

"Promises are the uniquely human way of ordering the future..."*

Executive Summary

- *Carry & roll down*, is one of the most common ways to compare Fixed Income instruments.
- iTraxx continued to outperform €Stock50, benefiting from its carry and the attractiveness of credit in general.
- Volatility remained at a low level since last, March's, financial crisis.
- Real Money and Hedge funds added risk on iTraxx during June, it reached two time the historical average long.

"Contentment is not the fulfilment of what you want, but the realization of how much you already have."

* Hannah Arendt.

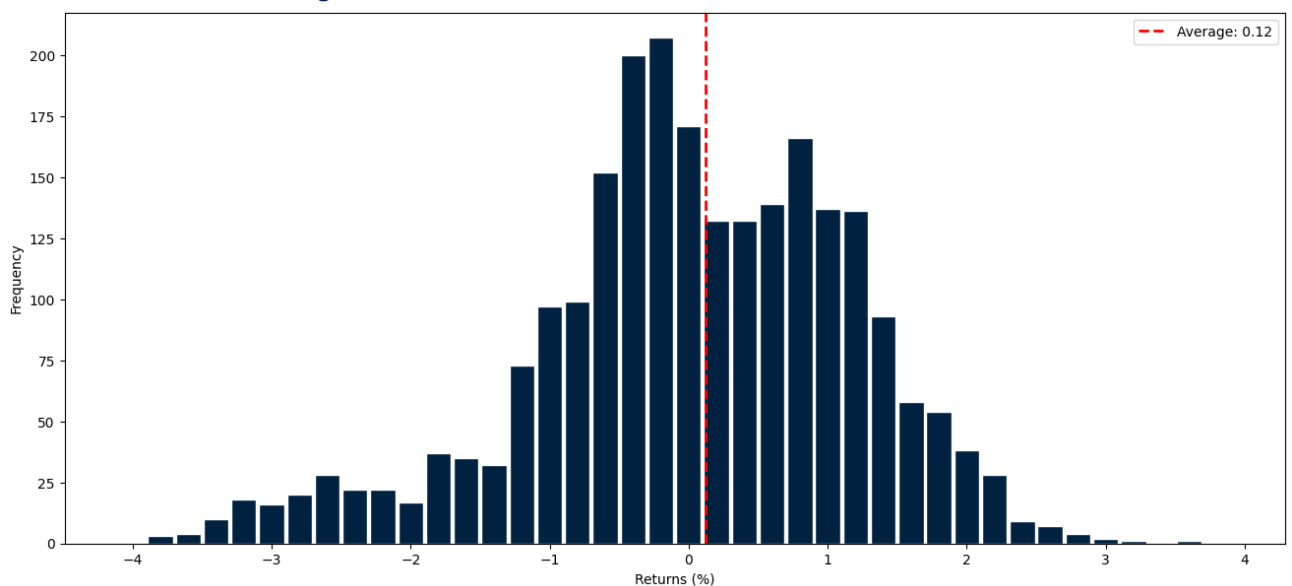
Does the Carry & roll down effectively materialize?

Carry & roll down ("C&RD") is one of the **most common metrics in Fixed Income to estimate the expected return** of an instrument. While Carry is simple (Coupon, yield to maturity...), roll down is dependent on "**curves shape**" and is therefore more **difficult to apprehend**, as some instruments have a limited number of observable curves points across maturity. Despite its widespread use this **figure is also controversial**, as **we are predisposed to recall only negative information** and, as such, to believe C&RD **may overestimates expected return**. Selwood regularly communicates C&RD so we wished to study this metric. C&RD is a crucial factor for investors to consider, among others, when evaluating fixed-income investments.

To determine the efficiency of C&RD it is necessary to compare the promises (**C&RD**) **made ex-ante** with the **actual return after 1 year (ex-post)**. We examined the iTraxx Main 5Y On-The-Tun ("OTR") series, one of the most prevalent credit derivative instruments. From 2013 until June 2022, we computed daily the return of holding 1X long unfunded OTR index for 1 year. And we computed daily the C&RD. Therefore, for each day we have the **realised return subtracted from the expected return** (C&RD).

Fig.1 Analysing the daily distribution of the return difference reveals: (i) **a mean above 0% at 12cts**, demonstrating the **absence of bias** (no embellishment); (ii) **the median is around 11cts**, indicating that one is more **likely to gain than lose**. (iii) To conclude the left side with a longer tail likely explains the investors' sentiment that C&RD may overstate realised returns, as they are more likely to recall those tails than the multiple minor gains above ex-ante C&RD.

Fig. 1: Distribution of 1Y realized iTraxx Returns minus C&RD



Source: Selwood AM France, Bloomberg.

While C&RD is specific to an environment with given level and curves shape, **it is also crucial before implementing a directional strategy, to evaluate the risks** associated with the investment, such as **default risk and other market conditions**.

