Investment Strategy

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ASSET MANAGEMENT LIMITED

Credit hot spots: assessing contagion and spillover risks

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- **Tightening liquidity conditions and rising recession probabilities have brought certain credit hot spots from within European banks and emerging markets to the fore.**
- **This note tries to provide some context around the recent credit risk flare ups and highlights why these risks are idiosyncratic and not systemic.**
- **If anything, these recent developments act as a good reminder why focusing on quality in sovereigns, credit, and equities is crucial as global growth slows and liquidity tightens.**

Liquidity is tightening and global growth is slowing…

Co-ordinated global central bank tightening is beginning to put pressure on the financial conditions globally. This is happening at a time when global growth prospects are not looking particularly upbeat - with the World Bank highlighting that stagflation risks are rising amid sharp slowdown in growth (*World Bank: Global Economic Prospects, June 2022*). Recession probabilities have risen across the developed world, especially in the West. For instance, our own recession probability indicator rose sharply so far this year and now points to a 50% chance of a US recession over the next 12 months.

…causing some credit risk flare ups…

As a result of deteriorating global outlook and tightening monetary policy, credit concerns have risen sharply for some segments of the market. In the DM while the Fed has led the tightening, European and EM bonds have suffered the most with the excessive monetary tightening combined with soaring oil/commodity prices, putting toll especially on the fundamentally weak corporate and sovereign credits. With financial conditions in Europe, UK and even EMs now tightening to the levels seen during the COVID-19 sell-off, it is not surprising to witness sudden and frequent flare-up of hot spots in corporate and sovereign credits. The recent credit concerns of the Swiss Bank Credit Suisse, resulting in excessive widening of CDS spreads and sharp plunge in its share price is an example (see FT article *How big is the capital hole at Credit Suisse? Swiss bank's shares have tumbled to historic lows amid social media storm*, *October 04 2022*). In the emerging market space, it is the financial distress of certain weak and low-rated sovereigns (Sri Lanka, Pakistan, Argentina, and Egypt) exacerbated by the economic fallout from the Russia-Ukraine crisis. Egypt is one example here with its sovereign bond index declining by c25% YTD.

Starting with the European credit, the recent widening of Credit Suisse CDS spreads- buying protection against a company defaulting on its debt- has worried market participants with many comparing the situation to Lehman Brothers collapse in 2008. This comes at a time when European bonds are already under immense pressure with the rising probability of a recession in the region. Bloomberg European Aggregate Bond Index has recorded its second worst monthly performance in September with the index having lost around c16% YTD, underperforming Bloomberg US Aggregate Bond Index. Similarly, Markit iTraxx Europe index (quoted in spread)- comprising of 125 equally-weighted credit default swaps on European IG companies-has jumped to the widest level since 2012. The significant widening of European credit spreads and relative underperformance versus its US counterpart is justified given the 1yr recession probabilities are the highest in Europe compared to other DMs.

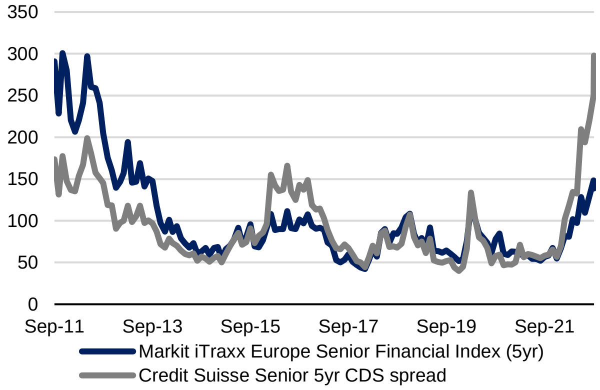
…which are idiosyncratic and not systemic…

