Brandywine Global

PRICING PRESSURES AND GLOBAL HIGH YIELD

- Credit investors in developed and emerging markets (EM) have been trying to understand the rapid decline in credit and foreign currency valuations.
- Structurally lower growth from China is our primary concern and it is no longer just an EM issue. Weaker Chinese growth, as reflected in trade, has an impact on the global economy.
- Given the scope of price depreciation and currency weakness, value appears to be developing in the short term, in our opinion.

4Q 2015

Global High Yield Perspectives
4Q 2015

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SYNCHRONICITY (NOUN)

The simultaneous occurrence of events that appear significantly related but have no discernible causal connection.

Credit[1] investors in developed[2] and emerging markets (EM)[3] have been trying to understand the rapid decline in credit and foreign currency valuations.

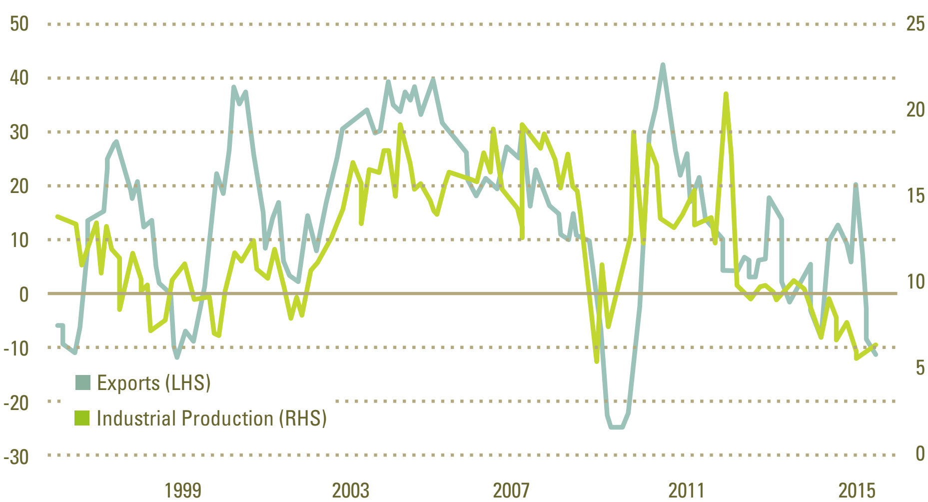
The reasons for these valuation declines have been pinned on (1) weak commodity prices and institutional structures in EM, (2) lack of inflation and impotent monetary policy in developed markets, (3) the ever present concern of lower growth emanating from China, and (4) a broader EM malaise based on EM central banks facing a classic, but treacherous dilemma of having to keep policy tight in the face of slowdowns to avoid currency instability.

CHINA – CAUSE FOR CONCERN AND OPPORTUNITY

Structurally lower growth from China is our primary concern. The two former concerns had largely been discounted into market prices the last several years. However, the decline in Chinese growth is a relatively new concept, not discounted into the credit markets until recently—despite private data highlighting structural weakness, especially evident in data sets like railcar loadings and electricity consumption.

The chart below graphs Chinese industrial production against Chinese exports in local currency terms (see **Figure 1**). The strength in the real-effective exchange rate[4] in the Chinese yuan has finally begun

Figure 1 China Exports and Industrial Production
(%) YOY Changes; 1996 to August, 2015



Source: CEIC, Empirical Research Partners to cause harm.

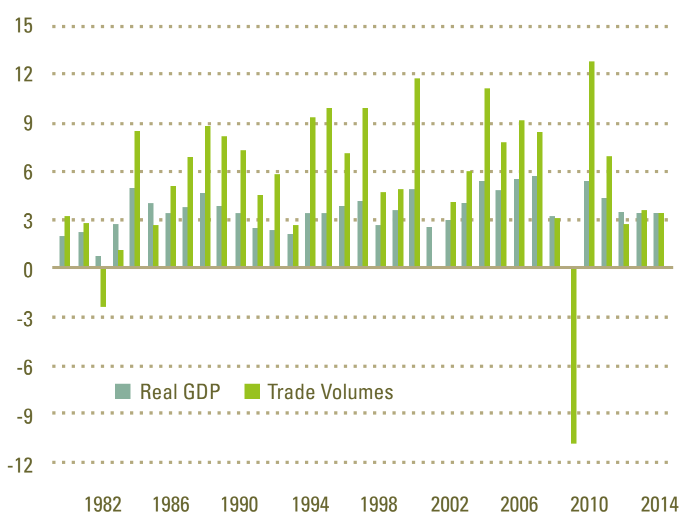
The issue is that this is no longer just an EM issue. Weaker Chinese growth, as reflected in trade, has an impact on the global economy.

