

A certain uncertainty

Executive Summary

- Rates have less of an impact on stocks and spreads, but volatility remains high, indicating uncertainty about peak rates.
- Uncertainty remains due to persistent inflation and continuous commitment from central banks to fight it.
- Predictions last year, failed on both the level of “Final rates” as well as on inflation and strength of the economy.
- The timing and severity of the recession (priced by inverted rate curves) are likely to be unexpected.
- The Blackstone CMBS default in Finland has caused some financial strain to emerge (so far isolated).
- To finish, a note on the Roll of iTraxx to come on the 20th of March with s39 trading ~6bps wider than current s38.

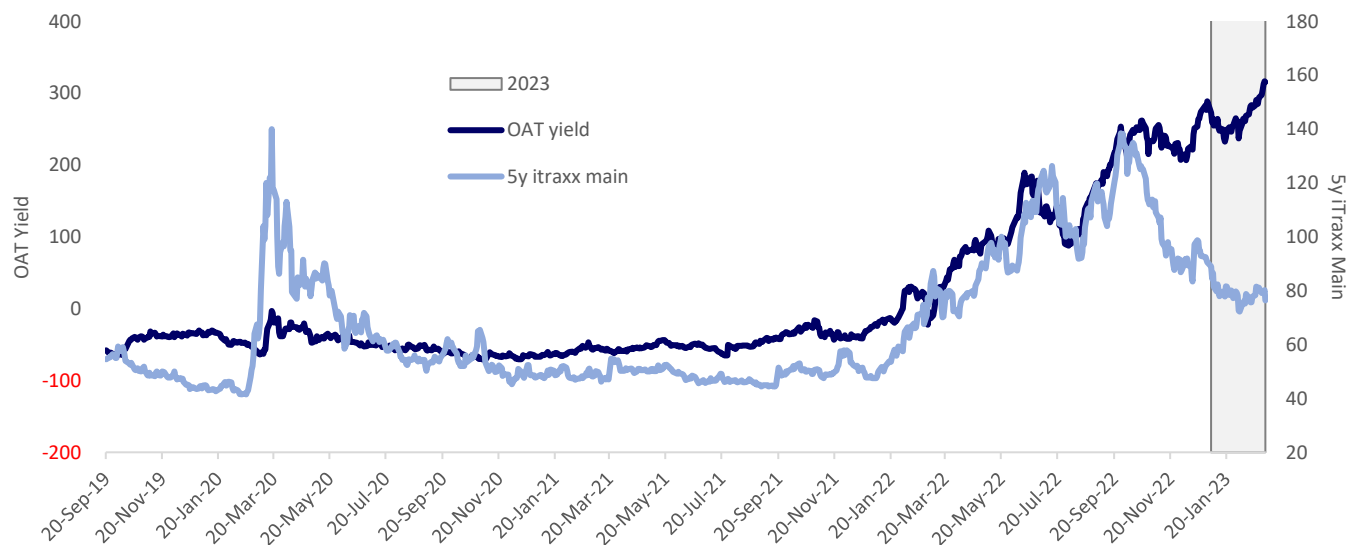
“Life is only certain in its unpredictability, but acknowledging this is not the same as giving up.”

Rates: From a leader to being a lone factor?

While rates and credit used to move adversely, we saw in 2022 rates leading the bear market, pulling spreads wider. As the market continues to fear more hikes, it is easy to conclude that spreads should stay under pressure until we reach a “pivot”. But what we have been observing since January is that the **rates have been moving sharply up**, but this time with a limited impact on credit spreads (**Fig.1**).

If we look at the moves of both the 5Y OAT and the 5Y iTraxx Main over the last 3 years we can see a relative de-correlation between rates and credit IG since September 2022 and almost a full de-correlation since the beginning of 2023. We think **rates could continue to move dramatically while IG spreads should be more muted**.

Fig. 1: Moves in 5Y OAT yield and iTraxx Main 5y (2019-2023).



Source: Bloomberg

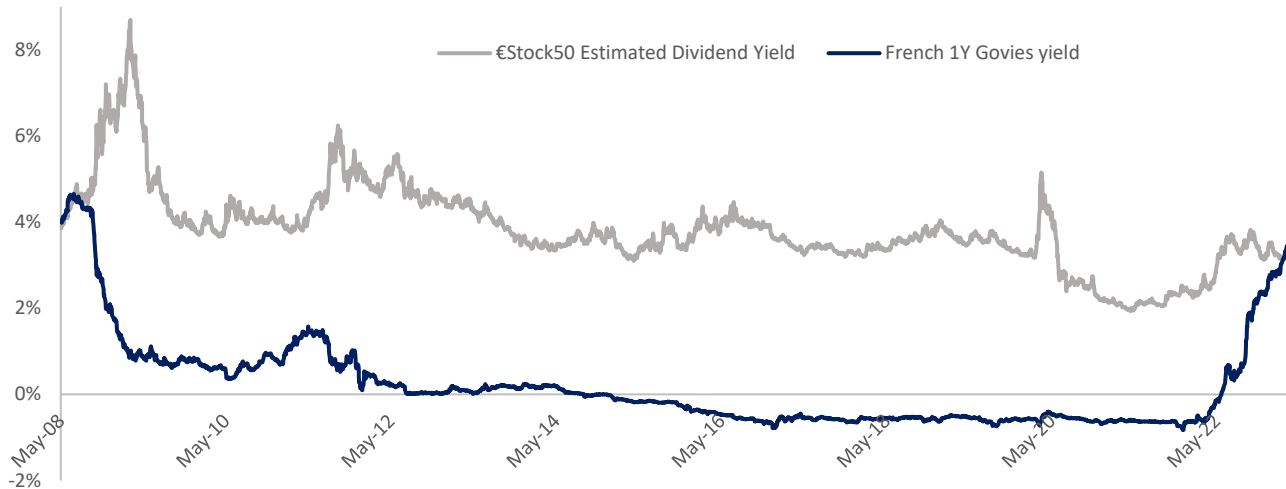
Rates are back to flat against stock index estimated dividend yield?

