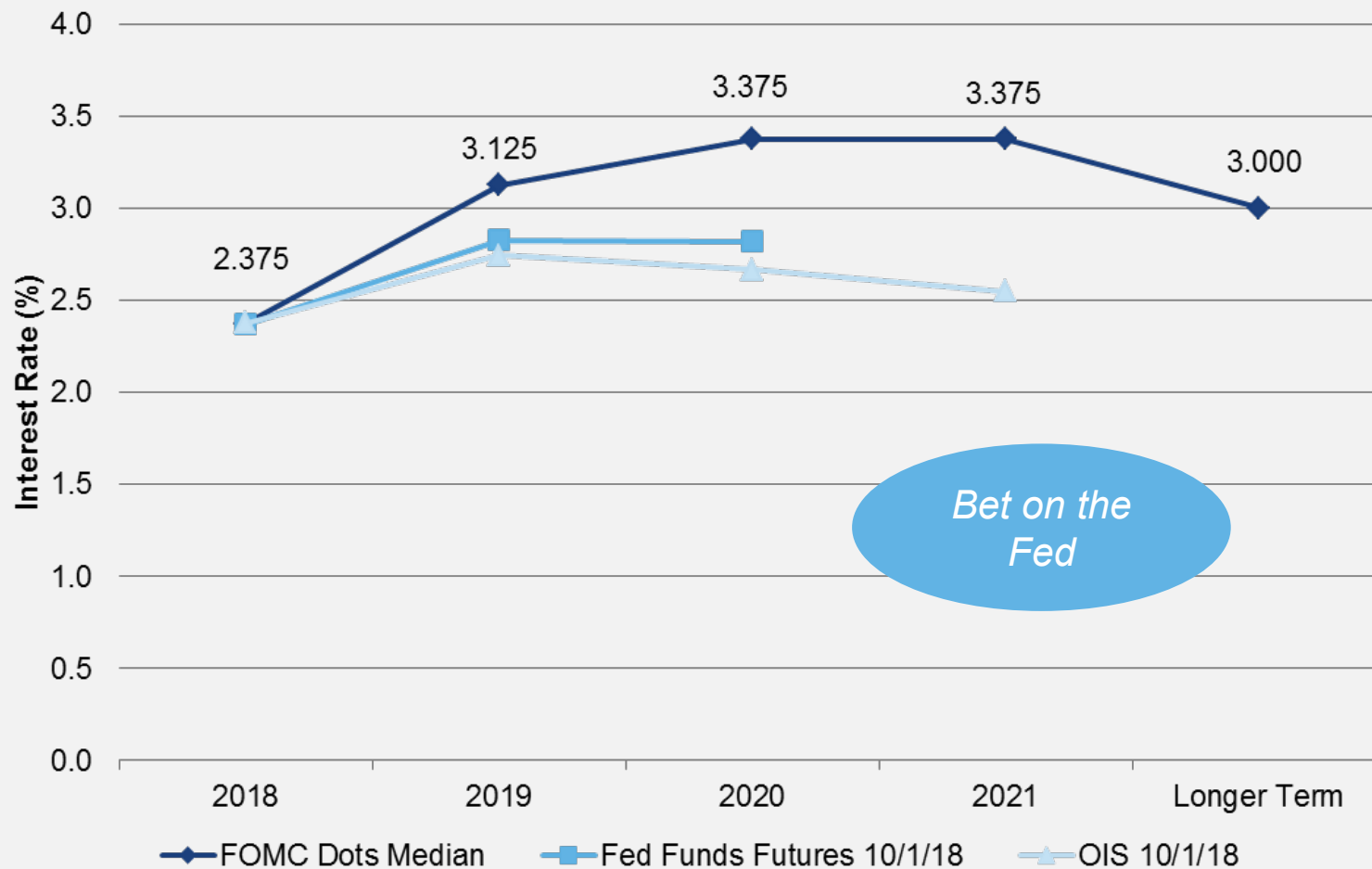
# BUT FINANCIAL CONDITIONS REMAIN LOOSE



Source: Federal Reserve Bank of Chicago National Financial Conditions Index through 10/12/18 Funding measures capture volatility and funding risk in the financial sector; credit measures capture credit conditions; leverage captures debt and equity measures

# THE FED EXPECTS TO HIKE MORE AGGRESSIVELY THAN CURRENT MARKET PRICING

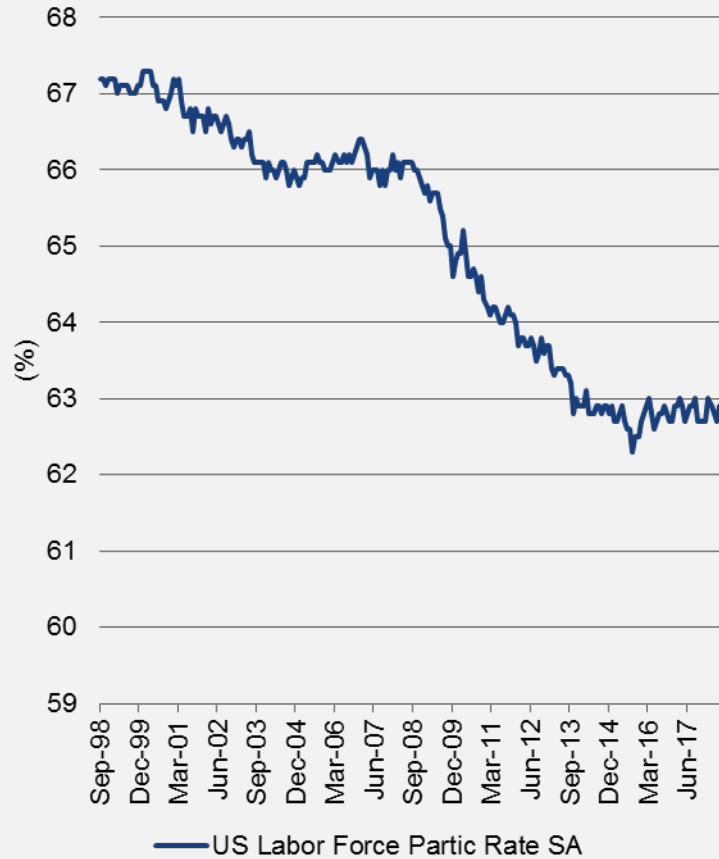
The market expects Fed tightening to stall, although market pricing for 2020 has risen 20 bp in the last month



