

Past Tears, Present fears: hopes for future

Executive Summary

- The September Roll so far looks perfect, with a positive roll of ~+6bps forecast between the new and old series.
- The period around the roll is generally a good investment opportunity.
- iTraxx continues to underperform this year relative to both cash bond portfolios and equities.
- iTraxx long positioning is back to the year's low on energy crisis fears.

“Winter is coming” motto of House Stark (HBO’s Game of Thrones)

iTraxx september roll s38/s37 and s38/s36:

One of the major risks we face while invested in the on-the-run series of iTraxx is a negative roll after a widening. If this were to happen the strategy¹ would suffer from the widening pre-roll and would be forced to monetize part of this loss as it rolls into a safer series.

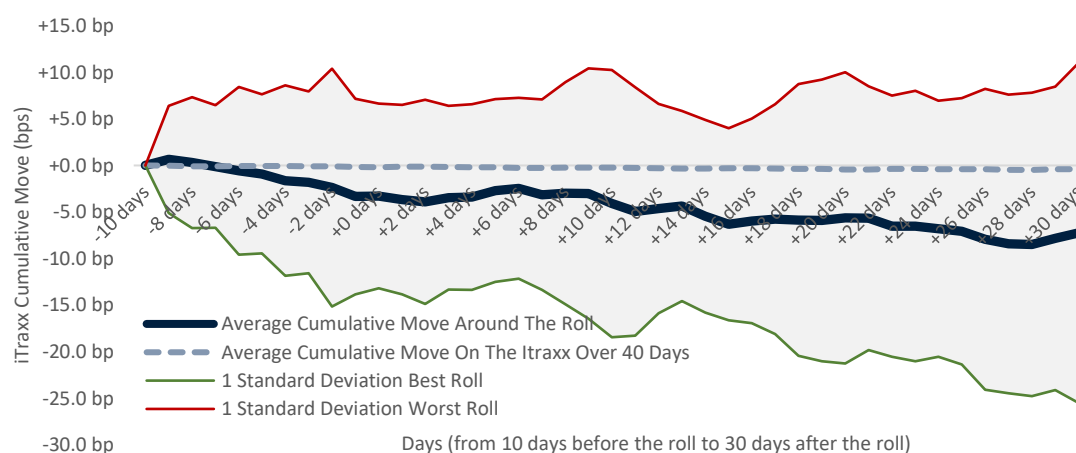
The next roll is priced today around +6bps, a clear positive for the strategy. As we move closer to the roll date, we now have a clear view of the names being removed from the existing series and the names being added. In fact in this roll there will be a very small degree of turnover in names as iTraxx Main will have one change with PostNL (trading at ~90bps) replacing Compagnie Financière Michelin (~60bps). PostNL has previously been in series S36 (the most recent series to be tranchéd). The upcoming name change was driven by the contracts differing liquidity as the volumes traded in the last six months were higher for PostNL relative to Michelin. The impact of the names switch is positive, albeit relatively small at +0.02bps. The extension of maturity from June 2027 to December 2027 is worth around +6bps. All in all the two effects have a positive impact of ~6bps. If we compare the upcoming S38 to the S36 series this roll increases to +13.5bps for a 1 year roll.

The stability of constituents of the portfolio - only one name changed - will have little impact on dispersion, which is still near the lows (see previous monthly letter: June-2022). The low dispersion is also a consequence of the lack of idiosyncratic risk priced in the index despite a headline index spread of around ~110bps. A lack of rating migration, with the rating agencies being very inactive of late, has also contributed. Note that the widest names in iTraxx are still only trading around ~300bps, so far from distressed levels.

