Where's the credit?

The Bund component now accounts for over 80% of credit yields! Is it time to sell credit?

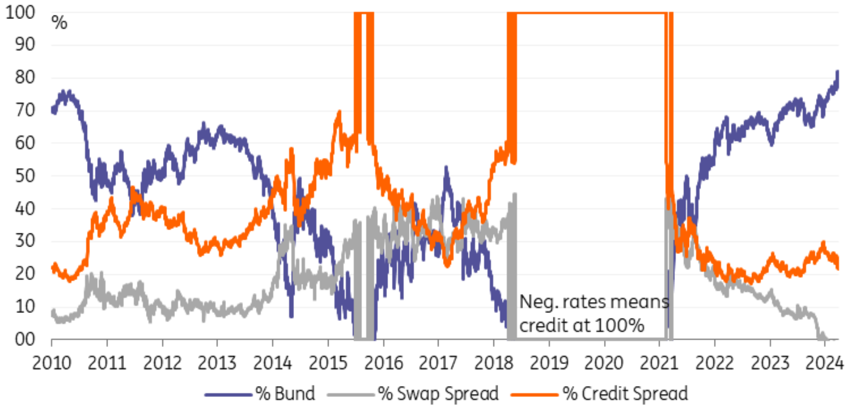
EUR IG credit continues to show relentless resilience, shrugging off nearly all negative sentiments and risks. While other markets see significant sell-offs, credit markets see a mere short-lived hiccup that promptly re-tightens. Spreads are still looking relatively tight, but there is nothing to drive them wider as the yield stays attractive and keeps the market very well bid. However, the changing rates and economic environment could finally be a reason for credit to be concerned.

When we look at the build-up of yield in the credit markets, we are surprised to see that the Bund is now accounting for over 80% of the yield in credit. This is a historically high percentage and leaves the credit spread component at very low levels. Credit spreads would need to widen from here in order to contain this.

These levels are only comparable to 2005-2007 when credit spreads were remarkably tight. The credit universe was of a different composition then, with the average rating being in the high single A area, versus the BBB average rating now. It's also noteworthy that this was just prior to the large market meltdown.

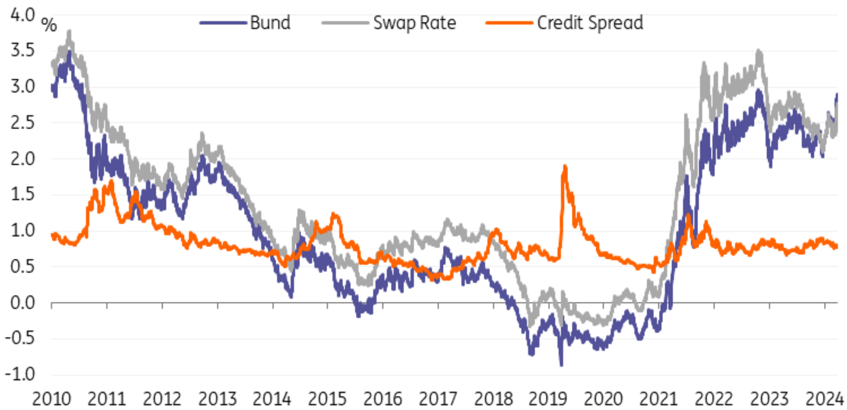
The rise in the Bund and subsequent rise in the Swap rate leaves the rate component as a significant part of the yield equation. The chart below illustrates how much of the credit yield on offer comes from the rates component versus the credit component.

The % build-up of Rate and Spread components of the Credit Yield



Source: ING, ICE, Refinitiv

Rate and Spread developments



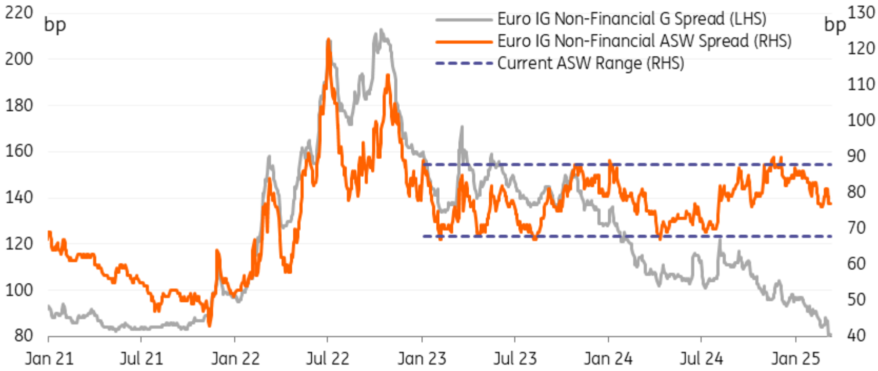
Source: ING, ICE, Refinitiv

Our rates strategists are discussing a scenario of the 10yr bund reaching 3.1% (from the current 2.9%) and the 10yr swap rate to follow up to 2.9% (from the current 2.77%).

The increasing Bund component could reach up to 85% assuming the credit spreads stay steady. In order to remain closer to nearly 80% of yield being the bund component, credit spreads would need to widen by 20-25bp from here. A 20-25bp would leave EUR IG corporate credit trading above the trading range.

As credit is currently benefitting from yield driving the large attraction, the credit spread remaining tight and becoming proportionately a small part of the yield equation could spark disinterest in credit. This could drive outflows from ETFs and mutual funds and result in lower demand for credit.

Spread developments and current trading range



Source: ING, ICE

Author

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com