This report has been prepared for the sole use of Peter Holmes on 08/04/2022

Favouring IG Credit over Equities

A new strategy, taking advantage of high IG vol relative to VIX

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Has Credit been 'sending a message' to Equities?

Some commentators observe High Yield returns lagging well behind Equities this year and see a major mismatch. However, this in itself is not a great argument for preferring Credit; HY *excess* returns have not been way out of line with equities.

A case for favouring Investment Grade over Equities, however

Recent Asset Allocation Quarterly contained preference for Investment Grade over Equities. The case for US IG spreads to widen more near-term doesn't look strong. And UST are stretched technically, so duration hit to IG returns may reverse in Q2.

Recommending LQD/SPY option strategy

If we turn out to be too sanguine on IG, the causes are likely to be negative for equities as well from this point. With IG implied volatility at a high historical level vs. equity vol, our idea is to sell LQD July puts to fund the purchase of SPY puts.

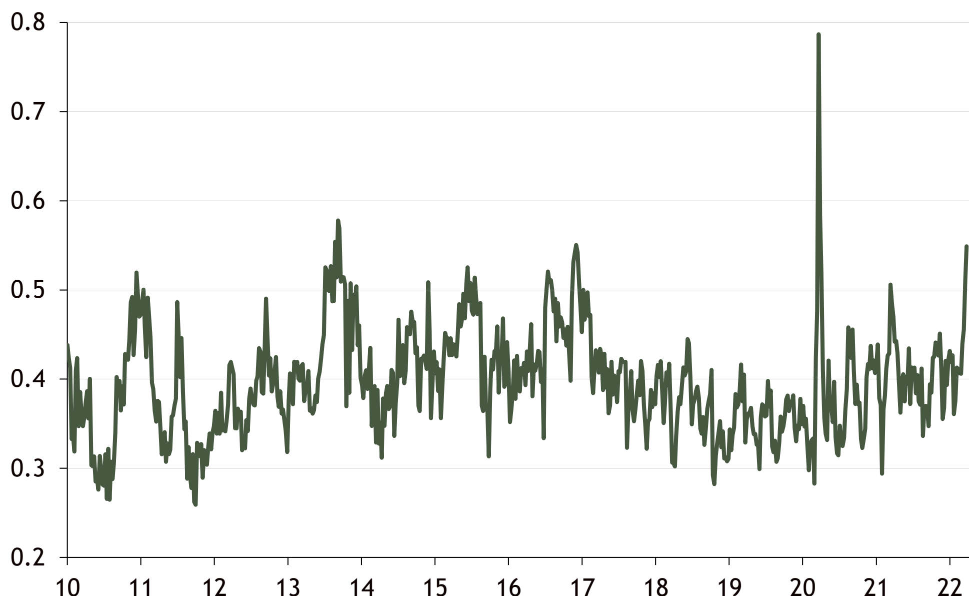
RELATED RESEARCH:

"Multi-Asset themes & trade recommendations", Multi-Asset Weekly 12th January 2022

"Volatility & sentiment in the Robinhood era", Multi-Asset Weekly 3rd February 2021

"We downgrade equities on increased risks to growth", Asset Allocation 17th March 2022

Key chart: US Investment Grade implied vol is high relative to Equity vol



Source: ASR Ltd. / Bloomberg

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Favouring IG Credit over Equities

We introduce a new recommendation using options, looking to take advantage of high US IG corporate bond ETF implied volatility relative to S&P 500 implied vol.

Revisiting our Credit vs. Equities stance

Our preference for Equities over Credit carried over from 2021 into early 2022…

At the start of the year ("Multi-Asset themes & trade recommendations") we expressed our Asset Allocation preference (at that time) for Equities over Credit in an absolute return context, recommending the sale of June puts on SPY (SPDR S&P 500 ETF Trust) to fund the purchase of June puts on HYG (iShares iBoxx High Yield Corporate Bond ETF). This aimed to take advantage of the SPY/HYG implied volatility ratio being towards the top end of its 10-year range.

…and our SPY/HYG strategy worked well…

Six weeks later ("Hedges and Volatility in Focus") we recommended taking profit on the strategy, with HYG having retraced more of its 2021 rally than SPY and High Yield implied volatility having risen vs. equity vol. We suggested that a 'duration shock' had worked through HY but that a 'credit shock' was not imminent.