At the same time, this gives little reason to view the rising credit concerns on European banks- Credit Suisse as another Lehman moment in the making. Rather- the credit concerns of Credit Suisse are reflective of weak underlying earnings and recent negative rating actions (*Source: Bloomberg Intelligence, Credit Suisse - Challenges Coming From All Sides*). These concerns may be more-company specific in nature rather than indicative of a system-wide problem, in our view. This is evident when we compare the trend in the 5yr CDS spreads of Credit Suisse versus the Markit iTraxx European spread (Chart 1 and 2) and also versus similar European banks (Chart 3 and 4) which points to a massive divergence between the 5yr CDS spreads of Credit Suisse versus other peers. Chart 7 compares the performance of Credit Suisse equity with that of global banks and broader global equities. Our observation is that this is unlike during the Lehman brothers collapse when there was sudden, sharp and co-ordinated widening of CDS spreads across the financial system (Chart 5 and 6). Besides, financial institutions now face stricter regulatory supervision and higher capital requirements compared to pre Global Financial Crisis of 2008/09 (Chart 8). Similarly, turning to EM sovereigns, it is not surprising that weaker, low-rated, frontier EMs have been the biggest losers this year amidst the backdrop of rising UST yields, bond market volatility, stronger dollar and China growth concerns. Tightening of financial conditions has made it challenging for EMs, especially the fundamentally weak and low-rated EMs, to raise debt. Argentina and Egypt have recorded the largest losses YTD in the EM sovereign bond space. As we have highlighted before, EMs with weak external positioning, grappling with high external debt, high short-term debt (% of reserves) and low FX reserve adequacy ratios will continue to remain the most vulnerable to the external volatility. Egypt ranks poor amongst the EMs in terms of its external positioning with research from The Institute of International Finance pointing to a still overvalued Egyptian pound (*Global Macro Views – Our EM exchange rate fair values, IIF, October 6 2022*). Any possible improvement in these weak markets is now conditional of an IMF bailout.

…but these developments act as a reminder that quality-tilt is important

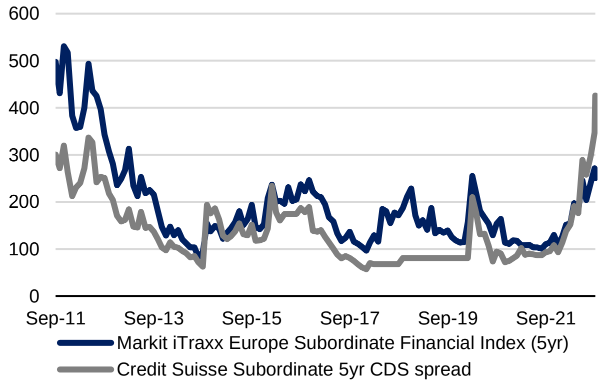
Having said that, we hold a cross-asset underweight position on Europe as a whole. We remain negative on the outlook for the EUR versus the USD and neutral on European IGs and underweight on European HY. In equities, we hold a high conviction underweight position in Europe-excluding-UK and remain negative on Eurozone bank equities. In the emerging markets space, while we hold a neutral stance on EM USD sovereign debt, focus here again should be on EM sovereigns with high credit quality (high quality GCC + Oman, and Brazil). We remain underweight EMs outside Asia in the equity context. From a cross-asset perspective we reiterate our quality-tilt (Quarterly Investment View, July 2022).

Chart 1: Markit iTraxx Europe Senior Financial Index vs Credit Suisse Senior 5yr CDS spread



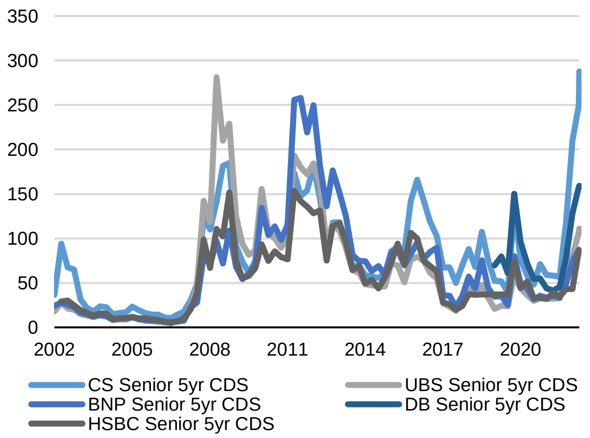
Note: Markit iTraxx Index quoted in spread, the chart shows senior CDS spread for 5yr tenor| Source: Bloomberg, and ADCB Asset Management

