THE WEEKLY BRIEF

By LYXOR CROSS ASSET RESEARCH

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No Stress in Distressed: Green Light for Credit Strategies

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Powell's dovish testimony to the Congress supported investors' sentiment, with full odds for a rate cut as soon as July 31st. Beyond the Fed, most other major central banks are also taking accommodating measures to tackle declining economic and inflation expectations and policy uncertainties. They are boosting macro and market global liquidity, as reflected in turning M2 indicators and various financial stress indicators. Our basket of assets most sensitive to liquidity (including leveraged loans, frontier markets, EM HY, niche structured products etc.) is continuing to rally and hoard carry flows.

Several credit metrics are deteriorating. Credit valuations are rich, corporate profits and margins are stalling. Meanwhile corporate cash balances are shrinking as opposed to corporate leverage near its highs (47% of GDP) in the U.S. Yet, we see only few red flags for credit markets for now. We are comforted by trends in the U.S. distressed segment, used as a leading indicator for mainstream markets.

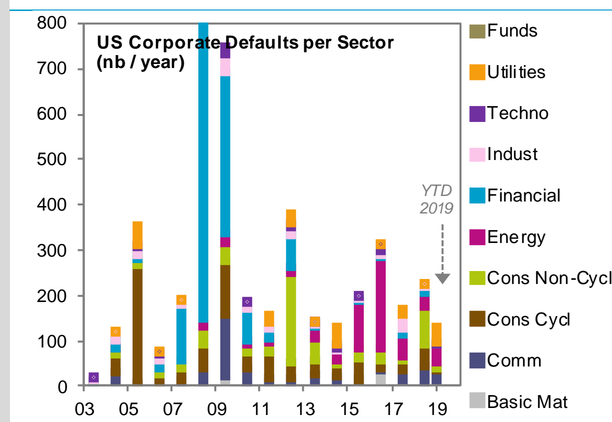
The supply of U.S. distressed debt briefly spiked by the end of 2018 and, to a lesser extent, back in May 2019. However, the outstanding value ($90bn) remains far below the previous peak back in early 2016 at nearly $400bn. Issues' bid-ask spreads are consistent with these trends, not suggesting a pending stress. Moreover, most of the distressed issues are concentrated in the energy, healthcare and communication sectors. Interestingly, trade and tech uncertainties are not yet showing in the corporate defaults plotted below.

With only about 12% of the distressed debt maturing within the next two years, liquidity pressure is likely to remain benign. Meanwhile, the number of issuers seeking a maturity extension, amendments or waivers to their financial covenants remain tame. Banks' corporate loans as well as covenants standards also remain supportive.

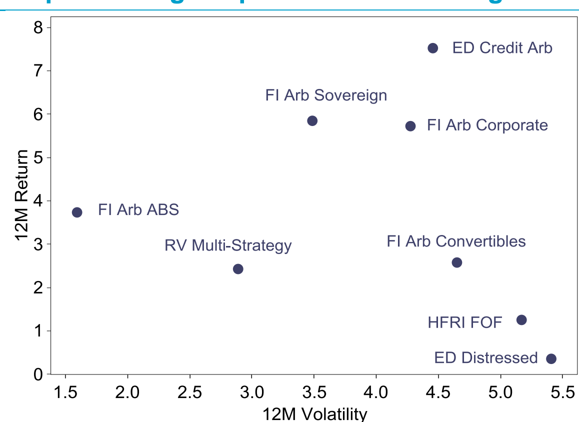
Finally, default rates on HY or loans continued to hover around 1.5% year-to-date and are not expected to breach 2% next year. Our view is that the next distressed cycle might not start before 2021.

This is comforting our positive view on credit and deep value market segments. We are O/W in U.S. and European HY and EM HC debt. We are also O/W on Credit and EM Macro focused hedge fund strategies, which could both benefit from decent dispersion and reasonable correlations. While Special Situation strategies hold few distressed issues, opportunities for stand-alone Distressed strategies remain too tight for now.

