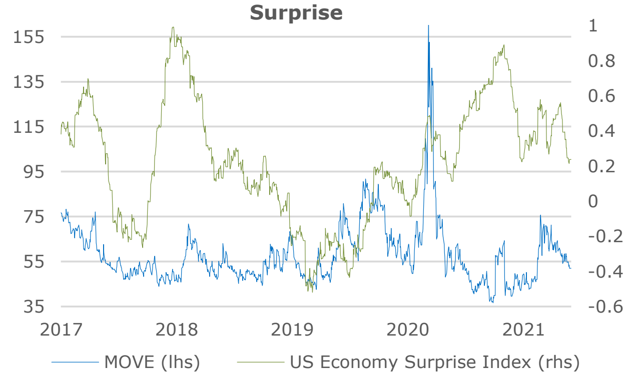
Monthly Spotlight

Interest rate volatility calmed down meaningfully

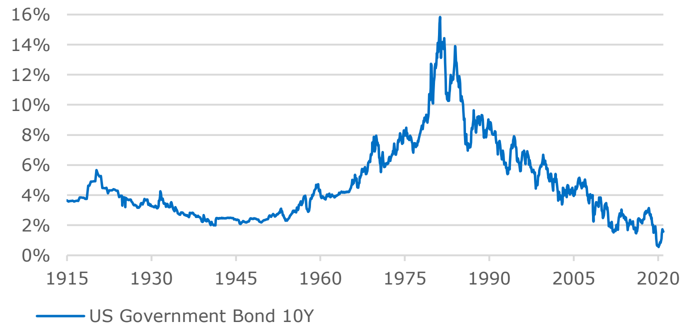
The steepening of the US Treasury bond yield curve increased the volatility of interest rates overall. This is well illustrated by the MOVE index, an indicator that measures interest rate volatility using the implied volatility of a basket of government bond options. However, the MOVE index is far from its late February peak and is now at the same level as a year ago. The FED's confirmation that it is deliberately accepting a temporary rise in inflation has reassured the market. Moreover, the economic surprise index has lost further ground, as actual economic performance has fallen short of (high) expectations and hence, implying that peak yield levels reached few months ago should not be tested in the short term.

Interest Rate Volatility vs Economic Surprise

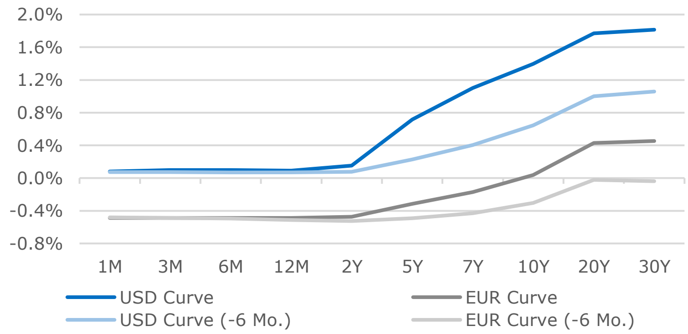


Rates Perspective

1) Historical US Treasury Yield: 10-year US government bond yield reached its 100-year low in 2020.

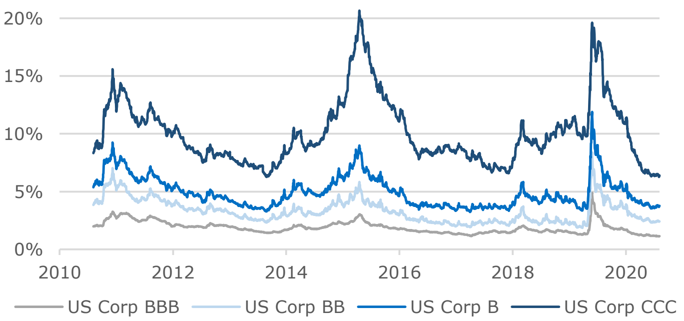


2) Interest Swap Curve: USD swap curve experienced a strong steepening, what is most evident with tenors > 2 years.