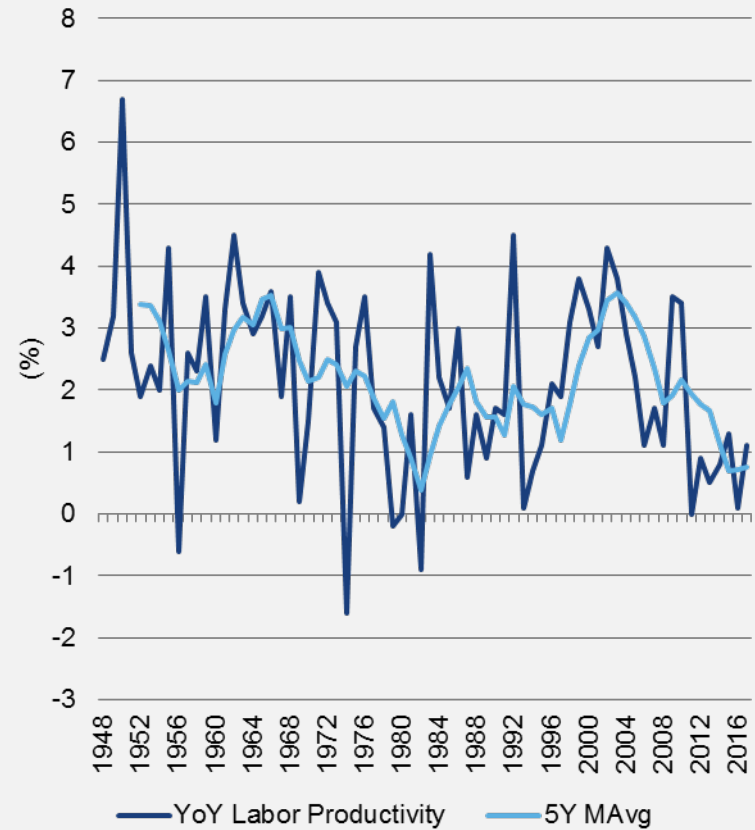
Source: Amherst Pierpont Securities LLC, Bloomberg LP