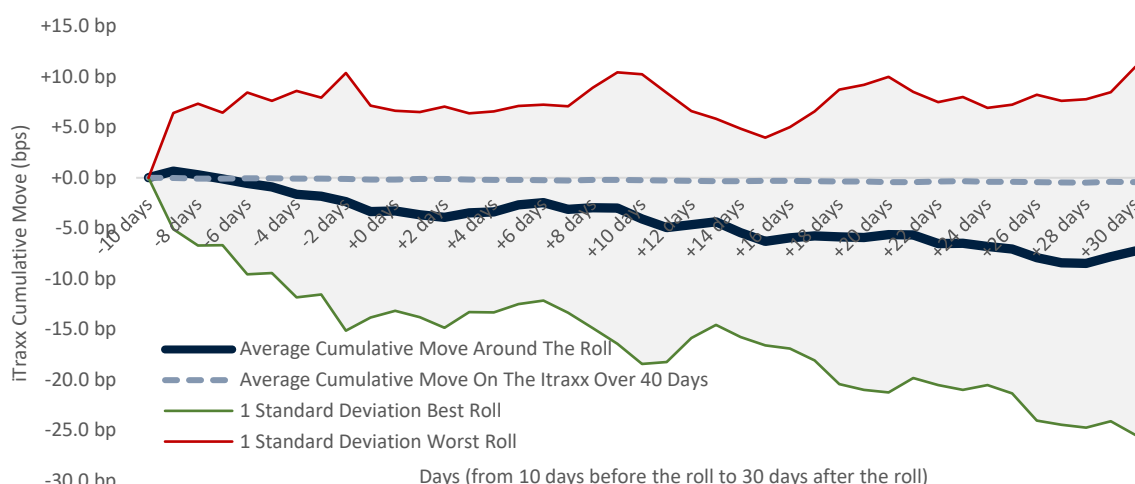
The roll is a good opportunity to invest in structured credit in general, and in senior index tranches in particular, due to rolldown being at its peak during the first year and the new tranchéd portfolio benefiting from a restriking of the index spread around 13.5bps wider (spread of the S38 series vs the S36 series). It is also a window where the liquidity is relatively higher and where the index tends to tighten. See fig.1

iTraxx underperform Cash Bond and Equity:

Fig. 1: Spreads moves around Roll



¹ Focus is on Long Only strategies managed by Selwood Asset Management France

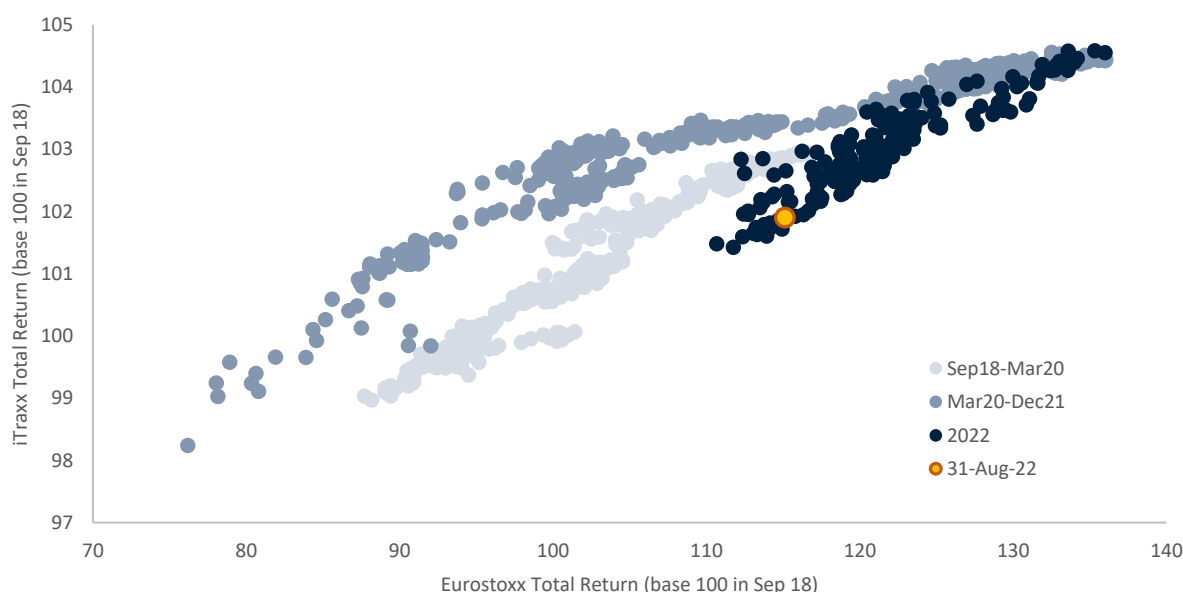


Looking at the performance of the **iTraxx Main 5Y in August**, it continues to underperform the equity market despite some inflows into credit at the beginning of summer. **The asset class continues to suffer from its “duration”** in an environment where central banks were behind the curve to tackle inflation in the first half of the year and are likely to overreact in the second half. In this backdrop investors fear dramatic moves in the rates market. There are also fears that an overreaction in monetary tightening may increase the probability of a harder, longer recession. All in all spreads are likely to stay volatile throughout winter.

