

Weekly commentary

If it's too hot, consider buying a CAT

July 25, 2016

by Dan Singleman

Senior Portfolio Manager, Sector Rotation
dan.singleman@fftw.com



Key takeaways

- The CAT market was created in the mid-1990s following hurricane Andrew and the impact it had on the insurance industry, left with substantial losses.
- CAT bonds acted as an additional source of "reinsurance" capital for primary insurers, providing an outlet to transfer excess loss of property to the capital markets.
- The Insurance-Linked Securities market may offer investors a unique opportunity to diversify their portfolio from traditional credit risk.

Full commentary

Financial markets globally climbed last week while continuing to shake off concerns of Brexit, a Turkish coup, economic data and earnings season. Here in the US, local media seemingly oblivious that it is late July, took to the airwaves, social media and print to proclaim that a Heat Dome had arrived across much of the country. But it is not just the US experiencing the heat as Europe too had above average temperatures last week. But nowhere was hotter than Mitribah, Kuwait having reached a sweltering 129.2 degree Fahrenheit (54 Celsius) which is likely the hottest ever recorded temperature outside of Death Valley. These types of headlines almost inevitably came with taglines of global warming and climate change which got me thinking about the Catastrophe Bond market and the opportunities which investors may want to consider.

The Catastrophe Bond (CAT) market was created back in the mid-1990's in the United States following the devastation caused by Hurricane Andrew and the impact it had on the insurance industry. The insurance industry was left with substantial losses and was unable to offer insurance at the same price level prior to the hurricane. What followed was the introduction of the Insurance Linked Securities (ILS) market with CAT bonds being the main component. These bonds acted as an additional source of "reinsurance" capital for primary insurers. This new market provided insurance companies with an outlet to transfer excess of loss property risk to the capital markets. From an investor perspective, the market provides a diversifying asset class less correlated to economic data, corporate business cycles, and bond-holder unfriendly boardrooms. CAT bonds are floating rate fixed income instruments referencing predefined perils. The bonds are structured with trigger mechanisms which determine when a bond would begin taking losses and pay-out formulas, which determine the amount of loss. The two main types of trigger events are Indemnity and Parametric. Indemnity triggers refer to attachment points which can be thought of as different levels of loss subordination. The bonds begin to take principal losses if the issuing insurer realizes pre-defined losses upon certain catastrophic perils occurring.

Corporate bonds primarily compensate investors for default risk while a CAT bond is compensation for a natural catastrophe occurring and trigger losses in excess of insurance loss levels. CAT bond investors have historically received on average 160-340 basis points more spread than similarly rated BB and single-B corporates, respectively. There are a couple of reasons why this anomaly exists. First, the market is relatively small when compared to other similarly rated asset classes and many investors are still unfamiliar with the CAT bond market. Secondly, CAT bonds are only issued to qualified institutional buyers which excludes the retail investor community.

Being a fixed income instrument with a stated coupon, there naturally is some degree of correlation with similarly rated bonds. CAT bond exposure is property reinsurance risk, which is generally not correlated with the macroeconomic or systemic market events as was proven during the 2008/2009 crisis. Corporate bonds are exposed to business cycles, Treasury securities are subject to economic and monetary policy, while the mortgage market is broadly tied to the jobs market and level of interest rates. The total return graph on the following page shows that during periods of market stress where both the Loans and High Yield market had large negative returns, the CAT bond market remained relatively resilient and provided attractive portfolio diversification benefits.

With the US bell weather market proxy, the S&P500, hitting all-time highs and with nearly 90% of the JPMorgan Global Diversified Government Bond Index yielding less than 2%, investors may want to consider diversifying away from hot markets and into something a bit more defensive.



