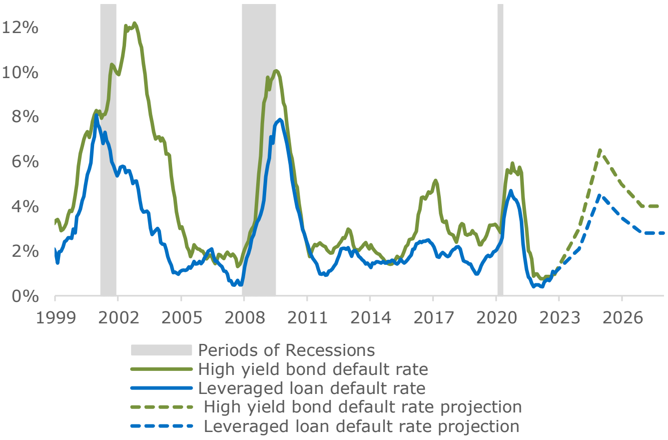
Monthly Spotlight

Rising expected default rates reflect weakening economy

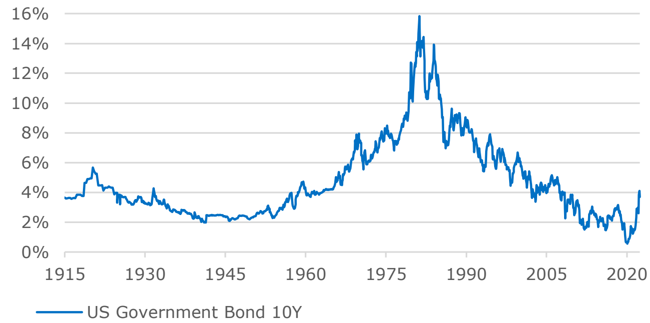
Slowing global economy, combined with tightening financing conditions and input costs inflation will lead to higher expected credit default rates in 2023 and beyond. In our observations, market participants expect that defaults would peak at around 6 to 6.5% in 2023 for high yield bonds and just below 5% for leveraged loans.

As the chart suggests, 2023/24 period will likely face sharp increase in defaults. However, the default rate will reach nowhere near the levels experienced during the 2008/09 Great Financial Crisis. In comparison to the earlier temporary spike of defaults during the 2020/21 pandemic-period, we expect prolonged period of elevated default rates until financing conditions improve and inflationary pressures ease.

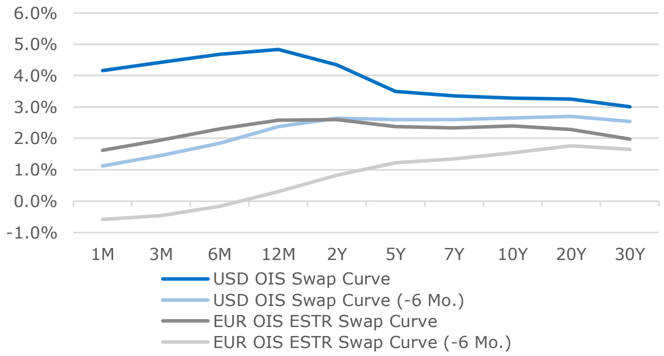


Rates Perspective

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

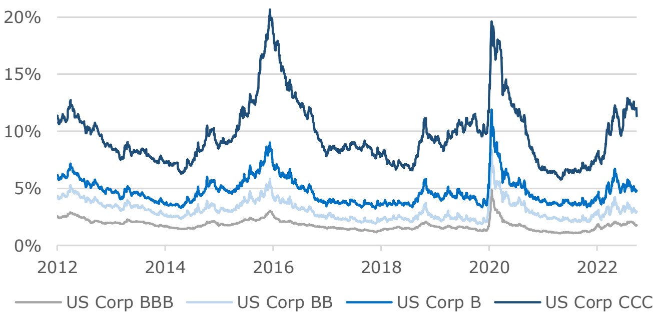


2) Interest Swap Curve: The USD and EUR curve further inverted while shorter tenors continued to increase.