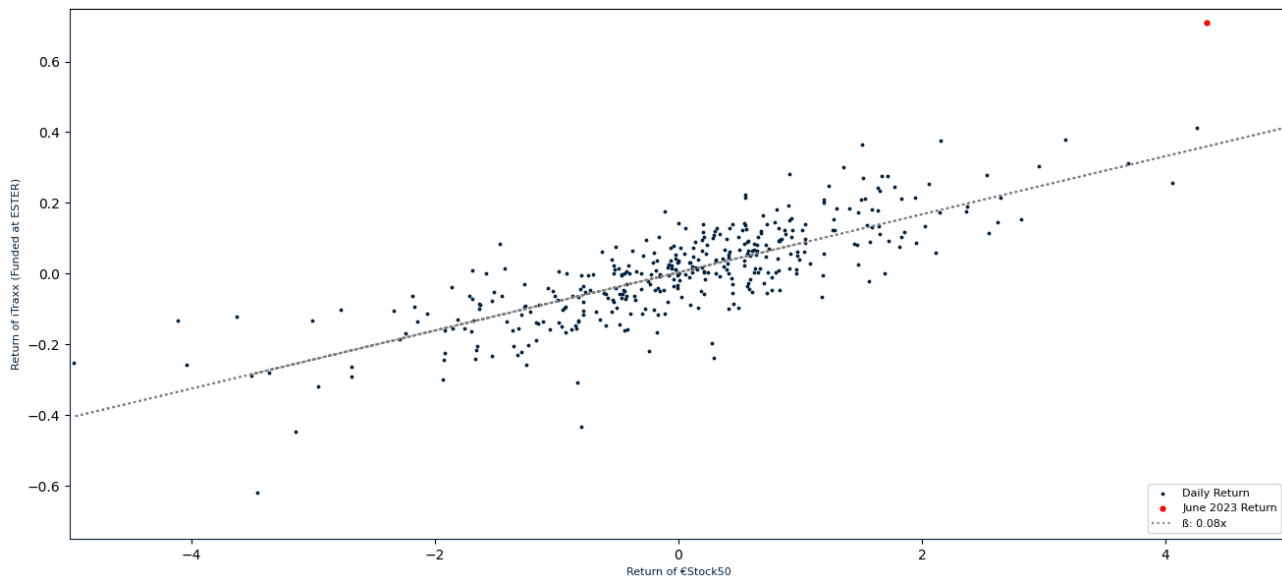
Synthetic credit beats stocks...

In June, long iTraxx has significantly outperformed €Stock50 as shows in Fig2 (Period for regression [December 2021 to June 2023]).

As we said in previous letters, **credit tends to outperform in uncertain environments and during recessions**. 2022 shows iTraxx suffering almost the most. It is not a surprise to now see iTraxx coming back against stocks.

In our view, carry and roll down favour credit products and Investment Grade in particular. Given the uncertainty around the potential level of rates, we would choose credit with a shorter duration. With central bank meetings coming we should have a clearer view on the pivot rates and then add duration. We would like to remind you that rates decorrelated from spreads in February 2023¹, serving as cushion in a crisis and stress environment.

Fig. 2: Correlation between €Stock50 and iTraxx Main (Funded)

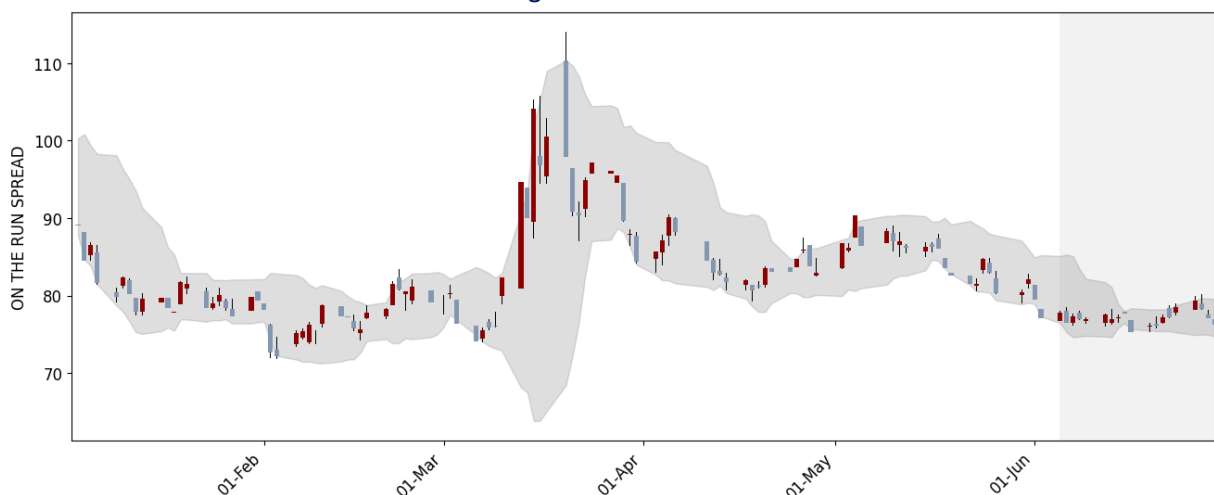


Source: Bloomberg.

... And risk was added on iTraxx.

While we approach the central banks' pivot rates, **volatility has decreased** since March financial crisis. (Fig.3).

Fig. 3: iTraxx Main levels



Source: Bloomberg

Real Money and Hedge Funds unwound their hedges (placed at the beginning of the month) and added more risk in the last week of June, whereas CTAs were active sellers in the first 2 weeks. Total positioning has increased to €30B, the double of its

¹ See Monthly Letter - April 2023

Fig. 4: iTraxx Main client positioning and level.



Fig. 5: June word cloud**



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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