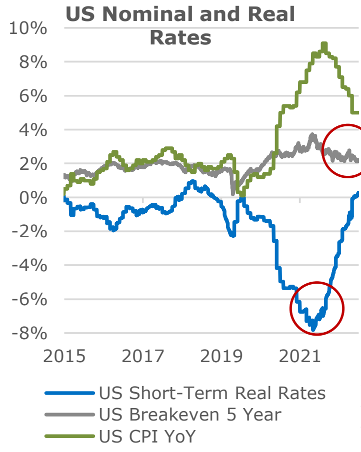
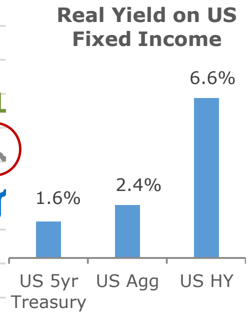
Monthly Spotlight

Recovering US real rates bring opportunities to credit investors

Following interest rate hikes and considering growing evidence that inflation expectations had peaked, the short-term real rates have been recovering from their record lows. At the same time, the 5-year breakeven inflation data suggest stabilization towards 2% range. The recovery of real rates is benefiting fixed income investors. When considering the longer term 5-year breakeven inflation levels, US investment grade aggregate implies positive real yields of 2.4%, while high yield (HY) credit reaches 6.6%.

US HY and private credit, yielding over 8 and 10% respectively in nominal terms, exceed also the current 5% YoY Consumer Price Inflation (CPI) levels. Significant portion of their yield premia reflects expectations of higher losses due to defaults. In order to keep beating inflation throughout the economic cycle, it is important to select managers, who had been disciplined and had not compromised their credit underwriting standards during the earlier low-rates environment and who have a track record of selecting quality borrowers. Such managers are best positioned to benefit from current market environment of high rates and wider credit spreads.

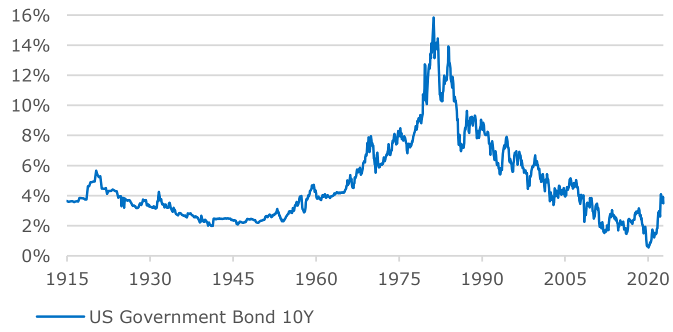




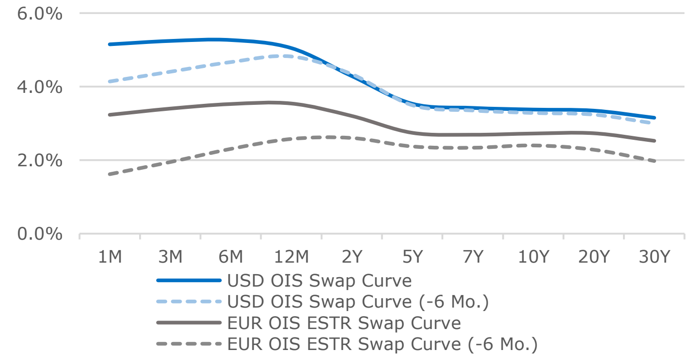
Real rate represented by nominal yield-to-worst minus US Breakeven 5-year inflation rate.

Rates Perspective

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

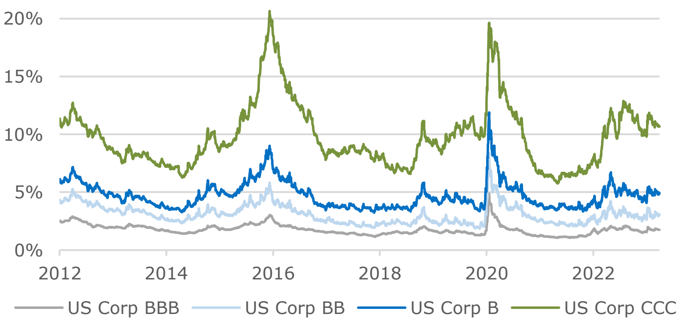


2) Interest Swap Curve: The USD and EUR curve further inverted as shorter tenors continued to increase.



