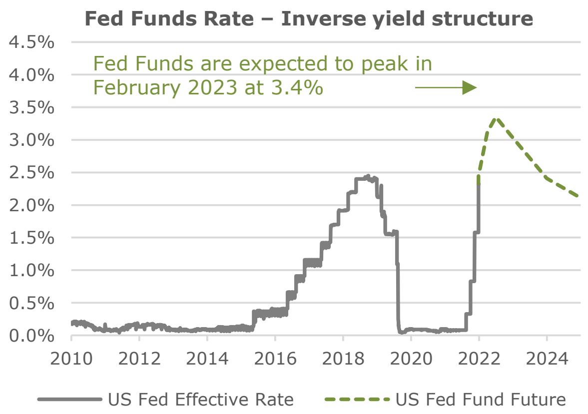
Monthly Spotlight

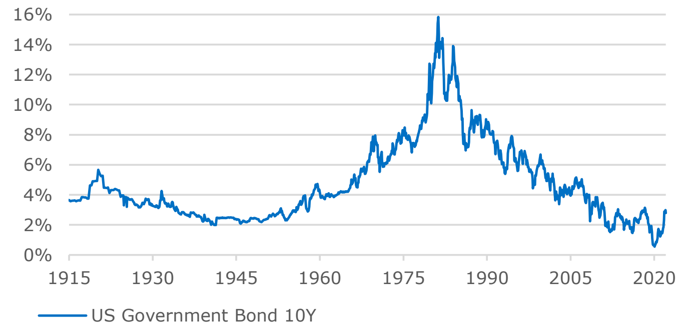
Markets price in a peak Fed Funds Rate of 3.4% in Feb '23

The peak Fed funds rate is currently priced in at a level of 3.4% (down from >4% in mid-June) for February 2023. However, the shape of the curve is of even greater importance. The inverse shape of the current Fed futures curve indicates that the market expects the Fed to succeed with its measures to curb inflation. After peaking at around 3.4%, interest rates are expected to fall towards ~3% by mid-2023 and even approaching 2% in 2024. This implies a (too?) favourable outcome with falling inflation figures and the avoidance of a severe recession. While this interpretation might prove correct, the risk remains high that inflation is more stubborn and interest rates could trend upwards again and/or remain at an elevated level for longer.

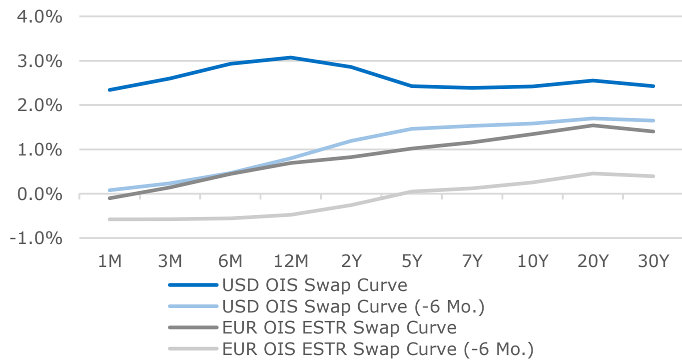


Rates Perspective

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

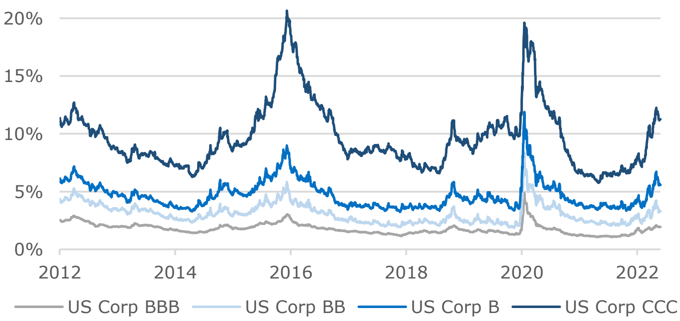


2) Interest Swap Curve: The USD and EUR curve lowered predominantly at longer tenors.

