JOHCM Funds

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Credit market review – Q3 2019

The world turned upside down

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The dog days of summer, when hopefully most of us escaped the office for the beach or country, are now a fading memory as the leaves turn and the autumn nights draw in. The term dog days of summer has classical origins and was historically associated with the period following the heliacal rising of the star system Sirius, which Greek and Roman astrology tied to heat, drought, thunderstorms, lethargy, fever, mad dogs and bad luck (or so Wikipedia tells me). I think that defines the current state of the credit market environment pretty well.

In this short update, I want to highlight three topics that may be of interest to you and your clients on broader credit markets trends.

1. High yield under pressure - earnings have been okay but more and more high yield issuers are coming under cyclical and secular pressures

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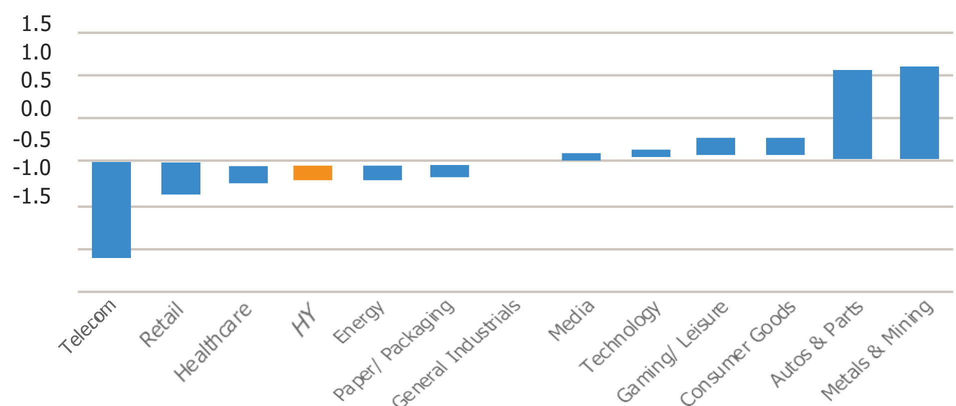
The more indebted, higher beta cohort of high yield issuers (which do not really feature in our credit portfolio) are struggling to delever. For these companies, it is critical that economic growth is sustained at these levels, if not higher.

Sector level trends were fairly evenly split here, with Metals & Mining, Autos & Parts, Consumer Goods, Gaming/Leisure, Technology and Media names reporting an increase in net debt year on year.

Wide dispersion in sector level leverage trends – YoY change in HY net leverage by sector



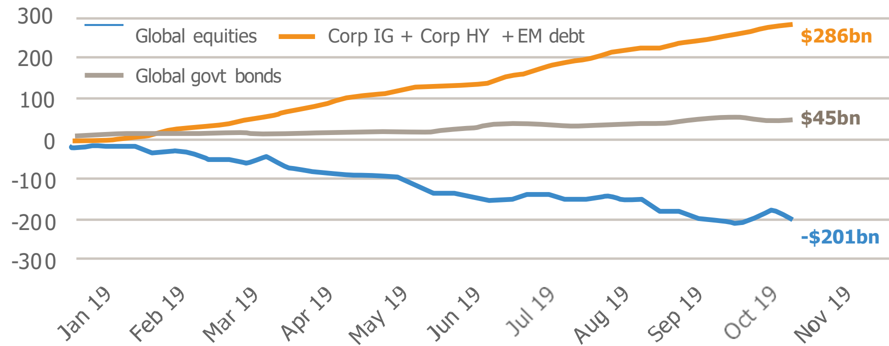
Source: Morgan Stanley Research, S&P Capital IQ, Bloomberg, FTSE Fixed Income LLC.

2. Record corporate debt issuance in September

Low interest rates and these sizeable inflows into investment grade and aggregate bond funds have fuelled record demand for corporate debt.

A picture is worth a thousand words. And the picture below says risk off. Inflows into bond funds for the year to date have totalled US$358bn, gold funds have absorbed US$15billion but US$201bn has flowed out of equity funds. Low interest rates and these sizeable inflows into investment grade and aggregate bond funds have fuelled record demand for corporate debt.

Risks-off flows resume

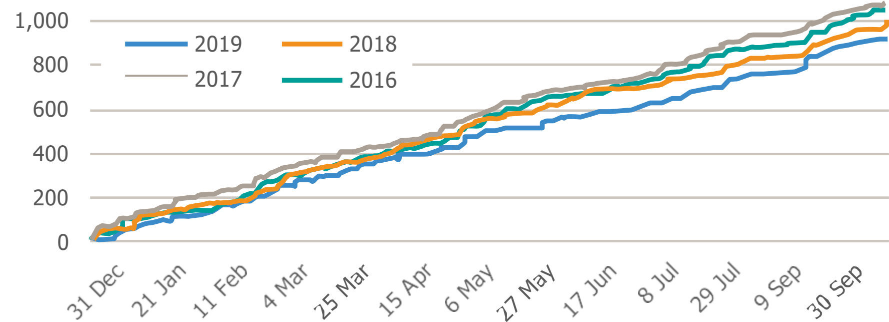


Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global.

