

*"The Market is designed to transfer money from the Active to the Patient."**

Executive Summary

- Long term approach should generate income, in a steady and low volatile way.
- Credit IG has the advantage to show small default risk with good carry and roll down.
- Theoretical benchmark credit cash index analysis shows illiquid behaviour in a volatile market.
- Liquid products tend to be more volatile than illiquid ones but they offer an exit door.
- Volatility from 30 days S&P options (VIX) shows the uncertain environment.
- In this uncertain environment iTraxx seems fairly priced

"Market liquidity is like oxygen; you only realize it's missing when it's gone."

* Warren Buffet

Theoretical Cash Index against Tradable instrument?

Jack Bogle, the innovative mind behind The Vanguard Group and a pioneer in index investing, became widely recognized for **advocating the use of cost-effective index funds** among individual investors. His notable achievements include a comprehensive exploration of the **comparative returns of actively managed funds versus equity market indices**.

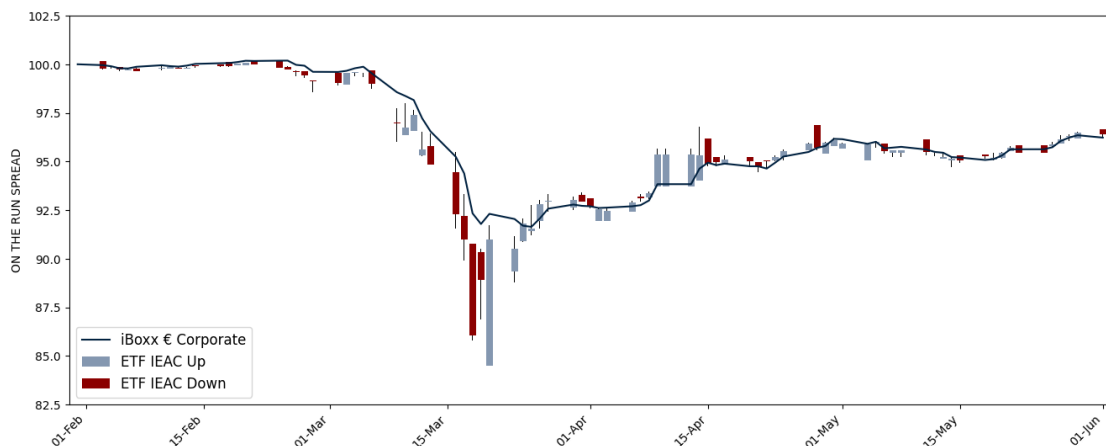
In 1976 Bogle's research and investment principles led to the introduction of the first retail index mutual fund, the Vanguard 500 Index Fund. He firmly believed that, **on average, actively managed funds often struggled to consistently surpass broad market benchmarks in the long term**, particularly when considering the higher fees and expenses associated with active management.

One of the well-known indices for **credit cash bonds** is the **iBoxx € Corporate**, and the **ETF IEAC** was developed to track its performance. Over the long term **they exhibit a strong correlation, although significant divergence may occur during a crisis**.

It is often reiterated that **bonds tend to experience reduced liquidity during stressful periods**. While the bid-offer spread widens, the mid-price does not fluctuate significantly. This is due to thin trading volumes caused by dealers' limited balance sheets and reduced appetite for less liquid assets in a stressed environment, where they might need to swiftly reduce their positions. Consequently, the iBoxx tends to fall behind in terms of price action, making it challenging to replicate with liquid products that adjust during trading. It is evident that the valuation (versus price action) of this index during a period of stress is not accurate.

When comparing the iBoxx NAV performance to the liquid ETF (IEAC) it becomes evident that during the peak of the COVID crisis in early 2020 the iBoxx lagged IEAC. **The iBoxx experienced a drawdown of -8% (not a tradable level!), while the ETF plummeted by -15%, giving a better idea of the real cost of exit**. Therefore, there can be a "feeling" of liquidity and lower volatility but mind the gap.

