Lazard Frères Gestion

Fixed Income Newsletter

Sept.
2021

Market backdrop

All eyes remained on monetary policy stances with the main focus on July's FOMC minutes and the Jackson Hole Economic Symposium held at the end of August. The Fed adjusted its communication slightly, with Fed Chair J. Powell integrating the principle of a forthcoming tapering but stopping short of any precise timetable and still emphasising that a reduction in asset purchases would not be a signal of any impending increase in key rates.

Government yields ticked up on both sides of the Atlantic. Alongside this, yield curves are steepening, particularly in the 2–10 year segment. High-yield credit indices (Corporate high yield, Financial AT1, Emerging markets) have been gaining ground, with the positive contribution from credit (tighter margins plus carry) outpacing the negative contribution from interest rates.

Changes in sovereign yields and credit indices

	31 AUGUST 2021	CHANGE
10-year sovereign		
Italy	0.71	9
Spain	0.34	7
France	-0.03	8
Germany	-0.39	8
Portugal	0.21	4
Greece	0.76	16
United States	1.31	9
Corporate		
ITRX MAIN	45	-2
ITRX XOVER	228	-8
ITRX SENIOR FIN	52	-2
ITRX SUB FIN	100	-3

	SPREAD LEVEL[1]	OAS SPREAD CHANGE	TOTAL RETURN 1M
Investment Grade (ER00)	86	0	-0.40%
Corporate IG (EN00)	85	1	-0.48%
Financials IG (EB00)	86	-2	-0.26%
Senior Financials (EBXS)	76	0	-0.32%
Sub. Financials (EBSU)	127	-6	0.00%
Hybrid Corporate IG (ENSU)	179	-3	-0.02%
Corporate Hybrid HY (HNEC)	220	-2	0.05%
Corporate HY (HEAE)	309	-13	0.33%
Contingent Convertible (JP AT1)*	464	-6	0.72%
Corporate Emerging IG (EMIB)	137	-14	0.72%
Corporate Emerging HY (EMHB)	559	-41	1.40%

Investment Grade Corporate Credit | Over the month, Senior credit margins widened by 1 bp while those for hybrid credit narrowed by 3 bps while the Covid-19 health risk lingered on. Earnings releases slowed but exceeded expectations overall and outlooks were revised upwards. Spreads widened across most sectors and especially in consumer goods, automotives, and healthcare, while the property, transport, energy and services sectors performed relatively well. **Bouygues, Eiffage**, and several funds have expressed interest in making a bid for Engie's subsidiary Equans. **Atos** saw its curve steepen following rumours that investment funds were taking an interest in the name. Indeed, Moody's raised outlooks for a number of issuers with **Holcim moving from stable to positive and both Valeo and EDF moving from negative to stable**.

The primary market was relatively busy over the month with €15 billion in issuance. The summer break got off to a late start following the issues of **Volkswagen**'s €2.5 billion triple tranche bond and the American **Becton Dickinson**'s €2.7 billon quadruple tranche bond (the largest Reverse Yankee this year). The final week of the month was particularly busy, with €9.4 billion coming to market. **Vonovia** accounted for over a third of the amount with a quintuple tranche issue for a total of €5 billion, the largest primary market transaction this year. Some of the funds raised will be used to refinance the bridge loan that was taken out for the **Deutsche Wohnen** acquisition. The property company also launched a second takeover attempt for Deutsche Wohnnen. Meanwhile, **National Grid** issued a 7-year (green) and 12-year (conventional) dual-tranche bond and German energy company **EnBW** issued a dual tranche hybrid bond (60NC7 Green and 60NC11). Following two quiet months, 7% of the volumes issued were investment grade hybrid bonds. Issuers are still enjoying favourable conditions and demand has been strong, which has resulted in a limitation of premiums and significant bid-to-cover ratios (3–4 times).

Source: Lazard Frères Gestion as of 31 December 2020.
1. Spread to call in basis points
Performance expressed in currency is exposed to exchange rate risk.
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Financial debt | August was a positive month for financial credit with the AT1 segment outperforming in an environment that remained favourable for risky assets despite the start of an uptick in sovereign yields.
The **first-half 2021 earnings season drew to a close for European banks with figures largely exceeding expectations** thanks to **lower-than-expected levels of loan-loss provisions** (including some provision reversals for certain UK, Swiss, and Nordic banks), as well as **higher revenues, particularly in terms of fees and commissions**. **Most banks have also downwardly revised their 2021 cost-of-risk forecasts** and are still not seeing any fresh bad debt formation. In terms of CET1 capital ratios, the average ratio rose during the quarter and levels should remain high.
Unicredit continues its due diligence process on Monte dei Paschi with a view to acquiring selected parts. The deal could include state-owned entity Mediocredito Centrale taking on the southern Italy branches and AMCO (also state-owned) taking the bank's non-performing loans.
The primary market was **dominated by US dollar-denominated AT1 refinancing** for Barclays, Swedbank, Standard Chartered and Nordea while BNP, KBC and Munich Re came to market with euro-denominated Tier 2 issuance.

High Yield Corporate Credit | Spreads tightened by 13 bps, compensating for the rise in rates. The remaining **second-quarter results publications were generally very good**, with some **better than expected and/or posting an improved annual outlook**. This positive news came despite a key issue shared by many companies, namely **the price rise in logistics and raw materials**.

Against this backdrop, the **weakest credit performed best**. We also note that **spreads tightened marginally**, reflecting investor interest in high-yield paper. In terms of sector performance, **retail** (Casino, Douglas), **energy** (Pemex, Raffinerie Heide) and **capital goods** (Rolls Royce, Frigoglass) **outperformed**, while the **technology** sector (Cellnex, Infrastructure Wireless Italia) fell back slightly.

The **primary market** raised €2.6 billion mainly via **refinancing transactions**, e.g. **Altice and Time Warner**, and **Evonik** (green hybrid). Lastly, Nordic property company **Castellum** issued €1 billion of hybrid debt to finance an acquisition.

Outlook

Market backdrop

- The **economic recovery continues** and is expected to remain robust. In the United States, **faster inflation and higher salaries** should be monitored.
- Second-quarter 2021 results were excellent. Corporate leverage ratios are improving, a fact that ratings should continue to reflect.
- **Default rates continue to fall in Europe** and should reach **1.8% by the end of the year** according to Moody's.
- **Credit spread levels are expected to remain stable** as fundamentals improve, but risk premia remain historically low.

Positioning

- **Underweight duration.**
- Overweight **high yield and subordinated debt (AT1)** with short/intermediate maturities.
- Overweight **cyclical and financial sectors**.
- Overweight exposure to the **periphery**.

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Completed on 13 September 2021.