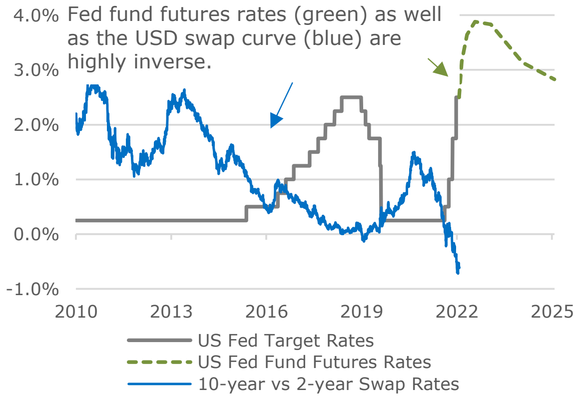
Monthly Spotlight

Yield curve indicates economic weakness, lower inflation

In March 2022, the USD swap curve became inverted and by the end of August the difference between the 2-year vs 10-year tenors fell to -0.6% (see also Alternative Credit Letter in April), a signal of economic weakness ahead.

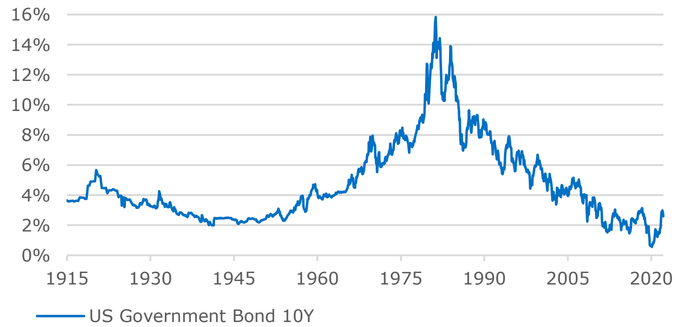
In June this year, the Fed funds futures curve also inverted, pointing to a more dovish stance of the Fed by mid-2023. This uncertainty about the future path of interest rates is caused by rising fears of recession and a potentially faster cool-down in inflation as a result of rate hikes. However, this interpretation might prove to be too optimistic as the wage-price spiral could become a more dominant factor. In general, volatility at the short end of the curve was particularly painful for short duration bonds, both in terms of interest rate and credit risk.

Inverse USD interest rate curve

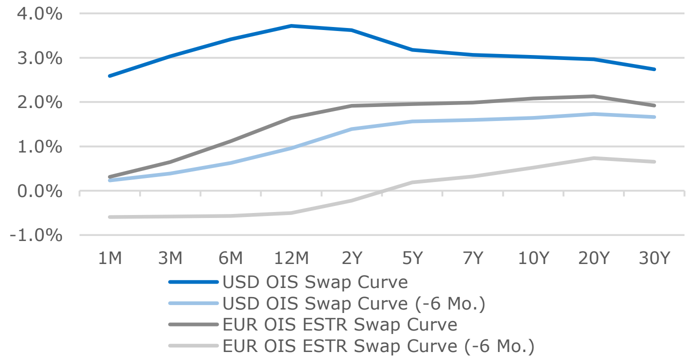


Rates Perspective

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

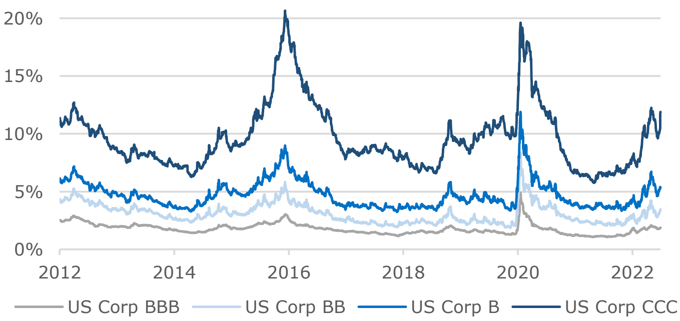


2) Interest Swap Curve: The USD and EUR curve increased predominantly at shorter tenors.

