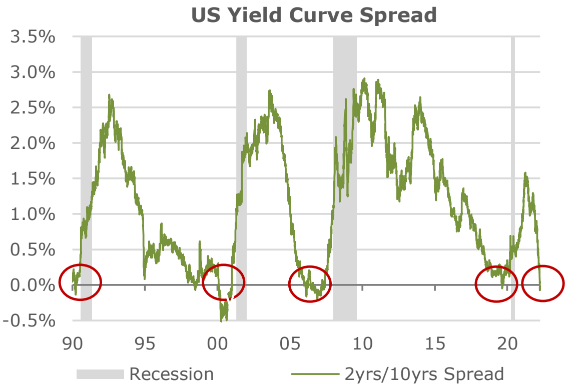
Monthly Spotlight

Yield curve inversion signals economic weakness ahead of us

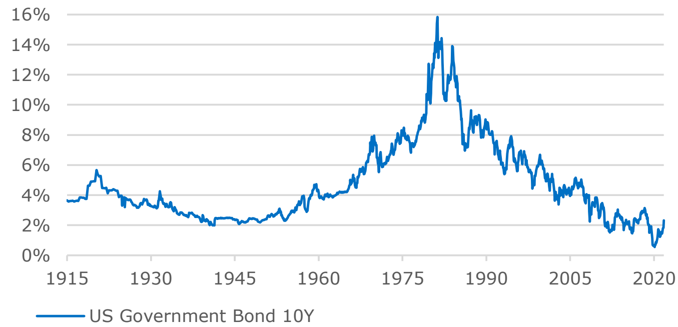
In macro-finance, it is well known that an inverted yield curve is signalling a recession or at the very minimum, it is indicating that the economy is operating in a late cycle. For example, the 2-year/10-year Treasury slope has inverted in advance of 7 of the past 8 recession periods. However, it is a less useful indicator in predicting the lead time when a recession emerges. On average, the slope inverted around 16 months before the start of the next recession. The inversion occurred in all but one instance (1973-75) before the peak in the S&P 500.

What does the inversion mean for the current cycle? At the minimum, we have to acknowledge that the economic recovery has entered its late stage and that current inflation pressure will hit profit margins. Should a vicious price-wage spiral be avoided, the lead time for the next recession will certainly be expanded.

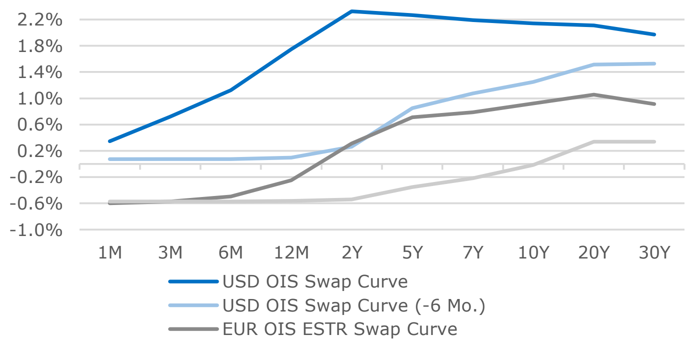


Rates Perspective

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

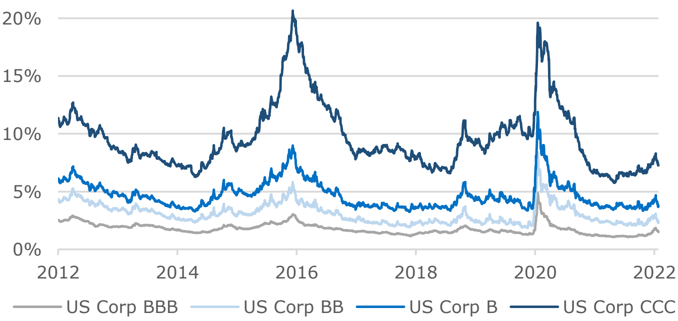


2) Interest Swap Curve: Both the USD curve and the EUR curve steepened predominantly at shorter tenors.

