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APRIL 2016 TIMELY THINKING

Credit market déjà vu: Volatile and full of value

We believe that staying focused on credit fundamentals and investing for the medium term in active credit strategies is the best approach to seek profit (or protection) from volatile markets.

SUMMARY

- After a volatile first quarter, we believe credit sectors like high-yield bonds, floating-rate loans and municipal bonds still offer value.
- These credit sectors provided positive total returns during the Fed's last tightening cycle from 2004 – 2007.
- Credit concerns stem from low economic growth and the advanced stage of the credit cycle. However, in our view, current valuations of below-investment-grade debt more than compensate for the credit risks.
- We believe active management is particularly important today, given the deep credit stress in sectors such as energy and commodities.

The bond market's volatility in the first quarter of 2016 had a familiar feel to it, as persistently sluggish global growth prompted renewed efforts by central banks to combat it. The good news is that after the quarter's gyrations, value in specific credit sectors discussed in our fourth-quarter 2015 report remains intact, despite strong rallies in these sectors after mid-February.

The year started ominously for risk assets, with a large sell-off in equity markets as well as the high-yield bond and floating-rate loan credit sectors. Investors reacted to fears of another global downturn akin to the financial crisis, possibly sparked by a Chinese hard landing and currency devaluation, and a U.S. recession. The S&P 500 gave up 9% between January 4 and February 11, with smaller losses for high-yield bonds and loans.

Central banks responded with a multipronged stimulus package by European Central Bank President Mario Draghi, and moves by Federal Reserve Chair Janet Yellen to scale back the number of rate increases expected this year, citing risks posed by "global economic and financial developments." China, for its part, denied that it was planning a major currency devaluation and pledged to do more to boost its economy.

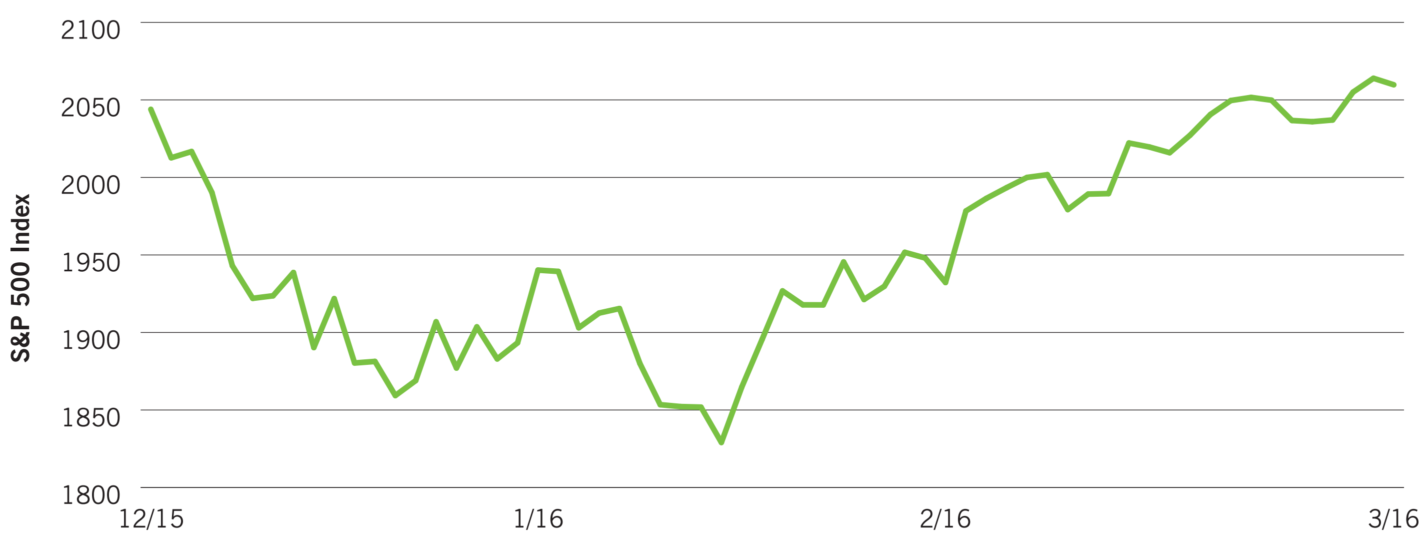
Markets bounced back sharply – the S&P 500 regained 12.6%, and high-yield spreads tightened from 887 basis points (bps) to 705 bps – just 10 bps wider than year-end, based on the BofA/Merrill Lynch U.S. High-Yield Master II Index. Exhibit A shows the V-shaped recovery of equities in the second half of the quarter.