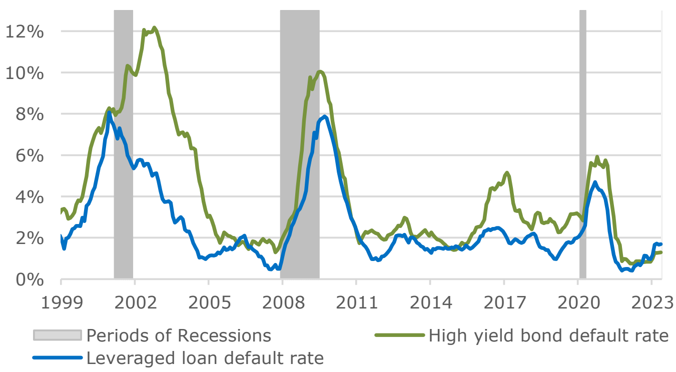
Corporate Perspective

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

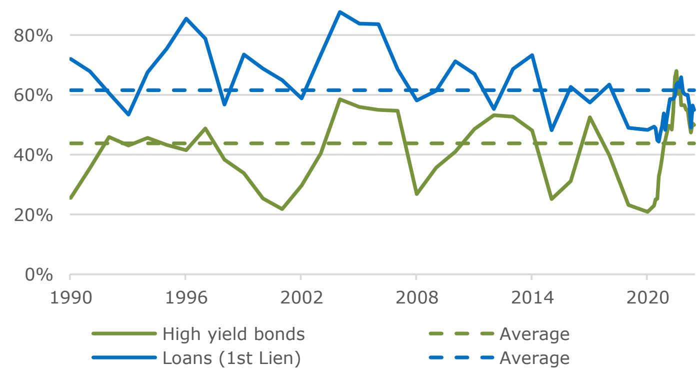


4) EU vs US: Credit spreads (OAS) between the US and EU have narrowed since the start of 2023.

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	54	-2
AA	77	-1
A	119	+2
BBB	176	+4
BB	310	+23
B	496	+13
CCC	1072	-5

Global high yield (bps)

	curr	Δ month
US HY	469	+19
EU HY	483	+11
Asia HY	991	+0
EM HY	546	+7

CDS spreads (bps)

	curr	Δ month
CDX IG - US	76	-0
iTraxx IG - EU	82	-1
CDX HY - US	475	+9
iTraxx XO - EU	434	-1

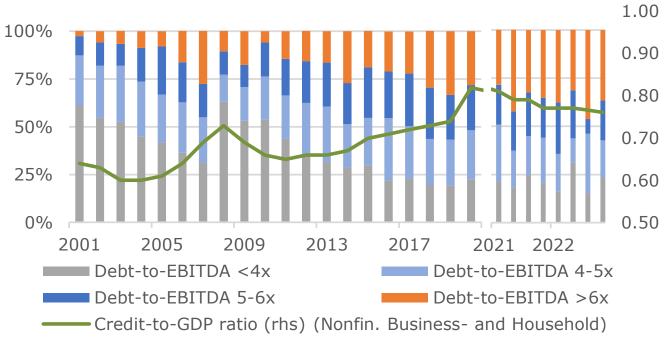
Loans and CLOs (yld, bps)

	curr	Δ month
US Loan	999	+56
CLO AAA	587	+25
CLO BBB	892	+40
CLO BB	1393	+60

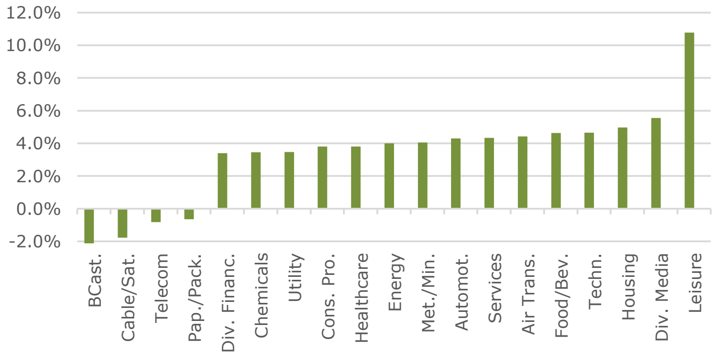
spread tightening (positive price action)

spread widening (negative price action)

