CREDIT STRATEGY IN A VOLATILE RATE ENVIRONMENT

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2016 was on course to be a strongly positive year for credit with three tailwinds benefiting the asset class in concert.

First, we saw a recovery and stabilisation in the price of crude oil, from a low of around $27 per barrel in February to a range of $40-$50. This in turn relieved some of the pressure on the energy sector, which makes up a significant part of the credit market and the high yield index in particular. Many issuers whose creditworthiness was doubtful at the lower ranges now are viable and their bond prices have recovered from distressed levels. Second, the oil price recovery was beneficial for emerging market assets generally, given that many of those economies depend heavily on commodity exports. Third, we saw government interest rates defy expectations and continue to decline globally, with much of the government bond market slipping into negative yield territory. Long term interest rates declined most sharply and yield curves flattened on speculation that there would be little to no growth or inflation and the four major central banks would be forced to maintain accommodative monetary policy for several years hence.

All that changed in November with Donald Trump's shock victory in the US Presidential Election. In just a few days we saw yield curves steepen sharply (Figure 1), not just in the US but globally. Many view his policy agenda as likely to foster growth and inflation, and there is probably an element of additional credit risk given his revenue and spending plans, and additionally his comments on the campaign trail (however seriously they should be taken) about renegotiating America's debt. Combined with the expected fiscal effects of a Trump economic plan, the expectations for the US Federal Reserve (Fed) policy have moved towards a tightening bias.

Emerging market assets have reacted particularly negatively to the situation with Latin America in the eye of the storm. The poor performance of Mexico in particular can be attributed to fears around a renegotiation or repudiation of the North American Free Trade Agreement (NAFTA) and resulting damage to the country's export sector.

In this new environment of more volatile interest rates and steeper yield curves, the performance of credit assets has been relatively stable. Spreads on developed market investment grade and high yield credit have kept steady, and drawdowns in the sector have been mostly driven by duration effects. We have observed in previous periods of rising rates that credit spreads have remained flat or even tightened; evidence suggests that the key driver of spreads is economic growth than monetary policy. Figure 2 shows the historical performance of US BBB credit spreads vs. the Fed Funds Rate and GDP growth – the inverse relationship with the latter is clearer.

The reason for this is that corporate profitability and cash flow will improve with economic performance and investors can feel more confident about debt servicing and repayment. Central banks on the other hand tend to respond in a lagged fashion to strong growth, since it is only when the economy reaches capacity and inflation starts to increase that monetary tightening is needed. Credit spreads can tolerate moderate inflation, provided companies are able to raise prices in line with their costs, and thereby preserve their margins. Higher inflation will be detrimental however if it provokes an aggressive response from the central bank.

OUTLOOK

We believe the outlook for credit from a fundamental perspective remains unchanged, with reasonable corporate results from the third quarter, 2016, and the expectation of continued, at-trend global growth. While inflation expectations have risen recently, they were previously at extremely low levels and are not high by historical standards. While credit performance has been stable generally, there has been significant divergence between sectors following the election. As an example, US financials have rallied on the expectation that existing regulation of the sector such as Dodd-Frank may be watered down or repealed.

Financials

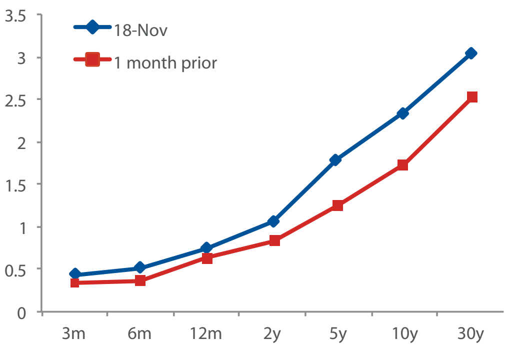
We have been positive on the financial sector's fundamentals, away from some specific banks, for some time given the secular trend in deleveraging, de-risking of business models and greater transparency. Since 2012, the total amount of debt outstanding for the financial sector has only grown modestly in comparison to the expansion in the industrial sector, as Figure 3 below shows.

Steeper yield curves should benefit the banking sector as the margins between long term lending and short term funding grow wider. At the same time, financials offer slightly higher spreads on aggregate vs. investment grade industrials. Legacy Tier 1 (subordinated) debt looks attractive for selected institutions, as does some of the new AT1 issuance. This combination of improving fundamentals and superior spreads makes the case for a continued relative value play on the financial sector versus industrials. Of course there is significant divergence on a regional basis – the Italian banking system still faces serious challenges in terms of non-performing loans and anaemic growth and we believe substantial additional measures are needed before full confidence can be restored in the markets.

