Cape Fixed Income Weekly

Cape Capital

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Unconditional – for a good recession

- Powell: Committed to deal with inflation in an "unconditional manner".
- ECB's anti-fragmentation tool: Don't interpret this as a dovish sign, the anti-fragmentation tool opens the door for what is inevitable even in Europe: frontloading rate hikes

Table 1: Performance overview

		Change			
	24-Jun-22	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	201	4	31	31	106
BBB	232	7	37	37	125
IG-ex BBB	62	-1	2	5	24
EUR HY Corp spread (bp)	588	36	104	77	270
BB	457	28	89	62	215
Capital Structure spread (bp)					
Bank AT1	538	13	79	41	216
Bank Tier 2	280	0	33	40	150
Corporate Hybrids	426	49	109	84	227
Sub Insurance	342	15	64	45	176
ETF Total return					
EUR IG ETF (IEAC)		1.1%	-0.5%	-3.7%	-12.0%
EUR HY ETF (IHYG)		0.5%	-1.7%	-4.2%	-12.4%
USD IG ETF (LQD)		0.6%	-0.4%	-3.8%	-16.2%
USD HY ETF (HYG)		1.3%	-0.8%	-3.9%	-12.1%
*Cape Fixed Income Fund (EUR B Inst.)		-0.2%	-2.0%	-2.5%	-8.3%
*Cape Fixed Income Fund (USD B Inst.)		-0.1%	-1.9%	-2.4%	-7.8%

* as of June 23rd 2022

		Change			
	24-Jun-22	1 Week	2 Weeks	1 Month	YTD
iTraxx Europe OTR (5 year, bp)*					
Main	109	-3	10	15	54
Xover	534	-30	33	71	285
Snr Fin	120	-3	9	15	57
Sub Fin	227	-7	16	27	111
CDX OTR (5 year, bp)*					
CDX IG	94	-6	3	12	37
CDX HY	529	-47	-3	48	228
Govt. bond yield (bp)					
10 year US yield	313	-10	-3	38	162
10 year Bund yield	144	-22	-8	49	162
10 year Gilt yield	230	-20	-15	39	133
10 year BTP yield	344	-15	-32	49	227
BTP - Bund spread	200	7	-24	0	65

*since index roll

Source: iTraxx, CDX, iShares, Bloomberg as of June 24th 2022

"The job of the Central Bank is to worry" (Alice Rivlin) – and there is no doubt that the Fed takes inflation seriously and therefore the market's focus *has* shifted from "where is inflation peaking" towards "how deep will the next recession be", especially after poor consumer confidence and PMI figures. Central Banks must choose the lesser of two evils and at least the Fed prefers -outspoken or not- an economy in recession vs. the risk of permanent inflation. As medium to longer term inflation expectations are slightly above normal levels (an inverted inflation expectations-curve during times with elevated inflation should be normal if CBs preserve their credibility), the Fed can't make any compromises and is forced to act harshly, essentially decoupling from the traditional policy of assisting the economy. During Powell's testimony at the congressional hearing last week, he reiterated his commitment to dealing with inflation in an unconditional manner. Since growth is an output rather than a target during these challenging times, the interest market has started to price in rate cuts in the expectation of a mild recession in 2023/2024. The forward rates of shorter dated tenors give a good indication of the market's expectation in terms of severity of the recession, which is currently relatively mild. Same goes for the ECB and the recent announcement to tackle fragmentation within the EU sovereign bond space which should not be taken as a dovish action. We think the opposite is true as it allows the ECB to hike through the neutral rate without the Italy-noise, in line with the global "frontloading reflex" among CBs. As we have written in previous "Cape weekly's" the market needs to "look through" for a more sustained rebound even though parts of the credit market started to look attractive (i.e. European IG credit risk, non-cyclical). We would argue that the market has gained a kind of "look through" in terms of the inflation cycle -albeit not knowing the altitude of the inflation-mountain to be climbed- but not yet on growth, so the "sell-the-strength" narrative is still alive. Hence, while inflation on a standalone basis favours HY over IG we think the opposite is true for the current phase where the market is focusing on adjusting to the growth slowdown/recession reality.

What does this mean for credit as an asset class? Credit does not need stellar growth (perspectives) and typically performs relatively well in a low-growth environment but screens very vulnerable when the market starts to price in a growth slowdown – irrespective of the starting point. Due to uncertainty on the depth of the slowdown, the equity-delta imbedded in credit risk is rising sharply. Consequently, investors are moving up the rating scale and are triggering de-compression across the board. There is no doubt, the market and global investors are currently facing such a phase but they have entered it in a far more bearish sentiment than previous cycles. Investors are holding (record) high cash balances, even surpassing March 2020 levels. This explains why hedging activities and the price for out of the money credit options remain relatively contained, i.e. people are not hedging despite extreme bearishness and

forced selling is not occurring in spite of the severe market moves within global fixed income and that's at least a move in the right direction. In addition, looking at default rates priced into EU IG, credit continues to look very attractive for medium term investors as a > 3-fold of the historic highest loss realisation rate is already priced into spreads.

To provide further information on Financials: The Fed published its 2022 stress test results on Thursday. While it is a US bank stress test, we note that 6 European banks were also included (via their US subsidiaries) with CS & HSBC US subsidiaries seeing the biggest CET1 drop under the adverse scenario. With this soft market tone, we have seen limited subordinated deals on the primary market this week. Barclays surprised the market with a new GBP AT1 (printing at 8.875%), which raised the call probability on BARC 7.875% despite it being non-economic. The company also announced that it would acquire Kensington Mortgages from Blackstone for GBP 2.3bn by financing the deal from internal resources, resulting in a 12bp negative impact on its CET1 Ratio. The M&A stories continued with Jyske announcing to buy Svenska's Danish operations and financing the deal with DKK 2.5bn AT1 and T2 issuance. Elsewhere, AIB announced selling another NPL portfolio which is expected to have a 40bp positive impact on its CET1 ratio and help improve on its credit rating (which is one notch away from IG from Fitch on its T2 currently and a potential Fitch upgrade could move its composite rating to IG). On the insurance side, Zurich agreed to sell its legacy traditional life insurance back book in Germany to Viridium Holding, which is expected to add 8ppt on solvency and reduce sensitivity. While this is positive for the fundamentals, we note regarding the technicals that ZURNVX T2 bondholders are facing supply risk.

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