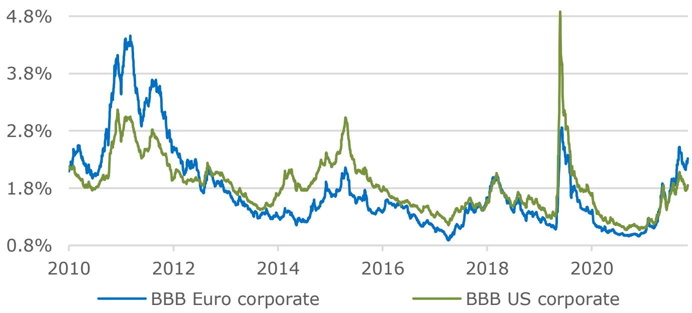


Corporate Perspective

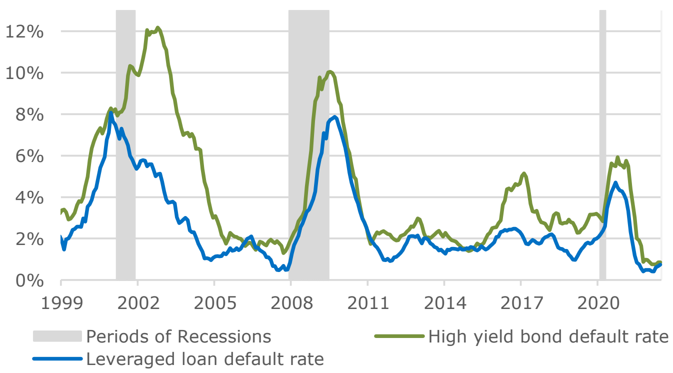
3) US Corp. Rating: Credit spreads (OAS) of lower rated high-yield bonds widened disproportionately.



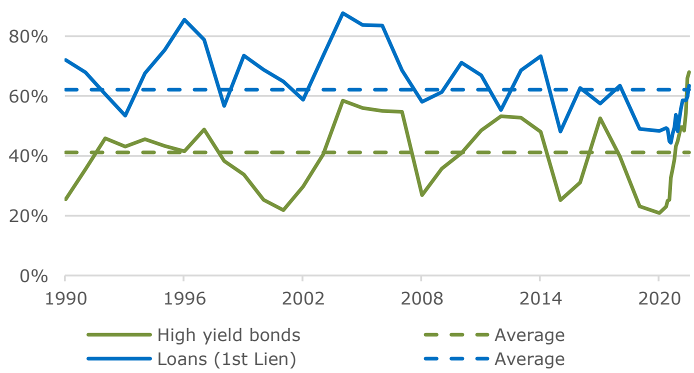
4) EU vs US: Credit spreads (OAS) between the US and EU have narrowed since the beginning of 2022.



5) Default Rates: 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	65	+6
AA	85	-1
A	119	-3
BBB	185	-7
BB	344	+16
B	527	-11
CCC	1175	+76

Global high yield (bps)

	curr	Δ month
US HY	503	+20
EU HY	553	-28
Asia HY	1360	-9
EM HY	596	-9

CDS spreads (bps)

	curr	Δ month
CDX IG - US	92	+12
iTraxx IG - EU	120	+19
CDX HY - US	533	+62
iTraxx XO - EU	588	+79

