Schroders

November 2024

Schroder Australian High Yielding Credit Fund

Portfolio Review

In November the portfolio returned 0.5% (before fees), ahead of benchmark by 0.2%. The underlying strategy has delivered a one year return of 11.3% (before fees) ahead of the benchmark by 6.9%.

At November end the portfolio is yielding 6.73% with an interest rate duration of 0.76 years.

Market Review

What a month! Where do I start? We have been submerged in primary issuance that has seen 2024 year to date corporate credit issuance exceed full year 2023 volumes by over 200%. But despite the strong supply pulse, credit markets are definitely not offering us any Black Friday discounts. Demand for Australian credit has significantly outstripped supply, evidenced by the primary deal pulse where bid books have been 4-5 times over-subscribed.

So what's sending credit markets into this frenzy?

As global credit spreads (risk premium) have been eroding with the insatiable demand for yield, the attractiveness of the credit asset class across the various markets is somewhat based on the directionality of global rates, but much more significantly for global investors.

This year we have seen stronger participation from Asian investors in Australian credit issuance, where final orderbook bids have been anywhere between 15-35% with stronger demand noted from Asia for subordinated credit issuance. This demand is not characteristic of historical demand levels, which have been typically below 10%. We can partly attribute this to the Australian macro environment where we have lagged the global rate cycle and with the RBA's ongoing 'sticky' inflation problem, there is the potential that domestic rates cuts continue to be delayed later into 2025.

When Australian rates dipped in September this year in response to the US cuts, the Asian investor bid weakened considerably for new deals. However as yields recovered as rate cuts for Australia were pushed back into 2025 in the latter part of this year, the Asian bid returned to Australian credit markets. In effect the demand for the 'all-in' yield is what is driving the attractiveness of assets as opposed to the risk premium achievable. Any deal exceeding a 6% yield is fair game.

Furthermore, there is a bit of FOMO happening for local investors. The past year has felt like an environment where everything will rally, and the risk of abstaining from a deal is possibly considered greater than the risk of participating in a deal that underperforms. This kind of investor behavior ultimately means that the price of risk is being incorrectly calculated and highlights an even greater need to have investment decisions which are firmly grounded in fundamental research and valuation assessments which respect the risk premium, as opposed to being caught up in the hype.

On the Tier 2 (T2) issuance front, this month QBE started us off with a $250mn 12NC7 at +180 basis points (bps) which looked relatively flat to their offshore issuance. 12NC7 refers to a security with a 12 year maturity which is non-callable for the first seven years. The book was 8.2x subscribed highlighting the strong demand especially when you consider this was their sixth time of tapping the AUD market in just 18 months.

We then had two deals from our domestic banks. Commonwealth Bank issued a 15NC10 which was priced at +165bps, exceptionally flat to the curve, whilst Westpac did a shorter dated USD 11NC10 pricing at +182bps swapped back to AUD. There continues to be a clear value differential across currencies.

Barclays then came to the AUD market with a 10.5NC5.5 at +200bps, which attracted the largest ever AUD T2 orderbook at A$5.85bn. Only A$1bn was printed so the deal rallied on the break in secondary.

Finally BNP closely followed Barclays, with an AUD 12NC7 at +200bps. This deal has subsequently underperformed in secondary, even though the book was well subscribed. This is likely related to BNP's equity price underperformance, a decent amount of existing supply in the name and a bit of market indigestion.

Market Outlook

With no shortage of new deals, we are heavily focused on valuations, especially with concerns over market indigestion heading into December. There are a number of new potential higher yielding issuances which will be competing for the same capital as subordinated bank paper. With names like Aurizon, Port of Newcastle, Qube Logistics and even Pacific National potentially issuing a hybrid, there is no doubt investors continue to be spoiled for choice even if we haven't been spoiled for spread!

Despite my complaining over reduced risk premium, I am excited to see so much activity in the Australian Debt Capital Markets. Liquidity has been very healthy this year supported by the higher demand and the solid outlook for credit fundamentals in Australia.

Positioning

So with all of this in mind, how are we positioning the portfolio into the end of the year?

To some degree that old adage 'Patience is a virtue' is what we are channeling right now. Some deals have tightened past the point which we consider our base case fair value, which is the absolute minimum compensation we should expect to receive given maturity and quality. The new CBA AUD 15NC10 T2 primary issuance this month was exceptionally tight however is now pricing wider than reoffer, whilst the WSTP USD 11NC10 T2 is tighter. We abstained from the former and invested in the latter, staying true to our process. Our focus remains on being active within the opportunity set to ferret out the best opportunities for our clients.

We have been transitioning the portfolio exposure from AUD T2 into USD T2 where the pickup for the same issuer can be as much as 20bps. We remain flexible with currency and curve as the longer dated primary issuance is pricing exceptionally flat to the existing curve. Again, this is just a manifestation of investors hunting for that magic 6%-plus yield.

We continue to see value in offshore banks bringing subordinated issuance to our market and Barclays was a great example of this.
Finally, whilst I have your attention, I would like to take the opportunity to wish you all a very merry holiday season.

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