A look back at prior equity sell-offs gives some context for the moves we’ve seen in credit. In 2022, while the return in equities fell -15% (130% to 115%), iTraxx returns fell -2.5%. If you compare this to the COVID sell-off in March 2020, the same -15% in equities corresponded to “only” -1% on iTraxx. See fig.2

Another contributing factor to synthetic credits recent underperformance is likely the better liquidity that iTraxx offers (compared to bonds). This liquidity advantage makes iTraxx **the instrument of choice for hedge funds to take a bearish view on Europe** (see previous letters re. CDX vs. iTraxx), as well as the **main instrument for real money investors to hedge their bond portfolios**. These forces meant that iTraxx was under pressure throughout this year due to **unbalanced buying interests**.

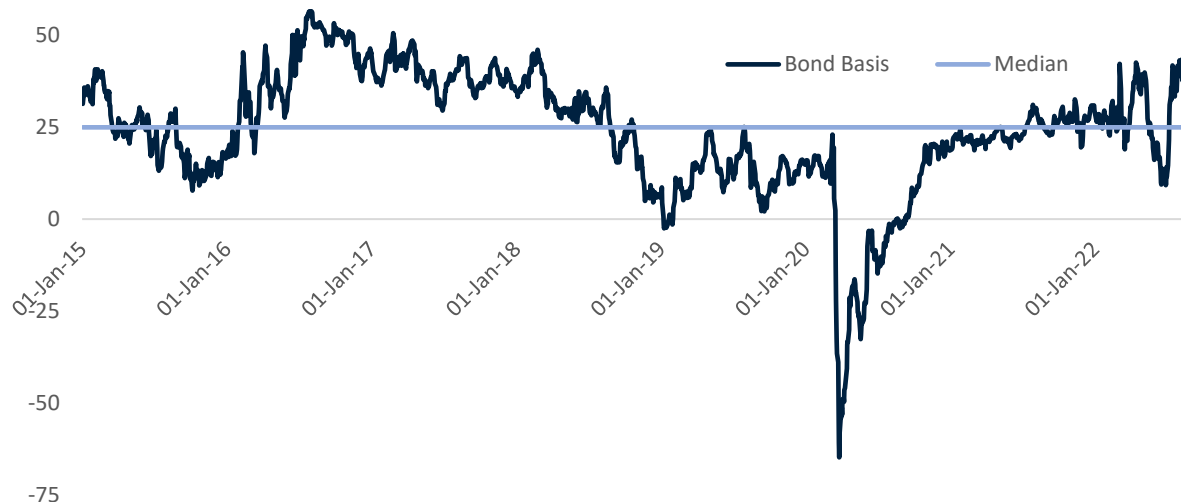
Fig. 2: Returns comparison between iTraxx and €Stocks for 3 periods



We are again **back to the shortest positioning of the year** (seen in July), after a more bullish summer period when we saw sellers of protection (i.e. investors adding long risk positions/reducing shorts).

As investors await some clarity on the path of future rates hikes the issuance decision for corporates becomes more “complicated” this year, this has led to a dearth of issuance of late which has been exacerbated by the summer period which is generally quieter in terms of primary issuance. This lack of issuance meant that the downward **pressure on bonds due to new** issues hitting the market was limited in the last quarter. These technical trends saw iTraxx priced ~40bps above its bond equivalent portfolio, see fig.3.

Fig. 3: Itraxx Main against Cash Bonds



Conclusion

Despite the challenging backdrop synthetic credit has faced and the present volatility it is experiencing, credit currently presents a good opportunity for investment. We obviously see that “Winter is Coming”. Nevertheless we believe that the prospective carry and rolldown, investor positioning, as well as favourable corporate metrics (e.g. rating stability, strong balance sheets, firm results, limited dispersion) favor credit over equities. The recent relative underperformance of credit only makes the opportunity more attractive. The fact that any significant recession should force a monetary policy reversal from the central banks is also likely to have a more supportive impact for rates and credit, as opposed to equity.

The upcoming roll presents, we think, a good window to gain exposure to synthetic credit given that it has recently underperformed cash bonds. At these levels of spreads, and with a longer investment horizon, the current backdrop presents a historically attractive risk/reward ratio.

Mathieu Labelle and Thibault Brohard, 09.09.2022

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Selwood Asset Management France,

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