Global Credit Income

Quarterly Review and Outlook

As at December 2015

FOR PROFESSIONAL / INSTITUTIONAL INVESTORS ONLY

Key Highlights

- Global investment grade credits largely narrowed over the quarter as investor sentiment started to improve with a little more optimism toward the macro backdrop.
- Credit valuations appear favourable from a longer-term perspective with spreads falling to levels attractive relative to history although shareholder friendly activity including mergers and acquisition and share buybacks etc. continues to be a risk to credit fundamentals.
- Although credit spreads were not immediately impacted by the recent US Federal Reserve (Fed) announcement to raise interest rate by 25bps, we remain concerned about the impact on credit markets as the cycle evolves.

Market Insights

Over the quarter, global investment grade credit spreads largely narrowed slightly as investor sentiment started to improve with a little more optimism toward the macro backdrop. The spread on the Barclays Global Aggregate Corporate Index narrowed by 7 bps in the quarter, closing at 1.59%.

Credit spreads were not immediately impacted by the US Federal Reserve (Fed) announcement at their December Federal Open Market Committee (FOMC) meeting of a 25 bps increase in the Fed Funds target range, bringing it from 0%-0.25% to 0.25%-0.50%.

The Barclays European Aggregate Corporate Index closed at 1.34%, narrowing by 14 bps over the period, and the Barclays US Aggregate Corporate Index finished the quarter at 1.55%, narrowing by 7 bps.

The US high yield credit market had a volatile quarter with spreads narrowing early in the period on the back of improved investor sentiment but then weakness from the Energy and Materials sector pushed spreads wider again. Overall, the Bank of America Merrill Lynch Global High Yield index (BB-B) spread closed marginally narrower (3 bps) at 5.53%.

Asian credit markets also strengthened in the quarter, with the JPMorgan Asia Credit Index (JACI Composite) average spread widening by 31 bps to 2.83%.

Issuance in investment grade credit was strong at the start of the quarter but slowed notably into year end, specifically in the run up to the seasonal holiday and following the interest rate movement by the Fed. Overall US issuance in investment grade credit for 2015 was around US$1.2 trillion.

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, credit conditions remain relatively accommodative, and as a result, spreads currently overcompensate investors for credit risk incurred.

Technicals in credit markets continue to remain the primary headwind to outperformance. Over the last year, 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.

Much has been written about reduced liquidity in global credit markets. Over recent years, supported by quantitative easing (QE) and forward guidance, many investors have been seeking additional yield including investing in credit. As QE programmes come to an end around the world, we would look for many of these carry trades to unwind which could lead to a dramatic increase in market volatility and wider spreads. In the credit space, the fear is that any such move could be exaggerated as retail investors may get shocked by negative absolute returns as interest rates rise and spreads widen. We believe additional liquidity compensation has been reflected over the last year as evidenced by the growing divergence between 'liquid' credit derivatives and the less liquid physical assets.

Fundamentals remain generally supportive of tighter credit spreads and recent spread widening has presented an interesting entry point from a valuation perspective. Despite 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 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.

In terms of risks, shareholder friendly activity (e.g. mergers and acquisition, share buybacks, etc.) continues to be a risk to credit fundamentals although most recent deals have been sensibly funded and appear strategically sound. With the Fed finally increasing interest rates for the first time in nearly decade, we also remain concerned about the impact on credit markets as the cycle evolves. Historically, rising interest rates have been positive for credit market performance; that is correlations between rates and spreads have typically been negative. However, the current fear within credit markets is an increase in correlations between the two as investors move to sell all fixed income exposure simultaneously. Although this has happened to some extent during recent bouts of bond yield rises, on balance we think a measured normalisation of cash rates globally (as economic activity improves) is positive for credit markets. That said we expect a pick-up in volatility as we approach normalisation from the Fed and other central banks. In summary, if rates rise for the "right reasons" (i.e. improving growth, lower unemployment, and higher economic activity), then we would see any market sell off as an opportunity to add exposure.