CREDIT REPORT | October

10th November 2020

Calamatta Cuschieri
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Highlights

S&P leaving Italy's rating unchanged at BBB, outlook revised to stable, dragged sovereign yields within the periphery

Euro IG outperforming HY credit as Covid-19 cases surge

Euro HY spreads, once more, widened as U.S. IG and HY spreads tightened further

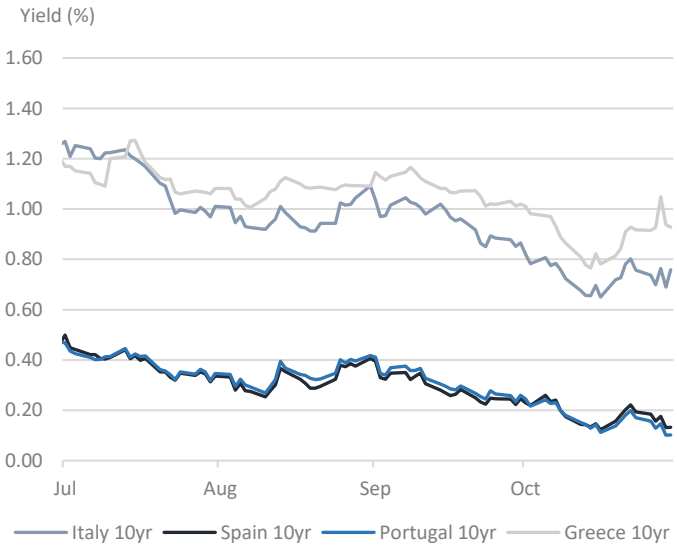
Measures imposed to mitigate the spread weigh on sectors

Sovereign yields

Euro Area: Although a pick-up in activity, following a severe deterioration, has in recent months created a sense of optimism for the single currency bloc, the rapid rise in Covid-19 cases across Europe is once more threatening the continent's recovery. Sovereign yields, portraying the increased uncertainty, inched lower.

Weighing on Italy's bond yields was the imminent S&P's rating action. S&P Global Ratings left Italy's credit rating unchanged: BBB, yet raising the outlook to stable, and making a downgrade towards junk level less likely. Pro-growth measures in Italy's 2021 budget and the ECB's expansion and extension of its pandemic emergency purchase programme (PEPP), proved supportive. Yields, previously portraying uncertainty, inched lower.

Pressure on the so-called periphery economies also eased, with yields, being dragged lower.

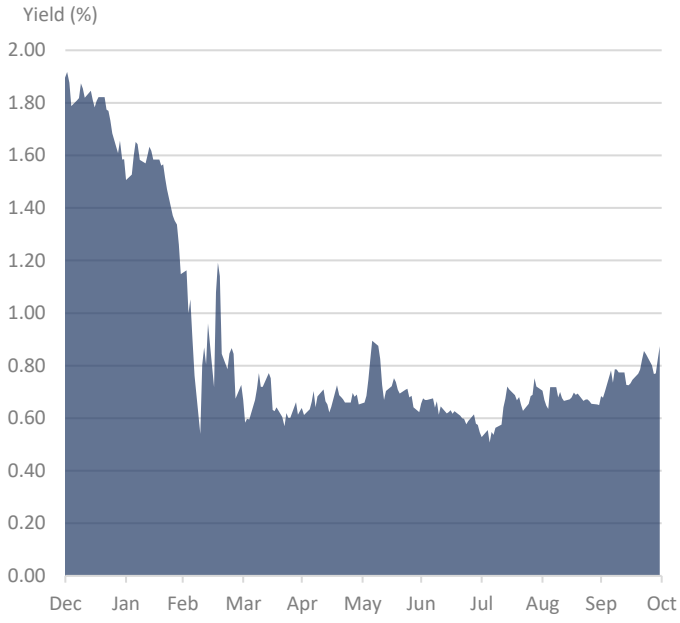


Source: Calamatta Cuschieri Investment Management

Figure 1: Benchmark 10 year European Sovereign Yields (July - October)

Movement in sovereign yields, particularly of those in the periphery, during the period under review remained conditioned by the record rise in coronavirus infection rates across the continent and the imposition of tougher restrictions on social contact.