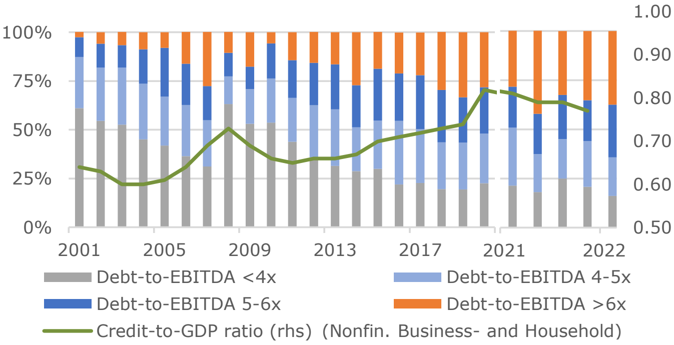
Loans and CLOs (yld, bps)

	curr	Δ month
US Loan	697	-6
CLO AAA	515	+49
CLO BBB	781	+27
CLO BB	1228	+15

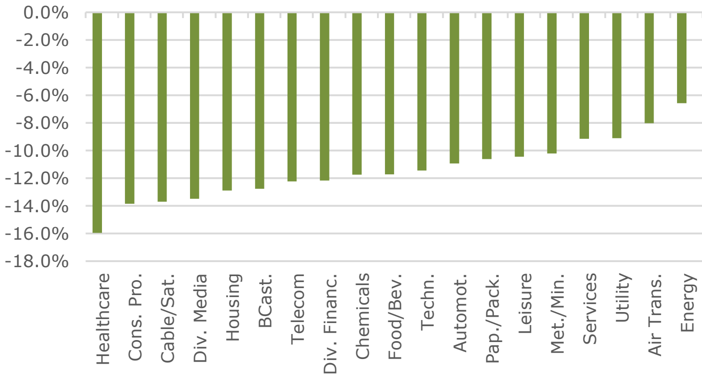
spread tightening (positive price action)

spread widening (negative price action)

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

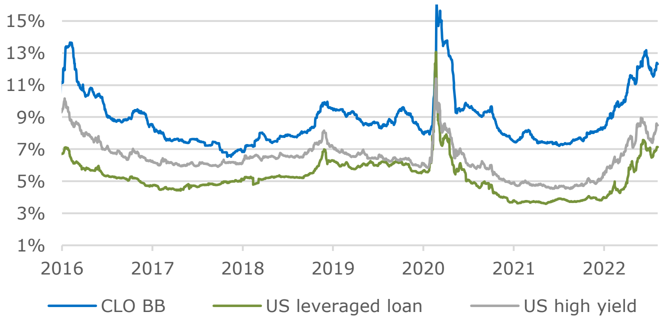


8) YTD Sector High-Yield Returns: All sectors are suffering YTD.

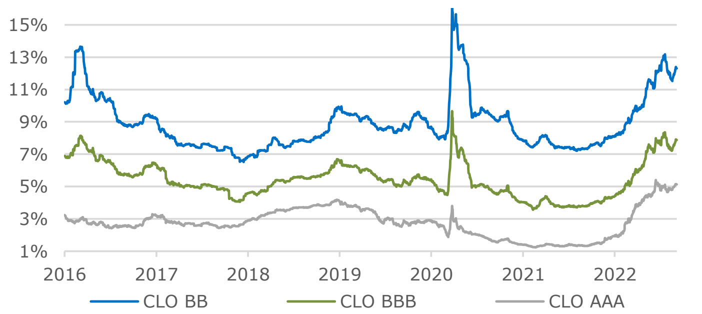


Alternative Perspective

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

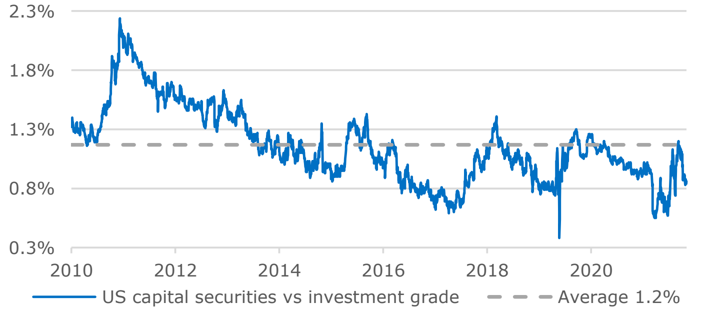


10) CLO Yields: CLOs offer an attractive yield premium over bonds and loans.



