Credit Matters
February 2023

Investors Fight the Fed – and Lose

Despite repeated central bank commitment to fight inflation, investors spent January celebrating any economic bad news on hopes that the year-long rate tightening cycle would soon revert. February's inflation data, however, was stickier than forecast in both Europe and the US, lifting interest rate projections up – and most financial assets, down.

The US 10-year Treasury yield rose to 3.9%, up from 3.5% at the end of January. US fourth-quarter earnings were mixed, while economic data continued to be inconclusive: the labour market remains strong, at the same time that the housing sector is cooling down, given the higher rate environment. The US yield curve inverted even more in February, reaching its lowest level since 1981. Some economists are warning about the emergence of typical top-of-the-market indicators, such as rising corporate stock buybacks, increasing retail fund inflows and more private equity firms issuing debt to pay themselves hefty dividends.

European bond and stock markets fared better, led by lower gas prices and China's opening up, which should help exporters. The world's second-largest economy posted in February the highest manufacturing growth in a decade.

Europe's positive economic momentum made the region's High Yield corporate spreads avoid any widening. The asset class was led by lower-rated and growth-sensitive sectors, such as Financials, Restaurants, Gaming, Leisure and Food.

Other leading Credit spread measures widened, given the general sell-off during the month, although the moves were relatively moderate given the record issuance seen in February: companies rushed to market to raise money ahead of any further hikes, and also to tap on growing retail appetite. Some investors are attracted by the higher yields available.

Floating-rate assets, such as Loans, outperformed, and so did the US dollar. Inflation expectations remained flat, increasing real yields when deflated by long-term inflation expectations; this hurt traditional inflation-protection assets such as gold.

Higher real rates, along with the effects of inflation and tighter monetary policies, have led some observers to warn about potential monetary policy errors. The central banks of the Eurozone and the US have scheduled rate-setting meetings on March 16 and 22, respectively.

Total Return (%)	Change % February	% 2023
Sovereign		
US Treasury	-2.4	0.1
UK Gilts	-3.4	-0.7
French OATS	-2.6	-0.7
Italian BTPs	-1.5	1.1
German Bunds	-2.5	-0.9
Credit		
Global Convertible	-2.1	2.6
US IG	-2.9	0.9
US HY	-1.3	2.6
US Leveraged Loans (LLI)	0.6	3.4
EU IG	-1.5	0.6
EU HY	0.0	3.3
UK Corp.	-2.5	1.5
AT1s	-2.4	2.8
EU Leveraged Loans (ELLI)	1.1	4.1
Asia & EM		
Asia USD Gov. Index	-1.4	0.8
Asia USD Corp. Index	-1.6	1.5
China Gov.	0.1	0.2
EM Gov. USD	-2.9	0.3
EM Corp. USD	-1.6	2.4
Equities		
S&P 500	-2.6	3.4
Nasdaq	-1.1	9.4
EuroStoxx 50	1.8	11.7
Hang Seng Index	-9.4	0.0
CMD & Curr.		
Oil (WTI)	-2.3	-4.0
Gold	-5.3	0.2
Bitcoin	0.9	39.6
USD	2.7	1.3

CDS Spreads (bps)	Change February	Change 2023	Spread
CDX IG US	5.0	-5.6	76.4
CDX HY US	32.6	-21.4	462.5
iTraxx Europe IG	0.3	-11	79.6
iTraxx Crossov. EU HY	-0.7	-60.4	413.7

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

Sign of the Times

According to Barclays Capital, and at the midpoint of the Stoxx600 Index corporate fourth-quarter 2022 earnings season (calls made in January and February 2023), an automated transcripts tool shows a historically high number of "transportation cost" mentions in Europe. "Destocking effect" and "inventory" mentions reached a decade high.

Theme of the month

European Banks

Knowledge: the key to CQS's three Rs:
Repeatable
Responsible
Returns

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Loans: Alpha Opportunities in 2023

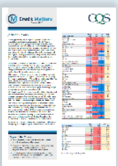
Q&A with Craig Scordellis

Good Times for Yield

PDF available on our website

The Case for Convertibles

Two-pager promoting the benefits of CBs



Credit Matters:

