

What spreads tell us about this “crisis”?

Executive Summary

- iTraxx spreads are at « crisis » levels
- A lack of dispersion within indices indicates limited sector or issuer- specific concerns
- Minimal evidence of specific default hedging by investors in short-dated single-name CDS
- Markets are not suggesting liquidity concerns - Interbank money markets have risen to pre-COVID levels but remain within historical bounds

⇒ **Credit Spread Level over-evaluates default risk, not materialized in all the above metrics**

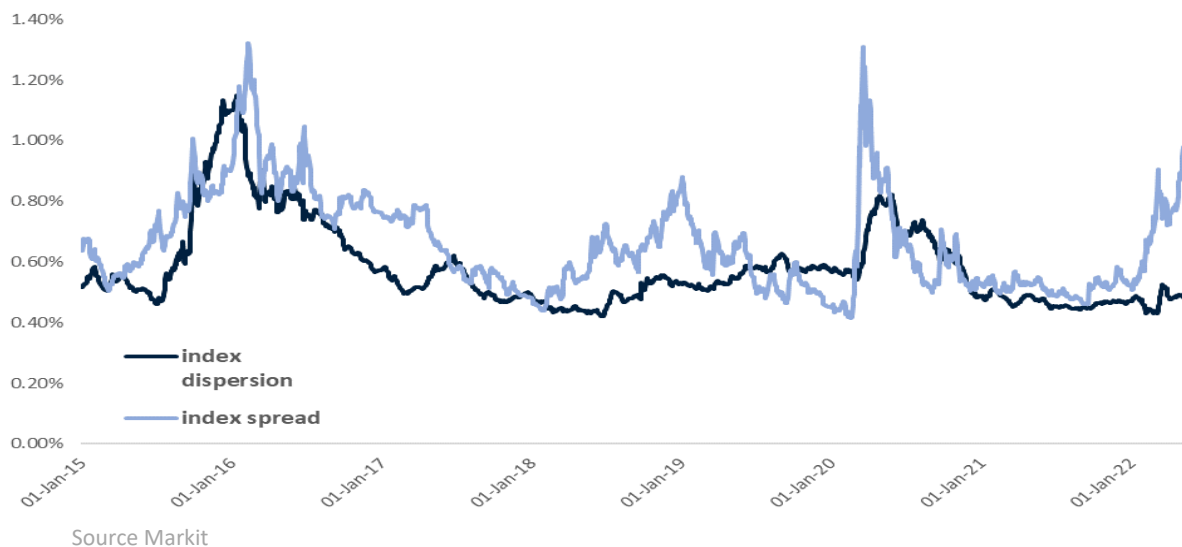
"Don't be seduced into thinking that that which does not make a profit is without value." Arthur Miller

Year-to-date asset performance has highlighted the many historic headwinds facing markets. Inflation, commodity prices, equities, rates and, obviously, credit are all reporting performance figures at extreme levels. But what do current credit spreads tell us about this “crisis”? Can we infer anything from today’s spread levels and should we worry about looming default or liquidity risk?

Default risk?

One of the key factors to consider when analysing a portfolio or index, is to look at the dispersion of its constituents (Fig 1.). As of the end of May, the **dispersion¹ of iTraxx Main is close to historical lows despite the extremely elevated level of the index**. The material widening in iTraxx Main this year has not been accompanied with a significant increase in index dispersion. This relationship stands in **marked contrast to both the Asian the COVID crises** where initially the index moved wider to be closely followed by a sharp increase in dispersion as the market started differentiating between specific sectors and single-names. **This absence of an increase in dispersion reflects the lack of idiosyncratic/default concerns in the iTraxx Main index and, in our view, limits the levels at which the index can widen further** without specific sectors or single-names coming under pressure. Of note, since 2015 the only instances where iTraxx Main moved well above 100bps have been in periods of higher dispersion.

