Credit Matters
December 2022

2022: Setting Opportunity for 2023?

The Covid-19 pandemic recovery hopes that lifted risk assets in 2021 all but disappeared in 2022, when both stocks and bonds were hit by surging inflation, the outbreak of the Russia-Ukraine war and a subsequent energy crisis. To top it all, pandemic fears kept China in stringent lockdowns for most of the year, while the crypto universe plunged following some high-profile bankruptcies. Yield curves inverted and the S&P 500 posted its biggest annual decline since 2008.

Credit spreads widened, pushed by protracted recessionary fears. High Yield (HY) outperformed Investment Grade (IG) in both Europe and the US, as its shorter duration was a benefit in a year of record rate hikes around the world. US rates, for instance, stated 2022 at 0.25% to end at 4.5%. The fastest ever Fed rate hiking phase came as inflation reached 9.1%.

UK gilts and corporate bonds underperformed, hit by the additional effect of a convoluted political year: the market reaction to an attempt to cut taxes and increase spending sent politicians around the world a stark message: a reversal of the ongoing Quantitative Easing-to-Quantitative Tightening (QE to QT) trend is not welcome.

The US dollar surged against most currencies, backed by a rising interest rate differential, especially against the yen. The Japanese currency reduced losses towards the end of the year, when the Bank of Japan announced a softening of its yield curve control policy. The country's 2-year yield rose above zero for the first time since 2015, practically bringing an end to the years of negative yields that followed the 2007-08 Financial Crisis.

Investors in alternative asset classes, such as Hedge Funds with the capacity to go both long and short and some momentum and directional strategies, outperformed given their flexibility. Some selective Credit and Asset-Backed Security (ABS) strategies were also successful as prices fell to near-distressed levels before showing some recovery in a year marked by volatility. ABS and Loans were also helped by their floating-rate nature.

The uncertainties that dominated last year seem to continue in 2023: inflation may be stickier than expected; the Russia-Ukraine war is ongoing; China continues to battle against Covid-19 and most economists expect a global recession.

This backdrop, combined with the attractive prices that 2022 left behind, may bring opportunity in 2023 (more overleaf).

Signs of the Times

Latest Manufacturing Purchasing Managers' Indices (PMI):

- Euro-area December: 47.8
- China December: 47
- US November: 49
- UK December: 44.7

Figures below 50 are considered contractionary

Total Return (%)	Change % December	% 2022
Sovereign		
US Treasury	-0.5	-12.9
UK Gilts	-4.4	-25.1
French OATS	-4.4	-18.7
Italian BTPs	-4.2	-17.0
German Bunds	-3.9	-17.6
Credit		
Global Convertible	-1.7	-16.0
US IG	-0.2	-15.4
US HY	-0.8	-11.2
US Leveraged Loans (LLI)	0.4	-0.6
EU IG	-2.0	-15.1
EU HY	-0.8	-11.1
UK Corp.	-1.9	-19.9
AT1s	2.5	-14.0
EU Leveraged Loans (ELLI)	0.3	-3.4
Asia & EM		
Asia USD Gov. Index	0.4	-13.9
Asia USD Corp. Index	1.7	-12.1
China Gov.	0.4	3.3
EM Gov. USD	2.1	-9.4
EM Corp. USD	2.8	-18.8
Equities		
S&P 500	-5.9	-19.4
EuroStoxx 50	-4.3	-11.7
Hang Seng Index	6.4	-15.5
CMD & Curr.		
Oil (WTI)	-0.4	6.7
Gold	3.1	-0.3
Bitcoin	-3.3	-64.3
USD	-2.3	8.2

CDS Spreads	Change % December	% 2022	Spreads (bps)
CDX IG US	8.4	65.5	82.02
CDX HY US	7.0	65.1	483.98
iTraxx Europe IG	-1.1	89.7	90.60
iTraxx Crossov. EU HY	3.3	96.1	474.11

Source: Bloomberg as at the last business day of the month indicated at the top of this report.

Theme of the month
Credit is Cheap

Knowledge: the key to CQS's three Rs:

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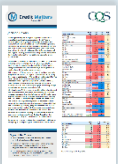
PDF available on our website

The Case for Convertibles

Two-pager promoting the benefits of CBs



Credit Matters:

