Investment Managers

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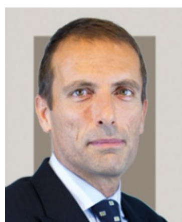
Research & Strategy Insights

Nearing entry point, but volatility merits caution

Credit market monthly review



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Key points

- November proved even harsher than October for risky assets, pushing credit returns deeper into negative territory.
- The pain has been particularly acute for high yield, upending the reflation trade that saw high yield outperforming investment grade for much of 2018
- An attractive entry point for credit must be close unless recession risk is around the corner.
- Idiosyncratic risk has risen and is likely to rise further.

November sees valuations revert to neutral

November proved harsher for risky assets than October and credit reacted accordingly amid the market correction. The contrast to earlier in the year is that spreads not only widened more in November than in any other month this year but they also widened to a comparable degree across regions (12-16% in relative terms). This suggests that presence of heightened global risk aversion rather than more specific market drivers, like the underperformance of euro credit in the second quarter because of Italy.

The November correction pushed credit returns deeper into negative territory (Exhibit 1). The pain has been particularly acute for European high yield (HY) which suffered a drawdown of 3-4% in returns depending on currency. HY is now trailing investment grade credit (IG) as well as government bonds year to date (Exhibit 2), upending the reflation trade that saw HY outperform IG for much of 2018. The repricing has been such that in some markets like euro credit, spreads have almost doubled since the February lows and are approaching levels last seen in early 2016 (Exhibit 3). Spreads are currently wider than at the end of 2016 which was followed by a constructive year for credit in 2017, albeit with markets supercharged by the fiscal impulse of the US tax reform. Valuations too have improved materially and our macro spread model shows that the overvaluation gap in credit has vanished and valuations have reverted to neutral for the first time in over two years (Exhibit 4).

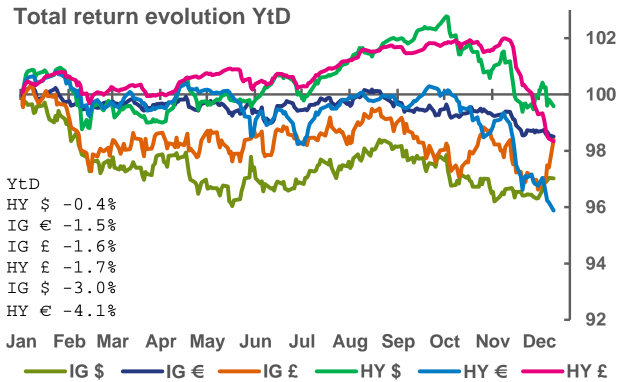
US high yield still within the normal spread range of a hiking cycle

Leaving aside a scenario where we are truly at the end of the cycle and US recession risk is set to materialise in 2019 (our base case is for US recession risk to materialise in 2021), we could be reaching a potentially attractive entry point for credit. Such rationale appears consistent with the price action we observe currently in US HY. Since October US HY spreads have broken out of the low and narrow range they have been trading within since late 2016, reaching 450 basis points over US treasury yields. While this widening has been substantial, it remains within the historic norms of previous hiking cycles (blue line in Exhibit 5). The timing of the current widening appears five to six quarters too early compared to the post-2004 end of cycle (“1” in Exhibit 5) or one to two quarters too late compared to what happened following the end of the cycle in 1997 (“2” in Exhibit 5).

That said, caution is warranted as markets are likely to continue trading in a volatile fashion amid reduced liquidity in the run up to the new year and as we navigate a plethora of risks during the first quarter of 2019. Beyond broader market trends,

rising idiosyncratic risk as reflected by increased spread dispersion (Exhibit 6) is another reason to be cautious. Following a lull of approximately one year, idiosyncratic risk has moved off its lows since the first quarter. Moreover, it remains below the levels we saw in 2015-16, suggesting that there may be more idiosyncratic risk to come in credit portfolios, making strong credit selection and 'landmine' avoidance essential in order to safeguard returns.