CMBS

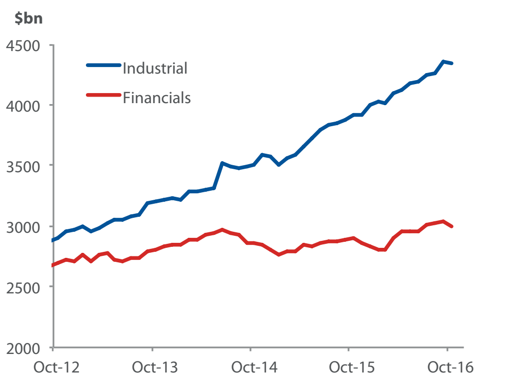
Commercial mortgage-backed debt is another sector that seems relatively attractive in the current environment and should be well placed in a volatile / rising rate environment. The sector is by and large floating rate or short term, so should be untroubled by changes

Figure 1: US Treasury Yield Curve (%)



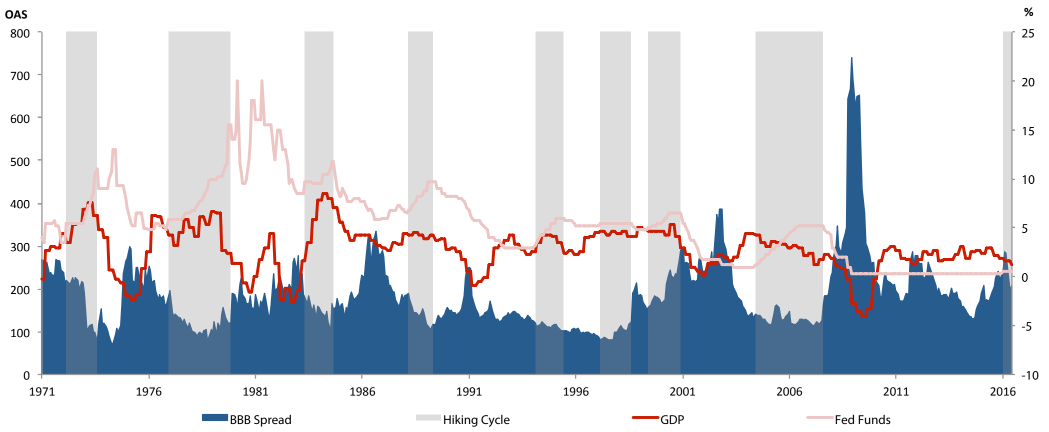
Source: Bloomberg as at 18 November 2016. Past performance is not a reliable indicator of future result

Figure 3: Total Nominal Debt Outstanding



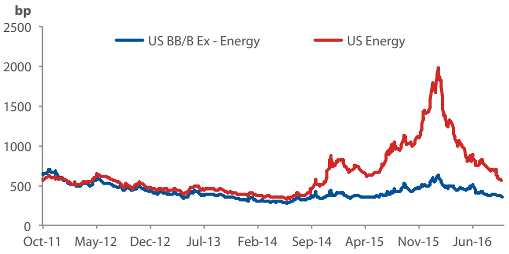
Source: Barclays, to October 2016 as at 2 December 2016.

Figure 2: US BBB Spreads vs Fed Funds and GDP



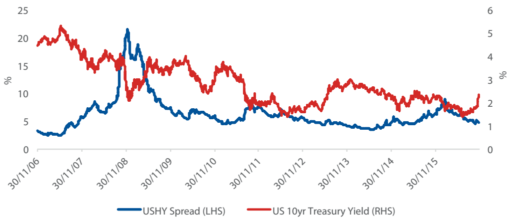
Source: Rogge Global Partners Ltd. / Bloomberg / Morgan Stanley / Moody's / The Yield Book to Aug 2016 / NBER (July 2016) as at 2 December 2016. Past performance is not a reliable indicator of future result.

Figure 4: US BB/B vs US Energy Credit Spreads



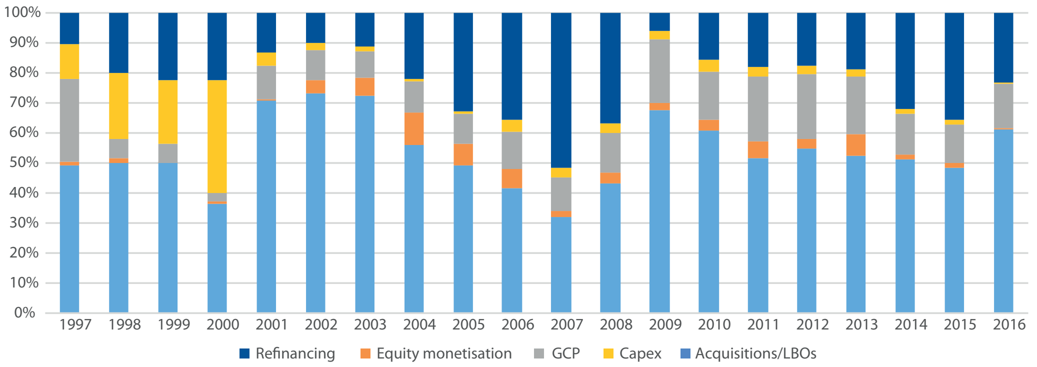
Source: Barclays / Bloomberg / Bank of America / Rogge Global Partners Ltd to October 2016 as at 2 December 2016.

