Greed and Fear

Where's the Value in Today's Markets

European Credit Derivatives Strategy
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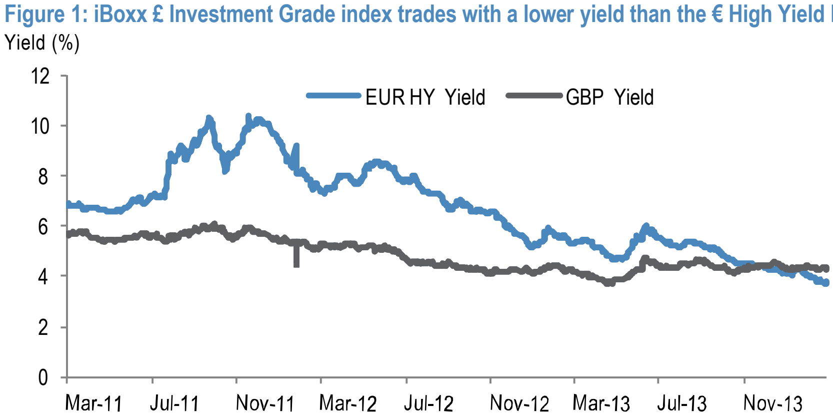
- **Market positioning is being driven, in our view, by Greed and Fear** – greed has seen short-dated high-yield spreads reach multi-year lows, while fear has kept long-dated spreads and yields elevated and curves steep. This has been driven by a world with plentiful liquidity where default rates are expected to be low for long, but the fear of a significant pick-up in inflation remains.
- **We believe these risks are largely priced in and that there are significant profits to be had from taking an opposing position**. Credit Markets are currently pricing in extreme levels – a continuation of the very low default rate environment and a significant rise in yields and defaults in the future.
- **We recommend three ways to position for this**:

1. Buy £ and € long-dated credit assets.
2. Long risk iBoxx £ TRS; short risk iBoxx €HY TRS.
3. Long risk iTraxx Main 10y; short risk iTraxx Crossover 3y.

Risky markets have rallied across asset classes and credit has been no exception. iTraxx Main spreads are now 6bp off their tights, and implied volatility has returned to multi-year lows. In such an environment, investors are struggling to find attractive opportunities where the risks are commensurate with the rewards on offer.

We believe that positioning has been driven by greed and fear and current market pricing reflects this. Market participants have been greedily searching for short-dated and high-yielding risk. Both short-dated and high-yield spreads and yields are at multi-year lows. At the same time, investors are fearful of a rise in yields from their all time lows. Longer-dated spreads and yields remain elevated, despite investors' comfort.

Figure 1: iBoxx £ Investment Grade index trades with a lower yield than the € High Yield Liquid index



Source: J.P. Morgan

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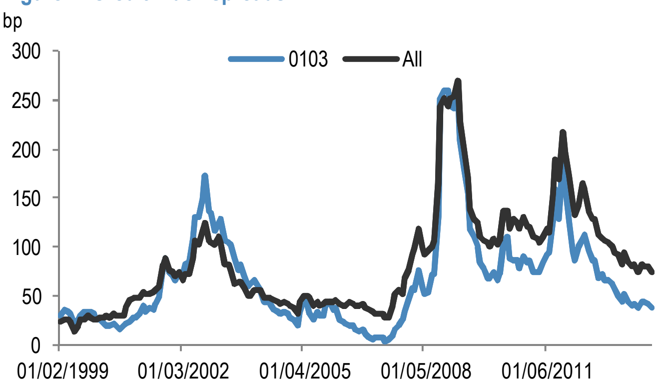
Greed

The main driver on the greed side has been a world with plentiful liquidity where the return on holding cash has been extremely low and companies and investors have been able to raise financing at very low levels. This has lead to two main themes that investors, including ourselves, have used as guidance over the past few years, namely the attractiveness of short-dated risk and high-yielding investments. Both of these have outperformed over the past few years and are now trading at multi-year lows.

