Monthly Spotlight

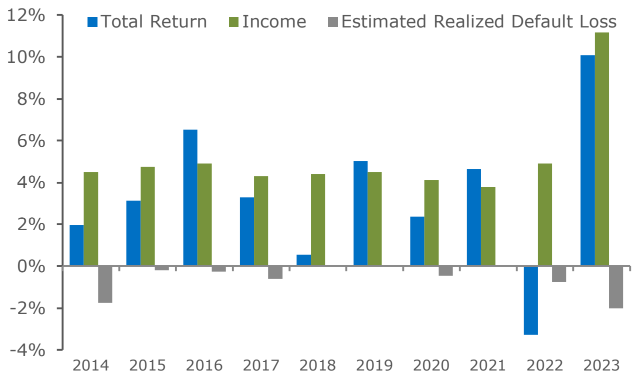
Income on European loans in context with default losses

Historically, the income and total returns on European broadly syndicated loans have been comfortably exceeding realized default losses. This trend is evident from the chart with incomes, comprising of interest and fees, exceeding 4% and realized losses well below 1%. Total returns with mark-to-market component have also remained strong with the exception of 2022 market selloff.

The rising interest rates have been fueling strong 2023 returns, with income of 10+% still providing substantial buffer against prospect of rising defaults. As the attractive market yields pose challenging financing conditions for borrowers, investment strategies backed by thorough credit analysis are best positioned to outperform.

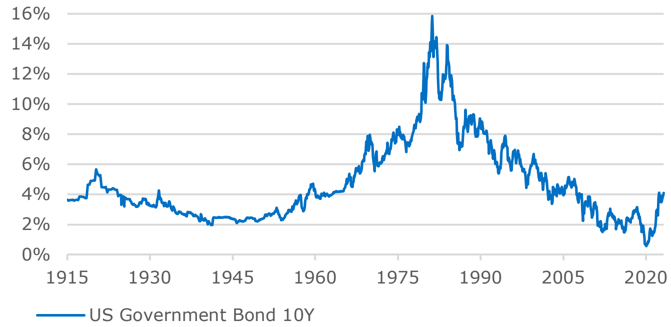
The new paradigm of high rates more than ever favors active investment approach, which allocates to borrowers with strong financials and business models, while avoiding weakening segments of the market. Such weak loan market segments include not just borrowers facing outright defaults, but also underperformers at risk of rating downgrades triggering selloffs.

Returns on European syndicated loans

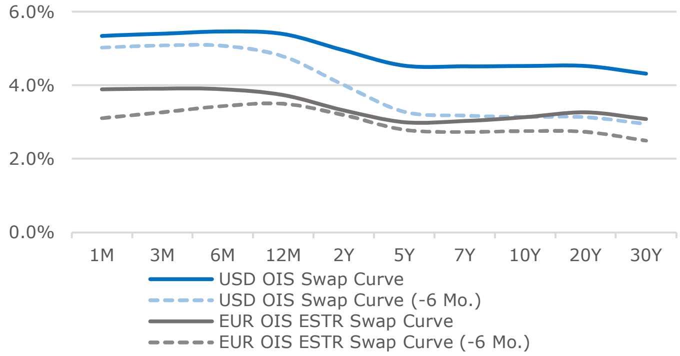


Rates Perspective

1) Historical US Treasury Yield: 10-year US government bond yield reached its 100-year low in 2020.

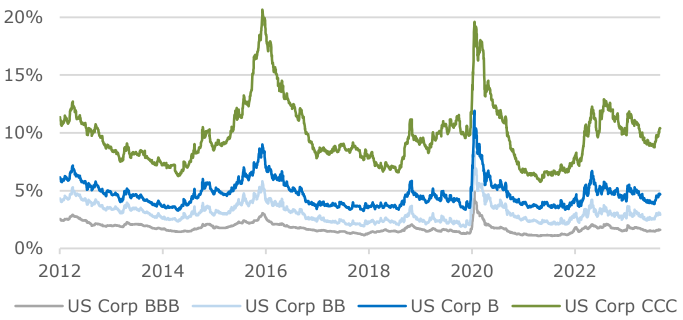


2) Interest Swap Curve: The USD and EUR curves remain inverted with shorter tenors continuously higher.



