

## Six reasons credit spreads are set to stay tight

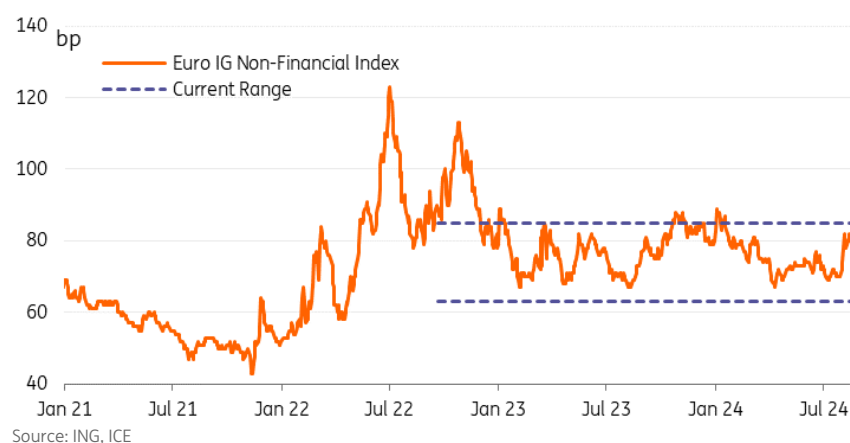
Buying on dips remains the mantra for the coming months, as periods of volatility and weakness will be short-lived and present attractive buying opportunities. Spreads should remain within a narrow trading range and promptly retrace towards tighter levels. Here, we outline the six reasons spreads will stay tight



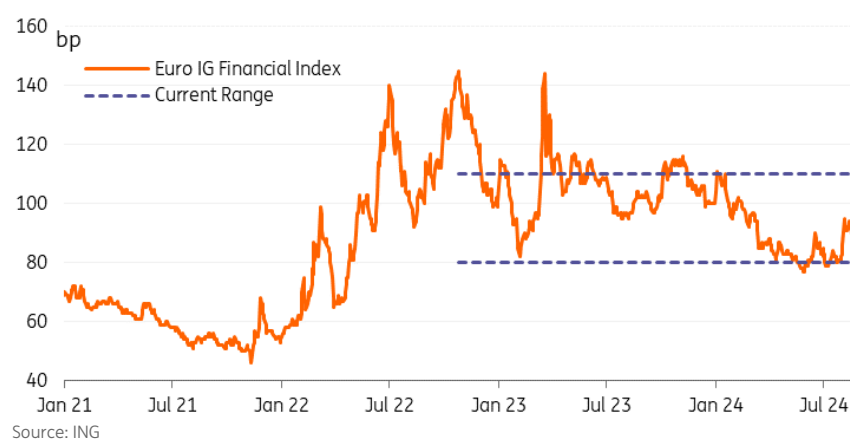
More aggressive market pricing of Federal Reserve rate cuts and the looming November presidential election are two key areas we'll be keeping an eye on when it comes to credit spreads

Supply, elections and rate cuts remain the three pillars underpinning spread developments in the coming months. We expect spreads will remain in a narrow trading range for the remainder of the year and volatility will be emphasised by these three pillars. A combination of recession fears in the US, concerns over a wider conflict in the Middle East, the unwinding of the Japanese carry trade due to the outperforming yen, and the markets now pricing in a more aggressive Federal Reserve rate cut have all contributed to the recent weakness in credit. We expect there could also be some volatility around the US elections in November. In our opinion, these periods of widening create an opportunity for pick-up, as spreads will stay mostly contained and retrace promptly on strong technicals.

## EUR IG Non-Financial trading range - in the value zone



## EUR IG Financial trading range - in the value zone

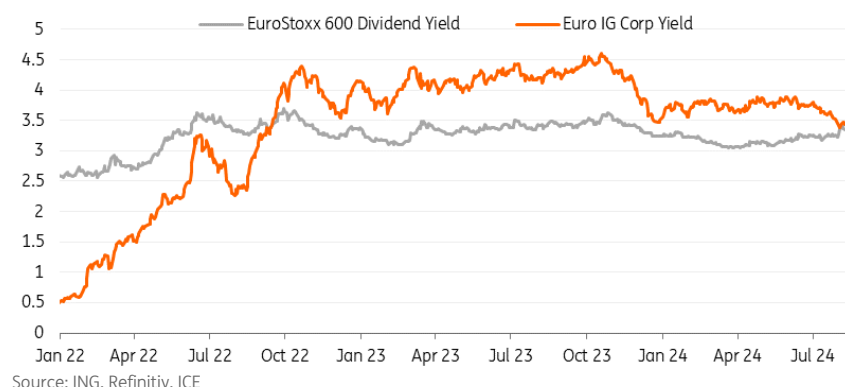


## Six reasons spreads will stay tight

### 1 Technical strength – demand is plentiful

Technicals have been keeping credit markets rather compressed and rangebound over the past six months. Strong inflows on the back of the very attractive yield are still present in the credit space. Demand remains high for credit, with yields still marginally in excess of dividend yields.

