

"Those who cannot remember the past are condemned to repeat it."*

Executive Summary

- The steepest and highest rates cycle of the last 20 years.
- Rates cuts likely not triggered this time by recession but just by lower inflation.

"Challenge lies not in the 'what', but in 'when'."

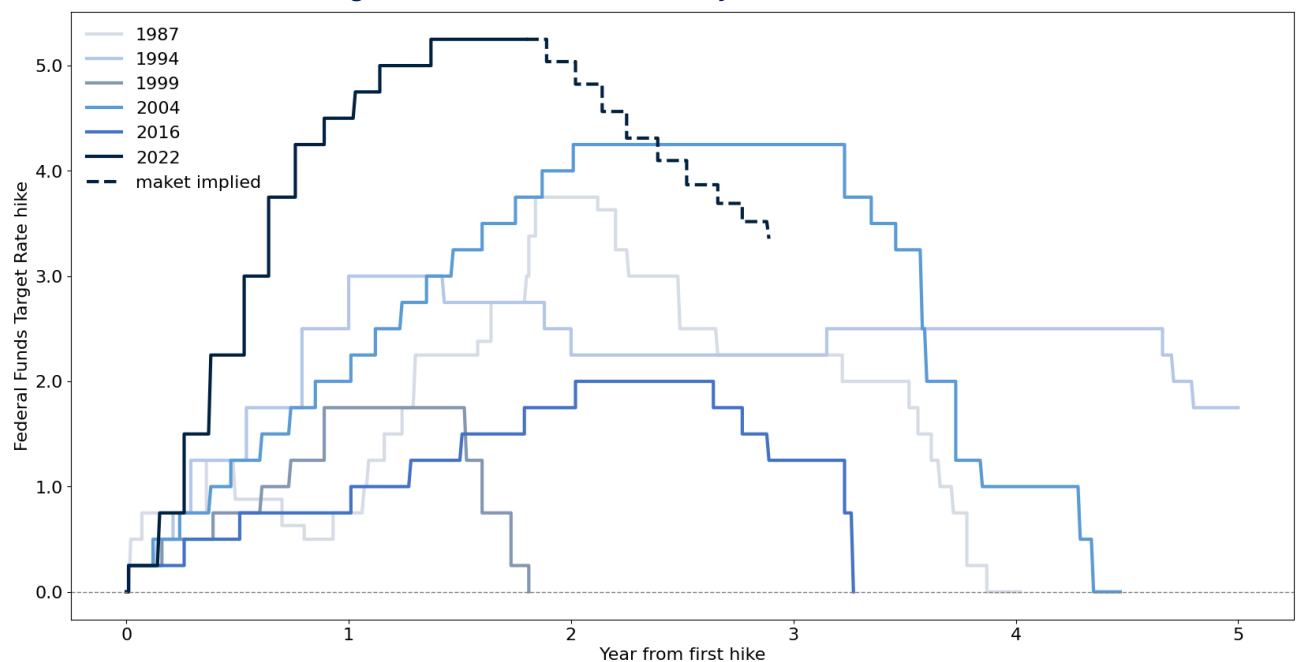
* George Santayana

Back to the future

Looking back at 2023, it can be said that it was notably a **positive year for stocks, credit, and rates** overall. A key factor behind this success was the effective **control of inflation expectation**.

The year started with a trend of **increasing interest rates**, which was anticipated to continue. Indeed, it is **the steepest and greatest path** of rates hikes in the last 20Y (see Fig.1). This initially stirred concerns in the markets about the **potential for a recession, which ranged from moderate to severe**. Looking at the historical path of rates, it is easy to anticipate severe cuts after a period of stable rates (in Fig.1: "market implied"), but this time, for once, the **FED may have tamed inflation** without a hard landing.

Fig. 1: Federal Reserve rates hikes Cycle in the last 20Y.



Source: Bloomberg

It's interesting to analyse the expectations surrounding Federal Reserve interest rates.

