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Credit where credit's due

by Richard Stutley, CFA

Bonds remain expensive today, with yields across the ratings spectrum having tracked core rates lower. While core rates have lifted off their lows from last year (US 10 year yields got as low as 0.5% in August 2020[1]), they remain unattractive at current levels. However, there remain areas of relative value within short duration high yield and dollar-denominated emerging market debt, as well as floating rate credit. Elsewhere, while there is limited upside from further spread compression, spreads are not at extremes, and hence there is no clear reason, from either a valuation or a fundamental perspective, why spreads should suddenly blow out. As a result, we retain meaningful allocations to those aforementioned areas of value, as well as some core investment grade credit.

For parts of the credit market (investment grade as well as sub investment grade/high yield debt) to be cheap, spreads would need to be significantly above historical norms in order to compensate for the risk that underlying interest rates move higher, and that is not what we see today. Dollar emerging market debt looks the best value at a headline level, with spreads at around 350 basis points[2]. They were below 300 for the full period between June 2005 and March 2008, which we think represents a level closer to fair value[3].

Credit fundamentals look reasonable, however. One of the lead portfolio managers at TwentyFour, our specialist credit manager, noted recently that the high ratio of upgrades to downgrades among US high yield issuers, combined with a falling default rate and shrinking volume of distressed debt, all combine to produce a strong fundamental backdrop for the asset class[4].

Corporate leverage is coming down, whilst interest coverage is at manageable levels. The picture has been helped by strong earnings and low funding costs. Arguably, this has made it easier for investors to keep buying the dip, which has supported equities and credit spreads. With over $300 million of new issuance in the US high yield market this year, twice what we saw at this stage in 2019, and no rise in overall leverage, it is clear that firms are taking advantage of the low rate environment to refinance and reduce their interest bills[5].

We spend most of our time analysing fundamentals like these, as well as valuations, but it is important to also keep an eye on shorter term signals and market dynamics. From a technical perspective, while government bond yields have been less and less appealing in absolute terms, stretched equity valuations have been likewise less attractive, and have resulted in some forced buying of bonds alongside central banks.

Further, the "war chest" of cash in money market funds that was built up early in the pandemic has been barely dipped into, with plenty of cash available to mop up any new net issuance of bonds. High yield markets in both the US and Europe have readily absorbed record supply this year[6], indicating plenty of interest for this debt, and spreads have continued to trade in a narrow range[7] despite the Fed's decision to wind down its Secondary Market Corporate Credit Facility.

We continue to like opportunities in certain parts of the credit market. As a term product (compared to equities, which one can hold in perpetuity), timing is more important when it comes to credit selection, and we continue to see reasonable conditions for our holdings today.

[1]US Generic Government 10 year yield, Bloomberg Finance L.P.

[2&3] J.P. Morgan EMBI Plus Sovereign Spread, Bloomberg Finance L.P.

[4]Chris Holman, 05/08/2021, "Don't Fight the Fundamentals on US High Yield"

[5]Deutsche Bank, Dealogic. 27/08/2021, "Global Leveraged Finance Weekly Wrap"

[6]Based on data going back to 2010. Deutsche Bank, Dealogic. 27/08/2021, "Global Leveraged Finance Weekly Wrap"

[7]Bloomberg US Corporate Statistics Index, Bloomberg Finance L.P.

Market Focus

- **Global equities returned +1.0% last week**
- **China's Vice Premier Liu He made a strong pledge to continue supporting private businesses after a spate of regulatory crackdowns in sectors from after-school tutoring to internet platforms rocked financial markets**
- **Brent crude fell by -0.1% to $72.6 a barrel**
- **Gold rose +0.6% last week to $1827.7 per ounce**

US

- US equities rose +0.6% last week
- Private payrolls disappointed with a 235,000 increase in August, the smallest gain in 7 months The median estimate was for an increase of ~750K
- The ISM manufacturing print for August rose to 59.5 vs. 58.5 expected. New orders were up to 66.7 vs. 61.0 expected
- Federal Reserve Chairman Powell said that there had 'been clear progress toward maximum employment', but he also noted that the recorded unemployment rate understates the amount of slack in the labour market
- Initial jobless claims for the week ending August 28 fell to 340k vs. 345k expected
- Senator Joe Manchin demanded a 'strategic pause' in action on President Joe Biden's economic agenda, potentially imperilling the $3.5 trillion tax and spending package that Democratic leaders plan to push through Congress this autumn

UK

- UK equities ended the week flat
- The UK manufacturing PMI for August 2021 came in at 60.3, down slightly from 60.4 in July, indicating strong expansion albeit at the lowest rate since March
- The Office for National Statistics reported that 94% of the adult population in England had Covid antibodies in the week starting August 9th - the highest percentage yet
- U.K. firms added almost 200k job posts last week. There are almost 1.7 million 'active' vacancies registered online
- PM Boris Johnson returns to Parliament this week facing a backlash from members of his Conservative Party amid reports he is planning a manifesto-breaking tax hike on British workers to boost funding for social care

