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AEGON **INSIGHTS**

# How tight can credit spreads get?

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Alexander Pelteshki, portfolio manager, is a member of the multi-sector portfolio management team. He specializes in top-down asset allocation, global bonds, and corporate credit. He is a co-manager for our strategic bond and core plus strategies.

***Credit markets are flashing a signal that hasn't appeared in decades: corporate bonds are trading as if default risk has virtually disappeared. This compression in credit spreads – the extra yield investors demand to hold corporate debt over government bonds – has created either an extraordinary opportunity or a dangerous trap.***

Global credit spreads have reached generationally tight levels. US investment grade credit spreads are trading in the high 70s – near decade lows. The picture is very similar across developed markets, with European investment grade credit making new tights almost daily this summer.

There is very little risk premium built into high yield either. Looking at credit spreads alone, the market has not been this complacent about corporate default risk in a very long time. The creditworthiness of corporate issuers appears fairly priced in current compensation for default risk.

## The driving forces

We are not negative on the market here. The driving forces behind spread compression are very strong – US annuity sales hit an all-time high in the second quarter, investment grade mutual fund flows reached a four-year peak in July, and investor bearishness remains quite high. This flow dynamic can be explained by the still attractive yields in global fixed income markets.

Therefore, unless growth materially deteriorates, global central bank interest rates are reduced meaningfully, or if Inflation rapidly re-accelerates, we could witness not only the persistence of tight credit spreads, but potentially see spreads reach new all-time tights.

## The strategic opportunity

Despite that outlook, we would not be chasing this rally. We believe it is not a question of 'if' credit spreads normalize toward their long-term averages, but a matter of 'when'. The timing could be very near, or in several quarters.

Instead of guessing on binary outcomes, we believe this market creates opportunities to introduce cheap, convex hedges, that still allow investors to maintain high defensive yield in portfolios. This setup would allow investors to extract healthy yield from the market, while leaving money positioned to help manage against sharp spread widening when it comes.

## The bottom line

The current environment offers both attractive yields and cheap hedges. Rather than timing the exact turn, investors can aim to capture today's tight spreads while hedging tomorrow's inevitable widening – potentially creating one of the best risk-adjusted opportunities available.

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