# POTENTIAL GROWTH STILL FACES CHALLENGES

**Labor force participation remains relatively low**

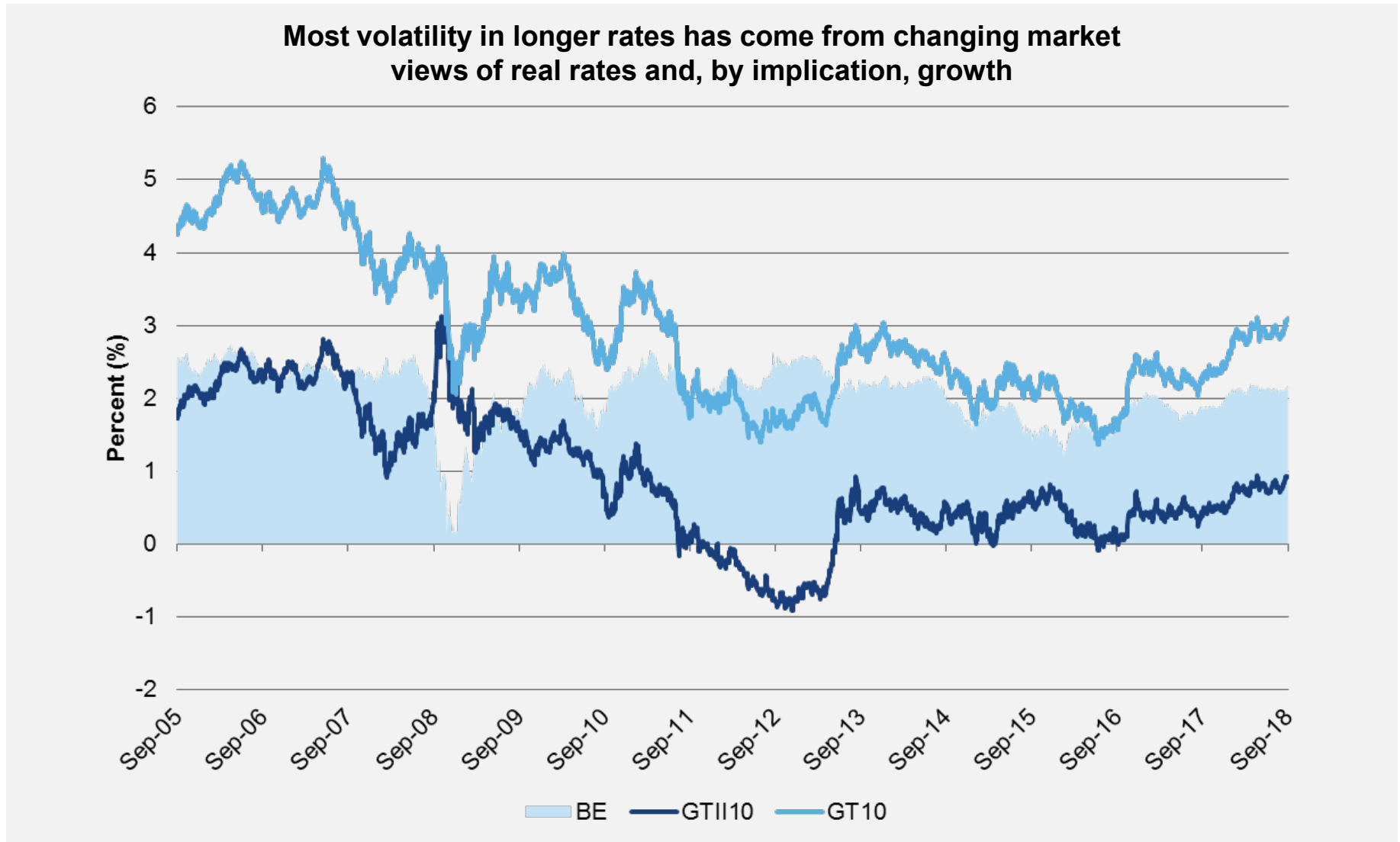


**Labor productivity remains relatively low**



Source: Bureau of Labor Statistics as of Sep 30, 2018

# GROWTH, MORE THAN INFLATION, DRIVES LONG RATES



Source: Bloomberg, LP, Amherst Pierpont Securities LLC as of Sep 26, 2018



# REALIZED RATES SHOULD FLATTEN FASTER THAN FORWARDS

The 2s10s yield spread implied 1-year forward: less than 10 bp



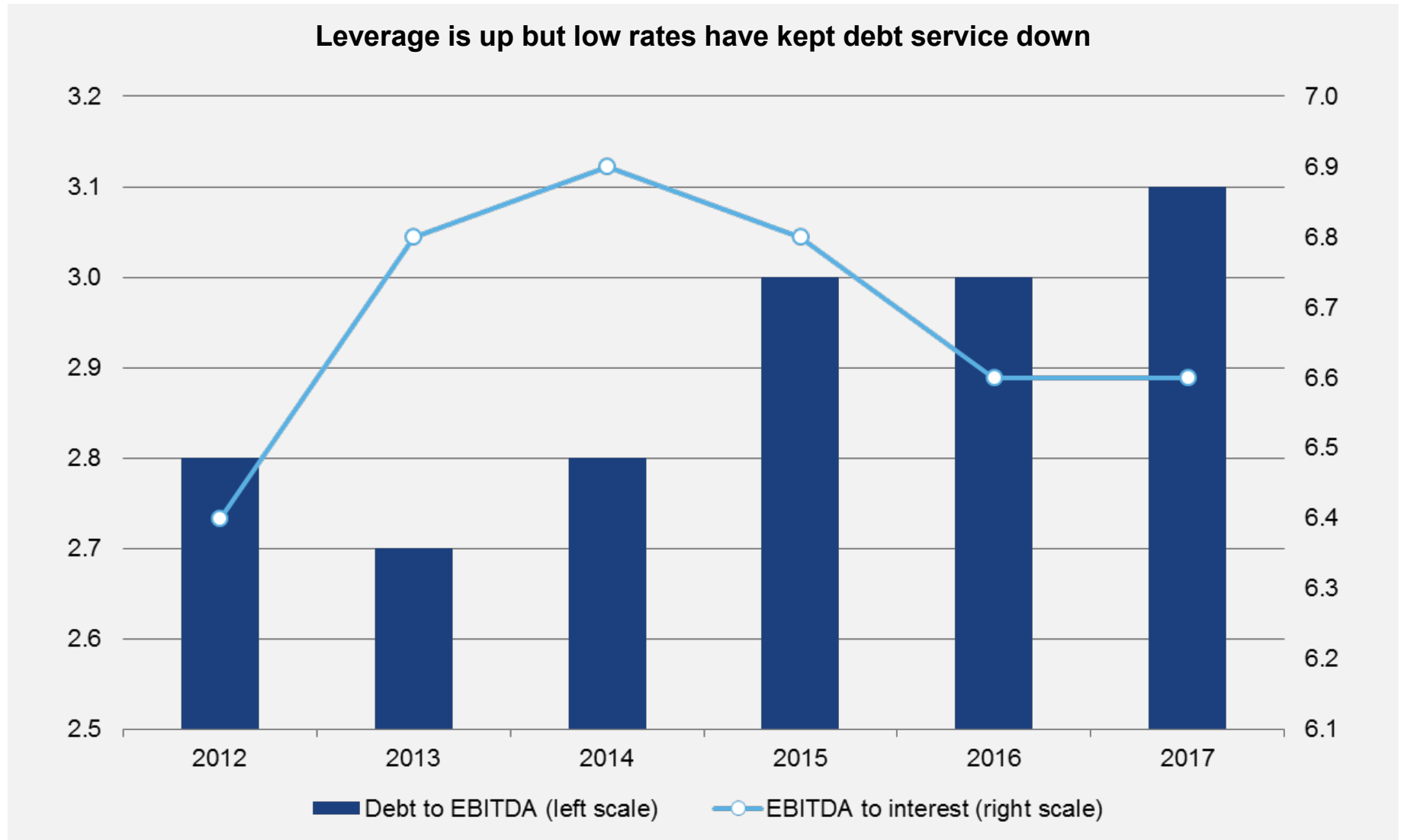
Source: Bloomberg, LP, Amherst Pierpont Securities LLC, as of 8/13/18

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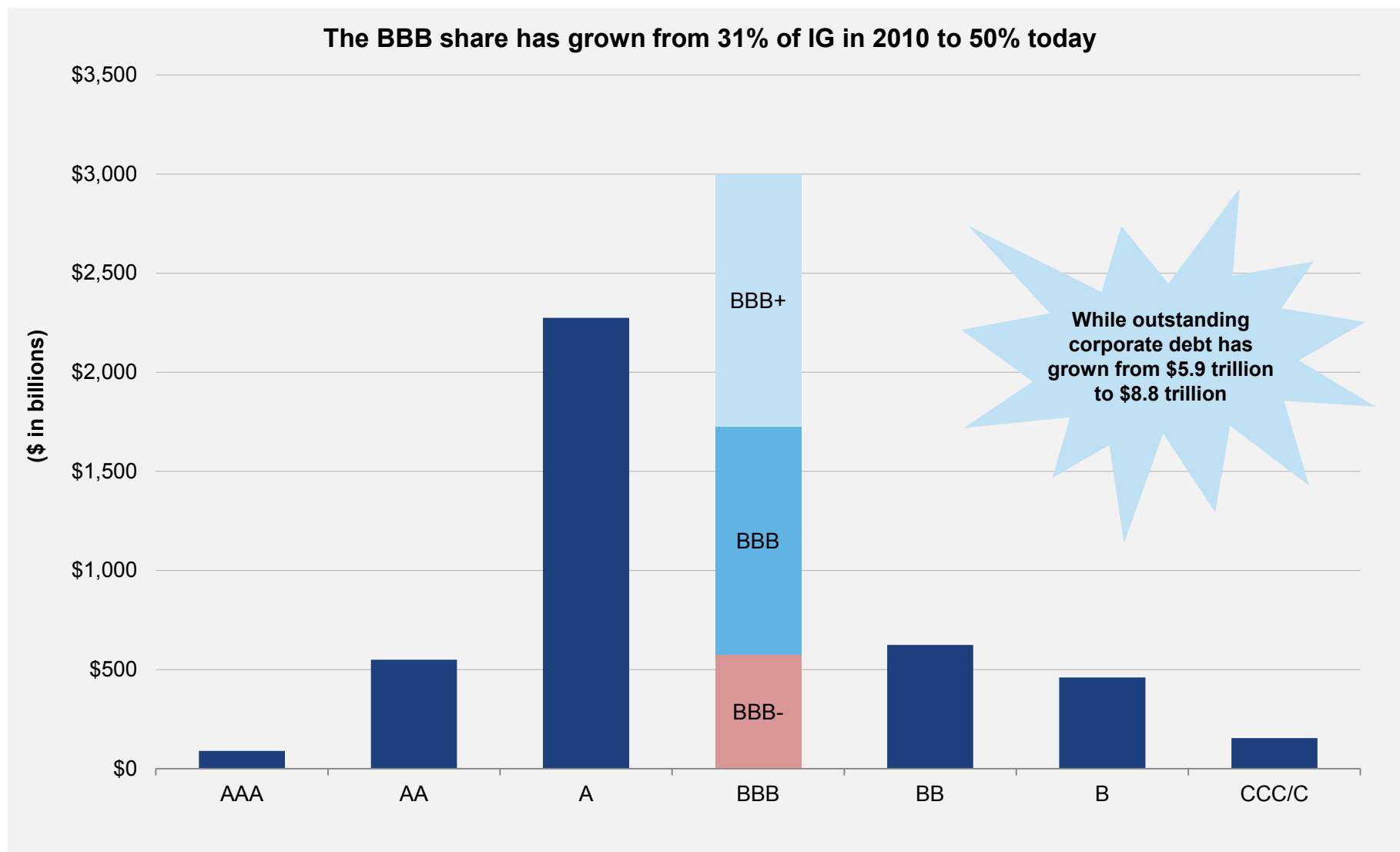
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# THE LOW COST OF DEBT RELATIVE TO EQUITY HAS ENCOURAGED IG LEVERAGE WITHOUT RAISING DEBT SERVICE



Source: Standard & Poor's. Investment grade nonfinancial corporates including real estate and utilities. Chart shows median ratios.