In the end; the sharp increase in rates last year did not have a massive negative impact on stocks. As an example, €Stock50 is back to its end of 2021 level (after an underperformance during the beginning of 2022 and a come back since November 2022), while the **1Y French rate moved by more than 4%** (-0.6% at end of 2021 to 3.4% today). We are now back at a level where **stocks' estimated dividend yield is almost at the 1Y sovereign yield** (in US and in Europe) – (**Fig. 2**)

It is no surprise that since February we saw inflows in Money Market funds that almost disappeared during negative rates area (2012-2022). Credit attract strong inflows, while massive primary issuance compared to 2022, continues to find demand without weighting on the secondary market.

If rates continue to increase, while stocks hold firm, it will support credit and Money Market Funds. As we stated in a previous letter a recession **should favor IG credit and rates compared to HY credit and stocks**.

Fig. 2: €Stock 50 and 1Y France yield



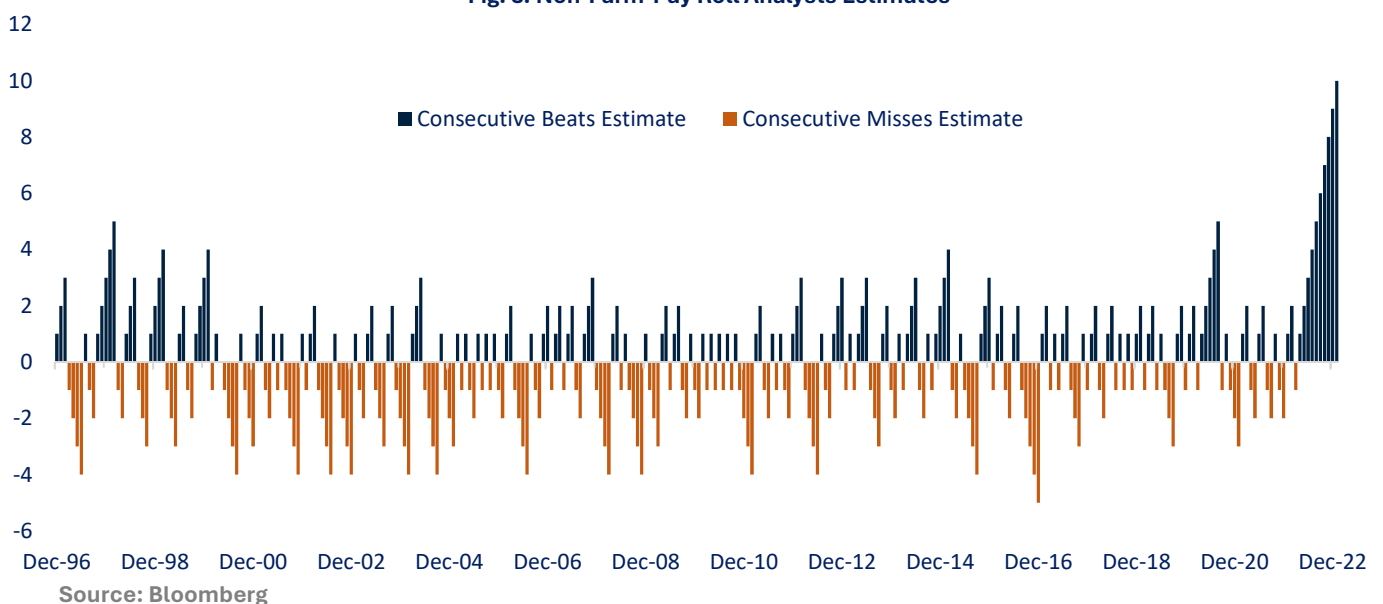
Source: Bloomberg

Are the data so unexpected or are experts getting poorer at making predictions?

We are now in **unchartered territory**. Everyone was surprised by inflation and how sticky it was, and while Central banks may have been slow to react, since the 1st quarter of 2022 they were quite clear that they will be committed to fight it. Despite inflation staying at a high level, **market struggles to see 2Y rates much higher than the next already announced rate hikes**. Another example of uncertainty is **the constant beats of estimates from the analyst since 2021** compared to the last 25Y (**Fig. 3**)

Analysts' wishful thinking is that rate increases will drive down the economy, but this hasn't happened yet. The same is true for rates, where the market's conviction that a recession was imminent led to a sharp inversion of the 2Y-10Y curve. They repeatedly review the projection on pivot rates since they struggle to imagine terminal rates that are significantly higher. According to our assessment, a recession will happen, but it will likely surprise the market with its size and timing, beginning with weak industries that depend on financial conditions/financing.

Fig. 3: Non-Farm-Pay Roll Analysts Estimates



Source: Bloomberg

Word Cloud from Selwood Asset Management France streaming of financial news during the month. A word cloud is a visual representation of text data, which is used to depict keyword metadata on websites, or to visualize free form text. Tags are usually single words, and the importance of each tag is shown with font size or colour

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