

“Forecasting financial markets is little more than an educated guess.”

in “A Random Walk Down Wall Street”, Burton Malkiel famously wrote that “a blindfolded monkey throwing darts could perform as well as the experts.” Imagine what a monkey without the blindfold could achieve! And I was already on my way to the zoo looking for some help.

Temptation in the outlook’s exercise is always to sell fear, stressing overvaluations, pointing out the imminent bubble (sparkling bubbles make festive seasons, don’t they?). Fear always finds buyers, truth doesn’t... The only truth I’ve found is that when an expert makes a prediction, all he ever sees is a monkey staring back at him in the mirror.

So instead of prophecies on market directions, I would like to show you in this letter, the pockets in European credit markets that encapsulate best relative value.

Executive Summary

- The basis between Investment Grade Cash and Synthetic favors Synthetic.
- The performance of High Yield, suggest compressed level with Investment grade.
- This year low realized volatility, makes credit options appealing, including the deep out of the money.
- The continuous flow on junior tranches has sent correlation to attractive level for the senior ones.
- The steepness of rates curves helps the attractiveness of 5Y maturity for credit (compared to money market).
- Credit remains appealing from a carry perspective, while equity valuations; particularly in the U.S. appear stretched. Much of the strength in U.S. equities has been driven by the technology sector, which now accounts for nearly half of the S&P500. This concentration has raised serious concerns on valuations.

Looks for Value

Consensus today leans toward darker skies: geopolitics remain tense. Equity valuations, especially in the tech sector that has powered global markets, look stretched. Europe struggles with sluggish growth and China faces persistent structural challenges. Looking up, one sees clouds, not sun.

Yet the 2024 consensus also predicted a much weaker 2025 than the year we ultimately experienced. This reminds us to think creatively and avoid becoming trapped in familiar narratives.

One key reason risk assets has performed so strongly in 2025 is that investors remained conservative for most of the year. Positioning was cautious, and every dip, sometimes just a brief “blip”, triggered rapid FOMO-driven flows that helped markets recover almost instantly.

While € Investment Grade cash spreads appear extremely tight, now at levels last seen in 2017, the synthetic market tells a different story: iTraxx Main remains roughly 10 bps above its 2017 low of ~42.5 bps. The basis [$1.7 \times$ (iTraxx Main Spread) – (IG Cash Index Spreads)] therefore looks attractive (Fig. 1).

Fig. 1: Basis between IG Synthetic and Cash


In High Yield, both cash and synthetic spreads appear unusually close to IG (Spreads compression). The IG-HY synthetic basis [$4 \times (\text{iTraxx Main Spread}) - (\text{iTraxx Xover Spread})$] (Fig. 2) is as compressed as in 2021, even though today's spreads are nowhere near the tightest levels of the past five years.

Fig. 2: Basis between Investment Grade and High Yield in synthetic


In High Yield, the basis between synthetic and cash also shows Xover (HY Synthetic) to be relatively expensive versus cash (Fig. 3). We remain far from the extreme cheapness of 2022 in Xover (while IG Main is back near its cheapest 2022 levels). This asymmetry is notable.

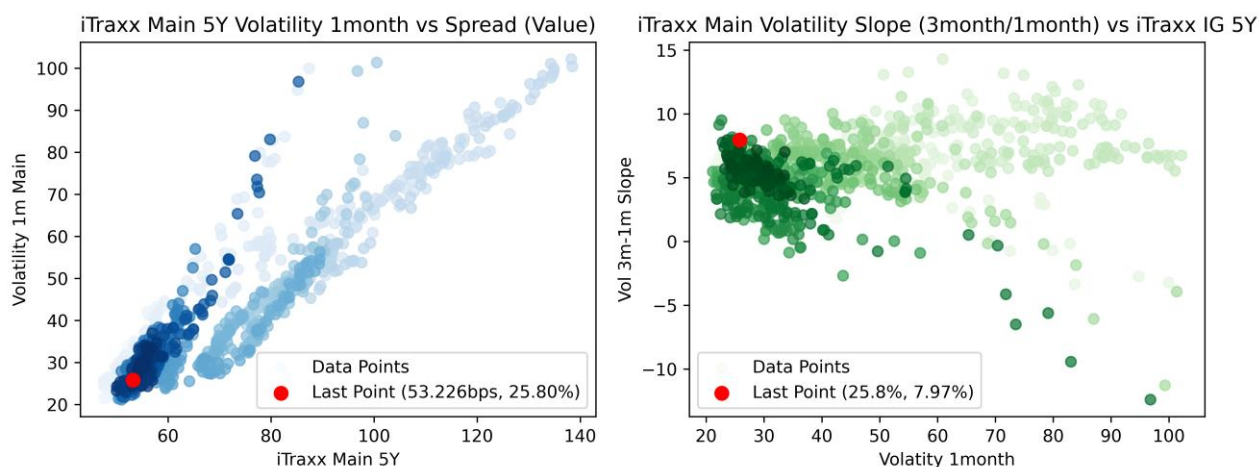
Fig .3: Basis between High Yield synthetic and High Yield cash indices


This would help us draw our first conclusions: (i) synthetic IG looks attractive compared to IG Cash (ii) If market deteriorates, cash should underperform synthetic in IG and (ii) HY should underperform IG.

A rising tempest whispers below the stillness of the surface.

