

XAIA INVESTMENT  
Quarterly Letter  
2024|03



# Credit's Paradox: Tight Spreads, High Demand?

The credit market has shown remarkable resilience in the current high interest rate environment. While the increase in interest rates by global central banks initially led to a repricing of assets and a widening of credit spreads, we have since seen a gradual tightening and reduced volatility in the credit market. This resilience has continued even as restructuring activity has increased and creditor-on-creditor violence has intensified, as noted in our last report.

The current credit market presents a compelling paradox: widespread corporate restructuring and compressed credit spreads. This report examines the underlying factors contributing to this tight credit environment. As central banks lower interest rates and markets anticipate further cuts, we aim to clarify the dynamics underpinning this resilience in credit markets. By examining market behavior and macroeconomic influences, we aim to provide insights into the current state of credit and its potential trajectory going forward.

## XAIA INVESTMENT Quarterly Letter 2024|03

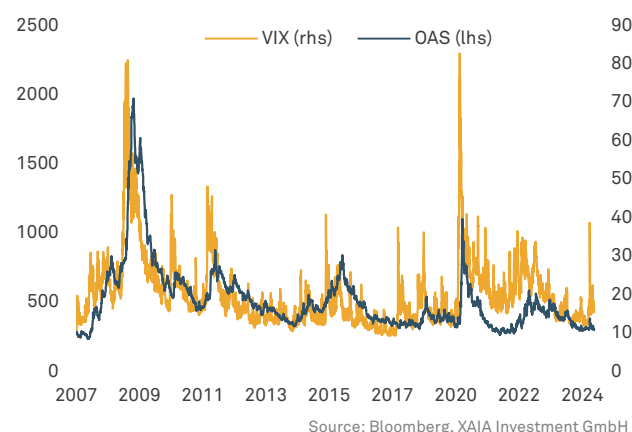
Philipp Graxenberger  
Tel +49 89 589275-122  
Philipp.Graxenberger@xaia.com

Josef Pschorn  
Tel +49 89 589275-126  
Josef.Pschorn@xaia.com

## The unwinding of the yen carry trade – evidence of credit market resilience

For evidence of the resilience of credit markets, we need look no further than recent history and in particular the events of early August, when a sharp appreciation of the Japanese yen sent shockwaves through global markets. This sudden move triggered a cascade of liquidation as leveraged hedge fund investors unwound their positions in stocks and other risk assets, leading to a notable sell-off in equity markets and a dramatic spike in the VIX (volatility index). This volatility spike is one of the most significant in recent history.

**CHART 1: CREDIT SPREADS VS. EQUITY VOLATILITY**  
Bloomberg US Corporate High-Yield Average OAS vs. VIX Index



Looking at the credit market's response to this major volatility event, we see an interesting phenomenon: credit spreads remained remarkably stable despite the turmoil. Historically, credit spreads and equity volatility show a high degree of correlation, especially during periods of major volatility spikes. In this case, however, credit spreads widened minimally and the movement in credit spreads is barely visible on the long-term chart (CHART 1), a reaction not comparable to other high equity volatility events such as the Lehman crisis or the Covidien crash.

The lack of spillover to credit risk suggests that the unwinding of the carry trade was primarily a localized volatility event, centered on Japanese issuers in the credit space. The behavior of credit spreads in the US or Europe suggests that markets are complacent and that systemic risk in the credit market is low. Moreover, the stability of the credit market effectively signaled that the dip in the equity market presented an attractive buying opportunity, further demonstrating its role as a reliable indicator of broader economic health. This episode serves as a reminder of the complex interplay between different asset classes and the valuable insights that can be gleaned from observing their relative behaviors during periods of market stress.

## Tight Credit Spreads despite a High-Yield Environment: The asset-liability arbitrage condition

In today's complex financial landscape, we observe an intriguing phenomenon where credit spreads remain tight despite a high-yield environment. This situation presents an apparent paradox: government yields in the US have offered returns ranging from 4-5%, investment-grade bonds >5% and private credit was yielding 9-11%. In this context, one might expect equity returns to be more readily achievable in the 15-25% range. However, this is not the case, and understanding the underlying dynamics requires a deeper examination of the asset-liability arbitrage condition and current market forces.

The asset-liability arbitrage condition serves as a fundamental principle in financial markets, stating that asset yields should exceed the cost of debt (CoD) in order to generate a sufficiently high return on equity (ROE). This condition is crucial for investors, as it determines whether it is more advantageous to own assets or liabilities. In the current market, we observe most cash-flowing assets offering returns on assets (ROA) between 5-12% in USD. In an environment of higher base rates, lenders demand returns of 7-10% in USD. Therefore, the narrow spread between asset returns and the cost of debt constrains ROE to a tighter 7-13% range. This makes investing in debt very attractive.