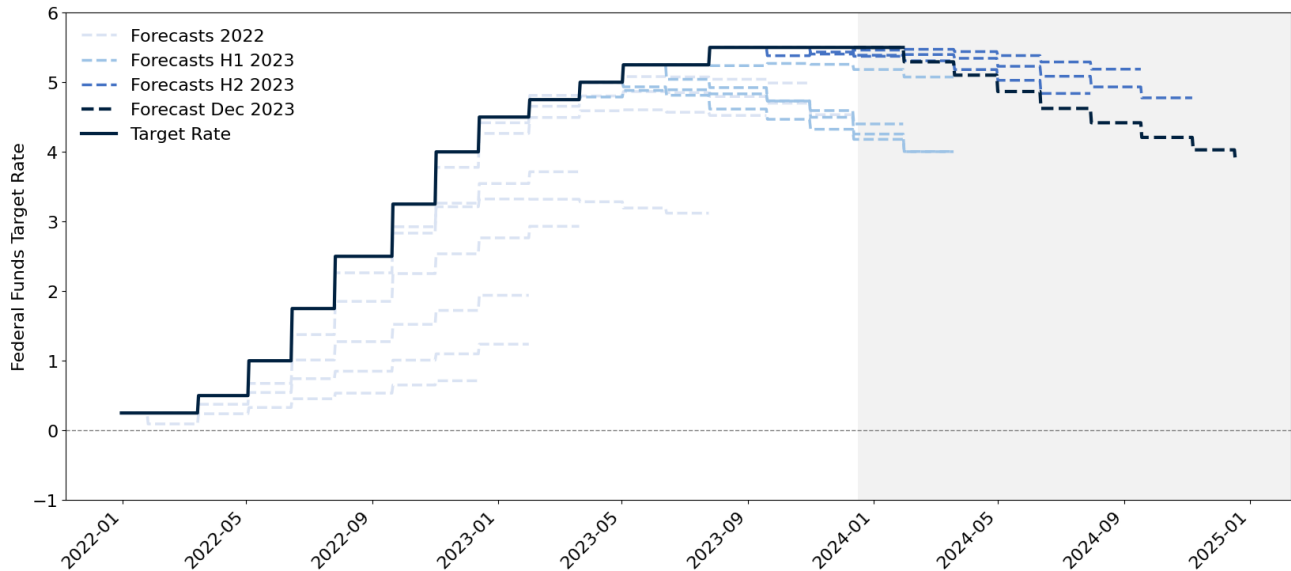
In 2022 market **analysts generally had a more dovish** stance on interest rate projections. The actual 2022 rate trajectory turned out to be more aggressive (steeper) than anticipated. Historical data confirms that such a sharp increase in rates is not typical.

A **critical juncture occurred in the back half of first quarter 2023**. Elevated interest rates contributed to the **collapse of several U.S. regional banks and Credit Suisse**. These institutions faced challenges in refinancing and unrealized losses on long-term government securities, leading to bank runs. This situation influenced inflation expectations, **prompting anticipations of earlier and more significant rate cuts**. However, central banks, notably **the Federal Reserve and the Swiss National Bank, intervened effectively to stabilize** the markets. This action facilitated a rapid recovery in asset values and led to a resurgence of inflation and interest rates to their pre-crisis levels.

The market has once again then demonstrated a more cautious (dovish) and somewhat pessimistic outlook.

In 2023, the overall **resilience of the economy surprised** the market. With inflation declining and concerns about a recession easing there was an increasing expectation among market participants for an upcoming change in interest rates. This anticipation particularly grew over the **summer of 2023, as we approached what was considered the pivot rate.**

Fig. 2: Federal Reserve rates hikes Cycle and forecasts



Source: Bloomberg

The strategic challenge remains in accurately **predicting the timing of the first rate cut** if it was to occur. This cut could be triggered either by a reduction in inflation or by the onset of a recession. The debate between Bears and Bulls was around a hard, soft or No landing of the economy.

A Tale of Market Triumphs and Defeats

Asset Performers and Underperformers of 2023:

Type	Asset	Total Return 2023 (%)	Annualized Volatility 2023 (%)	Worst Drawdown 2023 (%)	Return / Volatility 2023*
Cash Overnight	Ester Capitalized	3.4	-	-	-
	Fed Fund Capitalized	5.1			
Cash GOV Indices	iBoxx SOV Italy	8.6	7.2	-4.7	1.2 x
	iBoxx SOV €	6.4	7.3	-5.5	0.9 x
	iBoxx SOV France	5.9	7.8	-6.1	0.8 x
	iBoxx SOV Germany	4.8	7.5	-5.6	0.6 x
Cash CORP Indices	iBoxx € HY	11.7	2.6	-2.7	4.4 x
	iBoxx € IG	7.8	4.4	-3.3	1.8 x
	iBoxx € Fin	4.8	7.5	-5.6	0.6 x
	iBoxx € AT1	2.8	14.6	-22.4	0.2 x
Synthetic + Overnight	iTraxx Main 5Y	6.0	1.6	-1.2	3.7 x
	iTraxx Xover 5Y	16.3	6.5	-4.7	2.5 x
	CDX NA.HY 5Y	14.3	6.3	-3.8	2.3 x
	iTraxx SUB FIN 5Y	8.1	4.3	-3.9	1.9 x
	CDX NA.IG 5Y	7.3	1.4	-0.7	5.3 x
	iTraxx Main 10Y	6.8	2.4	-1.6	2.8 x
	iTraxx SEN FIN 5Y	6.1	2.3	-2.0	2.6 x
Stocks	€ Stock50	20.2	13.8	-10.1	1.5 x
	\$ S&P	26.3	13.0	-12.0	2.0 x
Commodities	Bloomberg Index	-12.6	12.6	-14.6	-1.0 x