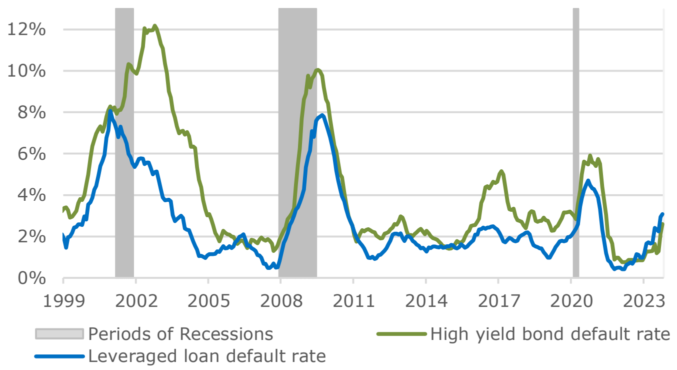
Corporate Perspective

3) US Corp. Rating: Credit spreads (OAS) of lower rated high-yield bonds widened disproportionately.

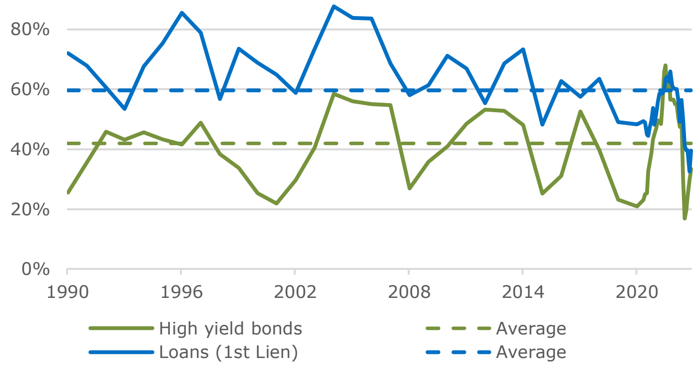


4) EU vs US: Credit spreads (OAS) between the US and EU have narrowed since the start of 2023.

5) Default Rates: HY bond default rates are structurally higher (Ø4.1%) vs. loans (Ø2.6%).



6) Recovery Rates: Recovery rates of leveraged loans are higher (Ø60%) vs. high yield bonds (Ø42%) due to lower severity.



OAS spread change overview across major credit asset classes - as of month end

US corporates by rating (bps)

	curr	Δ month
AAA	49	+2
AA	68	+4
A	114	+8
BBB	162	+11
BB	292	+18
B	468	+55
CCC	1040	+121

Global high yield (bps)

	curr	Δ month
US HY	442	+39
EU HY	483	+46
Asia HY	775	+16
EM HY	508	+36

CDS spreads (bps)

	curr	Δ month
CDX IG - US	80	+6
iTraxx IG - EU	86	+6
CDX HY - US	517	+36
iTraxx XO - EU	450	+22

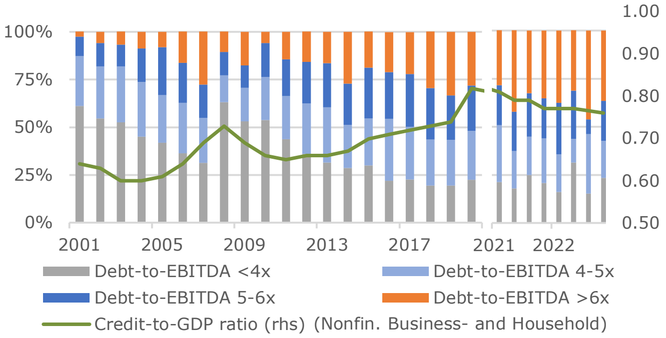
Loans and CLOs (yld, bps)

	curr	Δ month
US Loan	979	+30
CLO AAA	706	-42
CLO BBB	1089	+23
CLO BB	1471	+8

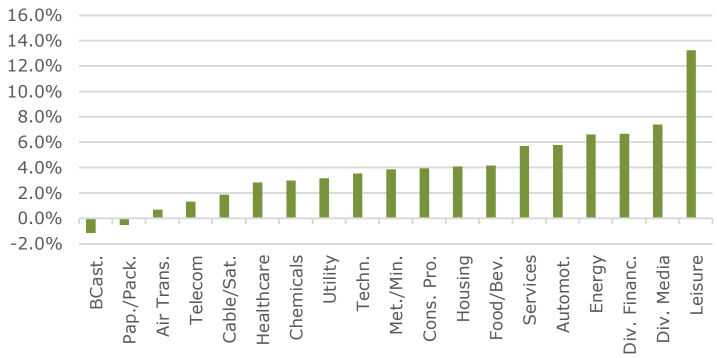
spread tightening (positive price action)

spread widening (negative price action)

7) US Leverage: Debt-to-EBITDA ratio of US companies remained stable at elevated levels.

