Cape Fixed Income Monthly

Cape Capital

MONTHLY COMMENT – APRIL 2022

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

Anti-Goldilocks at its best

- The month of April has shrugged off any "strong seasonality" argument. Rate hike bets have increased to 4x 50bps so that the Fed may reach the neutral rate as soon as September 2022 (…to reassess the next steps…) while inflation and geopolitical pressures did not abate. Therefore, Global Bond markets have experienced a sharp repricing throughout the month. As written in our "weekly" letter, we recommend staying cautious but reckon that the market might hit "underweight-overhedged" soon.
- The Cape Fixed Income Fund was not shielded from the credit spread widening but outperformed the broad Fixed Income market due to its generically lower interest rates sensitivity. The Fund stays on the cautious side and holds a generous cash buffer. Still, we have selectively and slowly increased the credit duration within defensive names which look attractive.
- The rate hike "anticipation" was accompanied by a sharp re-pricing of financial assets in general and the Fixed Income asset class in particular. As we move into the "execution phase" we see credit dispersion to increase quite soon and default rates to follow with a time lag. While default rates are more relevant for the High Yield market, we stress that a higher dispersion warrants an up-in-quality mentality with less cyclical exposure in the IG world too, but we recommend buying these defensives into further weakness.

Markets in correction mode…

The month of April has caused important corrections in rates and credit markets with essentially no place to hide. The challenging macro backdrop cannot be tackled by an adequate policy support as inflation prints have moved (significantly) higher, leaving only little room for dovish surprises. Hence, within a few months the market has moved from a regime where "policy & Technicals" have capped credit spreads at low levels to an environment where "Fundamentals" dictate the upper bound of the trading range. The "Fundamental" equilibrium leads undoubtedly to a structurally higher credit spread environment and we do not believe that the market will go back to the 2H-2021 trading regime. The relatively high cross-asset correlation adds to further headache for global investors and is weakening the position of Fixed Income as an asset class in balanced portfolios, however, there are early signs the equity-bond correlation has peaked. As a result of the heightened cross-asset correlation, cash buffers are deemed as a source of quasi-diversification as Fixed Income assets fail to do so. Therefore, we expect "yield buyers" (Insurance, Pension Funds, etc.) to buy into the market only when it looks "attractive", simply because "fair" is not enough in the absence of diversification benefits. So, spreads have to trade close to the upper bound of the new trading range for the time being and we expect this to be still moderately higher than the levels seen end of April.

As written in our weekly comments (April 25th) the worry is concentrated around "macro" while "micro" is showing remarkable resilience with a comfortable liquidity situation in the relevant universe of the Cape Fixed Income Fund (developed world IG, Senior & Subordinated level). Looking at leverage ratios, we noticed small uptick compared to the end of 2021 and we expect some further upward pressures but we reckon this comes after a prolonged period of time of de-leveraging. We definitely expect a higher dispersion, i.e. within some segments the "Fundamental" credit spread cap will move out of the comfort zone. This is also reflected by corporate margin expectations for 2022/23 vs. prior margin levels, in particular within cyclical sectors and names. While the adverse development on the margin front is unlikely to immediately threaten the survival probability of the companies, the market has to discount a prolonged period of time of margin squeeze which should slowly feed into spreads.

…but let's give a little bit of credit to credit

Nevertheless, even within the new range we think that defensive names have reached a level where they may start to look attractive and investable. Additionally, the market looks rather under-risked at the time being with an underweight positioning in Fixed Income assets and a decent overweight in Money Market vehicles. Looking at data from the synthetic

market, which cannot always been taken as a proxy for investors' underweight/overweight behaviour in bonds but typically gives a good indication. The "underweight" becomes apparent: The long-risk exposure of non-dealers in the iTraxx Senior Financials, just to take the most severe example, is currently at….the 0% percentile…; hence, as opposed to the end of 2021 the level of anticipation of a further correction seems overly high right now which points to little risk of forced selling (…which typically has the potential to break the credit market). We therefore see an opportunity to slightly increase the credit duration within quality names without increasing the nominal-at-risk as high cash buffers are utmost important given the level of macro-uncertainty.

Fund performance & positioning

In the month of April the Fund returned around (-1.53%) depending on share classes, compared to (-2.78%) and (-3.66%) for IEAC (IG) and IHYG (HY) respectively, denominated in EUR.

Major bond benchmarks are down year-to-date between (-8%) and (-14%) which posts one of the worst start of a year in history. While IG credit returns are in the absence of defaults more or less mean reverting, the correction based on interest rates in negative territory (CHF, EUR) may be of permanent nature. The Cape Fixed Income Fund strategically and generically reduces its interest exposure to the corridor of 1-2y at any time to be less dependent on the path of interest rates. This ensures that returns are linked to credit risk where investors get overcompensated vs. even the highest historical loss realisation rates.

The Fund is positioned for ongoing volatility on the rates front and holds a relatively high cash buffer. Wherever possible we prefer strong bond structures, i.e. dated securities with a relatively high coupon reset. Despite the moderate increase of credit duration within quality segments we have maintained an overall avg. credit duration on a Fund level of <4y as we increase the credit duration only very slowly throughout 2022. For now, we follow a pure focus on "solvency" with a clear overweight on the Tier 2 segments where coupon distributions are mandatory as opposed to Tier 1s. This reduces any linkage to profitability or capacity to distribute discretionary coupons which further strengthens the resilience of the portfolio. Hence, we keep following a disciplined approach with credit risk from quality companies in combination with low interest rate risks.

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