Credit Matters

September 2022

Hiking Central

A slew of **31 rate hikes** around the world (and over half of them were 75 basis points or more), sent both equity and fixed income markets lower in September. Sticky inflation led many central banks to carry out "jumbo hikes," including the US Fed and the European Central Bank. The month also saw a far-right election win in Italy and an accident in the Russia-Europe gas pipeline that many fear is sabotage.

But it was the **turbulence in the UK gilt market** that amplified the month's losses in the last week of September. A mini-budget that included substantial, unfunded tax cuts led to a sharp increase in UK gilt yields, which challenged pension funds following Liability-Driven strategies (LDI); as part of their asset-liability duration match, schemes buy interest rate swaps often receiving fixed interest to increase duration, while paying a floating rate that became more expensive as yields rose. The Bank of England intervened, calming markets, while Liz Truss' new government later revoked some of the tax cuts. Sterling pared losses, but gilts posted a historic monthly loss.

Long duration assets were especially hit by the global rate-rising cycle, with US Investment Grade credit (IG) underperforming High Yield (HY). Oil and other commodities also fell, dragged down by recession fears, and leading industry body OPEC to start considering output cuts. **The US yield curve remained inverted,** while primary markets remained subdued due to the elevated rate volatility.

All major international equity markets plunged, taking the year-to-date loss of the leading S&P 500 and EuroStoxx 50 indices to a negative 25% and 24%, respectively.

The **US dollar** continued its ascent, supported by rising domestic rates and safe-haven demand. Only the currencies of oil exporting-Brazil and Mexico are up against the greenback this year. In contrast, the yen has lost 20.5% against the US currency, and sterling, 17.4%.

This month's moves have made bond yields more attractive as **Credit has become cheap (more overleaf).**

Total Return (%)	Change % 1 month	% Year-to-date
Sovereign		
US Treasury	-3.4	-13.5
UK Gilts	-7.1	-26.3
French OATS	-4.1	-16.9
Italian BTPs	-3.7	-16.7
German Bunds	-4.1	-15.4
Credit		
Global Convertible	-4.5	-19.2
US IG	-4.8	-18.3
US HY	-3.9	-14.6
US Leveraged Loans (LLI)	-2.0	-3.3
EU IG	-3.7	-15.1
EU HY	-3.8	-15.3
UK Corp.	-8.6	-25.5
AT1s	-7.1	-23.2
EU Leveraged Loans (ELLI)	-3.2	-6.6
Asia & EM		
Asia USD Gov. Index	-4.3	-16.2
Asia USD Corp. Index	-3.2	-15.2
China Gov.	-0.3	3.3
EM Gov. USD	-3.9	-13.3
EM Corp. USD	-3.3	-25.1
Equities		
S&P 500	-8.6	-24.8
EuroStoxx 50	-6.6	-23.0
Hang Seng Index	-12.2	-27.0
CMD & Curr.		
Oil (WTI)	-3.9	11.0
Gold	-2.4	-8.8
Bitcoin	-2.7	-58.5
USD	2.5	17.4

CDS Spreads	Change % 1 month	% Year-to-date	Spreads (bps)
CDX IG US	15.4	114.1	106.12
CDX HY US	13.5	104.6	599.78
iTraxx Europe IG	13.3	183.3	135.30
iTraxx Crossov. EU HY	9.0	164.5	639.33

Source: Bloomberg as at 3 October 2022.

Signs of the Times

- I told him the story of the beer distributor I knew who was hiring high school dropouts to drive trucks for $110,000 a year and college graduates to do sales for $55,000 a year. We simply don't have enough blue-collar workers... (from The 10th Man.")
- Correlation between the US dollar DXY Index to the MSCI World Growth Index: -0.4 over the past 20 years (higher dollar is negative for world growth).

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CQS' monthly market update

CQS partnering with the Science Museum on climate change

Chart of the Month

Difference HY Credit Spread and Equity Risk Premium

Source: Bloomberg and CQS analysis as at 28 September 2022.

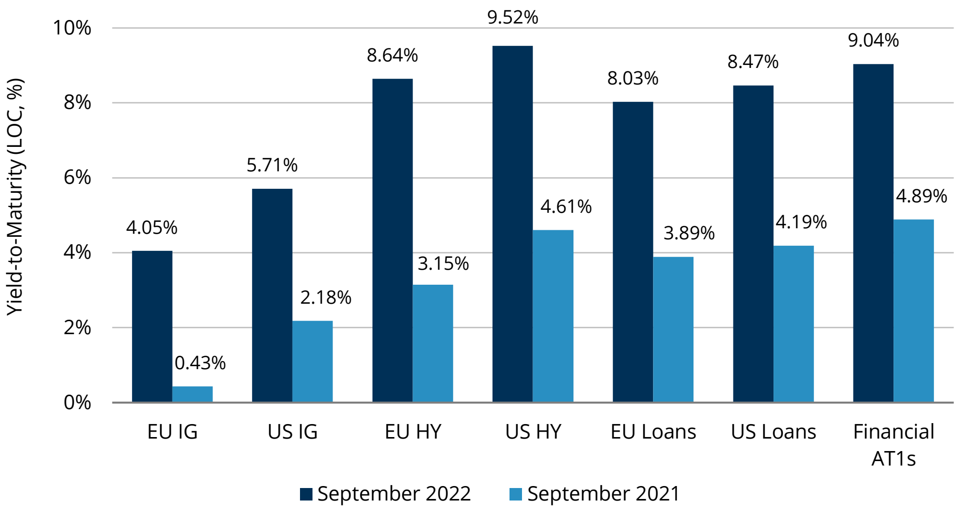
Credit is cheap

Despite recent stock market losses, earnings per share forecasts for the world's leading S&P 500 Index still point towards an increase this year, from last, and also in 2023. This has led to a reduction in the index's Equity Risk Premium (ERP), from 341 basis points (bps) at the beginning of the year, to 279bps at the end of September. At the same time, US HY Credit spreads have more than doubled since late December to the present 552bps. This means that while equity markets remain broadly optimistic about US companies' ability to increase profitability, Credit markets are discounting a tougher environment ahead, with rising defaults.

As seen in the **chart above,** the divergence between the two started and became more pronounced after April, when central banks such as the Fed reiterated hawkish signals in order to combat sticky inflation. Despite hopes of a dovish pivot during the summer, central banks' commitment to their present hiking path only accentuated the contrast between bond and stock market narratives.

The difference in expectations has made Credit cheap relative to Equities, providing opportunity for managers to pick quality names at attractive prices: US IG, for instance, now yields 5.7%, c. 1.5% more than what investors were paid in US HY on January 1st.

Good Times for Yield



Source: Bloomberg as at 30 September 2022

Important Information

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

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