# ΛLPINUM INVESTMENT MANAGEMENT

TURNKEY SOLUTIONS FOR WEALTH MANAGERS AND FUND MANAGERS

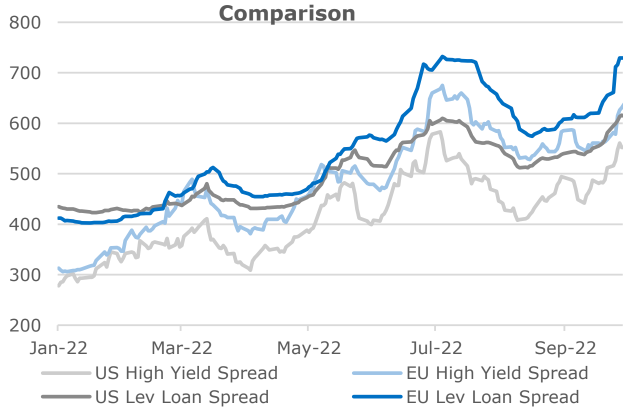
**Alternative Credit Letter** — **November 2022**

## Monthly Spotlight

### EU loan spreads increased in 2022 from 400 to 700 bps

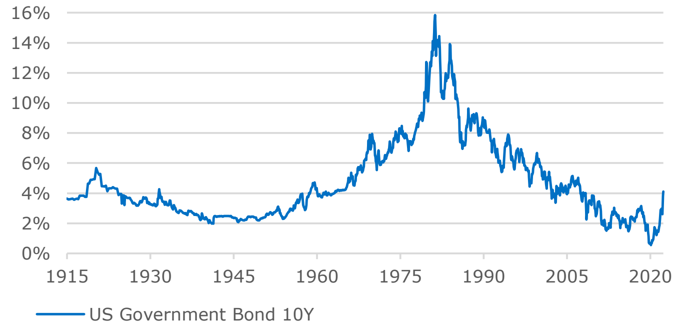
Since the start of the year, credit spreads of European loans have increased from around 400 bps to above 700 bps. At the same time, short-term interest rates have just been lifted to around 2% by the ECB on October 27th. As a consequence, European loans earn now on average an attractive yield of 9% p.a., which represents a decent premium vs. other segments of the high yield market. As the chart demonstrates, not all HY sectors have evolved equally. For example in the US, spreads for HY bonds and leverage loans rose by around 200 bps. At the same time, European HY spreads widened by ~300 bps to ~600 bps. Fundamental factors such as the energy and power crisis in Europe have partly led to this spread gap, but also technical factors have been at play, such as increased demand for loans by new CLOs in the US, contrasting with forced selling in Europe.