…although we closed it too soon…

With the benefit of hindsight, we would have been better off holding on to the position for a while longer; in the intervening 5 weeks, HYG has returned -0.7% against SPY's +6.5% - see Chart 1.

…as a 'gap' opened up between S&P 500 and High Yield return patterns

However, HYG's 'message' for equities should not be exaggerated because HY *excess* returns have not been wildly out of line; duration has been important for HY investors as well as IG

I have seen some market commentators use similar charts to suggest that credit markets are providing a bearish message for equities and that the 'gap' between the two lines will be corrected by equity returns falling towards the HY return line. While ASR shifted to preferring DM Credit to Equities in this month's Asset Allocation, Chart 1 would not be a good representation of the investment case. As Chart 2 shows, comparing HY *excess* returns versus equities shows no major 'gap' in relative asset class performance over the past year. In other words, the 'duration shock' has been an important part of HYG's clear underperformance vs. SPY so far in 2022 in Sharpe ratio terms, even if the duration impact has been far more negative for US Investment Grade corporate bonds than High Yield (see Chart 3).

Why we now adopt a clear preference for IG Credit vs. Equities

March's Asset Allocation showed a clear preference for IG Corporate Bonds over Equities…

…partly reflecting the upgrade in ASR's bias on duration risk to a slight overweight

Our latest Asset Allocation document does not contain a clear preference for High Yield relative to Equities. Rather, the implied preference is for Investment Grade corporate bonds over Equities. The positive stance on IG partly reflects the upgrade in our bias on duration risk to a slight overweight (from neutral), with ASR's Economics team still expecting US inflation to fall sharply and the Fed not to hike rates by as much as discounted by the market. Moreover, from a technical perspective, bond momentum is already near 30-year lows (see Chart 4), as noted in Monday's *Essentials*.

But in addition the case for further marked widening in

In addition, the case for a further marked widening in US IG OAS at this point does not seem particularly strong. The spread widening from the start of the year until mid-March was sharp but needs to be seen in the context of: a), how narrow spreads had become by Q3 last year; and b), the adverse flows as 'credit tourists' (enticed in earlier years by attractive yields and central bank support programs) reduced

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US IG OAS just yet doesn't seem particularly strong…

…with the US corporate sector net lending position still in good shape

holdings in response to capital losses. With the initial 'duration shock' absorbed into flows, IG spreads (currently in the 42nd percentile of the past 25 years) should track downgrade risk. In that regard, Chart 5 is important because it highlights the still-strong corporate sector net lending position (while it only goes up to Q3 last year, we do not think there has been a marked deterioration since).

With US IG implied volatility at a high level relative to equity vol, our idea is to sell LQD puts to fund the purchase of SPY puts

Given the technically oversold nature of corporate bonds, and the strong bounce in equities over the past 2-3 weeks, our idea is to sell LQD (iShares iBoxx $ Investment Grade Corporate Bond ETF) puts to fund the purchase of SPY puts. LQD 3-month implied volatility is quite stretched vs. SPY 3-month vol, having only been higher in the post-GFC era during the early stages of the pandemic (Chart 6).

Risk-reward considerations behind our option strategy

If it turns out that we're too sanguine on IG bonds, the underlying cause(s) should drag equities lower as well

If we turn out to be too sanguine about the prospects for US IG yields (and the LQD price) to stabilise around these levels, it will by definition be because IG credit spreads widen and/or UST yields rise further. None of the main candidates for scenarios in which these events happen look bullish for equities: a *very* sharp slowdown in growth pressuring even IG spreads wider; inflation staying well above 4% for a considerable period; or real UST yields rising further on the back of more Fed tightening than expected.

Real IG yields have arguably backed up enough already to start representing a headwind for equities

Chart 7 highlights that real *IG corporate* bond yields (based on forecasts for inflation) have backed up sharply and are now well above the long-term downtrend line. History suggests that equities tend to struggle when real IG yields move more than about 80bp above their long-term trend as is close to being the case now.

But doesn't this go against the idea that IG *spreads* look low relative to the VIX?