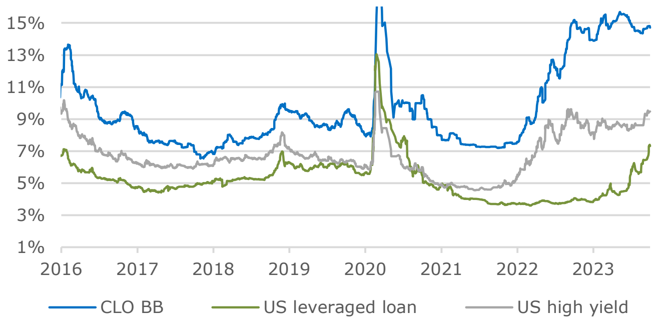


8) YTD Sector High-Yield Returns: Positive YTD results across most of the sectors, with leisure outperforming significantly.

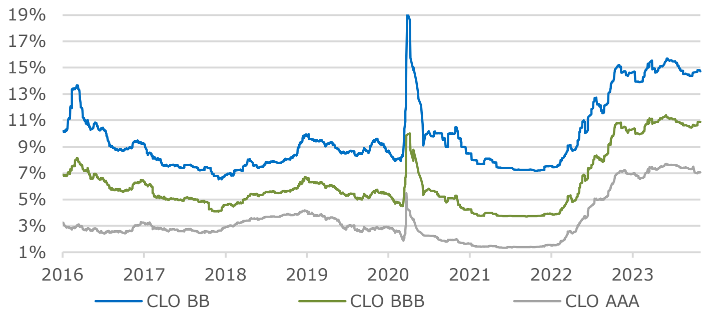


Alternative Perspective

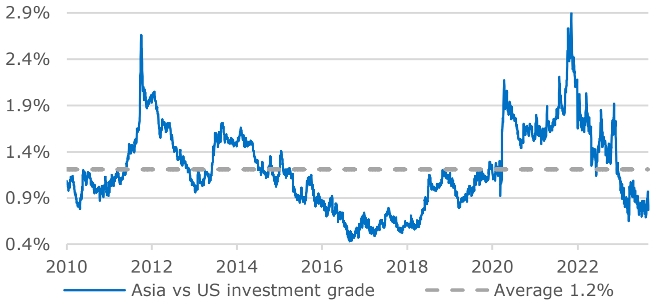
9) Loans vs. CLO vs. HY: CLO BB yields are wider vs Loans and HY bonds.



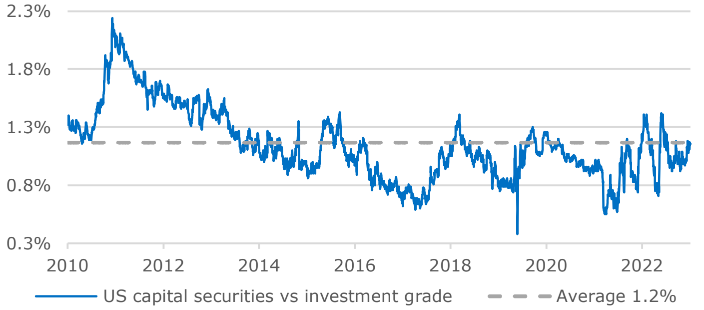
10) CLO Yields: CLOs offer an attractive yield premium over bonds and loans.



11) Asia vs. US: Asian IG spreads have tightened thanks to gradual post-COVID recovery and US inflation easing.



12) Capital vs IG.: Capital Securities structurally earn a premium vs. US IG bonds. Capital Securities are dominated by the financial sector.



