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Asset Management

A changing tide: what the move from QE to QT means

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If 2018 was the year where quantitative tightening started to take hold, 2019 is the year it's likely to strengthen its grip. After a decade where central banks flooded the markets with liquidity in order to stoke the economy, they began to reverse this process last year, looking to shrink their balance sheets and normalise interest rates after years of unconventional monetary policy.

This reversal process is however already having a profound effect on financial markets, as illustrated by the extent of negative asset class returns across the board in 2018. With signs of moderation in global growth, recession indicators are murmuring, and volatility has replaced an unusually long period of calm.

For credit investors, we are entering a new era of fragility where broader economic conditions are more likely to have a negative impact on credit spreads. There is a need to tread carefully, but if heeded, the stage is set in the year ahead for the nimble and well positioned investor to take advantage of the move from quantitative easing to quantitative tightening (QE to QT).

EBBS AND FLOWS OF CREDIT LIQUIDITY

Credit markets, along with most financial markets, have benefited significantly in recent years from a wave of central bank liquidity. Easy money has rippled through all credit market subsets, providing a strong tailwind for tighter valuations, supported by improving underlying fundamentals.

However, the recent shift from QE to QT, in our mind, has had an impact on market momentum. The retrenchment of tourist investors (tactical allocators), who don't consider credit a mainstay of their investing, has left some areas of the market susceptible. This retrenchment has led to a significant shift in the performance of the different credit market subsets, best illustrated by the fact that after 100% of major credit market subsets produced a positive absolute return in both 2016 and 2017, this number dropped to only 27% in 2018.

Interestingly it is some of the more specialist credit markets that have led the way in this negative trend, with good examples being corporate hybrids and bank capital, both of which produced particularly weak returns, which we believe was driven principally by this retrenchment of tourist investors.

We believe this theme will continue to be the main driver of markets this year, where the 'safe havens' may not necessarily be where investors expect them given the impact of extreme monetary policy over the last decade.

UNEXPECTED SAFE HAVENS

The areas of credit that held up better in 2018 were those with typically less interest rate sensitivity, such as short duration high yield, European leveraged loans and US leveraged loans. European loans notably outperformed their US counterparts, driven principally by a stickier buyer base, with a larger mutual fund buyer base of US loans making them more susceptible to broader market risk off sentiment.

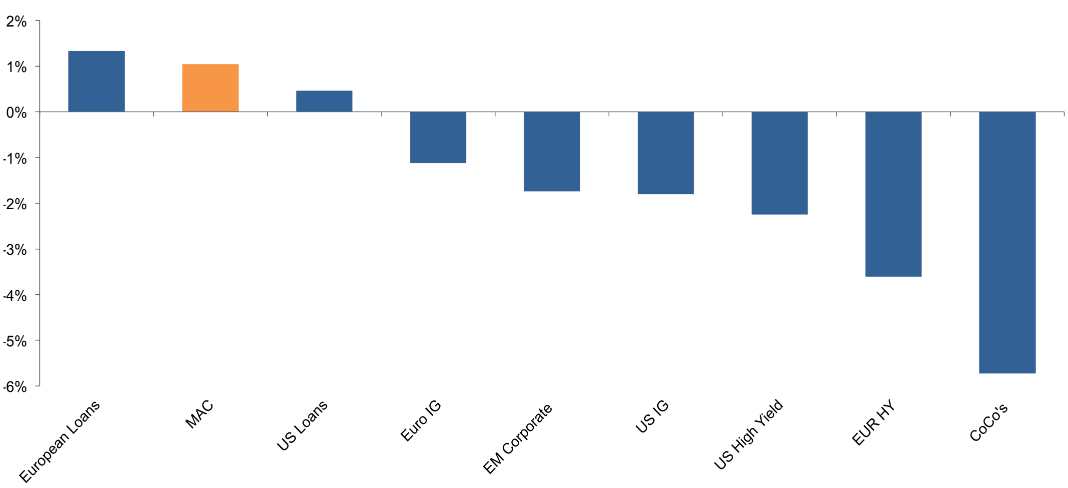
This demonstrates how important it is both to understand the behavioural dynamics of individual market subsets and be selective in approach, which is why these are key themes for us this year. We believe these 'market technicals' (technical aspects of market analysis), along with issuance levels and fund flows, will likely have a meaningful impact on market direction in the year ahead.

OPPORTUNITY SET TO INCREASE, BUT SELECTIVITY IS KEY

As we progress further into an era of reduced central bank support and tightening liquidity, we believe we are likely to see increased divergence in the performance of different credit market subsets. And while each investment opportunity should be assessed on its own merits, we believe the year ahead is likely to be less about reaching for returns and more about preservation of capital.

In this vein, dynamism and selectivity are going to be key to avoiding the more susceptible areas of the credit market. As such we believe an unconstrained approach to credit investing is set to yield the best results in the year ahead, where a broad opportunity set and flexibility to adapt to changes in credit risk premia and market technicals across different areas, will not only result in a better investment outcome, but also one that is better than the sum of the underlying constituent credit market subsets.

MARKET RETURNS 2018 IN LOCAL CURRENCY



Past performance is not a reliable indicator of future results, losses may be made. Calendar year returns for the Strategy; 2018: 2.0%, 2017: 6.9%, 2016: 11.4%.

Source:
Investec Asset Management, Bloomberg, as at 31 December 2018. Performance is gross of fees (returns will be reduced by management fees and other expenses incurred), income is reinvested, in USD. Multi-Asset Credit Strategy inception date: 01 January 2016.