* Top 3 in green, bottom 3 in red

Source: Bloomberg, Selwood AM

- **Sovereign Debt Performance:** In comparison to 2022, sovereign debt has shown robust performance, though it continues to operate in a volatile environment. Notably, Italian, French, and broader European bonds have outperformed German bonds. This outperformance is largely due to relatively wide levels; in terms of carry and roll down compared to Germany.
- **Cash Index and iTraxx Comparison:** The cash index has outperformed the iTraxx, primarily driven by duration. In terms of credit effect, Synthetic instruments (CDS Index) have outperformed cash.
- **Stock Market Resilience:** Stocks have demonstrated a strong performance, notably in the absence of a recession materialising. This resilience suggests a robust underlying market sentiment despite economic uncertainties.
- **High Yield (HY) vs. Investment Grade (IG) Performance:** There has been a modest Beta outperformance of High Yield (HY) bonds compared to Investment Grade (IG) bonds. This is particularly noteworthy given the higher interest rates and the anticipated difficulties HY companies may face in future refinancing.
- **Financial Sector, Especially AT1 Bonds:** The financial sector, and particularly Additional Tier 1 (AT1) bonds, have struggled to perform following the March incidents with SVB, and Credit Suisse defaulting on its AT1 bonds. The underperformance indicates a heightened risk perception in this segment.
- **Europe vs. US in Credit Markets:** There has been a return of European credit performance relative to the US after a significant underperformance in 2022. This shift is partly attributed to hedge funds aggressively betting against Europe in the 1st semester of 2022 and cutting the position in Q4 2022.
- **Rates and Spreads Decorrelation:** There has been a notable decorrelation between interest rates and credit spreads.

2024, several themes are emerging:

- **Economic Resilience and Central Bank Policy**:** The resilience of the economy, combined with effective central bank actions to tame inflation, is a positive sign. With interest rates reaching a pivot point and potential rate cuts on the horizon, this was positive for risky assets like stocks and credit spreads. With stock prices currently high and spreads very narrow, it seems like the market has already take all the positive news. There's a significant imbalance, with the upside limited while the downside remains important. However, rates and duration at this level show a more balanced picture (as inflation risk is now limited) not to say with some beneficial asymmetry. Economic growth in Europe and China appears weak, and there are political concerns in Ukraine, the Middle East, Taiwan and with US elections looming these factors may not be fully accounted for in current prices. This is evident in the current state of Credit Options skew, which are at their lowest level since before COVID. In this situation it's wiser to be cautious. We favour investing in Credit with duration over Stocks.
- **High Yield (HY) vs. Investment Grade (IG) Performance**:** The recent outperformance of High Yield (HY) bonds over Investment Grade (IG) bonds might not persist into 2024. Refinancing challenges could eventually impact the cash flows of weaker companies, possibly affecting the performance of HY bonds.
- **Potential in Financials and AT1 Bonds**:** Financials, and particularly Additional Tier 1 (AT1) bonds, appear undervalued. Their current cheapness could make them attractive investment opportunities.
- **Comparison of US and European Credit Markets**:** Despite the US economy appearing stronger and the European economy weaker, the spread between the two (iTraxx IG vs CDX NA IG) is gradually tightening. There is a possibility that this spread might increase again if growth continues to diverge between the two regions.
- **Interest Rate Outlook and Potential Rate Cuts**:** Current interest rates for periods ranging from six months to five years are relatively low, particularly considering that a significant economic downturn hasn't occurred. It may be too soon to expect imminent reductions in these rates. We might see a slight increase in rates in the initial quarter before any decreases take effect. Nonetheless, the interest rate sector remains appealing as central banks possess the flexibility to lower rates if unexpected economic challenges arise.

These themes reflect a cautiously optimistic outlook for 2024, suggesting opportunities in various sectors despite the potential challenges mentioned.

Mathieu Labelle, Thibault Brohard - 31.01.2024

Fig. 3: 2023 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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