Fig. 1: iBoxx € Corporate compared to ETF (Open, Close, Low, High)



Source: Selwood AM France, Bloomberg.

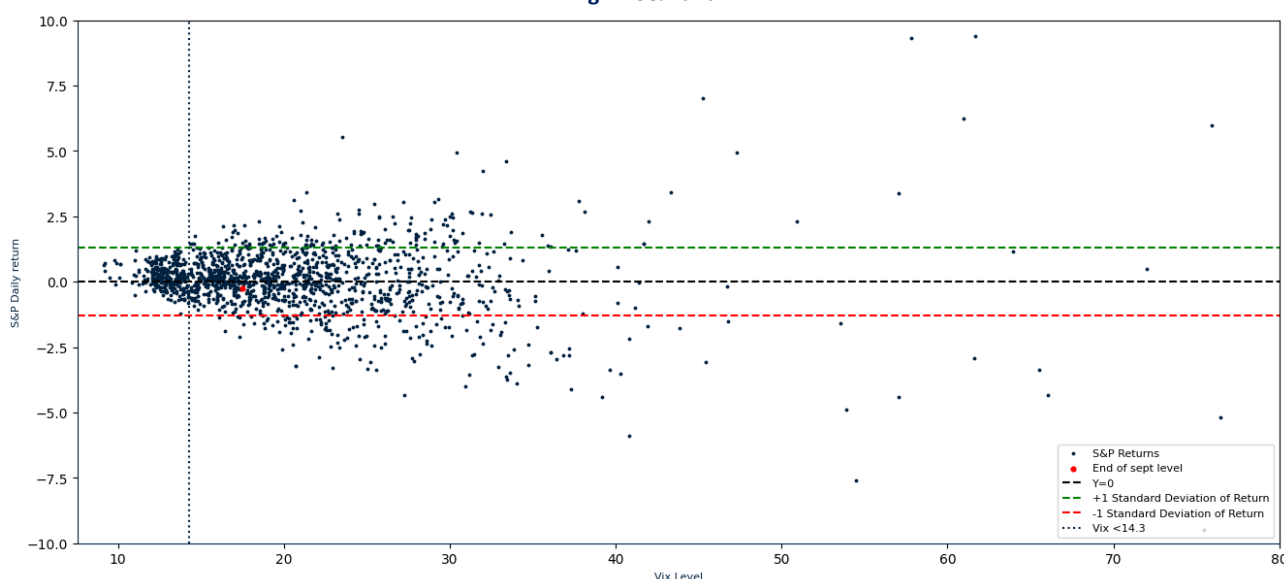
iTraxx show a fair level of Spread in regards of volatility.

Market volatility represents a direct gauge of unpredictability. One of the most esteemed indices for gauging volatility in developed markets is the **VIX index**. This index is computed by taking a weighted average of the implied volatility of different options on the S&P 500 index. Finally, the VIX is scaled to represent the expected annualized volatility of the S&P 500 index over the next 30 days. The final value is expressed as a percentage.

Analysing the daily returns of the S&P in relation to the VIX level (Fig.2), we observe that once the VIX surpasses 14.4, the S&P index begins to display fluctuations of approximately ± 1 standard deviation (around $\pm 1.30\%$) in its daily returns.

This observation leads us to qualitatively determine that a **stressed market environment typically emerges when the VIX surpasses ~14.4**. Illustratively, in Fig.2, it is evident that by the end of September, the **VIX had peaked at 17.5**, indicating heightened uncertainty and market stress.

