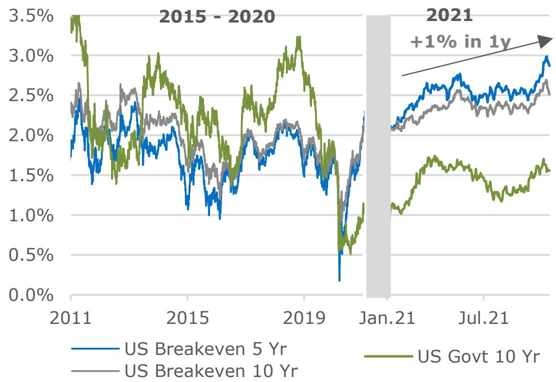
Monthly Spotlight

Is inflation about to peak?

Since the beginning of 2021, breakeven inflation has risen sharply, and has reached almost 3% at the end of October, leading to a breakout in short term nominal yields and a bear flattening of the yield curve. Now, markets price in two rate hikes in H2 2022.

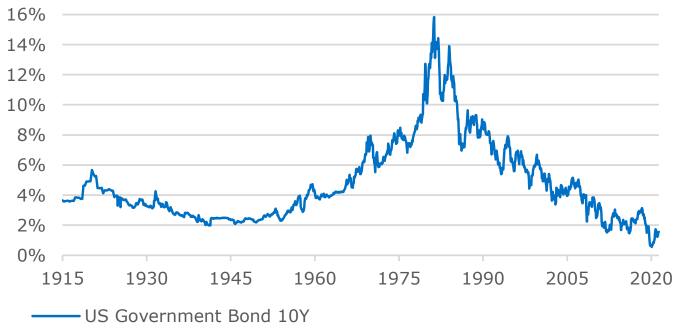
Over the past decade, breakeven inflation has been relatively steady at around 2%, while 10-year US Treasury yields ranged between 1.5% and 3.5%. Despite the rise in inflation in 2021, Treasuries have not moved to previous levels of 2.5%. Therefore, concerns about a stagflation scenario have increased. At the same time, many of the demand-side and supply-side inflation forces are related to the pandemic and are expected to ease as economic activity normalises.

US Inflation and Treasuries

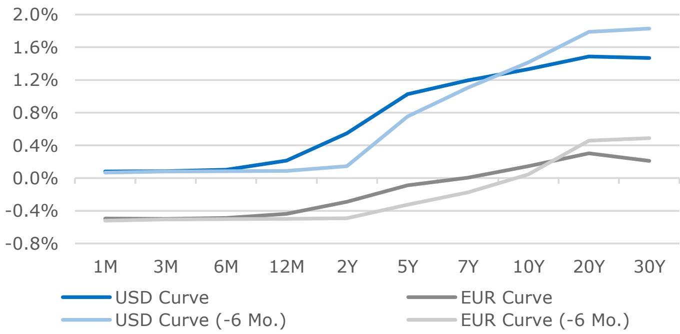


Rates Perspective

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

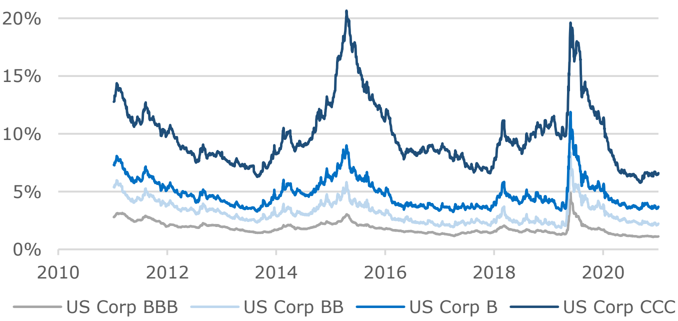


2) Interest Swap Curve: The USD and EUR swap curves steepened at the short end (1-5 yr) and lowered slightly at the long end.

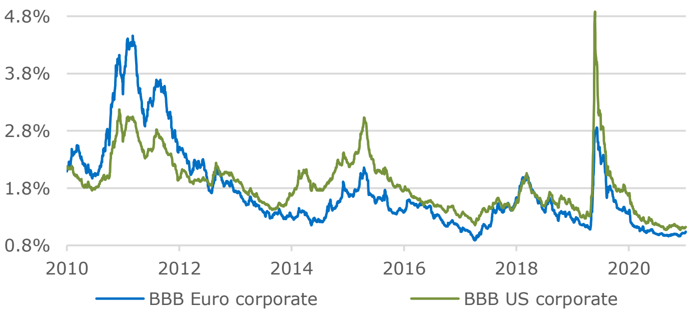


Corporate Perspective

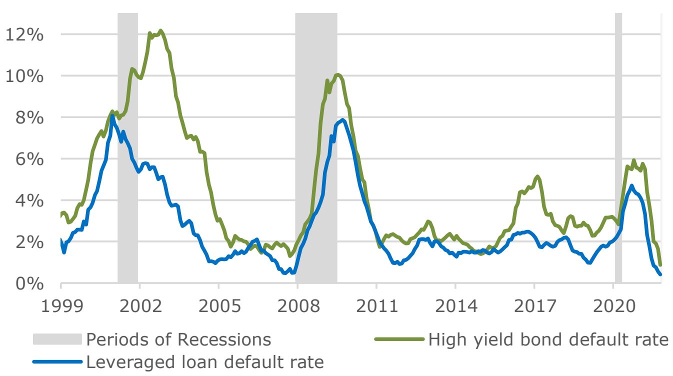
3) US Corp. Rating: Credit spreads (OAS) of lower rated high-yield bonds widened disproportionately.