One pushback to the idea of, in effect, selling US IG volatility to buy US equity volatility is that, on the face of it, it does not sit well with evidence such as Chart 8 that IG *spreads* look low relative to the VIX curve.

We think the elevated level of the VIX forward curve vs. its pre-pandemic range does not preclude negative equity returns (alongside range-trading IG OAS) in Q2

However, a 'structural shift' of sorts has been at play since late 2019 which can help explain the gap. Index implied vol is a function of constituents' implied vol and their implied correlation. While the latter fell as the S&P 500 rallied (a normal state of affairs) from March 2020 lows, heavy stock-level call option activity in the US kept average constituents' implied vol elevated and led to an unusual divergence between implied correlation and index vol which has persisted (Chart 9). The VIX last diverged for any major length of time from credit spreads in the second half of the 1990s. Interestingly, that was also a period which saw an uptrend in call option volumes relative to puts.

Trade implementation: With LQD at 120.7 and SPY at 458.4, we recommend selling 4 LQD July 15th 2022 puts with a strike of 116 to fund the purchase of a SPY July 15th put with a 420 strike.

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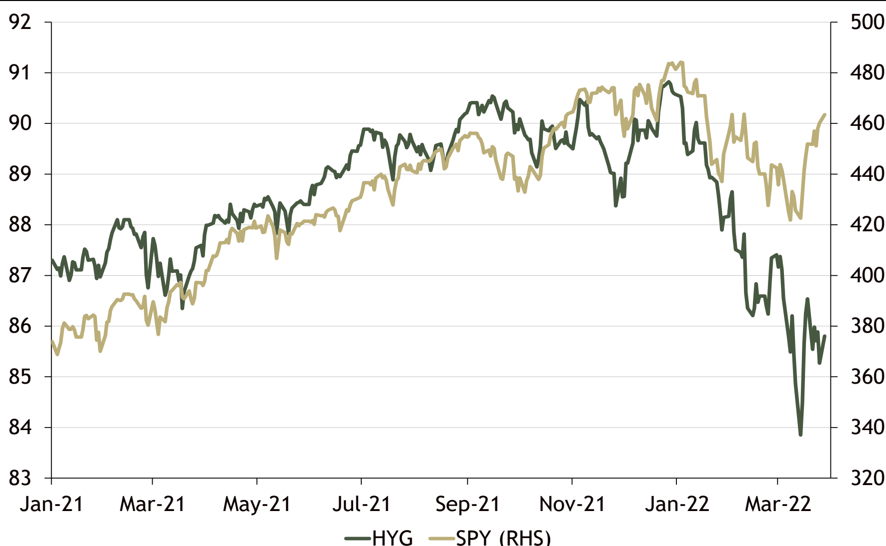
In January we recommended the sale of June SPY puts to fund the purchase of HYG puts. Six weeks later we recommended taking profit, with HYG having retraced more of its 2021 rally than SPY and HY implied volatility having risen vs. VIX

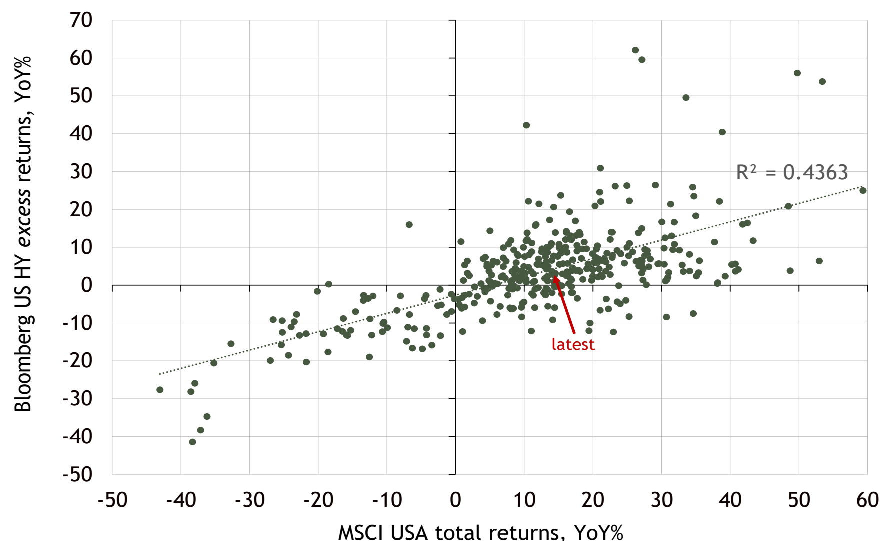
Chart 1: US High Yield and S&P 500 ETF total return indices



