

Schroder Australian High Yielding Credit Fund (Wholesale Class)

Portfolio Review

In March, the Fund returned -0.35% (after fees), behind the benchmark by 0.7% and 5.9%(after fees) over one year which is 2.2% ahead of the benchmark.

At March end, the portfolio is yielding 5.7% with an interest rate duration of 0.2 years.

Market Review

With ongoing conflict in the Middle East delivering unprecedented global oil supply disruption, financial markets have struggled to gain a clear read on inflation or growth outcomes. The longer the conflict endures, with oil supply dislocated, the more likely we are to experience significant global macroeconomic consequences. It is fair to say, nothing in this new regime is “Strait” forward.

The scale of the supply disruption from the Iran conflict has no historical precedent. The flow of oil through the Strait of Hormuz collapsed from ~20 million barrels per day to a mere trickle — representing at minimum a 10 million barrel per day reduction in Gulf production. Gulf producers including Saudi Arabia, Iraq, Kuwait, and the UAE collectively saw output fall by at least 10 million barrels per day by mid-March. Qatar Energy declared force majeure on all LNG exports, removing approximately 20% of global LNG supply from the market.

With supply under pressure during the month, consumers have felt the pressure at the bowser, whilst the RBA flexed its muscles, delivering at 25bps hike to the cash rate. Not surprisingly we, as much as anyone, have concerns over rising inflation and constrained growth through demand destruction and subsequent economic scarring.

We still believe that should the military action in the Gulf be short-lived with a T.A.C.O trade in the not-too-distant future, we could see a reasonably quick recovery with the re-opening of the Strait of Hormuz. However, the longer the war grinds on, the more concern we have over the time it will take for the economy to normalise. By anyone’s measure the path of outcomes here is anything but straight forward.

Australian investment grade credit spreads have widened since the start of the conflict, however perhaps not to the extent expected, which could partly be due to market participants waiting for President Trump to reverse. However, it is reasonable to assume that the tight spread levels seen just prior to the conflict, driven by strong economic backdrop, healthy corporate fundamentals and credit metrics are unlikely to return soon. The abrupt shift to an inflationary, potentially recessionary macro environment has repriced risk across the credit complex. But the question remains, do spreads have further to widen from here?

Outside of the macroeconomic and geopolitical impact on credit markets, we know there is a fair build-up in the credit supply pipeline, which although very much welcomed from a market growth perspective, could weigh heavily on spreads as we enter the next quarter.

The mechanism is familiar but more acute than recent episodes: elevated oil prices increase input costs for energy-intensive corporates; inflation persistence narrows central bank flexibility; tighter financial conditions raise the cost of refinancing; and growth uncertainty weighs on earnings expectations.

New issuance has been disrupted but surprisingly not to the extent we expected. Typically we would see investors sitting on their hands causing market dislocation, however this month has seen issues from NBN, Dalrymple Bay Coal Export Terminal, Charter Hall Finance, MyState Bank and Meridian Energy, all exhibiting healthy book size. Mandate announcements from Qantas, NextDC, and Investa Commercial Property Fund were put on hold or cancelled quite reasonably as appetite for higher-beta credit faded as we moved further into the month.

Somewhat unexpectedly, Verizon visited the A\$ market with a rapid-fire \$1.3b subordinated offering over three tranches. Verizon is a high-quality US telecommunications company, which has issued senior paper in AUD in the past, however this time they came with a corporate hybrid (Fix/FRN NC5.5y and a NC10.5y). Pricing looked tight from the outset against the market backdrop. The company printed almost the full amount of demand and it was unsurprising to witness some early underperformance on the lines, +15bps and +20bps on the shorter and longer calls respectively as we closed out the month. I should note here that we abstained from participation given valuations did not stack up.

Overall, the combination of spread widening, rate volatility, and investor risk aversion meant new deals were focused on the high-quality names, printing shorter maturities than typical. There is very little appetite for long duration credit here. The Banks and SSAs - benefiting from flight-to-quality dynamics - have continued to access markets, but at wider spreads than prevailed in January and February.

Corporate Australia's exposure to the oil supply disruption:

High oil prices impact consumers immediately, hurting household budgets more broadly than any rate rise could, especially because they touch everyone rather than only mortgage holders. Here's some food for thought, based on an average \$700k mortgage, if you fill up your 50L petrol tank once a week, with an increase in price since the start of the month being roughly 50c/litre, that is the equivalent to a 25bps rate hike. Of course, this could worsen the longer the fuel crisis endures as fuel prices could go higher.

With that in mind, the team has been reflecting on the possible winners and losers from recent events. It's fair to say, there are quite a few losers. Any retail and consumer sectors are the obvious candidates where underperformance should be expected. Lower travel demand impacting names like Ampol, Qantas and NZ Airlines and a softer consumer likely feeds through to the Retail A-REITs.

Port throughput could weaken, but is unlikely to be material given the diversity of cargo and the monopolistic position they enjoy, similarly toll roads could experience a temporary reduction in traffic volumes.

I wanted to take the opportunity to highlight that the High Yielding Credit Fund cannot invest in any structured credit. This includes RMBS, CMBS, CLOs and ABS. This is a very positive attribute of the Fund especially as we expect structured credit to feel the most pressure as interest hikes and petrol price increases put pressure on consumer balance sheets.

Portfolio Update

With the tweets and noise causing the market to gyrate between risk-on and risk-off this month, we have taken the opportunity where possible to trim risk, with the view that protraction of the conflict will result in weaker macroeconomic outcomes which have the potential to negatively impact credit spreads.

Since early March we have been protecting the portfolio with CDS derivative positions held across Australia, the US and European markets, which has assisted in insulating the Fund from the full impact of spread widening to date.

Against this backdrop, the portfolio reflects a cautious but selective posture. We are maintaining diversification across our Tier 2 exposure and have moderated our total exposure to the sector, preferencing senior corporate paper and an elevated cash level to prepare for opportunities once we receive clearer signals regarding the way forward. We are focused on retaining high levels of liquidity and using the dispersion in spreads to identify opportunities across sectors and issuers which have not been present in the recent period where credit spreads regardless of differentiation have been trading similarly.

Market Outlook

The outlook for Australian credit markets is dependent on the reopening of the Strait of Hormuz. The severity of any further market selloffs will be determined by the duration of the conflict and severity of damage to infrastructure in the region. The range of outcomes remains unusually wide, from a contained selloff to pricing a deep recession, and as I have mentioned previously, our positioning is reflective of this uncertainty.

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