Jamieson Coote Bonds

The one thing to watch in 2019 – corporate credit

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Jamieson Coote Bonds

- If you only watch one thing in 2019, make it corporate credit spreads, for the beast of corporate credit has been awakened, and where that beast goes, you must avoid.
- Trump tax cuts elongated the corporate cash flow cycle, delaying repricing of credit.
- Watch the downgrade cycle as rate hikes bite and investment grade credit faces a 'maturity wall'.
- Market gets Powell'd for the first time. Don't fall in love this Christmas.

JCB Performance Since Inception*

PERFORMANCE*	GROSS RETURN	NET RETURN	INDEX	vs INDEX NET FEES
1 MONTH	0.30%	0.24%	0.32%	-0.08%
3 MONTHS	0.26%	0.08%	0.24%	-0.15%
12 MONTHS	2.66%	1.94%	2.36%	-0.42%
24 MONTHS	3.76%	3.02%	3.21%	-0.19%
36 MONTHS	3.66%	2.93%	3.17%	-0.24%
SINCE INCEPTION ANNUALISED	4.00%	3.28%	2.98%	0.30%

* Inception date of the unit trust is 1/12/2014. Inception date vs index is 31/12/2014. Past performance is not an indicator of future performance.
** Net Asset Values (NAV) are quoted after the deduction of all fees and expenses. JCB Active Fund aims to pay distributions semi-annually at 2% p.a. of NAV: a distribution of 1.0% was paid on 30/06/2018.

DATE	NET ASSET VALUE	ENTRY PRICE	EXIT PRICE	AVERAGE RATING
30th NOVEMBER 2018**	1.0640	1.0651	1.0629	AAA

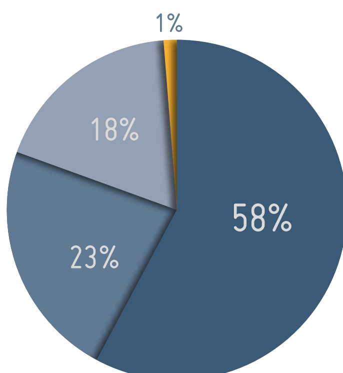
Jamieson Coote Bonds Active Fund (JCBAF) - November 2018

Month End Portfolio Mix

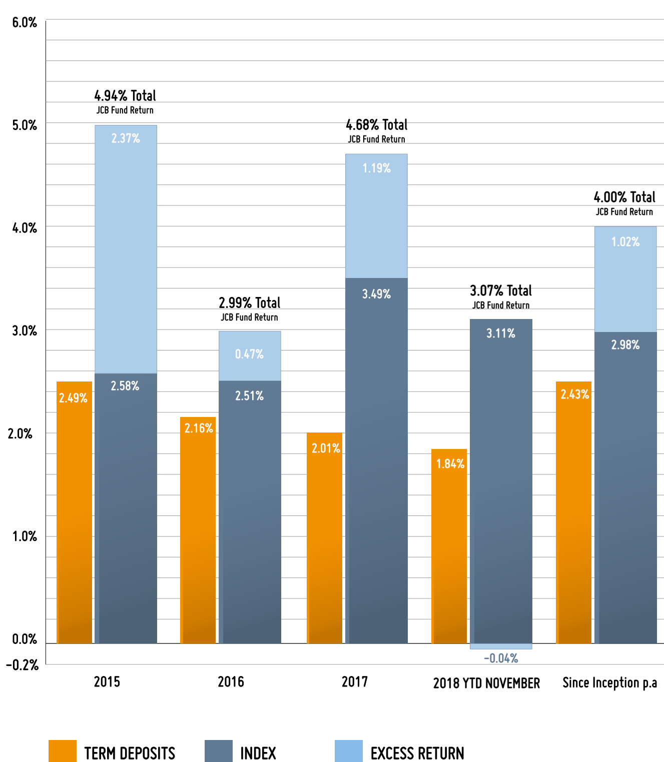
Australian Government Bonds	57.8%
State Government Bonds	22.7%
Supra National Bonds	18.2%
Cash	1.3%

KPI Averages

Duration	5.97 years
Index Duration	6.24
Average Coupon Rate	3.38%
Tracking Error	0.58
Average Weighting	AAA



JCB Calendar Year Gross Returns vs Term Deposits



Source: Reserve Bank of Australia (as at November 2018) and Channel Capital (as at November 2018 as the fund's administrator). Assumes retail deposit & investment rates for amounts over A$10000 held for six months. Aus Govt Bond Index: Bloomberg Ausbond Treasury 0+ yr index and Excess Return is the return generated by the JCB Active Bond Fund (institutional, inception: 1 Dec 2014) over the index. Past performance is not an indicator of future performance.