No distressed fever in 2019



Outperforming Corporate Credit Strategies



Sources: Bloomberg, HFR, Lyxor AM

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PERFORMANCE

CTAs give back some of their gains from bonds

Lyxor UCITS Peer Group Performance

	Last Week*	MTD**	YTD**	# of funds
CTAs	-0.1%	1.4%	9.5%	25
MSCI World	0.1%	1.3%	18.6%	
Risk Premia	0.3%	1.0%	3.5%	21
Global Macro	0.3%	0.9%	5.0%	40
Global Lyxor UCITS Peer Group	0.0%	0.5%	4.3%	243
Event-Driven: Special Situations	0.0%	0.3%	6.1%	7
L/S Equity Directional	0.0%	0.3%	5.1%	61
L/S Credit	0.1%	0.3%	4.6%	31
Event-Driven: Merger Arbitrage	0.1%	0.2%	1.9%	22
Bloomberg Barclays Global Aggregate Bond Index	-0.1%	0.2%	6.2%	
L/S Equity Market Neutral	-0.2%	0.0%	0.4%	36

*Last Week from 07/02/19 to 07/09/19; **MTD & YTD as of 07/09/19

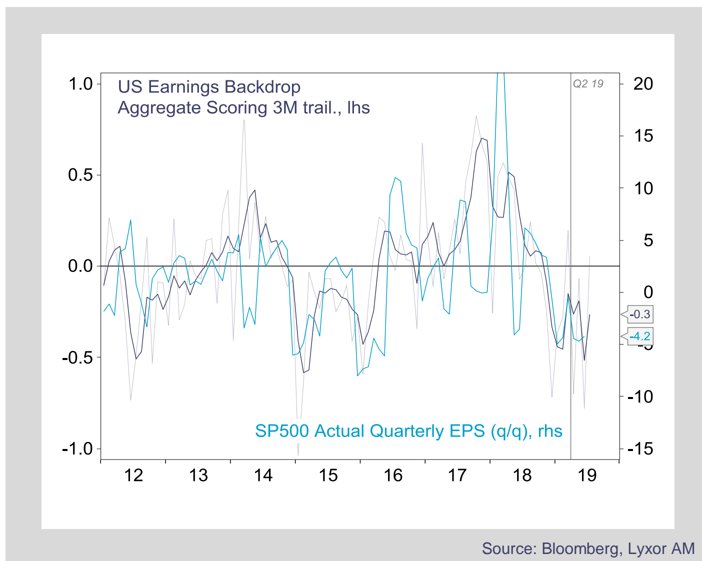
Source: Lyxor AM

Powell's dovish testimony supported full odds for a rate cut as soon as July 31st. The job market report and CPI were released above expectations but are not expected to change the Fed's course. Risk assets reacted cautiously on hold ahead of the U.S. Q2 earnings season, but short dated Treasury yields fell, and the curve steepened.

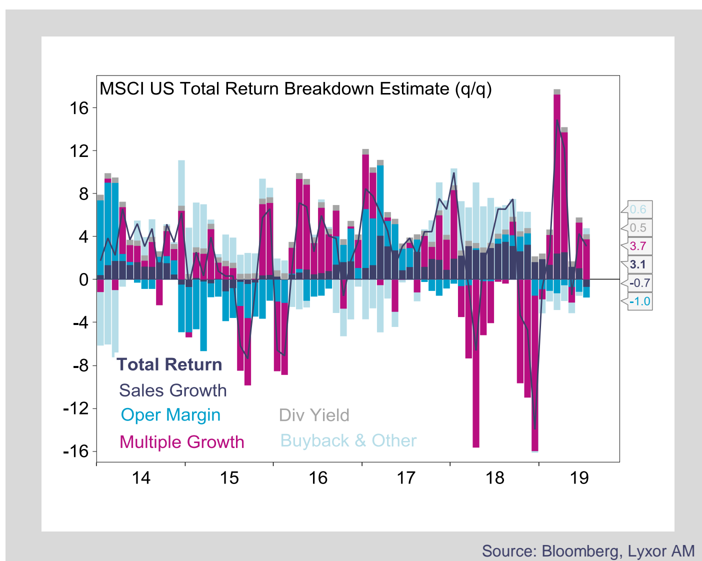
CTAs which hold large long bond and USD positions gave back some of their earlier gains.

