Cautious optimism

Craig Scordellis considers the opportunities in credit markets

We continue to see great long-term investment opportunities in credit markets. Whilst economic conditions are less favourable, we do not see global recessionary conditions and subsequent systemic defaults in the medium term, but rather lower growth for longer. Parts of the credit market do not depend on high levels of growth, but investor concerns regarding the global economy have led to dispersion in valuations and performance within credit sectors, providing opportunity for fundamentally-based active investment managers.

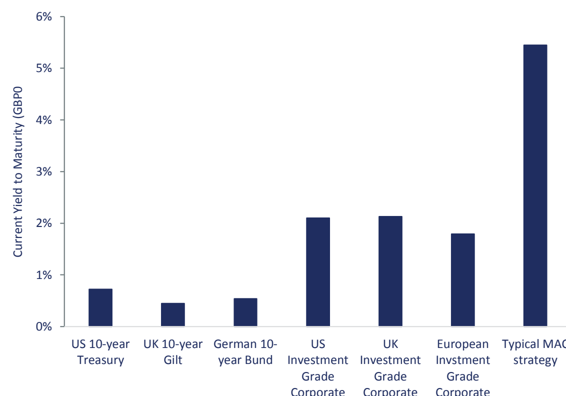
Yet we must not be complacent and, if investors are to take full advantage of the opportunities and mitigate market risks, we continue to believe that the flexibility of a Multi Asset Credit (MAC) approach is needed.

Rising short-term volatility in markets

Today's credit markets are characterised by increased levels of volatility in the short term, driven by a number of factors including geopolitical uncertainty and central bank policies, as well as by the growth of daily liquidity products and exchange traded funds in areas which were previously dominated by institutional and bank capital.

Changing consumer behaviour and new technologies are also driving profound secular change across a wide range of sectors and industries.

Comparing yield



Source: CQS, ICE, as at 14 August 2019.

The result is increased dispersion of investment returns, including pockets of potential defaults. Thorough research must continue throughout the life of the investment.

More recently, credit investors face another new challenge, low levels of income with heightened sensitivity to short term interest rate moves. This has been caused by the rapid compression of government bond yields. Indeed, recent estimates suggest that $15 trillion of outstanding bonds now trade at negative interest rates. These moves have been exacerbated by the influence of central bank asset purchase programmes and the growth of passive credit strategies, algorithm strategies and the influence of currency hedging for global asset managers.

The advantages of a flexible approach

We are optimistic about the selective investment opportunities available in credit markets in the current environment. These changes present opportunity. However, to paraphrase Harold Wilson, we are optimists who like to carry raincoats too. In investment terms, that raincoat is the flexibility which comes from a MAC investment approach.

Today, for example, to protect investors from the effect of minimal and even negative yields in part of the investment grade bond market, we seek to capture visible secured income and to offset interest-rate sensitivity in sub-investment grade assets such as like European loans and in investment grade Collateralised Loan Obligations, with rate floors which are increasingly valuable to investors. These asset classes have been less affected by the yield compression and can be combined with tactical allocations to diverse sub investment grade opportunities, which have lagged recent rallies.

Thorough, disciplined and ongoing ESG-aware fundamental analysis is needed if asset managers are to be able to lend to the right companies in a fast-changing business environment, to mitigate defaults and realised losses, and, increasingly, to capture tactical opportunities in unloved individual investments. We believe it is possible to find good-quality companies in the UK, in lagging sectors in the US, and in the financials sector in Europe, where regulatory capital requirements act like traditional maintenance covenants to the benefit of investors.

In the end, we believe that long-term material outperformance of broader credit markets can only come from disciplined fundamental investing. In our view, the broad universe of investment MAC provides investors with the flexibility needed to avoid realised losses on defaults through fundamental research, and a sufficiently diverse investment universe by asset class and geography, to build a portfolio with the potential to outperform the underlying market with lower levels of fundamental risk and volatility.

Written by Craig Scordellis, head of long-only multi-asset credit, CQS

In association with