Cape Fixed Income Weekly

Cape Capital

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Global Bond Markets: Down-but-not-Out

- With the 10y UST trading around 2.9% ytm it is roughly 4 standard deviations above its 1y moving average and exactly at the top end of the downtrend which has started in the early 80s. IG credit spreads in EU and the US have widened significantly and already price in a recessionary environment. Is this a combination to buy? – We still recommend a cautious positioning, but the market might hit "underweight – overhedged" soon.
- The lack of places to hide puts Global Bonds as an asset class in a heightened competition with the Money Market Asset Class in a world where holding cash may not hurt any longer on a nominal level. As rates and credit provide poor diversification benefits to equities in an Anti-Goldilocks world the "cash allocation" instead of bonds has become the "new diversification". While it may be too early to call a relief for bonds, we think that the rates/credit vs. equity correlation has peaked and more dispersion within credit is ahead of us.
- The Q1 GDP contraction has surprised the market, but it is unlikely to change the Fed's outlook. The most important component, private domestic demand, has grown at an annualized rate of 3.7%. This is rather strong considering the current inflation rate which erodes some of the purchasing power.

Table 1: Performance overview

		Change			
	29-Apr-22	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	151	13	17	24	56
BBB	173	14	19	26	66
IG-ex BBB	54	4	3	7	16
EUR HY Corp spread (bp)	450	46	40	63	132
BB	354	36	33	52	112
Capital Structure spread (bp)					
Bank AT1	447	44	40	65	125
Bank Tier 2	224	23	30	44	94
Corporate Hybrids	299	25	18	55	100
Sub Insurance	265	25	30	48	99
ETF Total return					
EUR IG ETF (IEAC)		-0.4%	-1.4%	-2.4%	-7.9%
EUR HY ETF (IHYG)		-1.6%	-2.1%	-3.6%	-7.9%
USD IG ETF (LQD)		-0.7%	-2.4%	-6.9%	-14.6%
USD HY ETF (HYG)		-0.9%	-2.1%	-4.5%	-8.7%
*Cape Fixed Income Fund (EUR B Inst.)		-0.7%	-0.8%	-1.4%	-4.6%
*Cape Fixed Income Fund (USD B Inst.)		-0.7%	-0.8%	-1.3%	-4.3%

* as of Apr 28th 2022

		Change			
	29-Apr-22	1 Week	2 Weeks	1 Month	YTD
iTraxx Europe OTR (5 year, bp)*					
Main	90	8	11	17	35
Xover	428	40	53	91	179
Snr Fin	102	11	14	21	40
Sub Fin	197	24	30	45	82
CDX OTR (5 year, bp)*					
CDX IG	84	4	11	17	27
CDX HY	461	27	54	90	161
					*since index roll
Govt. bond yield (bp)					
10 year US yield	293	3	11	58	142
10 year Bund yield	94	-3	10	29	112
10 year Gilt yield	191	-6	2	24	93
10 year BTP yield	277	10	29	65	160
BTP - Bund spread	184	14	19	35	48

Source: iTraxx, CDX, iShares, Bloomberg as of April 29th 2022

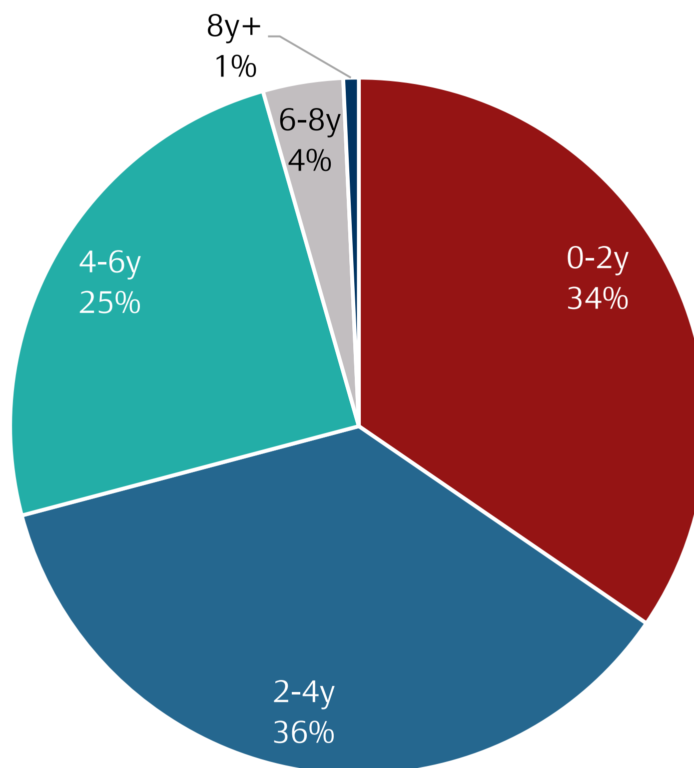
Looking at seasonality within the Fixed Income Markets, "April" typically stands out as a strong month with both credit spreads tightening and interest rates falling. The 2022-version turned out to be the opposite and has caused substantial losses with US IG down -6% (!) for the month while EU IG dropped around -2.5%. Since the focus on growth deceleration has escalated throughout the month, High Yield corrected by another -3%. We are convinced that valuations from a fundamental point of view (micro) look rather "OK" at these levels but not necessarily vs. the inflation-growth mix. However, as opposed to the past, we think that investors will not buy into the bond markets where valuations are just about compensating the aggregate risk level. One of the major reasons is the heightened cross-asset correlation with a lack of diversification benefits coming from the Fixed Income asset class (please see chart below, Equity/IG correlation). In other words: The asset class has to be outright "cheap" to be investable and the current correction is therefore not necessarily a consequence of heavy selling but more one of a buyer strike. High cash balances are not deployed even if valuations have re-priced to a satisfactory level based on historical comparisons. Nominal rates are used to discount cash flows from financial assets and these nominal rates trade far away from spot inflation and inflation expectation. With this huge gap in mind for both bonds and money market in one, and with the "soon-positive-money market rates" investors can hoard cash at lower opportunity costs. Hence, in the