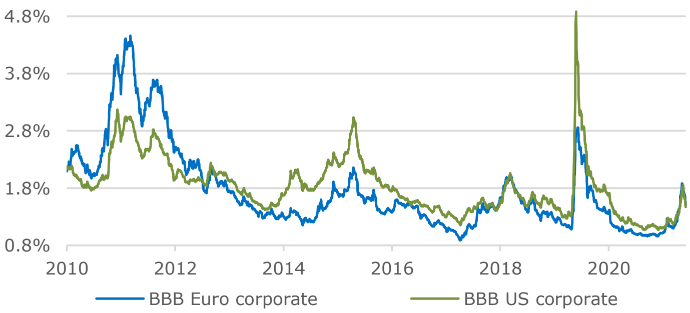


Corporate Perspective

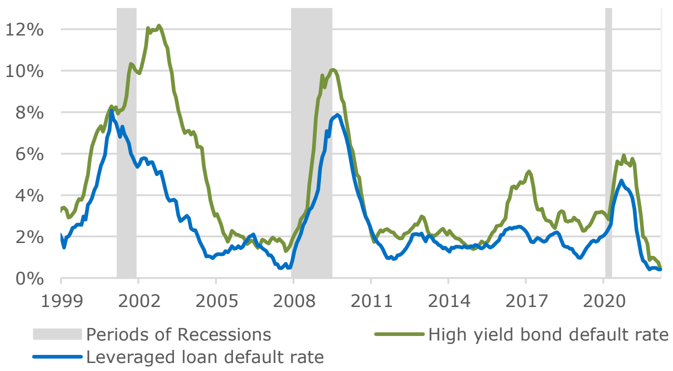
3) US Corp. Rating: Credit spreads (OAS) of lower rated high-yield bonds widened disproportionately.



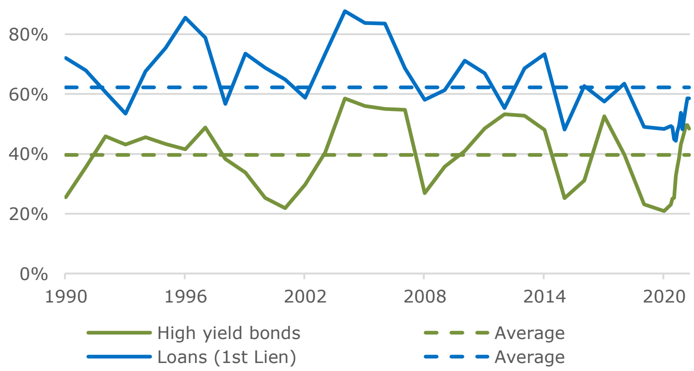
4) EU vs US: Credit spreads (OAS) between the US and EU have narrowed since the beginning of 2022.



5) Default Rates: Default rates peaked in Q4 2020. HY bond default rates are structurally higher (Ø4.3%) vs. loans (Ø2.7%).



6) Recovery Rates: Recovery rates of leveraged loans are higher (Ø62%) vs. high yield bonds (Ø40%) 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	58	-11
AA	74	-8
A	99	-6
BBB	149	-11
BB	237	-38
B	377	-34
CCC	729	-42

Global high yield (bps)

	curr	Δ month
US HY	343	-34
EU HY	400	-45
Asia HY	1292	-28
EM HY	447	-48

CDS spreads (bps)

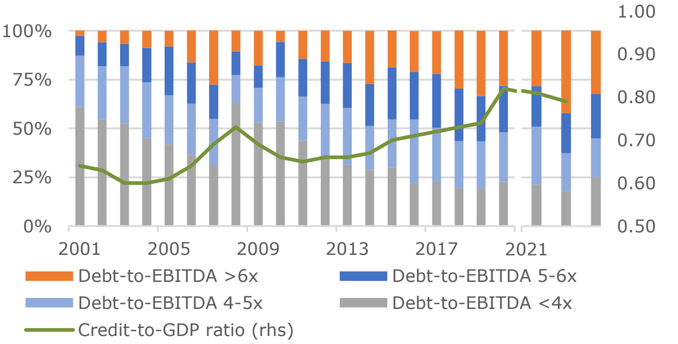
	curr	Δ month
CDX IG - US	67	-0
iTraxx IG - EU	73	+2
CDX HY - US	376	+11
iTraxx XO - EU	338	-6