Taking measure of interest-rate and credit risks

Despite the rebound, today's environment poses a unique set of interest-rate and credit risks for fixed-income investors. Profits for S&P 500 companies are expected to fall 9% for the fourth quarter, which would be the fourth consecutive quarterly earnings decline and the first such streak since the financial crisis. Tepid economic growth remains a burden on companies. At the same time, we believe the Fed is still likely to raise its target fed funds rate this year, as it is very close to achieving (and perhaps exceeding) both its unemployment and inflation targets. Though not as urgent as previously thought, fixed-income investors remain vulnerable to rising short-term interest rates.

In this vein, we believe the case for the three sectors we highlighted in our fourth-quarter report – high-yield bonds,

Exhibit A **The S&P 500 was buoyed by central bank stimulus.**



Source: St. Louis Federal Reserve Bank, March 31, 2016.

Data provided is for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an index. See end of report for important additional information.

floating-rate loans and municipal bonds – remains intact, should short-term rates rise.

In Exhibit B, the dotted square box shows the last period (2004-2007) in which the Fed hiked its target fed funds rate. All three sectors had positive total returns during that period, so it would appear that a likely scenario of modest hikes would pose relatively little threat to returns in these three sectors.

Credit concerns also remain legitimate, given continuing slow economic growth combined with a reasonable likelihood that the U.S. economy is in the latter innings of the current credit cycle. Despite this, however, in our view current valuations and income offered by below-investment-grade debt more than compensate for the credit risks assumed. We also believe active management is particularly important and relevant currently, given deep credit stress in particular sectors, including energy and commodities issuers.

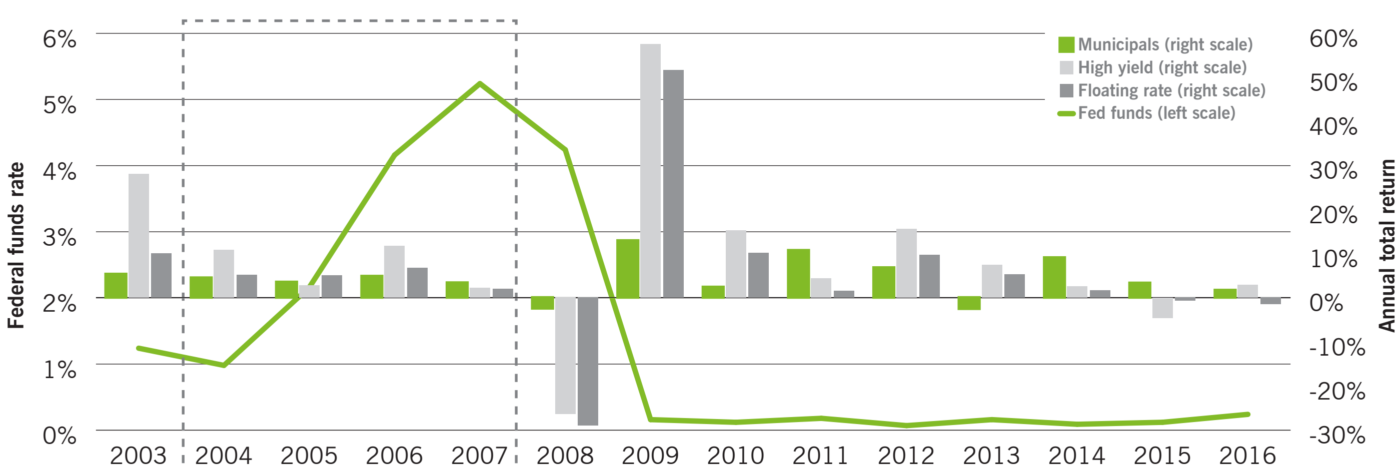
Spreads on both high-yield bonds and floating-rate loans are at levels comparable to 2011, in the aftermath of the financial crisis, and are 143 basis points and 68 basis points higher than the median over the past 10 years, respectively. Of course, spreads could always widen further, but today's levels represent a "value cushion" that is very rare – slow growth and high expected default rates are already reflected in today's prices, with discounts below fair value, in our view.

