

No Gas To Burn

- September ended with volatility across all asset classes, duration products have suffered from rates selloff
- Surging natural gas pricing puts pressure on utility bills for European industries and consumers; so far, no meaningful impact within the utility issuers' cash spreads
- Europe has recorded sharp inflation prints mainly due to energy price spikes, unlikely to have a meaningful impact on medium- to long-term inflation expectation due to subdued wage growth
- Credit valuation has come down from the recent peak, implied vol rose sharply as a result of excess downside hedging activities, correlation within IG credits also suggests a modest pickup in systemic risk

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Table 1: Weekly performance overview

	Change						Change				
	01-Oct-21	1 Week	2 Weeks	1 Month	YTD		01-Oct-21	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	85	1	2	0	-7	iTraxx Europe OTR (5 year, bp)*					
BBB	97	1	2	0	-11	Main	50	1	5	6	-6
IG-ex BBB	33	1	1	0	3	Xover	254	12	27	28	-20
EUR HY Corp spread (bp)	309	21	28	15	-49	Snr Fin	57	1	6	5	-9
BB	229	15	20	11	-27	Sub Fin	111	4	13	11	-14
Capital Structure spread (bp)						CDX OTR (5 year, bp)*					
Bank AT1	323	25	32	15	-79	CDX IG	52	1	6	6	-4
Bank Tier 2	112	2	3	-2	-21	CDX HY	298	23	20	23	5
Corporate Hybrids	195	14	19	6	-27						*since index roll
Sub Insurance	152	8	10	5	-23	Govt. bond yield (bp)					
ETF Total return						10 year US yield	146	1	10	17	55
EUR IG ETF (IEAC LN)		0.0%	-0.2%	-0.5%	-0.5%	10 year Bund yield	-23	0	6	15	35
EUR HY ETF (IHYG LN)		-0.4%	-0.6%	-0.3%	2.5%	10 year Gilt yield	100	8	16	31	81
USD IG ETF (IEAC LN)		-0.7%	-1.0%	-0.9%	-1.5%	10 year BTP yield	81	3	9	12	27
USD HY ETF (IHYG LN)		-0.2%	-0.3%	-0.2%	3.3%	BTP - Bund spread	104	3	3	-3	-8
*Cape Fixed Income Fund (EUR B Inst.)		-0.3%	-0.4%	-0.2%	1.6%						
*Cape Fixed Income Fund (USD B Inst.)		-0.3%	-0.4%	-0.1%	2.2%						

* as of Sep 30th 2021

Source: Bloomberg, Bloomberg Barclays, Markit as of October 1st 2021

How time flies, it is already October! Volatility has officially seized the market this week in all aspects. 10-year US treasury yields have breached 1.5% while the S&P 500 has slipped close to 4% since its peak. As for the credit market, investment grade credit spreads (including capital structures) have widened anywhere between 2 to 30bps depending on the beta sensitivity of the segment. Duration has mainly suffered from the sharp jump in rates and curve steepening and the IG ETF has lost more than 0.6% in Sep as a result.

Surging natural gas prices globally have been gaining lots of attention. The continuing recovery in industrial demand and the transition into low emission form of utility (i.e. gas replacing coal) are sending gas demand and prices through the roof. Europe as a net importer of natural gas (from Russia and the US LNG) is under mounting pressure of rising utility bills, which could weigh on industrials whose margin is sensitive to input commodity prices. This is on top of the other worsening factor, freight costs for global logistics, bringing further headwinds to sectors with low pricing power. Some European governments (Spain, Italy, France) are discussing subsidy measures to ease the excess utility cost which will, to a certain degree, offset a significant spike in inflation prints in the near future. So far, in the credit market, while CDS levels of major utility producers have experienced some volatility, cash bond spreads remained well contained and continue to be dominated by rates moves.

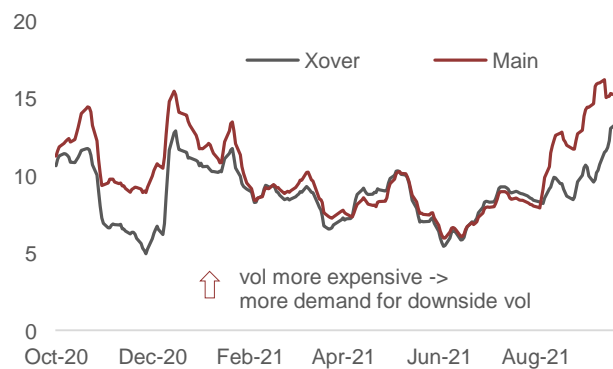
Major European countries have released inflation prints beating estimates which are largely attributable to utility prices and the unwind of the previous VAT cut in Germany. Both Core Goods and Services remain close to trend with Service continuing to recover while Goods price increase starting to normalize. This short-term shock is unlikely to have a meaningful impact on the medium- to long-term inflation expectations as wage growth in Europe remains subdued vs. the momentum seen in the US.

