

## Small factors combine to pressure credit

Weakness in credit markets in the form of wider spreads and the primary market struggling, begs the question of what is driving the recent weakness in credit markets? The answer to the question seems to be a combination of many smaller factors including credit looking expensive, a shift from yield buyers to spread buyers, and limited issuance windows



From a technical perspective credit markets should be well supported, but that is not the case, so what is going on? After a long period of limited supply, earnings blackouts, mutual fund inflows and volatility, liquidity should be plentiful. The abundant cash should be put to work in primary markets, but the opposite is true. Primary is struggling, which begs the question what is driving the recent weakness in credit markets? We currently see both secondary market spread widening and less demand in primary (in conjunction with higher new issue premiums and lower subscriptions levels). The answer to the question seems to be a combination of many smaller factors.

- **EUR credit is expensive.** EUR corporate spreads are trading in overbought territory, below the trading range we have outlined. EUR financials and USD corporates trade in the middle of their trading range, whereas USD financials actually trade wider than the range. EUR corporate spreads are looking very expensive compared to EUR financials, USD corporates and USD financials. Taking last week as a proxy, financial spreads tightened and much of

the primary market deals were met with a stronger appetite compared to corporates. High Yield has been under the most pressure, namely off the back of comments regarding the significant tightening of lending standards.

- ***Illiquid market resulted in a squeeze that primary is widening out to true levels.*** Credit (particularly EUR corporates) has been very illiquid over the past number of months, as the corporate sector purchase programme (CSPP) holds a large portion of the market and supply has been minimal. Therefore, investors are long on cash, as not too many bonds are available. This has resulted in secondary markets becoming too squeezed, and thus spreads do not reflect the true value of where spreads need to be. As such, primary markets will continue to drive secondary spreads by pushing secondary spreads wider to match the primary levels, which is the true place where substantial supply meets substantial demand.
- ***Are yield investors saturated or taking a breather?*** Thus far in 2023, it has been yield investors that have been driving credit markets. With the much higher yields being offered in credit, there was very strong inflows and decent demand. This recent weakness could be signalling a saturation, as rates have dropped from their peaks, resulting in less yield being offered. Therefore, we need to see a shift from yield buyers to spread buyers meaning a repricing is needed to create more value for spread investors.
- ***Concerns on the external environment.*** Risks and negative drivers still remain high, thus turbulence and volatility is expected. Concerns on inflation, recession around the corner and importantly tightening bank lending conditions will all weigh on credit. Tightening lending standards will have a negative credit effect. The feedback loop to credit spreads is evident and thus should be a negative driver for spreads. New issue premiums (NIPs) on newly issued bonds will increase and, ultimately, spreads will need to be priced wider long term. This will particularly be the case for the high yield market. This isn't necessarily driving spreads now but does add an additional negative factor in a secondary effect.
- ***More sector diversification and alpha driven investment.*** As economic background becomes more questionable, sector diversification has risen and becomes more important (certain sectors will see low demand in primary and secondary, for example autos).
- ***Certain sectors have created losses.*** The real estate sector continues to be under pressure, with spreads 60bp wider from 3 months ago, while the rest of the market is closer to 5bp wider. We continue to underweight the rates sensitive sector and expect a continuation of underperformance.
- ***The primary market is now fully based on windows of opportunity.*** The macro environment has become ever so important for credit and rates thus primary markets will remain closed during economic data publications, central bank meetings and holidays. Therefore, when an issuance window is open, there is a big rush of new deals, from corporates, financials and sovereigns, supranationals and agencies. Saturated primary markets therefore results in very heavy days of supply indigestion. It becomes too much for one day, rather than a pure lack of value.
- ***Lower demand for new issues.*** Furthermore, primary market tickets have not just reduced in size, but also have become fewer. This gives us a real bearish feel, as both liquidity is drying up and there is an active preference to not participate.
- ***CSPP is basically non-existent in credit.*** CSPP being tapered and ultimately ending fully in July, has left reinvestments very low, meaning no added buyer of credit. Reinvestments have been only around €1bn per month in April, May and June.
- ***Mutual funds flows have faltered over the past month.*** Mutual funds were negative again last week with outflows of 0.4% from EUR IG. This marks the third week of consecutive outflows. Flows on a year-to-date basis are still positive at 3.8% of AuM, and inflows are

very much skewed towards the belly of the curve, with the short end seeing outflows, in both EUR and USD.

- **Reverse Yankee supply is adding to the barrage.** Reverse Yankee supply was also plentiful last week, with €8bn issued. The calculation is now very favourable for a cost saving advantage for US issuers to bring a EUR bond to the market, namely on the back of USD spread underperformance versus EUR. There is roughly 10bp or so on average cost saving advantage on the 5yr and a substantial 45bp on the 10yr area. Deals included Booking, AT&T, Corning and American Tower. These deals were priced very much in line with the market, as stated above NIP is higher due to some supply indigestion. Reverse Yankee deals tend to offer a more attractive NIP, particularly when the cost saving advantage is decent. This adds to the barrage of EUR supply we are seeing, further adding supply indigestion pressure.

All in all we are still constructive on credit markets long term but we do feel a repricing in the short term is necessary as the dynamics of the market changes. We expect to see more turbulence and weakness in credit over the coming weeks. Moreover, we will continue to see days with very heavy supply indigestion. Credit remains much an alpha game, with sector and name selection being of utmost importance.

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