Fig. 2: S&P and VIX



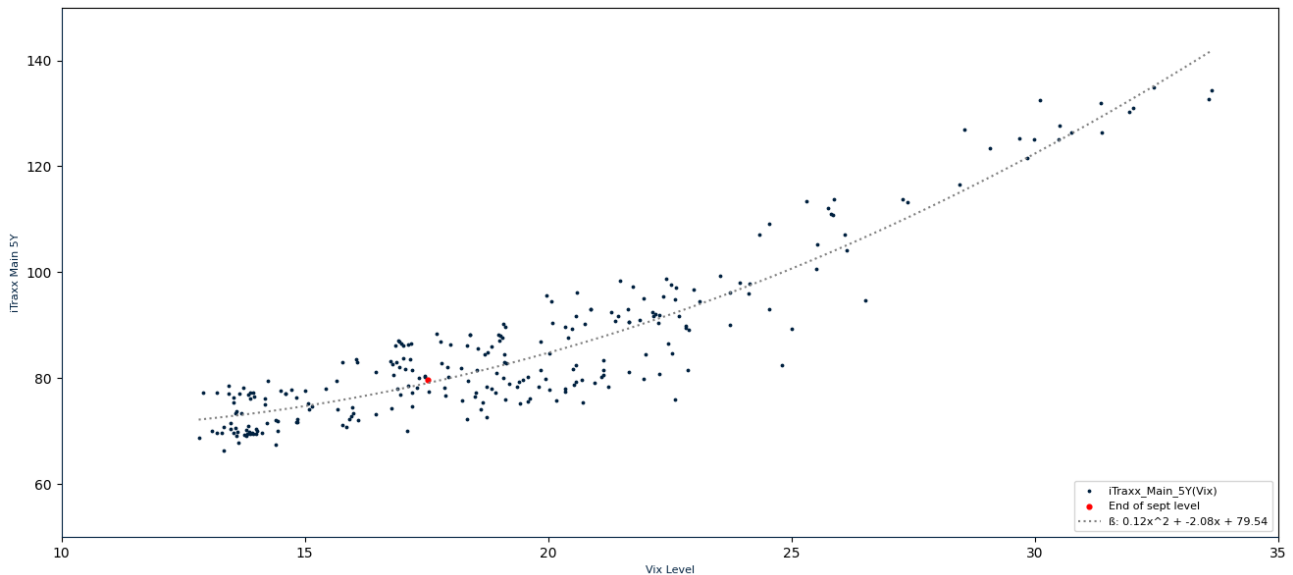
Source: Selwood AM France, Bloomberg.

The credit spread serves as an important indicator for investors, analysts, and stakeholders, providing valuable insights into the perceived credit risk and market sentiment associated with a specific corporate bond and the issuing company.

A wider credit spread typically suggests that investors perceive the company's credit risk to be higher. Factors contributing to this perception may include the company's financial health, debt levels, cash flow stability and free cash flow, market position, and overall industry and economic conditions. **High-level spreads indicate, to some extent, the uncertainty that companies face in dealing with challenges and the risk of a potential default.**

Upon close examination of the **correlation between iTraxx Main 5Y and the VIX** in Fig. 3, it becomes evident that the polynomial regression suggests **that iTraxx is priced fairly, considering the current market volatility**. The analysis does not point towards undervaluation or overvaluation, but rather indicates an appropriate pricing in line with the prevailing market conditions.

Fig. 3: iTraxx Main 5Y compared to VIX Level



Source: Selwood AM France, Bloomberg.

Conclusion:

Our word cloud highlights China capturing significant attention due to indications of economic weakness. US Auto makers strikes, and a government shutdown emerged last month, with ongoing (never ending) discussions about Inflation, ECB, and FED's rates, as well as the Ukraine/Russia conflict.

Market uncertainty persists, evident in the notably high level of VIX. Generally speaking, credit and rates tend to excel during crises. It remains challenging to determine whether rates are now at an equitable level. However, we demonstrate that in the current volatile and uncertain environment, spreads are at a fair level. Hence, it is unsurprising to observe increased inflows into credit and rates since the beginning of the year. We believe that we have some compelling solutions in this “search for carry” landscape.

Mathieu Labelle & Thibault Brohard. 19.10.2023

Fig. 4: September 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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