Summary
• In 2019 performance varied substantially across credit market segments, reflecting the inherent diversity of the investment universe.
• While we expect this diversity to persist, some of the 'global' pressures that drove volatility in 2019 have eased, making for a more stable backdrop.
• We will continue to look to exploit bottom-up opportunities as they arise across the credit universe, with areas of the bank capital and corporate hybrid universe comparing favourably at present.
• The unusual nature of the 2019 rally makes some areas of the high-yield market particularly interesting.

Plenty of choice against a steadier backdrop

While the overall backdrop may be more stable in 2020, Garland Hansmann explains why there will be no shortage of choice for bottom-up credit investors

How was 2019 for credit markets and what do you expect in 2020?
Various events saw investors' risk appetite and interest rate expectations oscillate in equal measure in 2019. This created a volatile backdrop for credit markets.

Performance and asset valuations varied substantially across market segments, reflecting the inherent diversity of the investment universe, where each market segment reacts quite distinctively to macro, market, and geopolitical events.

While we expect this diversity to persist, some of the 'global' pressures have eased: fears over US monetary policy loosening coming too late have abated, and the world has become more accustomed to the reality of ongoing US/China trade tensions. This makes for a more stable backdrop for credit markets.

What big themes are you positioning your portfolio for?
We think it's very hard for credit investors to predict which segment of the market will outperform. There are so many factors at play, with multiple (and unpredictable) potential outcomes. Further complicating this is the involvement of central banks, which are using credit markets not in pursuit of investment return but as a monetary policy tool – a phenomenon that underscores the importance of deep fundamental research and an active and dynamic approach, in our view.

Instead of making top-down calls in the portfolio, we will continue to look to exploit bottom-up opportunities as they arise across the credit universe. This means the (indirect) driver of any skews in the portfolio's overall allocation will be our global sector specialists' investment ideas, as we seek to identify the investment opportunities with the most compelling risk-adjusted return potential.

Is the low/negative interest rate environment forcing you to take more risk?
Lower rates and tighter credit spreads may be enough to tempt some market participants to move to riskier parts of the market. Our approach tends to lead us in the opposite direction: lower yields mean higher valuations, which create an opportunity to take profit in that area of the market and find more overlooked (i.e. more attractively valued) opportunities elsewhere. This typically pulls our portfolio to more defensive areas of the credit market as spreads become tighter.

Where do you see the best investment opportunities going into 2020?
Dynamism across this diverse opportunity set will remain key. But right now, our bottom-up process is revealing some good value opportunities within the bank capital segment. Bank capital gives investors a similar yield for a better underlying credit quality than US high-yield BB rated bonds, which have become quite expensive leading us to take profits on some of our positions there.

We have also uncovered some attractive bottom-up investment ideas within corporate hybrids (subordinated debt of typically investment-grade issuers), which often provide similar upside potential to higher quality high-yield bonds and tend to perform better in market sell-off scenarios, resulting in a more defensive return profile.

Furthermore, the rally of 2019 has been somewhat unusual in terms of the segments of the market that have driven returns. In the sub-investment grade space, higher quality BB rated bonds have performed better than lower rated (B or CCC), suggesting that while investors are searching for yield they remain wary of over-reaching for risk. The potential for B and CCC rated instruments to see a price correction is something we are currently watching closely.

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