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Asset allocation update

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Taking credit to where it is due

In recent weeks, markets have had to deal with a multitude of issues. These have included the economic weakness and stock market sell-off in China, a sticking plaster for the Greek debt crisis, a decline in commodity markets (which has reignited disinflation concerns), and weaker US employment cost index data. The latter has led to fears that the US Federal Reserve could decide to raise interest rates later rather than sooner. Our asset allocation debates, however, have focused on credit markets, and for asset allocation portfolios we have now reduced exposure to corporate credit to neutral. Our rationale is outlined below.

In our view, the corporate credit cycle is mature; while we expect low positive excess returns from credit over the next 12-24 months, a variety of negative pressures are now coming to the fore.

From a fundamental perspective, earning growth in the US appears to be struggling, and this is pressuring a few important credit metrics. Specifically, debt-to-EBITDA looks high compared to previous cycles, and corporate activity has moved away from being broadly credit-neutral and is instead becoming credit-negative (as reflected in the mixture of share buybacks, dividend policies and leveraged M&A activity). In addition, corporate bond supply is substantial, and secondary market liquidity has travelled a well-documented road of deterioration over the cycle, demanding a prospectively higher (if still modest) liquidity risk premium. EBITDA interest cover is, however, very high and supportive of continued strong performance from credit, even though it has been weakening over the last six months. The strength in interest cover is largely a function of low rates, but this is not to diminish its support for the likely positive (but modest) excess returns that may come over coming quarters.

Credit spreads are not egregiously tight, and the widening in high yield corporate spreads in Europe over the past twelve months has led some of the less strategic asset allocation portfolios to rebuild positions. However, credit spreads are not excessively wide either, given growing illiquidity risks and deteriorating fundamental creditworthiness, and the prospective risk that investors who might be taking interest rate risk through the medium of corporate bonds may choose to exit the asset class now that the Fed appears to be moving away from its highly accommodative policy stance. Our reduction in credit exposure has been achieved by trimming holdings on a Pan European basis, and specifically reducing investment-grade debt in the UK and high yield in Europe.

We would emphasise that within fixed income as a whole we continue to prefer corporate credit to government bonds, where our asset allocation portfolios remain underweight.