# PM's note: beware of listening to the noise (and your own biases)

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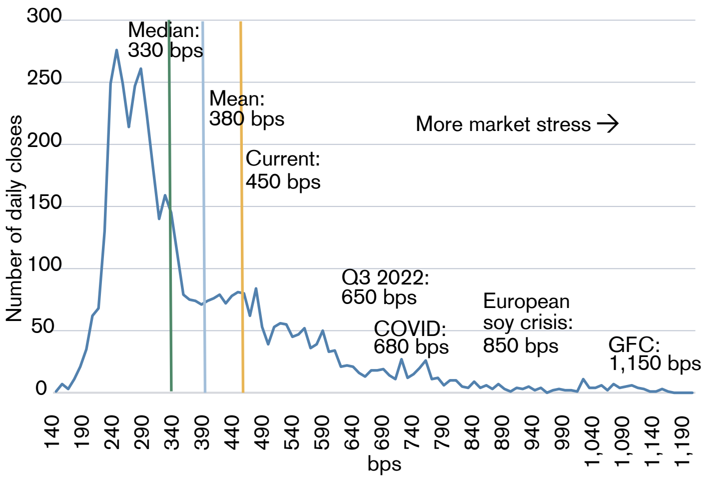
**We find ourselves once again at a fascinating juncture in financial markets. Over the last twenty years, I have more often been at the extreme in terms of risk avoidance compared to my peers than at the extreme in terms of seeking risk, which is why many of my peers and colleagues see me as "bearish". Indeed, for many years, I tried to routinely "self-adjust" for a built-in bearish bias.**

**As of today, though, I am not self-adjusting. Instead, I am acknowledging that my risk awareness may place me far from the mean view for a considerable period. Two major notes of caution: I actually am very bullish about fixed-income markets (particularly the less credit-risky ones). Yet, the fact that markets seem to be sleepwalking into a potential crisis makes me look bearish by even acknowledging that risk exists, and when a major correction occurs, it may happen so rapidly that I become bullish on the more liquid riskier parts.**

**Don't believe the hype – we are still within normal ranges**
As we wrote in our last piece, anyone reading the financial press would think we were already in crisis territory. "Recession …," "Crisis …," and "Volatility …" tend to lead current headlines. Markets, however, are not of the same view. You would expect spreads on high-yield credit – a gauge of investor sentiment – to be unusually wide to reflect a higher perception of risk. Thus far, though, our two main developed-market high-yield credit indices are well within what might be described as a normal range. They certainly are not reflecting anything like the hysteria that commentators would suggest nor the tightening of credit conditions that we eventually expect to see. In Europe, the Markit iTraxx Crossover, an index composed of credit default swaps on the most liquid high-yield issuers, is at roughly its 73rd percentile, and although it is wide of its mean and median, it lies well inside Q3 2022 levels and is very far below the levels seen in Q3 2011 or during the Global Financial Crisis.

**Current credit spreads wider than historical mean yet well below "crisis" territory**
Distribution of crossover spreads since launch

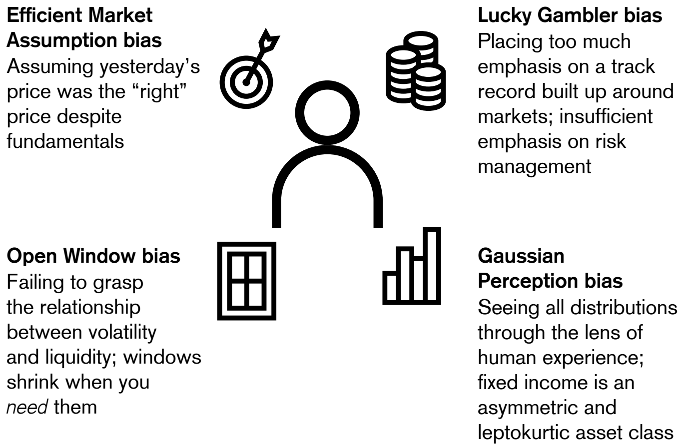



Sources: Bloomberg, Credit Suisse Asset Management
Data as of the end of April 2023.