# BBB DEBT NOW CONSTITUTES 50% OF OUTSTANDING INVESTMENT GRADE CREDIT



Source: Standard & Poor's. Shows face value of outstanding US corporate bonds. Includes financial and nonfinancial as of 6/30/18.

# IG CORPORATE PORTFOLIOS NOW HAVE MORE CLIFF EXPOSURE

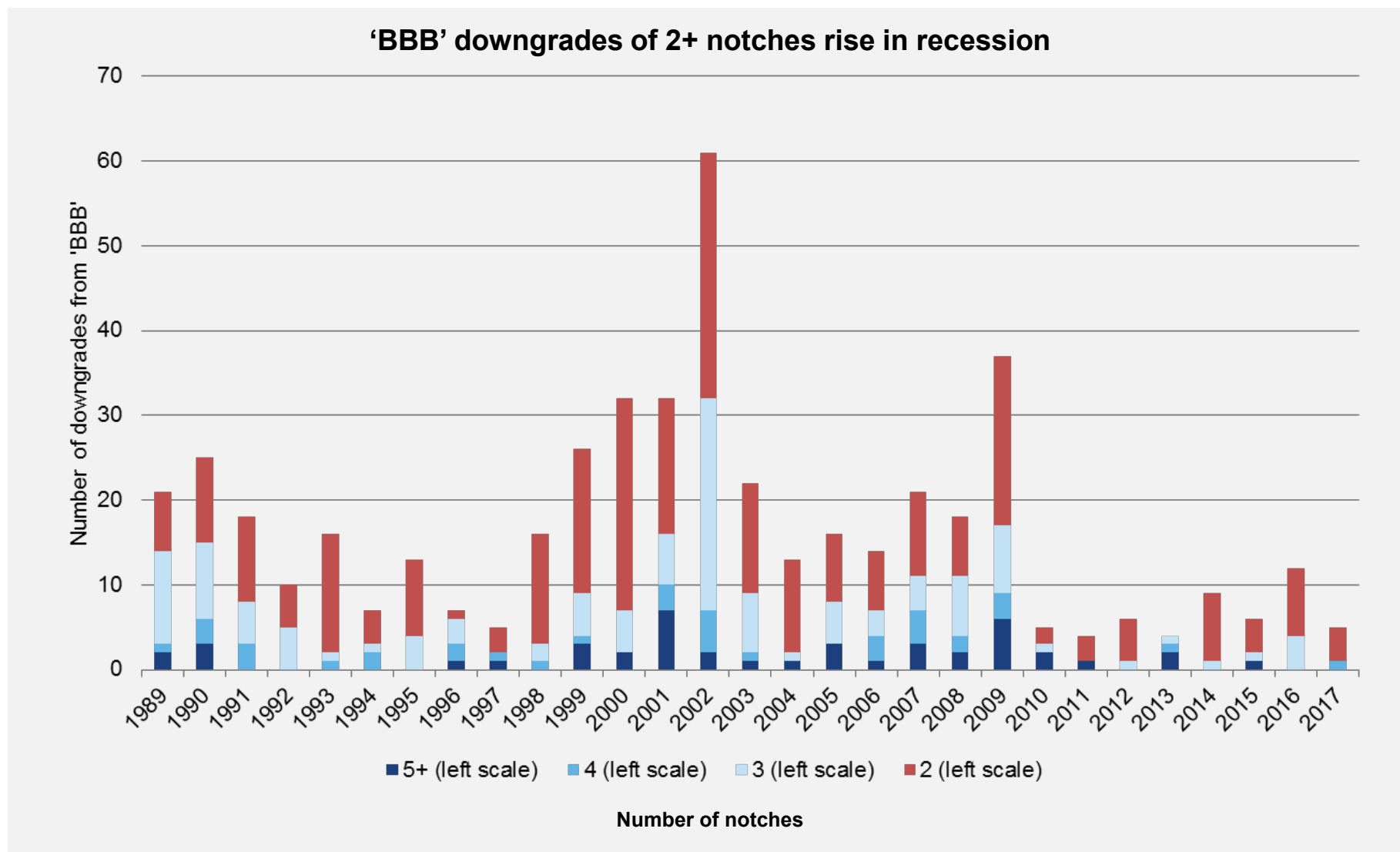
**Potential downgrade to BB would widen spreads significantly in stable markets and catastrophically under systemic stress**

*Yield spread (bp) between 10-year 'BBB' and 'BB' bonds*



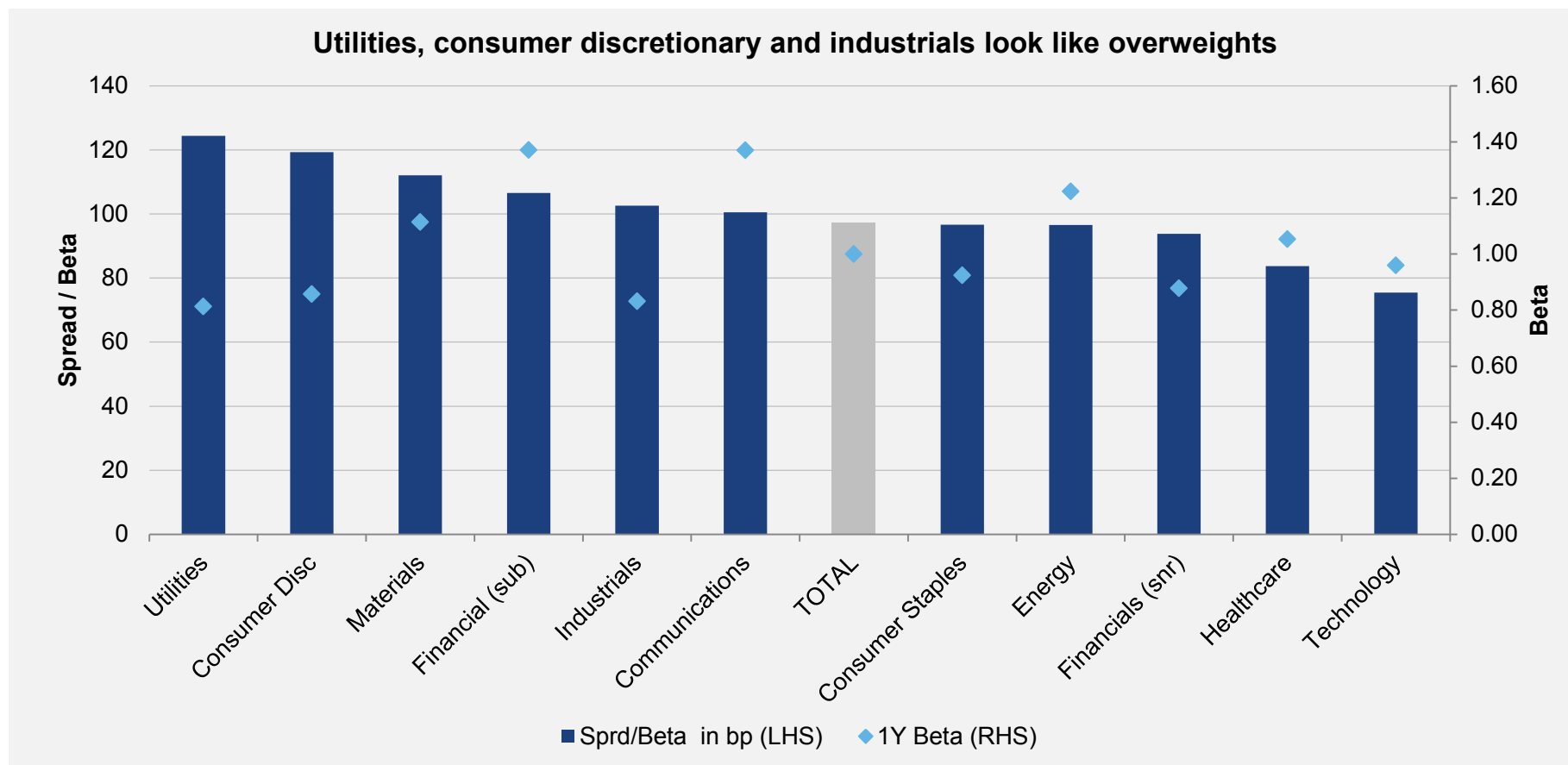
Source: Standard & Poor's.

