Alternative Credit Letter

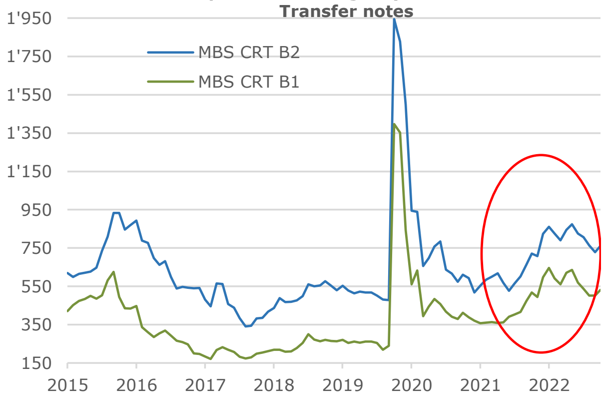
May 2023

Monthly Spotlight

MBS credit spreads have been widening significantly

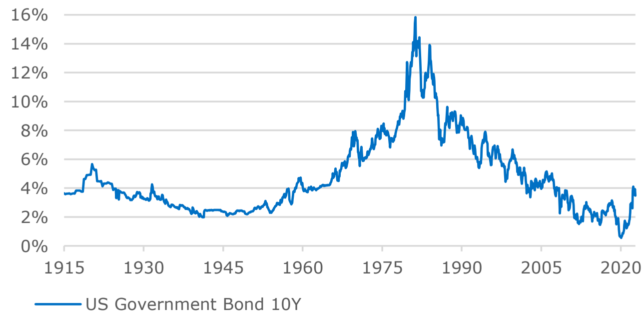
Since the start of the FED's tightening, credit spreads on residential mortgage-backed securities (MBS) have been widening significantly. For example, the credit spreads on junior B1 and B2 tranches of Credit Risk Transfer notes (CRT) have doubled since their 2017 lows. These junior CRT tranches absorb initial losses on diversified US agency residential mortgage-backed pools (e.g. Fannie Mae). The increased credit spreads on CRTs compensate for potential stress ahead in US housing market. However, earlier CRT vintages, in particular those issued prior to the Pandemic, have benefited from a number of tailwinds. Namely, the previous years' low default environment, low rates (stimulating prepayments while locking up cheap funding costs) and robust house prices growth (house prices remain almost 40% above 2019-levels) have all led to robust performance and de-risking of CRTs issued prior to 2021. Given the divergence among the CRTs, an active management of any such investment, with detailed knowledge of the underlying mortgage pools, remains necessary.

Credit spreads on US Agency MBS Credit Risk Transfer notes

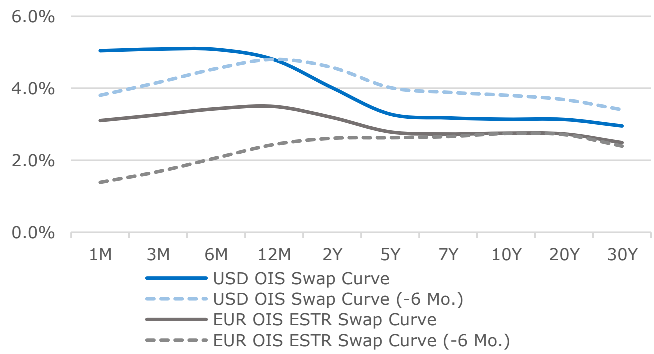


Rates Perspective

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

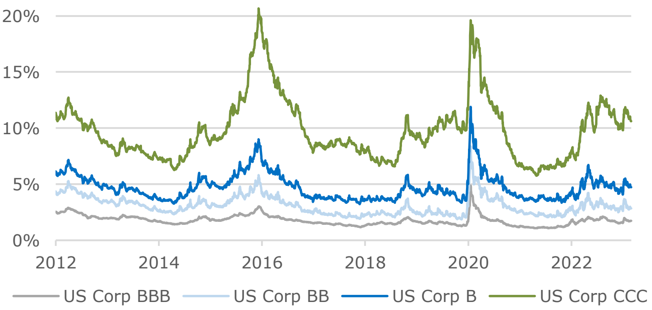


2) Interest Swap Curve: The USD and EUR curve further inverted as shorter tenors continued to increase.



