Lazard Frères Gestion

Fixed Income Newsletter

December
2021

Market backdrop

Omicron beats inflation. Despite a robust set of European PMI index data at the start of November and persistently high inflation that J. Powell has stopped calling 'transitory', **sovereign yields fell across the board when a new Covid-19 variant emerged in South Africa**. Meanwhile, a resurgence in the pandemic was also hitting Europe particularly hard. **In France and Germany, 10-year yields fell by 24 bps and 26 bps** respectively and falls were only slightly less marked in the eurozone periphery. **Rates subsided less in the United States where the 10-year rate 'only' fell by 11 bps to 1.45%.** Omicron has yet to take hold in the US and, more significantly, US inflation has reached a thirty year high. The Fed has also begun to scale back its asset purchasing programme. Generally speaking, **central banks' messaging appeared to take a more moderate tone** and contributed to rates moving lower. The Bank of England even left its key rates unchanged, which also spurred a sharp correction: -22 bps over the month. **Curve flattening, which in October affected the 10–30 year segment, this time most clearly affected 2–10 year yields** with Germany flatter by 9 bps and the US by 18 bps. **All credit indices widened**. Investment grade indices widened from 20 bps to 22 bps and the widening increased progressively for the other indices in line with risk and up to 62 bps for the emerging market corporate high yield index.

Changes in sovereign yields and credit indices

	30/11/2021	CHANGE
10-year sovereign		
Italy	0.97	-20
Spain	0.40	-21
France	0.01	-26
Germany	-0.35	-24
Portugal	0.33	-19
Greece	1.25	-7
United States	1.45	-11
Corporate		
ITRX MAIN	58	7
ITRX XOVER	287	26
ITRX SENIOR FIN	68	9
ITRX SUB FIN	130	17

	SPREAD LEVEL[1]	OAS SPREAD CHANGE	TOTAL RETURN 1M
Investment Grade (ER00)	111	22	0.17%
Corporate IG (EN00)	110	22	0.18%
Financials IG (EB00)	111	21	0.15%
Senior Financials (EBXS)	99	20	0.24%
Sub. Financials (EBSU)	166	31	-0.21%
Hybrid Corporate IG (ENSU)	214	33	-0.38%
Corporate Hybrid HY (HNEC)	263	29	-0.37%
Corporate HY (HEAE)	379	43	-0.53%
Contingent Convertible (JP AT1)*	378	46	-0.97%
Corporate Emerging IG (EMIB)	151	11	0.12%
Corporate Emerging HY (EMHB)	724	62	-1.85%

Investment grade corporate credit | **Spreads widened by 22 bps for the senior segment and by 33 bps for the hybrid segment amid persistent interest rate volatility and risk aversion**. By the end of the month, all sectors had surrendered to wider spreads. The property sector (Unibail RW, Deutsche Wohnen, Carmila, Vonovia) underperformed, as did the energy sector, which suffered from the fall in oil prices (Gazprom, Eni, OMV). With the month end dominated by growing Omicron fears, hybrids and corporates in the most covid-sensitive sectors were under pressure (Ryanair, EasyJet, Wizz Air, ADP, Booking, Intercontinental). **General Electric**'s three-way split received a patchy welcome from the credit agencies: S&P placed it on negative watch while Moody's confirmed its rating and maintained its negative outlook.

The corporate investment grade primary market remained active with almost €29 billion in issuance. Issues mainly took place during the initial weeks of the month. In terms of sectors, utilities (EDF Green, RWE Green, Tennet, Stedin) proved the most active, ahead of infrastructure (ASTM with a sustainability-linked bond, APRR) and healthcare (Thermo Fischer with a triple tranche). Hybrid issuance saw **Iberdrola** come to market with a Green offering. **For issuers, the environment deteriorated significantly in the second half of the month.** Investors became more selective, bid-to-cover ratios diverged, and issue premia increased. SRI formats accounted for over 50% of primary market volumes, confirming their rising popularity in the second half of the year.

