CREDIT MARKETS IN FY18 – A WRAP-UP

PERPETUAL INVESTMENTS

31/07/2018

Given we have just passed the end of the 2017-2018 financial year, it's an appropriate time to reflect on the most prominent themes that have influenced credit market dynamics and broad portfolio positioning over the past twelve months. It's also an opportunity to paint a picture of the current (three to six month) outlook for credit markets as we see it, with particular emphasis placed on some of the contributors (both positive and negative) which feed into the composition of our view.

In the first of this two part piece regarding observations around credit markets – the recent past and the near future – we look at what has been influencing our appetite for credit over the last twelve months.

Supportive conditions in the first half

Through the first half of financial year 2017 – 2018, economic and market conditions were broadly supportive of credit markets. Volatility across risk assets was muted (driven by indications of synchronised and strong global growth), inflation across most major economies was benign and close to peak stimulatory monetary policy measures remained in place. Bolstering this view was persistent strength in company earnings observed in both the domestic and many major offshore markets.

It seemed that as fast as potential geopolitical risks appeared they were gone, swiftly dissipating while appearing numb to global political woes and the controversial actions of neophyte US President Trump. Instead, market participants remained focused on supportive central bank rhetoric and data which pointed to a positive outlook for global economic growth. This combination of dynamics proved an ideal environment for adding to credit exposure, where the risk of default was suppressed given the supportive economic conditions in place. Credit spreads across both capital and ratings structures continued to grind tighter throughout the first half of the financial year, with higher yielding assets outperforming less risky counterparts. Portfolios with exposure to the higher yielding segment of the market were well rewarded.

Implications on portfolio construction

An increase in credit exposure can be implemented in various ways; for example, deploying cash held, increasing the weighted average life of a portfolio or by buying assets further down the capital structure, where reward for risk assumed is enhanced when credit spreads are contracting. Sector choice is also an important part of the decision making process in terms of capital allocation and relative valuations. In line with our positive outlook for much of the first half of the past financial year, we used a combination of these levers available to increase our exposure when deemed appropriate.

Portfolios benefited from significant spread contraction when market conditions were supportive of credit, which was the case in the first half of the financial year. However, when spreads have had a strong run of tightening, this can, in turn, result in a marked reduction in the dispersion of spreads on market securities as a whole. This may serve to make credit investing more challenging. Broadly speaking, with a clustering of spreads, the frequency of attractive relative value opportunities in both primary and secondary markets diminishes. However, such conditions do play to our strength as active managers. Disciplined sector rotation and security selection in this environment affords us the opportunity to continue to add value through prudent and extremely selective management within portfolios.

Challenges in the second half

The past financial year was not all one-way traffic in terms of credit spread dynamics. The second half of the financial year proved more challenging for credit investors. Changing central bank policies, inflation uncertainties and increased geopolitical risks resulted in credit markets conditions turning less supportive in January. This prevailed during the second half of the financial year.

Episodes of geopolitical risks – most evident in Europe and the US, uncertainty relating to trade wars and protectionism, hawkish rhetoric from the US Federal Reserve and broad based rising yield curves all influenced spikes in volatility from multi year lows. Credit markets were not wholly insulated from broader instances of risk off sentiment. However, domestic spreads were less influenced by market movements than their offshore counterparts. This resilience in domestic spreads was heavily influenced by domestic supply and demand conditions alongside the fact that despite movements across broader risk assets, fundamentals remain strong and economic data indicators positively biased for the most part. Although outperforming offshore counterparts, a widening bias was observed in domestic credit spreads during the second half of the financial year.

Despite the spread widening observed, a disciplined approach to portfolio composition and active management afforded us the opportunity to prudently position as seen appropriate to withstand broader market pressures and continue to achieve above benchmark returns while also protecting clients' capital.

Key take-outs – what does this mean for your clients?

- In an environment where credit spreads are tighter than their historical averages, disciplined sector rotation and active security selection continues to provide the ability to add value for investors.
- For investors, ensuring their fund manager is prudent in investing in credit markets and extremely selective in the management of portfolios remains key to achieving successful portfolio outcomes.

Outlook – coming soon

The credit outlook is an integral part of our investment process. In the second part of this two part series, we will take a deeper dive into how the quantitative indicators and qualitative overlay blend to provide a consensus view of where we see current credit markets and the most appropriate way to navigate opportunities and risks for the period ahead.

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