# RECESSION RAISES BOTH THE PROBABILITY AND SEVERITY OF DOWNGRADE



Source: Standard & Poor's.

## SPREADS IN LOWER-BETA SECTORS LOOK ATTRACTIVE



	Utilities	Cons Disc	Mat	Fin (sub)	Ind	Comm	TOTAL	Cons Stap	Energy	Fin (snr)	Health	Tech
1Y Beta	0.81	0.86	1.11	1.37	0.83	1.37	1.00	0.92	1.22	0.88	1.05	0.96
Spread	101	102	125	146	85	138	97	89	118	82	88	72
Sprd / Beta	124	119	112	107	103	100	97	97	97	94	84	75

Source: Bloomberg, APS calculations. Beta is calculated by regressing the daily change in sector spread against the daily change in total market spread from Oct 1, 2017 to Sep 30, 2018.

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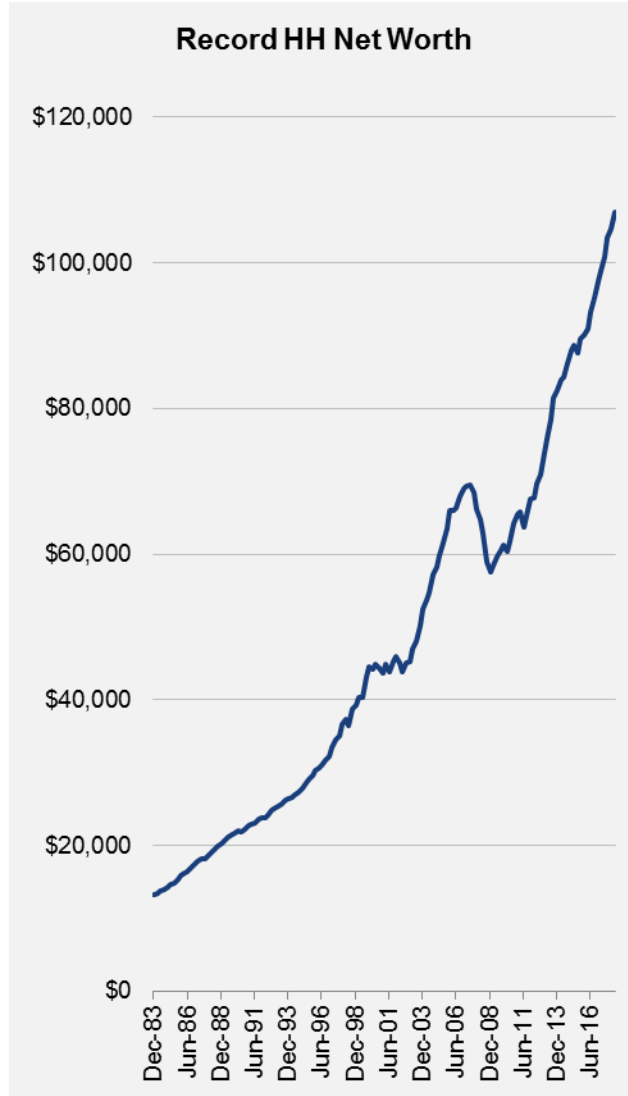
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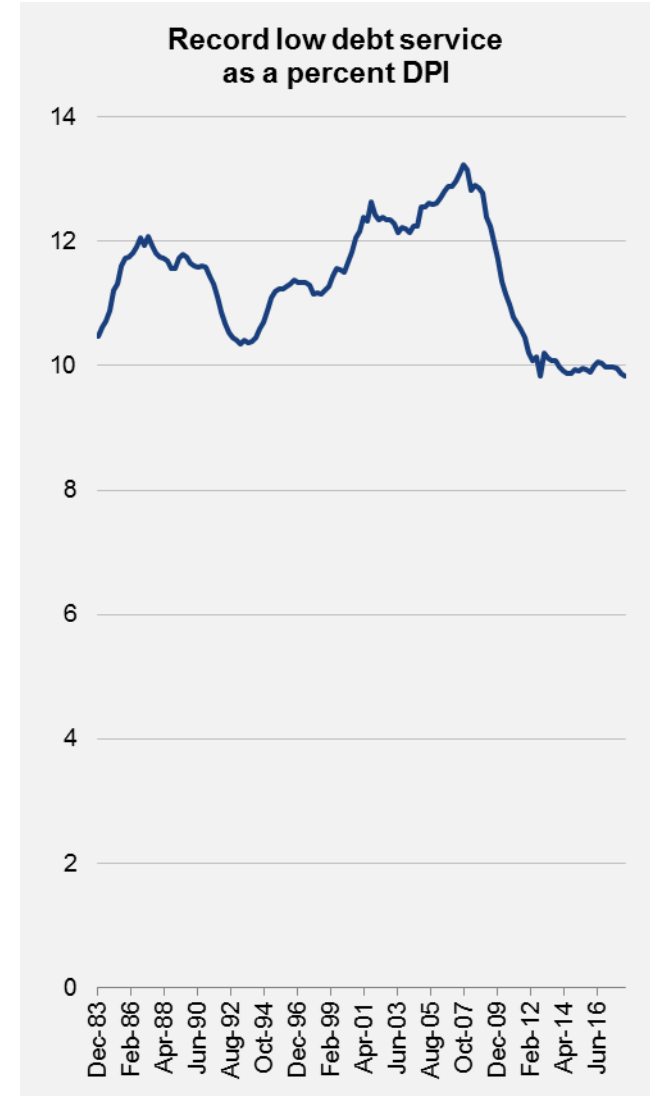
# HOUSEHOLD BALANCE SHEETS LOOK STRONG



