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The tide is high

Weekly Digest

29 October 2018

– Stephen Nguyen, CFA

Uber, the popular US ride-hailing company, is best known for its cheap, reliable and fast service, and not for the leveraged balance sheet it has built up over its lifetime. Uber's earnings remain in negative territory and it relies on debt finance to support its growth. Earlier this year, Uber successfully raised $1.5 billion from its second issuance of high-yield loans with strong investor demand pushing up the loan size from the initial offering of $1.25 billion. At a time of high demand, tight spreads, low default rates and weak lending standards, what might this tell us about the US credit landscape today and have we now reached a tipping point?

Overall, it can be argued credit markets are exhibiting increasingly late cycle behaviour. Yes, the US economy remains strong, helping to strengthen company balance sheets, putting downward pressure on default rates and driving performance in the corporate credit market. However, while the macro drivers in the economy seem supportive there are reasons for concern. One corner of the credit market that has recently caught the eye of a number of leading financial institutions is where Uber has been issuing - the leveraged loan market.

Leveraged loans are typically issued by highly indebted companies and usually offer a quarterly floating rate coupon comprising Libor plus a fixed margin. Given the likely continued path of central banks towards monetary policy normalisation in the coming years, buyers have been attracted by the floating rates these loans offer which can provide some protection against rising interest rates. The market has seen considerable growth over the past few years, currently valued at over $1 trillion having doubled in size over the past six years. 2017 was another year of record issuance as the low interest rate environment sees investors continuing to reach for yield, reflected in the tight spreads we see today. Moreover, in recent years Collateralised Loan Obligation demand has underpinned the new supply.

However, there are growing concerns surrounding this asset class which have been highlighted by key financial institutions and leading figures of late, from the Bank of England to rating agencies such as Moody's. For one, investors' continued willingness to accept weaker protection against deterioration in borrowers' repayment capacity is a clear concern. The Bank of England expressed their concerns that lending terms are loosening with the rise of 'covenant-lite' loans, which lack key protections that are typically demanded to lend to riskier companies. The issuance of 'covenant-lite' loans means that debt is being issued to borrowers with fewer restrictions in terms of posting collateral, payment or levels of income. Around 80% of the new leveraged loans are now 'covenant-lite', while eight years ago all loans had a full package of these protections.

Although near term risks remain muted, supported by Moody's Liquidity Stress Indicator which is near record lows, it is nonetheless important to observe quality indicators within this asset class. When rates rise to the point where pain is felt, this could be an area of the market that reveals it first. We have little exposure to leveraged loans at Momentum, primarily because it is a difficult market to access for various regulatory reasons. That aside, today we are more cautious. As Warren Buffett said, you only find out who's swimming naked when the tide goes out. We advocate bathing suits today.

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The **Marketplace**

- Brent crude fell by 3.6% last week to $77.7 a barrel
- Gold finished the week up 0.2% at $1234 an ounce
- Corporate earnings mixed
- Global indices decline as stocks sell off

Market **Focus**

US

- The Dow Jones fell 3% last week to 24,688
- GDP expanded by 3.5% in Q3. 2018 has seen the stronger quarter on quarter growth in four years. Consumer spending increased by 4% which accounts for 70% of the economy
- The Nasdaq fell 3.6% to 6852.4
- Mixed corporate earnings announced this week, weak data from Amazon and Google but Twitter notably posted revenues up 29% year on year
- Pending home sales index rose 0.5%, the gauge fell 3.4%
- The S&P worst month since 2015, and was down 3.9% last week taking into negative YTD territory

UK

- Philip Hammond is to set out a new budget today. An extra £13bn in higher than expected tax revenues could sweeten the pill , though with Brexit dominating tough choices lie ahead in delivering 'an end to austerity'
- UK car production was down 16.8% year on year in September
- GBP fell 1.9% against the dollar last week on the back of political uncertainty: Its steepest decline since February
- The FTSE 100 index fell 1.6%

Europe

- The Eurostoxx 50 fell 2.4% to 3134.9
- Angela Merkel to give up leadership of the CDU after 18 years
- Euro-area PMI fell to 52.7 in October from 54.1 in September which was below expectations. Factory growth was at its lowest since December 2014
- S&P did not as expected downgrade Italy's credit rating from BBB- as Moody's did last week though their projected outlook is negative