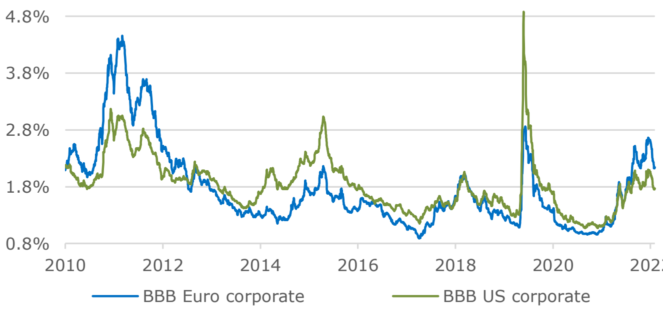


Corporate Perspective

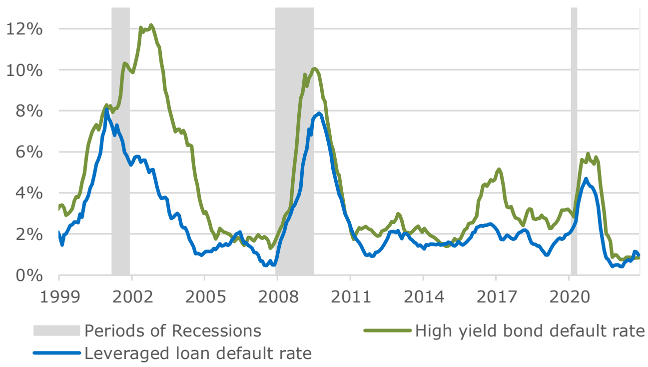
3) US Corp. Rating: Credit spreads (OAS) of lower rated high-yield bonds widened disproportionately.



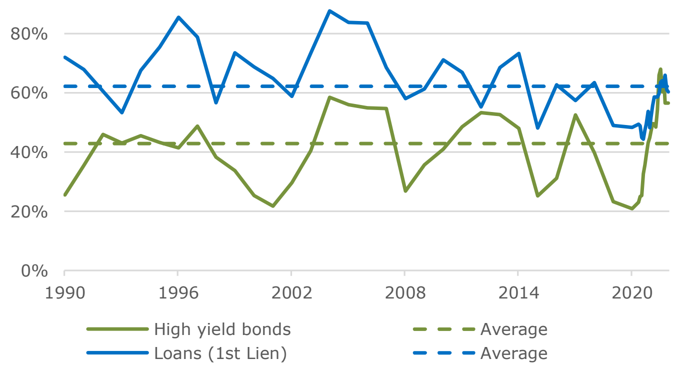
4) EU vs US: Credit spreads (OAS) between the US and EU have started to widen since the second half of 2022.



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	53	-10
AA	77	-15
A	117	-23
BBB	177	-26
BB	297	+2
B	479	-4
CCC	1130	-70

Global high yield (bps)

	curr	Δ month
US HY	455	-8
EU HY	506	-74
Asia HY	1092	-444
EM HY	535	-49

spread tightening (positive price action)
spread widening (negative price action)

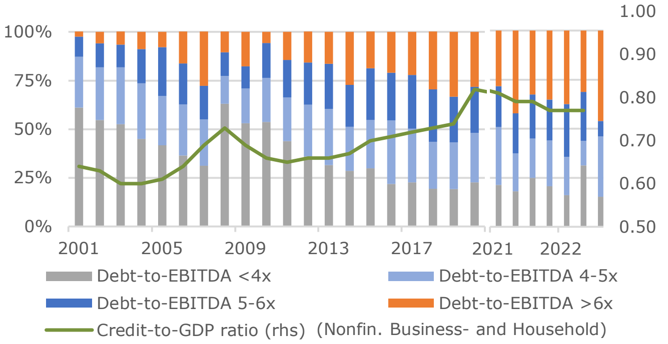
CDS spreads (bps)

	curr	Δ month
CDX IG - US	76	-15
iTraxx IG - EU	92	-22
CDX HY - US	452	-68
iTraxx XO - EU	459	-96