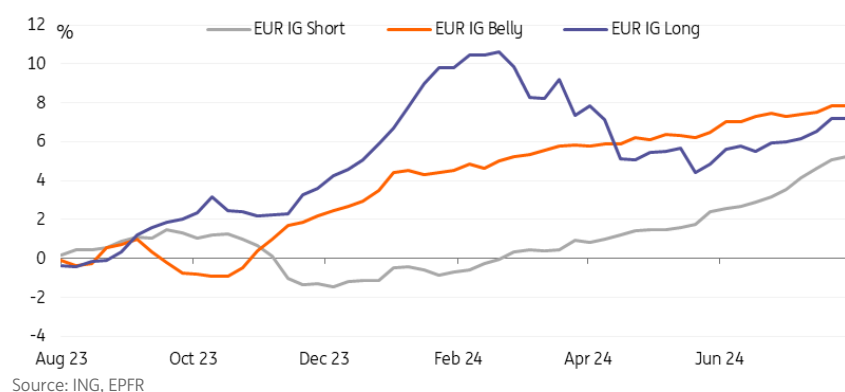
## Credit yield still in excess of dividend yield



We have also seen strong inflows from mutual funds and ETFs, with EUR investment grade inflows amounting to 6% of assets under management (AuM) on a year-to-date basis, and nearly 8% on a 52-week basis. EUR high yield remains positive but to a lesser extent with just 3.3% of AuM inflowing on a YTD basis. The same high demand for credit is also seen in USD credit on a YTD basis, with over 6% of AuM flowing into USD IG and just under 6% of AuM into USD HY.

EUR IG mutual fund flows have been very concentrated in the short end of credit over the past several months. On a YTD basis, the 0-4yr area has seen 6.5% of AuM inflowing, and the 4-6yr area has seen 5.2% of AuM inflowing. Meanwhile, the 6yr+ bucket has only seen 2.6% of AuM flowing in YTD.

## Flows concentrated in the short to belly of the curve



We have already seen some steepening of credit curves over the past few months, but we expect more to come. The long end is not attractive enough to position there (apart from in the primary market, when some new issue premium is being offered). The value area is still in the short to the belly of the curve from both a spread and yield angle (as yield curves still look flat). For corporates, there is a 20bp spread steepness level, we expect that will continue towards 30bp. Similarly for financial spreads, the current steepness is 30bp, which we expect will reach 40bp (using the differential between 7-10yr index and 3-5yr index).

Lastly, the European Central Bank is still holding a rather significant amount of the EUR corporate

credit market. As it stands, the ECB holds €303bn under the Corporate Sector Purchase Programme and €46bn under the Pandemic Emergency Purchase Programme. This is a significant 20% of the EUR IG Corporate credit market, which totals c.€1.7tr. This reduces volatility in the market in times of weakness and acts as a backstop for spreads.

## 2 Technical strength – slowdown in supply

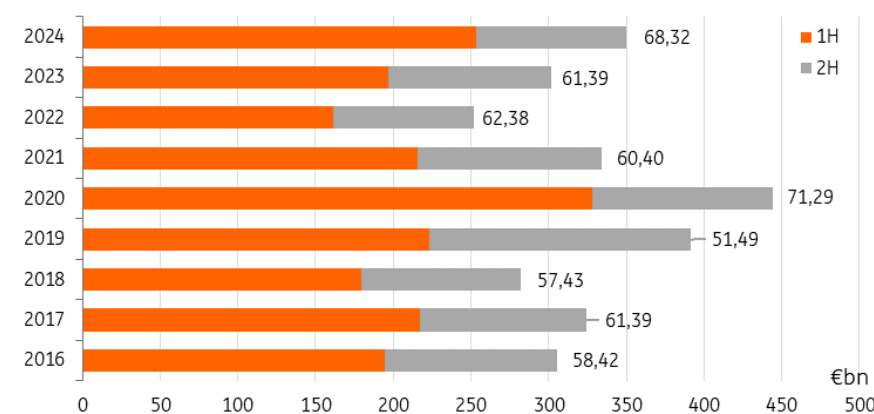
Supply so far this year has been strong with corporate YTD supply already sitting at €257bn, running ahead of previous years, and financial supply sitting at €351bn. The surprise to the upside has been met with very strong demand, as subscription levels have been at record-breaking levels (an average of nearly four times versus the normal average of three times) while new issue premiums have been very low (as low as 0-4bp on average).

As suspected, supply has been significant in the first half of the year with front loading to take advantage of the large demand, relatively tight spreads and uncertainty on the horizon for the second half of the year with growing geopolitical concerns and multiple elections taking place.

Normally, we would see a 60-40 split between the first half of the year versus the second. This year, we expect the split could be closer to 70-30. The primary market has already opened back up rather early and many deals have been priced. Naturally, the end of August and September will still be plentiful with supply, but a slowdown in the fourth quarter will be more dramatic.

### Substantial supply has been front loaded

Supply split between first half and second half of year



Source: ING, Dealogic

We had forecast an increase, but not record-breaking supply for corporates in 2024. We are certainly on track to see more supply versus last year, despite a slowdown expected in the second half. However, we may see supply surprise slightly more than previously expected. This comes on the back of a soft landing and as such, an increase in M&A activity. We expect supply will continue to be met with strong demand. Already, the deals being priced in the past week have been met with very strong demand with still-low NIPs and large books. The value in the market is still very present at these levels and strengthens our view of a buying-the-dip market.