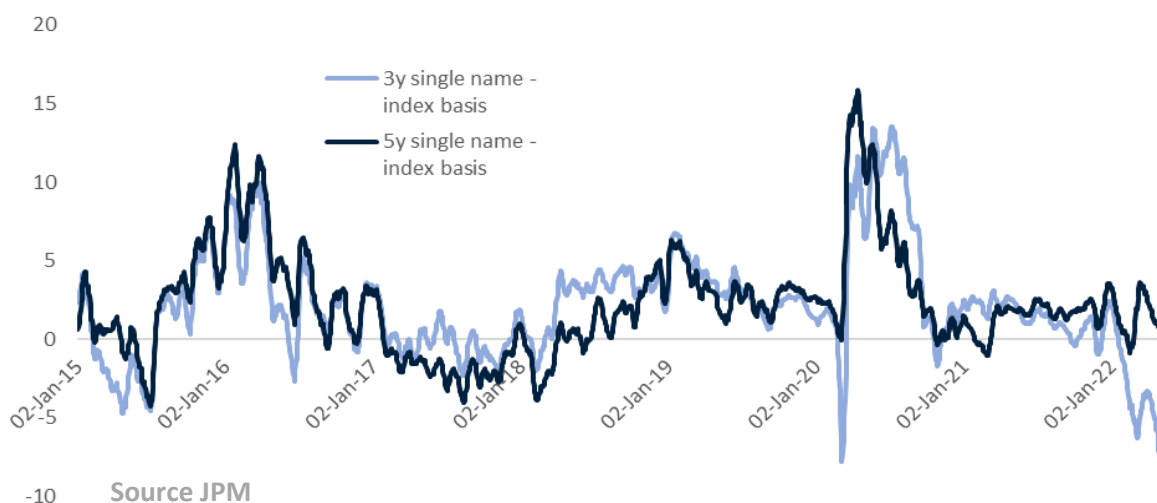
Fig. 1: Current dispersion – very similar to 2018, very different to 2016 and 2020



¹ Dispersion is the standard deviation of “underlying constituent CDS spreads” divided by the index spreads.

This lack of perceived default risk is even more striking when looking at the basis between the index and its single-name constituents (Fig. 2). Any specific pressure on a sector, region, or cluster of names should push this basis wider as market participants try to hedge their exposure to the specific names of concern. This puts hedging pressure on single-name spreads but has little impact on the overall index. This is not what we have witnessed this year. In contrast what we have seen is a **very limited widening in the 5y basis and a significant tightening in the 3y basis** (i.e. 3y single-names have outperformed the index). We put this down to investors choosing to use short-dated indices, as opposed to more targeted single-names, as the primary asset to *indiscriminately* hedge default risk. These moves do not point to investors seeing specific entities posing a material default risk.

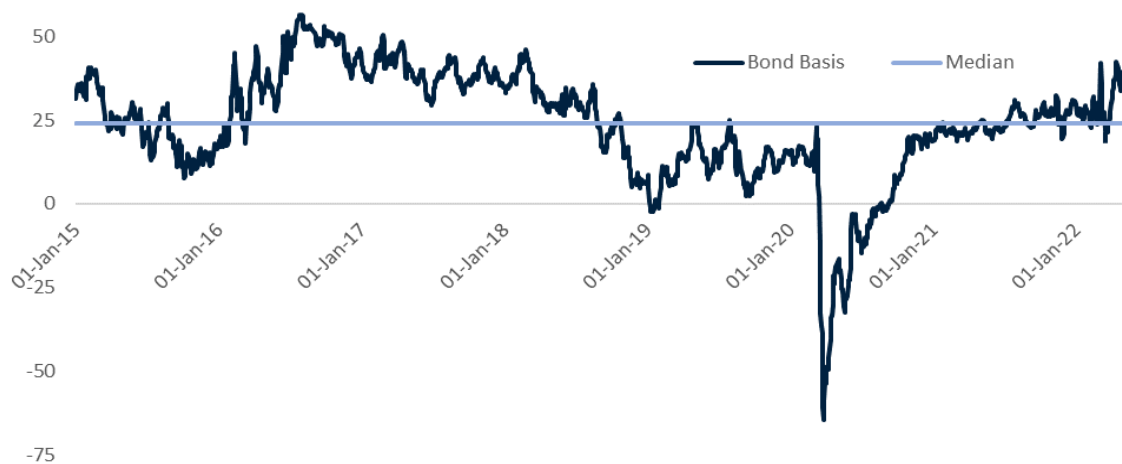
Fig. 2: Short-dated single-names are not indicating elevated default concern so far.