This week's market developments

Tuesday, July 19

- UK CPI growth increased to 0.5% y.o.y. for June
- UK Core CPI growth increased to 1.4% y.o.y. for June
- UK PPI Output growth increased to -0.4% y.o.y. for June
- US Housing Starts increased to 1,189,000 for June

Wednesday, July 20

- UK ILO Unemployment Rate decreased to 4.9% for May
- Eurozone Consumer Confidence (advance estimate) decreased to -7.9 for July

Thursday, July 21

- Japan All Industry Activity Index growth decreased to -1.0% m.o.m. for May
- US Existing Home Sales increased to 5,570,000 for June
- US Leading Index growth increased to 0.3% for June

Friday, July 22

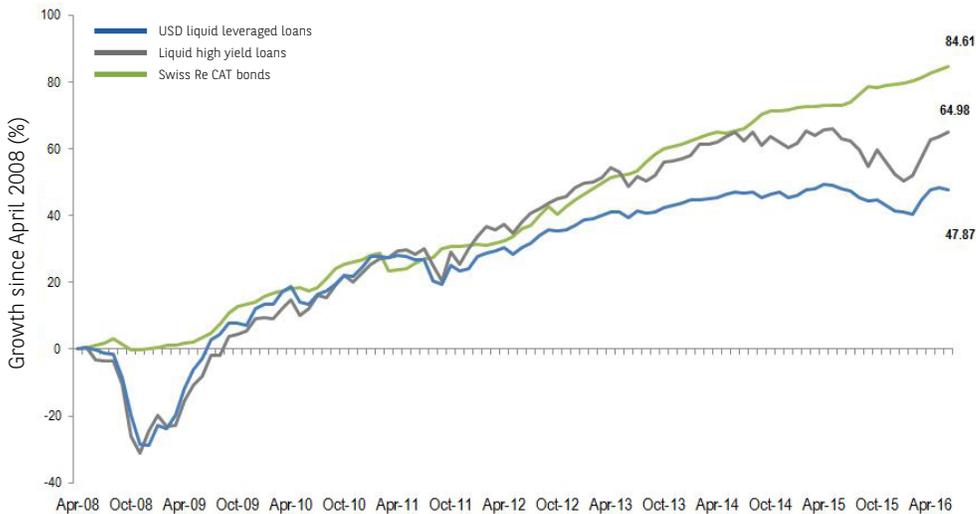
- US Markit Manufacturing PMI (preliminary estimate) increased to 52.9 for July
- Eurozone Markit Manufacturing PMI (preliminary estimate) decreased to 51.9 for July
- Eurozone Markit Services PMI (preliminary estimate) decreased to 52.7 for July
- UK Markit Manufacturing PMI (preliminary estimate) decreased to 49.1 for July
- UK Markit Services PMI (preliminary estimate) decreased to 47.4 for July

Source: Bloomberg, as of end July 25, 2016



Chart of the week

USD liquid leverage loans, liquid high yield loans and Swiss Re CAT bonds growth since April 2008 (%)



Source: Markit iBoxx, Standard & Poors as of June 30, 2016



Next week's market developments

Tuesday, July 26

- US Markit Services PMI (preliminary estimate) is expected to increase to 52.0 for July
- US Consumer Confidence Index is expected to decrease to 96.0 for July
- US New Home Sales are expected to increase to 560,000 for June

Wednesday, July 27

- UK GDP growth is expected to increase to 0.5% q.o.q. for the 2nd quarter
- US Durable Goods Orders growth is expected to increase to -1.3% m.o.m. for June

Thursday, July 28

- Eurozone Consumer Confidence (final estimate) is expected to remain at -7.9 for July
- Japan Jobless Rate is expected to remain at 3.2% for June
- Japan National CPI growth is expected to remain at -0.4% y.o.y. for June
- Japan Industrial Production (preliminary estimate) is expected to increase to 0.5% m.o.m. for June

Friday, July 29

- UK Mortgage Approvals are expected to decrease to 65,800 for June

Source: Bloomberg, as of end July 25, 2016



Central Bank watch

	Last move	Date of move	Current policy rate	Implied 3m rate on March 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.42 %	July 27, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.21 %	September 8, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.01 %	July 29, 2016
BoE	-50 basis points	March 5, 2009	0.50 %	0.35 %	August 4, 2016