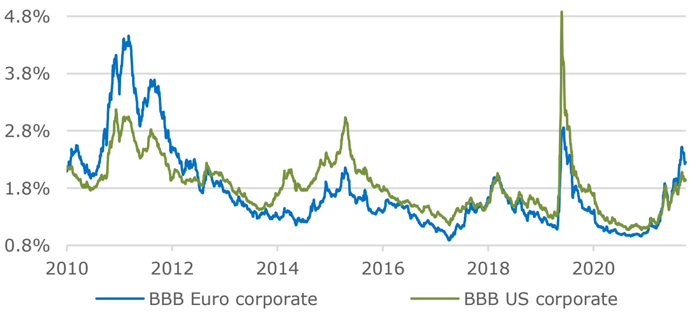


Corporate Perspective

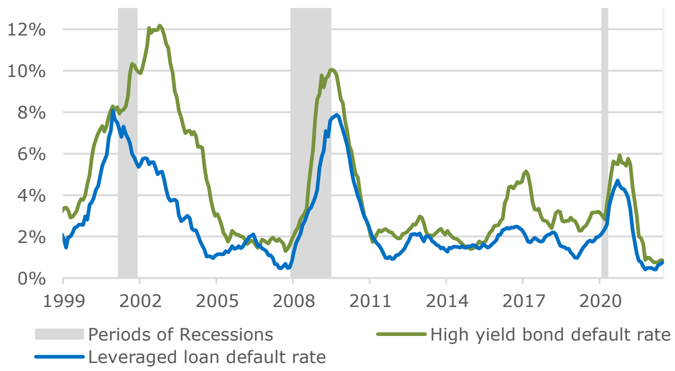
3) US Corp. Rating: Credit spreads (OAS) of lower rated high-yield bonds widened disproportionately.



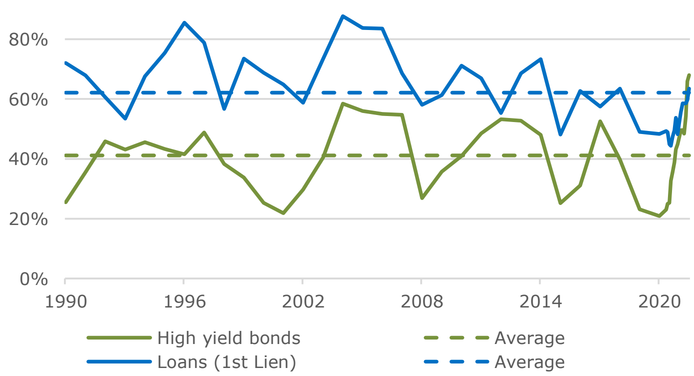
4) EU vs US: Credit spreads (OAS) between the US and EU have narrowed since the beginning of 2022.



5) Default Rates: 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 (Ø41%) 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	60	-11
AA	86	-10
A	0	-132
BBB	194	-10
BB	328	-89
B	558	-94
CCC	1126	-68

Global high yield (bps)

	curr	Δ month
US HY	498	-89
EU HY	591	-50
Asia HY	1462	+81
EM HY	622	-54

CDS spreads (bps)

	curr	Δ month
CDX IG - US	80	-20
iTraxx IG - EU	100	-17
CDX HY - US	471	-100
iTraxx XO - EU	509	-72

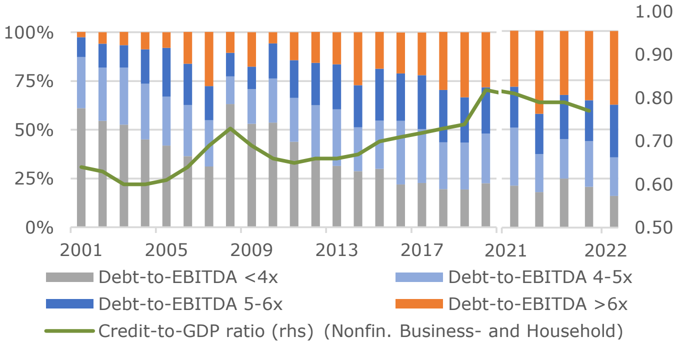
Loans and CLOs (yld, bps)

	curr	Δ month
US Loan	703	+28
CLO AAA	466	-40
CLO BBB	754	-29
CLO BB	1214	-35

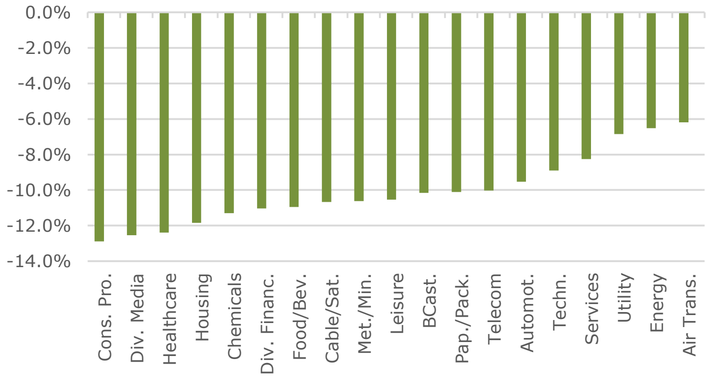
spread tightening (positive price action)

spread widening (negative price action)

7) US Leverage: Debt-to-EBITDA ratio of US companies remained stable at elevated levels.

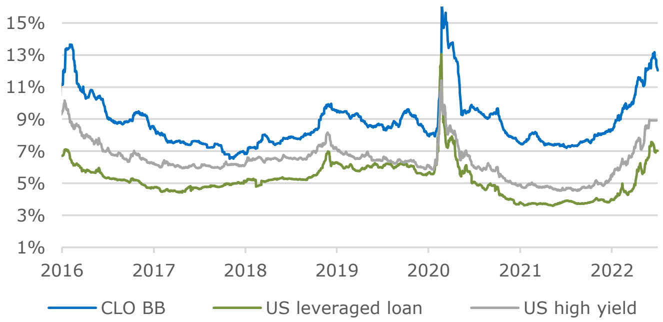


8) YTD Sector High-Yield Returns: All sectors are suffering YTD.