Scatterplots point to high-yield value

For some perspective on today's pricing of credit, Exhibit C has two scatterplots – the left for high yield, the right for the S&P 500. The dots compare valuation levels for each month since 1988 with subsequent three-year annualized total returns. While the dots aren't tidy, they make two basic points. In general, the southwest-to-northeast slant of the dots indicates that as the sector gets cheaper (measured by spreads for high yield and earnings yields, or E/P[1], for stocks), subsequent three-year returns get higher.

The dots on or very close to the red horizontal lines – indicating the current spread level and earnings yield, respectively – make a specific point about today's valuations. For high yield, whenever spreads have been at or near the current level of 705 bps (on the BofA/Merrill Lynch U.S. High-Yield Master II Index), subsequent three-year

Exhibit B **High yield, loans and munis had positive returns in the last rate-hike cycle.**



Sources: Barclays, BofA/Merrill Lynch, S&P/LSTA, St. Louis Federal Reserve Bank, Eaton Vance, March 31, 2016. Municipals are represented by the Barclays Municipal Bond Index. High yield is represented by the BofA/Merrill Lynch U.S. High-Yield Master II Index. Floating rate is represented by the S&P/LSTA Leveraged Loan Index. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an index. See end of report for important additional information.

[1]E/P is the inverse of the price/earnings ratio, and is used to provide a yield for stocks that can be readily compared to bonds. This E/P ratio is based on the cyclically adjusted P/E, commonly known as CAPE, Shiller P/E or P/E 10 ratio – a valuation measure based on the S&P 500 equity market – defined as price divided by the average of 10 years of earnings (moving average), adjusted for inflation.

Exhibit C **At current valuations, high yield has historically had positive returns, equities greater extremes.**

Sources: BofA/Merrill Lynch, S&P, Eaton Vance, March 31, 2016. High yield is represented by the BofA/Merrill Lynch U.S. High-Yield Master II Index. Equities are represented by the S&P 500 Index. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an index. See end of report for important additional information.

annualized returns have all been strongly positive, ranging from 8% to more than 20%. For the S&P 500, when stocks had earnings yields roughly equivalent to today's level of 3.8%, the range of outcomes has been much wider – from negative 20% to positive 30%, and about a third of the time the results were negative. At current relative valuation levels, high yield has been the stronger-conviction choice for investors seeking a tighter range of expected return outcomes.

The observation above should not surprise investors. Exhibit D shows that over the past 10 years, high yield has provided almost the same return as stocks, with two thirds the volatility; over the past 20 years, stock annual returns exceeded high-yield annual returns by 121 basis points, but high yield exhibited just under two thirds the risk and a superior (higher) Sharpe ratio. The high annual income generated by high-yield bonds has been a big factor contributing to these historical risk/return relationships.

Exhibit D **High yield has had better risk-adjusted returns than stocks.**

10 years ended - March 2016	Return (%)	Standard deviation (%)	Sharpe ratio
High Yield	6.9	10.6	0.54
S&P 500	7.0	15.3	0.38
20 years ended - March 2016	**Return (%)**	**Standard deviation (%)**	**Sharpe ratio**
High Yield	6.8	9.0	0.47
S&P 500	8.0	15.4	0.36

Sources: BofA/Merrill Lynch, S&P, Eaton Vance, March 31, 2016. High yield is represented by the BofA/Merrill Lynch U.S. High-Yield Master II Index. Equities are represented by the S&P 500 Index. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an index. See end of report for important additional information.

Defaults as a lagging indicator

Given that we are in the latter part of the credit cycle, we anticipate that defaults for both high-yield bonds and floating-rate loans are likely to increase from current levels; each are currently near their 10-year medians. However, if investors wait for defaults to peak, we believe they will have missed a value opportunity, because current discounted prices already reflect a significant rise in default rates.

In floating-rate loans, for example, the March 31 Index price of 91.5 means the market is expecting total credit losses of 8.5% over the lives of the loans, which on average has been three years. When you factor in an average 70% default recovery rate that lenders have historically achieved, this implies a three-year annual default rate of 9%, which exceeds the three-year annual rate during the height of the financial crisis. This scenario seems very unlikely to us.