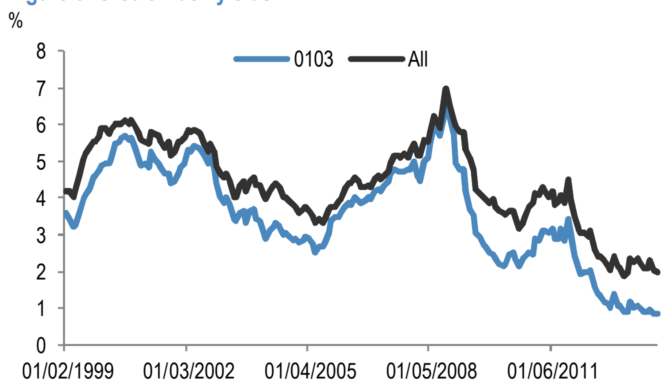
The spread of our Maggie € Credit Index for the 1-3 year bucket has significantly outperformed the broader market (Figure 2). Spreads in the short dated bucket are 12% off their multi-year lows. When we look at yields, an even starker picture is drawn; the yield of short dated credit has significantly outperformed the broader market driven both by lower credit spreads and by the steepening of the swap yield curve (Figure 3).

Figure 2: Credit index spreads



Source: J.P. Morgan.

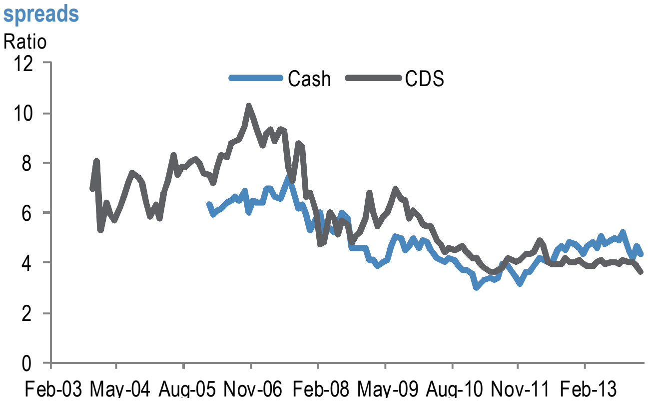
Figure 3: Credit index yields



Source: J.P. Morgan.

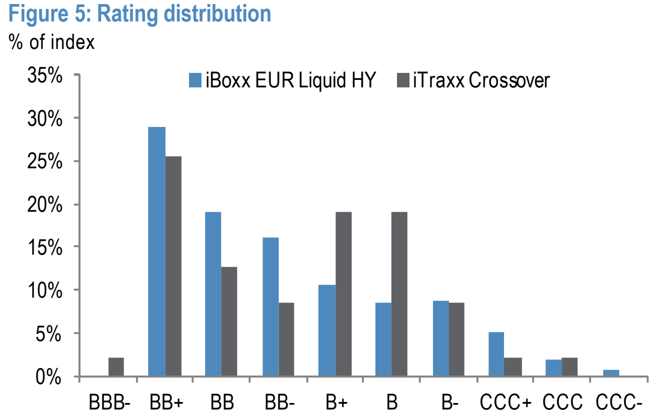
In both CDS and Cash bonds, high yield has outperformed investment grade with low defaults encouraging investors to search for higher yielding assets. Figure 4 shows the spread ratio between the J.P. Morgan high-yield and high-grade indices along with the spread ratio of the iTraxx Crossover to iTraxx Main indices. The ratio in cash bonds is just over 4 times, while for CDS it has compressed to 3.7 times, the lowest level observed since the iTraxx indices were introduced in 2003.

Figure 4: Compression: Ratio of high yield to investment grade spreads



Source: J.P. Morgan.

Figure 5: Rating distribution



Source: J.P. Morgan.

