ANALYSIS

Credit Continuum

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Late credit cycle behaviour warrants increased focus on fundamentals

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Credit markets are currently caught between two opposing forces.

Signs of a second-quarter global economic slowdown have become more visible, particularly in locations or sectors that have so far been relatively insulated.

In the US, we expect second-quarter economic growth to be more modest than the first; the service sector (PMI) reading fell below expectations in May, converging towards the manufacturing sectors' low scores, while there was also a significant slowdown in job creation and wage growth.[1]

On the other hand, central banks are conveying a dovish message, indicating they will act on signs of further deterioration. As the market is now anticipating close to 100 basis points of rate cuts in the Federal Fund's Rate over the next 12 months, the Fed has not pushed back on these expectations, consolidating the bull market in government bonds.

Meanwhile the European Central Bank's (ECB) President Draghi has announced an extension of its forward guidance on possible rate rises to mid-2020 and left the door open to several potential actions the ECB could take if needed, including reopening the asset purchase programme that was interrupted earlier this year.[2]

In our view, the uncertain macro environment in a late-credit-cycle phase leaves investors little room for complacency for companies with balance sheet volatility. In a situation where tail risks continue to be high, we believe corporates, specifically investment grade rated, that have been comfortably increasing leverage over the past few years should adopt a more conservative stance going forward.

This approach should ensure the continued support of investors and justify tight valuations. We have no doubt that many levers exist to preserve investors' confidence, but markets will likely scrutinize any deviation from deleveraging plans in such uncertain times.

1. https://www.ft.com/content/9fcc59fe-8601-11e9-a028-86cea8523dc2, https://www.ft.com/content/3ee2a85e-891d-11e9-a028-86cea8523dc2, https://www.ft.com/content/c54d6c3e-8d01-11e9-a1c1-51bf8f989972
2. https://www.ecb.europa.eu/press/pressconf/2019/html/ecb.is190606~32b6221806.en.html

From a technical point of view, credit markets are no longer undersupplied. Gross issuance has risen over the last few weeks and is no longer below last year's levels. Inflows into credit markets were partially interrupted last month and, although flows have since resumed, it shows the sensitivity of demand to economic volatility. [3]

In our view, valuations reached attractive levels in May and triggered some 'buy-the-dip' mentality, as investors put to work some of the dry powder accumulated during the late 2018 sell-off.

However, dispersion in credit markets remains tangible and shows investors' selectivity when buying on lower valuations, highlighting the importance of credit selection.

The early-June rally emphasizes the need for portfolios to be invested to capture the carry and possible price appreciation available after market dips. However, in parallel portfolios should also maintain a preference for issuers with solid cash flows and resilient balance sheets which should provide some protection in volatile times against a backdrop of rising geopolitical tensions.

This encourages us to balance, with some caution, credit exposure between investment grade and high yield, while actively managing interest rate duration through high-quality credits and liquid instruments.

3. Source EPFR Global, as of 22 May 2010

Important Information