Credit Matters

July 2022

Is Goldilocks Back?

Markets **rallied** in July as recession fears outweighed inflation concerns – leading investors to believe that the ongoing aggressive monetary tightening will soon come to an end. The goldilocks environment where the economy is not too hot to warrant substantially higher interest rates, nor too cold to cause a recession, seems to be back after being prominent in the post 2007-08 Financial Crisis years.

Lower inflation expectations also fed hopes of a future central bank dovish pivot. This came on the back of falling oil prices, with WTI futures trading at $100 per barrel at the end of the month, down from $122 in June. Hopes of lower disruption in global supply chains also increased expectations of easier monetary policy ahead. The US Fed said in a paper that supply factors account for about half of the run-up in current inflation levels – hence any improvement in the post-Covid supply troubles should bring inflation down.

Both **stocks and bonds gained**, with the tech-heavy Nasdaq index posting double-digit gains. Long duration assets, including long maturity sovereign debt also outperformed. The UK and Italy didn't rally as much, following the resignation of Boris Johnson and Mario Draghi – with the latter renewing concerns about a European Union break-up. In order to counter such fear, the **European Central Bank** (ECB) unveiled a programme by which it will be allowed to buy bonds of financially challenged countries. The ECB also lifted rates for the first time in more than a decade.

High Yield outperformed Investment Grade in the US, lifted by narrowing spreads and a rather positive earnings season. In **Europe, corporate bonds posted their best month ever**, helped by the underlying base/sovereign rate rally and as year-to-date (YTD) losses have left some debt attractively valued.

More stable and short-duration assets such as loans and Asset-Backed Securities lagged. **Asian** assets suffered amid China's real estate woes, triggered by a mortgage payers' strike.

The **US dollar continued to ascend,** taking its YTD gain against the euro, the yen and sterling into double-digits.

Some market observers **question the risk-on market mode**, arguing that the Fed is still on a tightening cycle – it raised rates by 0.75% in July – and that leading indicators are signalling a recession. Others believe that goldilocks is back.

Signs of the Times

- Risk on: Bitcoin gained 27% in July, reducing its YTD loss to 49%.
- US inflation reached an annualised 9.1% and Q2 growth shrank for a second consecutive month.
- The IMF cut global 2023 growth forecasts to 2.9%, from 3.6%

Total Return (%)	% MTD	% YTD	% 3 yr	YTW %
Global Agg.	1.8	-12.4	-7.3	2.6
Global Agg. Securitis.	2.6	-7.4	-3.2	3.2
Global HY	3.1	-14.3	-5.2	8.7
Global Convertibles	3.7	-14.8	7.2	
US Treas. 7-10yr	3.0	-8.1	-0.4	2.7
US IG	3.0	-11.8	-0.4	4.4
US HY	5.1	-9.8	5.2	7.9
US B HY	5.2	-9.4	3.0	8.4
US Ba HY	5.3	-9.3	8.6	6.3
US Caa	4.0	-13.0	-1.9	12.9
US ABS	0.5	-3.3	2.0	3.7
US Leveraged Loans (LLI)	2.0	-2.6	7.8	
Palmer Sq CLO Debt Index	-0.6	-6.3	7.6	
US BB CLOs	-0.9	-8.6	13.8	
UK Gilts (GBP)	2.6	-12.6	-9.7	2.0
Ger. Bunds (EUR)	4.6	-7.1	-8.5	0.6
Ital. BTPs (EUR)	1.1	-10.5	-4.5	2.5
EU IG	4.7	-7.8	-6.7	2.4
EU HY	4.7	-10.3	-1.7	7.0
EU HY FIN	3.0	-12.3	-4.9	7.6
EU Fins	2.9	-14.7	2.2	
AT1s	5.1	-13.2	1.6	8.1
PanEur ABS Euro hdg.	-0.3	-1.4	-0.5	
EU Leveraged Loans (ELLI)	2.3	-5.5	3.7	
AsiaPac Agg.	0.1	3.3	11.3	1.7
AsiaPac Corp.	0.8	1.1	7.5	2.1
China Agg.	-0.1	-3.2	16.6	2.7
China Corp.	0.9	2.9	16.6	
EM Asia Credit	0.0	-11.6	-6.2	6.4
EM Aggregate	1.5	-15.9	-9.7	7.0
EM Hard Curr Agg	1.2	-17.5	-11.9	6.7
S&P 500	8.4	-13.9	35.9	
Nasdaq	11.4	-21.5	48.2	
EuroStoxx 50	7.3	-13.7	5.2	
Hang Seng Index	-7.8	-13.9	-26.9	
Oil	-5.3	33.1	76.1	
BBG Comdty Index	4.5	23.3	54.8	
Bitcoin	27.1	-48.6	150.2	
USD	1.0	6.7	6.4	
NYFed Small bus. optimism index	0.0	-9.5	-13.4	
NYFed corp. bond distress index	18.2	44.4	100.0	

OAS (% change)	% MTD	% YTD	OAS LAST %
Global Corp	-6.9	68.0	1.63
Global HY	-7.4	61.9	6.16
US IG	-5.8	58.7	1.46
US HY	-14.2	72.4	4.88
US MBS	-39.1	-9.7	0.28
EU IG	-13.3	99.0	1.89
EU HY	-7.5	90.7	5.93
EU CDS Xover	-12.1	110.7	5.09
EU CDS IG	-15.6	109.5	1.00
UK Corp	-5.8	71.1	1.95
EM Agg Hard	2.0	44.6	4.12
EM Corp	2.2	41.7	4.72

Bloomberg as at 29 July 2022.

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Five Credit Views in Five Charts

By Darren Toner

www.cqs.com

Q&A with Craig Scordellis

Good Times for Yield

PDF available on our web site.

The Case for Convertibles

New two-pager promoting the benefits of CBs.

Credit Matters:

CQS' monthly market update

CQS partnering with the Science Museum on climate change

CHART OF THE MONTH:

Source: BBG, ICE and LCD as of 31 December 2021.

INCOME AS A SHOCK ABSORBER

(Excerpt from Darren Toner's Five Credit Views in Five Charts):

For bond investors, the flipside of rising rates is more attractive levels of yield. For instance, US sub-Investment Grade debt is presently yielding almost 8%, meaning that the asset class would have to fall considerably before investors incurred losses (for more on this, read our recent Q&A with Craig Scordellis, CQS' CIO – Credit, Good Times for Yield). Higher coupons give investors a bigger buffer to absorb any mark-to-market losses. As seen in the chart above, US High Yield has only delivered negative annual returns in two of the past ten years, bolstered by the return from income.

FROM OUR RESEARCH DESK

Some parts of the Credit market are attractive because of the higher yields following the first half sell-off. Some believe that IG has reached attractive levels, having lost about as much as it lost in previous recessions. Other asset classes may have further to drop if economies fall into a recession, forecasters say.

Central banks care about Credit because of its links to liquidity and therefore inflation. They may rein in their hawkishness if there is much Credit distress. The NY Fed recently released a Corporate Bond Market Distress Index, which indicates the market functioning appears "healthy" at present.

Given the outlook ahead, we have categorised any company that we look at into 5 different concern areas, an exercise we also did in 2020 during Covid-19. The goal is to come up with a proxy of the actual potential default risk. The concern areas are:

1. **Refinancing Risk/Liquidity**
2. **Margin Sensitivity to Inflation**
3. **Recession Exposure**
4. **China Zero-Covid Policy**
5. **Russian Energy Exposure**

Important InformatiMon

[1]S&P, The European Speculative-Grade Corporate Default Rate Could Rise to 3% by March 2022, 18 March 2023.

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