In a very simplified financial scenario with total assets of \$1,000,000, debt of \$600,000, and equity of \$400,000, we analyze the impact of different costs of debt on Return on Equity (ROE), assuming a consistent 10% Return on Assets (ROA). With a 10% ROA, the company generates \$100,000 in operating income. When the cost of debt (CoD) is 5%, interest expense is \$30,000 (5% of \$600,000), resulting in net income of \$70,000 and a 17.5% ROE ( $\$70,000 / \$400,000$ ), demonstrating a significant leverage effect. However, when CoD increases to 8%, interest expense rises to \$48,000, reducing net income to \$52,000 and dropping ROE to 13% ( $\$52,000 / \$400,000$ ). This comparison illustrates how lower CoD enhances the leverage effect, creating a wider spread between ROA and ROE (7.5 percentage points vs. 3 percentage points). As the spread narrows with higher CoD, ROE becomes constrained, making debt investments more attractive relative to equity. This dynamic suggests that investors may prefer debt due to its higher returns, potentially leading to shifts in capital allocation strategies and influencing overall market dynamics. This example highlights how changes in CoD impact investment decisions.

Historically, lower interest rate environments allowed for expanded ROEs, sometimes reaching up to 25%, despite lower asset returns. This was primarily due to the extremely low cost of debt, which created a favorable asset-liability arbitrage condition. Generally, lower rates tend to lead to expanding ROEs, while higher rates

compress them. This historical context helps explain why certain sectors, such as real estate and utilities, performed well during periods of lower yields, as the loosening of the asset-liability arbitrage condition allowed for higher ROEs.

The current market dynamics have led to interesting behaviors across various asset classes. We have witnessed a tightening of credit premiums, observable in credit spreads, asset-based lending, private debt, and strategic risk transfer transactions. This tightening reflects the relative attractiveness of credit investments in the current environment. As investors seek yield in a high-rate world, they are increasingly turning to credit markets, which in turn leads to compressed spreads and a more challenging environment for achieving attractive excess returns on credit investments.

## Increasing demand for liquid credit

The credit market finds itself in an intriguing position as we enter the final quarter of 2024. Despite fundamental reasons suggesting caution, credit spreads remain tight, reflecting a complex interplay of factors. The compensation for taking credit risk has diminished, making excess returns increasingly elusive. However, the overall yield picture tells a different story, one that is catching the attention of institutional investors who have remained on the sidelines until now.

The rapid increase in fixed income yields has created an attractive proposition for yield-hungry investors. Pension funds, typically targeting returns of 3.5-4.5% in Germany and 6-7% in the US, now find these benchmarks within reach through BBB-rated bonds in both USD and EUR. This development is prompting a strategic shift, with many institutional investors favoring more liquid credit investments over complex, illiquid assets. While most institutional investors operate on 5-year strategic asset allocation plans, making quick pivots challenging, there are signs that this tide is beginning to turn, particularly in the US.

**CHART 2: BBB-YIELDS ARE ATTRACTIVE ENOUGH**  
YTW for EUR 10y BBB-rated bonds vs. a 4% target yield



Source: Bloomberg, XAIA Investment GmbH

## Is the best yet to come?

The focus on nominal returns, rather than spreads alone, appears to be a key driver of the significant compression in corporate credit spreads. This dynamic, coupled with the recent steepening of the yield curve from strongly inverse levels, makes liquid corporate bonds with higher duration more attractive than illiquid and/or floating-rate investments.

As we look ahead, the credit market presents a nuanced picture. While overall spread levels are tight, limiting broad-based excess return opportunities, the attractive all-in yields create strong technical support. The potential influx of capital from institutional investors, if realized, could further bolster this trend. This dynamic environment suggests a market that, while challenging for generating significant alpha, offers stability and consistent returns. Investors may need to be more selective, focusing on specific sectors or credit qualities that offer relative value. Additionally, the interplay between credit spreads and overall yields underscores the importance of a holistic approach to fixed income investing in the current market landscape.