Second, active management can be key in building portfolios of companies that may help mitigate default risk – passive allocations that mirror the Index must include all issuers, including those most at risk. Third, waiting for defaults to improve can reduce potential total return because spread tightening (bond price appreciation) historically has preceded peaks in default rates. Exhibit E shows that in 2009 and 2011, high-yield spreads anticipated the turn in default rates – the tightening started while default rates were still increasing.

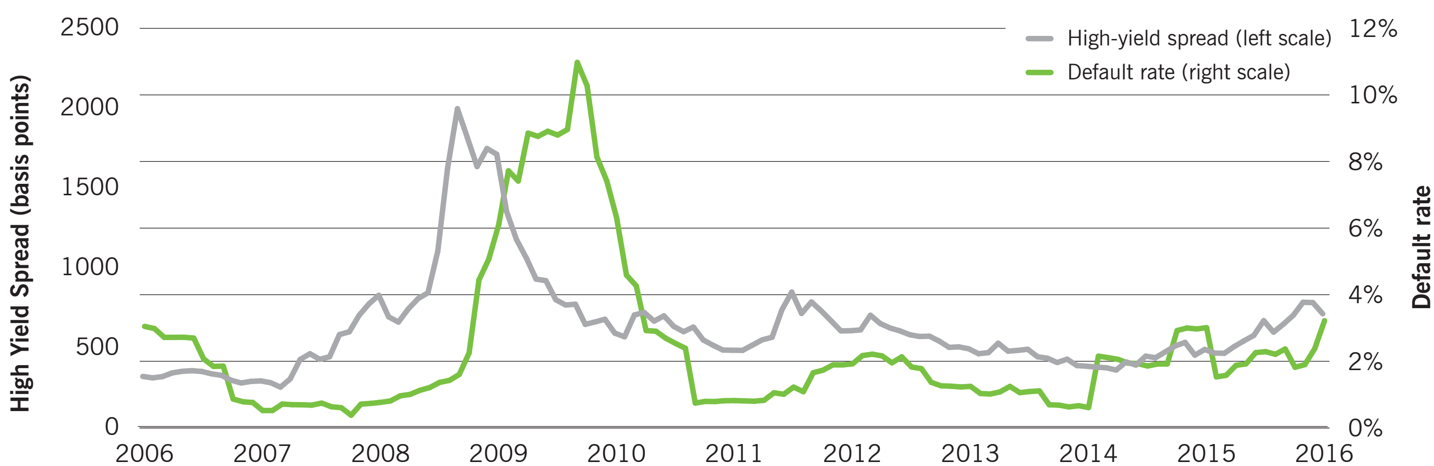
The case for munis remains intact

In our last report, we also made the case that municipal bonds – the top performing bond sector of 2015 – also deserve consideration, based on the gradual improvement in the finances of most municipalities in the years since the 2008 financial crisis. (There are a handful of well-publicized exceptions, including Detroit and more recently, Puerto Rico and Chicago.) Over the first quarter, AAA-rated municipal-to-Treasury ratios have increased, making their valuations more attractive. But munis still are not cheap on an historical basis, so we believe active management will be particularly important this year in finding value within the sector. That said, we expect high-quality municipal portfolios to offer investors a potential shelter from the storm of a “risk-off” market environment. Finally, laddered muni strategies may add some predictability of potential return in the event of rising interest rates.

Déjà vu going forward

For the bond market, the first quarter of 2016 was déjà vu all over again, which is likely to be the pattern for some time. We believe that staying focused on credit fundamentals and investing for the medium term in active credit strategies is the best approach to seek profit (or protection) from volatile markets.

Exhibit E **High-yield spreads have tightened (bond prices have risen) even as default rates increased.**



Sources: BofA/Merrill Lynch, JPMorgan, Eaton Vance, March 31, 2016. High-yield spreads are represented by the BofA/Merrill Lynch U.S. High-Yield Master II Index. Default rates are provided by JPMorgan. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an index. See end of report for important additional information.

Index Definitions

Barclays Municipal Bond Index is an unmanaged index of municipal bonds traded in the U.S.

S&P 500 Index is an unmanaged index of large-cap U.S. stocks.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

BofA/Merrill Lynch U.S. High-Yield Master II Index measures USD-denominated, noninvestment-grade corporate securities.

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Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Historical performance of the index illustrates market trends and does not represent the past or future performance.

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