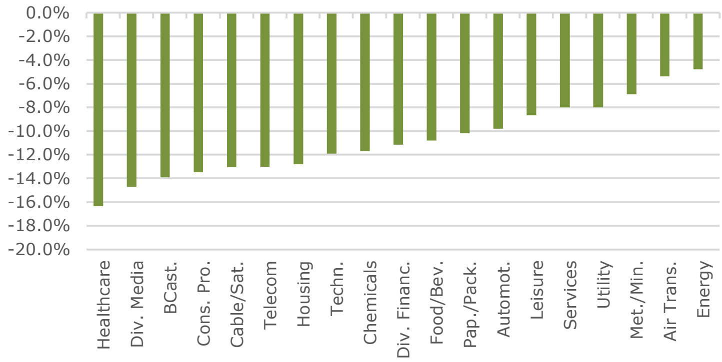
Loans and CLOs (yld, bps)

	curr	Δ month
US Loan	875	+18
CLO AAA	600	-60
CLO BBB	885	-100
CLO BB	1370	-125

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

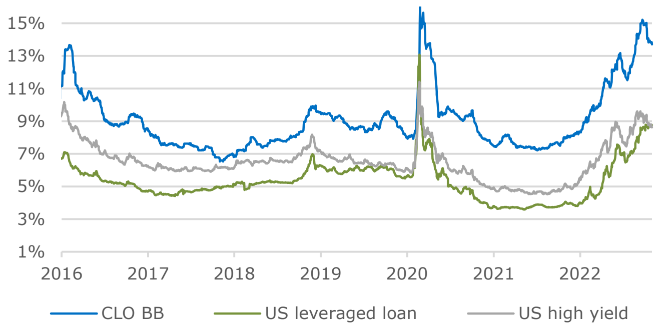


8) YTD Sector High-Yield Returns: All sectors have continued to suffer YTD.

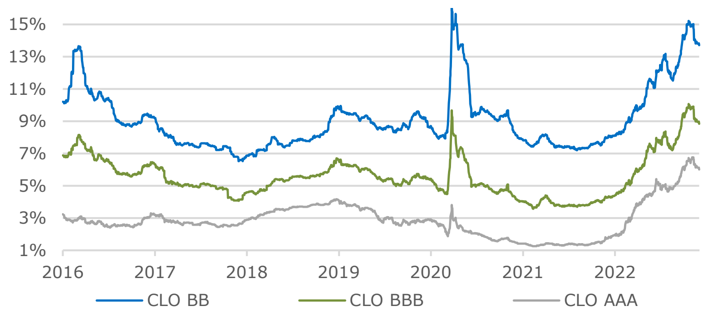


Alternative Perspective

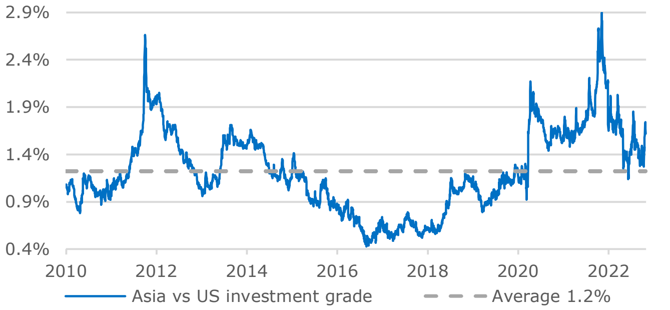
9) Loans vs. CLO vs. HY: CLO BB yields are wider vs Loans and HY bonds.



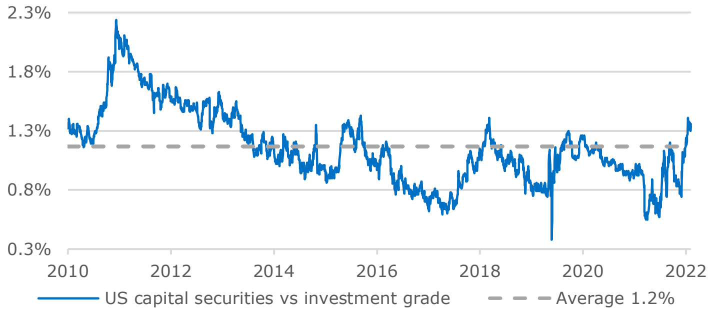
10) CLO Yields: CLOs offer an attractive yield premium over bonds and loans.