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.



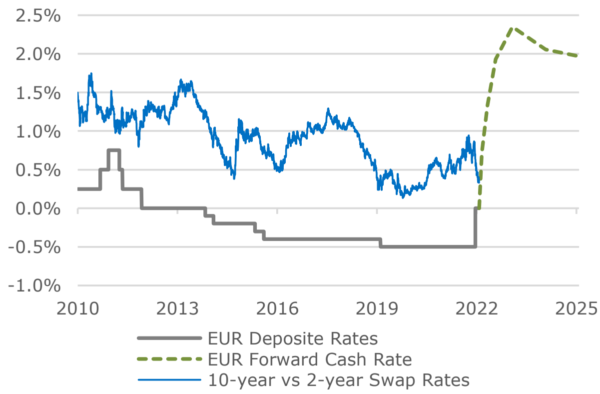
Education Corner

Euro yield curve illustrates economic fragility

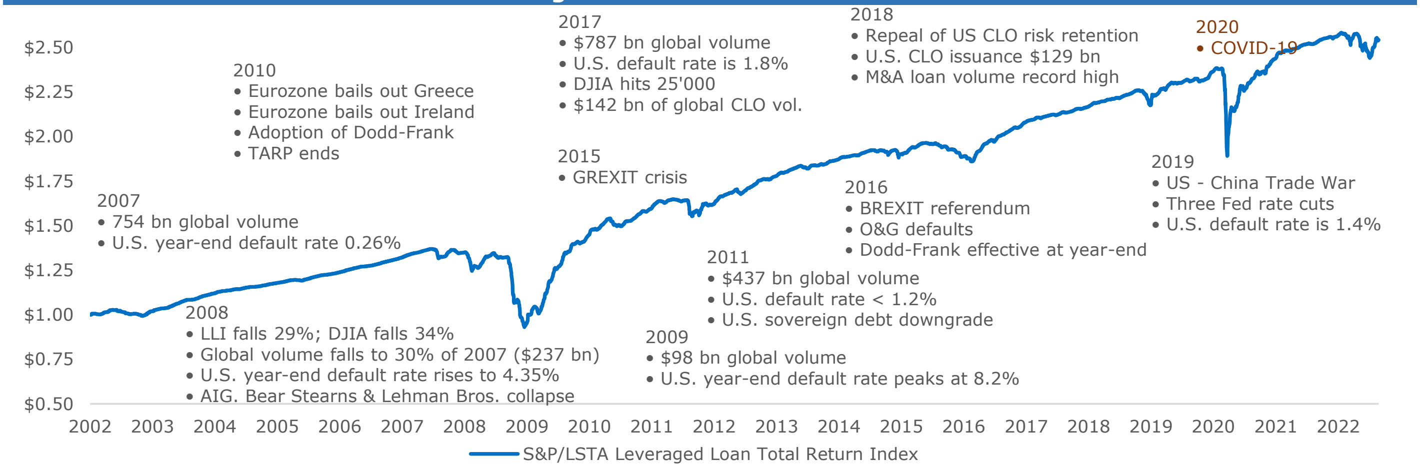
Compared to the USD swap curve, the Euro swap curve shows no inversion, despite the fact that the EU faces deep economic shock and fragility from spiking gaz and energy prices.

Market pricing indicates a more hawkish stance of the Fed as compared to the ECB. As we pointed out in the "Monthly Spotlight", the market expects the Fed to raise rates aggressively in the very short term, but is expected to shift back to a more dovish stance due to an anticipated cooling of the economy in 2023. The Eurozone shows a different picture, as the market assumes that the ECB will only raise rates to around 2% until mid-2023. Simplified, it can be interpreted that the short-term economic pain is more severe in Europe, but economic optimism should return in 2023.

Euro interest rate curve



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