U.S.: U.S. treasures edged higher in October, buoyed by optimism on positive economic data and that a deal can be reached on a fresh U.S. coronavirus relief package which offset worries emanating from the fast-rising case counts. Expectations of a larger government stimulus, backed by then-presidential candidate Joe Biden boosted U.S. borrowing costs. The benchmark 10-year Treasury yields, rose as high as 0.874%, the highest since June.



Source: Calamatta Cuschieri Investment Management

Figure 2: Benchmark 10 year U.S. Treasury yield

Corporate credit market

In October, corporate credit proved to be quite volatile. While the performance in the asset class was mixed, corporate bonds, fenced by doubts revolving around the Covid-19 pandemic and the need to re-impose movement restrictions, held up relatively well, overall.

European investment grade returned 0.772% while the US investment grade space, saw a marginal negative return, at -0.174%, as benchmark yields rose. While furthering on its outperformance, observed in Q3 on U.S. investment grade space, European investment grade outperformed the European, U.S., and Emerging Market high yield.

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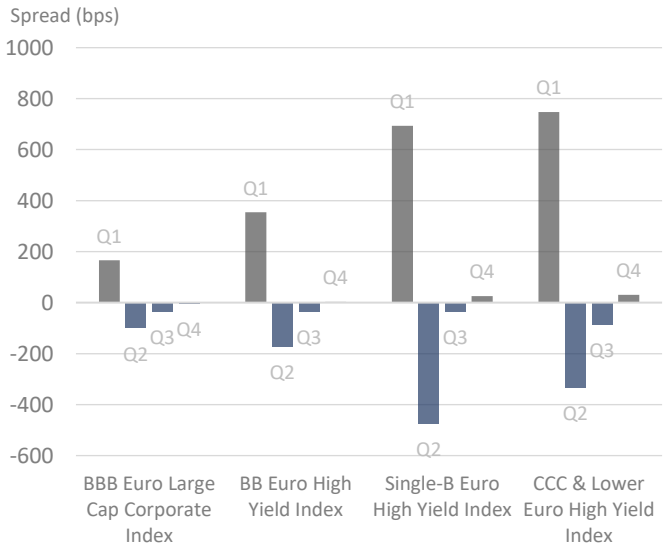
Within the high yield segment, returns on both the U.S. and Emerging Markets were positive, generating a modest positive return, albeit a sharp reversal in sentiment in the last week of the month.

Movement in credit spreads

Credit Rating Implications: Growing concerns about the ability of corporates to service their debt at the peak of the unprecedented Covid-19 pandemic led to substantial widening. However, ensuing such period, of rising economic uncertainty, a credit spread reversal was expected.

Subsequent to substantial widening, witnessed in Q1, reaching significant highs of over 1000 bps, credit markets reversed. Following the considerable fiscal and monetary stimulus, and easing of restrictions, which paved the way for the economy to resume activity, spreads in both Q2 and Q3 significantly tightened.

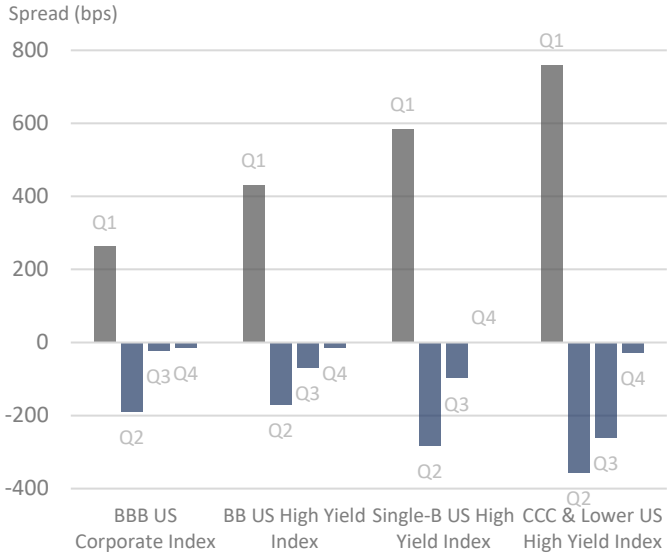
Euro IG and HY: While spreads in European investment grade remained practically flat, with the exception of further tightening in the BBB segment, upon the rapid rise of Covid-19 cases, European High Yield spreads, once more, widened marginally in October.