And yet, an increasing number of people are paying attention to the more bearish comments we make, noting our caution about the tightening of credit conditions and the likely consequences of a credit cycle. That, alongside the slightly higher level of discrimination at the lowest end of the rating spectrum, helps manage our fear that any major credit crunch could still be described as orderly rather than as an outright panic.

**Being aware of biases**
Rather than list all of the biases that can affect us, I want to zoom in on a few that I feel are relevant for us to examine – and focus on one in particular that I think is highly relevant to today.

**Behavioral biases in fixed income**




### Behavioral biases

- **Efficient Market Assumption bias:** assuming yesterday's price was the "right" price despite fundamentals.
- **Open Window bias:** failing to grasp the relationship between volatility and liquidity; windows shrink when you *need* them.
- **Lucky Gambler bias:** placing too much emphasis on a track record built up around markets, and insufficient emphasis on risk management.
- **Gaussian Perception bias:** seeing all distributions through the lens of human experience; fixed income is an asymmetric and leptokurtic (i.e. outcomes are biased toward the mean) asset class.

In my opinion, the final bias could also be called a **"Lack of Relevant History"** bias, and I'm going to try to describe it by means of an imagined conversation between a potential investor and a financial market practitioner within the relevant asset class:

**Investor (INV):** What is your current allocation to asset class XYZ?
**Financial market practitioner (FMP):** Hugely overweight.

**INV:** Why such a large overweight?
**FMP:** It offers a premium over liquid Investmet Grade (IG) public corporate credit and has lower levels of volatility. The credit fundamentals are also very sound, and the underwriting is very conservative.

**INV:** OK, so I understand your first statement. However, I would counter that the premium may not be huge and is less than the recent move in IG credit spreads. But please tell me more about the lack of volatility and the high-quality fundamentals.
**FMP:** Well, this asset class has experienced only 3% volatility over its entire history.

**INV:** But surely the reason for the low volatility is the fact that it's illiquid and trades very infrequently.
**FMP:** No. The reason for the absence of markdowns is that there is always someone who is holding a very high cash balance waiting to buy anything that trades below USD 0.95. In fact, the amount of dry powder waiting to invest is currently at all-time highs.

**INV:** And the credit fundamentals?
**FMP:** Well, the long-term average default rate is below 3%, with the average recovery rate at around 80%.

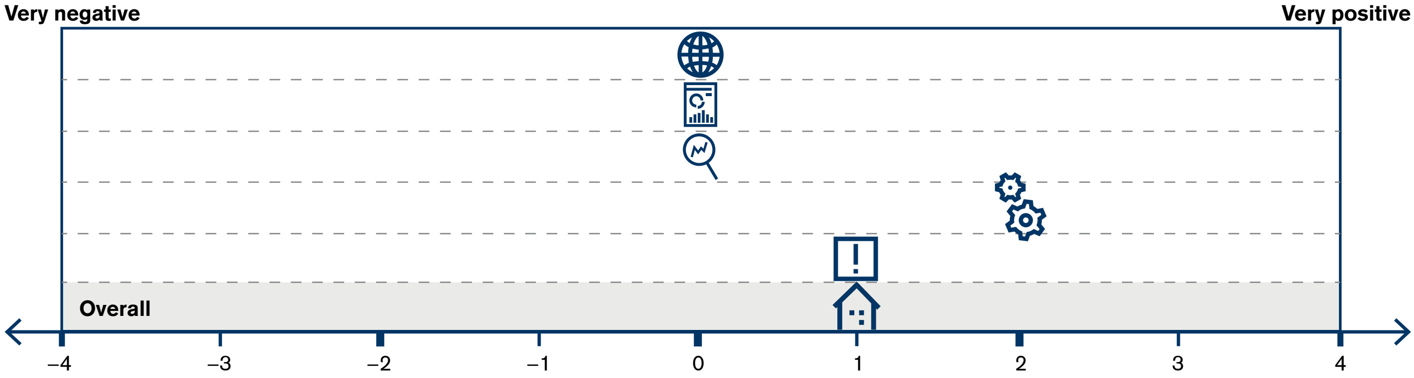
**INV:** Wow, that sounds fascinating. One last question before I invest: How long has the asset class been around?
**FMP:** It emerged just after the last credit cycle.