The chart below shows how vital this connection is to understand (see **Figure 2**). Trade volumes over the last 35 years have generally exceeded real gross domestic product (GDP).[5] However, a few periods stand out when this relationship did not hold: early 1980s, early 2000s, 2008 and 2009, 2012 through to today.

Prior to the current cycle, every one of these time periods coincides with a recession!

While 2012 through to today's data are not as extreme as past recessionary impulses, the data point to an elevated probability of recession—which we believe explains the challenges in EM currencies, credits and sovereign yields and lower-quality developed market credit.

Figure 2 The World Growth Rates in Real GDP and Trade Volumes
(%); 1980 through 2014



Source: International Monetary Fund **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

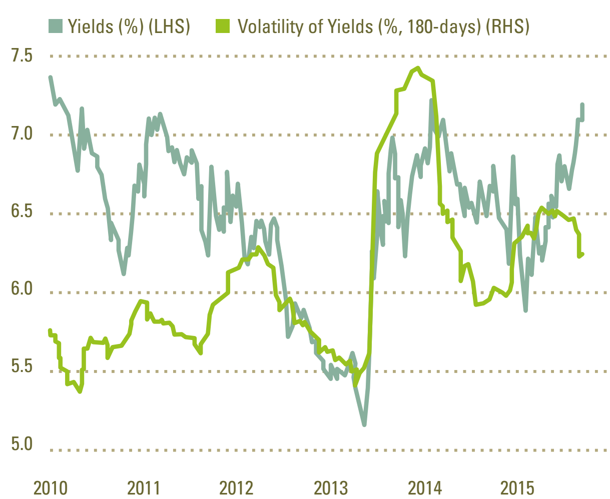
EMERGING MARKETS AND CORPORATE PRICES DECLINE – ATTRACTIVE ENTRY POINT?

Yield movements have been most pronounced in local-currency markets. Rising yields and weaker currencies brought on by weaker trade volume and lower commodity prices created a real challenge in the third quarter (see **Figure 3**). And the third-quarter EM sovereign and EM local-credit performance illustrated well what makes the EM-value credit trade precarious from a timing perspective. EM yields and currencies are predisposed to negative feedback loops, which compounds pressure on EM credit and sovereign assets. Developed market credit, in contrast, typically benefits from the fact that G4[6] currencies and sovereign bond yields often act as automatic stabilizers in relationship to credit spreads.[7] That negative feedback loop in EMs can last for a long time, deteriorating value just by virtue of the strength of the negative feedback loop, both creating an eventual value opportunity while limiting its current attractiveness.

To highlight the dynamics of a negative feedback loop in EMs, consider that bond yields and lower growth are quickly forcing EM governments to rationalize spending, limiting any potential benefit from fiscal stimulus—forget the re-investment necessary to keep roads, bridges, and electrical grids operating. Slowing growth serves to weaken currencies.

Weaker currencies and an environment of impending Federal Reserve (Fed)[8] tightening have curtailed the ability of central banks outside China to cut rates and support growth. Only a few EM central banks have been able to cut policy rates: India, thanks to a credible central bank governor, and eastern European countries, thanks to deflationary pressure in Europe and stable current accounts that support currency valuations. Moreover, weak or unstable currency valuations serve to only raise import / currency-pass-through inflation, causing local-currency investors to demand higher sovreign and credit yields, which begins the negative feedback loop again. Eventually the links break down, but EMs have a

Figure 3 Emerging Market Local Currency Government Bonds
(%); As of 9/30/2015



Source: Institute of International Finance. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

much greater potential to overshoot valuations during these negative feedback and real economic destruction can occur before financial markets stabilize.