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If you only watch one thing in 2019, make it corporate credit spreads, for the beast of corporate credit has been awakened and if that beast heads south, it will take the markets as you know them down for the count.

The beast of corporate credit debt is awakening from a Quantitative Easing (QE) induced slumber. JCB believes holding credit risk with equity holdings into 2019 and 2020 could be a dangerous proposition, given the highly positive correlations and the violent asymmetry of credit performance in many late cycle environments. Credit spreads gapped wider during November, playing catch up to a more normalised investment cycle after the Democrats split Congress in the U.S. mid-term elections. Corporate credit is the lifeblood of the financial system and JCB believe a material negative re-pricing has the potential to derail economies. The policy settings that would alleviate negative credit issues are years away from helping (rate cuts and more QE), while portfolios are still overweight to credit and huddled together in a crowded space.

Trump tax cuts elongated the corporate cash flow cycle, delaying repricing of credit.

Trump's tax cuts for corporations provided a roughly 500 basis points kicker to corporate cash flows coming straight off the U.S. Government's balance sheet. Credit has held its ground despite higher risk-free rates, as corporates have been swimming in excess 'tax cut' cash, which thereby re-calibrated their default risk. With the Democrats regaining control of the House, JCB expect the credit party has just been shut down as Trump's ability to spend is curtailed by a hostile House. Year-on-year change goes from a baseline of +500 basis points to zero. From here on, the cycle should behave in a far more normalised way, where credit delinquency from higher rates starts to bite and credit spreads widen, creating a dangerous feedback loop for the economy, where as the U.S. housing and autos are already experiencing significant decay. Credit spreads have a long history of being a fantastic lead indicator for equity performance – they widened aggressively in mid-2007, months ahead of a peak in equity markets in late 2007, and they started tightening aggressively in late 2008, a few months ahead of equity market lows of early 2009.

Watch the downgrade cycle as rate hikes bite and investment grade credit faces a 'maturity wall'. Credit quality is weak, covenant quality is thin, and liquidity is appalling. That is not a strong starting point to face an epic wall of refunding.

Investment grade credit faces a $500+ billion refunding requirement in 2019, 2020 is $620+ billion and higher again in 2021. Over 16% of companies in the Russell 3000 are 'zombies' – defined as firms that are unable to cover debt servicing costs from current profits. With more than half of all U.S. investment grade debt rated BBB, one notch above junk, it is highly susceptible to a credit ratings downgrades. Such a move would trigger forced liquidations from investment grade only products, many of which are housed in ETFs. The amount of asset protection underpinning high-yield credit contracts is at the weakest point in the cycle viewed through the prism of covenant lite issuance, and on top of these negatives – secondary market liquidity is one sixth of the size of liquidity that was available into the last crisis. Therefore, the structure of the market is twice as much corporate debt outstanding, more than half at a lowly BBB credit quality, but only 17% of the available liquidity from the prior crisis to serve twice as much outstanding debt. It doesn't take a genius to identify the obvious flaws in this set up.

JAMIESON COOTE BONDS

Market gets Powell'd for the first time, don't fall in love this Christmas

Until October, U.S. Federal Reserve Chairman Powell had been a straight shooter. He had stayed true to gradual rate hikes and showed little care for equity market moves. It seems that markets found his trigger point. Powell told markets in early October, "we are a long way from neutral rates" causing a sell-off in bond markets which ultimately sent equities into the tailspin of the October/November volatility and drawdown. Just six weeks later, without a large change in economic data, Powell suggested we are "very close to neutral" implying less rate hikes and soothing concerns for risk markets.

The grand irony of this move from Powell is that a Christmas risk rally allows the U.S. Federal Reserve the room to continue hiking rates. JCB expects the Fed to hike in December 2018 and continue with two additional hikes over 2019 towards the 3.00% stated policy objective. That's 72% of the last rate hiking cycle of 2004-2006, which caused the world's biggest financial calamity since the great depression. This time around we are going on 72% (according to Federal Open Market Committee dot plot) with twice as much weight in the backpack. Is it just JCB's view or does the math not work out for you either?

The fundamental pillars supporting most asset prices are experiencing violent cracks in the framework. The investment ground of the last 10 years has disappeared. Looking ahead, JCB believes that markets will face less liquidity, higher rates and tighter credit conditions, all of which should curtail economic activity moving forward. Less economic activity, combined with higher rates means credit delinquencies. Don't fall in love this Christmas, 2019 is likely the year of credit decay bringing grand volatility to markets.

JCB Active Bond Fund performance in November

For the month of November, the JCB Active Bond Fund (the Fund) returned (gross) 0.30%, underperforming the Bloomberg AusBond Treasury (0+Yr) Index by 0.02%. JCB lightened durations after a surprise stronger employment print for the second time in as many months, only for the market to rally immediately out of strong domestic data, lifting bond valuations higher through the month.

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