Daily Note

WHERE ARE WE IN THE CREDIT CYCLE?

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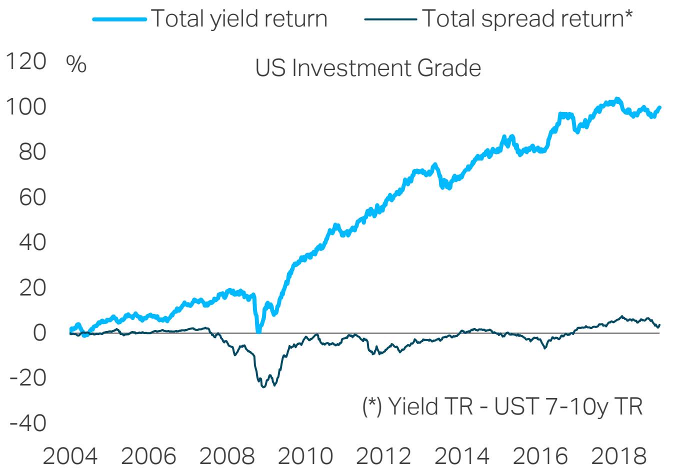
- **Timing the cycle is paramount to producing good credit returns**
- **Our credit cycle framework indicates we are in the 'slowdown' stage**
- **This is when returns for credit investors tend to be the worst**

Credit: an asset class for all seasons? Corporate credit is a remarkable asset class, and one that is too often overlooked by investors. Corporate bonds provide exposure to both interest rates and the corporate sector and, as such, are extraordinarily resilient to market and economic swings. Chart 1 shows total returns for US investment grade over the last 15 years. Even during the global financial crisis (GFC) IG's drawdown was only 17%, compared to the 57% of the S&P 500. And it only took 15 months from the trough for the asset class to stage a full recovery.

Low vol means high risk-adjusted yield returns for credit. Since 2004 IG had average annual returns of 4.7%, which pales in comparison to the 8.2% stocks enjoyed. But credit delivered those returns with less than 5% annual volatility, vs 16.7% for equities. As a result, bonds' Sharpe ratio was nearly 1 – about twice as high as equities. Even Treasuries were more volatile than corporate bonds, with the 7-10y sector producing 4.5% annualised returns with 6.1% vol.

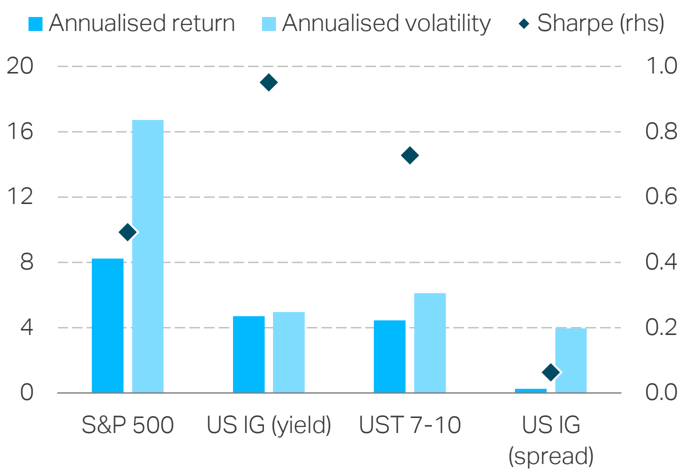
Timing the credit cycle is key for spread investors. Investors who only gain exposure to credit spreads, however, have enjoyed significantly lower returns. As chart 2 shows, the annualised return in the past 15 years has been a measly 0.25%, associated with 3.9% vol. Excluding the GFC things look a bit better, with 2.9% annualised returns and a Sharpe of 0.75. But during this period stocks did better too, with average returns of 13.4% and a Sharpe of 0.86. This suggests that timing the credit cycle is of paramount importance for credit investors to generate alpha – especially so now that funding costs in the US are no longer negligible

Chart 1: Credit resilience in action



Source: Bloomberg, TS Lombard

Chart 2: Last 15 years' relative performance



Source: Bloomberg, TS Lombard

Credit cycle past its peak. We've been arguing since at least last June that the best days for credit are behind us. We have therefore reduced our exposure to credit in Asset Allocation from a 4% overweight position a year ago to 11% underweight now. Why? The market provides the first clue – the consistent underperformance of credit spread vs stock prices. US equities peaked last October, while IG spreads bottomed in February and never recovered. HY peaked at the same time as equities, but junk bonds prices, just like IG, have fallen more than the recent relationship with stocks suggests they should have. This was due to increased volatility transferring value from bond- to equity-holders.

