Cape Fixed Income Weekly

Cape Capital

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Credibility vs. Growth: 1:0

- Long-term inflation expectations re-priced lower, 5y5y US Inflation Swap trades below 1y average
- 1H-2022 has seen extremely high losses for global Fixed Income markets, IG credit (US & EU) valuations are attractive – and will likely stay attractive if X-asset correlation stays high.

Table 1: Performance overview

		Change			
	01-Jul-22	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	216	15	19	53	121
BBB	251	19	25	63	143
IG-ex BBB	66	4	3	9	28
EUR HY Corp spread (bp)	660	72	108	181	342
BB	517	60	88	153	276
Capital Structure spread (bp)					
Bank AT1	573	35	48	129	251
Bank Tier 2	299	19	19	65	169
Corporate Hybrids	531	105	154	219	332
Sub Insurance	373	31	45	98	207
ETF Total return					
EUR IG ETF (IEAC)		0.6%	1.7%	-2.6%	-11.5%
EUR HY ETF (IHYG)		-1.6%	-1.1%	-5.8%	-13.8%
USD IG ETF (LQD)		1.2%	1.8%	-1.8%	-15.1%
USD HY ETF (HYG)		-1.0%	0.3%	-5.8%	-13.0%
EUR Corp. Hyb. ETF (EHYB)		-3.9%	-4.2%	-9.4%	-18.8%
*Cape Fixed Income Fund (EUR B Inst.)		-1.0%	-1.2%	-3.9%	-9.2%
*Cape Fixed Income Fund (USD B Inst.)		-1.0%	-1.1%	-3.7%	-8.7%

* as of June 30th 2022

		Change			
	01-Jul-22	1 Week	2 Weeks	1 Month	YTD
iTraxx Europe OTR (5 year, bp)*					
Main	121	11	9	31	65
Xover	591	57	27	145	341
Snr Fin	132	12	9	33	70
Sub Fin	251	25	18	62	136
CDX OTR (5 year, bp)*					
CDX IG	101	7	1	20	44
CDX HY	577	48	1	111	277
					*since index roll
Govt. bond yield (bp)					
10 year US yield	288	-25	-35	-3	137
10 year Bund yield	123	-21	-43	5	141
10 year Gilt yield	209	-22	-41	-7	112
10 year BTP yield	308	-36	-50	-12	191
BTP - Bund spread	185	-15	-7	-17	50

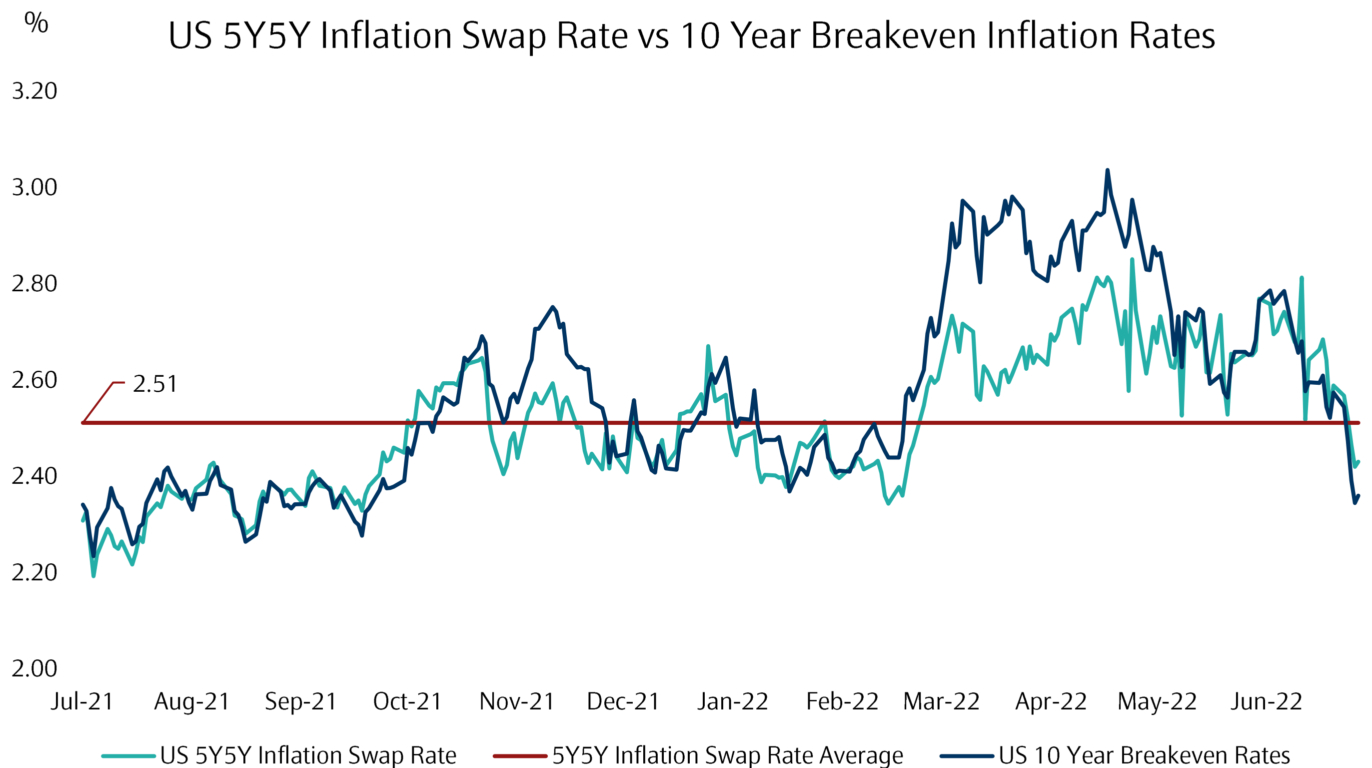
Source: iTraxx, CDX, iShares, Bloomberg as of July 1st 2022