Liquidity Risk?

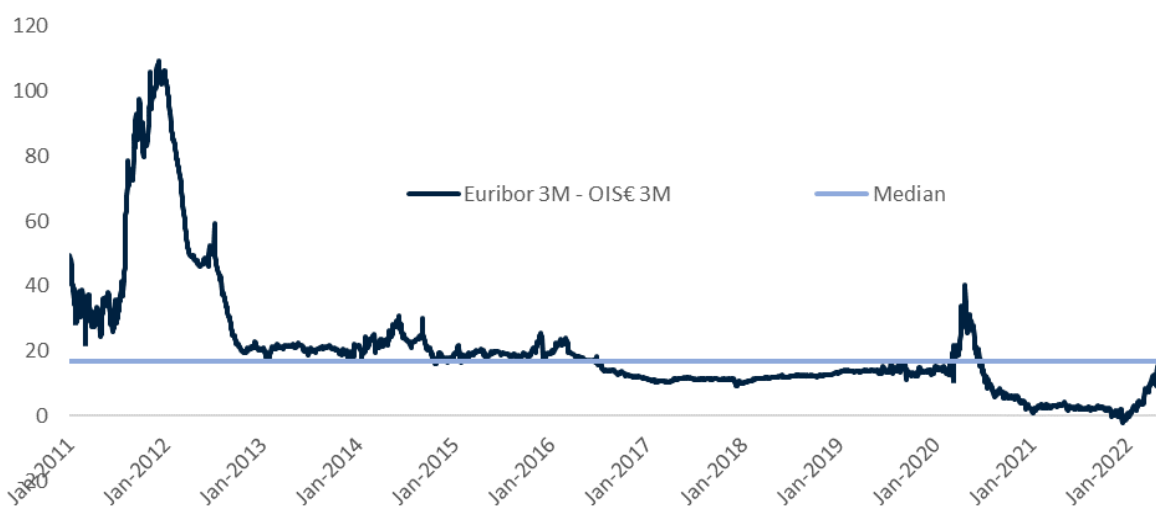
The spread between cash bonds and CDS, and more generally between two correlated assets that have different levels of liquidity, is a good indicator of the amount of liquidity and of the risk of forced liquidations or capitulation in a market (Fig 3.). As positions need to be unwound the most illiquid assets will typically significantly underperform more liquid ones. So far this year we have seen the opposite, namely a normalisation of the basis as the more liquid asset (the CDS indices) underperformed the less liquid ones (cash bonds/single-name CDS). These moves indicate that the widening witnessed this year is more a consequence of macro hedges being put in place via liquid indices - see the DTCC positioning data from the last month's investor letter. These moves have led to a more defensive positioning among market participants in iTraxx Main which should limit the risk of a gap wider in spreads.

Fig. 3: Cash bond-CDS basis at "fair price", indicating limited liquidity stress



What the cash-CDS basis shows is also reflected in prevailing unsecured interbank funding costs, a market that is often seen as a gauge of the level of “trust” dealers have in each other. If we look at the difference between 3-month Euribor (unsecured interbank loans) and the Estr swap market with 3-months maturity (Fig 4.) we see this spread has normalised as it rises from its historical low post the COVID crisis, a low that was driven by the large amount of coordinated support from the central banks.

Fig. 4: The interbank market indicates a normalization of post-COVID liquidity excesses



Source Bloomberg

Conclusion: there is no doubt that markets are still facing **a large number of uncertainties** but, despite the widening, the current low level of single-name dispersion, as well as the lack of liquidity pressures, supports our positive view on the relative **attractiveness of investment grade credit indices**. Within the indices, **we still favour super-senior risk** as a good way to take long exposure while not being at risk from an increase in dispersion should the focus for markets move from the systemic to the idiosyncratic.

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Selwood Asset Management (France) Investment Team – as of 01-06-2022

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