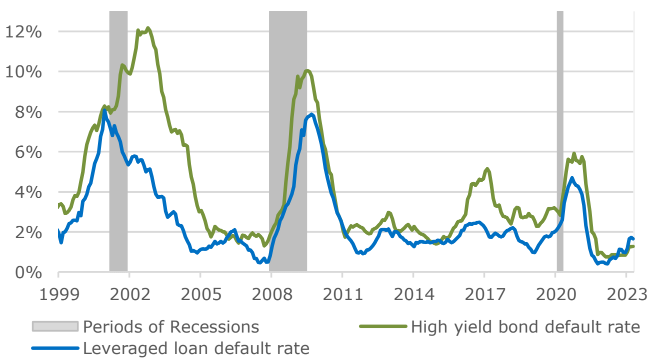
Corporate Perspective

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

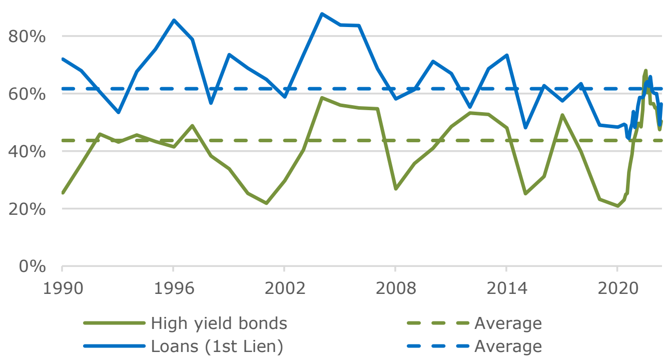


4) EU vs US: Credit spreads (OAS) between the US and EU have narrowed since the start of 2023.

5) Default Rates: HY bond default rates are structurally higher (Ø4.2%) vs. loans (Ø2.6%).



6) Recovery Rates: Recovery rates of leveraged loans are higher (Ø62%) vs. high yield bonds (Ø44%) 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	56	-1
AA	78	-2
A	117	-5
BBB	172	-5
BB	287	-1
B	483	-8
CCC	1077	-53

Global high yield (bps)

	curr	Δ month
US HY	450	-8
EU HY	472	-2
Asia HY	991	-49
EM HY	539	+3

CDS spreads (bps)

	curr	Δ month
CDX IG - US	76	-0
iTraxx IG - EU	83	-1
CDX HY - US	466	+3
iTraxx XO - EU	435	-1

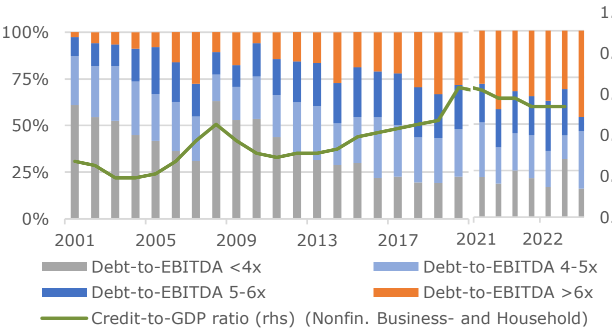
Loans and CLOs (yld, bps)

	curr	Δ month
US Loan	943	+8
CLO AAA	562	-11
CLO BBB	852	-24
CLO BB	1333	-30

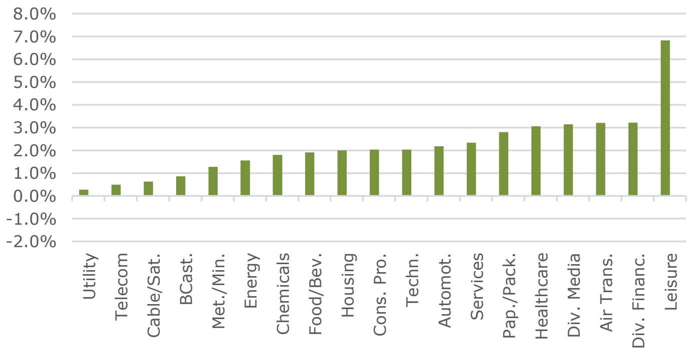
spread tightening (positive price action)

spread widening (negative price action)