Credit volatility in iTraxx Main 5Y is trading at mid range (~25 points) relative to the index level (Fig.4). Options appear relatively inexpensive in absolute terms given the potential obstacles ahead: geopolitics, tech valuations, infrastructure financing needs, fiscal trajectories, and the possible resurgence of inflation, to name only a few.

Credit option markets also show a skew (3 months vs. 1 month) near high (~8 points) of its historical range for the current spread environment (Fig.4). This reinforces the view that the market remains cautiously positioned.

Fig. 4: Credit option volatility and maturity skew


Our overall outlook remains unchanged. We continue to expect episodes of moderate to elevated market stress. However, cautious positioning of market with hedges in place and an underweight stance in higher-risk assets, should allow the market to absorb moderate downside shocks and recover efficiently.

It should also mitigate the effects of a more persistent bearish trend, particularly in an environment where “buy the dip” and even “buy the blip” behavior continue to outweigh panic selling. The relative cheapness of tail-risk options provides valuable protection should the market shift into a true downside regime.

Some things shine and rise; others fall into unexpected affordability.

Since 2023, several large participants have emerged in the iTraxx tranche market, particularly on the equity side. Selwood has long argued that the on-the-run iTraxx Main index is well protected against defaults due to its construction and rolling mechanism. Indeed, since inception, the iTraxx Main 5Y IG index has never experienced a default within the first two years of a series. The on-the-run series are generally considered very secure, as they roll every six months for the index and annually for tranches.

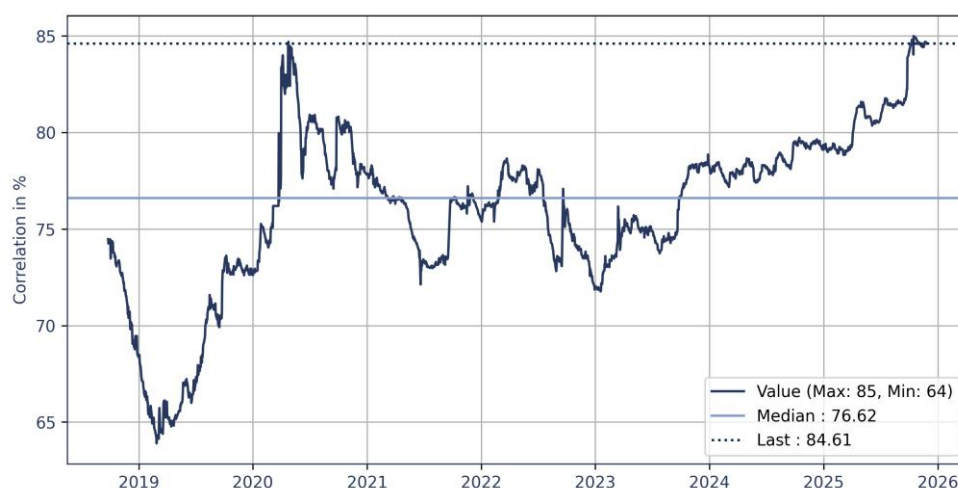
Furthermore, balance-sheet and cash-flow metrics of Main constituents (with no single name trading above 160 bps in Series 44) suggest an extremely low probability of default over the next 12 months. This shared conviction has encouraged more aggressive investors to seek yield through equity tranches rather than through leverage.

Dealers, however, increasingly lack the balance-sheet capacity to warehouse senior tranches. As a result, they have been forced to cheapen the less appealing super-senior tranches, difficult to trade due to their large notional's and low intrinsic leverage and capital cost. As a comparison:

- November 2024: index at 57 bps → [12–100%] tranche priced ~25.5 bps; equity tranche priced ~8.05%
- November 2025: index at 55 bps → [12–100%] tranche priced ~30 bps; equity tranche priced ~6.95%

While options are priced through volatility, credit tranches are priced through correlation. Today, implied correlation in super-senior tranches is comparable to 2020; periods of broad systemic stress (Fig.4).

Fig. 5: iTraxx main 5Y Super senior Tranches



Yet today there is no prevailing sense of systemic crisis. The elevated correlation appears flow-driven: persistent demand for equity tranches has pushed dealers to shed or reprice senior risk, inflating implied correlation and leaving super-senior tranches unusually cheap.

Conclusion

Valuations in both credit and equity markets remain elevated. Since 2000, markets have faced a major crisis roughly every two to three years. From this historical standpoint, a downturn in 2025 would have been plausible; since it did not materialize, the likelihood of a market adjustment in 2026 remains significant.

Credit curves are currently steep relative to overnight rates, providing a degree of protection should a crisis arise. However, the risk of renewed inflation cannot be overlooked. In this context, maintaining credit exposure remains a reasonable strategy, with potential annual returns of 4–6%, and the possibility of outperforming other asset classes during stressed market conditions.

It's always striking to observe that over the past 25 years, the Euro Stoxx 50 has delivered a 4% annualized return, while the EUR IG iBoxx index returned around 3.5%, illustrating how a steady, conservative approach can match more volatile equity strategies over time. If anything, 2026 might turn out to be a “turtle” year, favoring consistent over erratic “rabbit” performance.

Within credit, we maintain a preference for Investment Grade, particularly through synthetic exposures. Within this segment, super-senior tranches provide an additional layer of potential outperformance when implemented efficiently. High Yield can also offer value, but only within well-diversified and granular portfolios, as defaults remain an inherent part of this segment.

Mathieu Labelle (CIO – Selwood AM France), 28.11.2025

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