Exhibit 1: all credit in the red year –to-date after November's drawdown



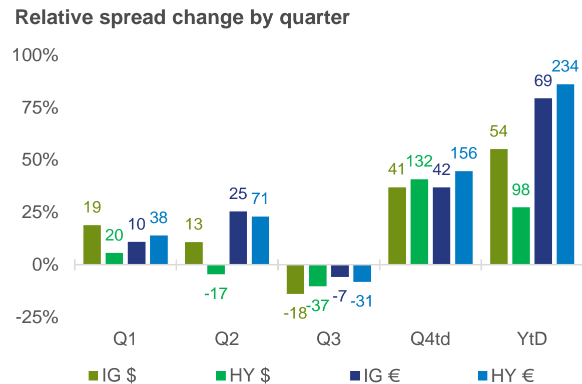
Source: Intercontinental Exchange (ICE), Bloomberg and AXA IM R&IS calculations

Exhibit 2: govies prevail year- to-date while credit mostly outperforms equity

Returns year-to-year across key asset classes				
$	UST	HY	Equity	IG
	0.0%	-0.4%	-1.3%	-3.0%
€	Bund	IG	HY	Equity
	2.5%	-1.5%	-4.1%	-14.1%
£	Gilt	IG	HY	Equity
	2.5%	-1.6%	-1.7%	-13.1%

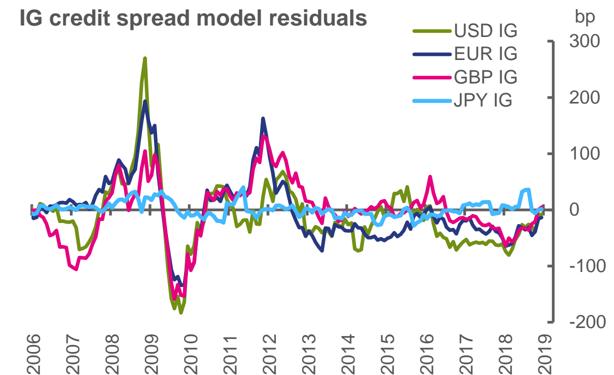
Source: ICE, Bloomberg and AXA IM R&IS calculations

Exhibit 3: spreads in European credit have nearly doubled year-to-date



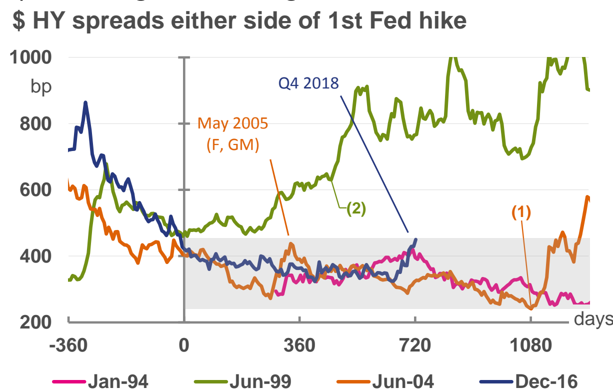
Source: ICE, Bloomberg and AXA IM R&IS calculations

Exhibit 4: the silver lining of the market repricing is that the overvaluation gap has closed



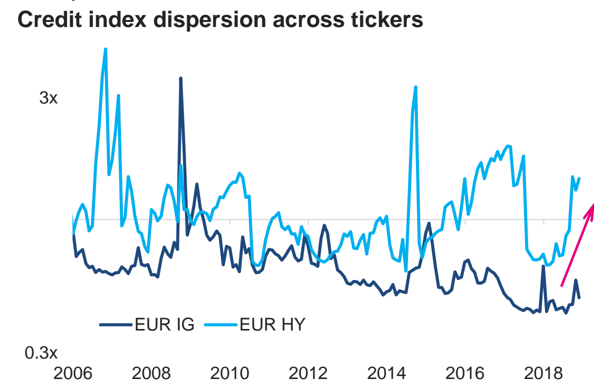
Source: ICE, Bloomberg and AXA IM R&IS calculations

Exhibit 5: US HY still within a normal hiking cycle spread range but testing the boundaries



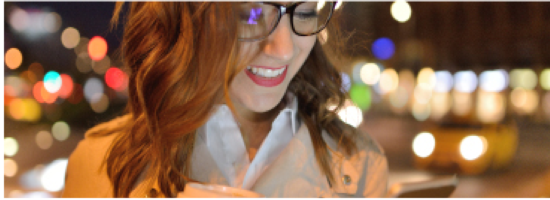
Source: ICE, Bloomberg and AXA IM R&IS calculations

Exhibit 6: increasing spread dispersion reflects rising idiosyncratic risk



Source: ICE, Bloomberg and AXA IM R&IS calculations

Our Research is available on line:



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