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Optimising total return with short duration in euro credit markets

Boutaina Deixonne, Head of Euro IG & HY Credit recently talked to French media, Quantalys

Read below their discussion on the euro market conditions and why Boutaina believes in this environment an active, total return approach may help find opportunities.

Where are we are on market conditions after this retracement?

In 2022, central banks, whether in Europe or the United States, began to raise rates and we were expecting to have a rather gentle and gradual rise in rates. In fact, we ended up in 2022 with a rise that was abrupt and very aggressive on the part of central banks.

So this means that in 2022, we had a very complicated year in terms of returns for the asset class, but today, we find ourselves with very attractive returns. For example, the investment grade (IG) market offers a return of 3.6% while the high yield (HY) market offers a return of almost 6%[1]. We have not seen these yields for over ten years, even though the fundamentals of some of these issuers are very solid and resilient.

If we look at the credit spread or credit premium, the situation is a little different. This is because we have seen very significant tightening of these credit spreads over the last twelve or so months. Even after the recent volatility pushing spreads wider in early August, the IG market offers an average asset swap spread just in line with the 10Y historical average, while the high yield is even slightly tighter vs. the 10Y historical average.

That's why at AXA IM we believe that active, conviction-based management, is important when seeking the best opportunities. Therefore, we aim to have a stable process which will allow us to determine whether it is the time to invest or not. It allows us to ask questions such as:

- Is this the time to increase the risk or reduce the risk?
- What are the sectors on which we want to rely? Sectors on which we want to be underweighted.
- And then, within the sector itself, what are the names that we are comfortable with given the relative value? And then the names that we would like to discard.

What are the elements that can disrupt or improve this market for the coming months?

Central banks and their monetary policies are the obvious ones that can influence markets in the coming months, particularly in the US where recent macroeconomic data has been confusing and contradictory leading to concerns that the Federal Reserve has made a mistake keeping rates too high for a long time. For now, we maintain our expectations for 25bps rate cut in both September and December. But there are also elections and we have already seen this volatility through the election in France. The next big one is the US which is likely to add a little bit of volatility. Earnings will be also monitored by market participants. Indeed, the initial wave of Q2 results season has been mixed from consumer discretionary industries (Consumer Goods, Airlines) but also from sectors exposed to China such as Automotive and Luxury. We expect to enter a cycle that may be less promising, which could have an impact on cyclical sectors. As a result, we think it is important to be agile and have a flexible investment management approach with the aim of taking advantage of opportunities and mitigating losses.

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[1] Source: AXA IM, Bloomberg as of 31st July 2024

If we focus on the primary market because it is a bit like the thermometer of the credit market. Where do we stand? Is it still dynamic?

It's a very strong market. In 2023, we had almost € 600 billion of issuance between financial and non-financial issuers which was completely absorbed by market participants. This trend is continuing in 2024. Today, we have almost € 430 billion issued. These are huge amounts in the Euro Credit market across all sectors - even in the real estate sector, which was a bit shunned last year. Real estate issuers are now able to issue across all seniorities.

Whether it is senior debt, subordinated debt, perpetual debt or the famous AT1, we have a very dynamic market. There are also a lot of US issuers coming to take advantage of the buoyant environment in the European market. So, it's a very dynamic, very healthy market that's functioning well and therefore liquidity conditions are extremely good. But again, having flexibility, analysing companies, means that we don't invest in everything. There are companies that we are positive on, that we go into with spread levels in mind or with yield levels in mind, and then there are other companies where we have to be careful. We think it is important to be selective.

And when we talk about a Total Return Bond strategy on credit, what performance drivers are we talking about?

At AXA IM, we have a total return strategy that has seen strong inflows in recent quarters and months. It aims to provide investors with flexibility, diversification and liquidity, while taking a simple, vanilla approach. For example, we don't invest in fund of funds or securitised assets.

The main performance driver is our ability to allocate between investment grade and high yield. While it must remain an investment grade strategy, it can go up to 50% in high yield. This allows us to seek attractive yields while remaining an investment grade strategy. We also use derivatives, such as futures, to manage duration or credit derivatives to adjust credit beta.

Duration is also one of its key performance drivers. With a range of -2 to +6, the investment team has a lot of flexibility to adjust the duration according to our convictions.

In conclusion, can we look at short duration because for a long time it was not necessarily very interesting. Why is it interesting today?

Some investors are interested in having a barbell strategy - a total return strategy that is very flexible and then a strategy that is very defensive. Four years ago, we wouldn't have talked about short duration. But today, with the inversion of the curves, with this normalisation of rates, we have a return on the short end of the credit curve that is almost equivalent to all-maturity index, but with volatility that will be almost half as high. So, it's really something quite new and attractive that we have today.

So we are taking advantage of this aberration to be able to play this short segment as well.

Exactly. And in that part, we may benefit more from the secondary market than the primary market, but it makes perfect sense because it's still a liquid market with interesting financial conditions.

Source: AXA IM, Quantalys as of June 2024. Updated 9th August 2024

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