

## September 12, 2022 – Investment Commentary

### Take a Walk on the Positive Side

Last week, the S&P 500 jumped 3.7%, the Nasdaq rose 4.1% and the Dow fell 2.7%, while the Stoxx Europe 600 gained 1.2%. The U.S. 10-year Treasury yield rose 13bps for the week to 3.3%. Stocks broke a string of three weekly losses, as investors appeared to grow more confident that the market had reached at least a temporary bottom after surrendering about half of its summer rally.

In the depths of the euro debt crisis in June 2014, the Mario Draghi-led European Central Bank instituted a historic policy of cutting interest rates below zero in the hopes of spurring economic growth, catalyzing business investment, boosting the labor market, and throwing a lifeline to the weaker economies. Now the European Central Bank raised interest rates from 0% to 0.75% last week attempting to curb inflation and take a walk on the positive side of interest rates. A rate increase that large is rare for the ECB and the most it has ever raised interest rates in a single hike. Eurozone inflation is higher than in the US, increasing 9.1% in August as energy prices are surging in the eurozone amid the war in Ukraine. On Thursday, Fed Chairman Jerome Powell reiterated the Fed's commitment to curb inflation in the US, setting the stage for another 0.75% rate hike later this month. Shorter-term yields climbed on his remarks. St. Louis Fed President James Bullard also said last week that Wall Street is underestimating a scenario in which interest rates have to stay higher for longer to bring inflation back to 2%.

### Keeping It Real

The market expects rate cuts beginning in the middle of next year. The next reading of the Consumer Price Index will be released Tuesday. Last week, rates rose across the curve with the 2 year rising 17bps to its highest level since 2010. The 10 year-2 year is now -25bps, and the 10 year-3 month at 25 bps is maintaining its heading towards recession. Finally, the Investment Office is committed to “keeping it real” by monitoring the 10 year real yield (calculated by subtracting the expected inflation rate from a bond's nominal yield) rose 17bps to 0.89%, its highest level since early 2019 where in April 2022 it turned positive for the first time in in two years. In the current environment, where interest rates were recently at all-time lows and stock valuations high at the end of 2021, rising real rates have been one of the factors leading to a repricing of stocks to sharply lower levels.

### Uncertainty Creates Opportunity

Given the challenges that the global markets have been facing, including geopolitical crisis, inflationary pressures, energy security, China demand weakening and supply chain pressures, Europe has been especially affected by these issues that could lead to a wide-ranging effect for industries and its consumers. This backdrop is creating a stressed credit investment opportunity set in Europe that we believe is increasingly attractive, where many companies may need to reconsider their capital structures while facing declining earnings power. While Europe is under pressure to tackle these challenges, its fragmented nature (i.e. 27 countries, differing legal systems, languages and incentives) creates a challenge for coordinated ECB action and fiscal policy to resolve these issues.

Peripheral bond yields have proved instructive in assessing levels of financial stress across the eurozone. For example, the spread — the difference in yield/cost of funding — between German and Italian bonds has

widened, expressing concern from investors about the creditworthiness of Italy relative to Germany. This counters the ECBs' desire to minimize differentiation between the different member countries' cost of capital — particularly for indebted Italy.

The ECB even went as far as announcing a new “anti-fragmentation tool” designed to reduce this fiscal risk. Not surprisingly, details are yet to be agreed upon and this has led to a spread re-widening at the same time that German yields have risen meaningfully on an absolute basis. The Italian 10 year yield crossed 4% up from 3% a few weeks ago, though the Italian government BTP - German government Bund spread was flat at 2.32%. The Investment Office monitors the spread between the Bund and Italian bond which has widened recently although it is still below the stressed level of 2.50%. For Italy, it is both relative (to the Bund) and absolute (the cost of debt).

### Portfolio Construction

The Investment Office is working with a private alternative manager with investment stressed/distressed credit experience in Europe and the United States that we believe is well positioned to capture the burgeoning opportunity set and may be suitable for certain qualified purchasers.

#### Disclosures

*Investment Commentary Sources: Bloomberg and Morningstar*

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