Cape Fixed Income Weekly

Cape Capital

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Growth vs. Inflation Dilemma

- U turn in Chinese tech stocks triggered by a pledge from the Chinese authority to support the economy and the (global) markets; geopolitical headlines have brought some cautious optimism among investors.
- Fed announced a 25bps lift-off and hawkish stance for the rest of the hiking cycle; dynamic between growth and inflation remains a major concern for the market.
- Risk is still skewed towards the downside despite the recent rebound. However, in some non-cyclical segments we bought into the current weakness and have slightly increased credit duration.

Table 1: Performance overview

		Change			
	18-Mar-22	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	146	-7	-5	22	51
BBB	165	-8	-5	25	57
IG-ex BBB	52	-4	-9	4	14
EUR HY Corp spread (bp)	438	-17	-27	51	120
BB	342	-16	-23	43	100
Capital Structure spread (bp)					
Bank AT1	429	-29	-57	58	107
Bank Tier 2	206	-13	-16	27	76
Corporate Hybrids	266	-22	-50	2	67
Sub Insurance	254	-12	-26	34	88
ETF Total return					
EUR IG ETF (IEAC)		0.3%	-1.4%	-1.0%	-4.8%
EUR HY ETF (IHYG)		1.3%	0.4%	-1.8%	-5.1%
USD IG ETF (LQD)		1.4%	-1.5%	-1.0%	-7.9%
USD HY ETF (HYG)		2.0%	0.0%	-0.3%	-4.5%
*Cape Fixed Income Fund (EUR B Inst.)		0.3%	-0.3%	-1.5%	-3.4%
*Cape Fixed Income Fund (USD B Inst.)		0.3%	-0.2%	-1.4%	-3.3%

* as of March 17th 2022

		Change			
	18-Mar-22	1 Week	2 Weeks	1 Month	YTD
iTraxx Europe OTR (5 year, bp)*					
Main	70	-10	-12	4	15
Xover	339	-47	-59	17	66
Snr Fin	79	-13	-17	4	18
Sub Fin	149	-24	-33	9	27
CDX OTR (5 year, bp)*					
CDX IG	64	-11	-10	-1	9
CDX HY	358	-43	-34	2	65
					*since index roll
Govt. bond yield (bp)					
10 year US yield	215	16	42	11	64
10 year Bund yield	37	12	44	10	55
10 year Gilt yield	150	1	29	-3	53
10 year BTP yield	189	4	36	-2	72
BTP - Bund spread	152	-8	-9	-12	17

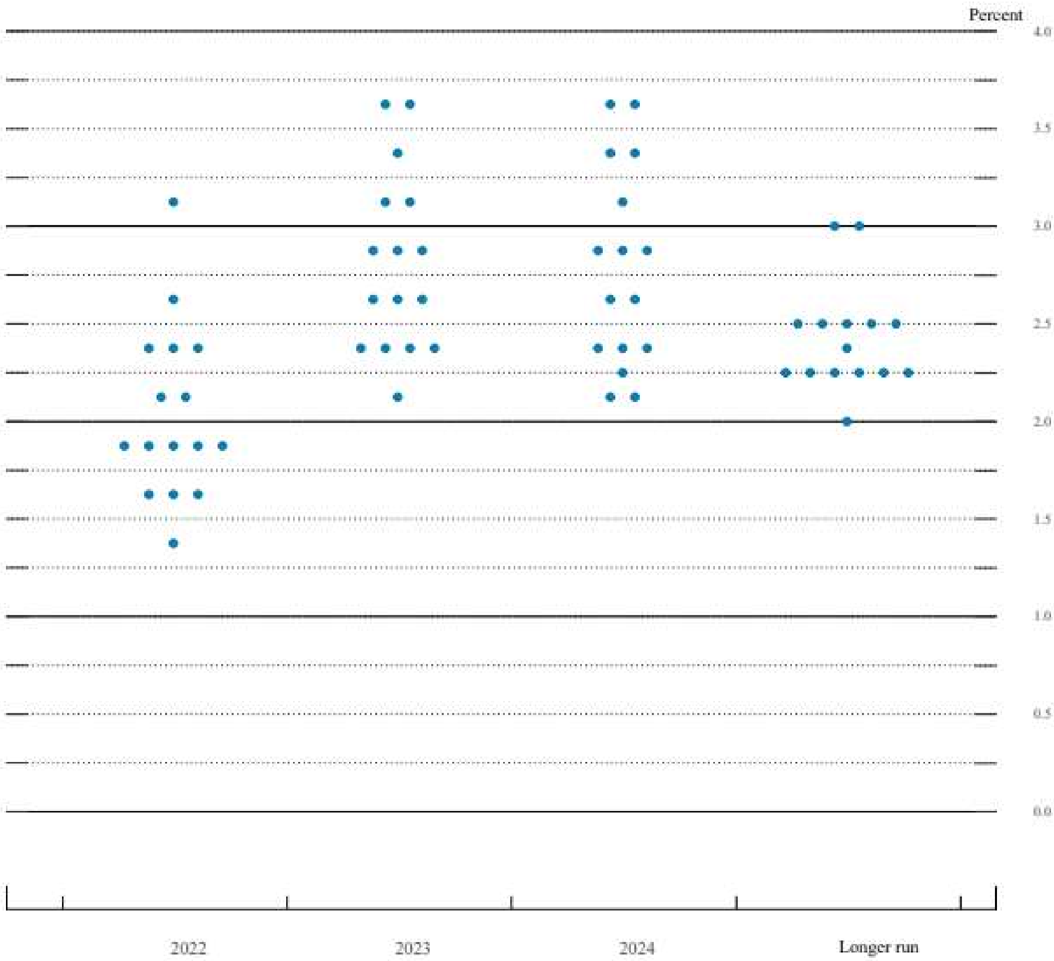
Source: iTraxx, CDX, iShares, Bloomberg as of March 18th 2022