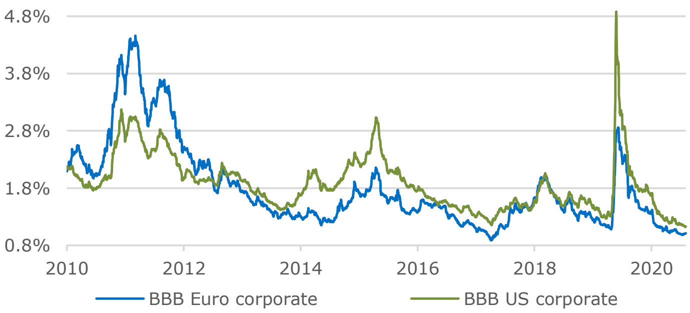


Corporate Perspective

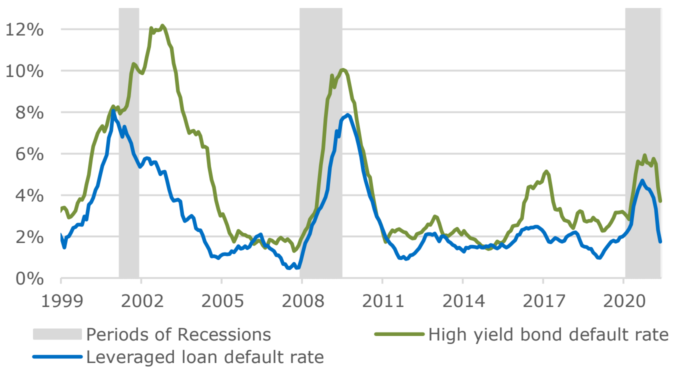
3) US Corp. Rating: Credit spreads (OAS) of lower rated high-yield bonds continued to tighten disproportionately.



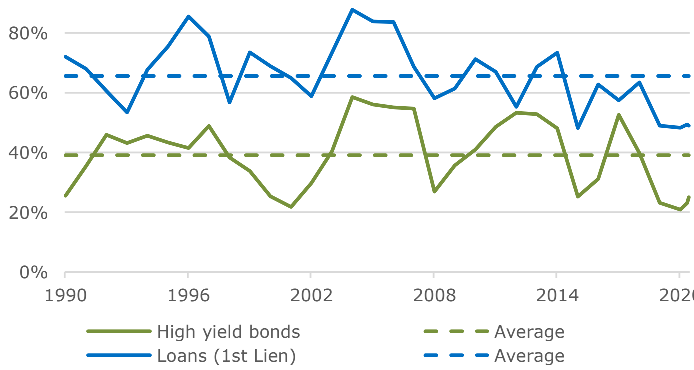
4) EU vs US: Since the Covid-19 spike, credit spreads (OAS) between the USA and EU have converged in tandem to lower levels.



5) Default Rates: Default rates of HY bonds & loans are peaking. HY bond default rates are structurally higher (Ø4.4%) vs. loans (Ø2.8%).



6) Recovery Rates: Recovery rates of leveraged loans are higher (Ø66%) vs. high yield bonds (Ø39%) due to lower severity.



OAS spread change overview across major credit asset classes - as of month end

US corporates by rating (bps)

	curr	Δ month
AAA	46	-2
AA	54	-3
A	69	-4
BBB	113	-4
BB	242	+5
B	377	+14
CCC	639	-11

Global high yield (bps)

	curr	Δ month
US HY	334	+6
EU HY	303	-1
Asia HY	707	-7
EM HY	382	+0

CDS spreads (bps)

	curr	Δ month
CDX IG - US	51	+0
iTraxx IG - EU	50	+0
CDX HY - US	288	+2
iTraxx XO - EU	247	-2

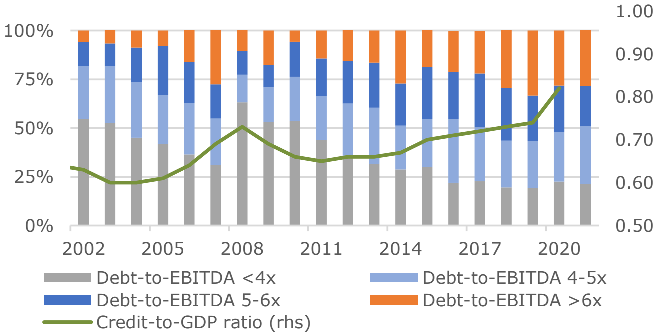
Loans and CLOs (yld, bps)

	curr	Δ month
US Loan	364	-6
CLO AAA	132	-6
CLO BBB	374	-18
CLO BB	743	-15

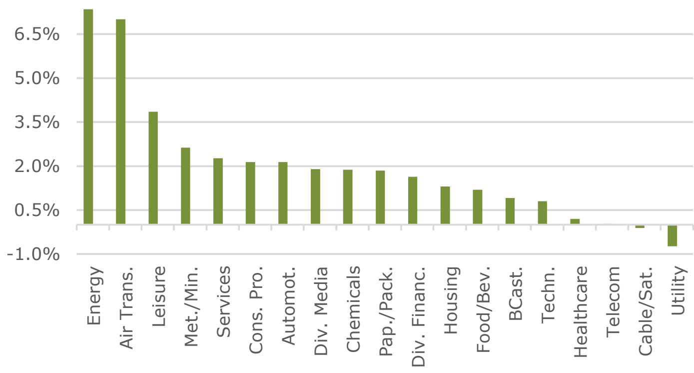
spread tightening (positive price action)

spread widening (negative price action)

7) US Leverage: Debt-to-EBITDA of US companies has remained stable at high level in Q1 2021.

