Global Credit Income

Market background

The global macroeconomic backdrop was supportive for credit markets over much of the quarter, despite the significant volatility seen in August in response to weak US labour market data and a surprisingly hawkish Bank of Japan. In the US, falling inflation and expectations of rate cuts led to a sharp drop in Treasury yields. The Federal Reserve subsequently reduced interest rates for the first time in four years in its September meeting; after much debate across markets around its potential size, the 50bps cut reflected a slowing labour market and increased confidence around inflation dynamics. Sovereign bond yields also fell in Europe; the European Central Bank made its second 25bps rate cut of the year in September, prompted by growing confidence around inflation dynamics and an ongoing backdrop of lacklustre economic growth.

Against this backdrop of rallying sovereign bond markets, credit markets across the asset-class spectrum posted gains. The top performers were asset classes that pay fixed coupons; these benefited from the fall in risk-free rates, particularly in the US – where investment-grade and high-yield bond markets both delivered solid returns. In Europe, the high-yield market and the investment-grade market posted similar total returns, with credit spreads little changed across both markets.

Floating-rate assets such as collateralised loan obligations (CLOs) lagged fixed-coupon bonds as they did not benefit from the rally in bond yields. However, attractive carry and some credit spread tightening in the CLO market – boosted by improved sentiment over the macroeconomic outlook – helped the market to deliver strong absolute returns.

Performance

The Strategy produced a positive absolute return over the quarter, outperforming its cash-plus benchmark* and keeping pace with the rally in the broader credit market, in a strong period for fixed income (interest rate-sensitive) assets.

All areas of the portfolio added to performance from an asset class perspective, with the portfolio's exposure to investment-grade bonds in the US and Europe leading performance. The rally in sovereign bond yields across both regions boosted higher-duration (more interest rate-sensitive) assets.

The portfolio's significant allocation to structured credit also helped performance. Despite these floating-rate assets lagging fixed income markets, attractive carry meant they still produced a positive total return.

Holdings in short-duration high-yield and emerging market high-yield bonds also boosted performance, with the former continuing to benefit from elevated levels of carry as yield curves remained inverted. Bank capital, or AT1s, also continued to make headway over the quarter, helped by attractive carry.

From a sector perspective, banking and real estate led the portfolio; no sectors detracted from performance.

*Where performance is gross of fees, returns will be reduced by management fees and other expenses incurred. Net performance is net of highest institutional segregated portfolio management fee.

Not all securities held have been discussed. For further information on how the overall strategy performed during the period covered, please reference the relative performance noted in the Performance review section.

Past performance does not predict future returns; losses may be made.

Portfolio activity

We increased our allocation to European investment-grade bonds, which continue to offer attractive value relative to the US investment-grade market and the high-yield segment of the European bond market.

We have selectively participated in new issuance in the high-yield market, where issuers have come to the primary market at attractive spread levels.

We continue to favour segments of the market such as short-duration high-yield debt and bank capital, which offer a good balance of attractive carry and downside protection.

Outlook and strategy

Amid continuing uncertainty around global economic growth, inflation trends and the behaviour of central banks, the strong recovery of credit markets has continued. Markets now appear convinced about the prospect of a 'soft landing' for the US economy, and the start of looser monetary policy from the Fed signalled by its initial 50bps interest rate cut in September should be positive for fixed income markets. However, we continue to believe the road ahead is likely to remain bumpy – credit-market valuations are likely to remain volatile and the decline in government bond yields is unlikely to be smooth; we have already seen rate cut expectations being pushed out a number of times due to the ongoing strength of economic data. The looming US election also has the potential to generate further volatility. This environment should ultimately create opportunities for the flexible and dynamic manager.

While market technicals – such as supply/demand dynamics, fund flows, and interest-rate volatility – have been key factors driving markets, we believe company fundamentals (i.e., corporate health/strength) will increasingly come to the fore. Corporate fundamentals are generally starting from a position of strength, with reasonable leverage levels and strong interest coverage across large parts of the credit market. As macroeconomic conditions weaken, we will inevitably see an increase in default rates, but we believe this rise is likely to be less pronounced than in previous recessions given the factors mentioned above. That said, in an environment where default rates are rising, idiosyncratic (company-specific) credit risk abounds, and this underscores the need for differentiation and active portfolio management.

More broadly, yields remain elevated compared to history, offering investors compelling valuations and a dramatically improved income profile relative to recent history. Not only does this higher level of income mark a shift in regime for investors who have been starved of yield for many years – boding well for the outlook for asset-class demand – it also has historically shown itself to be a source of higher quality and less volatile returns for credit investors. Furthermore, higher yields also typically provide a buffer to absorb further market stresses. While credit spreads have compressed, dispersion is extremely high; this creates compelling bottom-up opportunities for investors that follow flexible and dynamic approaches. As the market begins to discriminate between issuer fundamentals, sector dispersion in credit markets will likely increase further.

Specific risks.

Currency exchange: Changes in the relative values of different currencies may adversely affect the value of investments and any related income. Default: There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss. Derivatives: The use of derivatives may increase overall risk by magnifying the effect of both gains and losses leading to large changes in value and potentially large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. Emerging market: These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems. Equity investment: The value of equities (e.g. shares) and equity-related investments may vary according to company profits and future prospects as well as more general market factors. In the event of a company default (e.g. insolvency), the owners of their equity rank last in terms of any financial payment from that company. Interest rate: The value of fixed income investments (e.g. bonds) tends to decrease when interest rates rise.

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