Source: Bloomberg

Disclaimer

Bloomberg is the source for all data in this document as of July 22, 2016 unless otherwise specified. This material is issued and has been prepared by Fischer Francis Trees & Watts* a member of BNP Paribas Investment Partners (BNPP IP)**. This document is confidential and may not be reproduced or redistributed, in any form and by any means, without Fischer Francis Trees & Watts' prior written consent. This material is produced for information purposes only and does not constitute: 1. an offer to buy nor a solicitation to sell, nor shall it form the basis of or be relied upon in connection with any contract or commitment whatsoever; or 2. any investment advice. Opinions included in this material constitute the judgment of Fischer Francis Trees & Watts at the time specified and may be subject to change without notice. Fischer Francis Trees & Watts is not obliged to update or alter the information or opinions contained within this material. Fischer Francis Trees & Watts provides no assurance as to the completeness or accuracy of the information contained in this document. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Investment strategies which utilize foreign exchange may entail increased risk due to political and economic uncertainties. Investors should consult their own legal and tax advisors in respect of legal, accounting, domicile and tax advice prior to investing in the financial instrument(s) in order to make an independent determination of the suitability and consequences of an investment therein, if permitted. Please note that different types of investments, if contained within this material, involve varying degrees of risk and there can be no assurance that any specific investment may either be suitable, appropriate or profitable for a client or prospective client's investment portfolio. Given the economic and market risks, there can be no assurance that any investment strategy or strategies mentioned herein will achieve its/their investment objectives. Returns may be affected by, amongst other things, investment strategies or objectives of the financial instrument(s) and material market and economic conditions, including interest rates, market terms and general market conditions. The different strategies applied to the financial instruments may have a significant effect on the results portrayed in this material. The value of an investment account may decline as well as rise. Investors may not get back the amount they originally invested. Past performance is not a guarantee of future results. The information contained herein includes estimates and assumptions and involves significant elements of subjective judgment and analysis. No representations are made as to the accuracy of such estimates and assumptions, and there can be no assurance that actual events will not differ materially from those estimated or assumed. In the event that any of the estimates or assumptions used in this presentation prove to be untrue, results are likely to vary from those discussed herein. This document is directed only at person(s) who have professional experience in matters relating to investments ("relevant persons"). 1 Any person who is not a relevant person should not act or rely on this document or any of its contents. The performance data, as applicable, reflected in this material, do not take into account the commissions, costs incurred on the issue and redemption and taxes. * Fischer Francis Trees & Watts, Inc. is registered with the US Securities and Exchange Commission as an Investment adviser under the Investment Advisers Act of 1940. BNP Paribas Investment Partners UK Limited, is authorized and regulated by the Financial Conduct Authority. Registered in England No. 02474627, registered office: 5 Aldermanbury Square, London, England, EC2V 7BP, United Kingdom. FFTW is a brand name of BNP Paribas Investment Partners UK Limited in the UK. BNP Paribas Investment Partners Singapore is registered with the Monetary Authority of Singapore for the conduct of Fund Management business and is the holder of a Capital Markets Services License. BNP Paribas Investment Partners Singapore is also registered with the US Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940, as amended. References in this material to Fischer Francis Trees & Watts Singapore are to the registered business name (Business Reg. No. 53207544K) of BNP Paribas Investment Partners Singapore Limited (Co. Reg. No. 199308471D). ** BNP Paribas Investment Partners is the global brand name of the BNP Paribas group's asset management services. The individual asset management entities within BNP Paribas Investment Partners if specified herein, are specified for information only and do not necessarily carry on business in your jurisdiction. For further information, please contact your locally licensed Investment Partner. For investors located in the United Kingdom, any investment or investment activity to which this document relates is available only to and will be engaged in only with Professional Clients as defined in the rules of the Financial Conduct Authority.