With iTraxx Crossover currently trading at 280bp, investors are compensated for an annual default rate of only 3.5% or just 1.75 names from the 50-name portfolio (assuming 20% recovery). Similarly, the iBoxx €HY index is trading with a spread of 330bp implying a 4% annual default rate over the coming years. Average high-yield default rates have averaged 3.7% over the past 30 years in Europe meaning that High Yield only just compensates for default risk, with little headroom for a pick-up after a period of low defaults. The current CDS and Cash bond indices have 4.5% and 8% of their composition rated CCC or lower.

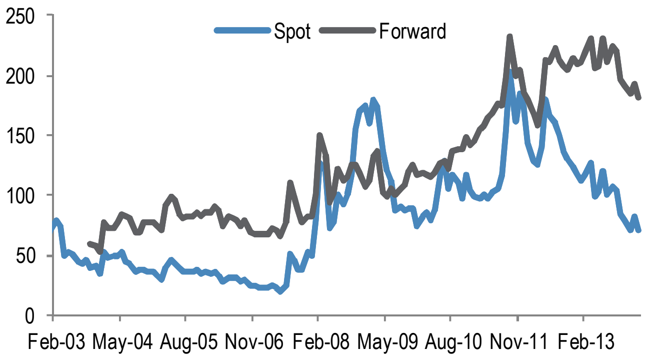
With the benefit of high liquidity and low defaults largely priced in, we believe investors are no longer compensated for taking on short-dated and high-yield risk.

Fear

On the fear side, investors remain concerned about an increase in yields and spreads from their current low levels. The fear of increased future inflation and a pick-up in default rates has kept forward spreads and yields at very elevated levels. iTraxx Main 5y5y forward spreads are currently at 190bp – around 20bp below the all-time high that 5y spreads reached in 2011 and above the wides reached during the credit crisis in 2009. Forward yields are also at extreme levels, particularly for sterling credit where current forward yields are around 5.5% for long-dated credit compared to current yields of 3.1% for 5-year credit.

Figure 6: iTraxx Main Spreads and Forwards

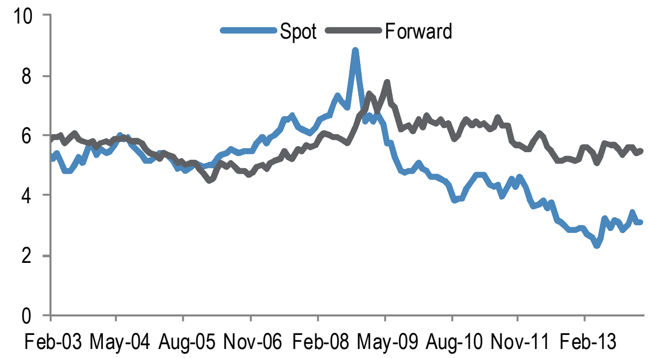
Spreads (bp)



Source: J.P. Morgan.

Figure 7: Sterling IG Yields and Forwards

Yields (%)



Source: J.P. Morgan.

What's not priced in?

It seems to us that the risks of higher yields and a rise in defaults in the future are largely priced in, as is evident from high forwards in both spreads and yields. Moreover, the benefit of ample liquidity and low near-term defaults is also largely priced in.

In our view, not only are these risks priced in, but they are pricing in almost the extremes of what we have seen over the past ten years. High-yield spreads only just compensate for average default rates without any compensation for market risk or a pick-up in defaults. Conversely, long-dated yields compensate for significantly higher yields in the future again almost at the extreme of what we have seen over the past ten years.

We believe investors should focus their risk taking on areas where upside risk is not priced in and conversely should focus their hedges in areas where downside risk is

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not priced in. Default rates may pick up in the near term as the global stimulus provided by central banks is removed. Additionally, deflation and low yields may be here to stay as they have been in Japan over the past 20 years.

We believe the following three trades are attractive ways to position for this:

1) Buy £ and € long-dated credit assets.

