A record-breaking quarter

Credit market monthly review

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Key points

- The first quarter of 2019 has been record-breaking in credit markets, with some surprising winners
- The dovish change in the European Central Bank's policy outlook at its 7 March meeting boosted the performance of euro credit
- Fund flows have picked up in credit, on the back of strong year-to-date performance and the overall attraction of credit for fixed income investors, amid low interest rates

A record-breaking quarter for credit

The first quarter (Q1) of 2019 has been record breaking for credit markets, with some surprising winners. US dollar high yield (HY) has posted its best quarter in 25 years (Exhibit 1) and rather unexpectedly, sterling investment grade (IG) has delivered its best performance in 23 years, seemingly oblivious to the ups and downs of the Brexit process. The reversal in fortunes for credit and risky assets more broadly has been quite glaring. Indeed, taking US dollar HY as an example – the spread evolution has been the most bullish since 2012 (Exhibit 2), the year that followed the peak of the eurozone crisis.

ECB pivot boosts euro credit

The dovish change in the European Central Bank's (ECB) policy outlook at its 7 March meeting came hot on the heels of a similar pivot by the Federal Reserve, which boosted the performance of euro credit. Typically, in such a central bank backdrop, the spread dynamic is one of spread compression, where lower rated credit (higher beta) outperforms higher rated credit (lower beta) in beta adjusted terms. Indeed, euro HY has benefited since early March, outperforming euro IG and even matching US HY in relative spread performance terms (Exhibit 3). Eurozone spread risk premia have retraced more broadly and have outperformed their US counterparts. As an indication, euro-periphery financial spreads have retraced to levels not seen since June 2018. Tactically, a pause in the outperformance of euro versus US credit and even some reversal could be expected at this juncture – with a China-US trade deal a potential catalyst – an alpha generating opportunity trade which can be actioned through credit default swap (CDS) indices.

Fund flows hold up as credit remains attractive amid low rates, despite richer valuations

Credit's strong year-to-date performance has prompted a rebound in retail flows. A prompt way of measuring these is through credit Exchange-Traded funds and indeed three-month rolling flows reveal substantial inflows across credit products and styles for both USD and euro denominated funds (Exhibit 4). The one credit product/style that has seen a reversal in flows, is that of floating rate credit (FRNs) which is entirely consistent with the change in central bank expectations, which have now priced out further rate hikes by the US Federal Reserve. The one word of caution on credit is that the strength of the spread rally has pushed valuations back into rich territory. This is the case from both: (i) a fundamental valuation perspective as shown by our one-factor model between iTraxx Xover spreads – euro sub IG credit in CDS – and the eurozone composite Purchasing Managers Index – PMI (Exhibit 5) as well as (ii) a cross-asset relative value perspective as shown by our three-factor model versus rates, FX and equity volatility (Exhibit 6). Rich valuations notwithstanding, it remains the case that credit still offers a potential decent spread pick-up for fixed income investors, over government debt amid the 'lower for longer' interest rate backdrop globally.

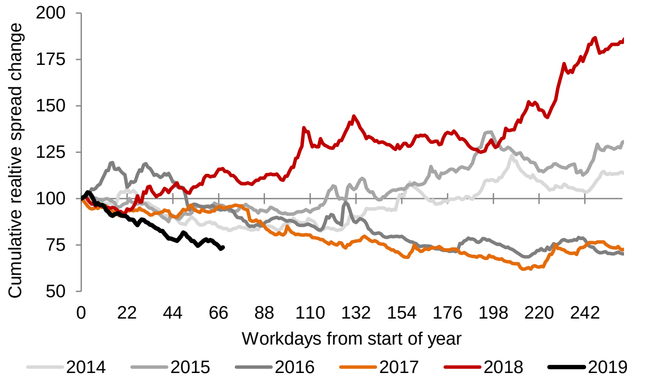
Exhibit 1: Q1 2019 returns have been very strong if not record breaking in certain credit markets

Q1 returns and how they rank over the past 21-25 years			
	History	Rank	Return
USD IG	25y	2	5.0%
EUR IG	21y	3	3.1%
GBP IG	23y	1	4.9%
EM IG	21y	2	4.5%
USD HY	25y	1	7.4%
EUR HY	22y	7	5.3%
GBP HY	22y	8	4.7%
EM HY	21y	2	8.8%