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

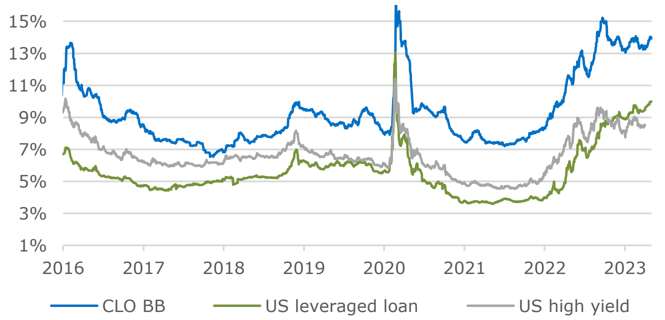


8) YTD Sector High-Yield Returns: Positive YTD results across most of the sectors, with leisure outperforming significantly.

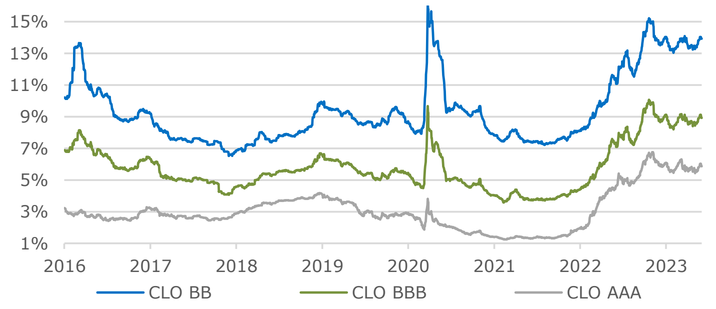


Alternative Perspective

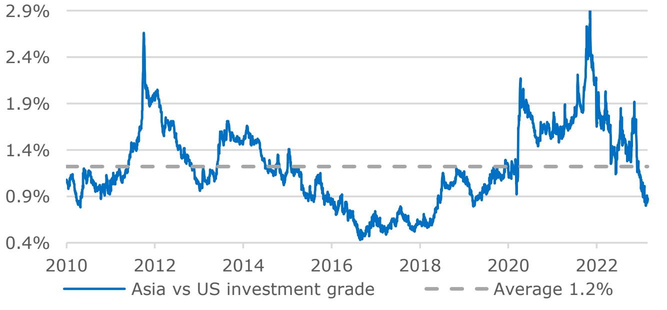
9) Loans vs. CLO vs. HY: CLO BB yields are wider vs Loans and HY bonds.



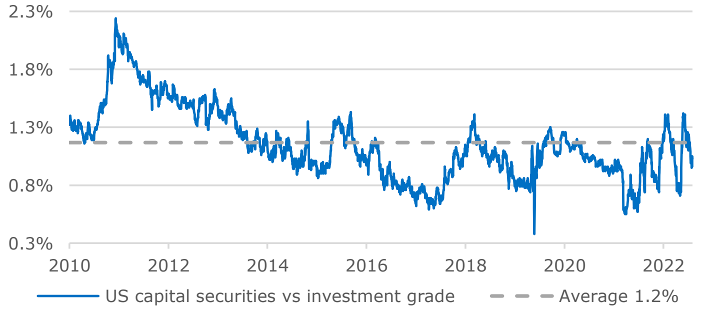
10) CLO Yields: CLOs offer an attractive yield premium over bonds and loans.



11) Asia vs. US: Asian IG spreads have tightened thanks to gradual post-COVID recovery 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.