Rest of the World/Asia

- The benchmark Global Emerging Markets index rose +3.4% last week
- Japanese equities rose +4.5% last week
- Chinese Equities rose +4.3% last week
- China's President Xi Jinping has said that the country will set up a new stock exchange to provide financing for innovative smaller firms
- China's August services PMI came in at 46.7 vs. 52.0 expected, the weakest reading since April 2020
- Japan's final services PMI for August was revised down to 42.9 versus 43.5 in the flash reading
- Australia's services PMI for August was revised down to 42.9 versus 43.3 in the flash reading

Europe

- European equities fell -0.2% last week
- Eurozone inflation rose to 3% in August from 2.2% in July. This was above the ECB's 2% target. Higher energy, food, and industrial goods prices drove the increase
- The European Commission's economic sentiment index fell to 117.5 in August from a record high of 119.0 in July
- Euro-area retail sales for July showed a -2.3% slowdown versus 0.0% expected after the previous month was revised up +0.3 percentage points to +1.8%

Past performance is not indicative of future returns. Source: Bloomberg Finance L.P., returns in local currency unless otherwise stated.

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Market Summary

Asset Class / Region	Currency	Cumulative returns: Week ending 03 September	Month to date	YTD 2021	12 months
Developed Markets Equities					
United States	USD	0.6%	0.3%	21.6%	32.7%
United Kingdom	GBP	0.0%	0.4%	14.2%	26.4%
Continental Europe	EUR	-0.2%	0.2%	20.3%	31.1%
Japan	JPY	4.5%	2.8%	13.0%	26.2%
Asia Pacific (ex Japan)	USD	3.5%	1.0%	2.9%	19.3%
Australia	AUD	1.0%	0.4%	17.4%	27.3%
Global	USD	1.0%	0.8%	18.8%	32.3%
Emerging Markets Equities					
Emerging Europe	USD	4.0%	2.3%	22.8%	42.8%
Emerging Asia	USD	4.0%	0.8%	0.8%	17.7%
Emerging Latin America	USD	-1.1%	-2.1%	3.1%	27.5%
BRICs	USD	3.9%	0.9%	-2.0%	9.4%
China	USD	4.3%	1.0%	-11.4%	-3.9%
MENA countries	USD	1.2%	0.0%	25.9%	35.3%
South Africa	USD	2.9%	-0.1%	9.3%	33.3%
India	USD	4.4%	1.1%	25.2%	53.0%
Global emerging markets	USD	3.4%	0.6%	3.4%	21.0%
Bonds					
US Treasuries	USD	0.0%	-0.1%	-1.8%	-3.1%
US Treasuries (inflation protected)	USD	-0.4%	-0.1%	4.1%	5.7%
US Corporate (investment grade)	USD	-0.1%	-0.1%	-0.3%	1.5%
US High Yield	USD	0.4%	0.2%	4.7%	10.2%
UK Gilts	GBP	-0.6%	0.1%	-3.9%	-3.0%
UK Corporate (investment grade)	GBP	-0.2%	0.1%	-1.4%	2.3%
Euro Government Bonds	EUR	-0.4%	-0.1%	-1.9%	-0.2%
Euro Corporate (investment grade)	EUR	-0.2%	-0.1%	0.3%	2.1%
Euro High Yield	EUR	0.1%	0.1%	3.9%	8.2%
Japanese Government	JPY	-0.1%	-0.1%	0.2%	0.4%
Australian Government	AUD	-0.2%	-0.4%	-0.5%	-0.2%
Global Government Bonds	USD	0.2%	0.3%	-3.4%	-1.5%
Global Bonds	USD	0.2%	0.2%	-2.5%	-0.2%
Global Convertible Bonds	USD	1.1%	0.8%	1.6%	13.3%
Emerging Market Bonds	USD	0.5%	0.1%	-1.1%	1.4%

Source: Bloomberg Finance L.P. Past performance is not indicative of future returns.

Market Summary

Asset Class / Region	Currency	Cumulative returns: Week ending 03 September	Month to date	YTD 2021	12 months
Property					
US Property Securities	USD	3.5%	2.0%	32.0%	40.7%
Australian Property Securities	AUD	2.4%	0.8%	15.2%	25.2%
Asia Property Securities	USD	1.7%	1.7%	4.4%	9.6%
Global Property Securities	USD	2.4%	1.5%	20.5%	30.9%
Currencies					
Euro	USD	0.8%	0.7%	-2.7%	0.5%
UK Pound Sterling	USD	0.7%	0.9%	1.6%	4.6%
Japanese Yen	USD	0.2%	0.3%	-5.8%	-3.2%
Australian Dollar	USD	1.9%	1.9%	-3.1%	2.5%
South African Rand	USD	3.1%	1.5%	2.7%	17.6%
Swiss Franc	USD	-0.3%	0.3%	-3.1%	-0.4%
Chinese Yuan	USD	0.3%	0.1%	1.1%	6.1%
Commodities & Alternatives					
Commodities	USD	0.9%	1.4%	31.0%	47.0%
Agricultural Commodities	USD	-1.0%	0.8%	21.8%	46.7%
Oil	USD	-0.1%	-0.5%	40.2%	64.8%
Gold	USD	0.6%	0.8%	-3.5%	-5.2%
Hedge funds	USD	0.5%	0.3%	4.5%	9.4%

Source: Bloomberg Finance L.P. Past performance is not indicative of future returns.

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