

All eyes on Inflation (or Recession?)

Executive Summary

- September Roll, so far perfect for our strategy, with a positive Roll of ~8bps between the new and old serie.
- Itraxx continue to underperform this year compared to cash bond portfolio and equity
- Itraxx positioning back to year's low on energy crisis fears

"Winter is coming" motto of House Stark

iTraxx september roll s38/s37 and s38/s36:

One of the major risk we beard, while we are invested in on the run itraxx, is a negative roll after a widening. As the strategy will suffer from the widening before the roll and we will roll into a safer series with a spreads lower, so losing the opportunity to tighten back.

The next roll is priced today around +8bps. As we move closer to the roll date, we have now a clear view of the names going out and the ones going out. In fact it will be a very small turnover with PostNL (~90bps) replaced by Sky LTD (~20bps). Sky Ltd was already in the S36 (on the run Tranches portfolio). Names were switch due to the liquidity; volume traded in the last 6months were higher on Sky Ltd compared PostNL NV. The impact of the names switch is negative: -0.6bps. The extension of maturity from June 27 to December 2027 is around +8.5bps. All in all the two effects have a positive impact of ~8bps. If we compare to the s36 series we are circa +15.5bps.

The stability of constituents of the portfolio with only one names in and one out, will not modify the dispersion, wich is low (see previous monthly letter: Month-2022).

The roll is a good opportunity to come investing on Tranches, with rollwdown at its peak on the first year and with a restriking of spread of **tranches on a wider new s38** series. Also a **window were liquidity is high** during the roll, when it attracts interests.

Itraxx underperform Cash Bond and equity:

Looking at the performance of **iTraxx Main 5Y**, in august, it continue to underperform **Equity market**. Despite some inflows on credit at the beginning of summer. **The asset class continue to suffer from its "duration"** in an environment where Central bank were behing the curve in first half of year and likely to overreact in the second quarter. It started with ECB's 75bps hike in July, traditionnaly cautious to rise rates. Market expect a 75bps in September, to finish with a deposit rate around 1.5% a te end of year. rates dragging performance of Cash Index and

