

Soft panic for a soft landing?

Executive Summary

- Inflation and its concomitant rate hikes, sent us into a new financial conditions environment.
- CDS Index became the favorite instrument to play on a credit deterioration, thus putting iTraxx at a cheap level.
- Different studies show ordely widening, with no stresses nor liquidity concerns (volatility, defaults, ratings, beta).
- Concerns remain with an inflation/recession fight by the central banks.



Motivational poster produced by the Government of the United Kingdom in 1939.

New Paradigm:

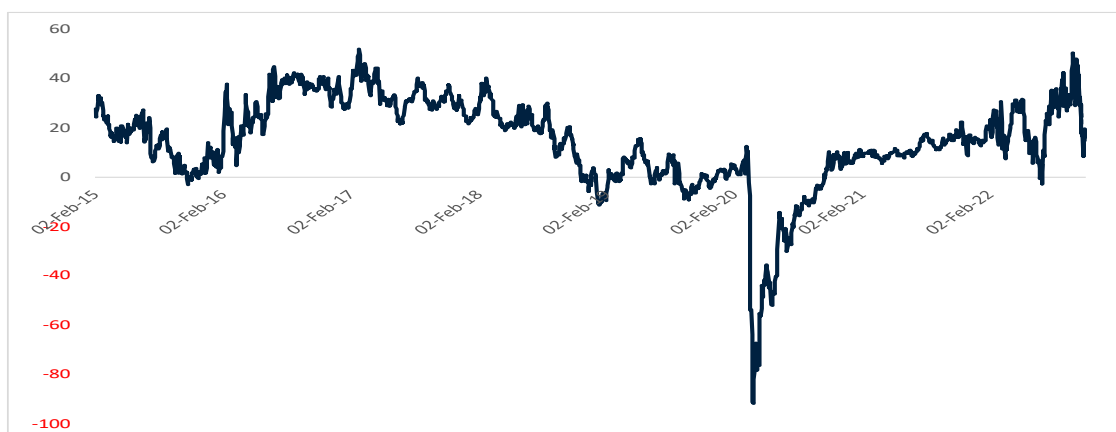
The COVID crisis forced Governements and central banks to increase their support throughout 2020-2021. The result of these measures inadvertently achieved a goal that central banks, particularly in Europe and Japan, had been trying to achieve for years, namely **bringing inflation back**. The risk however is that **inflation can be persistent**, something we may have forgotten afters years of price stability and QE. With this shift in dynamic central banks have also shifted their stance. **The focus among central banks is now the fight against inflation**, achieved through a material **tightening of fiscal and financial conditions**. Reversing a 20-year trend, rates have moved up significantly as central banks started their policy tightening. Companies that had previously benefited from cheap financing are now facing a very different interest rate and financing backdrop.

This move to a new environment has pushed investors to hedge or to bet against rates and spreads. On the credit side, CDS IG indices moved from 50ish to 100-140bps over the course of the year, albeit following a relatively smooth path with limited volatility. We highlighted, in previous letters, the fact that CDS Indices have become a major instrument investors are choosing to use to implement hedges. This choice to bet against spread widening via synthetic products, instead of cash instruments, sent CDS indices to the wides relative to cash bonds and even saw CDS indices underperform relative to equity markets. Whilst this change of environment looks dramatic in terms of the performance of assets, **it was done in an orderly manner** while simultaneously responding to compounding geo/political events.

iTraxx–Bond Basis, back to business as usual:

We have previously highlighted that **the iTraxx index particularly has unperformed its equivalent bond portfolio**, reaching a peak basis differential close to ~50bps. With primary issuance resuming after a pause in the summer, the basis came back dramatically, helping iTraxx to perform well versus cash bonds. **Today's level reflects a degree of balanced positioning**, with the basis back within its historical average range. During a crisis, bonds typically cheapen versus CDS Indices, as liquidity becomes an increasingly important factor in the price dynamic. What happened this year, however, was the opposite. Investors used iTraxx as a major tool to hedge their positions or to short the European market, causing it to materially underperform. The October performance of iTraxx shows the reversal of this move, with iTraxx coming back against both CDX IG index and against bonds. **This Basis was one of the few metrics that was distorted and only reversed to a neutral level last month**. See Fig. 1.

Fig. 1: iTraxx – Bond basis



Source: JP, Selwood AM

Multiple metrics show a change but with no distortion or dislocation:

As already mentioned in our previous letters, **2022 has been a year in credit that has been notable due to the lack of dislocations**, despite the significant widening of credit spreads. This can clearly be seen from:

1. **Realised volatilities** only briefly (and moderately) spiked above average. They have since come back to more normal levels. See Fig. 2 which illustrates a lack of fear or hedging need.
2. The **dispersion** in the iTraxx Main indices is still near the historical lows. See Fig. 3 which outlines **a lack of idiosyncratic concerns amongst the index constituents**.
3. We have not seen any significant rating **migrations**, at least within the investment grade indices. The weighted average rating factor (WARF¹) on the iTraxx Main indices is flat on the year and still below 2020 levels. Within Crossover however we are at multi-year highs, albeit most of this was driven by the 2020 crisis. See Fig. 3 which points to a lack of idiosyncratic concerns.
4. Finally, looking at a dislocation indicator² on the European CDS indices (iTraxx Main 3y/5y/10y, iTraxx Crossover, iTraxx Financials Senior and Subordinated) 2022 stands in stark contrast to any previous period of widening (See Fig. 4).

➔ All this points to an **orderly widening** with little to no surprises. **We are in a significant change of regime, where momentum matters, but so far this has not translated into material dislocations.**

Fig. 2: iTraxx Main 5Y Volatility

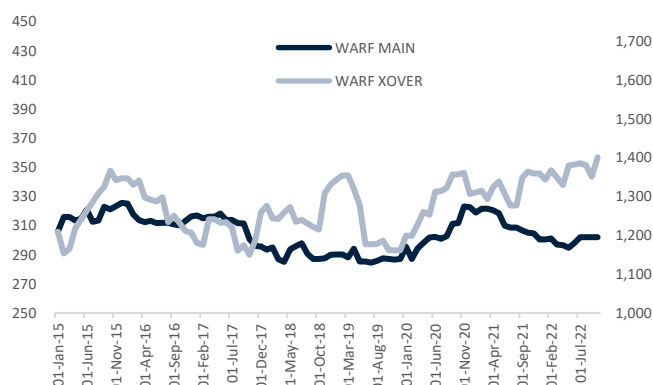
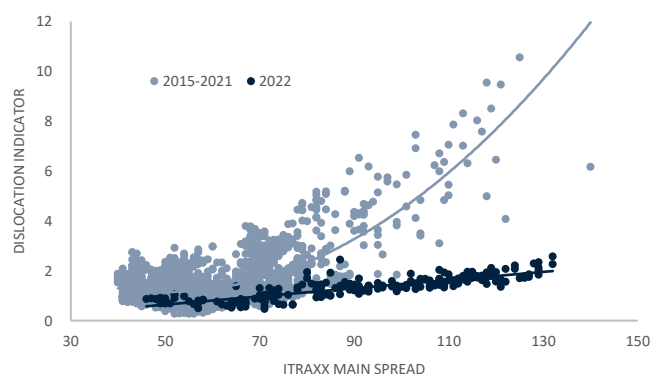


Fig. 3: iTraxx Main Dispersion



¹ Weighted Average Rating Factor

² Measure of decorrelation between all those iTraxx indices

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