**US versus Pan-Euro HY Spreads Comparison**

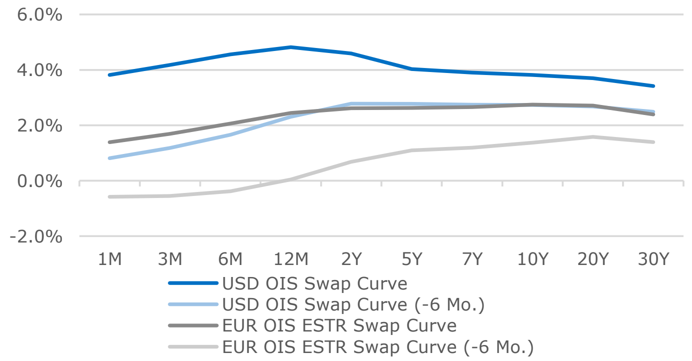



## Rates Perspective

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

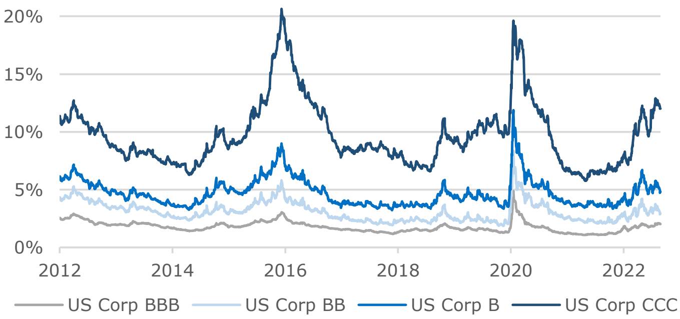



**2) Interest Swap Curve:** The USD and EUR curve further inverted while shorter tenors continued to increase.

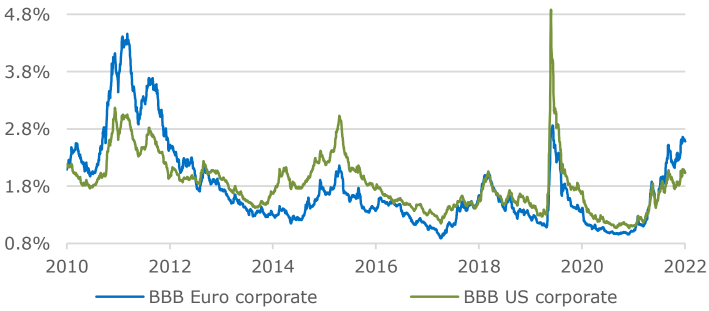



## Corporate Perspective

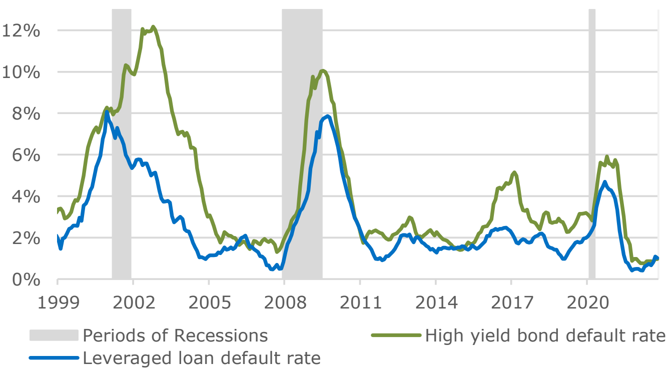
**3) US Corp. Rating:** Credit spreads (OAS) of lower rated high-yield bonds widened disproportionately.



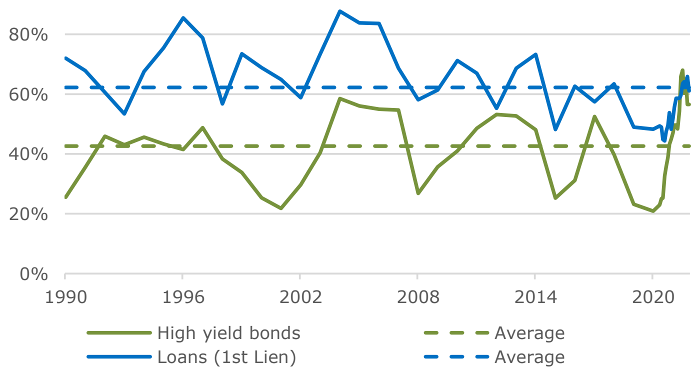

**4) EU vs US:** Credit spreads (OAS) between the US and EU have started to widen since the second half of 2022.




**5) Default Rates:** HY bond default rates are structurally higher (Ø4.2%) vs. loans (Ø2.7%).




**6) Recovery Rates:** Recovery rates of leveraged loans are higher (Ø62%) vs. high yield bonds (Ø43%) 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 | 63 | -10 |
| AA | 92 | -4 |
| A | 140 | +2 |
| BBB | 203 | -3 |
| BB | 295 | -71 |
| B | 483 | -91 |
| CCC | 1200 | -81 |

**Global high yield (bps)**

| | curr | Δ month |
|---|---|---|
| US HY | 463 | -80 |
| EU HY | 580 | -45 |
| Asia HY | 1536 | +32 |
| EM HY | 584 | -63 |