Alternative Perspective

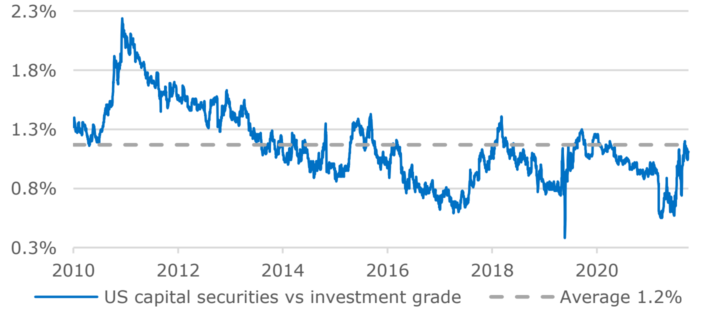
9) Loans vs. CLO vs. HY: CLO BB yields are wider vs Loans and HY bonds.



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

11) Asia vs. US: Asian IG spreads are elevated primarily driven by 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.



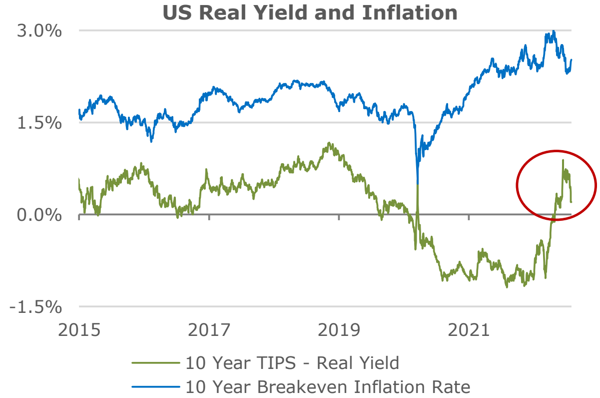
Education Corner

US Real Yields remain in positive territory

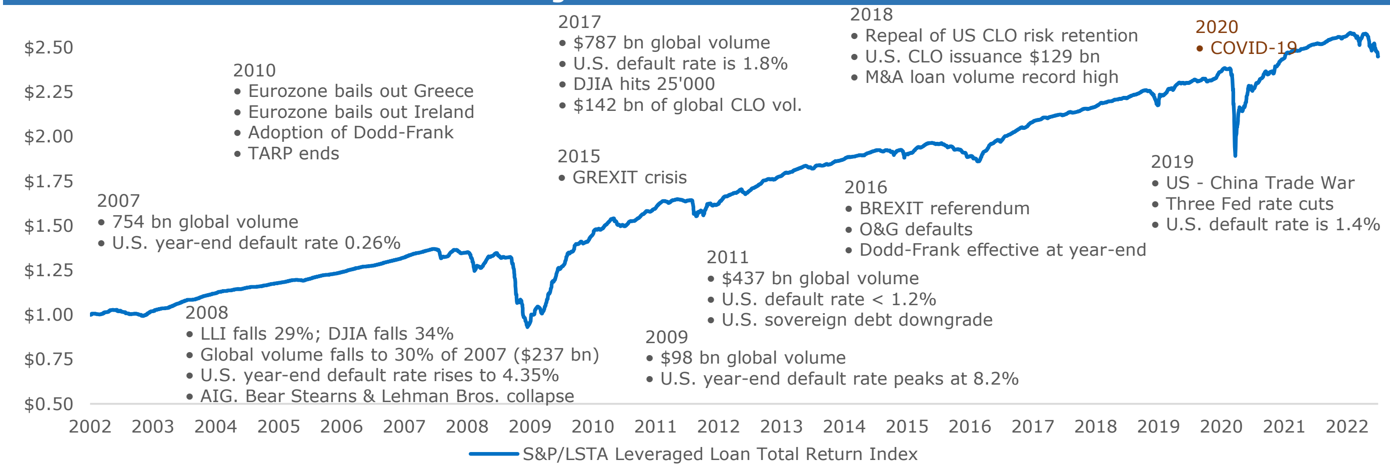
In the Alternative Credit Letter of May 2022, we reported on the first rise in real yields above zero after two years in negative territory - a minimum requirement to fight high inflation rates.

In the meantime, nominal and real yields have declined markedly from their mid-June highs as inflation expectations have fallen significantly. The chart shows that real yields (nominal interest rates ./. expected inflation or break-even inflation) trade now at around +0.2%, calculated on the basis of 10-year bonds. At the same time, long-term inflation is settling at ~2.5%. The value of this figure is debatable, as it is very difficult to measure inflation expectations adequately. However, the fact is that central banks place a lot of weight on inflation expectations and therefore it is important to understand the concept with its advantages and disadvantages.

US Real Yield and Inflation



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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