Source: ASR Ltd./ Bloomberg

Some commentators have used similar charts to suggest credit markets are providing a bearish message for equities. While ASR shifted to preferring DM Credit to Equities in this month's Asset Allocation, Chart 1 by itself would not be a good representation of the investment case…

Chart 2: US Equity and High Yield excess returns since 1990

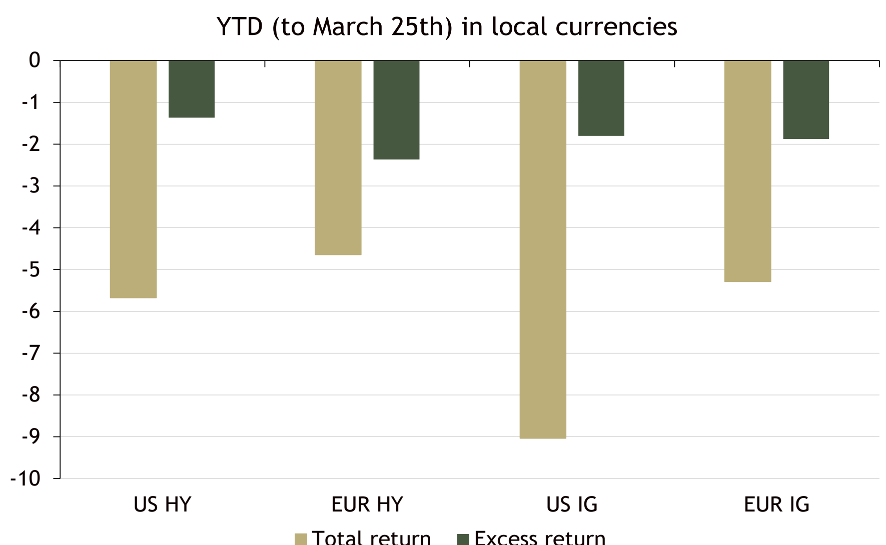


Source: ASR Ltd./ Bloomberg

…since comparing HY *excess* returns vs. equities shows no major 'gap' in relative asset class performance over the past year

In other words, the 'duration shock' has been an important part of HYG's clear under-performance vs. SPY so far in 2022 in Sharpe ratio terms…

Chart 3: US & EUR corporate bond returns



Source: ASR Ltd./ Bloomberg

…even if the duration impact has been far more negative for US Investment Grade corporate bonds than High Yield

Our latest Asset Allocation document does not contain a clear preference for High Yield relative to Equities…

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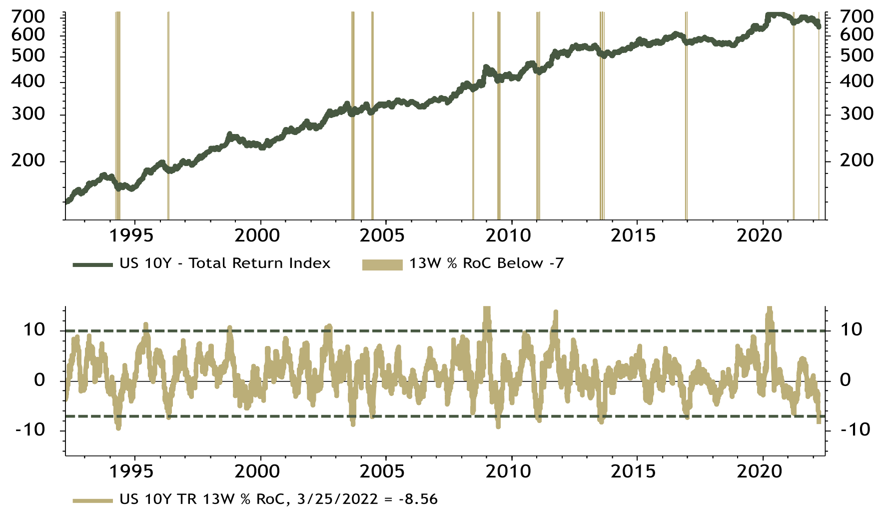
...rather, the implied preference is for IG corporate bonds vs. Equities