Given the scope of price depreciation and currency weakness, value appears to be developing in the short term, in our opinion. Select higher-quality local currency sovereigns offer value and more limited default risk than lower-quality developed market credit at this point.

The upside associated with this trade has limited correlation[9] with default risk, and instead is centered around a weakening of the U.S. dollar (USD) (see **Figure 4**). If the dollar weakens, these yields will offer enormous value and benefit from a further tailwind in currency appreciation.

Lower-quality corporate credit markets have not been spared. Dollar prices declined in leveraged loan[10] and high yield[11] bond markets throughout the quarter (see **Figure 5** and **Figure 6**). The standout performer was the European leveraged loan market.

This price degradation in lower-quality credit assets in Europe and the U.S. indicate an opportunity in our opinion—if we are not entering a recession. The relative spread between high-quality and low-quality

Figure 4 Emerging Market Crises and the U.S. Dollar
As of 9/30/2015

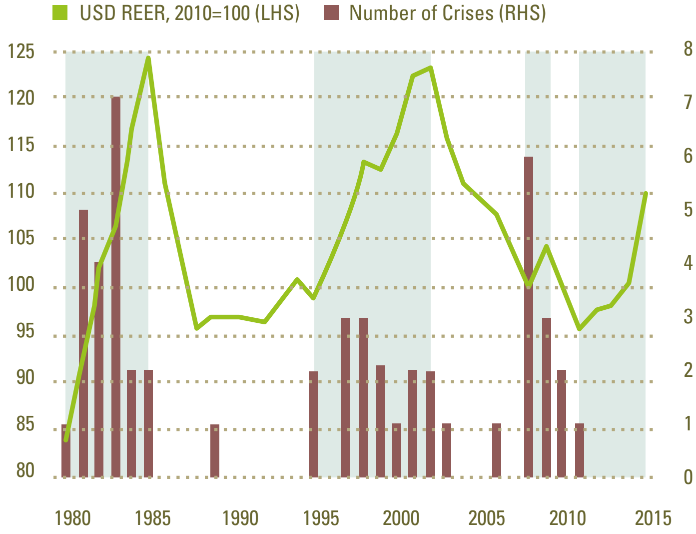


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Figure 5 ETF[12] Performance, EM Sovereign, EM Corporate and U.S. High Yield[13]
Index, rebased 1/1/2014=100; As of 9/30/2015

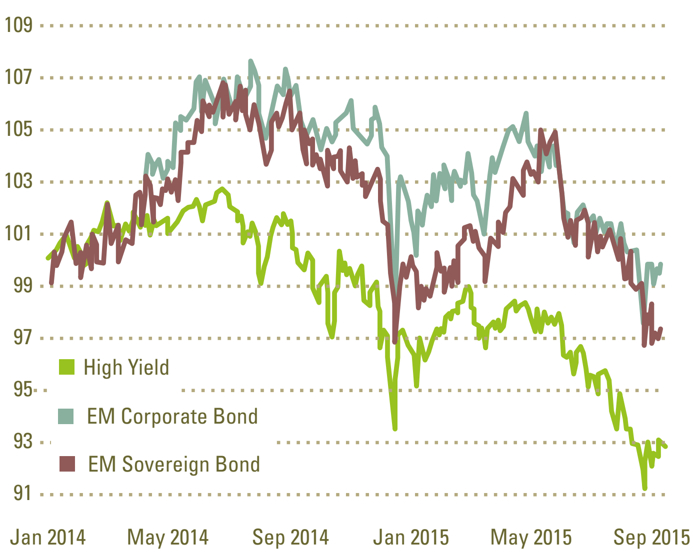

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Figure 6 S&P U.S. and Europe Leveraged Loan Indices[14]
Index; As of 9/30/2015

