19.07.2023

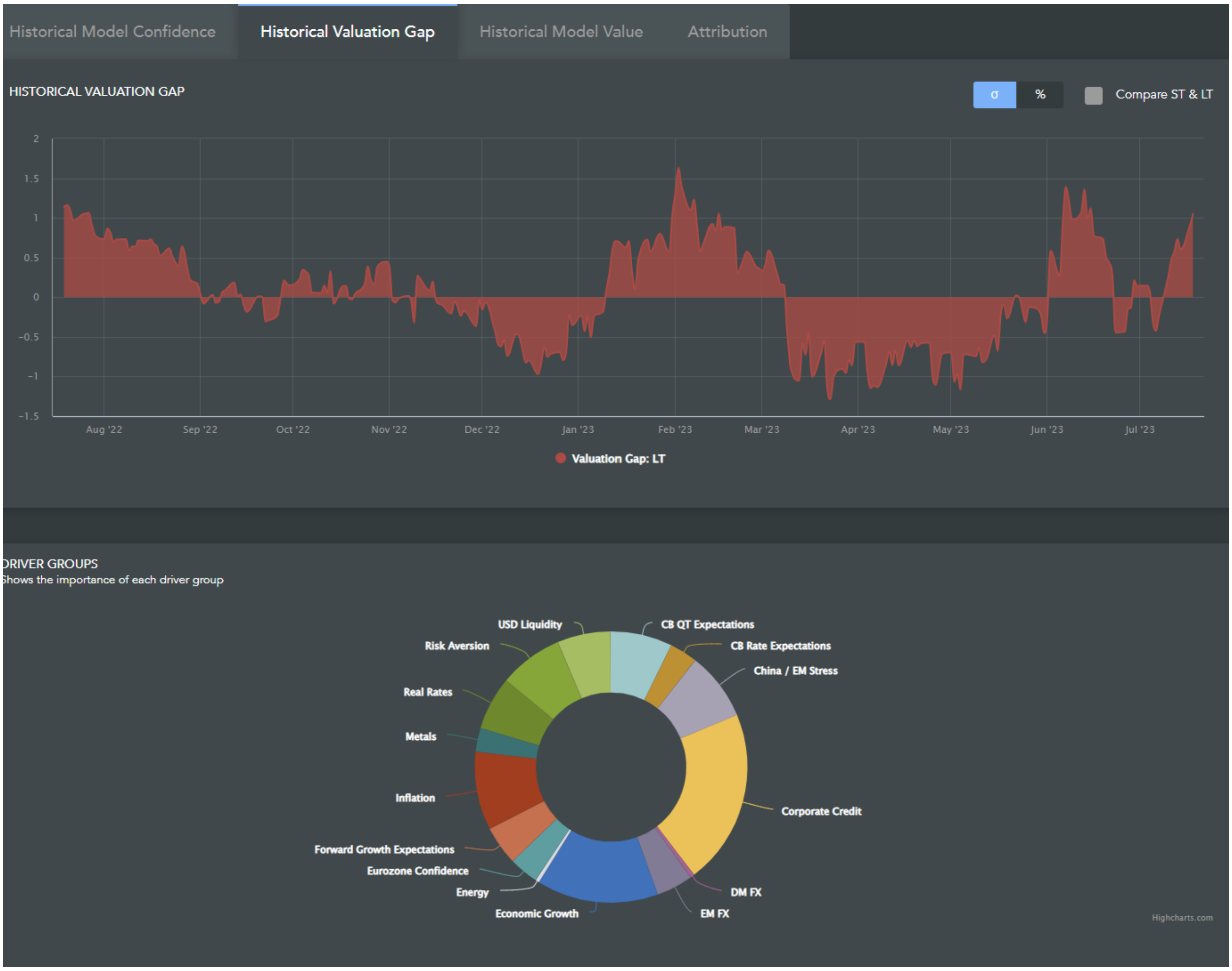
Watching Credit

Credit spreads continue to grind tighter and provide sponsorship for the equity rally.
A rally that is still being led by the Magnificent Seven but which has recently shown signs of broadening out. Various metrics show cash is coming in from the side-lines, shorts are being covered, speculative/high beta stocks are performing strongly.

That begs the question how important is the **role of easy credit** in helping this rally continue and drag up the lower quality parts of the equity market?