Figure 5: US High Yield Spreads vs. US 10yr Treasury Yields



Source: Bloomberg, to November 2016 as at 2 December 2016. Past performance is not a reliable indicator of future result.

Figure 6: High Yield Use of Proceeds



Source: BofA Merrill Lynch Global Research, S&P LCD, to October 2016 as at 2 December 2016

in underlying reference yields, as the coupons adjust within a few months. Moderate growth and inflation will also benefit the sector as it boosts the value of the properties serving as collateral for the mortgages, and thereby improves the credit quality of the issue. The sector is of course not as liquid as the corporate market, but one can earn a decent premium for taking on this risk. There is also probably an element of stigma remaining around the sector from the financial crisis, but one should bear in mind that underwriting standards have tightened significantly since then, such that loan-to-value metrics are much lower than previous (which reduces the risk of a capital loss) even as the spreads on offer are substantially higher.

High yield

The high yield market has had a strong rally in 2016 following two years of volatility driven by the oil sector. Most of the pain has already gone through the energy sector and those who survived have recovered sharply, as is shown in Figure 4. The dispersion of the energy sector versus the wider market underscores the importance of active sector selection.

Looking forward, high yield credit has by its nature shorter duration than investment grade, both from the tenor and the cushion from coupon income. Historically the market has shown little correlation to the performance of government interest rates. In most cases the spreads have remained stable or even decreased as government yields have risen.

As with the previous analysis for investment grade credit, high yield responds much more directly to economic growth. The relationship is stronger the lower the credit rating, as the company in question will be more leveraged and geared to an improving economy. Inflation is generally benign for high yield companies as it erodes the real value of their debts; conversely deflation is very bad for the asset class as there is less of a cushion for margins and equity. The fears of deflation globally were certainly a contributor to high yield's poor performance in late 2015 to February 2016, and as those concerns abated we saw a strong rally in response.

Looking at the prevailing fundamentals, the high yield sector has remained in reasonable shape after the shakeout in the energy sector.

Leverage has increased in the US market but this has been mitigated by a stable rate of interest coverage, which means that companies are still able on the whole to service their debts as previously. In Europe, leverage has remained stable and the coverage ratio has actually improved over the last few years as rates have fallen and the economy has come out of recession.

In high yield credit, the use to which debt is put is as important as the level of debt itself. We therefore pay close attention to the use of proceeds data on an individual and aggregate level, as an early warning signal of default risk. Issuance of new debt to refinance existing bonds is sensible when yields are stable or falling as it will reduce the company's future interest burden. Companies may also issue bonds to finance capital expenditure or acquisitions; this is also a fair use provided the investments are sensibly planned. Increasing debt to fund a share buyback or special dividend however is rarely prudent and generally portends a rise in default rates. A rule of thumb is defaults increase in the coming years when less than 50% of high yield issuance proceeds are used for refinancing. We did touch that threshold in 2015 but this year the metric has recovered to 60%.

The schedule for maturing debt in the high yield market does not look onerous for 2017 as companies have used the opportunities this year to refinance their debt at lower rates. Even if the Fed does tighten policy, it should not have a material effect on the asset class, particularly if growth does improve from present rates.

In valuation terms, high yield credit spreads are around or slightly tighter than their historic medians, but look in line with fair value when forward looking default rates are taken into consideration. Spreads on the lower rated (CCC) companies have tightened most significantly since February so the opportunity is less compelling, while higher rated BB issuers will have more sensitivity to changes in government rates given the lower credit spread cushion.

CONCLUSIONS

Overall, the repricing in government yields has not adversely affected the developed credit markets and on a forward basis there are some decent opportunities. Steep yield curves provide not just an attractive premium for taking moderate levels of term risk, but also a "rolldown" effect, whereby bond prices rise as yields drop with each step closer to maturity. At present the two to five year range offers a sweet spot in our opinion; longer dated credits will face more volatility as government rates fluctuate.

Investment grade financials and high yield offer an attractive premium to cash and government debt given their fundamentals; securitised debt also provides a haven of low duration income that stands to benefit from rising rates. Emerging markets have suffered in recent weeks but may look attractive again once the macro conditions have stabilised.

The significant divergence in performance by region, sector and individual issuer that we have observed historically suggests that a flexible approach should be optimal. Moving away from a traditional benchmarked approach to credit in a period of volatile interest rates will have the dual benefits of removing the embedded duration in the index (around 6-7 years for global investment grade), while also allowing the investor to diversify away from sectors and issuers whose fundamentals are weak or deteriorating.

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