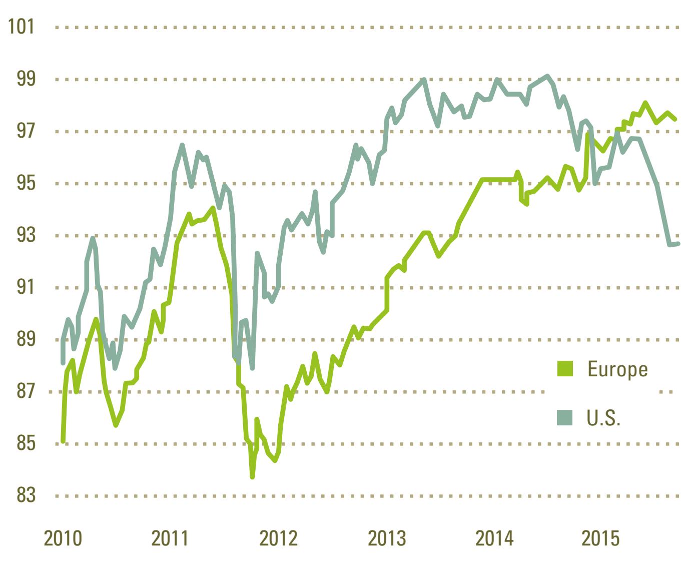

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Figure 7 Extra Spread Paid by High Yield Corporates Relative to Investment Grade Corporates[15]
(bps), option-adjusted spreads; As of 9/30/2015

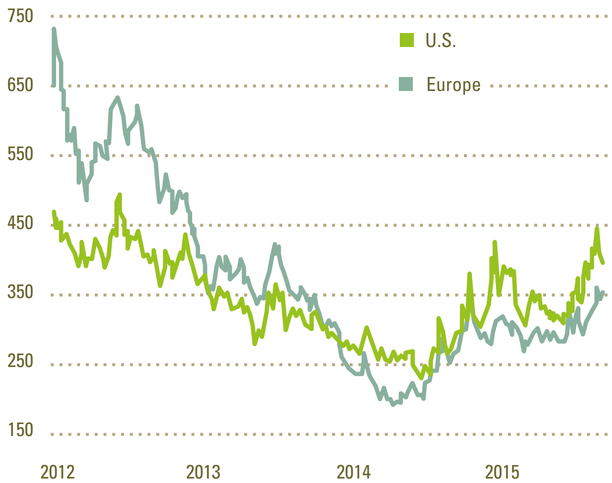

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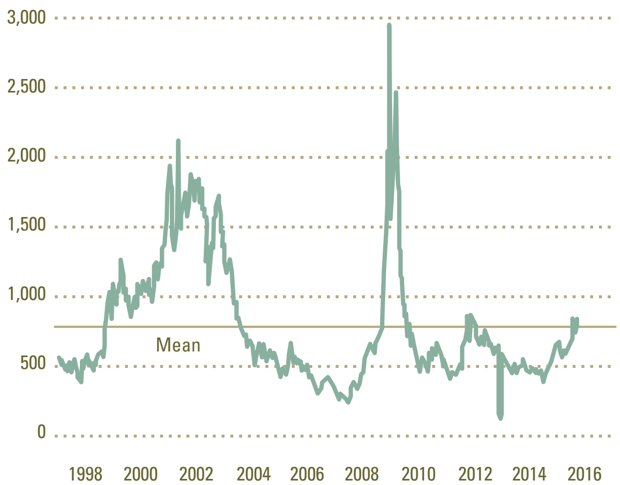
Figure 8 Relative Spread: U.S. HY CCC less BB Spreads[16]—Recession or Value?

OAS Spread: U.S. HY CCC - BB (Bps); As of 9/30/2015



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credit assets looks most appealing in the U.S. (see **Figure 7**). The key caveat here is that the opportunity is largely embedded in commodity-oriented credits.

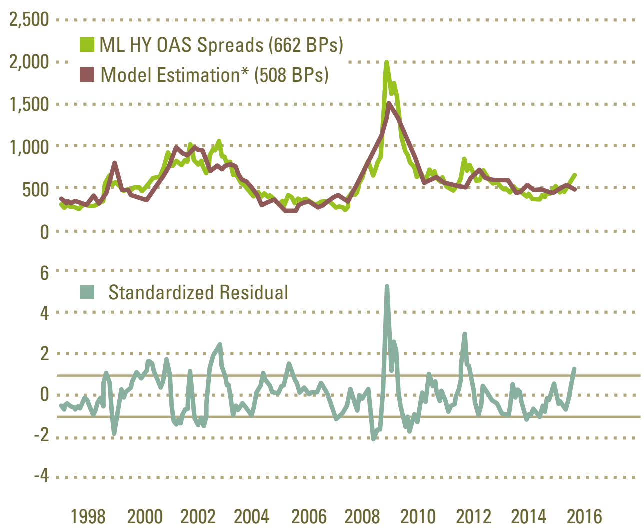
SYNCHRONICITY ?

