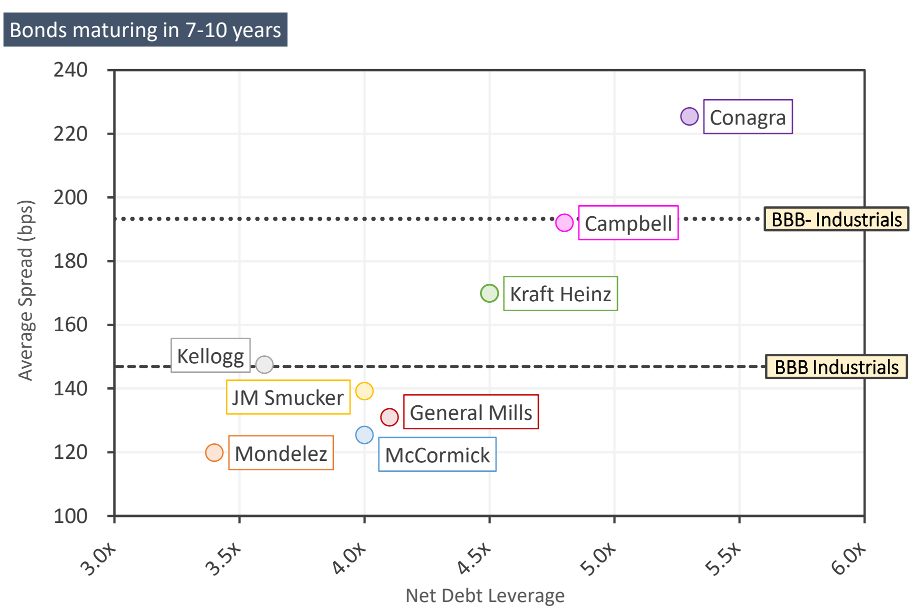
Underweight Food and Beverage Credit

Investment grade food and beverage credits have outperformed the broader corporate index with year-to-date total return of 3.39% compared to 3.17% for the Bloomberg Barclays US Corporate Index. This comes after a year of extremely negative returns of -4.45% compared to -2.81% for index eligible industrials with spread widening in longer duration bonds contributing to the majority of the underperformance.

Despite the recent rally, we are cautious on these credits as secular changes in consumption habits including an increased preference for lower cost generics erodes traditional pricing power. Further, slower population and economic growth in developed markets limits organic revenue potential offsetting margin gains from efficiency improvements. The latest earnings announcements from Conagra (weak performance in recently acquired Pinnacle Foods) and Kraft Heinz ($15.4bn impairment charge) highlight these trends. The industry is in an active phase of consolidation, and pressure from activist investors might also lead to more aggressive use of balance sheets to the detriment of bondholders.

For highly rated credits (single-A and better), looser financial policies create doubt as to how much these companies value high investment grade ratings in a period of persistently low interest rates. For credits in the BBB range, acquisitions have driven up leverage to levels that are more consistent with high-yield credits. Ratings agencies have given these companies a long leash to meet deleveraging targets, so we think downgrades to high-yield in the near-term are unlikely as these businesses will continue to generate strong free cash flow and have the flexibility to curtail shareholder returns to strengthen balance sheets. While we expect downgrade risk to remain low, we think investors should continue to assess whether management teams are committed to maintaining investment grade ratings. More importantly, investors should seek adequate compensation out the curve for potential downside risks that may slow deleveraging momentum.



Source: Bloomberg, Company Filings, Clearwater Advisors

Focusing in on packaged food companies in the mid-to-low BBB space, intermediate term bonds for Kraft Heinz look fairly priced after the company announced a dividend cut to free up cash flow, but spreads could have further room to widen if operational trends do not improve. Conagra bonds appear to offer better risk/reward for investors that have more credit risk tolerance. We are bearish on General Mills and JM Smucker which trade tight for current credit ratings and leverage profile. Revenues for these firms are skewed toward the US increasing the possibility of event risk in our opinion.