

## Playing € corporate deterioration?

### Executive Summary

- iTraxx spread continues its trend wider and its underperformance vs. CDX IG
  - The move seems to be led by directional flows rather than by an increase in default risk
  - Despite the wide level of the index, dispersion remains limited
  - Special focus of the month: using put credit options to hedge a long credit portfolio
- ⇒ **Credit spread levels do not represent fundamental default risk, but macro positioning and a consensus in bear market expectations**

*“Let us not look back in anger, nor forward in fear, but around in awareness.” James Grover Thurber*

## Is the underperformance of European credit markets relative to the US justified?

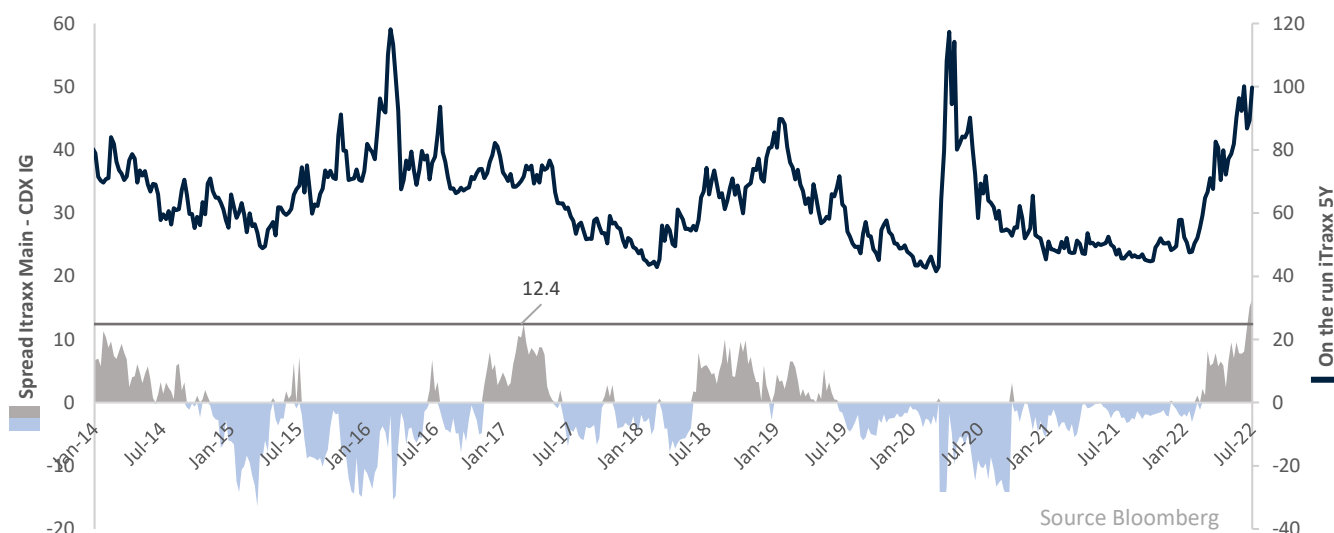
The recent underperformance of iTraxx Main has its root in the macroeconomy and investor flows, as evidenced by the fact that client positioning on iTraxx main is back to its smallest “net long” of c.US\$15bn from a 2021 average of US\$33bn.

There is no doubt that the Ukraine-Russia war should have a larger impact on European economies relative to North America. The direct impact of disruptions and potential rationing in the energy supply chain would have material consequences for European companies, especially those in Germany and Eastern Europe.

This has lead some large hedge funds to short European markets, with many (such as Bridgewater<sup>1</sup>) being vocal about these positions in the press. This has played into the significant underperformance of iTraxx Main relative to CDX IG, with iTraxx currently trading 20bps wider to CDX IG, the largest differential for at least eight years (Fig 1).

For comparison, during the European sovereign crisis - a systemic risk of breakup that was specific to the Eurozone – iTraxx was trading 60bps wider to CDX IG. Comparing these events to current levels, we can see that the market is assuming that the relative investment grade credit risk of European corporates vs. the US due to the ongoing energy crisis is 30% as severe as the relative credit risk that was priced at the peak of the Eurozone sovereign crisis.

Fig. 1: Itraxx Main Spread (Post European Crisis), and spread with the CDX NA IG



<sup>1</sup> Source FT - 08/06/2022 : “Bridgewater bets against US and European corporate bonds on slowdown fears”

**The divergence between the two indices is, in our view, overdone.** We believe that the moves have been largely driven by speculative macro positioning that takes little account of the actual underlying risks in credit at an idiosyncratic level. Indeed, **divergence** between the two benchmark investment grade indices typically occurs in parallel with an **increase in dispersion within the index**. We have seen limited evidence of this so far (Fig. 2)

**As we stand**, iTraxx is trading 20bps wide to CDX IG, with the five widest names in Main ranging **between 150bps and 350bps**. Such dispersion is still near historical lows.

