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11 April 2017

Credit market monthly review: March 2017

Despite a March correction, the outlook for US credit remains positive

- We remain constructive on both USD credit and the credit markets more broadly. While we are now more comfortable with USD Investment Grade than we were at the start of the year, we still prefer USD High Yield because of the superior carry trade.
- French credit recovered from its February underperformance in March.
- The outperformance by financials can persist near term, given the scope for further spread compression between financials and non-financials.
- We do not expect a material negative impact on EUR credit spreads from the European Central Bank's decision to cut its monthly bond buying programme from €80bn to €60bn from this month.

US credit markets endured something of a correction in March but overall we believe the outlook for the asset class remains positive. During the month US credit spreads notably underperformed their EUR and GBP counterparts (*Exhibit 1*). As a result, their lead in this year's spread rally has narrowed. But, we see this as a healthy and overdue correction within a bull trend rather than anything more sinister. Indeed, US HY spreads were 50bps too tight at the end of February according to our spread cycle analysis tool, an overshoot that has now been broadly corrected. The reflation trade came under pressure too, as a 2% drawdown in return in US HY in early March narrowed its outperformance over US IG (*Exhibit 2*). The full month's performance would have been worse, however, had it not been for the strong finish by HY in the last few sessions of the month, which helped revive the Q1 reflation trade in credit.

There were three potential factors behind the HY market correction: heavy supply, a decline in oil prices and worries about the US Federal Reserve's plans for interest rates. Of these, we think supply was the most credible culprit. Oil did play some part, but it is worth noting that the widening in HY spreads had started ahead of the sizeable drop in the price of oil seen on 7 March. Furthermore, although the HY energy sector was among the top three underperformers during the correction, it was not a big negative outlier, as was often the case during the 2014-15 oil/commodity market correction. As a result of this, we see the correlation between oil and HY energy (*Exhibit 3*) as rather circumstantial and, thus, do not expect oil markets to affect US HY returns materially going forward. Moreover, the default outlook is improving briskly, with the 12-month trailing default rate having eased to 3.9% for US HY overall (1.2% if the energy and commodity sectors are excluded) from over 6% in late 2016. Our default rate model forecast is for a 2.6% 12-month trailing default rate in one year's time for US HY and 2.2% for European HY.

We remain constructive on USD credit and the credit markets more broadly. We are now more comfortable with USD IG than we were at the start of the year because the risk of a duration correction has declined as market pricing and Fed communications have become more closely aligned. That said, we maintain a preference for USD HY over IG given the former's superiority as a carry trade. Indeed, at around 6%, the yields on USD HY are nearly twice as high as USD IG or EUR HY. In USD terms, high yield instruments have returned 1.2% more than investment grade ones on average year to date, while in EUR terms that number is 1.3%. As an indication of expected returns, if credit was to earn just its yield until the end of the year, USD HY would finish in the lead with a full year return of 7.2%, followed by USD IG and EUR HY at 4.1% and then EUR IG at a meagre 1.3%.

The Republic strikes back. French credit recovered strongly in March after a decidedly lacklustre February (see blue bars in *Exhibits 5 and 6*). This resurgence came after French politics became more 'orthodox' with independent candidate Emmanuel Macron polling well in his bid to become the next French president. Over the same period, French credit also outperformed USD IG, recording 20bps of positive excess returns while amid other country cohorts returns were flat to negative.

Financials to outperform Non-financials. One other notable pattern on Exhibits 5 and 6 is the strong outperformance by financials over non-financials. Not only did ample supply weighed on non-financial spreads in March, but the ongoing supportive backdrop for banks and insurers, which includes the prospect of less onerous regulation, a cyclical upswing in growth and a steepening of the yield curve buoyed financials. As a result, the EUR IG financials index (EB00) produced 76bps of excess return over the month, nearly double the 39bps of EUR IG non-financials index (EN00). Given the scope for further compression in the financials vs non-financials spread differential, the outperformance by financials could persist. (*Exhibit 4*).

Corporate quantitative easing tapering is not a major risk for spreads. Markets appear unduly preoccupied with QE tapering by the ECB, including its corporate purchases (CSPP), as well as the expected conclusion of the Bank of England's corporate QE programme (CBPS) over the next two to three weeks. We do not really share such concerns because:

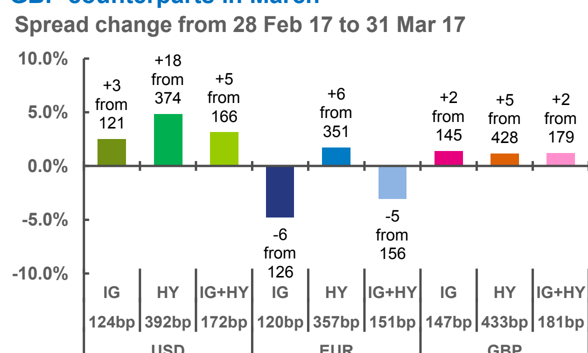
i. Recent ECB communication suggests that talk of tapering appears quite premature and is unlikely to appear in official ECB communications before September at the earliest;

ii. Spread direction has shown no correlation with the amount of bonds purchased (either weekly or monthly) under either the CSPP or the corporate bond purchase programme; and

iii. In any case, we expect a higher share of credit purchases by the ECB as the monthly amount of asset purchases drops from €80bn to €60bn as a result of scarcity issues within the sovereign bond market. This suggests that it is possible for the CSPP to maintain its current average pace of monthly purchases at €8bn.

