Cape Fixed Income Weekly

Cape Capital

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Michael Lienhard: michael.lienhard@capecapital.com
Sarah Zhu: sarah.zhu@capecapital.com
Luca Orlando: luca.orlando@capecapital.com

Dovish Rate Hike - Hawkish Facts

- The Fed delivered a 50bps rate hike as expected and this week's CPI print will likely indicate that inflation has peaked. This is not enough for the market right now as the focus moves from "uncertainties in terms of peak level" to "the extent at which inflation can slow", especially after inflation has infected the service sector, supporting the "permanent camp".
- Powell expects a stable unemployment rate in the range of 3.5% - 4% which would be an "OK" scenario. However, with job openings reaching a new all-time high in March (>11mln in March) and unit labour cost growth accelerating by >7% y/y during the first three months of 2022 the market has a hard time to believe in less inflation pressures coming from the job market.
- EUR denominated IG yields have reached Covid-highs and credit spreads price in a recession. So far, the economic sentiment outweighs the under-risked positioning in global portfolios and the corresponding valuations.

Table 1: Performance overview

		Change			
	06-May-22	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	161	10	24	30	66
BBB	184	11	27	33	76
IG-ex BBB	57	3	7	4	19
EUR HY Corp spread (bp)	488	38	82	98	170
BB	381	27	61	77	140
Capital Structure spread (bp)					
Bank AT1	466	19	66	82	144
Bank Tier 2	240	16	42	52	110
Corporate Hybrids	317	18	38	58	118
Sub Insurance	279	14	41	54	113
ETF Total return					
EUR IG ETF (IEAC)		-1.4%	-2.2%	-3.8%	-9.2%
EUR HY ETF (IHYG)		-1.7%	-3.8%	-4.3%	-9.4%
USD IG ETF (LQD)		-1.4%	-2.2%	-6.4%	-15.8%
USD HY ETF (HYG)		-0.8%	-2.3%	-3.7%	-9.5%
*Cape Fixed Income Fund (EUR B Inst.)		-0.3%	-1.1%	-1.8%	-4.9%
*Cape Fixed Income Fund (USD B Inst.)		-0.3%	-1.0%	-1.7%	-4.6%

* as of May 5th 2022

		Change			
	06-May-22	1 Week	2 Weeks	1 Month	YTD
iTraxx Europe OTR (5 year, bp)*					
Main	96	6	18	21	41
Xover	462	35	86	103	213
Snr Fin	107	5	18	20	44
Sub Fin	205	7	37	40	89
CDX OTR (5 year, bp)*					
CDX IG	87	3	11	19	30
CDX HY	480	19	62	96	179
				*since index roll	
Govt. bond yield (bp)					
10 year US yield	313	19	23	53	162
10 year Bund yield	113	19	16	48	131
10 year Gilt yield	200	9	3	29	102
10 year BTP yield	313	36	47	84	196
BTP - Bund spread	201	17	31	35	65