Source: Calamatta Cuschieri Investment Management

Figure 3: European IG and HY credit spreads

U.S. IG and HY: Contrasting European credit, U.S. investment grade and high yield spreads, with the exception of the Single-B rating bucket which witnessed marginal widening, furthered on the tightening observed in Q2 and Q3.

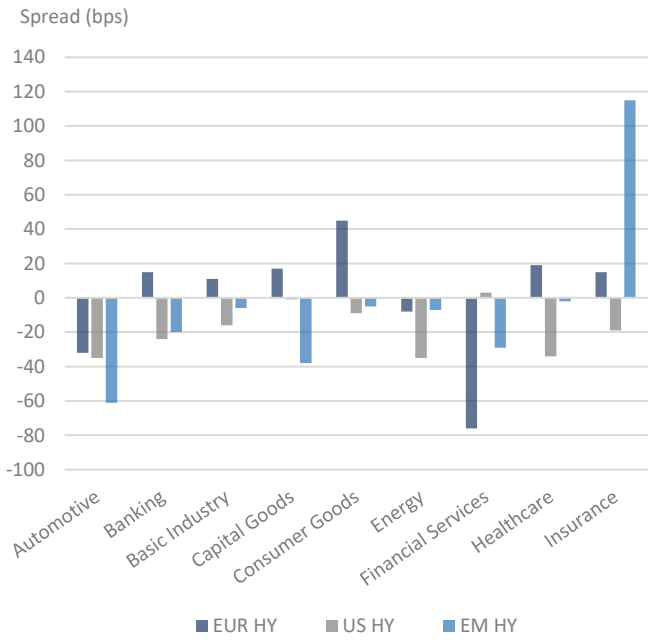


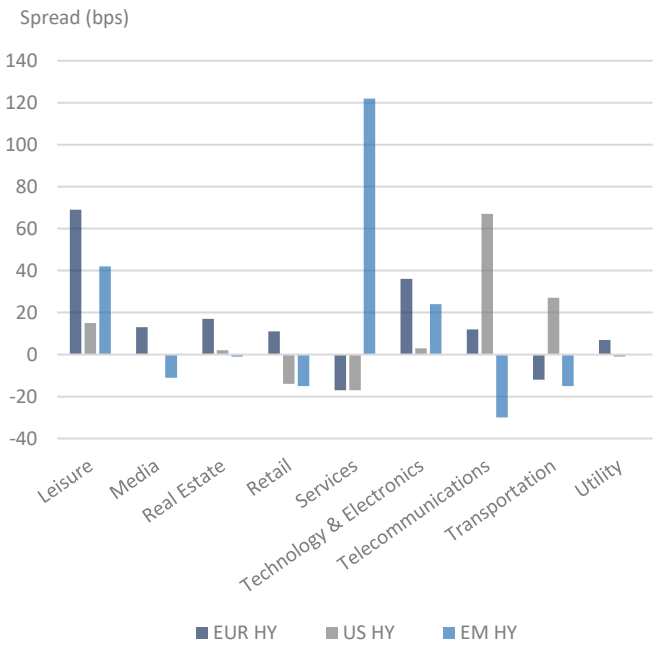
Source: Calamatta Cuschieri Investment Management

Figure 4: U.S. IG and HY credit spreads

Sector Implications: Albeit performance of both investment grade and high yield corporates is influenced by general price market movements, the impact does vary, with certain sectors proving more vulnerable to others. The measures imposed, aimed at reducing the spread of coronavirus, have on some sectors, weighed more than others. Economic data and credit spreads, certainly portray the latter.