Last week was eventful – it started with a vol spike in the Chinese tech sector followed by a U-turn as Chinese policy makers vowed to support the slowing economic growth and the beaten-up market amid a new wave of COVID outbreaks and lockdowns. Elevated cross-asset correlation dominated the risky asset price actions over the week. On the geopolitics side, headlines on the Russia and Ukraine negotiations brought cautious optimism though the rhetoric was later denied by the Russian side. This was then followed by the Biden-Xi call end of the week where China has reiterated the condemnation of the invasion. Despite the intra-week rally especially on the cyclical front (6% in SPX and >8% in Nasdaq), we continue to see some downside risk and are not convinced in the strength and duration of the bounce. However, based on current credit valuations and the ongoing strong fundamentals investors should prepare to lookout for opportunities.

On Central Bank actions this week, the Fed has lifted its policy rate by 25bps to the range of 25-50bps and the median dot showed another 6 hikes (i.e., the median target rate would be 1.875%) to follow later this year from the published dot plot (Chart 1). One participant dissented with a vote for a 50bps hike, a sign for the accelerating need to normalize the soaring price pressure. The decision and the hawkish stance were widely expected by the market. On economic projections, similar to other major Central Banks (ECB and BOE), the inflation projection has been revised up and growth revised down, in line with the stagflation-narrative spreading in the market right now. Energy prices among other raw material shortages remains the major concern for the market. On the one hand, supply side disruption cannot be directly tackled by Central Banks and fuels inflation; on the other side, both rising input cost and tightening financing condition dampen the economic growth at the late stage of the expansion cycle. 10yr US Treasury yields reached 2.1% and the curve flattened (which is typical in a hiking cycle) but for the most part not yet inverted.

Within the credit market, spreads on average followed the rally in other parts of the risky assets space. Locally, we continue to observe the trend of quality decompression with higher quality lower beta names (hence the defensive part) outperforming the higher beta ones (cyclicals). Bid axes have been persistent on the most stable names whose credit spreads have also nearly doubled YTD. CDS indices retraced from recent peaks and touched pre-invasion levels intra-week following news of progress in Russian-Ukraine negotiations. Though the risk is certainly tilted towards the downside with the utmost uncertainty continuing to be the geopolitical development, on the relative basis, we think the credit market is starting to over-compensate risks, assuming only moderately higher default rates going forth. Valuations are not "an issue" any longer and fundamentals have, if at all, improved during Q1-2022, pointing to a more contained drawdown risk from here.

Chart 1: FED Dot Plot
March FOMC meeting, midpoint of target range for the federal funds rate



Source: https://www.federalreserve.gov/

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