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Identifying Relative Value In Credit Market Dislocations

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We have recently seen a prolonged, benign, and bullish credit cycle. It is our view that it is currently too late to be long and too soon to be short. We therefore fall into the cautious camp and are strategically positioned to take advantage of the opportunities provided by dislocations and decompressions in the market.

The current turn of the cycle will likely hit U.S. corporates before it hits European corporates. U.S. corporates have been more aggressive in their balance sheet management over the past few years whereas European companies, typically more traumatized by the financial crisis, have remained more conservative as a general rule. As is the traditional pattern, we believe that spreads will start widening before we witness any defaults.

The big question is when will the current bull cycle truly end and the bear cycle truly begin? We believe that we are close to reaching the definitive end of the cycle and, as a consequence, there is significant reward to be found for those prepared.

Trading Strategies

This article sets out three trading strategies that seek to take advantage of the next cycle, whilst maintaining the appropriate downside protection.

♦ **Decompression & Dislocation**

As the cycle turns, high yield companies which are highly levered will be impacted heavily and first. Therefore, it makes sense to consider long positions on investment grade corporate credit and short positions on high yield credit. This is a clear opportunity which is not currently priced in. For example, if you look at the spread differential between investment grade and high yield corporate bonds, both in Europe and in the U.S., the ratio of high yield spreads to investment grade spreads is at a historic low.

This means that current investment grade spreads are extremely wide compared to their high yield counterparts. This offers an attractive entry point as, fundamentally, high yield spreads should underperform. This is the case in Europe and the U.S., but we believe that the opportunity is even more attractive in Europe given that the ratios are lower.

Why is this you may ask? The answer is two-fold, firstly short-term interest rates are in negative territory forcing European investors to aggressively chase yield. As a consequence, high yield has been a natural choice for many investors particularly given benign credit conditions and implicit low default risk. Secondly, investment grade companies are often considered a proxy for systemic risk, given their close relationship to banks and sovereign assets (effectively systematic assets). The sustained state of uncertainty caused by recent European political upheaval has helped to maintain systemic fears at a high level therefore providing upward pressure on the investment grade spreads.

The combination of these opposing dynamics – benign credit conditions compressing high yield spreads and systematic fears pushing up investment grade spreads – translates into a very attractive spread differential.

This ratio has been at a historic low for the past eight years. However, the further we move through the cycle, the less sustainable these levels become and the more pronounced the dislocation.

In the post-financial crisis recovery cycle, a low spread ratio between investment grade and high yield was commonplace. The market is no longer subject to a systematic crisis, but the fears are still priced in. As the market inevitably turns, we expect a prolonged period of decompression accelerated by high yield defaults finally occurring.

We believe investors can take advantage of the decompression on the horizon. If one believes that the current credit cycle is over, the simplest way of playing this turn would be to short credit assets. However, this simple approach generates negative carry and significant negative roll down, not to mention the risk of drawdowns if spreads continue to grind tighter, so if you are wrong on timing, then this bet can come at a high cost. Given these risks, an alternative is to take a long position on investment grade and short position on high yield at a roughly four to one ratio. This approach allows you to take a bearish view on the cycle and high yield going forward whilst providing proportional downside protection. This trade is carry neutral and offers slightly positive roll down, therefore positioning it as an effective and costless strategy at the end of the cycle.

♦ Dangerously Steep

If we consider credit curves throughout different stages of the credit cycle, there is typically a recovery phase. Following the Global Financial Crisis (GFC), we would categorize 2009 to 2014 as the recovery stage. In this recovery phase, there should be a steepening of the credit curve as the market broadly is convinced that the risk of short-term defaults is decreasing. Conversely over the next five to 10 years, as the cycle becomes bearish, the curve should flatten. Despite being eight to 10 years into the post-GFC recovery phase, credit curves remain steep. Given that we believe change is afoot, the entry point is very attractive now because the curve has never been steeper.

A good way to take advantage of the turn is to take positions on the credit curve in anticipation of a flattening. To do that you can go short risk on the short end of the curve and long risk on the long end of the curve. This creates more or less neutral carry and only slightly negative roll down, minimizing the capital at risk and providing a flexible window for the turn to take place, but offers strong convexity in a market upheaval.

♦ Playing the Positive Basis

The tapering of quantitative easing (QE), which started in September, will have a strong impact on current corporate bond spreads. The reduction of the purchasing program from $60 billion of fixed income assets, of which $7 to $9 billion is corporate credit, to $30 billion will be significant if we presume that it will be a proportional reduction.

Demand will clearly be weaker. Corporates anticipating weaker demand for this asset may be willing to pre-fund some of their 2019 needs. We do not anticipate a bloodbath as some have predicted, but rather a slow drift to underperformance for these assets. Corporate bond spreads have been artificially compressed by the ECB's buying program and do not, therefore, adequately price in credit risk. Credit default swaps (CDS) do have this risk priced in because they are not as susceptible to the outside influence of QE. Therefore, if you consider the differential between the two asset classes for the same investment grade company and issuer, the difference is approximately 30 basis points for corporate sector purchase program (CSPP)-eligible issuers, which is particularly significant when considered in relation to spreads. It is important to note that this has recently partially corrected and the comparison has muted slightly since mid-September as synthetics have outperformed.

As a consequence of the tapering, we believe that this positive basis differential will collapse. We should, therefore, witness an outperformance of CDS spreads relative to cash bond spreads, leading us to sell cash and sell protection in CDS instead. We call this trade playing the positive basis.

When Cash No Longer King

In a credit crisis, cash is king. This leads to massive underperformance of cash assets versus synthetics. If you look at the basis between CDS and cash in every credit crisis, that basis becomes vastly negative. For example, in 2011 during the past bear credit cycle, the basis was negative 150 basis points in the U.S. and 100 in Europe. Therefore, if we move back to a bearish environment, you would move from a positive basis of 30 basis points to a negative basis of 100 basis points meaning that your overall portfolio would outperform by 30 plus 100 basis points of spread times the average duration of your portfolio.

Implementing this kind of positive basis trade is not only a carry positive position, but if the market does sour going forward and the cycle turns, it would generate capital gains on top of the positive carry.

While it is impossible to predict the exact moment when the bull cycle will definitively end, it will end and current over-reliance on corporate credit quality, liquidity, and depth will be a hard lesson for those exposed. Positioning yourself ahead of the market using some of these strategies is one good approach for the long term and offers complementary positioning to long credit exposure investors may have elsewhere in their portfolios. **BPM**

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