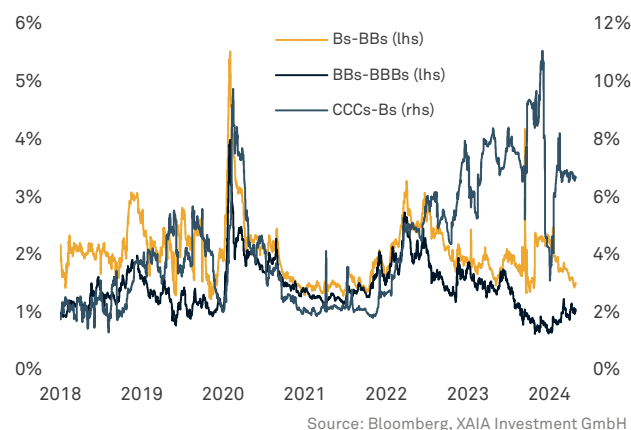
Savvy investors should be prepared to seek out niches and special situations to generate meaningful excess returns in this environment. Examining credit spreads in European high-yield across rating categories (CHART 3) reveals that only low credit quality offers attractive spreads. However, average spreads in the CCC-space are wide only due to distressed situations. The CCC-rated corporate bond market is highly dispersed, featuring many tight credits alongside some very distressed ones. In pursuit of meaningful outperformance, investors are pushed either into longer duration bonds or into the distressed part of the market. This trend exposes them to greater economic risks and the current creditor-on-creditor conflicts evident in the ever more complex distressed market we discussed in our last quarterly letter.

The credit market is at a crossroads, balancing tight spreads with attractive yields and the prospect of increased institutional investment. While challenges remain, particularly in finding value amid compressed spreads, the evolving landscape suggests that credit as an asset class could continue to benefit from strong technicals.

Investors looking for longer-term income, such as pension funds and insurance companies, should continue to find value in high-quality corporate bonds and can reduce illiquid assets in favor of more liquid ones. The environment is somewhat more challenging for spread-oriented investors, as spread dispersion is very high. Careful credit selection and a keen eye for special situations will be crucial for investors navigating this complex terrain. Uncorrelated strategies can offer attractive diversification for all types of investors in this environment, and can provide a safe haven should volatility return to the credit market.

### CHART 3: EUR HIGH-YIELD RELATIVE VALUE

Credit spread differentials between ratings



## Disclaimer

This document is published for the reader's personal and general information only and without any obligation, whether contractual or otherwise. It does not constitute and may not be construed as investment advice. All information contained herein is based on carefully selected sources which are considered to be reliable. However, XAIA Investment GmbH, Munich, cannot guarantee that it is correct, complete or accurate in all respects. Any liability or warranty arising from this document is therefore excluded completely.

The information in this document about fund products, securities and financial services has only been examined to ensure it is in compliance with Luxembourg and German laws and regulations. In some legal systems, the circulation of information of this type may be subject to legal restrictions. The present information is therefore not intended for natural or legal persons whose place of residence or business headquarters is subject to a legal system which places restrictions on the circulation of information of this type. Natural or legal persons whose place of residence or business headquarters is subject to a foreign legal system should therefore familiarize themselves with said restrictions and comply with them as appropriate. In particular, the information contained in this document is not intended or designed for citizens or persons subject to the laws of the United Kingdom or the United States of America.

This document is neither an offer nor a request to submit an offer for the acquisition of securities, fund shares or financial instruments. An investment decision regarding any securities, fund shares or financial instruments should be made on the basis of the relevant sales documents (e.g. official offering documents and prospectuses), but not on the basis of this document under any circumstances.

All opinions expressed in this document are based on the evaluation of XAIA Investment GmbH at the original time of their publication, regardless of when this information was received, and may change without prior notice. XAIA Investment GmbH therefore expressly reserves the right to change opinions expressed in this document at any time and without prior notice. XAIA Investment GmbH may have published other publications, which contradict the information presented in this document or lead to other conclusions. Such publications may be based on other assumptions, opinions and methods of analysis. The information given in this document may also be unsuitable for, or unusable by specific investors. It is therefore provided merely by way of information and cannot replace the services of a professional adviser.

The value of fund products, securities and financial services and the return they generate can fluctuate significantly. Investors may not recover the full amount invested. Past performance is not an indicator of future returns. No representation or warranty, express or implied, is provided in relation to future performance. Calculation of fund performance follows the so-called BVI method; simulations are based on time-weighted returns. Front-end fees and individual costs such as fees, commissions and other charges have not been included in this presentation and would have an adverse impact on returns if they were included.

This document is only intended for the use of those persons for whom it is intended and provided by us. It may neither be used by other persons nor forwarded or made accessible to them in the form of publications.

Nothing in this document is intended to provide or to replace tax advice and its content should not be relied upon to make investment decisions. This document is neither exhaustive nor tailored to the needs of any individual investor or specific investor groups. Investors should always consult their own tax adviser in order to understand any applicable tax consequences.

The contents of this document are protected and may not be copied, published, taken over or used for other purposes in any form whatsoever without the prior written approval of XAIA Investment GmbH.

© XAIA Investment GmbH 2024