Cape Fixed Income Weekly

Cape Capital

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Risk Off Continues

Risk-off continues due to geopolitical tension and hawkish central banks, Credit spreads have shown relatively less weakness compared to equities

Spread valuation back to 2020 level and screens now fair valued to cheap, though tightening monetary policy and exogenous geopolitics weigh on investor appetite and valuation expansion

Surging utility bills likely to further deteriorate given geopolitical tension, idiosyncratic risk may rise within the utility segment which has an important weight in the credit universe

Outflow seen in both IG and HY while leveraged loans and CLOs have seen inflows YTD, we continue to believe that the floating rate feature and low default environment will benefit the asset class in the current regime

Table 1: Performance overview

		Change			
	18-Feb-22	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	126	7	13	27	31
BBB	143	8	14	30	35
IG-ex BBB	49	2	7	12	11
EUR HY Corp spread (bp)	397	17	29	79	79
BB	308	12	29	64	66
Capital Structure spread (bp)					
Bank AT1	381	6	12	47	59
Bank Tier 2	182	8	18	43	52
Corporate Hybrids	272	22	29	47	73
Sub Insurance	227	14	27	49	61
ETF Total return					
EUR IG ETF (IEAC)		0.2%	-0.9%	-2.6%	-3.6%
EUR HY ETF (IHYG)		-0.3%	-1.4%	-3.2%	-3.9%
USD IG ETF (LQD)		-0.9%	-2.4%	-3.3%	-6.6%
USD HY ETF (HYG)		0.3%	-1.4%	-2.8%	-4.4%
***Cape Fixed Income Fund (EUR B Inst.)**		-0.4%	-1.2%	-1.7%	-2.0%
***Cape Fixed Income Fund (USD B Inst.)**		-0.4%	-1.2%	-1.6%	-1.9%

* as of Feb 17th 2022

		Change			
	18-Feb-22	1 Week	2 Weeks	1 Month	YTD
iTraxx Europe OTR (5 year, bp)*					
Main	71	4	6	18	15
Xover	346	20	31	84	73
Snr Fin	80	4	7	18	18
Sub Fin	151	10	13	33	30
CDX OTR (5 year, bp)*					
CDX IG	69	1	5	13	13
CDX HY	370	1	14	53	77
Govt. bond yield (bp)					
10 year US yield	193	-1	2	6	42
10 year Bund yield	19	-10	-1	20	37
10 year Gilt yield	138	-17	-3	12	41
10 year BTP yield	184	-11	9	50	67
BTP - Bund spread	165	-1	11	30	30

*since index roll

Source: iTraxx, iShares, Bloomberg as of Feb 18th 2022

Uncertainty continues to rise given the geopolitical tension, coupled with more hawkish tones from both the US and European central bank, the risk-off sentiment has been sweeping the financial markets. The typical haven assets outperformed while equities tumbled yet another week following previous weeks' mixed earnings. Credit spreads, while softened due to rising cross-asset correlation, have shown relatively less weakness compared to equities.

In terms of credit valuation, spreads on average are close to Sep/Oct-2020 levels (before the vaccine was first introduced) and for the lower-yielding higher quality names where rates are more dominant in total return, spreads have surged back to summer 2020 levels. On a standalone basis, credit is fair valued to cheap given healthy fundamentals. Nevertheless, tightening financing conditions and exogenous geopolitical tension weigh on investor appetite (seen in fund flow) and valuation expansion.

We touch briefly on energy prices in the light of geopolitical tensions; the potentially even higher energy prices from current elevated levels are likely to further press the profit margin for utility intense parts of corporates as well as headline inflation reading. For credit investors, given the high weight of the utility sector within the credit universe (especially within the hybrid universe), we keep a close eye on the development of credit metrics (leverage, CAPEX and operating cash flow) within the sector. Idiosyncratic risk could rise due to different forms of energy sources used in electricity generation as well as local government regulation on electricity pricing mechanics.

Fund flow wise, continuous outflow has been witnessed in both IG and HY while the latter has seen a relatively larger percentage of asset outflow. Relative to the benchmarked IG community, active mandates and HY investor community (mostly total return mandate rather than spread performance) tend to have a more flexible mandate and therefore more alternative investment vehicles available at hand to invest in floating rate products to mitigate / benefit from rising rates (ie. higher coupon for investors). As such, leveraged loans and CLOs in turn have seen a meaningful inflow YTD. Though the secondary market pricing of CLO tranches is not immune to broader market risk-off sentiment, the feature of floating rate and the ongoing low default rate environment have set a promising background for the asset class to outperform in the current regime. We continue to like this asset class and are positioned within the IG part of the tranches.

On the portfolio side, consistent with our recent communication, we remain at the front end of the credit curve across all segments. The current portfolio risk level (DTS: duration times spread) is at its multi-year low as we prioritize reducing drawdown risk given elevated macro uncertainty.

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