The first half of the year is over, and the market got an impression of what it means when the "DJ" leaves the party at its peak. Last week saw another sharp re-pricing of credit risk amid growing recession fears. As we discussed in the last "Cape Weekly" the narrative has shifted away from inflation and the highly regarded 5y5y USD inflation swap dropped by 15bps for the week, currently trading below the 1y average (see chart below). While the 5y5y inflation swap represents a longer-term inflation expectation, it is widely used as a credibility measure (i.e. tells policymakers whether markets are convinced a Central Bank has the tools to keep the inflation rate within its set target) and we currently think it is all about credibility. Medium to long-term breakeven inflation rates (the expected inflation which is priced into inflation-linked government bonds) moved close to the 2% area in the US and EU, i.e. the market has looked past the inflation question but is still lacking short-term visibility regarding the pace at which inflation subdues per unit of rate cut. The efficacy of policy transmission is the key component, as it determines the path of growth where the variety of different outcomes screens very high. "Growth falling faster than inflation" was the narrative last week, which caused a sharp re-pricing lower in rates and a corresponding flight into safe havens. The major challenge at this stage is that growth is only a by-product but not a target for most major Central Banks. By frontloading of the rate hikes Central Banks are galvanized by the market's re-pricing of future growth…i.e., the hit to growth is accepted, or better: weaker growth does not mean less hikes, fueling additional recession fears. As a result, we see US forwards starting to price in the first rate cuts in the second half of 2023, which can be interpreted in two ways: i) market is buying into the peak inflation narrative and a "not so hard landing" can be achieved as CB's can start focusing on repairing; ii) market agrees with the FED that in order to have inflation topping out, front-loading of hikes at the expense of a recession has to take place. The latter currently seems more likely. German inflation came in a bit lower than expected (7.6% YoY vs. 7.9% expected) but this may have been a result of the introduction of the 9 Euro public transport ticket, which will revert in September. As Central Bankers have completely changed to a data-only policy this does not imply a lower frequency of hikes.

That said, even with the growth-inflation dilemma in mind, current IG credit valuations deserve a close look. More defaults than the highest historical realized default rates are currently priced in. Accounting for the overly solid credit, solvency, liquidity measures and the already bearish investor positioning, the asset class has reached a level where many segments screen outright "cheap". IG benchmarks lost 12-16% in 1H-2022 which is one of the most severe drawdowns in a century in price terms. While in the absence of

defaults, IG credit returns are more or less mean reverting, the correction based on interest rates starting from negative territory may be of permanent nature. In some of our past "Cape weekly's" we were looking at bond-equity correlation which we think is crucial at this point. A low-carry asset class (EUR, USD) has to diversify equity risk in a balanced mandate context, and if it does not diversify it must be a high-carry asset class, i.e. valuations *have* to be and stay attractive. General ETF/Benchmark-driven flows were negative YTD, and we believe this may revert to a certain degree once the bond-equity correlation comes down from high positive levels. Hence, as this has not been the case, credit must stay attractive or become even more attractive.

On Fins and Corps: With most of the banks going into blackout period, we have seen only one T2 issued (by Generali) on the insurance side. DNB is scheduled to open the 2Q 22 European bank earnings season on 12 July. UBS announced a consent solicitation to replace LIBOR in the bond language of its USD 7.00% and 6.875% AT1s without offering any fee for bondholders. Regarding ratings, while Commerzbank's senior rating was downgraded by Moody`s (driven by its lower loss absorbing debt buffer), Virgin Money's upgrade made its T2s IG eligible for all indices. On the insurance side, despite Utmost getting upgraded by Fitch (resulting in its T2 going to IG) there was no follow through on the bond price. On the regulatory front, the ECB indicated that it may demand banks to rethink their dividend plans amid the recession risk, however we do not expect that it would ban the coupon payments on AT1s.



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