Exhibit 1

USD credit spreads underperformed their EUR and GBP counterparts in March



Source: Bloomberg, BAML and AXA IM Research

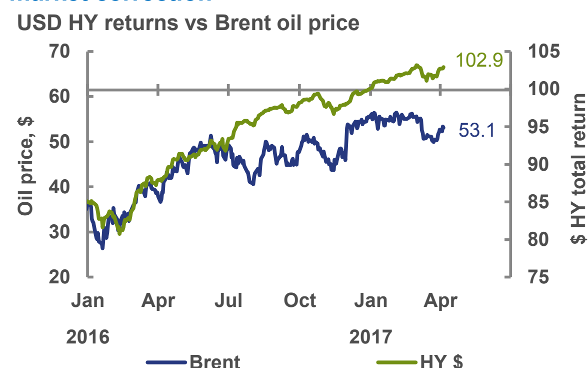
Exhibit 2

A strong finish by US HY revived the reflation trade of HY over IG in March

Source: Bloomberg, BAML and AXA IM Research

Exhibit 3

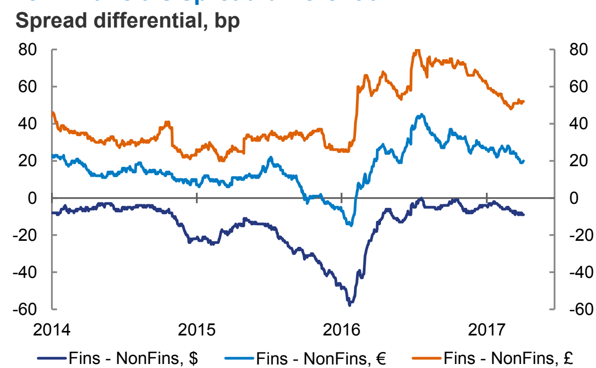
US HY market correction started ahead of the Oil market correction



Source: Bloomberg, BAML and AXA IM Research

Exhibit 4

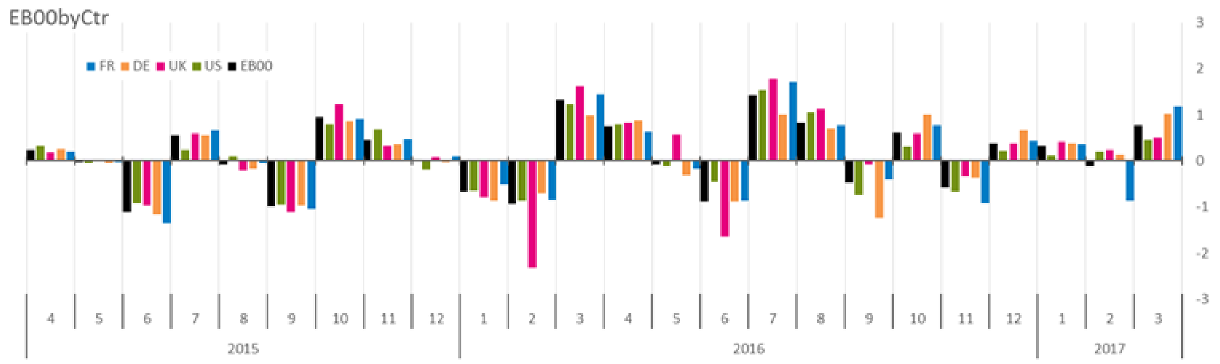
Scope for further compression in the financials vs non-financials spread differential



Source: Bloomberg, BAML and AXA IM Research

Exhibit 5

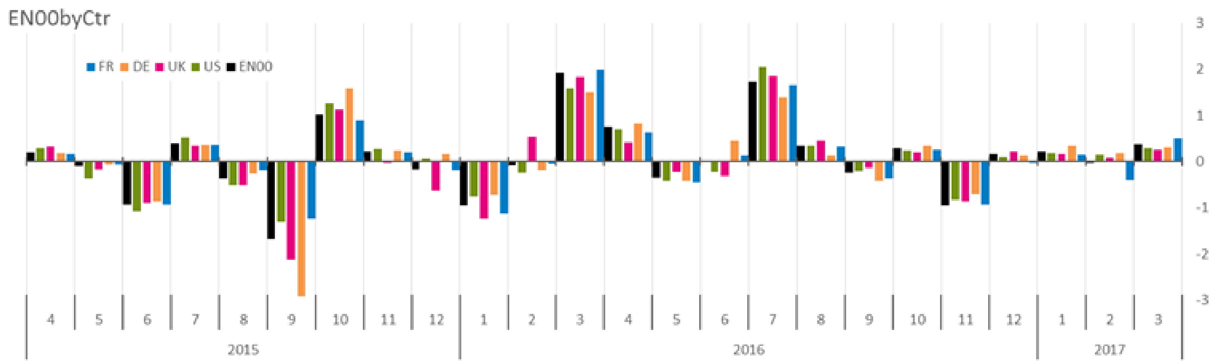
Monthly excess returns by country cohort within EUR IG financials (EB00)



Source: Bloomberg, BAML and AXA IM Research

Exhibit 6

Monthly excess returns by country cohort within EUR IG non-financials (EN00)



Source: Bloomberg, BAML and AXA IM Research

Our Research is available on line: **http://www.axa-im.com/en/research**

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