2) Long risk iBoxx £ TRS; short risk iBoxx €HY TRS

3) Long risk iTraxx Main 10y; short risk iTraxx Crossover 3y

Buy £ and € long-dated credit assets

The recent issuance and performance of the long-dated £ EDF bond issued with a 6% coupon and now trading at a yield of 5.15% is indicative of the value we see in long-dated bonds, particularly in the Sterling space. The already steep yield and spread curves in this area of the maturity curve offer significant value. As we highlighted earlier, forward yields are very high and investors should take advantage of this by switching out of short-dated into longer-dated assets.

We expect this to be compounded under Solvency 2, which encourages insurers to invest tin long-dated credit to gain the benefit of the matching adjustment (*Solvency II: Judgement Day*, A. Mehonic, 24 Oct 2013).

We highlight some of the highest-yielding assets in the £ space in Table 1 focusing on names where our Credit Analysts are not Underweight.

Table 1: Sterling long-dated credit

ISIN	Name	Ticker	Coupon	Maturity	Yield
FR0011710284	Electricite De France	EDF	6	23/01/2114	5.147
XS0248395245	Tesco Plc	TSCOLN	4.875	24/03/2042	5.115
XS0289810318	Tesco Plc	TSCOLN	5.2	05/03/2057	5.106
XS0104440986	3I Group Plc	IIILN	5.75	03/12/2032	5.091
XS0798491113	Time Warner Cable Inc	TWC	5.25	15/07/2042	5.031
XS0994920238	Directv Holdings/Fing	DTV	5.2	18/11/2033	5.027
XS0107203381	Mercantile Investment Tr	MRCLN	6.125	25/02/2030	4.955
XS0159013142	Tesco Plc	TSCOLN	5.5	13/01/2033	4.905
XS0562107762	Orange Sa	ORAFP	5.375	22/11/2050	4.885
XS0630584166	Time Warner Cable Inc	TWC	5.75	02/06/2031	4.861
XS0545440900	Telefonica Emisiones Sau	TELEFO	5.445	08/10/2029	4.834
XS0785710046	At&T Inc	T	4.875	01/06/2044	4.829
XS0830326269	Directv Holdings/Fing	DTV	4.375	14/09/2029	4.819
XS0932036154	At&T Inc	T	4.25	01/06/2043	4.819
XS0437306904	Rwe Finance Bv	RWE	6.125	06/07/2039	4.809
XS0426513387	At&T Inc	T	7	30/04/2040	4.786
XS0098255176	Abbey Natl Treasury Serv	ABBEY	0	15/06/2038	4.772
XS0812855277	America Movil Sab De Cv	AMXLMM	4.375	07/08/2041	4.756
XS0451790280	Koninklijke Kpn Nv	KPN	5.75	17/09/2029	4.751
FR0010039008	Orange Sa	ORAFP	5.625	23/01/2034	4.715
XS0735770637	Rwe Finance Bv	RWE	4.75	31/01/2034	4.697
XS0105244585	Tesco Plc	TSCOLN	6	14/12/2029	4.695
FR0010945436	Electricite De France	EDF	5.125	22/09/2050	4.657
XS0954302369	America Movil Sab De Cv	AMXLMM	4.948	22/07/2033	4.639
XS0276684700	Wells Fargo & Company	WFC	4.875	29/11/2035	4.635
FR0011132356	Electricite De France	EDF	5.5	17/10/2041	4.633
XS0221324154	Segro Plc	SGROLN	5.75	20/06/2035	4.623
XS0499449261	Dong Energy A/S	DONGAS	5.75	09/04/2040	4.621
XS0733786130	Gatwick Funding Limited	GATAIR	5.75	23/01/2037	4.621
XS0543369184	Lloyds Bank Plc	LLOYDS	6.5	17/09/2040	4.62

Source: J.P. Morgan

Long risk iBoxx £ TRS; short risk iBoxx €HY TRS

Our second trade is a relative-value trade using the iBoxx TRS indices to take advantage of the views expressed above. We recommend investors go long risk the iBoxx £ IG index versus short risk the iBoxx €HY LQD index via the TRS.

