European Junk Yields Lining Up With Treasuries

Would you buy risky corporate bonds whose return is slightly higher than one of the safest securities in the world, US T-Bills? Probably not. Nonetheless, the market seems to accept this. The question is: how long will it last? We believe this situation will not persist in the long run and for this reason we propose a strategy betting that the spread between "High-Yield" European corporate bonds and US T-Bills will increase.

While the US have managed to fully recover from the Great Recession, the EU economy is still stagnating in several sectors. Therefore, the two central banks are adopting different measures.

Treasury Bills and Fed Hawkish policy

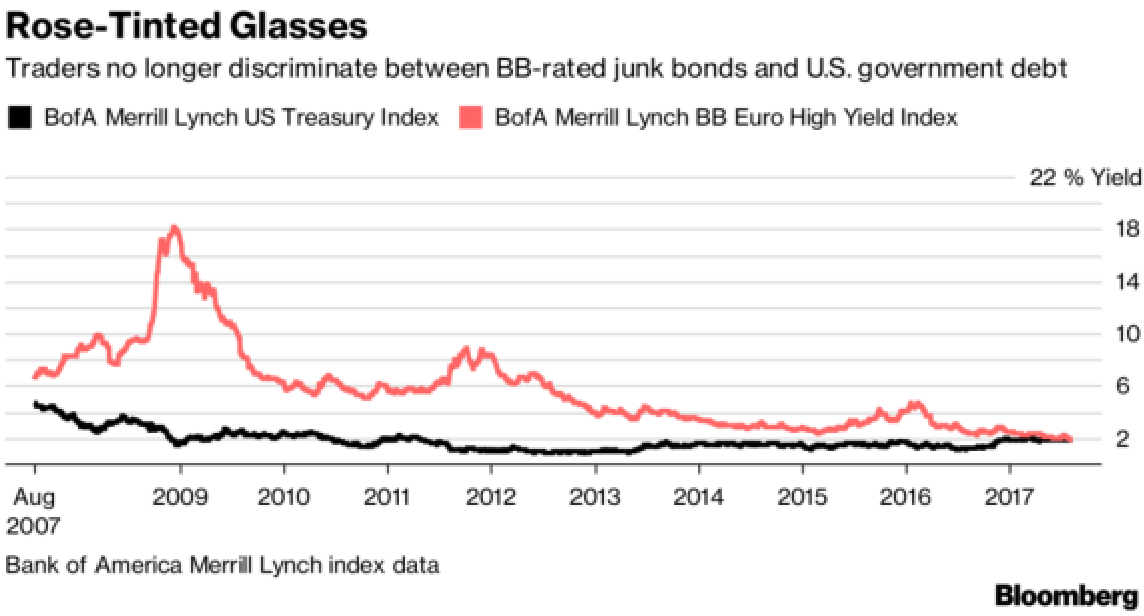
In 2017, after clear signs that the economy had been improving, the Federal Reserve, through its Federal Open Market Committee (FOMC), increased the federal funds rate twice (in March and in June) to a current range of 1% - 1.25%. This decision followed a long period of accommodative policy, which is still being adopted, although less intensively. The Fed's objective is to keep inflation at about 2% in the medium term and, consequently, it hopes to both stimulate employment and economic growth, albeit at a slower pace than before. Monetary policy decisions clearly have indirect effects on the interest rates of all securities, bringing the BofA Merrill Lynch Treasury Index to a level of around 2%.

European High Yields and QE

On the other side, the European Union has not fully recovered yet. More precisely, ECB's inflation target of 2% is still far away and the Quantitative Easing program, which aims at injecting further liquidity into the system, is being intensively implemented. One of the mechanisms that the ECB adopted to increase liquidity and support inflation is the Asset Purchasing Programme, which includes the Corporate Sector Purchase Programme (CSPP). The CSPP consists in massive purchases of corporate bonds in the Euro Area, with some limitations. For example, the minimum rating of the bonds that are purchased must be, at least, BBB-/Baa3/BBBL. This means that most of purchased bonds are "investment grade"; does this mean that junk bonds (rated below BBB, a term by which we usually refer to High Yields) are not affected by the CSPP? Not at all, as many investors seeking higher returns bought "High-Yield" bonds, whose yield to maturity consequently fell, whereas this is the mechanism by which ECB wanted to reduce the overall market perception of risk. In fact, investors continue to move down along the quality curve in the search for yield and returns. This credit compression trade continues to perform as corporate bond demand & supply dynamics remain intact. It is important to point out that the default rate for "High-Yield" bonds is slightly above 2%, according to Moody's, which is in line with the long-term average. Therefore, the lower yield is not justified by lower default risk, but just by a higher demand of these securities.

EU High Yields vs T-Bills

These two parallel trends led to the convergence of the yield to maturity of T-Bills and "High-Yield" bonds. If we look at historical data, this spread seems to reflect only the artificial conditions created by the two central banks, but is not justified by fundamentals. For this reason, in the following section we will explain how to exploit this apparently irrational market behavior.



(Source: Bloomberg.com)

How profit from a future divergence

In order to exploit this irrational situation in which Treasury Bills rated (AAA) are cheaper than junk bonds rated below (BBB), along with US 10Y Benchmark that are also close from being cheaper than junk bonds, the investor should build up a trading strategy that can speculate on the expected future widening of the spread among these assets. This goal may be reached by many different strategies, among which, in our point of view, the easiest and most efficient one is the following: going long on a Euro denominated ETF indexing Treasury Bills or indexing a 10-Year US Benchmark and going short an ETF on High Yield European bonds.

Balancing the weights of the two assets in order to have the same exposure to a respective change of 1bp in the two markets. Indeed, we are not interested in the absolute behavior of the two markets, but rather in the spread between the two securities and our gains will be only due to its widening, realizing an example of the so-called pair trading. Choosing between T-bills and the 10-Year Benchmark is a question of betting also on the future of the US curve slope; in particular, we believe that it is unlikely to witness a steepening of the curve in the future, due to the strong sensibility of its short end side to the monetary policy that is pushing it up, and the sensibility of its long end side to the economic expectations that, considering the difficulties of the Trump administration in adopting the tax reform, it will remain stable.

Therefore, considering that we are betting on the widening of the spread between European junk bonds and US bonds, it is irrelevant to use the long or the short end of the curve, in view of our forecast of no big changes. Contrarily, if the prediction was a steepening in the slope, it would have been better to use the short end, at the opposite with an extreme flattening the long end.

By a Euro denominated ETF we are getting rid of the exchange risk of holding USD, otherwise this strategy could be implemented by directly buying US bonds in USD and hedging the exchange risk by going short on a future on USD or buying a put option if we want to keep the upside potential.