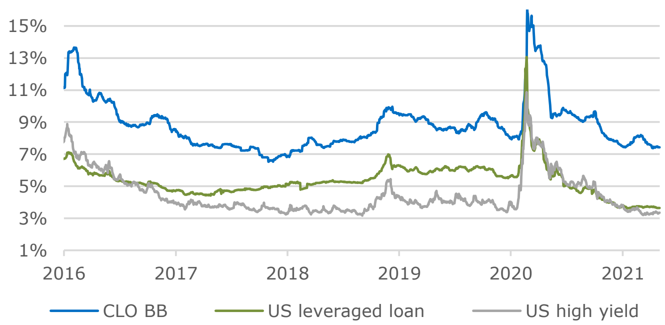


8) YTD Sector High-Yield Returns: Air transport, energy and leisure continued to catch up.

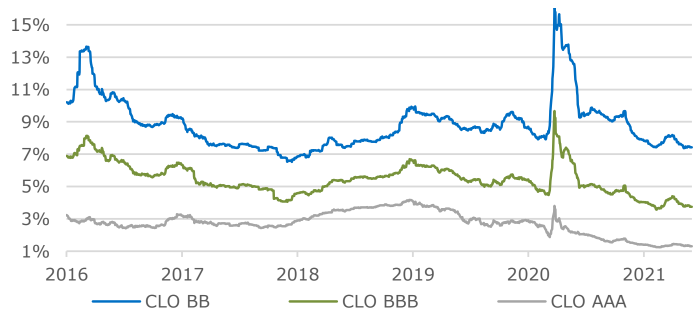


Alternative Perspective

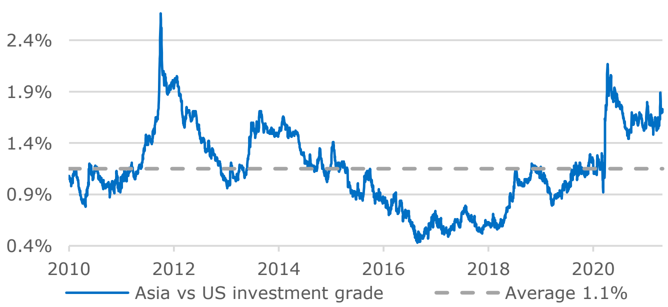
9) Loans vs. CLO vs. HY: CLO BB yields are still wider vs Loans and HY bonds, despite the recent price increase in CLO BB.



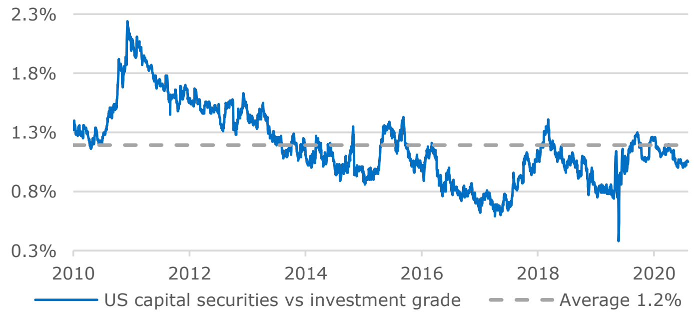
10) CLO Yields: CLO BB yields tightened more than higher rated CLOs. CLOs offer an attractive yield premium over bonds / loans.



11) Asia vs. US: Despite a recent tightening of Asian IG spreads they continue to offer a sizeable premium vs. US IG spreads.



12) Capital vs IG.: Capital Securities structurally earn a premium vs. US IG bonds. Capital Securities are dominated by the financial sector.



Education Corner

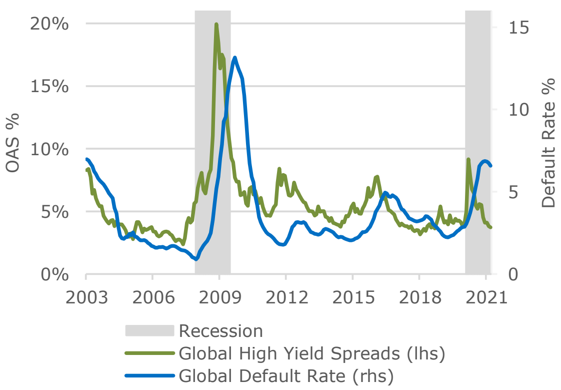
Default rates lag credit spread movements by a large margin

