This is an excerpt of Outlook Update: Credit Looks Cheap But Macro Risks Keep Building, published on September 4, 2018.

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Back-to-school report on US and European credit

Authors
Jim Reid
+44(20)754-72943
jim.reid@db.com

Craig Nicol
+44(20)754-57601
craig.nicol@db.com

Nick Burns
+44(20)754-71970
nick.burns@db.com

Michal Jezek
+44(20)754-55012
michal.jezek@db.com

It remains a macro world for credit, with no real concerns of a fundamental nature within the corporate bond universe. The problem is that the macro world has become increasingly complicated this year. At the start of 2018, when markets were extraordinarily becalmed, we did feel that 2018 would see the return of volatility and that credit spreads would widen in sympathy. The reality is that 2018 has certainly deviated from our roadmap even if spreads have migrated to roughly where we thought they would be at this stage of the year.

That there have been more macro shocks was relatively easy to predict given where we are in a central bank tightening cycle after such a long period of astonishingly easy money. However, these shocks (e.g. early Feb VIX spike, trade war dispute, Italian political crisis and more recently Turkey) have not really had a sustainable impact on the measures of volatility that typically drive credit spreads, but they have repeatedly led to bond market rallies on a safe-haven bid. So our view of more spikes in volatility has held back our view of higher rates – and it does make us wonder whether the two can co-exist at the moment; i.e. can we get higher yields if we have more 'events'?

Equity volatility is only a touch higher than where it started 2018 and bond volatility has barely moved out of its rock-bottom all-time-low range this year, especially in Europe. Even in the US, where we saw an early year yield spike, bond volatility is getting back closer to its December 2017 all-time lows again.

The dilemma we now have is that although our view on spreads this year has been correct and we think volatility spikes will continue, we need to acknowledge that spreads are now cheap relative to fair value based on our volatility models (outside of US HY). It also feels like the non-consensus trade would be to recommend a tactical overweight.

The reason we can't recommend an overweight, though, is that we still think there are plenty of macro landmines out there going into the end of 2018 that could again increase volatility. For the remainder of 2018, markets will likely continue to be in the crosswinds of strong US growth and decent earnings on one hand and macro risks remaining elevated on the other. We are unlikely to have seen the last of negative Turkey newsflow, are likely to see tensions rise as the Italian budget negotiations reach the crucial stage later this month, still have the trade war to contend with as we approach US mid-term elections, and will likely see a Fed that raises rates twice before the year end and an ECB that is likely to end QE purchases by then. If that's not enough, we should have a better idea of the direction of Brexit by year end – and even if we eventually see a softer Brexit than might have been feared several months ago, negotiations may be fraught at first, and as we get closer to crunch time the risk of the no-deal scenario may start to be more priced in to certain risk markets. **Net net, given that spreads already discount some of these elements, we think credit will widen only slightly more** into year-end even if our macro thesis plays out.

Perhaps unsurprisingly, shorter-duration HY with cash flows linked to still-decent economic growth has outperformed longer-duration IG with greater exposures to global trade. While we understand the rationale, those moves look overdone, esp. in the USD, and we thus **prefer IG over HY in both the EUR and USD space**. In relative terms, we see **more value in EUR over USD IG**. In Europe, monetary conditions will stay accommodative for some time, with negative front-end rates keeping captive demand for higher-quality IG paper. In the US, as the Fed keeps hiking and corporates continue with heavy stock buybacks and the M&A spree goes on, conditions for IG product may be less friendly. EUR IG has underperformed this year due to domestic risks that might subside somewhat by year end, further supporting our views despite short-term MtM risks due to politics. Also, cross-currency considerations would favour EUR paper more.

In both Europe and the US we continue to favour loans, and would arguably

- Our latest forecasts of USD, EUR and GBP credit spreads
- Macro overview
- IG & HY valuations
- Thoughts on the ECB QE/CSPP taper

We also provide a summary of key events and risks for credit into the year end, including Brexit, trade war, Italy, the US mid-term elections, and emerging markets.

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reinforce this view following the summer spread rally for HY bonds and our expectations for wider spreads over the remainder of the year. In general the relationship between loans and bonds has been maintained, particularly as bonds outperformed through July as spreads generally tightened. Much of H1 saw outperformance from loans as spreads widened, particularly in Europe. Our rationale for further loan outperformance is based on our expectation of further modest widening in credit spreads and higher volatility through the remainder of the year, but at the same time we expect the macro fundamentals to remain fairly robust. We still see this as a relatively "goldilocks" scenario for loans.
Our back-to-school note is organised as follows: