Credit Matters

November 2022

Peak Inflation? Markets Breathe

Below-expectations inflation prints in both Europe and the US lifted investors' hopes of a dovish central bank pivot, fuelling a market rally in both stocks and bonds. Hopes of less aggressive rate hikes were further supported by US Federal Reserve (Fed) meeting minutes, which showed that a majority of officials agreed it would soon be time to slow the pace of hiking. These hopes were further bolstered by comments from Fed chair Jay Powell at the end of the month suggesting less severe hikes to come.

Long-duration assets benefited most, including long-maturity sovereign bonds (so far one of the year's worst performers) and Investment Grade (IG) credit. Traditionally long-duration chip makers were among top equity winners, although the Tech-heavy Nasdaq index lagged the S&P 500, which was dragged down by the bankruptcy of the crypto exchange FTX.

The crypto woes did not deter the risk-on mode, which also lifted Emerging Markets, Chinese property equities, bond issuance and even M&A action in riskier assets.

Credit spreads tightened, especially in Europe, where gas prices fell amid full storage supplies and mild weather, averting fears of an inflationary energy crisis. European markets also breathed on the back of a falling US dollar, which puts less pressure on the European Central Bank to lift rates to defend the euro.

Still, plenty of analysts warned against the optimism, arguing that inflation expectations remain well above central banks' 2.0% target (the US 10-year breakeven rate is at 2.3%), at the same time, trailing inflation is elevated (7.7% in the US, 10.6% in Europe). Whilst rate hikes may come at a slower pace, rate rises are still forecast in Europe and the US; many believe that higher rates and inflation will continue to hit economies over the coming months. Leading Wall Street analysts have forecast a bear market for 2023 and the global yield curve (derived from the Bloomberg Global Aggregate Index) inverted in November for the first time in two decades.

Economic data, however, remains mixed and a global recession, unmaterialised. Those who see the bottle half full are buying equities on growth prospects, while those who are more risk-averse are embracing the attractive income offered by bonds. At least both camps got a boost in November, helping reduce this year's pain. Time will tell as to whether November was a bear market rally, or the beginning of a recovery.

Total Return (%)	Change % November	% Year-to-date
Sovereign		
US Treasury	2.8	-12.4
UK Gilts	3.0	-21.6
French OATS	2.3	-14.9
Italian BTPs	2.8	-13.4
German Bunds	2.0	-14.2
Credit		
US IG	4.9	-15.3
US HY	1.9	-10.5
US Leveraged Loans (LLI)	1.2	-1.0
EU IG	3.1	-13.4
EU HY	3.8	-10.4
UK Corp.	4.2	-18.3
AT1s	5.7	-16.1
EU Leveraged Loans (ELLI)	2.2	-3.7
Asia & EM		
Asia USD Gov. Index	4.1	-14.3
Asia USD Corp. Index	6.2	-13.5
China Gov.	-1.0	3.0
EM Gov. USD	4.0	-11.3
EM Corp. USD	7.4	-21.0
Equities		
S&P 500	5.4	-14.4
EuroStoxx 50	9.6	-7.8
Hang Seng Index	26.6	-20.5
CMD & Curr.		
Oil (WTI)	-6.9	7.1
Gold	8.3	-3.3
Bitcoin	-16.2	-63.1
USD	-5.0	10.7

CDS Spreads	Change % November	% Year-to-date	Spreads (bps)
CDX IG US	-16.2	52.6	75.64
CDX HY US	-13.1	54.4	452.49
iTraxx Europe IG	-19.5	91.9	91.64
iTraxx Crossov. EU HY	-17.3	89.8	458.81

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

Signs of the Times

The number of Private Debt deals in the first half of 2022 increased by 23% from the first half last year, but a 6% decrease from the second half of 2021, which might be an indicator of a tougher second half of 2022, according to the Deloitte Private Equity Deal Tracker. M&A activity is still the key driver for Direct Lending deals.

Theme of the month

Regulatory Capital

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

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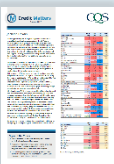


Credit Matters:

CQS' monthly market update

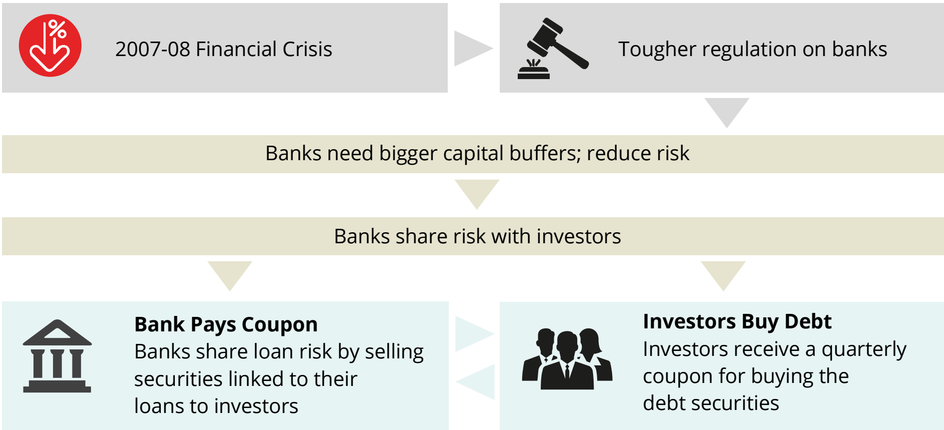
CQS partnering with the Science Museum on climate change

Regulatory Capital:

Long Term, Stable Income

Theme of the Month: Regulatory Capital

Figure 1: Regulatory Capital: Banks and investors swap credit risk for regular coupons



Source: CQS

Regulatory Capital: Long Term, Income

Following the 2007-08 Global Financial Crisis (GFC), more stringent bank regulation requires banks to increase their capital buffers. To free-up capital, banks in Europe and North America have partnered with strategic investors to share risk, creating an asset class previously not available to most investors: through a Regulatory Capital structure, investors now have the opportunity to access the bank loan universe, which typically provides high-quality, stable income from a diversified pool of borrowers.

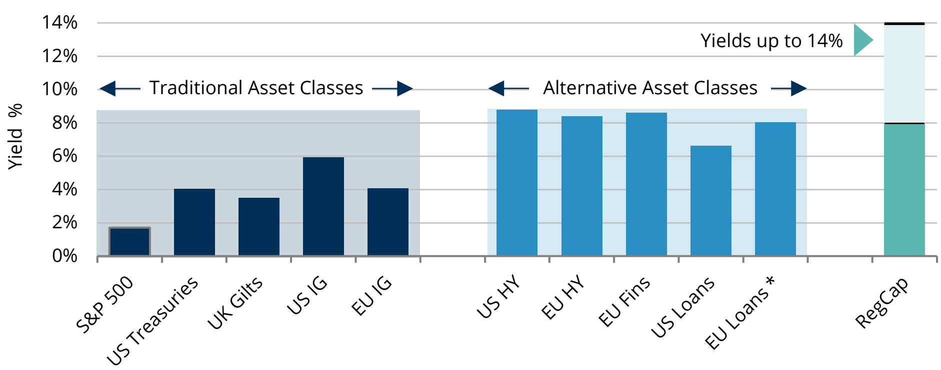
As seen in Figure 1 above, the Regulatory Capital mechanism is simple: banks share loan risk by selling debt securities backed by a pool of their core, high-quality loans. Banks keep the most senior tranches of those loan packages. Investors buy the higher-yielding, more junior tranches of those high-quality loan packages in exchange of regular coupon income. If the loan defaults, investors at the bottom of the capital structure will absorb the first losses. Bank loans, however, have a lower average default rate than publicly traded corporate bonds.

The structure works for both sides because their interests are aligned: by keeping loan risk, or having skin in the game, banks keep the loans on their balance sheet and continue to manage the customer relationship. To mitigate default risk, banks and specialised managers conduct thorough due diligence and monitor borrowers closely. The Regulatory Capital structure is designed to provide the following benefits:

1. High, stable income (Figure 2)
2. High quality collateral
3. Floating-rate
4. Low volatility
5. Low correlation
6. Diversification

To know more, read our recent piece: Reg Cap: Long Term, Stable Income.

Figure 2: Regulatory Capital provides high, stable income



Source: CQS as at 31 October 2022. * EU Loans data as at 30 September 2022.

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