Loans and CLOs (yld, bps)

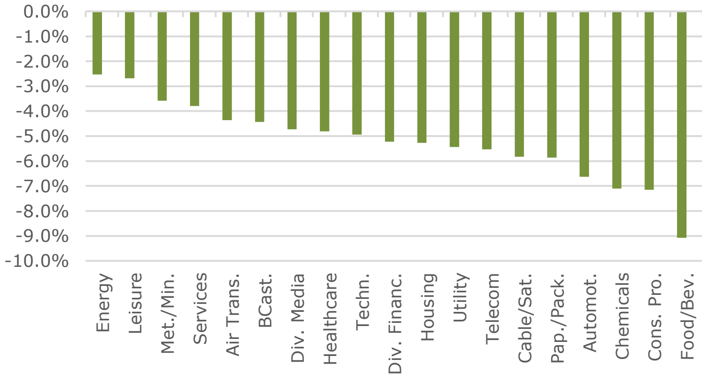
	curr	Δ month
US Loan	437	+12
CLO AAA	376	+74
CLO BBB	585	+63
CLO BB	964	+53

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 Q3 2021 compared to Q4 2020.

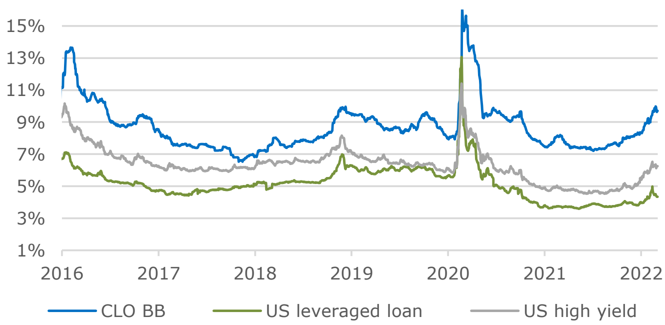


8) YTD Sector High-Yield Returns: Total return of food and beverage suffered the most.

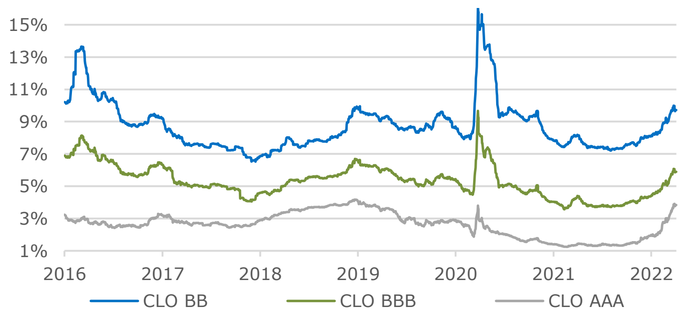


Alternative Perspective

9) Loans vs. CLO vs. HY: CLO BB yields are wider vs Loans and HY bonds.

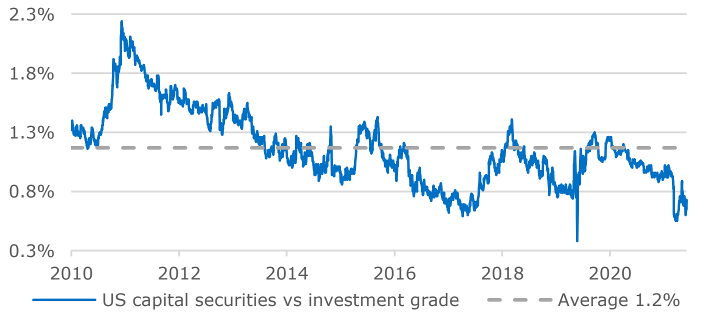


10) CLO Yields: CLOs offer an attractive yield premium over bonds and loans.



