Are we entering the zone of oversold credit?

With the Aperture Investors SICAV - Credit Opportunities Fund reaching its three year anniversary this August, Simon Thorp looks ahead and explains why long credit stands out in the current environment.

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Has corporate credit been oversold?

We may not have quite reached the moment when credit is "glaringly" cheap, but it does feel as though we have entered the "zone.

US markets are relatively simple: inflation or recession? Find yourself on the right side of that debate and one can anticipate the Federal Reserve's likely action with relative confidence. Equity, credit and rates market moves should then be fairly predictable.

The market is keen to read any macro weakness as an excuse for the Federal Reserve to pivot on their rate hike path. However we don't think this is likely. Macro data remains relatively robust, so the Fed will be determined to get rates up, which markets have priced in. While the economy is no doubt slowing, we think the US will avoid a deep recession for these reasons.

Europe has the same dilemma but with added complexities: Russian gas supplies, broader effects of the war and concerns over peripheral debt as growth slows and the ECB readies its "anti-fragmentation tool."

Emerging markets (EM) have had the most challenging time over the past 12 months. However, some markets, like Chinese property, are showing signs of bottoming out so we could be surprised by outperformance in EM assuming one is able to select the right countries and credits.

Currently, our base case is to remain defensive but to start selectively adding credit risk as we believe markets are oversold in any outcome other than an outright recession. Current levels in US and European HY indices are pricing in forward default rates of 7-9% on average over the next 5 years. This feels aggressive. We believe pockets of value may be found in:

1. Short duration, hard maturity BB and B bonds
2. Weak BBBs and strong BBs in defensive
   sectors that have been sold off too far in the general panic
3. Select HY credits that trade in the 60-75 basis points price region where our fundamental research leads us to believe that the likelihood of default is minimal

Are you favouring short or long credit in this environment?

More volatility has led to greater spread dispersion, and most of the "easy money" has now been made from the shorts as the market did a good job repricing vulnerable credit in Q2. One exception is the energy sector, which is particularly vulnerable as growth slows and the oil price potentially weakens. As one of the most crowded H1 2022 long sectors, we think prices could sell off. With the outperformance of equities over credit we also favour equity hedges (via futures and OTM put options) as a convex way of hedging credit risk.

This environment is very macro driven – if the economy weakens, then some of the better risk-adjusted shorts will likely be found in crossover bonds and weaker BBBs as talk of fallen angels (investment grade to "junk" status) will rise.

Long credit is becoming much more interesting and we're finding areas with positive convexity for the first time this year. We particularly like defensive sectors like TMT, healthcare and gaming. Many investors have been forced to sell these names because of redemptions so there are some good quality credits yielding double digits. We're implementing a barbell strategy to balance lower and higher rated credit risk. Although we may have to live with some volatility, we think now is the time to increase exposure to good quality names that are oversold.

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How is the Aperture Investors SICAV - Credit Opportunities Fund positioned for the second half of the year?

We expect less volatility and for spread dispersion to remain wide. On balance, we think that this period will see positive returns for credit, and we marginally favour US credit over European and IG/higher quality over HY and weaker names. It may be that markets sell off in the usually weak September/October period as investors peer into the murky gloom of 2023 and do not like what they see. But any further weakness from here should be regarded as a buying opportunity as credit markets are already priced for extremely bearish outcomes.

The current environment is very macro-driven, so we're putting less focus on event-driven or even special situations credit and prioritising long credit. We have a large relative value book that aims to mirror market trends while capturing mispriced opportunities. One specific theme in the portfolio is based on the end of ECB bond-buying. We also want to be prepared for market rallies, so we have increased long exposure to liquid derivative indices.

We're keeping a close eye on Japan in the event that inflation becomes more entrenched, which could shake markets up. So we have a few tail risk hedges on that theme.

As we enter the second half of 2022, we remain confident that the fund has access to the fullest spectrum of fixed income instruments, across longs and shorts, to deliver attractive risk-adjusted returns for our investors, regardless of the market environment. The focus as ever is on capturing alpha. Market dispersion and volatility have created plenty of opportunities in that regard from which we aim to benefit on behalf of our investors.