The positive stance on IG partly reflects the upgrade in our bias on duration risk to a slight overweight (from neutral)

From a technical perspective, government bond return momentum is already near 30-year lows

Chart 4: UST total return indices with 13-week % changes

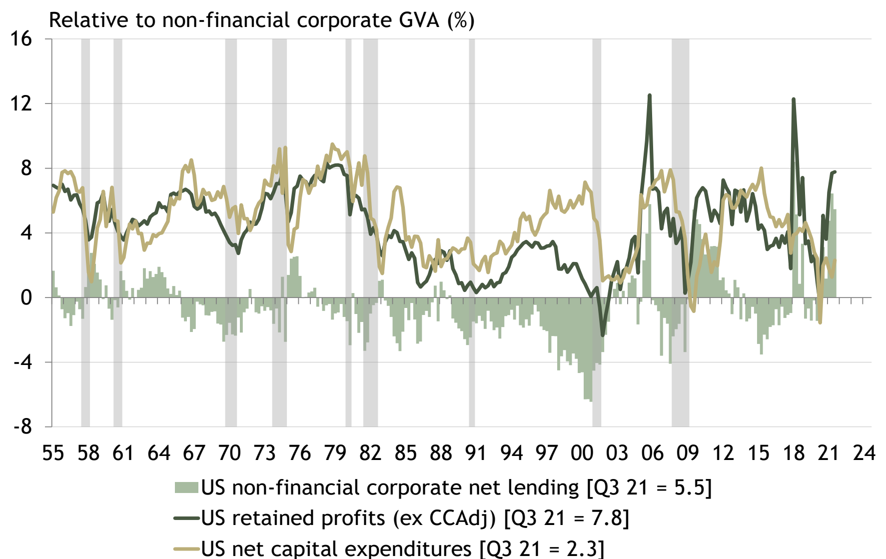


Source: ASR Ltd./ Refinitv Datastream

In addition, the case for a further marked widening in US IG spreads at this point does not seem particularly strong now that they've corrected higher to the 42nd percentile of the past 25 years

Chart 5 highlights the still-strong corporate sector net lending position

Chart 5: US non-financial corporate net lending

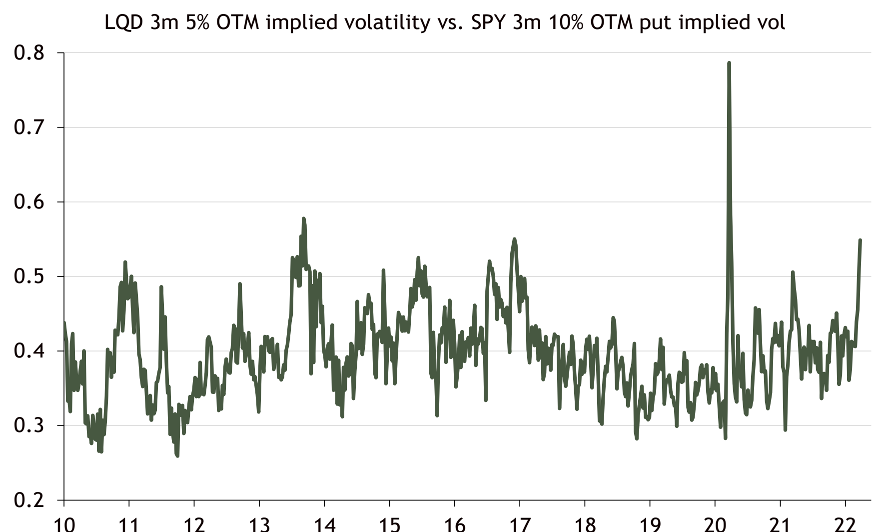


Source: ASR Ltd./ Refinitiv Datastream

Given the technically oversold nature of corporate bonds, and the strong bounce in equities over the past 2-3 weeks, our idea is to sell LQD puts to fund the purchase of SPY puts

LQD 3-month implied volatility is quite stretched vs. SPY 3m vol, having only been higher in the post-GFC era during the early stages of the pandemic