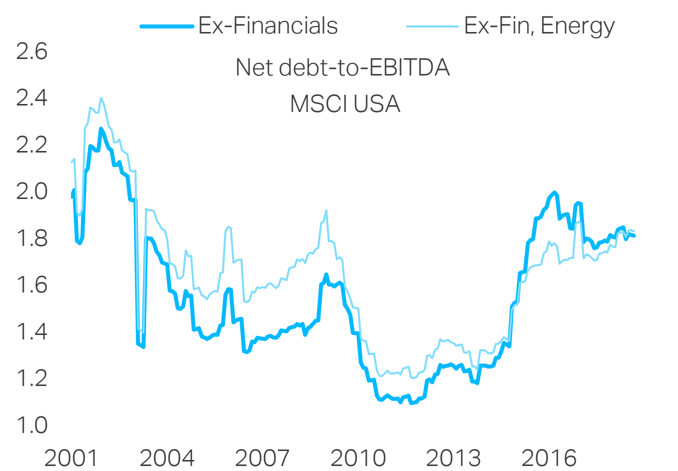
Leverage remains high. Another worrying sign for credit is the level of indebtedness in the corporate sector, something that Fed Chair Jay Powell singled out as his main concern with regard to financial stability. Leverage has mostly stabilised in the past 2-3 years (chart 3), and is manageable for now. Positive rating trends show that there is no immediate concern about IG credit quality, but in HY these have turned sharply negative again, with already 72 downgrades this year by the three main rating agencies vs only 28 upgrades. Cyclically-high leverage makes corporates vulnerable to possible downswings in earnings.

Capital outflows. As a result of all this investors have been taking money out of the credit sector for some time. Leverage loans ETFs have experienced smaller outflows than IG and HY, as investors followed issuance that shifted from junk bonds to the loan market – a typical late-cycle dynamic. But those too have now started to see significant redemptions.

A robust framework to monitor the credit cycle. While all the signs of a fast-aging credit cycle are clearly visible, we have built a framework that allows us to assess its maturity in a more robust and measurable way. We have looked at indicators in four broad categories – macro, financial conditions, risk appetite and leverage – for a total of 14 different measures (though this number is likely to grow) over the course of a typical cycle (7½ years).

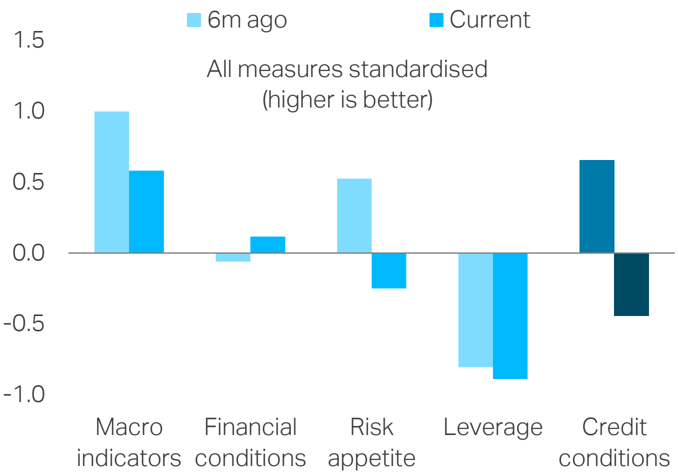
Credit cycle in the 'slowdown' stage. We found that macro indicators are still above trend but decelerating rapidly; financial conditions are on trend and getting slightly easier; risk appetite is below average and falling sharply; and leverage is high but stable (chart 4). The bottom line is that the cycle is in the 'slowdown' stage, with overall credit conditions somewhat below trend and rapidly getting worse. This is the stage of the cycle that is likely to deliver the worst credit returns. The 'recovery' stage (below-trend but improving credit conditions) should come next, bringing the highest credit returns in the cycle. But this still seems a long way away.

Chart 3: Leverage cyclically high but stable



Source: MSCI, Bloomberg, TS Lombard

Chart 4: Credit cycle in the 'slowdown' stage



Source: Various sources, TS Lombard