The Great Compression

In the first of a monthly visual series to explore key themes in the credit markets, portfolio manager Ian Horn looks at where he sees the best value in credit spreads, the impact of shortening market duration, and how flows are moving back into credit products.

Key Takeaways

- Spread tightening in investment-grade (IG) and high-yield (HY) markets is expected to continue in a strong technical environment.
- Spreads in longer-duration credit look particularly tight.
- European credit spreads continue to look attractive compared to the US in both IG and HY.
- A combination of fading recession risk, sustained inflows to the asset class and the prospect of central bank rate cuts this year will likely see the recent theme of compression continuing, as investors again search for yield.

Credit Spreads: Best Value in Europe, Compression Continues

Spreads have tightened significantly since early 2022. In spread terms, European credit currently trades wide to US credit. While this premium has compressed since the middle of 2022, in our view it continues to look attractive, particularly in IG.

We have also seen a theme of compression in recent months. Spreads between IG and HY, BBBs and single As, and subordinated and senior bonds have all compressed. This has been driven by a search for yield as the fear of rate hikes appears behind us, and investors rotate back into credit.

Fig. 1 – US & European IG spreads

Source: ICE Data Platform, as of 29th February 2024. ICE BofA US Corporate Index (C0A0), ICE BofA Euro Corporate Index (ER00). Indices selected represented best proxy for the US IG and European IG markets. For illustrative purposes only.
Duration: Markets Have Shortened Significantly and Why it Matters

Market durations have shortened significantly in the past two years due to lower market prices and limited longer-dated issuance.

Concurrently, investors have looked for longer-dated bonds to extend their duration, in anticipation of central bank rate cuts.

This supply-demand imbalance has created a strong technical and driven outperformance in longer-dated credit.

In this segment, we prefer lower-beta names and less cyclical sectors, achieving the desired interest rate exposure, but in names and sectors that should outperform should this technical pressure abate.

**Fig. 2 – Shortening duration in US and European IG**

![Graph showing duration to worst in years for US and European IG](image)

Source: ICE Data Platform, as of 29th February 2024. ICE BofA US Corporate Index (C0A0), ICE BofA Euro Corporate Index (ER00). For illustrative purposes only.

**Fig. 3 - Outperformance of longer-duration spreads in US and Europe**

![Graph showing spread to worst change in bps for US and European IG](image)

Source: ICE Data Platform, as of 29th February 2024. ICE BofA US Corporate Index (C0A0), ICE BofA Euro Corporate Index (ER00). For illustrative purposes only.
Duration: What Has Been the Impact on Spread Curves?

This outperformance in longer-dated spreads has caused spread curves to currently be ‘humped’. As a result, we are not always seeing more compensation, in terms of credit spreads, for the additional risks in longer-dated bonds.

Fig. 4 - Credit spread curves are currently ‘humped’, making longer-dated spreads look particularly tight

Economy: Are Recession Risks Fading?

Supported by resilient economic data and a strong labour market, many in the market see the risk of a recession in the US declining.

Monetary policy loosening in an improving or stable macroeconomic environment should be positive for risk assets, including credit. The prospect of a goldilocks scenario for the US still seems intact - strong economic growth, steady disinflation, low and resilient unemployment, and looser monetary policy in late 2024.

Fig. 5 - Recession looking less likely in US

Sources - Bloomberg – United States Recession Probability Forecast (ECRPUS 1Y Index). Displays the median forecast probability of recession. These are derived from the latest monthly & quarterly surveys conducted by Bloomberg and from forecasts submitted by various banks, as of 29th February 2024. For illustrative purposes only.
Flows: A Structural Rotation Back into Credit?

Flows into European government bond funds have slowed since the rally in November and December 2023 as investors rotated back into credit. This has been most visible in European HY but is also the case in European IG.

A lack of primary issuance coupled with strong inflows is providing a strong technical environment in European credit, particularly in HY. We expect this to continue, as the appeal of government bonds fades and corporate fundamentals remain sound.

Fig. 6 - Sharp reversal in European HY fund flows

Source: European Fund Flows, Citi Research. Data as of 9th August 2023 to 28th February 2024. Flows and AuMs include mutual funds and ETFs. Last datapoint of weekly flow numbers is a rolling 1-week flow from daily fund flows. For illustrative purposes only.

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**Index Descriptions**

**COA0** - The ICE BofA US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody’s, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

**ER00** - The ICE BofA ML Euro Corporate Index tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets. Qualifying securities must have an investment grade rating (based on an average of Moody’s, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

**ECRPU5 1Y** - Displays the median forecast probability of recession. These are derived from the latest monthly & quarterly surveys conducted by Bloomberg and from forecasts submitted by various banks. Starting in February 2022, Bloomberg requests that contributors provide quarterly forecasts with quarterly averages, instead of end-of-period forecasts. Yearly forecasts have always been yearly average, instead of end-of-period forecasts.

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