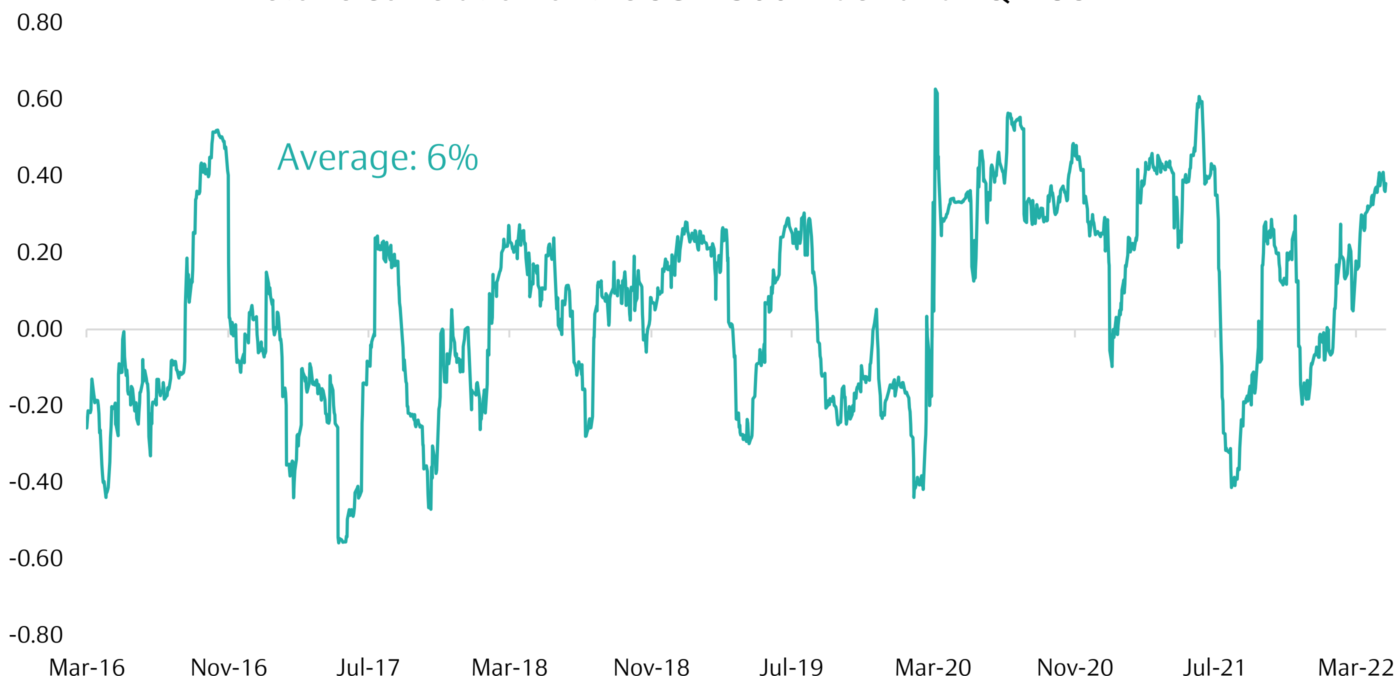
absence of diversification benefits the median investor demands an additional pick-up in (real) yield terms within the Fixed Income asset class. While we think that the rates and credit markets will remain volatile, and a healthy degree of caution is more than justified, we expect the rates/credit vs. equity correlation to ease somewhat providing some relief to the risk-parity methodology. This should ultimately support the asset class to a certain degree.

With Central Banks signalling decisive actions, the focus should start to move away from inflation in favour of (slowing) growth. This should support the thesis of "peak correlation" described above. However, in parallel this could trigger a wave of de-compression (IG credit outperforming HY) contrary to Q1-2022. Hence, from a portfolio management point of view we prefer strong issuers but would continue to moderately and selectively increase credit duration, albeit at a very slow pace as the level of uncertainty stays elevated. In spite of this, the bulk of the credit duration remains within the 2-4y space which is the natural "home" for the Cape Fixed Income Fund (as can be seen from the pie chart below). De-compression should help stronger issuers while additional risky asset shocks would lead to a moderate credit curve flattening (1-2y tenors underperforming vs. the rest on a beta adjusted level) while in more friendly scenarios the "belly" (around 5y) should perform well.

The long awaited Q1 GDP figures showed a contraction (-1.4%) which was a surprise. However, within the clearly positive private domestic demand the consumption was up +2.7% (in real terms) and capex +9.2% which are the most positive prints since Q2-2021. No doubt, the headline print was a clear miss, but there seems to be less demand destruction in the Q1-2022 numbers than expected. While this can be seen as a small positive from a growth perspective it only adds to the rate hike pressures on the part of the Fed.

- Current Credit Duration allocation within the Cape Fixed Income Fund:





** iShares iBoxx $ Investment Grade Corporate Bond ETF*

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