On Qi, credit spreads are the second biggest driver of the S&P500 after interest rate volatility. But for the Russell 2000 that pattern is inverted and credit spread are the biggest single macro factor.

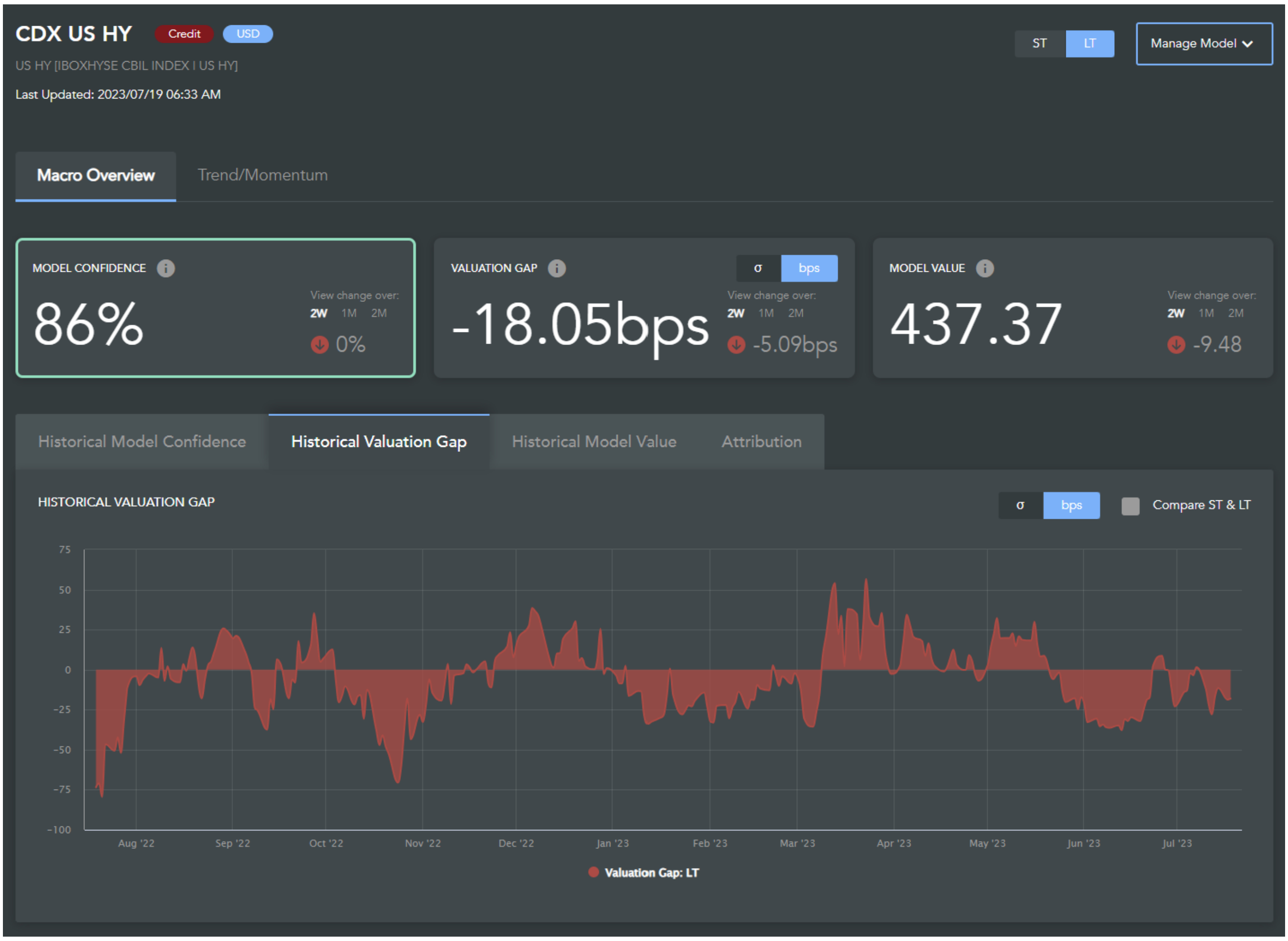
The Russell (below) also screens as twice as rich to macro as the S&P500. R2k is now over one standard deviation above macro-warranted model value (versus a +0.6 std dev FVG for SPX).



We can add that to a list that includes ARKK and the MEME ETFs: both +1.5 std dev rich.