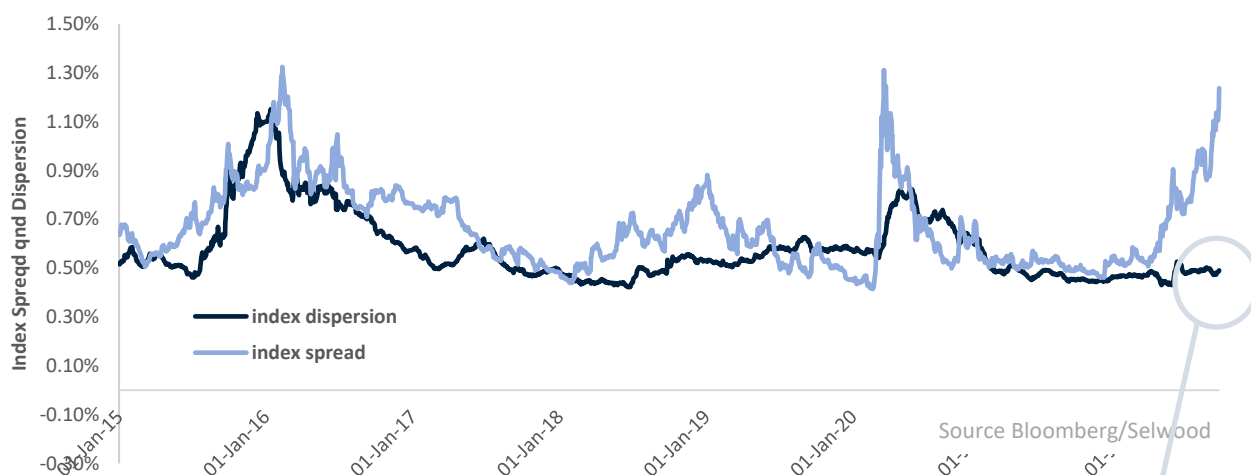
By comparison if we look back at the last spike in divergence (**Mar/Apr 2020**) - when CDX IG underperformed iTraxx by 34bps - the 5 widest names in the US index were ranging **between 900bps and 1300bps** with pandemic-impacted companies (especially cruise, retail and automakers) trading at distressed levels.

**The currently lack of dispersion can be seen as (i) a real lack of idiosyncratic risk or (ii) a lack of information/trading ahead of the earnings season.** Given that current volumes on single name CDS are significantly higher than average we expect reason (i) to be more compelling.

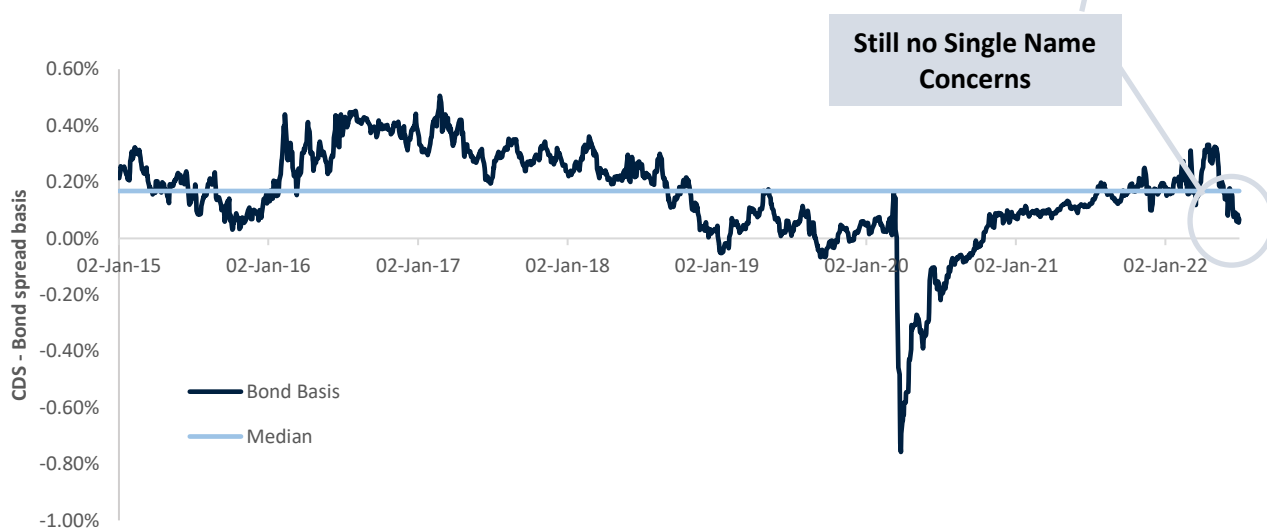
With the beginning of earnings season, **we would expect dispersion to pick up**. Quarterly results should highlight differentiation between those companies that are most impacted by the mix of inflation expectations/recessionary fear, in large part driven by the energy supply crisis. Despite this, **what really matters is how much dispersion we can expect vs. what the market is already pricing in the iTraxx vs. CDX IG spread**.

Below, we have updated the two charts from the previous letter highlighting that the perceived idiosyncratic risk within the index. Note that both still signal little cause for fundamental concern.

**Fig. 2: Itraxx Main dispersion update as of end of June**



**Fig. 3: Cash vs CDS update as of end of June**



## Options or not?

Because of their relatively short-term expiry, options are in essence volatility assets. The risk of being forced to roll as well as the cost of buying at the implied volatility levels (which are higher than realised volatility levels) can mean a hedging strategy using only options might not work, even in a sell-off scenario.

What has characterised this year's repricing is the slow pace/low volatility at which the widening has occurred. It is particularly striking when compared to 2020 which saw the fastest paced widening in the last 15 years. The differences mean that a hedging strategy that worked perfectly well in 2020 has been completely inefficient this year (even losing on a delta-hedged basis).

⇒ **2020 was about volatility and dispersion, so far 2022 has been about momentum and correlation**

**Fig. 4: Performances of long 3 month put strategy, rolled on monthly basis**

P&L of a delta-hedged long put strategy over the first 6 months of the year

P&L of a long put strategy over the first 6 months of the year



**Our conclusion** remains the same. We continue to see positioning against credit, and Europe in particular. However, for the index to move materially wider it would need to be fuelled by significant, specific, single-name concerns. Likewise, for dispersion to materialise, and with it the bets against Europe, this coming week's earnings season will be crucial. As mentioned in the previous letter, we continue to favour the more senior type of risks given the protection they offer from single-name disruption.

*Mathieu Labelle and Thibault Brohard, 05.07.2022*

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