Source: Lazard Frères Gestion as of 30 November 2021.
1. Spread to call in basis points
Performance expressed in currency is exposed to exchange rate risk.
Past performance is no guarantee of future results.
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Financial debt | In November, risky assets were put under pressure by persistent **interest rate volatility**, another **busy primary market, deteriorating liquidity levels** as bank traders prioritised reducing balance sheet risk ahead of year end, and a **resurgence in Covid-19**. **Financial credit was no exception, with spread widening that ranged from 32 bps for Tier 2 to 42 bps for AT1.** However, **corporate earnings results publications continued uneventfully alongside a very low cost of risk and a general decline in the outstanding stock of moratoria. Default rates are extremely low** and well below what bank models had forecast.

The **Financial Stability Board has raised its capital requirements for JPMorgan, Goldman Sachs, and BNP Paribas by 0.5%** of CET1 capital from January 2023, under its rules for global systemically important banks (G-SIBs), of which there are currently 30.

Positive rating changes continued this month with S&P upgrading Italy's outlook to 'positive', which had a knock-on effect for five Italian banks including **Intesa, Unicredit and Mediobanca.** The agency also placed **Bank of Cyprus (B-) on positive outlook**. **Fitch** revised **ING**'s outlook from negative to stable (A+) and the outlook for **ABN Amro** from negative to stable (A).

On the M&A front, **Unicredit sold its remaining 20% stake in Turkish bank Yapi Kredi, while BBVA announced the launch of a takeover bid for the remaining 50.2% stake in Garanti, also a Turkish bank. KBC announced the purchase of Austrian bank RBI's Bulgarian subsidiary, and BNP Paribas is considering selling its US subsidiary, Bank of the West**.

In terms of **legacy debt, balance sheet cleaning before the end of the Basel II transition period continues with Lloyds, Natwest, Rabobank, Credit Logement, and BNP** all calling or offering to buy back several securities. The **primary market was active** with, for example, **AT1 instruments denominated in euros for Sabadell, Unicaja and Deutsche Bank**, and **Tier 2 instruments for BFCM, and BCP Banca Popolare di Sondrio**. A lack of investor appetite meant that in most cases **issuers had to add a premium compared to the secondary market** of 5–30 bps depending on the issuer and the security's structure.

High yield corporate credit | Spreads **widened by 43 bps** in November following two weeks of stability. **Generally positive earnings releases resulted in spread compression between the triple-C and double-B segments (-50 bps)**. From the second half of the month, that compression reversed slightly, exacerbated by the news of a new Covid-19 variant on 25 November. In addition, the primary market had another **very active month with nearly €12 billion of new issuance**, mainly in **double-B rated credit**, which weighed on the secondary market.

Against this backdrop, **BB credit performed worst** while **triple-C outperformed**.

In terms of sector performance, **technology was the only sector to make gains**, buoyed by lower interest rates. **Energy and transport suffered most** due to fears about the new Covid-19 variant. The **property sector was pulled down** by Adler's bonds, which fell in the absence of a question-and-answer session following its earnings release. Telecom Italia was in the news for several reasons. Firstly, deteriorating credit ratios led to a downgrade by S&P (from BB+ to BB with a stable outlook). Secondly, KKR took advantage of the weak share price to launch a €10.8 billion buyout. Thirdly, the CEO's resignation, which came days after the takeover proposal, substantiates the scenario that the deal will go ahead.

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Outlook

Market backdrop

- In the US, economic data are consistent with **sustained growth in the fourth quarter**. **Inflationary pressures** are still very **strong** and the **labour market continues to tighten**.
- While **Omicron** is poorly understood at this stage, compared to other variants it seems to **cause less serious illness but is more contagious**. While the variant may shift the growth curve over time, it is unlikely to cause a sudden downturn.
- **Credit market fundamentals remain robust. Default rates** should reach **2.2% within 12 months** according to Moody's.
- Following **risk premia widening in November**, spreads should tighten in December amid subsiding volatility.

Positioning

- **Underweight in duration (US & Euro).**
- Overweight **high yield and subordinated debt (AT1)** with short/intermediate maturities.
- Overweight in the **peripheral eurozone, cyclical sectors and the financial sector**.
- **Long USD exposure.**

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Completed on 8 December 2021.