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

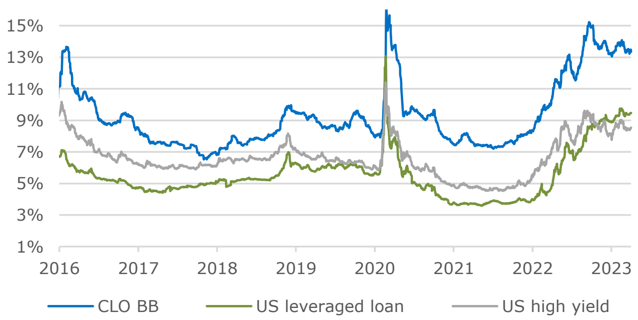


8) YTD Sector High-Yield Returns: All sectors have recovered YTD, with leisure outperforming significantly.

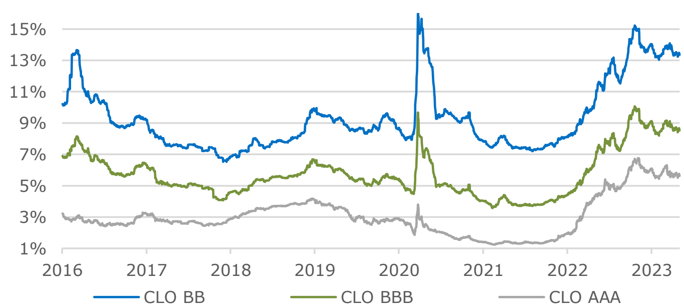


Alternative Perspective

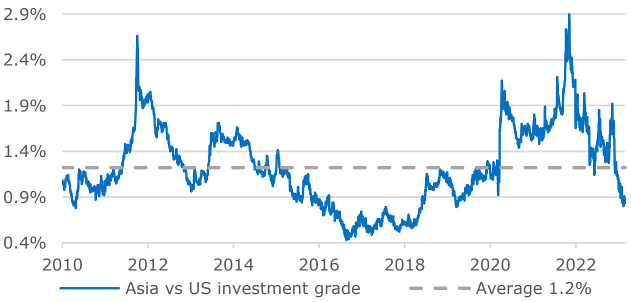
9) Loans vs. CLO vs. HY: CLO BB yields are wider vs Loans and HY bonds.



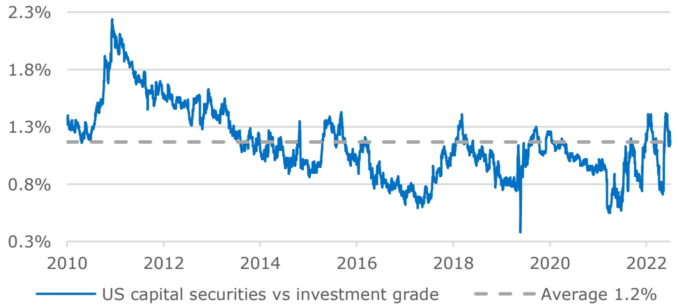
10) CLO Yields: CLOs offer an attractive yield premium over bonds and loans.



11) Asia vs. US: Asian IG spreads have tightened thanks to China's economy reopening and US inflation easing.