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.

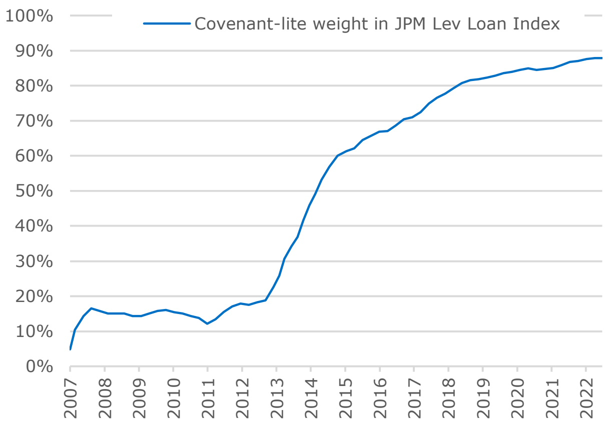


Education Corner

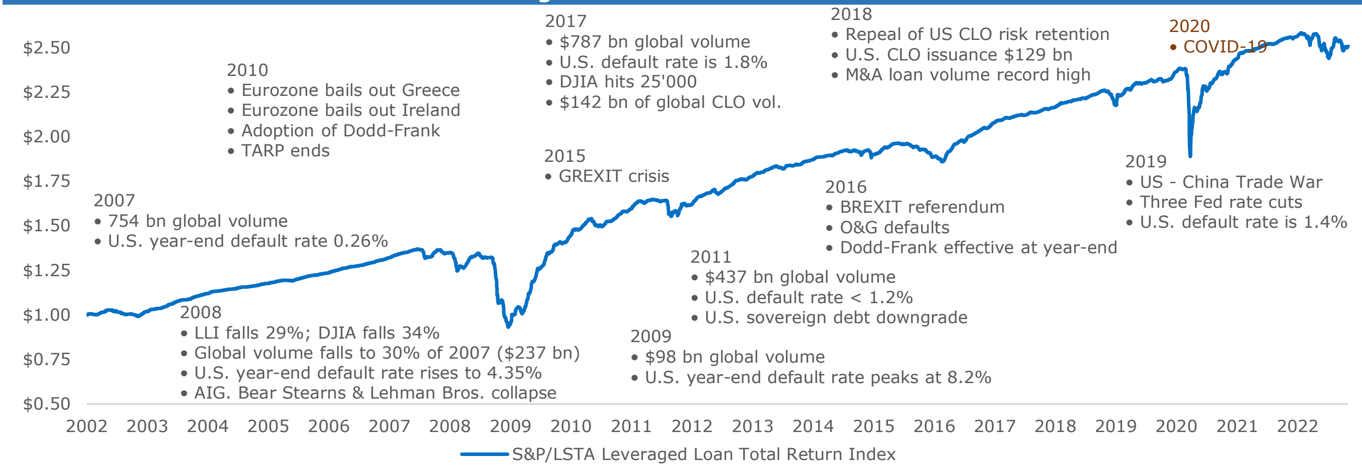
Covenant-lite loans remain at record highs after years of growth

Unlike standard loans, borrower-friendly covenant-lite loans are characterized by absence of regular contractual monitoring of borrower's creditworthiness (for example ability to pay interest due). Thanks to fierce competition, historically low interest rates and desire for more flexibility among both borrowers and lenders, the growth of covenant-lite loans accelerated after the Great Financial Crisis. Today they form majority of leveraged loans outstanding.

The negative impact of this trend is yet to fully materialize, but it is becoming apparent that covenant-lite loans will likely exhibit lower default recovery rates. An absence of effective early warning mechanism will prevent lenders from identifying early signs of deteriorating corporate performance and from taking timely protective actions before diminishing enterprise value.



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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