Credit Matters
October 2022

CQS

More Treats than Tricks

Market sentiment improved in October, from a negative September, despite the persistence of this year's main narratives: rates continued to rise and inflation remained high in both Europe and the US. Yet, a risk-on mode dominated the month, backed by unrealised recession fears and protracted hopes of a central bank dovish pivot. Despite weakening manufacturing and housing data, the US economy returned to growth in the third quarter, after shrinking in the first half of the year, while consumer health remained strong. Unemployment fell to the lowest level since man landed on the moon. In Europe, warm weather – and the subsequent lower gas prices –, and improving supply bottlenecks added to the optimism.

Risk rallied: Credit spreads tightened; commodities, leveraged loans and bitcoin gained, while the Italian-German sovereign spread narrowed. High Yield (HY) outperformed rate-sensitive Investment Grade (IG) in both Europe and the US, as **longer-duration assets suffered** from "jumbo" 75 basis point (bps) interest rate hikes. Debt securities with long maturities plunged: US Treasuries +25 years, for instance, fell almost 7%, taking their 2022 loss to 36%, the worst since records began in 1992.

Equities surged, with the S&P 500 adding 8.1%, reducing its year-to-date loss to 19%. Gains, however, were mitigated by a **Technology sell-off** towards the end of the month, triggered by disappointing earnings from Amazon.com Inc., Google parent Alphabet Inc. and Microsoft Corp. Large US Tech companies generate more than half of their revenues abroad, making them more vulnerable to a strong dollar, to a global slowdown and to rising US-China tensions.

After four consecutive monthly gains, the **US dollar gave up** some of this year's double-digit gains, dragged down by lower interest rate differentials with other countries and by a worsening Current Account deficit – of 3.9% of GDP, the widest since 2009. The US yield curve remained inverted.

UK assets partially recovered following the appointment of fiscally prudent Rishi Sunak as prime minister; he replaced Liz Truss after her planned mini-budget caused market turmoil.

Investors expect **further rate hikes** in the US and UK this week.

Total Return (%)	Change % October	% Year-to-date
Sovereign		
US Treasury	-1.5	-14.8
UK Gilts	3.3	-23.9
French OATS	0.1	-16.9
Italian BTPs	1.1	-15.8
German Bunds	-0.5	-15.9
Credit		
Global Convertible	2.2	-17.4
US IG	-1.1	-19.2
US HY	2.8	-12.2
US Leveraged Loans (LLI)	1.0	-2.3
EU IG	0.1	-16.0
EU HY	1.8	-13.7
UK Corp.	5.2	-21.7
AT1s	3.3	-20.6
EU Leveraged Loans (ELLI)	0.8	-5.8
Asia & EM		
Asia USD Gov. Index	-1.7	-17.7
Asia USD Corp. Index	-4.0	-18.6
China Gov.	0.7	4.0
EM Gov. USD	-1.6	-14.7
EM Corp. USD	-1.9	-26.5
Equities		
S&P 500	8.1	-19.1
EuroStoxx 50	9.1	-15.2
Hang Seng Index	-14.7	-33.9
CMD & Curr.		
Oil (WTI)	11.3	17.6
Gold	-3.3	-10.1
Bitcoin	6.1	-55.9
USD	-0.5	16.7

CDS Spreads	Change % October	% Year-to-date	Spreads (bps)
CDX IG US	-14.0	80.9	89.68
CDX HY US	-13.4	75.8	515.38
iTraxx Europe IG	-16.5	131.6	110.59
iTraxx Crossov. EU HY	-13.5	124.0	541.41

Source: Bloomberg as at 31 October 2022.

Signs of the Times

Why did the US Tech sell-off happen?