Table 2: Trade details

Instrument	Ticker	Expiry	Notional	Entry
iBoxx € LQD HY Index TRS	IBOXXMJA	20 December 2014	€ 100,000,000	166.94
iBoxx £ IG Index TRS	IYDU	20 December 2014	€ 100,000,000	270.16

Source: J.P. Morgan.

We believe this trade is attractive for the following reasons:

1) The £IG index provides exposure to longer-dated risk. While the mod duration of the €HY index is 2.5, that of the £IG index is 7.6.

2) The £IG index provides a higher yield than the lower-rated €HY index. The yield of the €HY index is 3.76 versus 4.31 for the £IG index.

3) The trade provides attractive valuation relative to NAV. The €HY index is trading 44bp above fair value, while the £IG index is 8bp above fair value.

Table 3: Index metrics

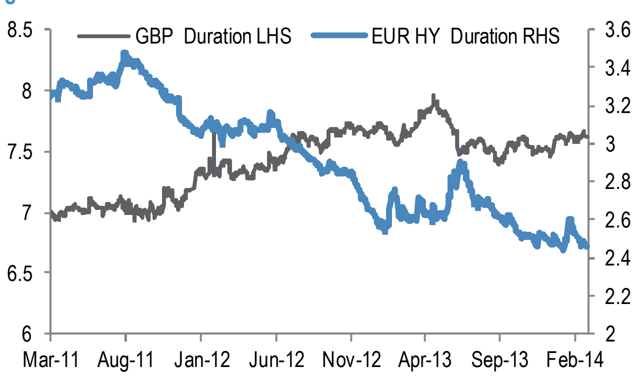
Instrument	Yield	Spread	Duration	Premium/Discount to NAV
iBoxx € LQD HY Index TRS	3.76	317	2.5	0.44%
iBoxx £ IG Index TRS	4.31	142	7.6	0.08%

Source: J.P. Morgan.

The £IG index provides exposure to longer-dated risk

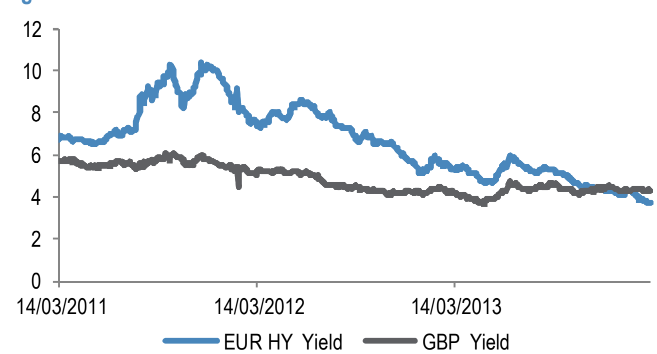
As highlighted above, we believe investors should be long risk through longer-dated instruments hedged with shorts in short-dated, high-yield instruments. The iBoxx £ IG index currently has a modified duration of 7.6 years versus only 2.5 for the € Liquid HY index. As Figure 8 shows, the duration of the €HY index has been shortening recently as bond prices have risen and many are trading above their call price. Conversely, the duration of the Sterling index has risen as yields have come down and longer-dated bonds have been issued.

Figure 8: Duration



Source: J.P. Morgan.

Figure 9:Yield



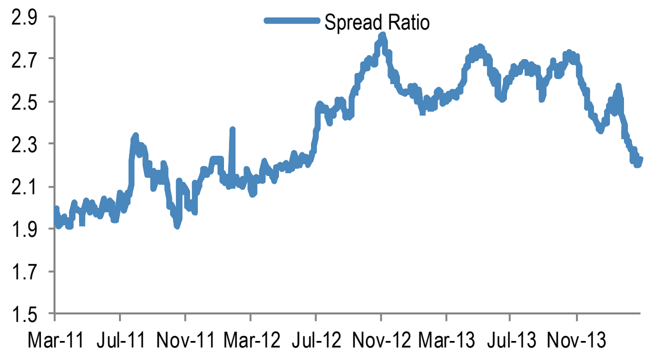
Source: J.P. Morgan.

