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LYXOR ALTERNATIVE UCITS

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EMBRACE THE CHANGE WITH LONG/SHORT CREDIT

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Change is in the air. A number of market-relevant factors may be approaching some form of conclusion. In this environment, we believe liquid, long/short strategies offer the best approach to achieving attractive performance in European credit markets.

As we begin to look towards the end of the year, it may be that thoughts naturally turn to change in Europe. However, even bearing this natural bias in mind, a number of factors appear to be gathering momentum currently and may prompt further change for markets: stress has been apparent in Emerging Markets (particularly in Turkey and Argentina, with uncertain implications from the recent elections in Brazil); the end of the ECB's QE programme is looming, as is Brexit early next year; the US yield curve is seemingly heading toward inversion; and the US is pursuing "Trade Wars" with its major partners even as the President's legal troubles mount.

In this context we might reconsider the classic 'cycle clock', where a mature cycle is typically marked by high asset valuations, rising corporate leverage and reduced growth. Long-only, beta exposure to credit is typically considered less attractive at this point, though diversification benefits remain valuable. More importantly however, the 'reach for yield' remains a powerful magnet for the asset class in an environment of high liquidity provisions and low interest rates. This continues to attract a variety of institutional investors, seeking the yield from credit markets; European HY markets offer a yield in excess of 4% (as of mid-October), while German 10Y bonds offer close to 0.4%. The ECB kept its benchmark refinancing rate at 0% in October, where it has been floored ever since early 2016 and is scheduled to remain "at least through the summer of 2019"[1].

[1] ECB monetary policy press release, 25 October 2018

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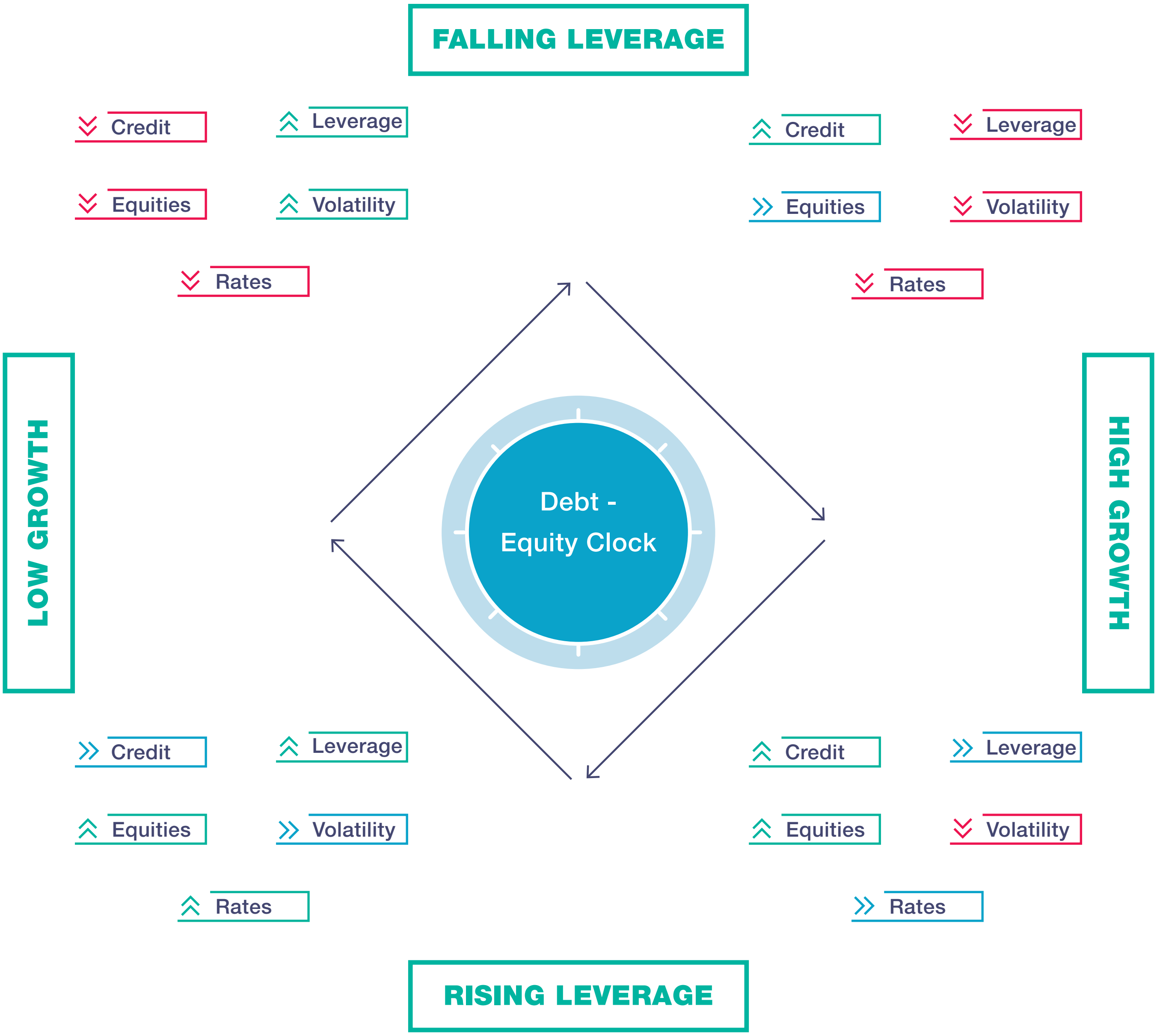