Asia / Rest of The World

- In Brazil, the right-wing Jair Bolsonaro won the presidential election, markets reacted favourably as he pledged to trim the deficit and reduce debt
- Saudi Arabia fallout overshadows three-day investment conference
- A painful week on the Nikkei index as it declined by 6% to 21,184
- The Hang Seng index fell 3.3% to 24,717

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 26 Oct. 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	-2.2%	-7.1%	2.3%	7.1%
United Kingdom	GBP	-0.7%	-6.4%	-5.5%	-2.4%
Continental Europe	EUR	-1.8%	-7.4%	-6.5%	-8.1%
Japan	JPY	-5.4%	-11.9%	-10.2%	-6.8%
Asia Pacific (ex Japan)	USD	-3.1%	-11.3%	-16.2%	-12.3%
Australia	AUD	-4.6%	-8.7%	-3.4%	-0.1%
Global	USD	-2.7%	-8.1%	-3.1%	0.9%
Emerging markets equities					
Emerging Europe	USD	-1.2%	-5.7%	-11.7%	-6.0%
Emerging Asia	USD	-2.7%	-11.8%	-17.8%	-14.2%
Emerging Latin America	USD	-1.4%	3.5%	-3.7%	-4.1%
BRICs	USD	-1.0%	-7.5%	-15.5%	-12.1%
MENA countries	USD	1.2%	-0.5%	6.7%	8.7%
South Africa	USD	-2.0%	-10.1%	-29.7%	-15.5%
India	USD	-2.2%	-8.9%	-15.7%	-12.6%
Global emerging markets	USD	-2.3%	-9.4%	-16.3%	-12.3%
Bonds					
US Treasuries	USD	0.4%	-0.4%	-2.2%	-1.5%
US Treasuries (inflation protected)	USD	-0.1%	-1.4%	-2.4%	-0.6%
US Corporate (investment grade)	USD	0.1%	-1.1%	-3.4%	-2.2%
US High Yield	USD	-0.4%	-1.4%	1.2%	1.2%
UK Gilts	GBP	1.1%	0.9%	-0.6%	1.8%
UK Corporate (investment grade)	GBP	0.7%	0.6%	-1.6%	0.7%
Euro Government Bonds	EUR	0.5%	-0.3%	-0.9%	-0.8%
Euro Corporate (investment grade)	EUR	0.0%	-0.1%	-0.7%	-0.6%
Euro High Yield	EUR	-0.4%	-1.3%	-1.4%	-1.4%
Japanese Government	JPY	0.4%	0.3%	-0.3%	0.2%
Australian Government	AUD	0.5%	0.6%	2.9%	3.8%
Global Government Bonds	USD	0.0%	-0.7%	-3.3%	-1.5%
Global Bonds	USD	-0.1%	-1.0%	-3.3%	-1.6%
Global Convertible Bonds	USD	-0.9%	-4.2%	-4.1%	-3.7%
Emerging Market Bonds	USD	-0.1%	-2.0%	-6.7%	-6.1%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 26 Oct. 2018	Month to date	YTD 2018	12 months
Property					
US Property Securities	USD	1.4%	-1.6%	-0.3%	2.1%
Australian Property Securities	AUD	-1.0%	-3.5%	-2.0%	1.9%
Asia Property Securities	USD	-1.7%	-6.7%	-12.3%	-9.7%
Global Property Securities	USD	-0.3%	-4.0%	-6.0%	-1.9%
Currencies					
Euro	USD	-1.3%	-2.1%	-5.4%	-2.7%
UK Pound Sterling	USD	-1.9%	-1.7%	-5.2%	-2.7%
Japanese Yen	USD	-0.1%	0.8%	0.0%	1.0%
Australian Dollar	USD	-0.7%	-2.2%	-9.4%	-7.8%
South African Rand	USD	-0.8%	-2.5%	-14.7%	-2.0%
Swiss Franc	USD	-0.3%	-2.4%	-2.6%	-0.4%
Chinese Yuan	USD	-0.3%	-1.1%	-6.3%	-4.5%
Commodities & Alternatives					
Commodities	USD	-1.6%	-1.6%	2.7%	7.5%
Agricultural Commodities	USD	-1.5%	1.5%	-3.7%	-4.6%
Oil	USD	-3.6%	-7.0%	15.0%	29.7%
Gold	USD	0.2%	3.2%	-5.8%	-3.2%
Hedge funds	USD	-0.8%	-3.2%	-4.4%	-3.2%

Source: Bloomberg. Past performance is not indicative of future returns

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Important notes