Most other hedge fund strategies were about flat this week.

Q2 Earnings and Alpha Preview: limited surprise in store



Source: Bloomberg, Lyxor AM



Source: Bloomberg, Lyxor AM

The U.S. Q2 earning season will start next week with diversified banks. Conditions of the quarter have been highly volatile, as suggested by our earnings backdrop tracker.

Overall, the macro backdrop and business uncertainties appear to have been the main drags. They have weakened the pulse in domestic and foreign activity, but only mildly so. We expect a manageable hit to sales growth reports. Some lead indicators suggest that conditions in Q3 could be easier. Weakening U.S. and global growth is putting pressure on margins, but so far corporate pricing power and labor productivity appear stable, pointing to stable operating margins.

Q2 earnings estimates have been moderately revised down (-2.4% in total, below historical average revisions). While comforting, it is not dramatically lowering the hurdle for reporting companies. This is similar for yearly estimates revisions, which also suggest limited surprise either ways.

Compared to last year, Q2 earnings are expected to drop -2.6% y/y, mainly dragged by tech and base resources sectors. Some companies have issued negative profit warnings, but mainly in the auto and industrial sectors so far. Otherwise, corporate guidance remains positively oriented.

Overall, Q2 results are likely to be mediocre but in line with market expectations. This quarter might not surprise the market much. Instead, the focus is likely to rapidly shift to Q3 corporate guidance, in particular on trade sensitive sectors (industrials, telecoms and tech).

Unlike previous quarters, Q2 might not dramatically alter the market structure, which points to balanced conditions for L/S equity strategies' alpha. Micro differentiation is partially distracted by transversal developments regarding trade, economic data and liquidity, as well as volatile style and factors.

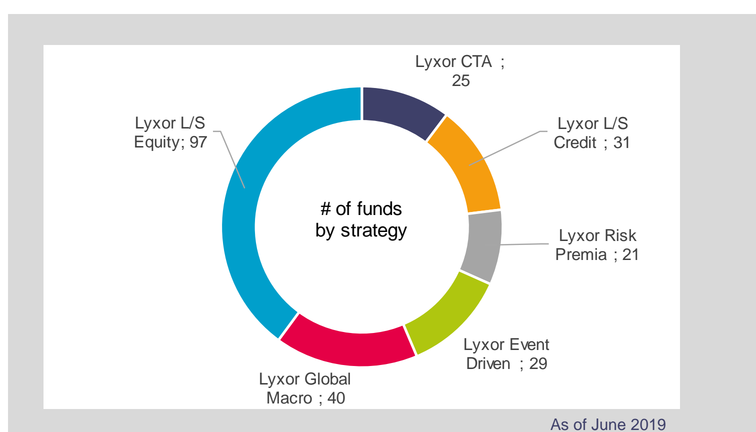
METHODOLOGICAL APPENDIX

The information contained in this report on the performance of onshore hedge funds is based on publicly available information. The universe of underlying funds is relatively stable but varies depending on the criteria of inclusion presented below. It is based on an unbiased selection from our hedge fund analyst team.

Performance is calculated on a weekly basis, as of end-Tuesday, using an arithmetic average (equally weighted average).

Regarding share classes used in these peer groups, we selected the primary share class as referenced in Bloomberg. Non-USD share classes are hedged in USD based on hedging costs available on Bloomberg.

Lyxor Hedge Fund Peer Groups: number of funds by strategy



- 243 strategies across the main categories in the industry
- USD 233 billion of assets under management

Criteria of inclusion

The criteria of inclusion are fourfold:

i) We only include UCITS strategies;

ii) Assessment by Lyxor’s Hedge Fund selection team based on funds’ materials or manager interaction;

iii) We only include strategies with assets under management of at least USD 50 million; and

iv) We only include strategies with at least a one-year track record.

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