**CDS spreads (bps)**

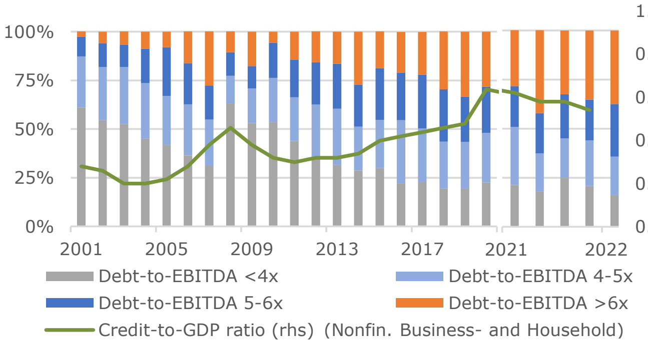
| | curr | Δ month |
|---|---|---|
| CDX IG - US | 90 | -16 |
| iTraxx IG - EU | 114 | -21 |
| CDX HY - US | 521 | -75 |
| iTraxx XO - EU | 555 | -96 |

**Loans and CLOs (yld, bps)**

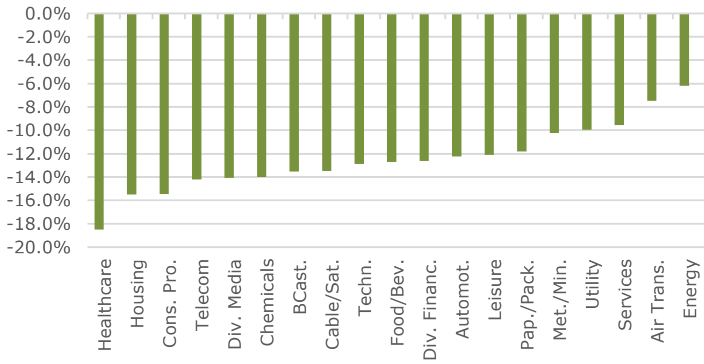
| | curr | Δ month |
|---|---|---|
| US Loan | 857 | +65 |
| CLO AAA | 660 | +50 |
| CLO BBB | 985 | +47 |
| CLO BB | 1495 | +73 |

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.