Source: US Census. Real median personal income 2017 dollars NSA



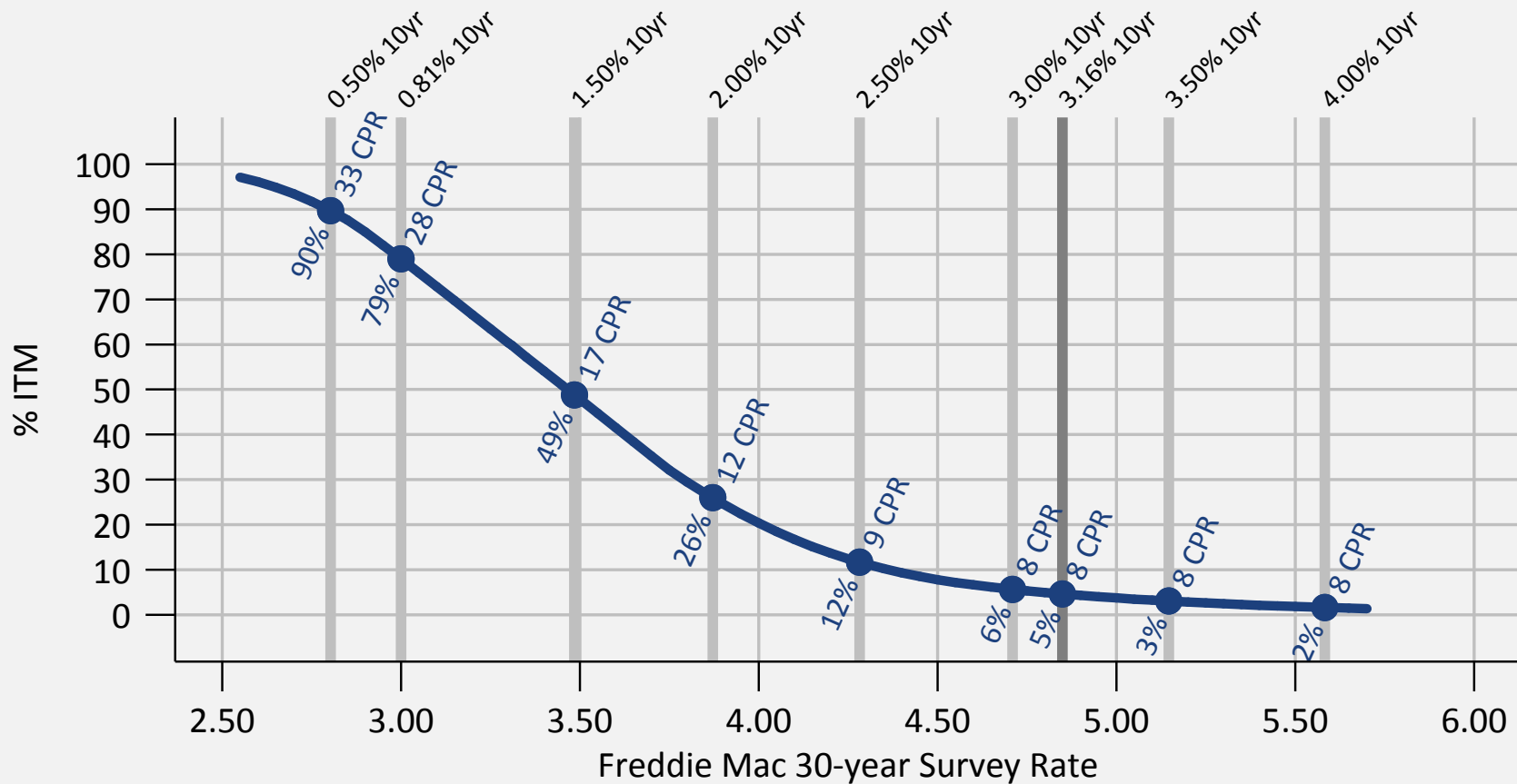
Source: Federal Reserve. HH and nonprofit net worth in billions of dollars NSA



Source: Federal Reserve. Household debt service payments as a percent of disposal personal income.