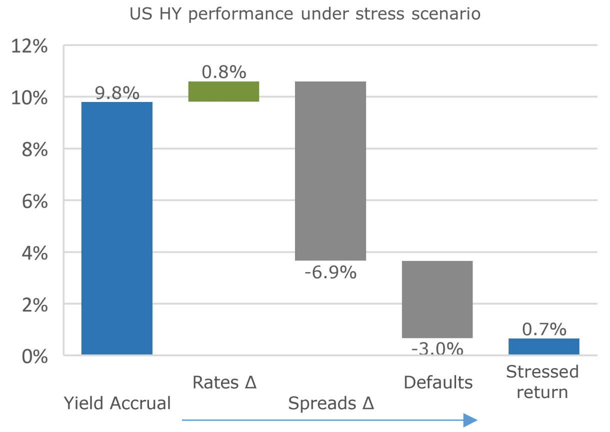
Education Corner

Elevated income buffers adverse market development

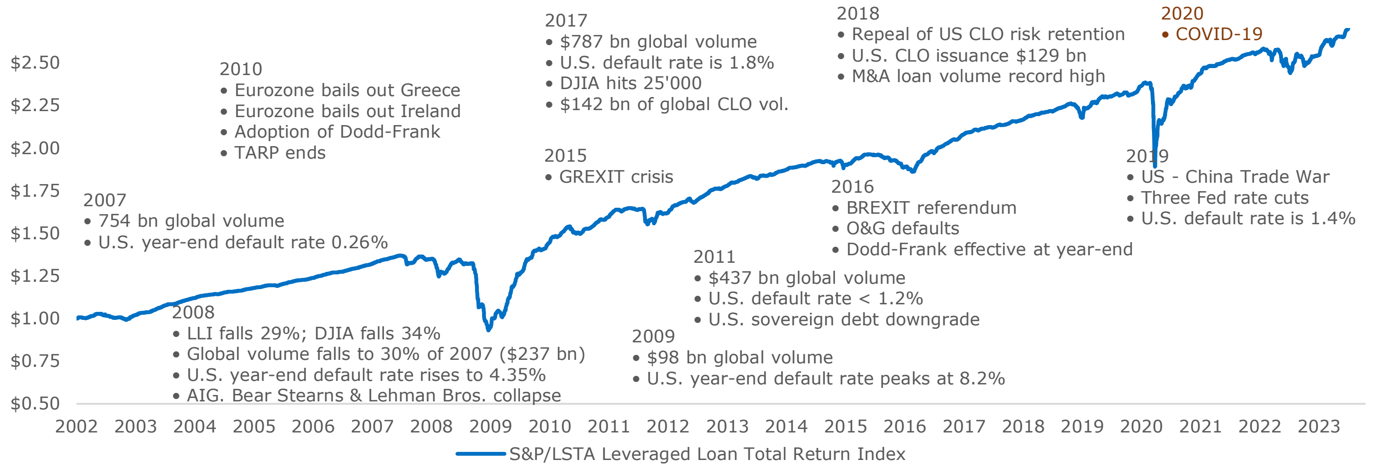
With yields at almost 10% p.a., US HY offers investors a very solid buffer during adverse market development. This can be illustrated by a hypothetical multi-factor 12-month scenario, stressing the projected total return with a simultaneous risk-free rate curve steepening (-25bps on short and +100bps on long maturities), credit spreads widening (+200bps) and elevated realized defaults (5% default rate with 40% recovery).

Given shorter duration (i.e. 3.5 years), HY markets are less sensitive to risk-free rate moves and curve steepening in particular. Hence a very small positive impact of +0.8%. In the next step, realized defaults (-3%), combined with credit spreads widening (-6.9%) on the remaining non-defaulted bonds reduce the scenario returns from 9.8% to 0.7%. To put this hypothetical stressed return in context, the scenario-based spreads widened by ~50% and defaults more than doubled from current levels.

While overall HY bond market remains robust by number of metrics (e.g. portion of BB-rated credits is among the highest historically), the increasing dispersion requires active management, dynamically avoiding weakening bond issuers.



US Loan Index Total Return - Attractive Long Term Yield Generation



List of Abbreviations

Capital Securities (Or preferred securities): Are fixed income securities combining features of bonds and preferred stocks.

CDS: Credit default swaps transfer credit event risk to another party in exchange of a perdiodically paid premium. CDX index covers the US IG-, iTraxx the EU IG- and iTraxx crossover (XO) the EU HY market.

CLOs: Collateralized loan obligations are structured finance securities collateralized predominantly by a large pool of different loans.

Default Rate: Number of defaulted corporate issuers of leveraged loans and high yield bonds.

Loans: Are syndicated, public tradable loans. Synonyms are «syndicated loans», «loans», «leveraged loans» and «bank loans».

OAS: Option-adjusted spread is the yield difference of an interest paying security to the risk free rate considering embedded options.

TIPS: Treasury Inflation-Protected Securities are US government linked to the US CPI Urban Non-Seasonally Adjusted.

Up-/ downgrades: Rating actions of Moody's and S&P of up-or downgrades of US high yield bond issuers denominated in USD.

Up-/ downgrade ratio: Number of upgrades of total rating actions.

Recovery Rates: Bond issuer-weighted recovery rates express the principal and accrued interest on defaulted debt that can be recovered in percentage of face value. Example:
Expected loss rate if US HY defaults were 10%: 10% ./. Estimated average recovery rate of ~30% = -7%; Example for Loans:
Expected loss rate if US Loan defaults were 10%: 10% ./. Estimated average recovery rate of ~65% = -3.5%;

Data and Price Sources

Alpinum Investment Management	Federal Reserve Bank of St. Louis	Palmer Square indices
Bank of America Merrill Lynch indices	Markit CDS indices	Preqin
Bloomberg	Moody's Investors Service	S&P
The Federal Reserve	J.P. Morgan	Federal Housing Finance Agency
US Census Bureau		

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