Green shoots from Italy this week as the cabinet approved their draft budget plan, suggesting a confident path forward to gradually reduce their debt to GDP ratio on the back of stronger growth. Additionally, the funding from the "Next Generation EU" will certainly be a significant part of the financial support. However, due to the absolute debt level (2020 debt to GDP >150%), any downward revision to GDP growth due to the global supply chain bottleneck, energy price shock or geopolitical uncertainty will bring disappointment to the current projection.

Just to give a bit more perspective on credit spreads within the different segments of the cash bond market as well as the derivatives market. As one can imagine, implied vol has steepened over the past two weeks (**Chart 1**) as investors added more downside hedges for growth shock and generally more uncertain macro-outlook in the wake of recent events in China and the hawkish Fed communication. Correlation within IG credit has also reversed its previous downward trending path (**Chart 2**), pricing in more systemic risk. Within the cash bond universe, while it was not long ago when valuations of the majority of the asset classes were within their 10th percentile, this is no longer true for the higher beta segments (namely the AT1s, Sub Insurance & Corporate Hybrids). Decompression has been the theme during the volatile sessions (**Chart 3**), which has opened up interesting entry points for some conviction themes.

Chart 1: Implied vol has steepened over the past two weeks

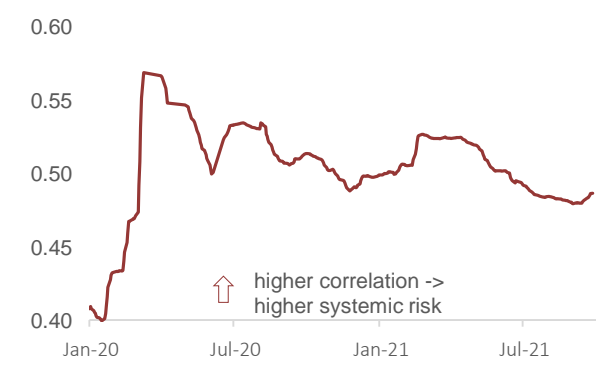
EUR IG and EUR HY CDS, implied vol, At the money, 1-month, 5day moving average



Source: Citi velocity as of October 1st 2021

Chart 2: Correlation within IG credit has also reversed its previous downward trending path

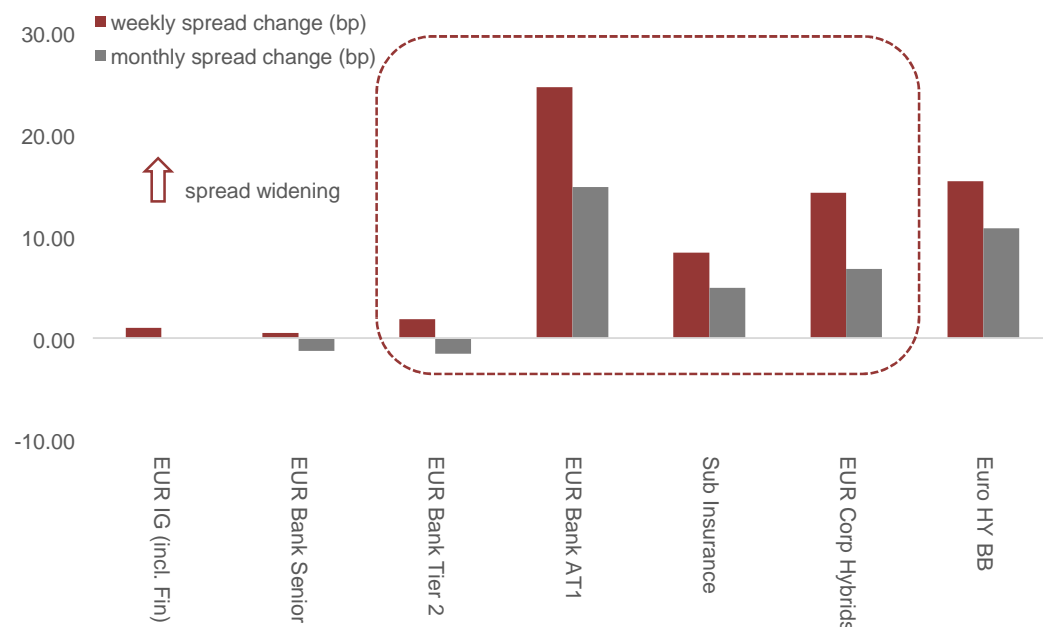
EUR IG CDS (iTraxx Main 5syr equity tranche), implied correlations



Source: Citi velocity as of October 1st 2021

Chart 3: Decompression within capital structure risks

spread change, in bps, Bloomberg Barclays indices



Source: Bloomberg as of October 1st 2021

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