Global Credit Income

Quarterly Review and Outlook

As at March 2016

FOR PROFESSIONAL / INSTITUTIONAL INVESTORS ONLY

Key Highlights

- Global investment grade credit spreads traded in a wide range over the quarter but ultimately finished largely unchanged.
- Fundamentals remain generally supportive of tighter credit spreads and recent spread widening.
- Credit valuations appear favourable from a longer term perspective.

Market Insights

Over the quarter, global investment grade credit spreads traded in a wide range but ultimately finished largely unchanged. Spreads widened at the start of the quarter but this trend changed half way through the quarter as the global backdrop moved to a more "risk-on" environment on the back of ECB's decision to include corporate bonds in its Quantitative Easing program and the FOMC's dovish stance. The spread on the Barclays Global Aggregate Corporate Index narrowed by 1 bps, closing at 1.58%. The Barclays European Aggregate Corporate Index closed at 1.31%, narrowing by 3 bps in the quarter, and the Barclays US Aggregate Corporate Index finished the quarter at 1.54%, narrowing by 1 bps.

Volatility continued in the US high yield credit market with weakness from the Energy and Materials sector. As expected we started to see a number of investment grade bonds in this sector downgraded to high yield by the major ratings agencies. Overall, the Bank of America Merrill Lynch Global High Yield index (BB-B) spread moved 15 bps narrower to 5.38%.

In Asian credit markets again there was relatively little movement, with the JPMorgan Asia Credit Index (JACI Composite) average spread widening by 3 bps to 2.87%.

In investment grade credit there were some sizeable deals brought to market in the quarter. Most notable was January's near record-breaking issue of US$46 billion in bonds by brewing giant Anheuser-Busch InBev in order to fund the acquisition of rival SABMiller. Exxon Mobil Corp also issued a notable deal, announcing US$12bn of new bonds in February. Apple announced a similar sized deal though under a cloud of scrutiny as it seeks ways to pay shareholders without moving offshore cash to the US, hence avoiding the higher tax rates. Apple also became the first US tech company to issue green bonds with US$1.5bn issued in bonds that will be used to finance renewable energy, energy storage and energy efficient projects, green buildings and resource conservation efforts.

Strategy Positioning

The strategy returned 1.55% (net of fees) during the quarter, whilst the benchmark returned 0.04%.

The strategy's running yield remained supportive of performance as did the narrowing in credit spreads in the quarter.

Credit Market Outlook

Credit valuations appear favourable from a longer term perspective. While spreads had narrowed markedly from GFC wides and had fallen to levels where valuations were neutral at best, widening throughout 2015 has seen value again become attractive relative to history. Default rates continue to be relatively low (despite some recent increases from the energy and mining sectors due to the lower oil price), credit conditions remain relatively accommodative, and as a result, spreads currently over compensate investors for credit risk incurred.

Technicals in credit markets continue to remain the primary headwind to outperformance. Over the last year or so, a record amount of corporate bonds have been issued into the market by corporates looking to fund at, what appear to be, very attractive all-in yield levels. Against that, demand has not been aggressive as many investors have assessed credit spreads as having reached the end of their post 2008 compression cycle. Furthermore, flows have turned sharply negative – particularly in high yield ETFs and mutual funds – causing some funds to take the rare step of suspending investor redemptions as more liquidity dried up, particularly amongst more distressed issuers.

Fundamentals remain generally supportive of tighter credit spreads and recent spread widening has presented an interesting entry point from a valuation perspective. Despite the challenges such as normalisation in the US, geopolitical concerns and continuous stress from the energy sector, the corporate debt market is expected to remain fairly stable, at least in the near term. Helped by steady economic growth in the US and accommodative monetary policy globally. Apart from energy-related weakness, Moody's-rated speculative-grade companies have remained mostly in good shape as reflected in solid liquidity, stable cash flows and a lack of maturity and covenant pressure.

Defaults in the energy and metals/mining sectors are likely to increase through 2016 (forecasts in the 7-15% range), and Moody's is forecasting a baseline speculative grade default rate of 4.1% a year out. With energy and metals/mining sectors within the high yield market trading at distressed levels, the increase in defaults looks largely priced in. In addition, we continue to expect a significant volume of investment grade Energy and Metals/Mining companies will be downgraded into high yield. This has started to come through in recent months and will likely endure as the major ratings agencies continue to focus their attentions on these sectors.

Our credit strategy and process employs a disciplined approach in the credit assessment and selection process, as issuer decisions will contribute meaningfully to overall portfolio performance. We believe that returns often overcompensate for credit risk, and that diversification across a large pool of lowly correlated assets will generate positive 'value-for-risk' outcomes for our portfolios.