Chart 6: Investment Grade implied vol is high relative to Equity vol



Source: ASR Ltd./ Bloomberg

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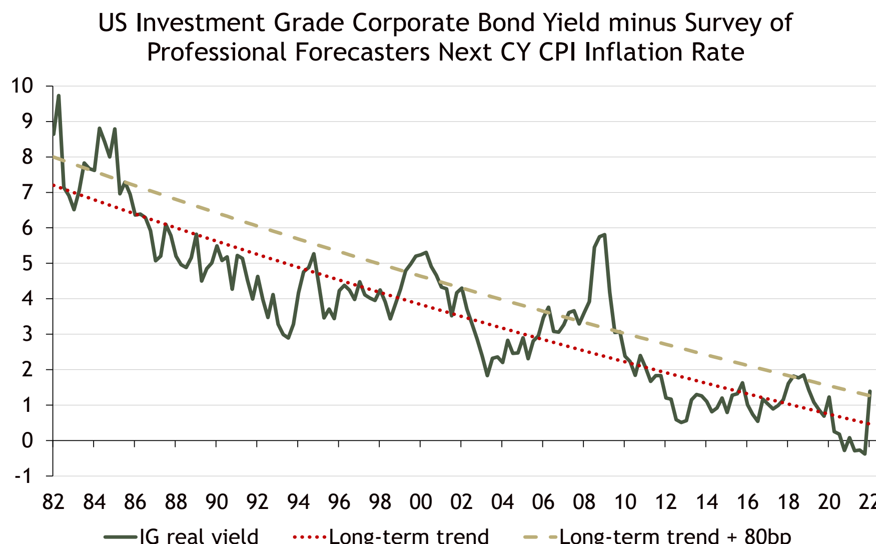
If we turn out to be too sanguine about US IG prospects, it will by definition be because credit spreads widen and/or UST yields rise further. None of the obvious scenarios under which these occur seem bullish for equities – they include UST real yields rising further on the back of more Fed hikes than expected

Chart 7 highlights that real IG corporate bond yields (based on forecasts for inflation) are now about 80bp above the long-term downtrend, which is roughly the point where equities have tended to struggle in recent decades

One objection to the idea of selling US IG volatility to buy US equity vol is that it does not sit well with Chart 8, which seems to imply that IG *spreads* are low vs. VIX curve

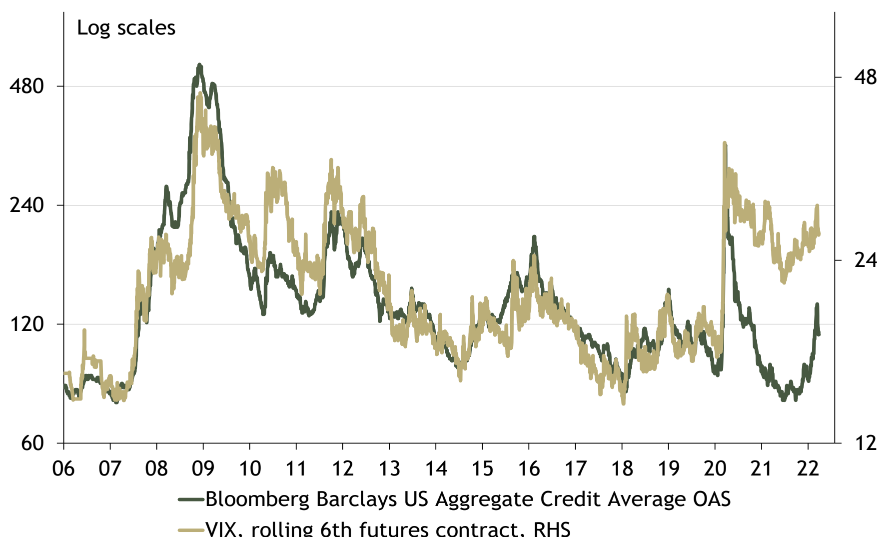
However, a 'structural shift' has been at play since late 2019 which can help explain the gap. Index implied vol is a function of constituents' implied vol and their implied correlation. Heavy stock-level call option activity in the US kept average constituents' implied vol elevated in 2020 and led to an unusual divergence between implied correlation and index vol which has persisted since we first discussed it in June 2020 (going on to expand on the theme in February 2021's "Volatility & sentiment in the Robinhood era")

Chart 7: US real IG yields reaching threatening level for equities?