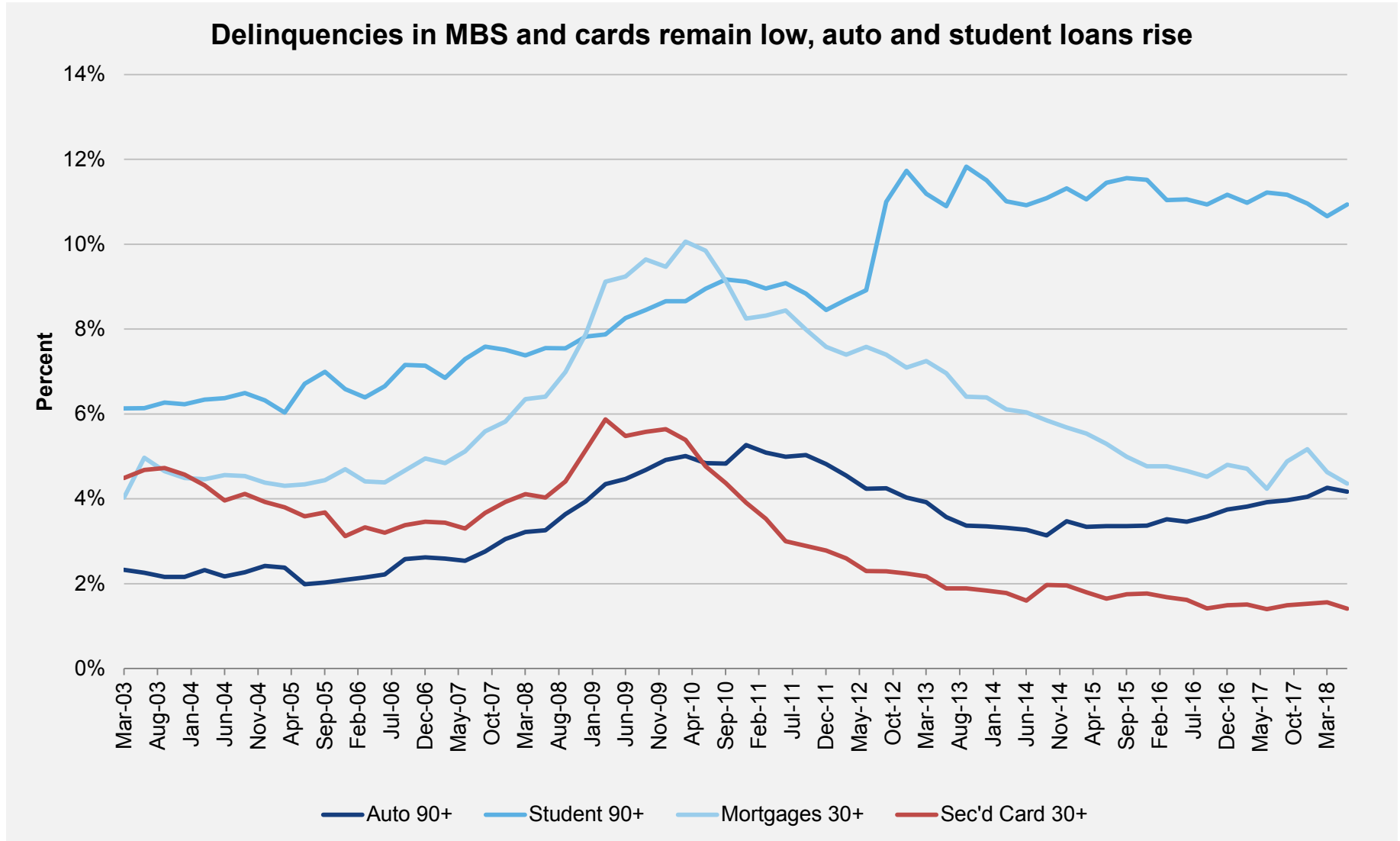
# YEARS OF REFINANCING HAVE CUT MBS PREPAYMENT RISK

Less than 5% of outstanding 30-year MBS have 75 bp or more of refi incentive



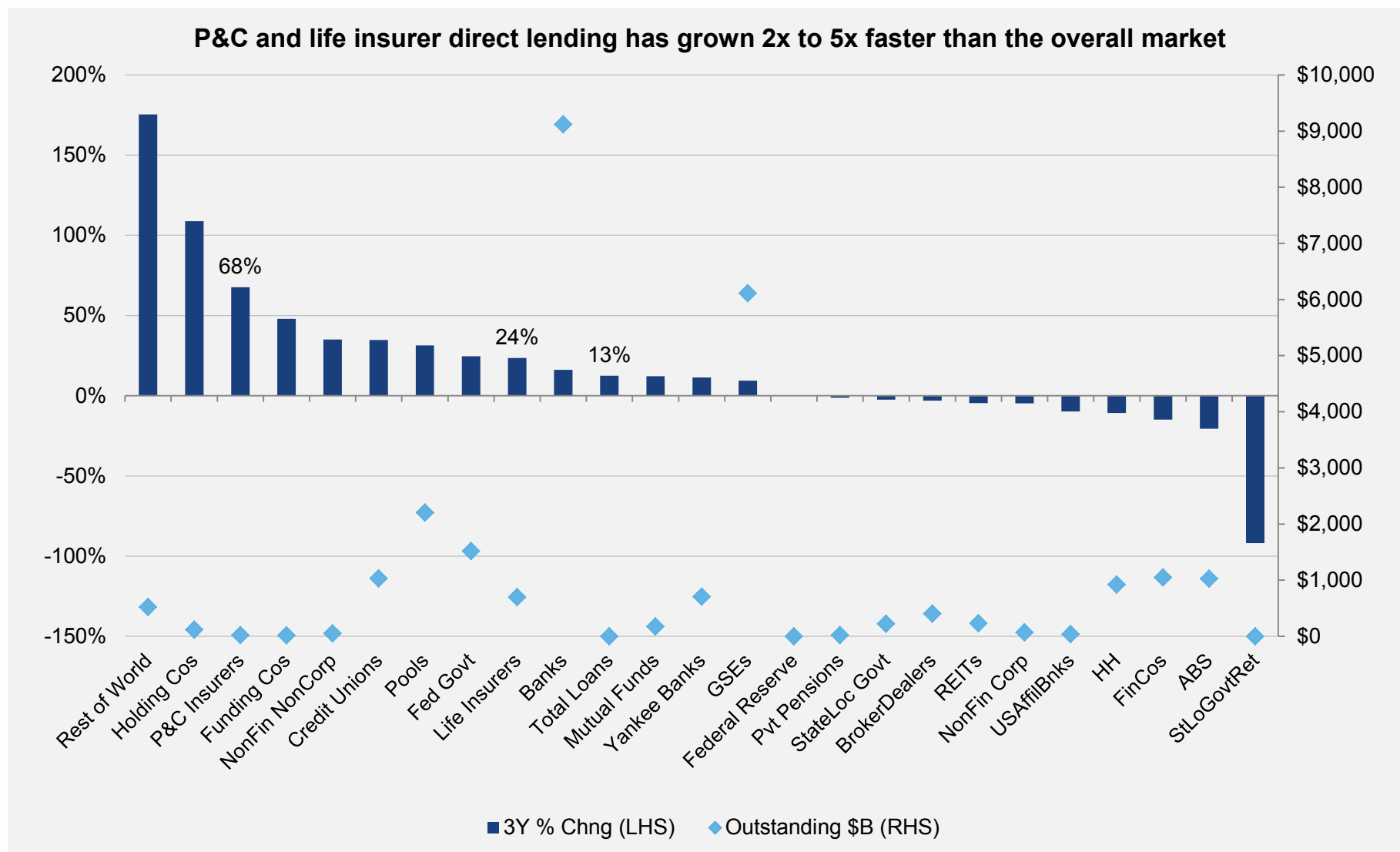
Source: Standard & Poor's, Fannie Mae, Freddie Mac, eMBS, 1010data, Amherst Pierpont Securities

# CREDIT LOOKS STRONG FOR MOST HOUSEHOLDS



Source: Mortgage DQs from the Mortgage Bankers Association, all others from the Federal Reserve.