CQS' monthly market update

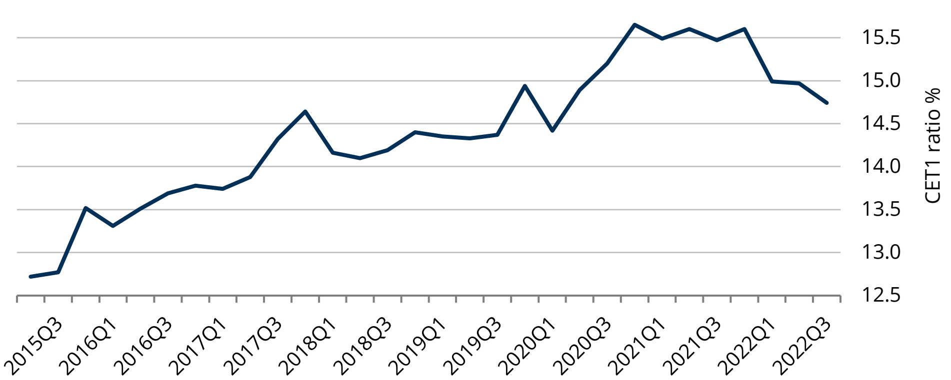
ABS Alpha Opportunities in 2023

Regulatory Capital:

Long Term, Stable Income

Theme of the Month: European Banks

Figure 1: European banks: Better capital ratios, stronger balance sheets



Source: European Central Bank as at 6 February 2023. CET1 is Common Equity Tier 1 capital.

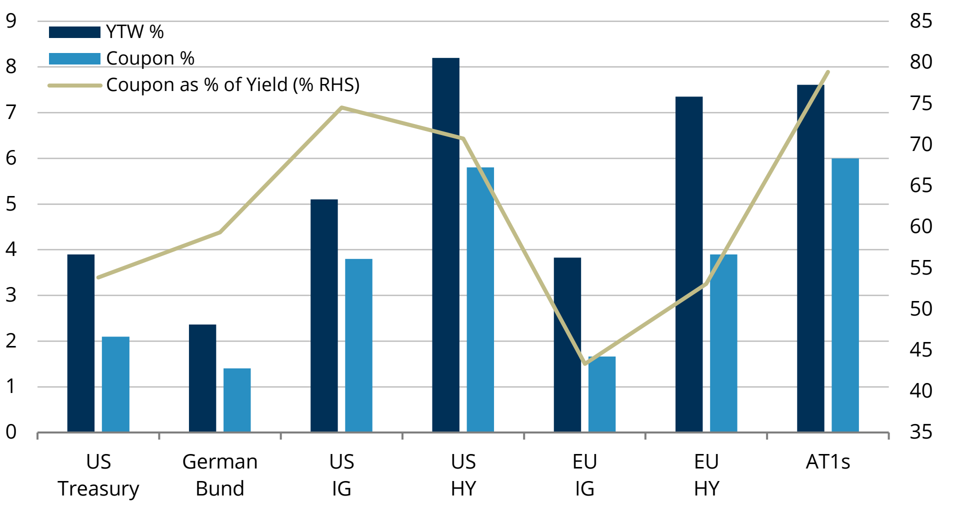
Why Do We Like Lending to European Banks?

As we expect growth, inflation and interest rate uncertainties to persist in 2023, we favour high-income securities, such as European Financials. We believe they offer:

- **Income**: European banks' coupons are attractive, especially those offered by lower-rated securities.
- **Better fundamentals**: More robust regulation has improved European banks' balance sheets and capital ratios (Figure 1).
- **Positive momentum**: Interest rates are rising in Europe (usually positive for banks' profit margins) and the region may avert a recession after all.
- **Attractive valuations**: European banks trade at wider spreads than their US peers.
- **Diversification**: The sector is ample and varied, in terms of credit rating and jurisdiction.
- We have a positive view of **Additional Tier 1 (AT1s),** a type of bank debt that can be turned into equity, or be written down, if a bank gets into trouble. We believe fundamentals are strong and the sector has been oversold due to technical volatility.

Read more: *European Banks: Fundamental Tailwinds & Income Generation* on www.cqs.com/insights.

Figure 2: AT1's offer high coupons, also relative to yield



Source: Bloomberg as at 31 January 2023. ICE BofA indices used. Index descriptions can be found on the last page. AT1s are Additional Tier 1 bonds. YTW is Yield to Worst. RHS is Right Hand Side.

Important Information

Index Descriptions: It is not possible to invest directly in an index: BofA Merrill Lynch Indices used with permission: BofA Merrill Lynch is licensing the BofA Merrill Lynch indices "as is," makes no warranties regarding same, does not guarantee the suitability, quality, accuracy, timeliness, and/or completeness of the BofA Merrill Lynch indices or any data included in, related to, or derived therefrom, assumes no liability in connection with their use, and does not sponsor, endorse, or recommend CQS, or any of its products or services.
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ICE BofAML US Corporate Index (C0A0) tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.
ICE BofAML European Currency Fixed & Floating Rate Non-Financial High Yield Constrained Index (H9PC) contains all non-financial securities in ICE BofAML European Currency Fixed & Floating Rate High Yield Index but caps issuer exposure at 3%.

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PRI Note: PRI is an investor initiative in partnership with UNEP Finance and the UN Global Compact. GMv10.

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