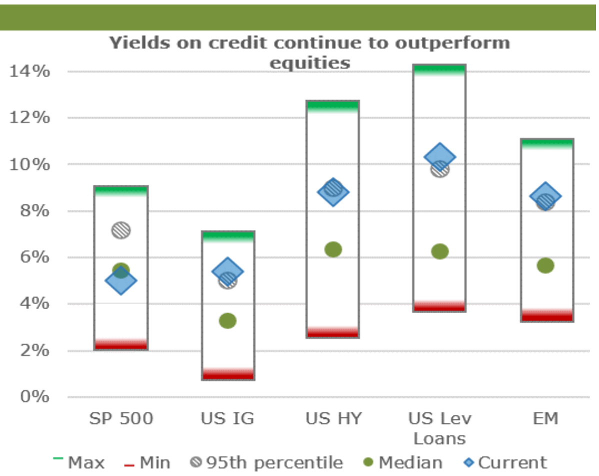
Education Corner

Yields on credit continue to outperform equities

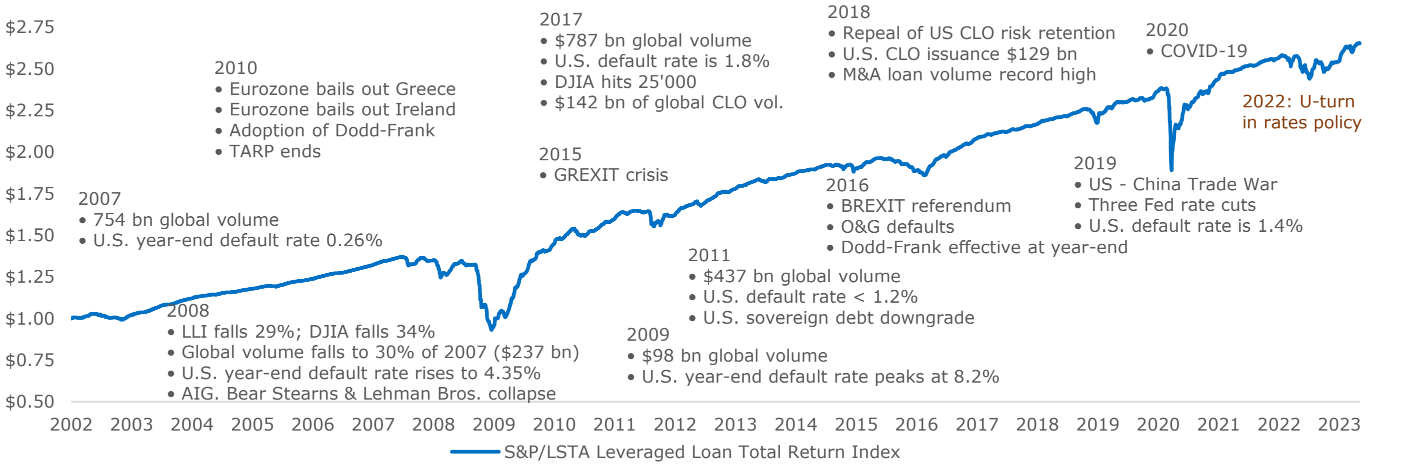
Yields across credit markets continue to outperform equities. When analyzing the data range since Dec 2009, the current yield levels are at, or exceeding, the 95th percentile. This means they are within the top 5% of yield values observed during the last more than 13 years. The maximum yield values often relate to short-term high volatility events, e.g. start of Covid pandemic.

The relative attractiveness of the presented credit sectors versus equities (represented by S&P 500 proxy) is driven primarily by increased risk-free rates and widening credit spreads. The spreads impact is most apparent in high yield and leveraged loans sectors, which have been pricing-in higher default risks. Ongoing, disintermediation of traditional financing providers, such as banks, brings additional opportunities to private debt managers, who can underwrite loans at much more attractive terms than during the hyper-competitive periods of cheap money not so long ago.

As a result, the initial credit margins over risk-free rates on newly underwritten deals have been increasing since 2022 and are now about 125bps higher on new versus maturing loans. At the same time, the rising financing costs require extra attention during managers' credit analysis.



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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