

GAM Star Fund plc – GAM Star Credit Opportunities (USD)

Marketing material for professional / institutional / accredited investors

Macro backdrop

Subordinated debt markets were fairly strong in December, despite a large rise in interest rates on both sides of the pond. The tone was particularly strong in the first half of the month, as spreads briefly broke through 300 basis points (bps) on Additional Tier 1 (AT1) Contingent Convertible bonds (CoCos) before drifting wider, ending the month 23 bps tighter at 304 bps. Spreads were relatively immune to French political uncertainty and other geopolitical developments, despite President Macron losing a no confidence vote and a surprise downgrade of the French sovereign rating by Moody's. Central banks were again a key driver of sentiment, as the Federal Reserve and European Central Bank's (ECB) 25 bps rate cuts were delivered with a hawkish tone (or less dovish for the ECB), which, combined with concerns around stickier inflation in the US, led to rates moving materially higher. Curves steepened and 10-year government bond yields rose significantly in December, by +40 bps and +28 bps in the US and Germany respectively. Sentiment turned negative in the second half of the month, albeit the impact was muted as technicals remain highly supportive, on a combination of inflows in credit and low supply towards year-end.

Valuations and fundamentals

Regarding credit markets, spreads remain at the tighter end of historical values. This is notably the case for AT1 CoCos which are close to 300 bps above government bond rates. While this could be justified by fundamentals, we know credit markets tend to be cyclical. As such, we believe some caution is warranted. Moreover, extension risk, which looks at the percentage of AT1 CoCos priced to perpetuity or call, is currently around 10%. When market conditions are poor it tends to peak at 100% and when market conditions are very strong, like currently, this percentage tends to approach zero, indicating that valuations are at their tightest. As such, from a risk-return perspective, we believe there is currently more value in Tier 2 and senior bonds from financials.

Key news flow during the month was centred around M&A, which continues to be a positive theme for financial bonds. On the banks side, UniCredit surprised markets by announcing an all-share offer for Banco BPM (potentially creating the number

two player in Italy) while raising its stake in Commerzbank to 28%. Both deals remain subject to considerable uncertainty – as both takeover approaches are hostile and political opposition (especially in Germany) is fierce. The theme of consolidation in the European banking sector remains credit positive, given the need to see the emergence pan-European champions and address fragmentation in the market. On the insurance side, Aviva's takeover of Direct Line led to strong performance of Direct Line Restricted Tier 1s, that were up circa 3% on the month, ending the year with a 26% total return.

In the insurance sector, EIOPA (the European insurance regulator) released the results of the 2024 stress test of European insurers. The results show that the sector would be resilient to an extreme adverse macro and market shock, as European insurers' aggregate Solvency II ratios would remain above minimum requirements, and all insurers would meet regulatory requirements after management actions. The average solvency ratio falls to 140% post management action from 222% (minimum of 100%), with an aggregate excess capital of close to EUR 130 billion in the stress scenario. This showcases the sector's very strong fundamentals and ability to withstand a very severe macro scenario.

Subordinated Debt

There were no new issues in December, in a seasonally quiet month. We expect supply to pick up in January as issuers take advantage of attractive funding conditions as spreads are towards historically tight levels. Issuance is expected to remain a positive technical with limited net supply as issuance is driven by refinancing of upcoming calls/maturities. Banks should remain active in managing upcoming maturities and calls by pre-financing calls/maturities early and engaging in friendly tenders.

Outlook

We remain positive going forward – with attractive yields against a backdrop of very strong credit quality. We continue to see financials as the most attractive part of the market, with rock-solid fundamentals and earnings that have benefitted from the normalisation of interest rates.



Anthony Smouha
Atlanticomnium



Grégoire Mivelaz
Atlanticomnium



Patrick Smouha
Atlanticomnium



Romain Migniac
Atlanticomnium

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4721 08/01/25