The £IG index provides a higher yield than the lower-rated €HY index
Despite the lower rating of the €HY index, the yield of the index is lower than that of the £IG index (Figure 9). While the spread of the €HY index is still higher than that of the £IG (317bp versus 142bp), this spread ratio has been compressing over the past year and currently trades with a ratio of 2.2 times. The higher yield of the £IG index is a function of both the longer maturity and steeper yield curve of Sterling versus Euro swaps.

The trade provides attractive valuation relative to NAV
Finally, we note that from a technical perspective, it is attractive to be long risk the £IG index versus short risk the €HY index. The flow of money into the €HY market has seen the index trade higher than the fair value. Conversely, the higher duration of the £IG index has seen investors taking differing views on this index, with some using it as a hedge for rising rates and others as a long risk opportunity.

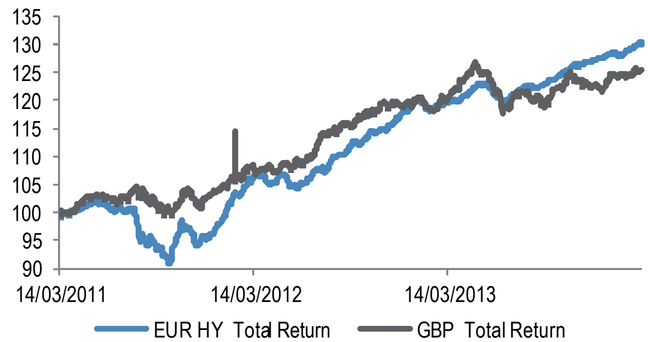
From a return perspective, the £IG index has outperformed the €HY index over the past few years (Figure 11) on a risk-adjusted basis. While the returns from both series has been similar, the volatility of the €HY index has been significantly greater.

Figure 10: Spread ratio



Source: J.P. Morgan.

Figure 11:Total return



Source: J.P. Morgan.

Long risk iTraxx Main 10y; short risk iTraxx Crossover 3y

The final trade we recommend is to be long risk through long-dated CDS and short risk through short-dated high yield CDS. We recommend investors buy protection on the iTraxx Crossover 3y and sell protection on the iTraxx Main 10y.

Given the liquidity of these indices, investors may find it more attractive to enter this trade through single names or baskets of single names.

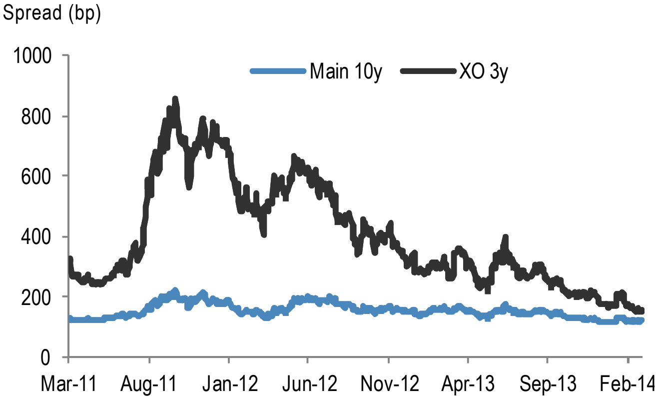
Table 4: Trade details

Instrument	Tenor	Notional	Spread	Upfront	Duration
iTraxx Crossover	3Y	€ 100,000,000	176	-9,850,690	2.88
iTraxx Main	10Y	€ 100,000,000	128	2,123,320	7.93

Source: J.P. Morgan.