Investment grade bond issuance, at US$166bn, was the busiest September ever and the third largest month on record in terms of gross supply

Investment grade bond issuance, at US$166bn, was the busiest September ever and the third largest month on record in terms of gross supply (behind US$175.7bn in January 2017 and US$173.8bn in May 2016). But the majority of the proceeds were used to redeem higher coupon debt and pay short- term maturities. As a result, net issuance is a more benign US$55 billion, which implies net issuance is tracking 18% below last year. Do not be alarmed by the headline numbers is the takeaway here. Recall that, unlike last year, many of the investment grade corporates found religion this year, as they focused on repaying debt to avoid being put on the naughty step by the market. As a result, it may be the case that we have put BBB leveraging story behind us.

USD IG cummulative issuance ($bn)



Source: Credit Suisse.

Pay attention to the funding (i.e. repo) markets

Facilitating a smooth transmission in the funding markets will be critical to avoid any spillovers to the risk markets in the fourth quarter when liquidity in the secondary markets typically fades.

Who would have thought that the overnight general collateral repo could spike to 10%? I don't want to get into too much detail on what went badly wrong in the repo market in September. There have been many explanations already written on it, but I would suggest that we are not exactly out of the woods yet. Yes, the Fed has managed to calm the markets for now via series of overnight repos. However, as we approach the end of the year, it is possible that we may see a repeat of this stress. The banks will be tested for the GSIB (Globally Systemically Important Banks – i.e. too big to fail) surcharge - in layman's term, the regulators will assess how much of an incremental buffer they need to carry in their capital ratios, based on a bank's static balance sheet at a given point in time. The core US banks are already running their capital ratios at about 50bp higher than they would like. As a result, they will most likely start shrinking their balance sheets as we approach the Q4 testing season. This means reduced liquidity for risk assets in terms of balance sheet warehousing. In other words, the banks will particularly want to be just agents in crossing risk between buyers and sellers, rather than holding risk assets on their own balance sheets.

Two data points to watch next:

1. Does the Fed announce an expansion of its balance sheet? If yes, by how much and how fast? The larger and the faster the balance sheet expansion, the more it will help ease repo market pressures.
2. Does the Fed put in a permanent repo facility? While this would make the Fed even more involved in the financial markets, it does help to offset any pressures in the repo market. I would still argue that this opens up a whole host of other issues, but it would fix the repo market hiccups.

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Our credit portfolio – Q3 2019 highlights

It is currently very hard to find value in the credit markets.

Our fixed income portfolio, as a key component of the **JOHCM Global Income Builder Fund**, held up well in Q3, returning 2.3%, in US dollar terms, for the quarter. A few highlights from the quarter:

- Our corporate credit segment (38% of the portfolio) returned +2.5% versus +1.7% for the US HY BB/B index, and +1.2% for the broader US High Yield index. It benefited from higher quality exposure (BBB and BBs) and a lack of exposure to stressed sectors, like energy.
- Quality remains tilted towards BBB/BB, largely unchanged from Q2.
- **It is currently very hard to find value in the credit markets.** As a result, our credit exposure declined slightly in Q3 due to tenders and calls by companies. The booming primary markets in investment grade and high yield, as companies took advantage of the low rates (i.e. tendered/called for higher coupon debt and refinanced with lower cost debt), boosted our portfolio, since we held some BBB and BB-rated companies that redeemed their debt earlier than expected and paid bondholders a premium to do so.

An investor should consider the Fund's investment objectives, risks, and charges and expenses carefully before investing or sending any money. This and other important information about the Fund can be found in the Fund's prospectus or summary prospectus, which can be obtained at www.johcm.com or by calling 866-260-9549 or 312-557-5913. Please read the prospectus or summary prospectus carefully before investing. The JOHCM Funds are advised by J O Hambro Capital Management Limited and distributed through FINRA member Foreside Financial Services, LLC. The JOHCM Funds are not FDIC-insured, may lose value, and have no bank guarantee.

Past performance is no guarantee of future results.

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Investors should note that investments in foreign securities involve additional risks due to currency fluctuations, economic and political conditions, and differences in financial reporting standards. Smaller company stocks are more volatile and less liquid than larger, more established company securities. The small and mid-cap companies the Fund may invest in may be more vulnerable to adverse business or economic events than larger companies and may be more volatile; the price movements of the Fund's shares may reflect that volatility. Fixed income securities will increase or decrease in value based on changes in interest rates. If rates increase, the value of the Fund's fixed income securities generally declines. Other risks may include and not limited to hedging strategies, derivatives and commodities.

The views expressed are those of the portfolio manager as of October 2019, are subject to change, and may differ from the views of other portfolio managers or the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice.