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4 February 2016

Credit market monthly review

Saved by the bell in January. HY to rebound vs IG in February?

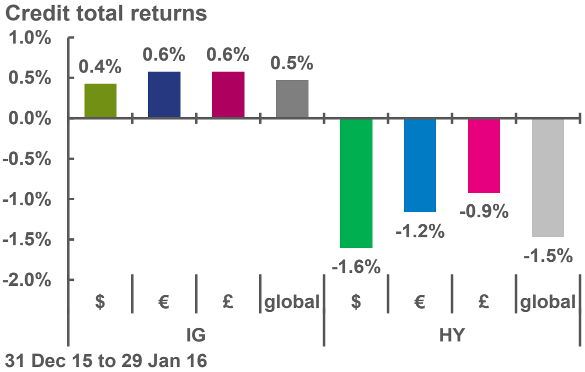
After a poor initial start to 2016, a strong finish to the month has helped global credit squeeze out +12bps of total return in January. It was investment grade (IG) credit that kept global credit afloat with +0.5% in January, while high yield (HY) managed to pare its losses to 'only' -1.5% (from as low as -3.3% on 20 January, *Exhibits 1-2*). The positive IG returns came thanks to the decline in rates, which more than offset the spread widening to push IG credit yields lower (*Exhibits 3-4*). In terms of seasonality, HY credit undershot its positive historical average January returns by a big margin, while European IG managed to match its historical average performance.

Looking ahead, we think that credit is overdue a month of decent returns, but headwinds remain aplenty:

- Concerns about China's growth and capital outflows remain front and centre. A decline in Chinese risk premia volatility is an important factor towards a more constructive backdrop for risk.
- The combination of US macro and Fed policy remains in a delicate landscape to balance. If the worse of the deterioration in manufacturing data is behind us, markets may start fretting about a March Fed hike. If US macro data continues to weaken without the Fed softening its language/stance, markets may get (even more) anxious about a Fed policy mistake.
- We need to see a stabilisation, at a minimum, in the oil price. While headlines about a cooperation between Saudi Arabia and Russia towards a production reduction are likely to remain just that, the fact that the conviction of speculative oil shorts may be shaken, could underpin oil prices to some extent.
- Ongoing selling by sovereign wealth funds (SWF), and into market strength in particular, is bound to persist, acting as a continuous headwind to risky asset performance.
- On the positive side, the broader dovish turn by central banks – Carney/BoE, Draghi/ECB and Kuroda/BoJ in order of appearance – could herald a return of carry trades and that should also benefit credit assets ('all you need is dove').
- Supply can weigh on spread performance either way. As it dried out in mid/late January, the lack of credit paper aided cash credit spread performance. Conversely, improved market conditions will elicit more issuance and hinder spread tightening. A saving grace in European credit is that as we move into February, the blackout-periods due to earnings season are only beginning.
- As for deciding a preference between IG and HY, it is a subtle affair. A significant spread decompression has taken place driving HY/IG spread ratios towards multi-year highs or in the case of US HY towards fresh highs. As a result, some spread compression (ie HY to outperform IG) in the near term appears quite a compelling proposition, from a 'trade entry point' perspective. On the other hand, if the flattening in govie curves continues (the UST 2-10s is now back to its late 2007 levels), investors may be encouraged to extend duration. In addition, any renewed weakness in the oil price can always hurt HY more than IG.
- Overall, we think that the spread compression factor will prevail and HY will manage to recoup in February some of its recent (think last three months) underperformance vs IG, albeit not with excessive conviction. Worth noting that HY flows have shown some tentative signs of improvement in the last couple of weeks – turning positive in the US and becoming less negative in Europe.
- From a seasonality perspective, February tends to be a month of positive albeit volatile returns (high standard deviation around the mean) as we see in *Exhibit 5*.

Exhibit 1

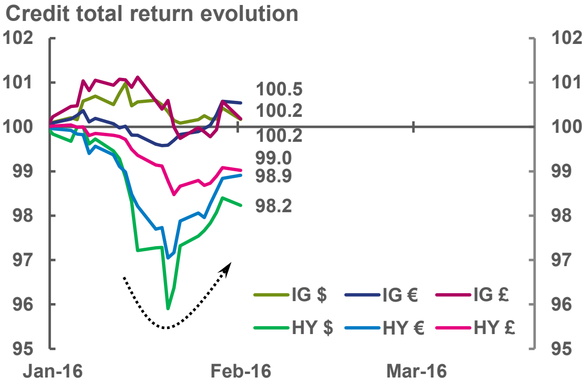
DM credit markets total returns – January



Source: BAML and AXA IM Research

Exhibit 2

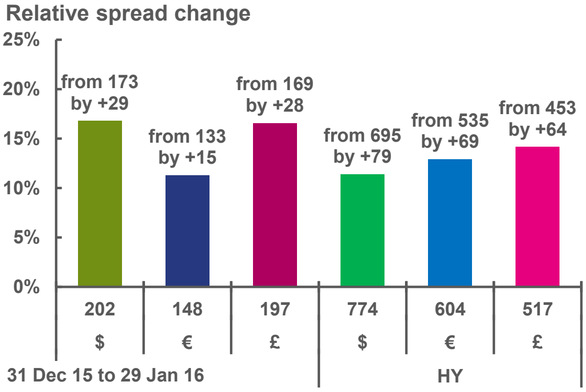
DM credit markets total return evolution – January



Source: BAML and AXA IM Research

Exhibit 3

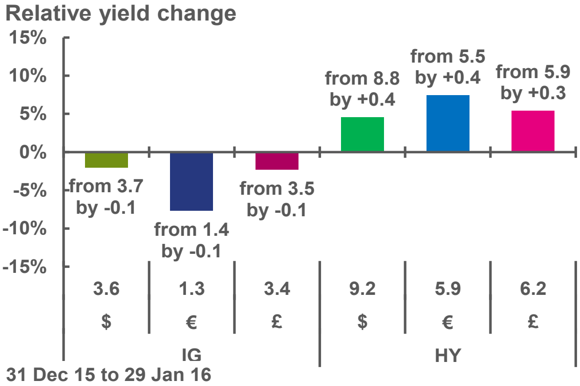
DM credit markets spread performance – January



Source: BAML and AXA IM Research

Exhibit 4

DM credit markets yield performance – January

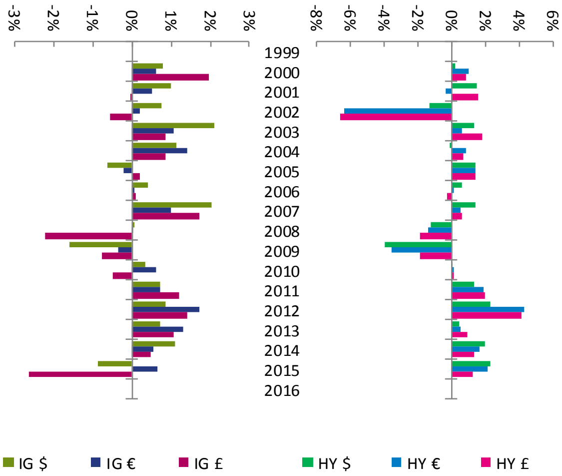


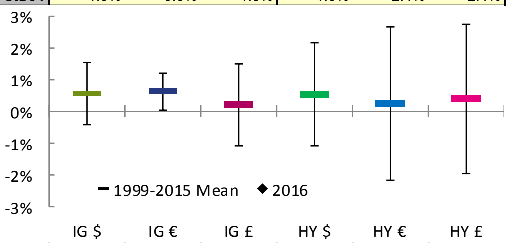
Source: BAML and AXA IM Research

Exhibit 5

Credit total return seasonals – February

Feb	Total Return					
	IG $	IG €	IG £	HY $	HY €	HY £
1999	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
2000	0.8%	0.6%	2.0%	0.2%	1.0%	0.8%
2001	1.0%	0.5%	0.0%	1.5%	-0.4%	1.6%
2002	0.8%	0.2%	-0.6%	-1.3%	-6.3%	-6.6%
2003	2.1%	1.1%	0.9%	1.3%	0.6%	1.8%
2004	1.1%	1.4%	0.9%	-0.1%	0.9%	0.7%
2005	-0.6%	-0.2%	0.2%	1.4%	1.4%	1.4%
2006	0.4%	0.1%	0.1%	0.6%	0.2%	-0.3%
2007	2.0%	1.0%	1.7%	1.4%	0.5%	0.6%
2008	0.1%	0.0%	-2.2%	-1.2%	-1.3%	-1.8%
2009	-1.6%	-0.3%	-0.8%	-3.9%	-3.6%	-1.8%
2010	0.3%	0.6%	-0.5%	0.1%	0.2%	0.1%
2011	0.7%	0.7%	1.2%	1.3%	1.9%	2.0%
2012	0.8%	1.7%	1.4%	2.3%	4.3%	4.1%
2013	0.7%	1.3%	1.1%	0.5%	0.5%	1.0%
2014	1.1%	0.5%	0.5%	2.0%	1.7%	1.4%
2015	-0.9%	0.6%	-2.6%	2.3%	2.1%	1.3%
2016	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Gain	13 of 16	14 of 16	10 of 16	12 of 16	12 of 16	12 of 16
Loss	3 of 16	2 of 16	6 of 16	4 of 16	4 of 16	4 of 16
1999-2015 Mean	0.6%	0.6%	0.2%	0.5%	0.2%	0.4%
StDev	1.0%	0.6%	1.3%	1.6%	2.4%	2.4%





Feb seasonals: February tends to be a month of positive albeit volatile returns (high standard deviation around the mean).

Source: Bloomberg and AXA IM Research

Our Research is available on line: **http://www.axa-im.com/en/research**

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