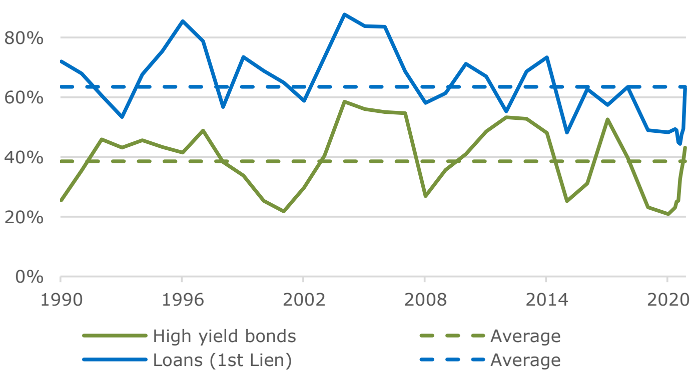
4) EU vs US: Since the Covid-19 spike, credit spreads (OAS) between the USA and EU have converged in tandem to lower levels.



5) Default Rates: Default rates peaked in Q4 2020. HY bond default rates are structurally higher (Ø4.4%) vs. loans (Ø2.8%).



6) Recovery Rates: Recovery rates of leveraged loans are higher (Ø63%) 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	48	+1
AA	56	+1
A	71	+1
BBB	111	+1
BB	218	+0
B	365	+1
CCC	648	-6

Global high yield (bps)

	curr	Δ month
US HY	315	+0
EU HY	322	+18
Asia HY	1338	+226
EM HY	411	+13

CDS spreads (bps)

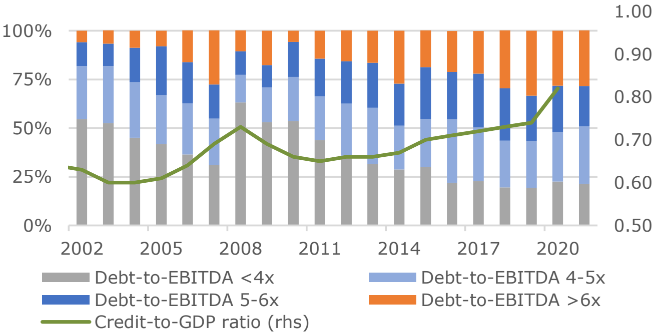
	curr	Δ month
CDX IG - US	52	-1
iTraxx IG - EU	51	+1
CDX HY - US	304	+3
iTraxx XO - EU	262	+8

Loans and CLOs (yld, bps)

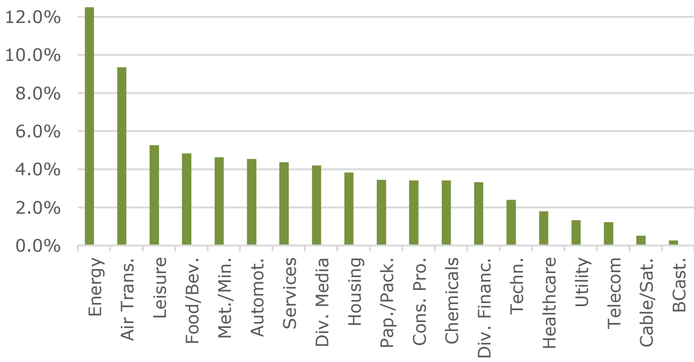
	curr	Δ month
US Loan	379	+8
CLO AAA	152	+8
CLO BBB	405	+9
CLO BB	759	+3

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.

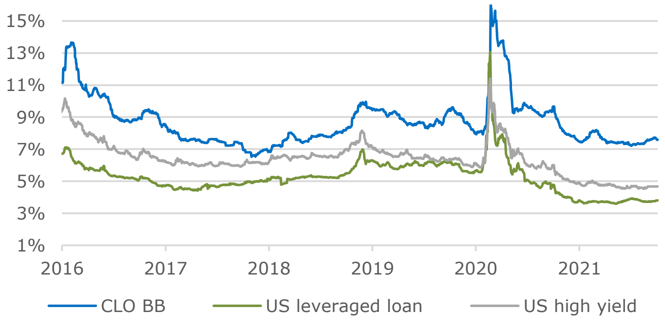


8) YTD Sector High-Yield Returns: The energy sector caught up the most on a month-on-month basis.



