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First State Investments

Global Credit Income

Quarterly Review and Outlook

As at December 2016

Key Highlights

- Despite not feeling the full benefit of the government bond sell-off, credit spreads moved marginally tighter in the month which led to the positive strategy performance.
- In the current low growth, low rate environment demand for higher yielding securities, including investment grade and high yield bonds, has increased.
- We believe that returns often overcompensate for credit risk, and that diversification across a large pool of lowly correlated assets will generate positive 'value-for-risk' outcomes for our portfolios.

Strategy Positioning and Performance

The strategy outperformed its cash benchmark in the quarter returning 1.52% (net of fees) compared to the benchmark return of 0.15%. Despite not feeling the full benefit of the government bond sell-off, credit spreads moved marginally tighter in the month which led to the positive strategy performance. Whilst the overall spread movement was marginal, there were some underlying sectoral shifts on the back of the campaigned policy measures in the US and the rise in energy and commodity prices over the quarter.

Demand for spread product generally remains buoyed by lingering accommodative global monetary policy and low issuance. However, geopolitical event risk and uncertainty over the growth outlook has kept (and will likely continue to keep) spreads range bound as supply is subdued as companies are hesitant to invest. There were no defaults in the strategy during the quarter.

Market Insights

The fourth quarter of 2016 was dominated by political events and the growing consensus that global monetary policy may be reaching the end of its effectiveness. Early in the quarter, global government bond yields rose on the expectation that the Bank of Japan (BoJ) and European Central Bank (ECB) were to wind back or change the focus of their quantitative easing programs. The momentum for higher bond yields was significantly added to in early November with the surprise US election win by Donald Trump, who will become the 45th President of the United States in late January 2017.

In physical credit, the Barclays Global Aggregate Corporate Index average spread moved 9 bps narrower to 1.25%, while the Barclays US Aggregate Corporate Index average spread fell13 bps to 1.18%. The Barclays European Aggregate Corporate Index widened 8 bps to 1.23%, due to the uncertainty of the Italian referendum in early December and continued talk of potential tapering from the ECB.

In contrast to the relatively quiet quarter in investment grade credit, the US high yield credit spreads moved notably tighter with the Bank of America Merrill Lynch Global High Yield index (BB-B) spread closing at 3.23%, down 75 bps from last quarter. Yields in the quarter were impacted by the OPEC announcement in November that it had reached an agreement to cut global oil production, seeing oil prices move higher. Risks to the downside remain however as the high yield market continues to be impacted by downgrades in energy and mining names, as the broader decline in energy prices from 2014 flows through the sector.

Credit Market Outlook

In the current low growth, low rate environment demand for higher yielding securities, including investment grade and high yield bonds, has increased. Flows will need to continue for the rally to be durable as supply will remain heavy.

Our credit strategy and process employs a disciplined approach in the credit assessment and selection process, as issuer decisions will contribute meaningfully to overall portfolio performance. We believe that returns often overcompensate for credit risk, and that diversification across a large pool of lowly correlated assets will generate positive 'value-for-risk' outcomes for our portfolios.