Source: Inter Continental Exchange (ICE) and AXA IM Research

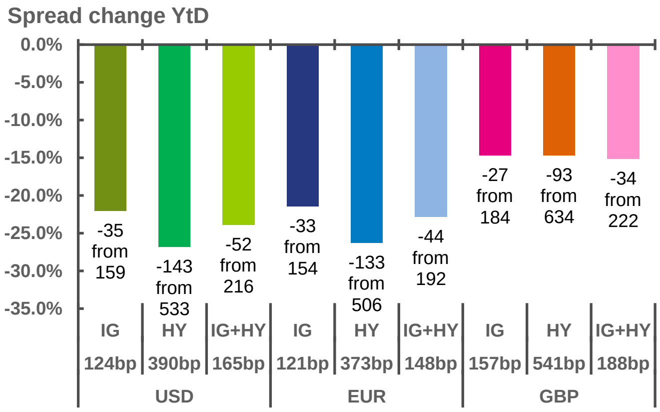
Exhibit 2: Spread evolution in 2019 so far has been the most bullish since 2012 (USD HY shown)

Intra year spread evolution rebased to the start of the year



Source: ICE and AXA IM Research

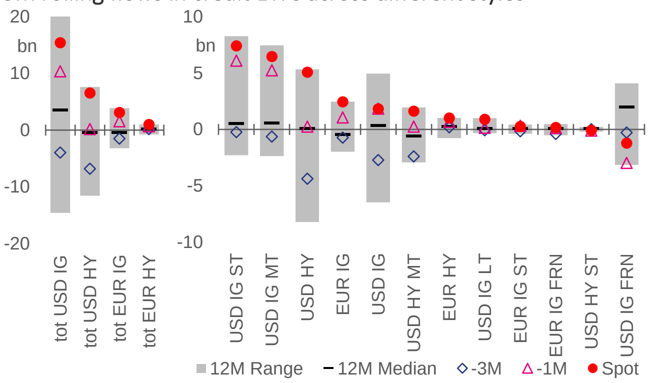
Exhibit 3: Boosted by the ECB pivot EUR HY has caught up with USD HY in relative spread terms



Source: ICE and AXA IM Research

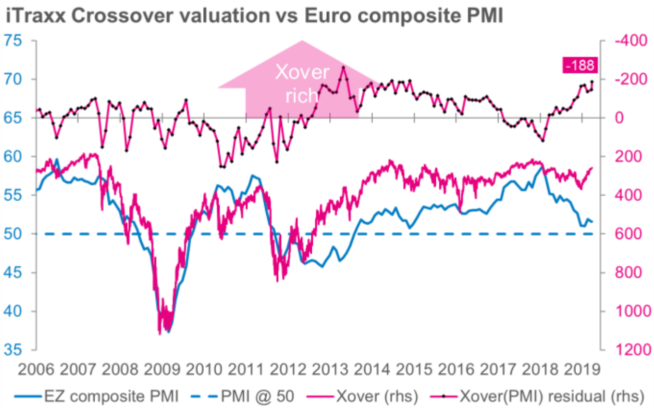
Exhibit 4: Where performance goes, flows will follow as the strong pickup in inflows in credit ETFs shows

3M rolling flows in credit ETFs across different styles



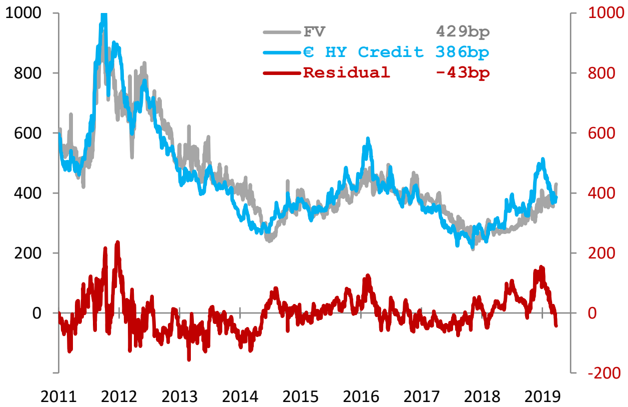
Source: Bloomberg and AXA IM Research

Exhibit 5: The iTraxx Xover-PMI wedge has widened further as ECB weighs on spreads while PMIs struggle



Source: Bloomberg, IHS Markit and AXA IM Research

Exhibit 6: Credit spreads have rallied to the point of trading rich vs cross asset volatility (rates, equity, FX)



Source: Bloomberg and AXA IM Research

Our Research is available on line:

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