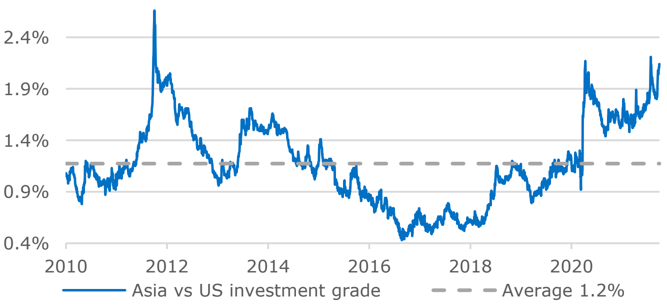
Alternative Perspective

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

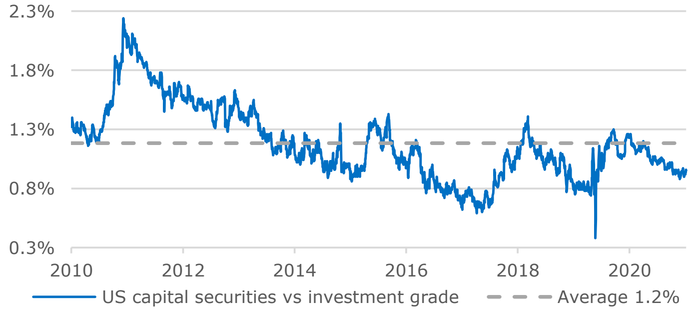


10) CLO Yields: CLOs offer an attractive yield premium over bonds and loans.

11) Asia vs. US: Asian IG spreads spiked in recent months due to the stress in the Chinese real estate development sector.



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

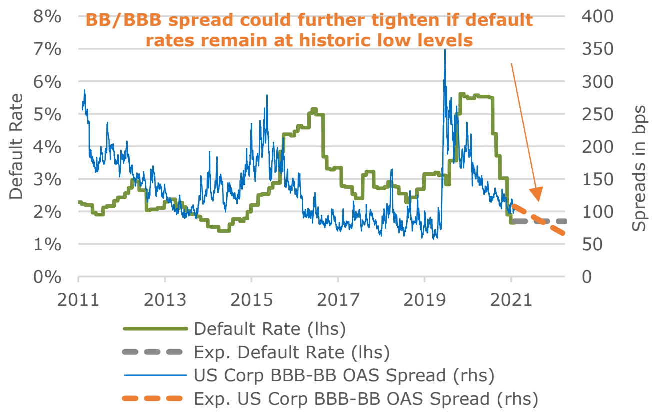


Education Corner

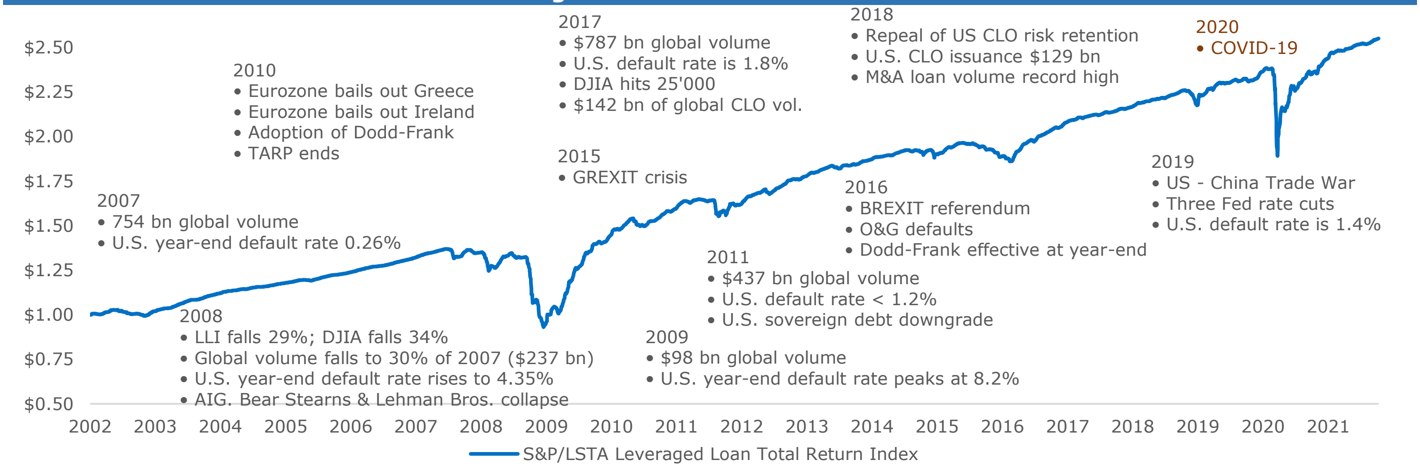
How favorable are high yield bond spreads?

The spread between investment grade and high yield bonds (measured by BBB/BB spread) is now 100 bps. If this 100 bps were assumed as a compensation for expected future defaults, the theoretical default rate would be 2.6%. This number can be calculated as follows: Dividing this spread by the long-term average recovery rate of 39% (see chart 6).

Currently, the 12-month default rate for U.S. high-yield bonds stands at only 1.7% and is expected to remain at a moderate level. Hence, thanks to historical low interest rates and the sharp economic recovery, (artificially) low default rates could stay for longer and spreads could further tighten.



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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