SAHYCF Commentary: Hopping along

Schroders · 2026-08-07 · English original

The market shrugged off a myriad of headlines to see higher beta bonds compress significantly, with Kangaroo AT1 paper leading the way in July. A seasonally slower pace of issuance and less available stock of higher yielding opportunities saw a grab for wider trading bonds.

Last month we wrote about markets moving between acute concern and complete indifference to geopolitical headlines. July proved to be more of the same as the re-escalation of the US-Iran conflict brought oil prices back into focus after we started with Brent Crude Oil near pre-war lows. While prices did not reach the ~US$120/bbl that we have seen, this did not stop some offshore analysts bringing energy price volatility back into their top risks for credit. However, there was little transmission through to the Australian credit market.

Arguably what caught more of the market's attention was US reporting season and capex updates from the US hyperscalers. Results themselves were impressive as revenue and earnings broadly topped expectations, with the impact of AI-related spending filtering through the economy. Steelmakers, energy providers and industrial property businesses are just some of the beneficiaries of the significant spend. Earnings were not just driven by the AI thematic however, with banks, airlines and consumer names all reporting strong results. Hyperscaler capex was broadly revised higher again. Amazon's surprise US$25bn issuance struggled to perform in the secondary market, causing a rethink of investor capacity for these names. Hyperscaler spreads were generically anywhere from +10-30bps wider across the curve, underperforming the US Investment Grade index which leaked ~5bps wider over the month.

Meanwhile the Australian credit market is just getting its first taste of the AI/data centre thematic, and largely through an operator with strong government partnerships. For the second month running issuance from CDC Data Centres was the highlight of domestic issuance, this time pricing $700m in its inaugural senior secured transaction across 6- and 10-year tranches following its successful subordinated issue. The deal was in aggregate 6x over-subscribed, a stark contrast to Amazon's ~1.6x deal coverage, a far weaker read on demand than their last print in March.

In a seasonally slow period, other issuance in the Australian market was limited to high-quality corporates like United Energy and DWPF, along with 3-5 year senior deals from Australian major banks, and offshore banks in covered format that did little to satisfy the market's appetite for yield. Despite only around $2bn being issued by non-financial corporates in July, we are now within striking distance of the all-time yearly record of $30.4bn, which was set only last year.

The absence of A$ subordinated supply supported a strong month of compression from Kangaroo AT1 and non-financial corporate subordinated paper. Barclays perpetual non-call 6-year led the way tightening as much as 40bps over the month. This was a perfect illustration of the grab for yield in an environment where base rates fell, making credit yields look more attractive, coupled with a scarcity of available inventory. Kangaroo bank Tier 2 and long-end corporate subordinated paper also benefitted from this dynamic and compressed versus peers, albeit to less of an extreme degree compared to AT1.

Australian CPI for the June-quarter came in lower than expected, which has put to bed any near-term talk of a rate hike. An extended pause is now consensus, with anywhere between no hikes and one future hike expected. Modest changes to the rate outlook are conducive for credit by keeping duration volatility low and giving issuers relative confidence in refinancing conditions. Meanwhile, the US Federal Reserve (Fed) kept rates on hold, providing only a brief statement of explanation, like last month. Opacity in the Fed's decision making will be a challenge in the coming months as investors look for signs that inflation is being managed credibly.

All eyes will be on the prospect of continued supply from the hyperscalers given the remarkable pace of issuance so far this year in the US. The continued broadening out to other currencies will be keenly observed. The ongoing conflict between the US/Iran remains a source of uncertainty, however, the possibility of geopolitical risk causing a wider risk-off event is feeling more remote as markets seem to be getting conditioned to whipsawing oil prices.

We await more non-financial corporate supply in August and September as Australian reporting season kicks off next month. After a near record year for non-financial corporate supply in just 7 months, we expect continued deal flow albeit at a slower pace post August results, which should be constructive for spreads. Our expectation is for issuance to mainly come from the senior space. It is hard to predict how much higher beta supply will hit the market, but should issuance continue to be sporadic, it will further entrench the grab for yield we saw through July. Strong fundamentals and this supportive technical backdrop leave us anticipating further compression for the higher-yielding bonds.

We do not expect any major surprises from the companies we hold at results given their high-quality market positions and strong cash flow profiles. The focus will be on interrogating forward guidance into FY27 given the uncertain macro backdrop; however, we remain convicted that our more defensive corporate credits should insulate the portfolio from any wider risks that could present in the listed universe.

The one area of concern we are watching is the unravelling occurring in some of the Australian retail private debt funds, as significant headwinds challenge the sector following years of unprecedented growth. The impact of higher inflation, interest rate increases, Government tax changes and increased regulatory scrutiny over the asset class has culminated in several private credit funds facing the reality of substantially lower returns, even recognising capital losses within their respective portfolios, particularly in commercial real estate. Although these issues are confined to private credit and have no direct bearing over public markets (debt or equity), we are mindful of the exposure that retail investors have to these illiquid Funds, which could present a broader challenge across all markets. When positioning the Portfolio for the months ahead we are focused on maintaining exposure to high quality and resilient companies which are well-placed to weather these idiosyncratic risks.

Our positioning resulted in a constructive month for the High Yielding Credit Fund in July as primary slowed and broker inventory was well sought after. Key drivers were Kangaroo AT1 and non-financial corporate subordinated paper. The significant compression in AT1 despite a mixed month for markets is strong evidence of the hunt for yield that is underway globally and locally, and the scarcity value of the product given existing local bonds have largely been called. After rotating into financial Tier 2 with conviction last month, we added to our non-financial corporate subordinated position in July as the pause in supply has seen wider trading bonds compress to peers. We continue to expect seasonally slower issuance; however, we suspect any further issuance of higher beta supply would be well received.

Tier 2 bank debt to senior ratios compressed slightly as the market's focus was firmly centred on AT1. We remain convicted in the technical setup for financial sub-debt and see room for further compression for Tier 2. As we called out last month, forward supply requirements are light, there is a wall of financial sub-debt due to be called before December and the continued growth of active and passive ETF strategies adds further depth to a somewhat indiscriminate buyer base.

While the higher beta end of the spectrum has led the way in terms of spread performance, the rest of the investment grade non-financial corporate market has seen spreads grind in gradually as elevated inventory is still being absorbed. We see scope for the longer end of corporate curves to perform should supply continue to be slow as expected.

Learn more about investing in the Schroder Australian High Yielding Credit Fund or the Schroder Australian High Yielding Credit Fund - Active ETF.

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