What about credit spreads themselves? US High Yield spreads are in a strong macro regime - model confidence is 86% and incredibly stable.

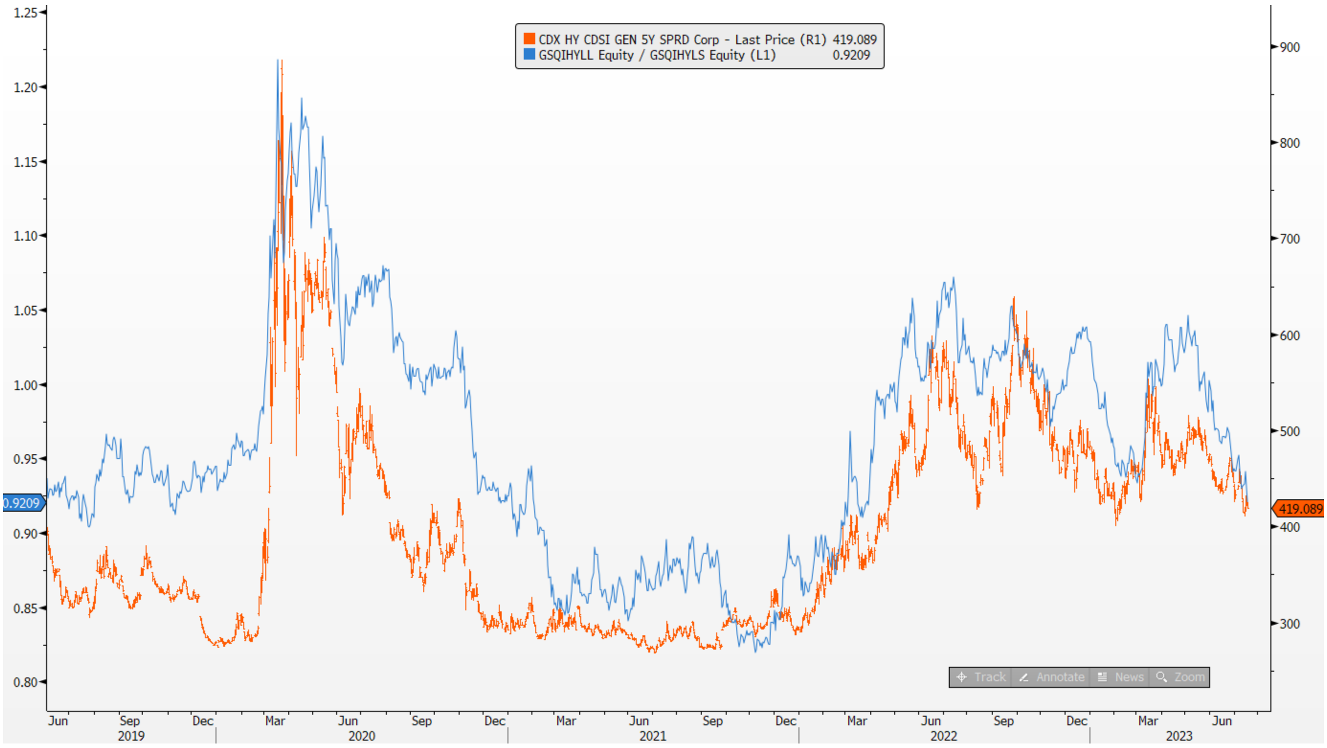
They now screen as 0.5 std dev or 18bp too tight versus prevailing macro conditions. Not a huge Valuation Gap but towards the tight end of recent ranges.



For now though macro momentum is supportive. Model value is trending tighter. Model value has moved from 483bp at the start of June to 437bp now. Until this turns wider, any FVG simply flags a market that is running ahead of fundamentals. Not an imminent reversal.

However, to the extent that credit spreads are fairly fully priced, that does in turn imply it's going to be **increasingly hard for low quality equity plays to keep performing**.

This is not yet a signal even with extended FVGs because of macro momentum. It is, however, an indicator that the **risk-reward trade-off is becoming harder** to chase the catch-up trade in high beta.



The Qi US High Yield credit basket is a long/short pair with strong tracking and less onerous carry dynamics. It has fallen 11% since early May and this HY spread tightening move. It is trackable on Bloomberg and tradeable via our partner Investment Banks.

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