# THE NEW FRONTIER: DIRECT LENDING



Source: Federal Reserve, Financial Accounts of the United States, Z.1

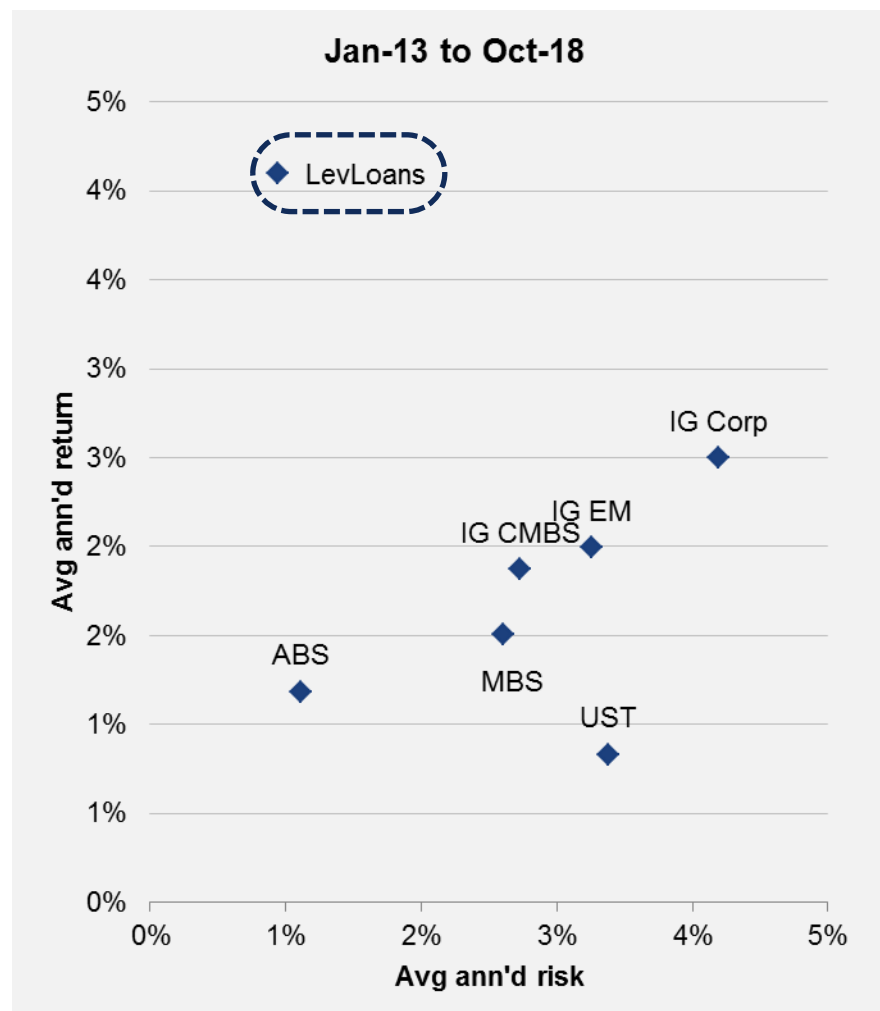
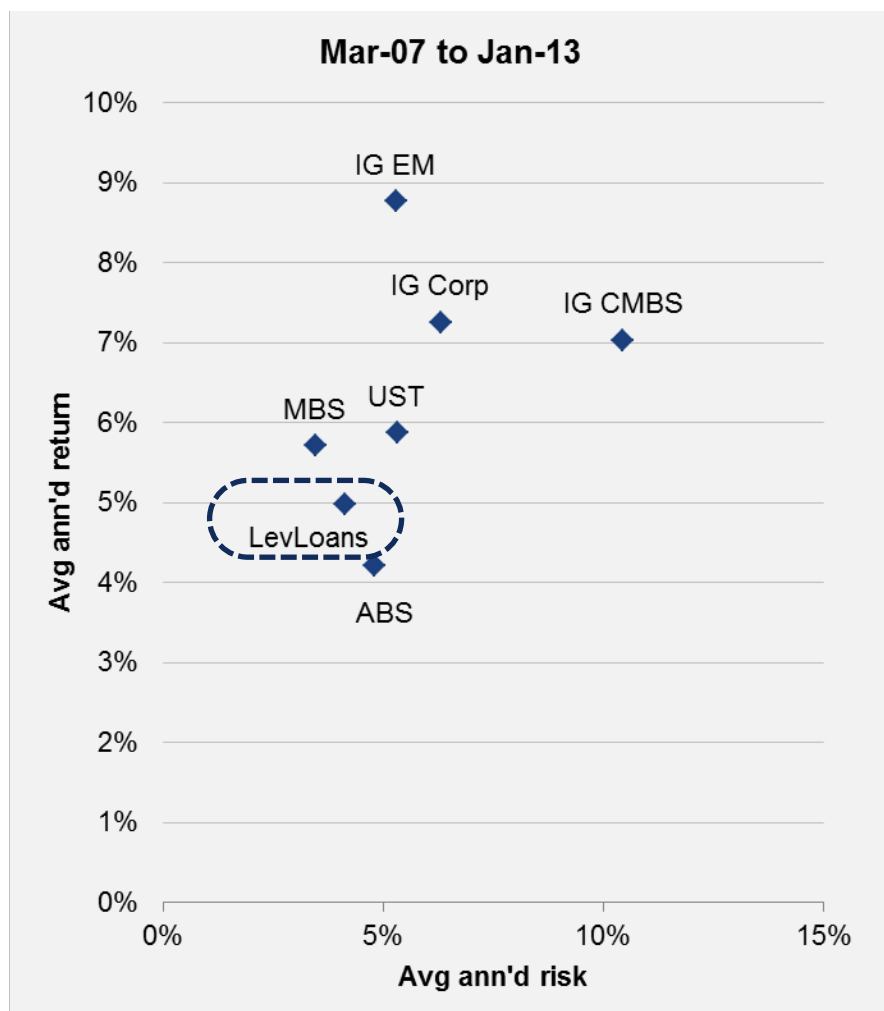
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# LEVERAGED LOANS HAVE DELIVERED COMPETITIVE RISK-RETURN

Leveraged loans have shown good return per unit of risk through and since the 2008 financial crisis



Source: Bloomberg/Barclay's unhedged total return indices. APS calculations based on daily returns. Dates of returns run from 3/30/07 to 1/10/13, and 1/11/13 to 10/18/18.

## CORRELATION WITH OTHER PARTS OF FIXED INCOME HAS BEEN RELATIVELY LOW

Leveraged loans have helped diversify broader portfolios

	IG EM	IG Corp	MBS	UST	LevLoans	IG CMBS	ABS	IG EM
IG EM	1.00							
IG Corp	0.48	1.00						
MBS	0.40	0.74	1.00					
UST	0.31	0.88	0.77	1.00				
LevLoans	0.37	0.17	0.02	-0.11	1.00			
IG CMBS	0.31	0.37	0.38	0.26	0.23	1.00		
ABS	0.20	0.43	0.36	0.45	0.01	0.15	1.00	
IG EM	1.00	0.48	0.40	0.31	0.37	0.31	0.20	1.00

Source: Bloomberg/Barclay's unhedged total return indices. APS calculations based on daily returns. Dates of returns run from 3/30/07 to 1/10/13, and 1/11/13 to 10/18/18.

### **Other considerations in leveraged loans**

- Clear risk to rates and weaker covenants
- Ability to leverage or deleverage exposure
- Ability to take advantage of relative value across managers



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