As the chart well illustrates, credit spreads front run corporate default rates. Therefore, default rates are not a useful gauge to predict future economic development, but it is rather the other way around. In essence, the prevailing spread levels reflect the expected future probability of default rates, what can be summarized in the simplified formula below:

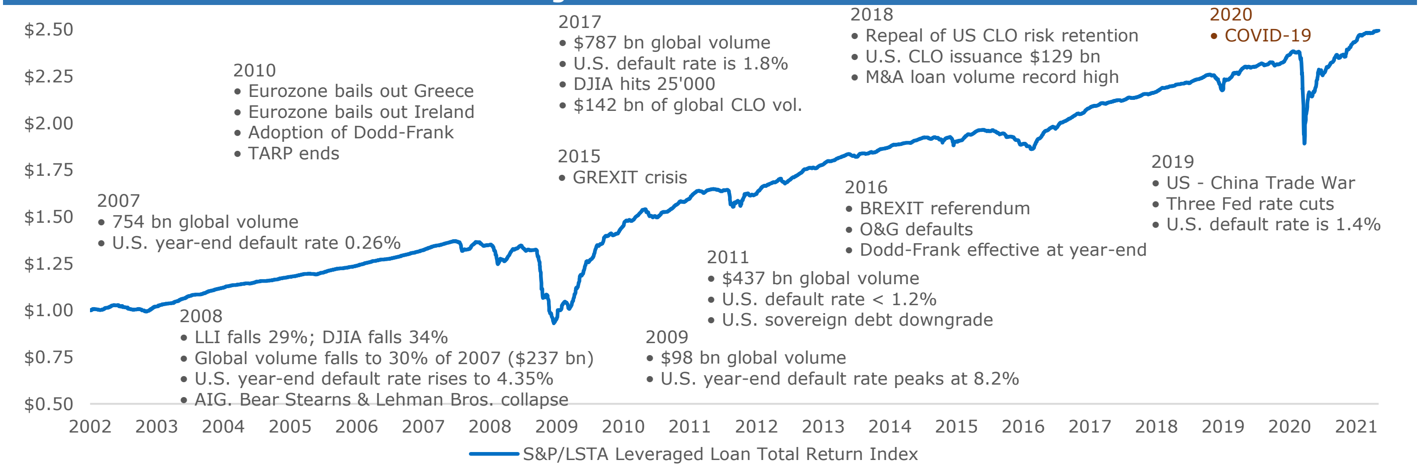
$$\text{Credit Spread} = (1 - \text{Recovery Rate})(\text{Default Probability})$$

Another example emerged in Q1 2020, when credit spreads reached their top level, but default rates peaked in late 2020. Hence, spreads provide an indication of where default rates could or should be trending. However, as it was the case in Q1 2020, markets tend to overreact in sentiment driven markets. Now, spreads indicate that the economic recovery should continue with low default rates.

Global Default Rates and Spreads



US Loan Index Total Return - Attractive Long Term Yield Generation



List of Abbreviations

Capital Securities (Or preferred securities): Are fixed income securities combining features of bonds and preferred stocks.

CDS: Credit default swaps transfer credit event risk to another party in exchange of a perdiodically paid premium. CDX index covers the US IG-, iTraxx the EU IG- and iTraxx crossover (XO) the EU HY market.

CLOs: Collateralized loan obligations are structured finance securities collateralized predominantly by a large pool of different loans.

Default Rate: Number of defaulted corporate issuers of leveraged loans and high yield bonds.

Loans: Are syndicated, public tradable loans. Synonyms are «syndicated loans», «loans», «leveraged loans» and «bank loans».

OAS: Option-adjusted spread is the yield difference of an interest paying security to the risk free rate considering embedded options.

TIPS: Treasury Inflation-Protected Securities are US government linked to the US CPI Urban Non-Seasonally Adjusted.

Up-/ downgrades: Rating actions of Moody's and S&P of up-or downgrades of US high yield bond issuers denominated in USD.

Up-/ downgrade ratio: Number of upgrades of total rating actions.

Recovery Rates: Bond issuer-weighted recovery rates express the principal and accrued interest on defaulted debt that can be recovered in percentage of face value. Example:
Expected loss rate if US HY defaults were 10%: 10% ./. Estimated average recovery rate of ~30% = -7%; Example for Loans:
Expected loss rate if US Loan defaults were 10%: 10% ./. Estimated average recovery rate of ~65% = -3.5%;

Data and Price Sources

Alpinum Investment Management	Federal Reserve Bank of St. Louis	Palmer Square indices
Bank of America Merrill Lynch indices	Markit CDS indices	Preqin
Bloomberg	Moody's Investors Service	S&P
The Federal Reserve	J.P. Morgan	Federal Housing Finance Agency
US Census Bureau		

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