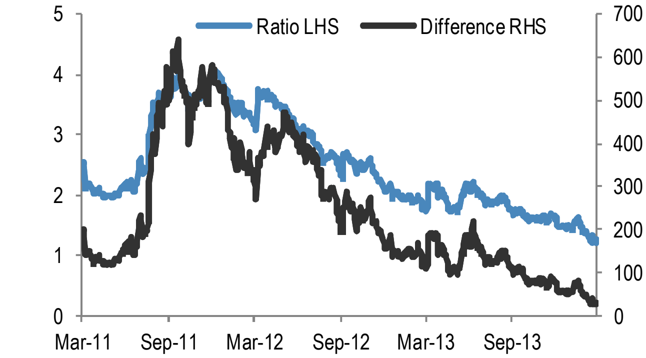
The spread ratio and difference between iTraxx Main 10y and Crossover 3y is currently at multi year lows. Having traded as high as 640bp in 2011, the spread difference between the two indices is currently at 45bp while the ratio of spreads is 1.35 times. Investors are therefore able to sell long-dated investment-grade risk and buy short-dated HY risk for only 45bp.

Figure 12: iTraxx Main 10y versus XO 3y



Source: J.P. Morgan.

Figure 13: Ratio and spread difference

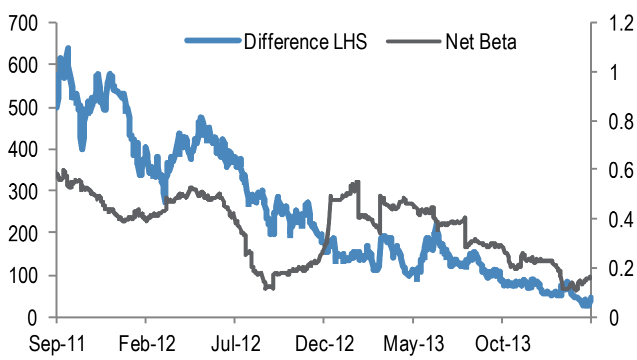


Source: J.P. Morgan.

We see this as a cheap option which will perform in market weakness, for a low cost. The trade has a short-risk bias with positive convexity. The current beta of the Crossover 3y to Main 10y is 3.4 times, meaning that for a 1bp change in the spread of the Main 10y, the Crossover index changes by 3.4bp (this is very similar to the beta of Crossover to Main 5y given that curves tend to move in a parallel fashion). The difference in duration between the two indices is currently 2.75 times, meaning the net position has a beta of 0.23bp (=3.4/2.75-1) relative to a 10y Main position. Therefore, a 1bp change in the 10y Main is equivalent to 0.23bp for the trade or €18,600 (=0.23bp × 7.93 × €100m) on the notionals given.

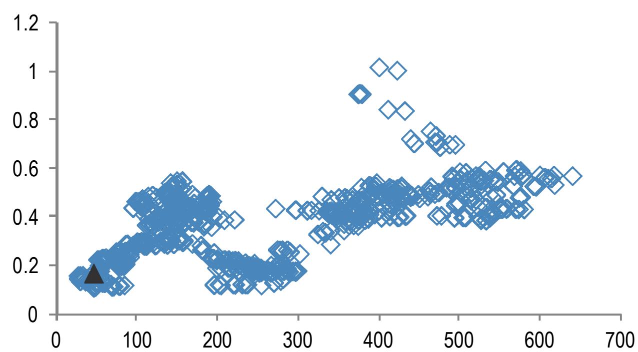
We expect the beta of the trade, however, increase as spreads widen and the differential increases, and fall as the differential between the two indices decreases (Figure 14 and Figure 15). This gives the trade an attractive positive convexity position – as the market widens, we expect the differential between the two indices to increase and net beta increases, making the trade more short risk. Conversely, as spreads tighten, the net beta declines meaning the short risk exposure decreases.

Figure 14: Beta versus Spreads Difference



Source: J.P. Morgan.

Figure 15: Beta versus Spreads Difference



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