Watch out for “Cliff”

Monthly update - November 2019

Aggregate spreads moves were unspectacular as vol went into hibernation

November was a reasonably constructive month in terms of credit spreads in aggregate. Realized vol fell asleep with credit indices trading within an unusually tight range. Macro data (both survey-based and hard data) in Europe started to stabilize, albeit from a rather low level. Geopolitical uncertainty has somewhat further abated or at least postponed further with only partially more clarity about the forward path. The dominant overriding theme within credit as an asset class, HY-IG decompression, came to a (temporary) halt in November. However, given the obviously weaker trending credit metrics within the lower quality spectrum, the market currently evaluates the location of what one might call “credit cliff”. For now, the “credit cliff” seems to be at the very low end, i.e. CCC/Caa1 area.

The HY / IG decompression theme has re-striked further towards the lowest end of the quality spectrum

Beneath the flattish surface, risk distribution has shifted. The market has re-striked its recently more bearish view further towards the lowest part of the HY index. Looking at the recent developments of this segment, we see risks being clustered more horizontally, i.e. ratings matter as much, or even more (for now), than a classic sector view, as the cycle might become the more immediate theme rather than disruption. After years of ultra-low rates and a generally credit-friendly environment, we see limited room for improvement for companies which are still struggling at the verge of CCC (or even below) from a credit metrics point of view. Depending on the strength of the cycle and where the overall macro picture goes, we will see a shift of the “credit-cliff”, i.e. whether the cliff moves towards the B- or even BB-segment. In addition, we believe that given the somewhat slower re-leveraging, the default risk-beta should be lower in Europe than in the U.S., meaning European companies will potentially stay solvent for longer than their U.S. counterparts for any given macro scenario. This is partly due to the more supportive QE program (albeit currently being quite OTM).

Albeit rich valuation, the ex-ante expected return still has some headroom to run…

We are not too pessimistic in terms of ex-ante credit returns. While the overall credit market has rebounded significantly this year, spreads are still quite a bit away from the post-crisis tights we have seen during 2017. Yield buyers might be not overly pleased about the current record low level. However, spreads on an isolated basis still have room to improve should the usual geopolitical threats ease further and the modest growth doesn’t melt down instantly. Even though the best of the “cycle” might be behind us from a credit perspective, “let’s give a little bit credit to credit” in terms of ex-ante returns. Given the generally low carry environment, the steepness of credit curves can provide some buffer. We generally like the CDS index tranches in this regard as i.e. the iTraxx Main 6-12% Tranche (5y) rolls down roughly 50-60% during the first 2 years of its lifetime. Next to the carry of roughly 1%, this adds to a decent income for a position that has empirically zero default and extension risk within a purely senior investment grade Index.

… but we prefer to be cautious and strive for positive convexity

Over the month, Financials have rallied the most, especially when going down the capital structure where spreads have tightened meaningfully into the month end. Legacy T1 papers have led the way up as Banks “LME-away” bonds which will not be compatible with the new regulatory framework, a theme which will accelerate towards 2020/2021, we strongly reckon. Especially the Swiss low-trigger bonds are in fashion since these papers look more and more like Dinosaurs as de facto the updated TBTF rule suggests that a combination of Equity and purely MREL compliant bonds might become more realistic for the future, which in turn means that some of the today’s pure capital instruments might become needless. We see value in striving for more positive convexity while reducing credit duration (which is different to i.e. end of 2017).

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