PMI data has, as yet, portrayed an unbalanced recovery. While manufacturing showed continued expansion and proved to be more resilient, services, reliant on human interaction are surely bearing the brunt of a rapid increase in Covid-19 infections and mobility restrictions. Inevitably, credit spreads of sectors impacted, widened.



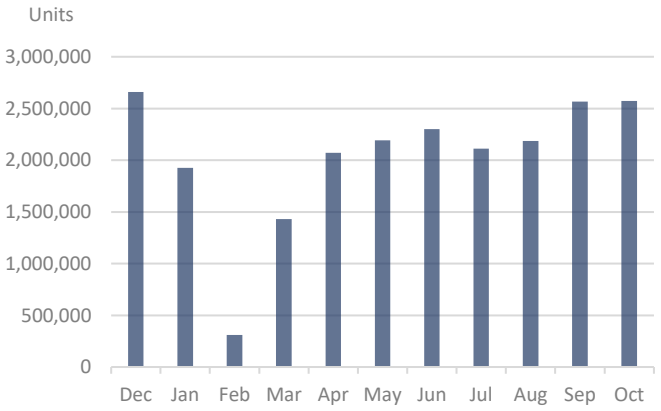


Source: Calamatta Cuschieri Investment Management

Figure 5: Sectorial Analysis – European, U.S., and Emerging Markets

Leisure, Autos, and Financials: With the Covid-19 pandemic seemingly back to full force in October, spreads of corporates within the leisure industry significantly widened. Although the restrictions imposed were less strict, when compared to those introduced earlier this year, a continued downturn within the sector was inevitable, with European high yield names – the worst impacted, and witnessing spread widening of 69 bps.

Against a backdrop of the industry seemingly reaching a bottom and stronger-than-expected recovery in sales across Europe, but more remarkably so in China, the automotive industry recorded a substantial tightening in spreads in October, leading to notable gains.

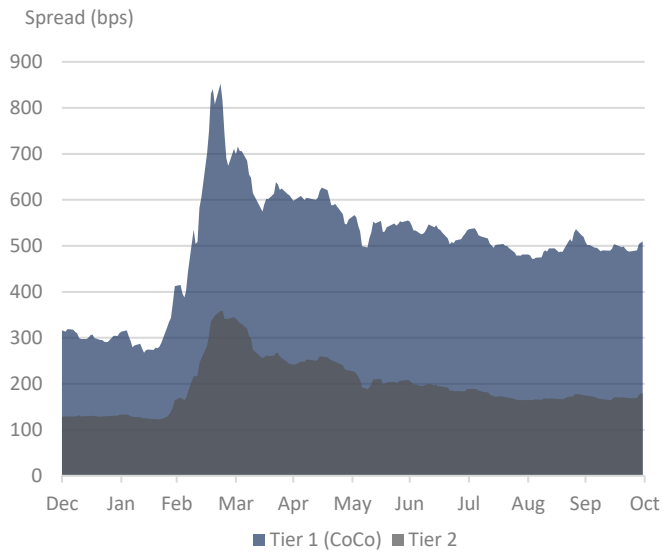


Source: Calamatta Cuschieri Investment Management

Figure 6: Number of passenger car and light truck sales in China

In October, banking institutions - forced by regulators to be adequately capitalized and prepared for such unprecedented scenarios, also witnessed some tightening, with better-than-expected results, improved capitalisation, and declines in non-performing loans proving supportive.

Albeit the substantial tightening in option adjusted spreads, for both Tier 1 and Tier 2 issues, witnessed at the peak of the pandemic, spreads for the month, remained largely flat.



Source: Calamatta Cuschieri Investment Management

Figure 7: Option Adjusted Spread of Tier 1 (CoCo) and Tier 2 Issues

Credit outlook

Moving forward, we believe that credit markets will be conditioned geographically, depending on the economy recovery path within the region.

We expect that U.S. sovereign and investment grade yields will continue to be conditioned by inflationary expectations, while high yield debt being more dependent on sector dynamics.

In Europe, we believe that the low inflationary expectations should aid sovereign yields to trade within a range. We believe that corporate credit should continue to be supported by monetary politicians and liquidity buffer levels.