Chart 2: Markit iTraxx Europe Sub Financial Index vs Credit Suisse Sub 5yr CDS spread



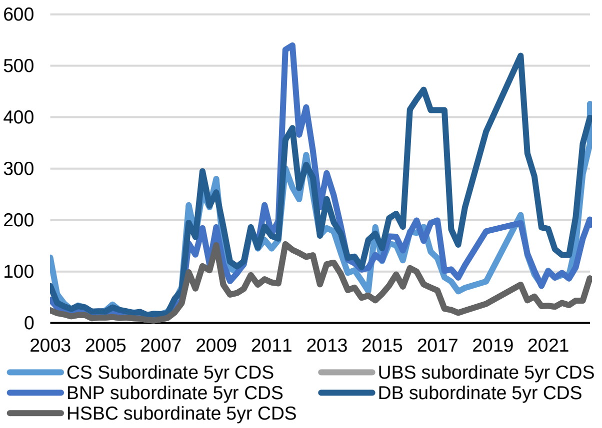
Note: Markit iTraxx Index quoted in spread, the chart shows subordinate CDS spread for 5yr tenor| Source: Bloomberg, and ADCB Asset Management

Chart 3: European banks senior 5yr CDS spread



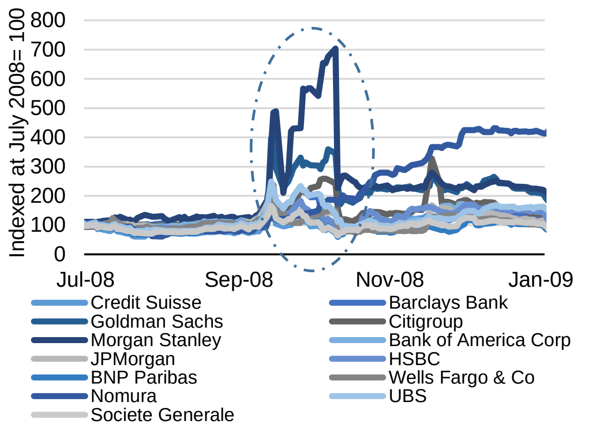
Note: The chart shows 5yr CDS spread of major European banks defined as largest banks by assets across Eurozone and UK; CS= Credit Suisse, DB= Deutsche Bank | Source: Bloomberg, and ADCB Asset Management

Chart 4: European banks subordinate 5yr CDS spread



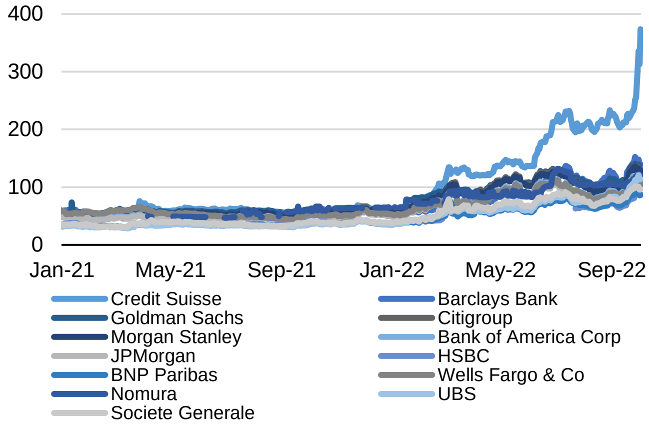
Note: The chart shows 5yr CDS spread of major European banks defined as largest banks by assets across Eurozone and UK; CS= Credit Suisse, DB= Deutsche Bank | Source: Bloomberg, and ADCB Asset Management

Chart 5: Major global banks' 5yr CDS spread (bp) during Lehman Brothers collapse in September 2008



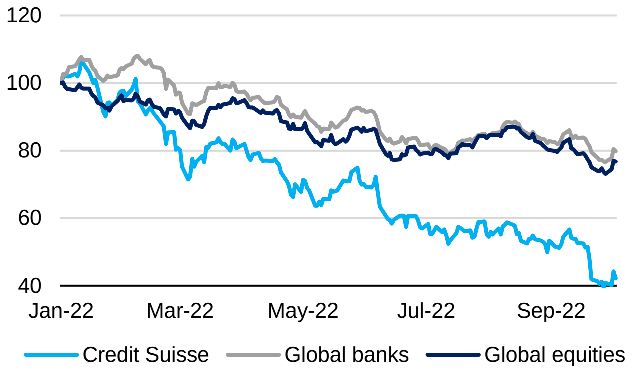
Note: The chart shows 5yr CDS spread of major global banks defined as largest banks by assets across Eurozone, UK, and the US | Source: Bloomberg, and ADCB Asset Management