Source: iTraxx, CDX, iShares, Bloomberg as of May 6th 2022

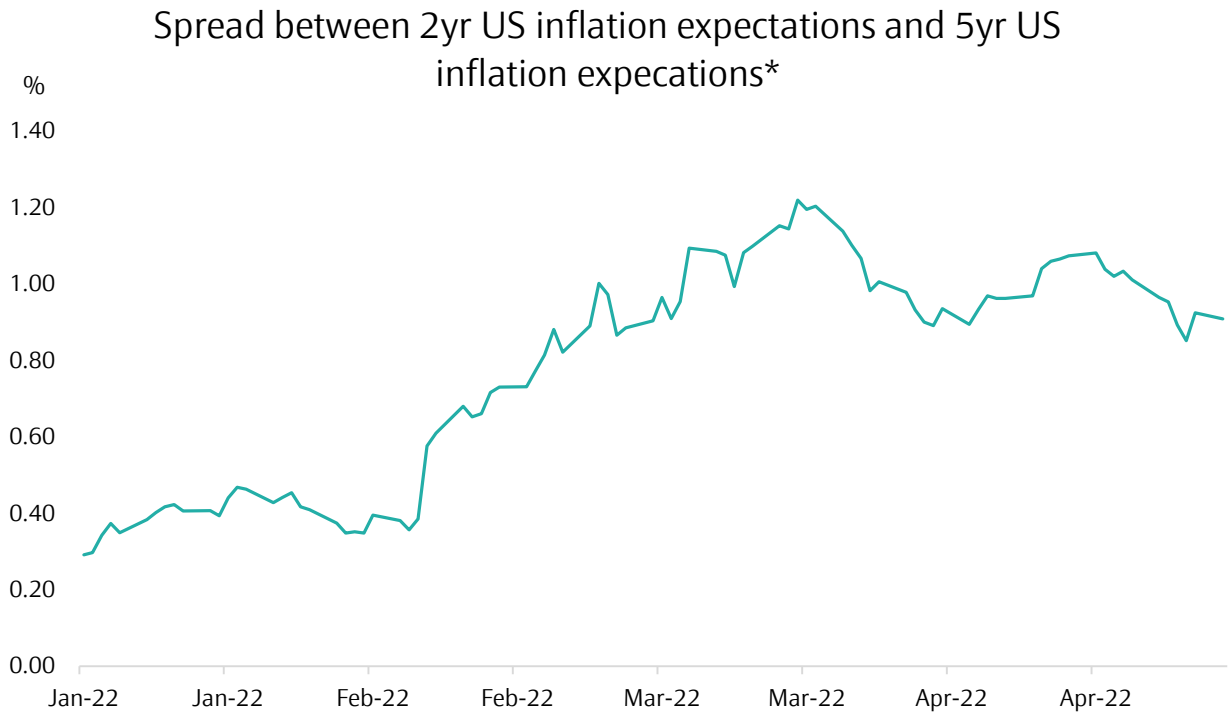
The long-awaited Fed meeting delivered what was expected in terms of rate hike. On the other hand, Powell's rhetoric was slightly more dovish than expected and markets felt ignored, adding a decent portion of risk premium towards the end of the week, sending most of the bond benchmarks to new YTD lows. As inflation has probably peaked the key question at this point is to what degree growth and inflation will move down in parallel...and in magnitude. Hence, we anticipate some more curve flattening during the coming weeks with a more "stable" bell/long end of the rate curve in combination with additional upward pressure on the short end. There seems to be little in the way for the Fed to become harsher at the next meeting given the market reaction towards the end of the week. To be more vocal, there is a difference between a Central Bank running for an adequate price/growth mix and a Central Bank trying to preserve its credibility. Therefore, with some signs of wage-price spiral in place in the US it looks increasingly likely that the 3%-mark is not only a valid policy rate but also a floor and the incentives to front-load rate hikes & the corresponding "bad" news is real. This corresponds with the shape of the inflation-expectation curve (see below graph)

With companies holding back on issuing bonds any stability will be used for supply, "capping" the intermediate recovery of the secondary market. In addition, the ECB has finally started to slow its purchases (as opposed to the last few weeks where they have been surprisingly active) which is leading to a painful emancipation of the bond market. Yes, the market is forward looking and the narrative of "more supply into ECB pulling back" is not new but we think there is room for over-proportional primary market concessions and it makes sense for portfolio managers to enter this phase with high cash balances.

In the wake of this challenging backdrop the fixed income asset class remains vulnerable. However, global investors have entered the fixed income bear market with healthy cash levels. In addition, new shorts become more expensive at the current levels and spreads look fair vs. spot & forward growth is priced in. The significantly elevated geopolitical uncertainties in combination with the impact coming from Central Bank tightening (not only through rates but also in form of QT) and the level of additional debt outstanding even on relative levels puts a layer of "uniqueness" where fixed income investors demand an additional risk premium above "fair", as we referred in other monthly or weekly comments. As the current bear market in the credit space is not necessarily built on selling pressure but rather on a buyer strike, we think the market remains challenged, especially if selling accelerates. As a result, we would not recommend increasing notional at risk at this stage but rather slightly extend some credit duration in defensive segments to increase upside while staying well buffered if markets correct further.

Thank you.

Michael Lienhard



**The graph above shows the US 2-year breakeven inflation rate minus the US 5-year breakeven inflation rate*

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