Expected S&P 500 Q3 2022 Earnings Per Share growth:

- Excluding Energy: -3.46%
- Excluding Technology: 5.14%

Source: Bloomberg as at 28 October 2022

Theme of the month

European CLOs

Knowledge: the key to CQS's 3 Rs:
Repeatable
Responsible
Returns

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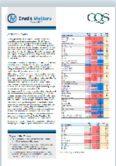
The Case for Convertibles

Two-pager promoting the benefits of CBs



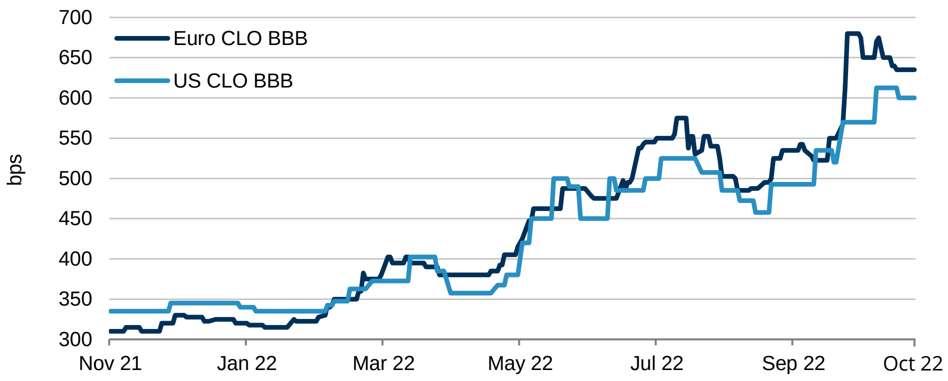
Credit Matters:

CQS' monthly market update

CQS partnering with the Science Museum on climate change

Theme of the Month: European CLOs

Rising BBB CLO spreads: strong risk-adjusted returns form IG-rated tranches



Source: CQS, CitiVelocity as at 28 October 2022.

In a continuous rising rate environment, we continue to view floating-rate securities as attractive. In particular, we see strong relative value in securities backed by diversified loan pools – an instrument known as Collateralised Loan Obligations, or CLOs.

As seen in the **chart above**, spreads on European BBB rated CLOs have widened significantly, especially relative to the US, offering an attractive entry point.

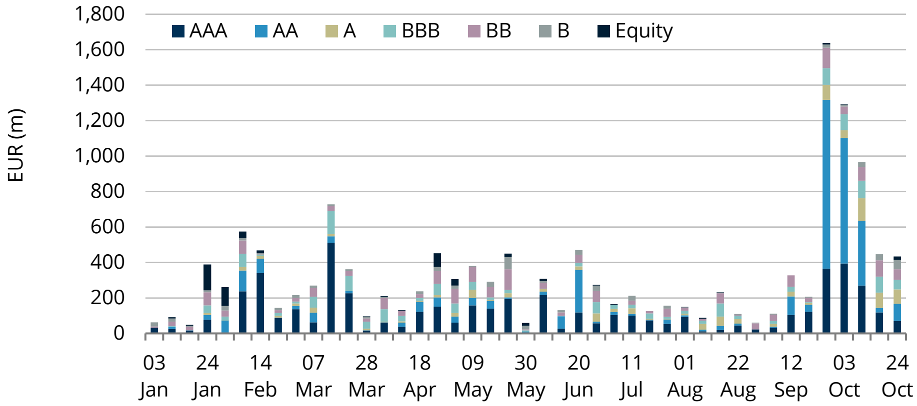
Their sharp move in October was triggered by the fiscally expansive mini-budget that the UK unveiled in late September, and which raised questions about Britain's creditworthiness. The resulting spike in gilt yields led to some leveraged pension funds receiving margin calls on their Liability Driven Investment (LDI) strategies, which forced them to sell liquid assets to meet the cash requirements. CLOs suffered from this deleveraging; **the graph below** shows how weekly public secondary market auction volumes through 2022 spiked following the September 23 mini-budget.

A few weeks later, the increased CLO supply in secondary markets continues to be absorbed, given the wider spread levels. Also, total-return investors that historically focused on more junior, subordinated tranches have moved up the capital structure to take advantage of the opportunity in IG-rated tranches. With prices in the 80s, and yields approaching 10%, these investors have been attracted to the total return opportunity in IG-rated bonds with robust structural protection.

As global rates continue to rise and inflation bites, the opportunity provided by income-generating, floating-rate assets remains attractive.

European CLOs: demand absorbs increased supply

Euro CLO BWIC volume (by week, 2022)



Source: CQS, CitiVelocity as at 24 October 2022. Auction volumes are expressed through a process known as BWICs (Bids Wanted in Competition).

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

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