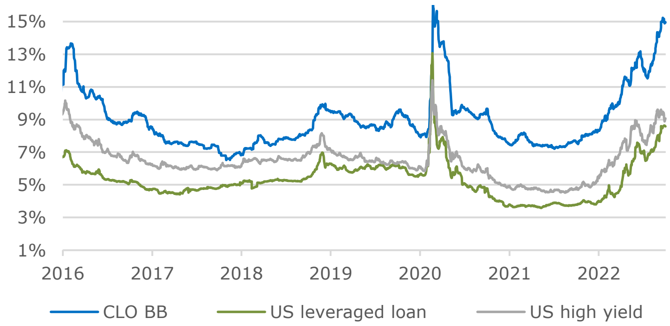



**8) YTD Sector High-Yield Returns:** All sectors have continued to suffer YTD.

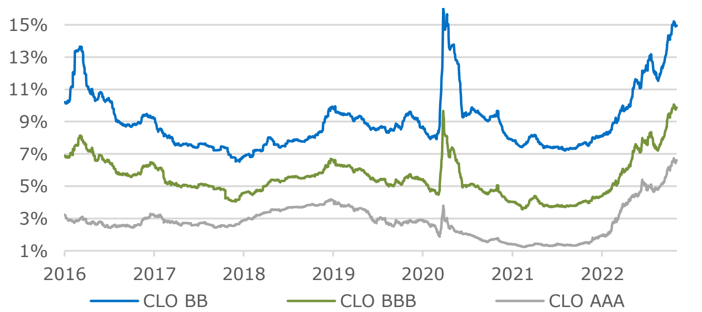



## Alternative Perspective

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

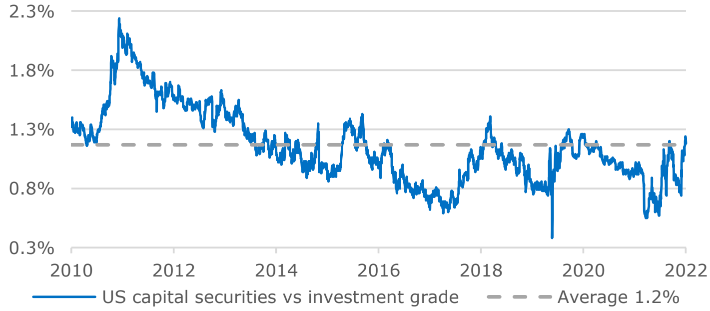



**10) CLO Yields:** CLOs offer an attractive yield premium over bonds and loans.




**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.



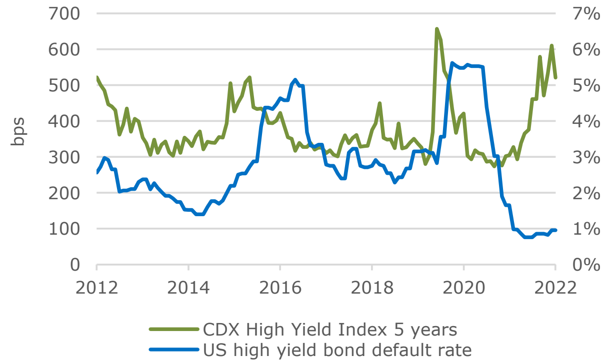

## Education Corner

### Current US High Yield spreads imply a default rate of ~6%

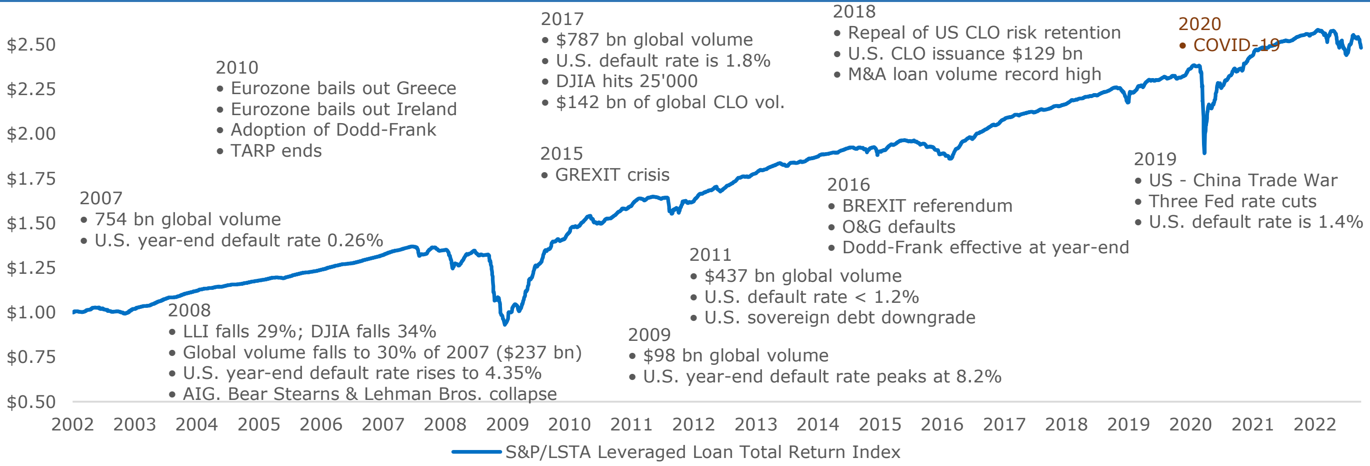
In the June 2022 Education Corner, we introduced the CDS high yield index as a benchmark for the 100 most liquid US single-issuer non-investment grade default protection swaps. As per the end of October, the credit default spread stands at 514 basis points, implying a default rate of more than 6%. The 6% is derived from a simplified calculation assuming a recovery rate of 40% and a 150 bps compensation after losses, i.e. (514 basis points - 150 basis points) / (1-0.4).

As shown in Chart 5), the average default rate over the past 20 years has been 4.3% and the current default rate is just over 1% and rising. In the eye of the storm of the pandemic, the default rate peaked at 6%. Major rating agencies expect that default rates could approach long-term average levels in 2023, but not levels beyond 4%.

**CDS US High Yield Spread vs Corporate Default Rate**



## 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

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