Source: Chenavari

While the picture for long-only, beta exposure to credit may therefore be mixed, the environment for relative value and long/short trading strategies has notably improved. Political and corporate developments are interacting with the receding tide of the ECB's asset purchases to provide increasingly attractive opportunities, as volatility and idiosyncratic risks pick up in Europe.

For example, the Auto manufacturing sector has been singled out for special treatment in the recent US trade complaints with Europe and NAFTA/USMCA partners Mexico and Canada. In addition, new regulations are pressuring manufacturers, with changes to diesel regulations and new car testing procedures being applied to all new car registrations from September.

IDENTIFYING IDIOSYNCRATIC OPPORTUNITIES

Fundamental developments within individual companies, not just at the sector level, are also providing idiosyncratic opportunities. French investment group Rallye holds the supermarket group Casino Guichard Perrachon as its primary asset, though each entity is separately quoted for trading. The complex ownership structure and collateral requirements for credit lines at Rallye sparked fears that a financial restructuring might be required at the parent level, though the highly levered balance sheet is being aided by plans to dispose of non-core assets.

As ever, credit markets provide a range of individual bonds and CDS to trade both long and short within the capital structures of such entities. In addition, such names are constituents of credit indices - iTraxx Crossover in the case of Casino. A detailed understanding of the fundamental drivers of these individual corporates is key to trading indices as well as the single names.

The Financials sector also continues to offer related opportunities. In Italy, the governing coalition between the League and Five Star Movement parties is being tested as they attempt to meet campaign pledges while drawing up budget plans acceptable to the EU Commission. Fears of profligacy have prompted investors to avoid Italian risks, with Moody’s pointedly giving itself more time to review its sovereign rating for Italian debt before downgrading its rating to Baa3 from Baa2 with a stable outlook. Selling of UniCredit AT1 bonds meant that nimble investors could briefly take advantage of near 10% yields from some bonds.

TOOLS FOR THE JOB

In the context of rising idiosyncratic risks and increasing geopolitical or financial warning signs, we believe that a long-only approach to investing in European credit markets is not sufficient. The current environment is providing significant opportunities, provided that investors deploy the correct approach and tools. For example, operating within the UCITS framework can ensure focus on a liquid portfolio that enables a genuinely nimble trading approach. The ability to specifically short corporate bonds is a key tool for positioning in complex situations. And the ability to use derivatives to construct positions with convex pay-off profiles allows for an efficient approach to trading volatility in credit markets.

Taking advantage of such opportunities requires dedicated resources and specialized expertise. With a decade of experience managing European credit and structured finance investments, Chenavari Investment Managers specializes in capturing such opportunities. Now is the time to embrace change.

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