Interestingly, the global trade volume data, relative spread data (**Figure 8**), and credit value indicators (**Figure 9**) are all signaling modest value—if no recession is on the horizon.

Global synchronicity is not yet apparent!

However, while we think more attractive bond prices and currency declines could mean better opportunities in credit and EM, we are closely monitoring indicators for signs of stabilization.

Figure 9 High Yield Offers Value - If No Recession
(Bps); As of 9/30/2015



Source: Merrill Lynch. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. A basis point (bps) is one one-hundredth of one percent (1/100% or 0.01%).

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Commodities and currencies contain heightened risk that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

Yields represent past performance and there is no guarantee they will continue to be paid.

ENDNOTES

[1] **Spread sectors** refers to sectors of the bond market, such as taxable bonds that are not Treasury securities, and includes securities such as agency securities, asset-backed securities, corporate bonds, high-yield bonds and mortgage-backed securities.

Credit refers to sectors of the bond market, such as taxable bonds that are not Treasury securities, and includes securities such as agency securities, asset-backed securities, corporate bonds, high-yield bonds and mortgage-backed securities.

[2] **Developed markets** refers to countries that have sound, well-established economies and are therefore thought to offer safer, more stable investment opportunities than developing markets.

[3] **Emerging markets** are nations with social or business activity in the process of rapid growth and industrialization. These nations are sometimes also referred to as developing or less developed countries.

[4] The **real-effective exchange rate** is the weighted average of a country's currency relative to an index or basket of other major currencies adjusted for the effects of inflation

[5] **Gross Domestic Product ("GDP")** is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time. **Real GDP** is a nation's total output of goods and services in constant dollar, or inflation-adjusted terms.

[6] **G4** refers to the US, Eurozone, UK, and Japan.

[7] A **credit spread** is the difference in yield between two different types of fixed income securities with similar maturities, where the spread is due to a difference in creditworthiness.

[8] The **Federal Reserve Board ("Fed")** is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

[9] **Correlation** refers to a relationship existing between mathematical or statistical variables which tend to vary, be associated, or occur together in a way not expected on the basis of chance alone.

[10] **Leveraged loans** are loans extended to companies or individuals that already have considerable amounts of debt. Lenders consider leveraged loans to carry a higher risk of default and, as a result, a leveraged loan is more costly to the borrower.

[11] **High yield**, or below-investment grade bonds are those with a credit quality rating of BB or below.

[12] An **exchange traded fund (ETF)** is a fund that tracks an index, but can be traded like a stock.

[13] ETFs represented are iShares EM Dollar Sovereign, EM Corporate, and High Yield.

[14] The **S&P/LSTA Leveraged Loan Index (LLI)** is an unmanaged index of U.S. leveraged loans. The **S&P European Leveraged Loan Index (ELLI)** is a market-value weighted index designed to measure the performance of the European institutional leveraged loan market.

[15] Spreads represented are Barclays U.S. High Yield vs. Barclays investment-grade U.S. Corporates and the Barclays Pan-European high yield and Barclays Pan-European investment-grade corporates. The **Barclays U.S. Corporate High Yield Index** covers the universe of fixed rate, non-investment grade debt, including corporate and non-corporate sectors. The **Barclays Corporate Index** is the corporate component of the U.S. Credit index. The **Barclays Pan-European High Yield Index** covers the universe of fixed-rate, sub-investment-grade debt denominated in euros or other European currencies (except Swiss francs). The **Pan-European Corporate Index** is the corporate component of the **Pan-European Aggregate Index** that covers eligible investment grade securities from the entire European continent.

[16] The Barclays US CCC-rated High Yield and the Barclays US BB-rated High Yield indices are the CCC-rated and BB-rated components of the Barclays US Corporate High Yield Index. The **Barclays U.S. Corporate High Yield Index** covers the universe of fixed rate, non-investment grade debt, including corporate and non-corporate sectors.

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