Cape Fixed Income Weekly

Cape Capital

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Forward Guidance: Out and Over

- Powell increases by 75bps to "gain flexibility later on this year", says that 75bps will not be common practise
- ECB discusses anti-fragmentation tool during emergency gathering which took place only a few days after the last official meeting, pointing to the heightened stress level

Table 1: Performance overview

		Change			
	17-Jun-22	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	197	27	34	33	102
BBB	226	30	37	38	118
IG-ex BBB	63	2	6	8	25
EUR HY Corp spread (bp)	552	68	73	67	234
BB	429	61	64	52	187
Capital Structure spread (bp)					
Bank AT1	524	66	81	46	203
Bank Tier 2	280	33	46	49	150
Corporate Hybrids	377	61	65	51	178
Sub Insurance	328	50	53	38	162
ETF Total return					
EUR IG ETF (IEAC)		-1.5%	-4.2%	-4.6%	-12.9%
EUR HY ETF (IHYG)		-2.2%	-4.8%	-4.4%	-12.8%
USD IG ETF (LQD)		-1.0%	-3.6%	-1.7%	-16.7%
USD HY ETF (HYG)		-2.1%	-6.1%	-2.2%	-13.3%
*Cape Fixed Income Fund (EUR B Inst.)		-2.1%	-2.6%	-2.6%	-8.0%
*Cape Fixed Income Fund (USD B Inst.)		-2.1%	-2.5%	-2.4%	-7.5%

* as of June 16th 2022

		Change			
	17-Jun-22	1 Week	2 Weeks	1 Month	YTD
iTraxx Europe OTR (5 year, bp)*					
Main	112	12	23	15	57
Xover	563	62	117	96	314
Snr Fin	123	13	24	16	61
Sub Fin	234	23	44	31	118
CDX OTR (5 year, bp)*					
CDX IG	100	8	19	9	43
CDX HY	576	44	110	57	275
					*since index roll
Govt. bond yield (bp)					
10 year US yield	323	7	29	34	172
10 year Bund yield	166	14	39	63	184
10 year Gilt yield	250	5	34	63	153
10 year BTP yield	358	-18	19	62	241
BTP - Bund spread	193	-32	-20	-1	57

Source: iTraxx, CDX, iShares, Bloomberg as of June 17th 2022

Amid relatively large bearish moves last week, the investment narrative clearly shifted from "peak inflation – soft landing" to a serious fear that inflation has de-anchored and economic contraction is unavoidable. Central Banks made it clear last week that they are in the "frontloading camp" meaning growth/cycle has become the output rather than the target. While the FED meeting on Wednesday was the most anticipated one, the SNB hiked by 50bps (first hike in 15 years as well as the first change in monetary policy in 7 years) and the pressure on the ECB is mounting. The forward guidance from the FED has drastically shifted to a day-to-day observation of hard data. With hiking by 75bps, Chair Powell tried to regain control and weakened the action by stating that 75bps hikes will not be common practice which was a relief for global rates markets, as there was a certain acknowledgement that front-loading is needed to fight inflation and to "gain flexibility later on in the year". Across the pond, the ECB addressed the fragmentation risks on a sovereign level on the back of tighter financial conditions. As we have argued during our last "weekly" publication, we expect the market to test the ECB's reaction to the BTP-Bund spread. The activation of the PEPP reinvestment flexibility should lead to tighter intra-EGB spreads as the ECB would purchase peripheral debt at the expense of core debt. While this will calm down the market to a certain degree it will ultimately not "be enough". Beyond the initial bullish reaction in the market, the PEPP reinvestment tool can be sufficient to backstop Greece but not a larger and highly indebted country like Italy. So, it is questionable that the "confidence"-dynamics the ECB is trying to trigger will continue in peripheral spreads, especially as the PEPP reinvestments amount to max. 25bn per month if not frontloaded. So, everything will depend on the new tool, an Anti-Fragmentation Purchase Facility (AFPF) of which details are not yet public. What is making markets nervous is the fact that emergency meetings are held very shortly after official ECB meetings (similar to the March 12th, 2020 meeting which was followed by an emergency meeting on March 18th, 2020).

Clearly, these are unprecedented times for fixed income investors, as global benchmarks are down between (-12%) and (-20%). Essentially none of the liquid segments are immune against Central Bank induced volatility. The Cape Fixed Income Fund has the advantage of maintaining a lower interest rate duration than benchmarks (1-2y) while targeting a medium-term credit duration to profit from carry, rolldown and potential spread tightening. While we expect the current volatility to stay, we highlight the relatively attractive spread levels of subordinated bonds of top-quality issuers (i.e. Merck, Total, Iberdrola).

On a corporate or financial level, Intesa announced the results of its consent solicitations – managed to pass it on its EUR 7.75% PN27 AT1 but had an unsuccessful outcome on the EUR 6.25% PN24 AT1 (given that it could have posed extension risk for bondholders

with the bank having no right to exercise a regulatory par call until after the first call date as it is grandfathered until June 2025). On the regulatory front, the Bank of England released its resolvability assessments on UK banks. While this was not a fail/pass exercise and was not market moving as such, the message is supportive for legacies in general. Regarding rating actions, Groupama got upgraded, taking the bonds to the same rating level with CNP and Sampo got a positive outlook, taking its T2 just half a notch away from the 'A bucket'. Finally, the M&A stories continued with headlines that the Dutch government is looking to sell ABN, seeing interests from BNP and other European lenders. In addition, CS surprised the market and announced calling its USD 7.125% AT1, despite it being uneconomic (!). In CS we stayed side-lined given the ongoing headline risks associated with the name.

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