U.S. CREDIT: FED UP

"Once again, the Federal Reserve sets the tune for the U.S. credit market. As the central bank begins raising interest rates in 2015, we expect a low-return, high-volatility environment. Our preferred positioning is defensive."

– Hans Mikkelsen, Head of U.S. High Grade Credit Strategy

Our view

Protective stance: As the Federal Reserve increases interest rates, volatility should rise. So should outflows from institutional and retail investors, with dealers unable to mitigate the sell-off. The front end of the curve looks particularly unattractive on a spread basis. Our preferred spread curve positioning is in 30-year maturities.

Unreaching for yield: The Fed's expected rate increases should mark the end of the reach-for-yield era. It should also start a period of underperformance in bonds that have benefited the most from easy monetary policy – including U.S. high grade. High-grade credit spreads should widen to 140bps in 2015, from about 125bps. We expect total returns will be near zero.

Jumping the shark: The best of times are over for the high-yield market, in our opinion. Returns in 2015 are likely to be sub-par in the 2-3% range. We expect default rates will rise modestly, to between 2% and 2.5%. OPEC's decision not to cut output bodes poorly for the HY Energy sector, which accounts for 15% of the HY market.

When a friend turns foe: The lack of liquidity should be a big story in the credit markets in 2015. While once sellers were scarce, now many investors are turning to the exits. We believe credit volatility will increase – exceeding the levels of 2013's so-called taper tantrum. Cash balances should run higher, too.

Key calls

Among our higher-conviction ideas:

- **High yield:** We envision healthcare being a top performer, while financials could benefit from higher rates. We also like autos and will replace technology with leisure and commercial services as an overweight. Our underweights: energy, retail and materials.
- **High grade**: With the risk of outflows, we like defensive sectors such as utilities. We are underweight banks and brokers, the most crowded high-grade trade. Generally speaking, we favor cyclical sectors as the pick-up in growth exposes non-cyclicals to releveraging risk.