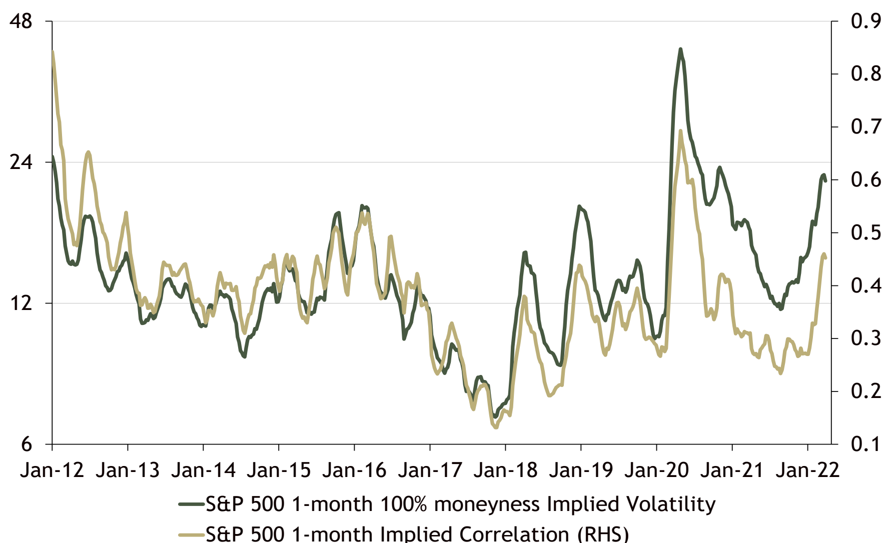
Source: ASR Ltd. / Philadelphia Federal Reserve / Bloomberg

Chart 8: US IG OAS (bp) versus VIX futures (%)



Source: ASR Ltd. / Bloomberg

Chart 9: S&P 500 implied volatility & implied correlation (10w MA)



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Multi-Asset Open Trade Recommendations

Trade	Date opened	Entry level	Latest	P&L*	P&L (normalised)
Fixed Income (DM)					*as % of 1 st.dev.*
Receive GBP 10-year inflation swaps	6-Oct-21	4.20%	4.53%	-33bp	-83%
GBP 10/30y curve steepeners	10-Nov-21	-17bp	-19bp	-2bp	-5%
KRW 2/10y curve steepeners	15-Dec-21	3bp	9bp	16bp	80%
EUR 10/30y curve steepeners	2-Feb-22	5bp	-19bp	-24bp	-98%
Short 10y Bonos / long 10y OAT	23-Mar-22	47bp	45bp	-2bp	-9%
Currencies					*as % of ann.vol.*
Long SGD vs. TWD	15-Sep-21	20.62	21.21	2.9%	71%
Long EUR vs. GBP **stop on a close below 0.8260, target 0.8950**	3-Nov-21	0.848	0.845	-0.8%	-10%
Long BRL, MXN & ZAR / short EUR & USD	17-Nov-21	100.0	112.8	12.8%	108%
Short CNH vs. IDR	12-Jan-22	2250	2252	-0.2%	-2%
Buy GBP/JPY 3m 151 puts, part-funded by selling 146 puts and 163 calls	23-Feb-22	44bp	-99bp	-143bp	
Equity/Credit derivatives & ETFs					*as % of ann.vol.*
Long Global Consumer Staples (KXI) / short Consumer Discretionary (RXI)	6-Jan-21	100.0	107.6	7.6%	51%
Long Fallen Angels (FALN) / short HYG (70%) and LQD (30%)	28-Apr-21	100.0	101.2	1.2%	20%
Long Global Materials (MXI) vs. market (VT)	28-Jul-21	100.0	105.2	5.2%	50%
Long Germany (EWG) / short Switzerland (EWL)	29-Sep-21	100.0	84.0	-16.0%	-100%
Buy SPY July 15th 420 put / sell 4x LQD July 15th 116 puts	**NEW**				

** all returns take into account positive/negative carry*

Source: ASR Ltd./ Bloomberg

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