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.

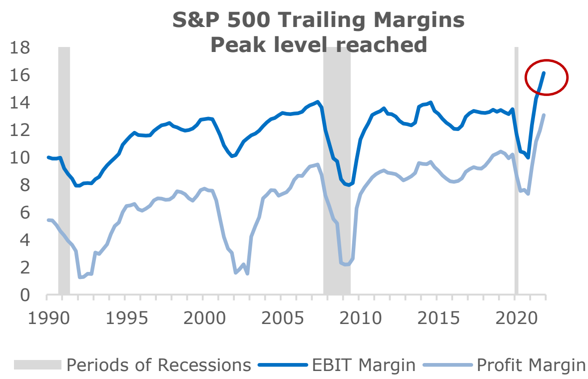


Education Corner

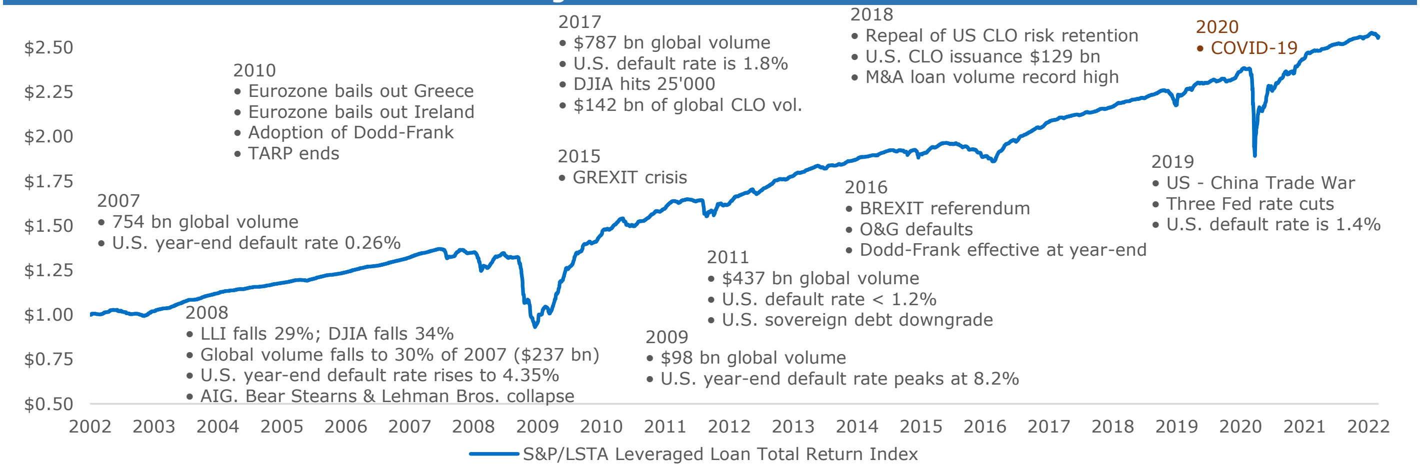
Peak profit margins will be a burden for equity valuations

Efficiency gains after the pandemic converted into higher profit margins and spiking corporate earnings. However, some supply bottle necks still exist or have even re-emerged after the Ukraine conflict has escalated. As a result, inflation numbers have risen considerably and a new interest rate hiking cycle has started. While higher production costs could mainly be passed on to the customers so far, the dynamic will change in the future, what will weigh negatively on corporate's profit margins. Rising rates, increasing commodity prices and higher labour costs will be too much of a burden to defend the peak margins reached in 2021.

Going forward, equity markets will not only face potential headwind from rising rates, but also from shrinking profit margins to defend high earnings multiples (i.e. PE ratios).



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		

Disclaimer

Contact Information:
Alpinum Investment Management AG
Talstrasse 82
CH-8001 Zurich
Tel: +41 43 888 79 30
Fax: +41 43 888 79 31
alpinumim.com