I am pretty confident that you all know a few parts of the fixed-income universe that fit this narrative. A hunt for yield by investors, the increasing value placed on an illiquidity premium (though this has rarely, if ever, been quantified), and the desire for banks to reduce leverage have brought about the emergence of a few new asset classes in the fixed-income universe. These subasset classes tend to be private, have experienced low levels of volatility to date, and are likely to have characteristics hidden by several (if not all) of the aforementioned biases. If you need any further help spotting them, please feel free to reach out to us.

In the meantime, remember to beware of your biases and, in particular, to look out for the **Lack of Relevant History** bias because the default, bankruptcy, and credit-tightening phase of the credit cycle is coming.

## CSAM fixed-income investment strategy

Risk appetite – investment grade




**Economic outlook (unchanged) –** Recession fears have started to abate, and inflation appears to have moved past peaks. Nonetheless, uncertainty over a successful economic soft-landing and renewed escalation of geopolitical risks remains.

**Credit fundamentals (unchanged) –** Generally, fundamentals have started to deteriorate and are expected to weaken going forward, as reflected by worsening credit metrics in earnings reports. For now, IG still looks solid, while concerns are mainly centered around HY and weaker credits.

**Valuation (unchanged) –** Most credit markets have started to price out a recession. IG valuations no longer look overly attractive in a historical context, but thanks to rates component continue to offer multiyear high yields. HY looks increasingly challenged, given tighter relative spreads.

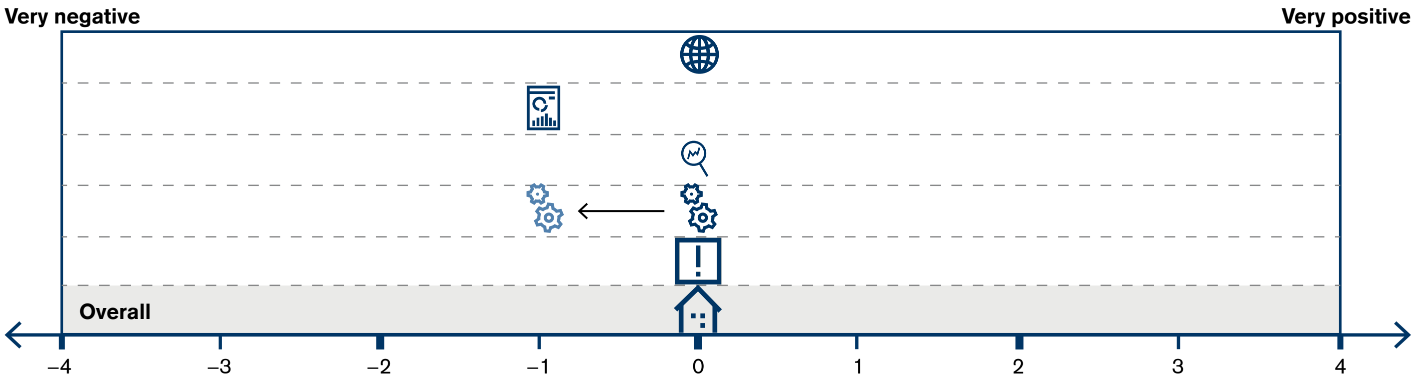
**Sentiment/technicals (unchanged) –** Flows for high grade remain positive, and investor surveys show the strongest overweight positioning in bonds since March 2009. Volatility remains elevated and liquidity below average.

**Tail risks (unchanged) –** CBs seem to have successfully moved inflation past peaks, but the market now shows signs of complacency by pricing out recessionary risks. The immediate effect of the energy crisis has been softened by mild weather recently.

Source: Credit Suisse, as of 14.04.2023
For illustrative purposes only.

## CSAM fixed-income investment strategy

Risk appetite – high yield

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**Sentiment/technicals (from 0 to –1) –** Fixed-income flows remain strong overall. However, high-yield flows remain challenged by investors allocating to attractively priced high grade instead. Volatility remains elevated and liquidity below average.

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