

Market backdrop

The sweeping uptrend in European sovereign yields got interrupted in October. **The 10-year Bund yield rose 3 bps to close the month at 2.14% and all other European debt yields recorded modest declines: French and Portuguese sovereign yields fell 4 bps each to 2.67% and 3.14% respectively while the Spanish equivalent fell 6 bps to end the month at 3.22%.** Sovereign debt from Europe's most fragile and indebted countries recorded the best performance, with Italy's 10-year BTP yield falling 22 bps, doubtless driven by new prime minister Giorgia Meloni's initial statements and relatively balanced government. The figures mask high volatility throughout the period. Until 21 October, yields continued to rise, with **the Bund peaking at 2.41%, some 30 bps higher than at the end of September. On 24 October, the upward trend reversed, triggered by surprisingly soft PMI results that highlighted the effect of tighter monetary policy on growth.** On 27 October, **the ECB's decision to raise its key rates by another 75 bps and its relatively hawkish message propelled yields back up again.** In the United Kingdom, Rishi Sunak's appointment as Prime Minister restored a semblance of calm and contributed to the upswing in yield levels. In the United States, the same events caused different effects. While **US rates also rose until 24 October with the 10-year T-Note peaking at 4.24%, some 42 bps above September's closing figure, PMI readings that were even softer than Europe's halved the rise and at the end of October the yield stood at 4.05%, an increase of 22 bps for the month.** Buoyed by positive third-quarter earnings releases, all credit indices tightened during the period.

Changes in sovereign yields and credit indices

	31/10/2022	CHANGE		SPREAD LEVEL ¹	OAS SPREAD CHANGE	TOTAL RETURN 1M
10-year sovereign						
Italy	4.29	-22	Investment Grade (ER00)	216	-6	0.19%
Spain	3.22	-6	Corporate IG (EN00)	206	-4	0.11%
France	2.67	-4	Financials IG (EB00)	233	-9	0.32%
Germany	2.14	3	Senior Financials (EBXS)	216	-6	0.15%
Portugal	3.14	-4	Sub. Financials (EBSU)	316	-28	1.12%
Greece	4.60	-23	Hybrid Corporate IG (ENSU)	322	-19	1.33%
United States	4.05	22	Corporate Hybrid HY (HNEC)	405	-13	0.17%
Corporate			Corporate HY (HEAE)	609	-56	1.73%
ITRX MAIN	114	-20	Contingent Convertible (JP AT1)*	571	-69	5.71%
ITRX XOVER	556	-84	Corporate Emerging IG (EMIB)	211	30	-2.29%
ITRX SENIOR FIN	123	-24	Corporate Emerging HY (EMHB)	817	-27	-1.40%
ITRX SUB FIN	220	-50				

Investment grade corporate credit | Credit spreads tightened over the month: -3 bps for senior and -19 bps for hybrid securities amid high interest rate volatility and lower risk aversion. Earnings releases, macroeconomic indicators, and central bank meetings helped to shape a particularly busy month. The property sector (Balder, Heimstaden, Aroundtown, CPI) clearly underperformed over the period due to deteriorating refinancing costs and precarious valuation levels. Both Moody's and S&P downgraded **CPI Property** from Baa2 to Baa3 and Moody's placed **Balder** (Baa3) on negative credit watch, which could ultimately push the issuer into the high yield segment. In contrast, the automotive sector (Volvo, Toyota, BMW, Mercedes-Benz, Daimler, Stellantis) finished the month on a high note with significantly tighter spreads. It was a similar story in the leisure and tourism related sectors as well as in utilities and telecoms. At the end of the month, Fitch raised Autostrade's rating from BB+ to BBB and adjusted its outlook from positive to stable.

Primary issue volumes for October came in at almost €24 billion, slightly down (-8%) from October 2021. Tennet launched a green quadruple-tranche issue for €3 billion and EDF succeeded in issuing a triple tranche for the same amount (€3 billion). Demand was slightly lower than in September with an average subscription rate of 3.1 times and an average issue premium of around 29 bps. Investors remained watchful and no hybrid instruments were issued in October. Noteworthy is that the average issue maturity was two years longer than in September, rising to 8.5 years from 6.5.

Source: Lazard Frères Gestion as of 31 October 2022.

1. Spread to call in basis points.

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Financial debt | October saw September's exaggerated shifts partly reversed. AT1s tightened by 31 bps to 78 bps, Tier 2 tightened by 35 bps and senior debt tightened by 5 bps.

Following the near collapse of UK pension funds, selling pressure eased noticeably mid-month as relative stability was restored and a drop in gilt yields ensued. As the blackout period came to an end several issuers seized the opportunity to anticipate their annual financing needs, especially in euros and US dollars, which should result in lower issuance volumes in the final quarter. Several buyback offers were launched as issuers took advantage of their instruments' lower valuation levels: BFCM, Groupama (Legacy), Credit Suisse (Senior), Zurich Insurance (Tier 2), Virgin Money, Shawbrook and Lloyds (AT1). **In a decision largely anticipated by the market, Sabadell announced it wasn't calling its AT1** owing to current replacement costs and **its bond price remained stable**.