## Total return with falling rates

Total return should increase more as rates fall further in the coming months. The EUR swap rates have already come down substantially, falling by over 100bp compared to this time last year, and falling 50bp in the past few months from the highs of this year. As a result, EUR corporates pencil in a YTD return of 2% and EUR financials have seen a return of 2.7%. This strong total return should increase further in the coming months as our rates strategists expect a further decrease in rates to the tune of 10-20bp, and some steepening of the rate curves as rate cuts continue.

### 4 Mostly favourable macro picture

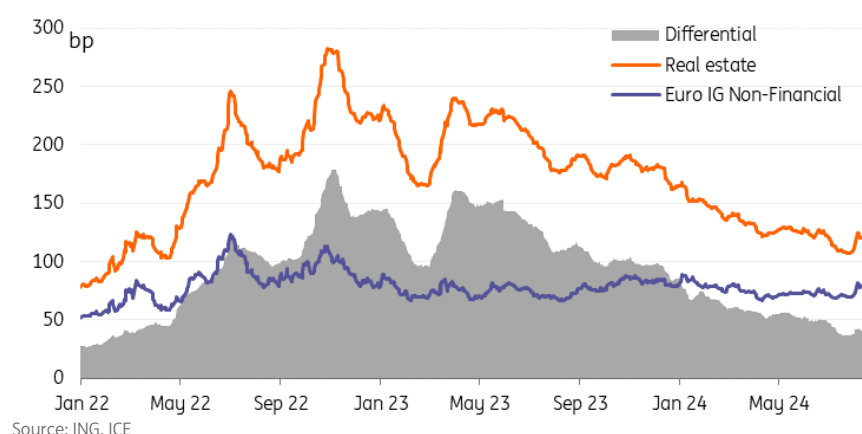
The macro picture still looks to be favourable for the most part. Recession is not our base case with a soft landing more likely, particularly in Europe. Inflation has been kept mostly under control and we don't foresee a resurgence at this time (although a resurgence of inflation is a risk to our more constructive outlook).

Furthermore, in the event of a Trump presidency in the US – and particularly in a constrained scenario whereby Congress is split with the Democrats winning the Senate and Republicans winning the House – Trump will have more of a focus on the international playing field. This will likely result in a deal with Russia over the Ukraine conflict and, potentially, some reduction in Middle East tensions. These are both credit positives. However, it is still questionable whether a favourable deal with Russia will be made. And on the flip side, any implementation of tariffs is a GDP negative. Read more on this in our latest election update here: [US presidential election: Three scenarios for markets](#).

### 5 Recovering real estate

The real estate state sector has recovered a great deal in the past few months after really feeling the pinch in the higher rates environment. The differential over the overall index has almost recovered to the levels of January 2022, which used to average between a 25-30bp premium for the sector versus around 40bp now. This is down from the significant 190bp differential at the peak real estate wides. Naturally, there is still some tension and uncertainty in aspects of the sector, but most names are in a comfortable enough spot. There has been some dispersion between names in terms of the performance of quarterly numbers. Broadly speaking, earnings growth remains robust while valuations have shown signs of bottoming out and have decreased in some places – but the recovery will be varied. We have also seen some issuers return to the bond market, a strong positive signal. With rates falling more from here, the sector should continue to feel relief.

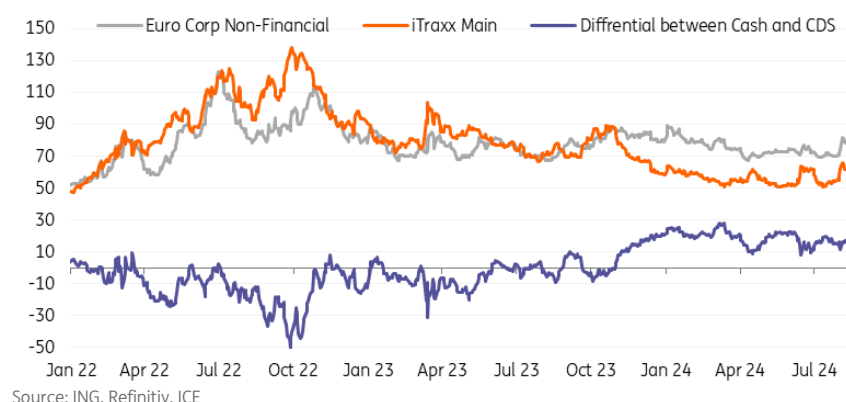
## Real Estate sector spreads have tightened substantially



### 6 Tight CDS and iTraxx Main

CDS levels are trading rather tight. The iTraxx main is trading at just 54bp, close to the tightest levels seen over the past two years, and is trading inside cash spreads. This indicates the low level of risk being priced in and notably low volatility. The implied one-year default rate of the iTraxx main at the moment is just 0.75%.

## CDS is trading tighter than cash spreads



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