Fig. 1: Weekly Tweet counts from selected public accounts

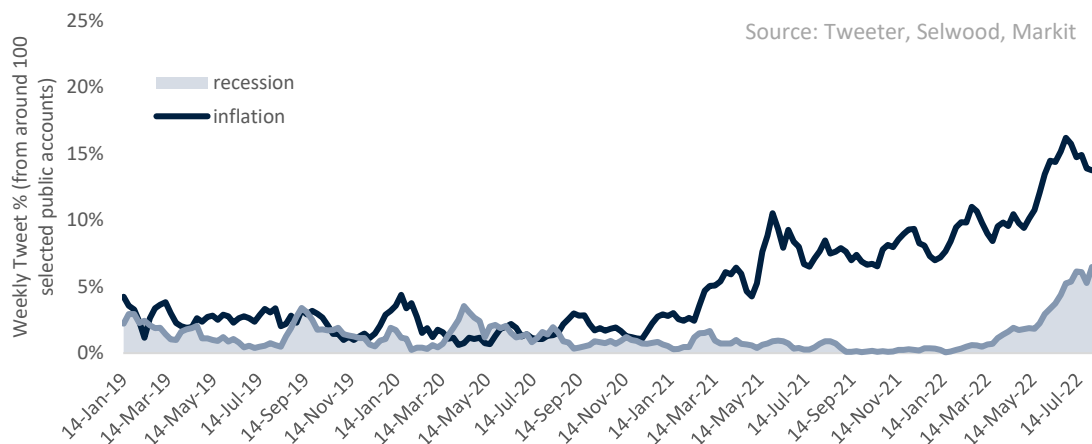


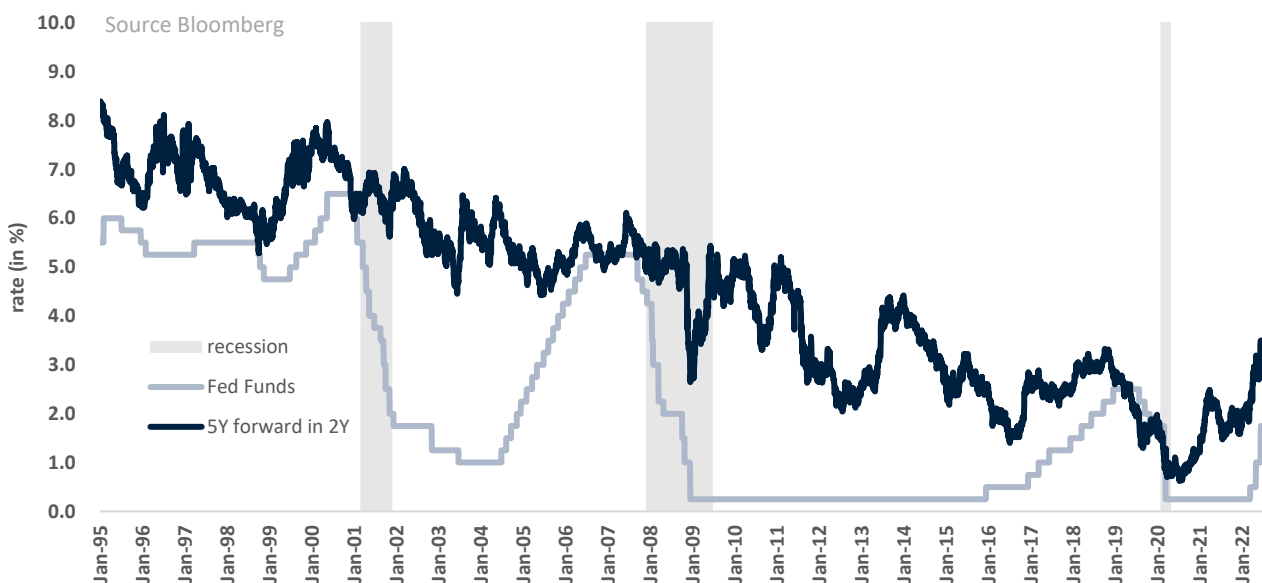
Fig. 2: Itraxx Main vs. Sentiment analysis



Forward guidance vs. forward expectations

We no longer have the Fed's forward guidance, but we do still have the market's forward expectations. With the sharp increase in the Fed funds and the downward trend in the forward rates witnessed of late we are back in a configuration that happened only on a very few occasions in the last 25 years, namely that **the market is pricing a 2Y forward 5Y swap rate at or below the Fed funds**, and this is before any new hikes (Fig. 3). **The only times that this has happened in the last 25 years have been followed by a recession and/or a decrease in rates.** While the current inflation dynamic means that we are not in exactly the same configuration as before, the data points to the market's base case scenario and provides further evidence for the reason of the rally seen at the end of July.

Fig. 3: US 5Y forward swap rate (starting in 2Y) vs. Fed Funds



Conclusion

July has been a volatile month, especially for the iTraxx Main index which at one point was trading 32bp wider than the CDX IG, fuelled by the threat of Russia halting gas flows through Nord Stream 1. However the sharp hike in rates, as well as the new base scenario for markets of a rapidly declining inflation (tamed not only by the actions of central banks but also by the worldwide declines in growth), helped trigger a month end rally that saw the iTraxx index tighten back near the 100bps level. So there are now 3 main factors to look at when pricing the iTraxx Main spread: (i) will the inflation come down as quickly as expected?, (ii) are we in a recession or will we enter one?, and of course, (iii) will Europe be able to build sufficient storage energy capacity for the upcoming winter months? **All this point towards a volatile market environment and should keep credit spreads under pressure in the coming weeks/months.**

Mathieu Labelle and Thibault Brohard, 01.08.2022

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