To date, quarterly results have matched our expectations as revenues improve due to higher rates and still-low cost of risk. However, some banks have begun generic provisioning ahead of what could be a more challenging backdrop.

Monte dei Paschi launched its €2.5 billion capital increase and Credit Suisse published a new strategic plan for a smaller, lower-risk entity with a fully underwritten CHF 4 billion capital increase (CHF 1.5 billion of which from Saudi National Bank which will become a 9.9% shareholder). This will reduce the CIB division's risk-weighted assets by up to 40% when the divestments are complete and improve the issuer's risk profile. As S&P and Moody's indicated at the time of the bank's recent downgrade, while the plan meets the identified needs, it carries significant execution risk and this remains a drag on its rating.

Moody's upgraded both the Bank of Cyprus' and Hellenic Bank's long-term ratings to Ba2 from Ba3 and maintained a positive outlook for each. The upgrade was driven by resilience in the Cypriot economy, which led Moody's to upgrade the country's macro profile. **Moody's also raised Deutsche Bank's long-term rating by a notch, with senior debt now standing at A1 with a stable outlook**, its best level since 2012 underpinned by improving profitability and a stronger risk profile. The ECB published its supervisory banking statistics for the second quarter of 2022. **CET1 capital levels have remained stable since the previous quarter at a comfortable 15%, while non-performing loans have fallen to an historic low of 1.85%.**

The ECB is also encouraging banks to repay their TLTRO-related loans. The central bank unilaterally changed the loan terms by adjusting the pricing structure and offering additional repayment windows.

In the Netherlands, **Aegon has decided to sell its Dutch pension, insurance (life and non-life), banking and mortgage origination businesses to the smaller Dutch competitor ASR**. The deal upon completion will be worth €4.9 billion and will see Aegon take a 29.99% stake in ASR. As a result, **S&P downgraded Aegon's rating by a notch**. It considers that the transaction weakens the insurer's profile as it will be forfeiting its second-largest profit generator.

High yield corporate credit | Following significant widening at the end of September, **spreads tightened in October (-56 bps)** when a new UK government steadied the market, European gas prices fell, and interest rates reversed direction in the last week of the month. We saw **spreads decompress** with BB credit outperforming lesser rated counterparts.

The **primary market** re-opened for those willing to pay high issue premia. **Three issuers came to market for a total of €1.65 billion: Tendam** at a yield of 10.7% with a floating rate note rated B, **Fedrigoni** at a yield of 11.25% spread across fixed and floating notes rated B+, and **Cirsa** at 10.75% with notes rated B-. In addition, **Stada managed to exchange €1.4 billion of bonds due in 2024** (from a total of €1.9 billion) for new 2026 bonds with a generous premium (8%).

In terms of **sector performance, property companies (SBB, Heimstaden)** are being affected by expectations of higher interest rates. The **consumer goods** sector (Upfield, Philips) is bearing the brunt of a gloomier European macroeconomic outlook set to dampen consumer sentiment. **Meanwhile, all other sectors are in positive territory**. The **automotive** sector (Faurecia, Jaguar) benefitted from good results published by several issuers as semiconductor supply bottlenecks eased. The **energy** sector (Saipem, Pemex) also did well, buoyed by higher oil prices and by **Saipem**, which reported better-than-expected results and upwardly revised its full-year 2022 outlook. The **transportation** sector (IAG, Lufthansa) enjoyed better-than-expected results and positive forecasts for fourth-quarter 2022 airline demand. In addition, **Autostrade's rating was raised to investment grade** following its takeover by the Italian Caisse des Dépôts.

Rating agencies announced several downgrades in October. S&P **downgraded Casino to CCC+**. **Moody's downgraded Elixior to B2 with a negative outlook** because of its poor ability to pass inflation through to customers. **S&P downgraded Telecom Italia's rating to B+ with a negative outlook** due to the significant amount of debt the company needs to roll over in the next 24 months amid macroeconomic deterioration and strong domestic competition.

Outlook

Market backdrop

- **In the United States**, economic indicators remain solid apart from the residential sector, providing the Federal Reserve with little reason to consider halting its monetary policy tightening.
- **In the eurozone**, economic growth remained satisfactory over the summer, but softer survey results suggest gloomier times ahead. Similarly, while the mild weather in October allowed for an improvement in the energy situation, this will be of little consolation as winter sets in.
- Third-quarter results reflect a mixed picture for companies and a satisfactory one for banks.
- **Investment grade credit flows** appear to have stabilised since the summer. Euro high yield credit outflows continued and this key element warrants close monitoring.
- **Credit carry is becoming more attractive**, but we believe that risk premium spread widening has further to go. Indeed, we would argue that hopes for a change in Fed monetary policy and an end to China's zero-Covid strategy are over-optimistic.

Positioning

- **Duration: underweight on US, neutral on Europe.**
- **Sovereigns: neutral on inflation-linked debt.**
- **Credit: neutral on investment grade, underweight on high yield and subordinated debt.**
- **Maturities: preference for short to intermediate maturities**
- **Sectors: banking, telecommunications, healthcare.**

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