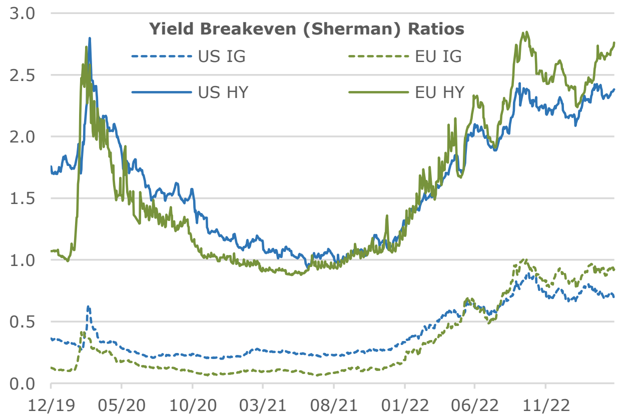
12) Capital vs IG.: Capital Securities structurally earn a premium vs. US IG bonds. Capital Securities are dominated by the financial sector.



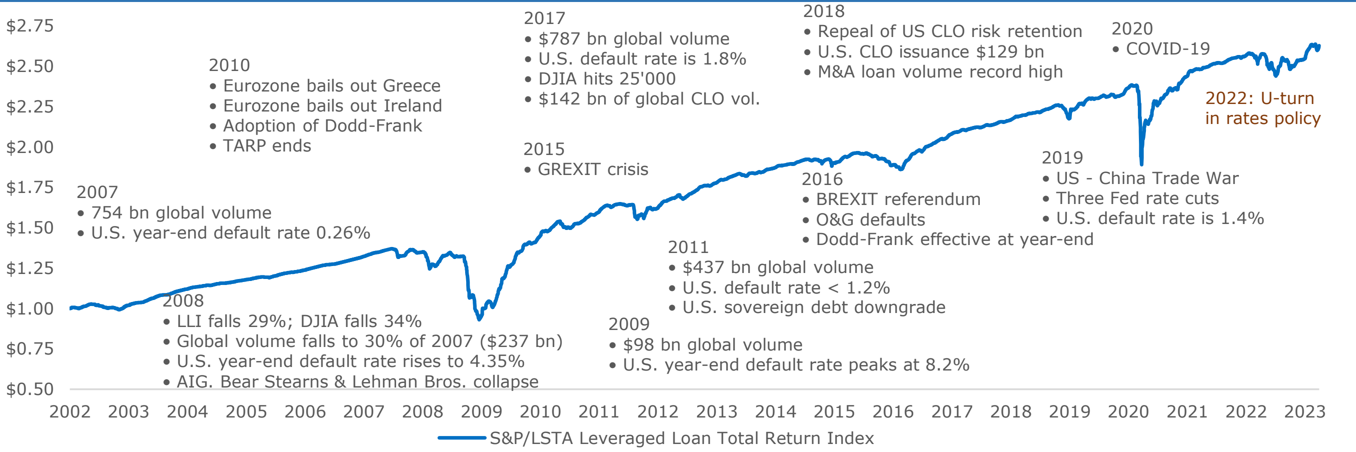
Education Corner

Yield breakeven ratios steadily climbing towards multi-year highs

The Yield Breakeven (Sherman) Ratios, calculated as yield divided by duration, measure the amount of yield investors earn for each unit of duration. These risk measures indicate by how much can yields rise, before incurring capital loss equal to annual yield accrued on investors' holding. A ratio of 1.0 implies that 1%point increase in yields will eliminate the entire year's worth of yield accrual. Since 2022 the Sherman ratios have increased significantly due to risk-free rates rising from their all-time lows in both US and Europe. The current high levels of Sherman ratios, especially among HY, suggest good level of yield returns protection from further central bank rate increases. However, as rate- and spread-change sensitivities tend to be similar on fixed coupon bonds, investors should observe both risk free rates as well as credit spreads widening as factors impacting the yield increase. Currently, wider spreads are reflected among European credits, which contribute to higher ratios of 2.7 vs 2.4 in HY and 0.9 vs 0.7 in IG markets. However, as spreads have idiosyncratic component, a portfolio manager can protect investors' returns by appropriate credit selection and diversification.



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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