Chart 6: Major global banks' 5yr CDS spread (bp) since 2021



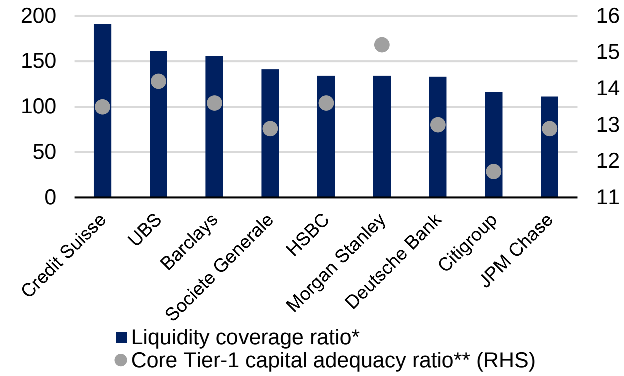
Note: The chart shows 5yr CDS spread of major global banks defined as largest banks by assets across Eurozone, UK, and the US| Source: Bloomberg, and ADCB Asset Management

Chart 7: Stock prices and MSCI indices (USD terms, indexed to 100 at start)



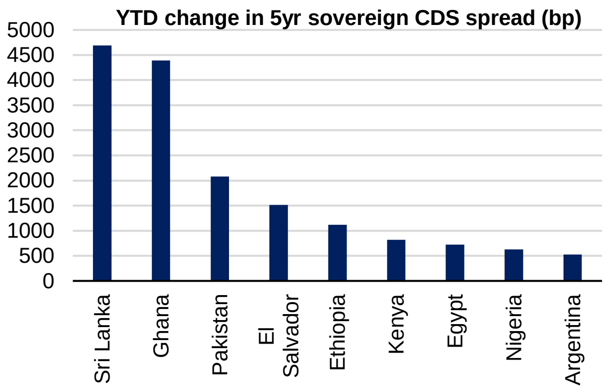
Source: Worldscope, Datastream, Refinitiv, and ADCB Asset Management

Chart 8: Key ratios of large banks (based on assets across Europe and US)



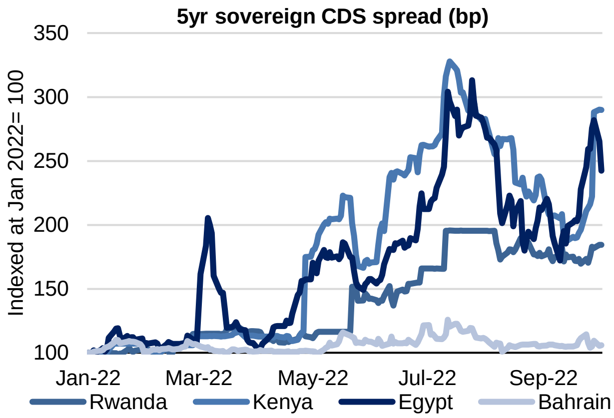
Source: Worldscope, Datastream, Refinitiv, and ADCB Asset Management
Notes: *represents the ratio of liquid assets to a company's net cash outflows expected within 30 days, expressed as a percentage. **reflects the ratio of core Tier 1 capital to total risk-weighted assets, expressed as a percentage. Core Tier 1 capital includes common shareholders' equity, retained earnings, accumulated other comprehensive income and minority interest, excluding goodwill, intangible assets, deferred tax assets, pension plan assets and other adjustments.

Chart 9: EM countries with largest YTD change in 5yr sovereign CDS spread



Source: Bloomberg, and ADCB Asset Management

Chart 10: Egypt 5yr sovereign CDS versus similar rated peers



Source: Bloomberg, and ADCB Asset Management

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