CQS' monthly market update

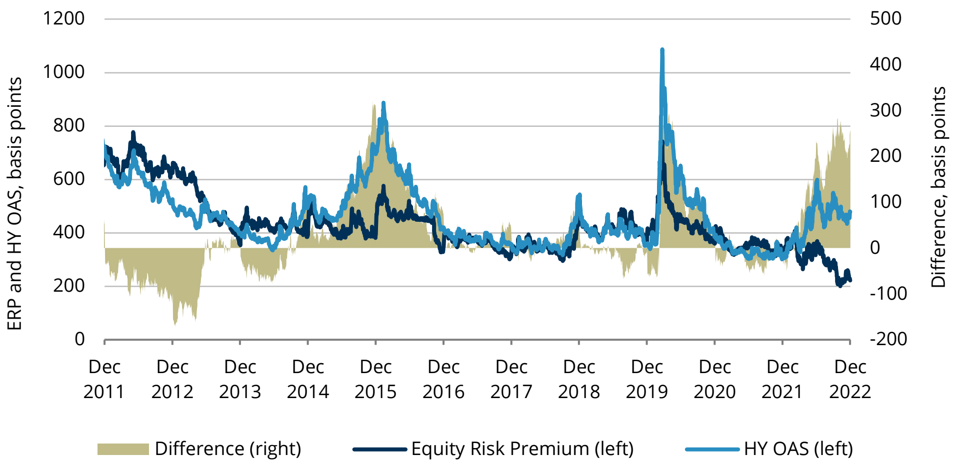
CQS partnering with the Science Museum on climate change

Regulatory Capital:

Long Term, Stable Income

Theme of the Month: Credit is Cheap

Figure 1: S&P 500 Equity Risk Premium – US High Yield Spread



Source: CQS as at 31 December 2022. OAS stands for Option Adjusted Spread. ERP is Equity Risk Premium.

Credit is Cheap

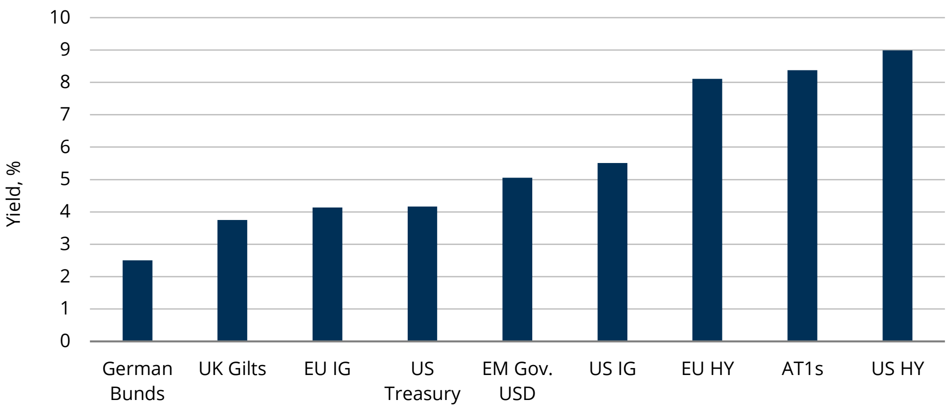
After a year of record interest rate hikes, no wonder Fixed Income (FI) asset classes ended the year on the cheap. Bonds suffered for a second year in a row, as 2021 penalised the asset class in detriment to Equities, which surged on expectations of a post-pandemic reopening. While stock indices suffered in 2022, they are still behind FI in terms of pricing uncertainty and the (still unconfirmed) recession that most economists foresee.

This timing mismatch has left Credit attractively valued relative to stocks. As seen in **Figure 1**, the difference between the risk premium between both asset classes has increased as Credit spreads (blue line) have widened relative to the Equity Risk Premium (ERP, black line). This may be due to the fact that last year's equity sell-off was largely driven by the higher equity discount rate, derived from the higher interest rates, rather than by any pessimism about future earnings: the US S&P 500 Index trades at 17.5 times its 2023 expected earnings, very close its long-term average of 17.4 times – hardly a recessionary sign.

The Credit repricing in 2022 has led to attractive yields: as seen **Figure 2**, European and US HY indices yield more than 8% (on a currency unhedged basis), substantially higher than the 3.75% seen barely one and a half years ago.

Investors willing to clip bond coupons may have attractive options in 2023.

Figure 2: 2023: Good Times for Yield



Source: CQS as at 3 January 2023. Yields are presented in the base currency of each index, and therefore on a currency unhedged basis. Yields may change substantially once they are currency-hedged.

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G1027666 / 01.23

CQS (UK) LLP
4th Floor, One Strand, London WC2N 5HR, United Kingdom
T: +44 (0) 20 7201 6900 | *F*: +44 (0) 20 7201 1200

CQS (US), LLC
152 West 57th Street, 40th Floor, New York, NY 10019, USA
T: +1 212 259 2900 | *F*: +1 212 259 2699

CQS (Hong Kong) Limited
3305 AIA Tower, 183 Electric Road, North Point, Hong Kong
T: +852 3920 8600 | *F*: +852 2521 3189

CQSClientServices@cqsm.com www.cqs.com Follow us

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