



Back to school - The edge of normality

In this note we update our views on credit markets and take stock after the holiday season as we go 'back to school'. One of the biggest problems we face is that there is no historical template for current global market conditions so we're all flying blind to a large degree. Never before have so many of the most important countries in the world printed so much money and left base rates so low for so long. Also never before has the most economically influential country in the world tried to start a slow process of reversing said extraordinary policy. So there is no road map for this journey, only educated (hopefully) predictions.

We've continued to be bullish EUR and GBP credit (especially HY) even though we've long felt that the only thing preventing another financial crisis has been extraordinary central bank liquidity and general interventions from the global authorities. Although we probably should have lightened up on occasions this year EUR HY has still seen positive excess returns and EUR and GBP IG only mildly negative excess returns with both strong relative to the USD market.

Our view overall is that the global financial system is so fragile and the global economy so lethargic and asset prices generally so high (with exceptions) that it near forces central banks into a continuation of easy monetary conditions. But what happens if the Fed raise rates soon? History tells us that spreads tend to tighten on average for 12 months after the first hike in the cycle before reversing course over the next two years. This perhaps shows the usual lag of monetary policy on financial markets and the economy. The caveat would be that we haven't seen the spread tightening in this cycle in the lead-up to a potential hiking cycle that we normally do. This perhaps illustrates that the historical context for this cycle is highly uncertain but at face value the immediate impact of a rate hike is not usually negative for credit.

Given the recent widening, in the three main currency blocks, only EUR BBBs have been tighter (just) than current levels for more than half the time through history. Indeed USD credit spreads are starting to reach levels that we've only exceeded when in a real crisis - so they are at the 'edge of normality'. There is little doubt that the post GFC lack of trading liquidity in all assets and credit in particular is increasing the amount of volatility in financial markets, especially as global central banks start to be more volatile and unpredictable themselves. This in turn is raising spread levels relative to the fundamentals. However one can argue it also gives investors more attractive levels than would normally be the case. The problem would arise if you felt that a global recession was imminent or that central banks were about to sharply reverse their course of the last 6-7 years. At this stage we don't think either will occur even if we think this is an entirely artificial, inefficient and subdued global economy.

The remainder of the note looks at, what we believe are, some interesting topical themes and potential opportunities that exist in credit markets. We first look the impact of commodity weakness on European credit and eye up potential opportunities, then move onto what we think is decent value at the long-end of IG curves and then look at how EUR credit has lost its valuation advantage it had relative to USD/GBP credit when we last explored this theme in late May.