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Global Central Banks Turning Hawkish

Fixed Income Monthly Update - December 2021

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December saw a global coordination in hawkish turn from monetary policy makers

December was a shortened month due to the holiday season with the first half being dominated by global Central Banks converging towards a more hawkish stance and shrugging off any Omicron concerns. The growing inflation globally has put Central Banks in a coordinated action mode to combat surging prices from all aspects (energy, supply chain, food, etc.). Following the Fed signaling accelerated taper and rate hikes implied from its dot plots and futures, the ECB also saw the looming pricing pressure alarming and took a slightly more hawkish tone during its December meeting. Similarly, the BOE unexpectedly raised its policy rate even amid a deteriorating macro backdrop. Despite the ongoing strong momentum in the underlying economic growth, the simultaneous shift from a "transitory" to a "more persistent" inflation narrative and the tightening financing condition (both monetary and fiscal) as a result set up the new background for 2022 which embeds more volatility should there be any bearish catalysts.

High conviction positions contributed to the positive performance into year-end

The Fund performed positively into the year-end largely thanks to the appreciation in valuation as spreads tightened across the board. Notably, the higher yielding part of the portfolio such as the Bank AT1s, Insurance RT1s as well as Corporate Hybrids outperformed, reversing the widening in November by a decent amount. Nevertheless, valuations remain mostly below the September peak, and we don't see it mean reverting to the 2021 peak level any time soon given the less supportive policy and the unclear COVID situation. However, we see the current valuations more fair and investable than was the case last summer, i.e. we start the new year relatively close to home in terms of the overall portfolio risk.

To give some portfolio stats as per end of December 2021, the credit duration stands at 3.8 years, marginally below the November figure as we moved closer to the front end. The portfolio carry remains at the average target of 2.5%, in line with the current rather fairly valued market environment. The disbursement of the cash into short dated callable papers as cash replacer proved to be a cautious yet correct move for our positioning in light of the mini-Santa rally.

All in all, 2021 was not a year for fixed income when comparing to other asset classes, but the Fund's performance managed to keep what the mandate was supposed to deliver and finished the year in the green.

2022 - a year of normalization and transition & credit beta likely less of a performance driver

Looking forward, 2022 is most likely to be a year of normalization and transition on multiple fronts including growth, inflation, policy rates, fiscal stimulus as well as supply and demand dynamics. So far corporate fundamentals are staying intact, and balance sheet liquidity remains ample though profitability growth will mostly likely come down from 2021 highs and hence deleveraging exclusively through earnings will gradually lose steam. In addition, company's ability to generate cash organically has deteriorated – albeit at a very high level. Given the highland that we are coming from, the leverage & liquidity situation is still far from influencing credit spreads directly, at least in investment grade names. However, as the credit cycle passes from its fastest recovery phase to a more mature expansion phase, dispersion should rise (which has already started to be priced in CDS tranche products, expect it to travel to the bond market soon which affects parts of the HY-market) and as a result beta will likely be less pronounced as a performance driver in 2022 and issuer-/bond selection starts to count again.

Omicron has pro-inflationary elements; we see good value in certain corporate hybrids amid demand-driven inflation

On the Covid front, as Omicron will likely prolong the normalization process of prices and inflation has moved towards a demand-side driven nature, we see good value in the lower end of medium-term tenors (3-4y tenors) in segments such as Corporate Hybrids where we see decent upside in selected names. Given valuations, we maintain a healthy combination with higher conviction positions and a slightly elevated cash buffer to step into the market in potential waves of volatility.

Impact on credit spreads from the PEPP exit is far from imminent

On the demand side, especially from the European credit perspective in light of diminishing Central Bank buying, even though the corporate bond purchases within the PEPP have been limited, the excess space left within the sovereign bond area will have a second order effect

given the lower liquidity in the system. Having said that, this is far from imminent, and we are coming from a record cash rich state.

Rates vol likely to remain elevated given market based terminal rates still screen relatively low; the Fund payoff is well positioned for the current market regime

On curve positioning, as policy normalization is on the horizon and the timing and speed of Central Bank action depends more and more on near-term inflation and job data prints, volatility will stay elevated, and investors therefore are likely to remain sceptical about duration products and seek calmer waters close to the front end of the curve. We are in the same camp and position the portfolio close to home for now as described above.

Further on the rates volatility front, while the anticipated three rate hikes in the US are almost fully priced in, the market still seems rather confident that the terminal rate of the cycle will be extremely low (right now just below 2%, which is below the last rate-hike peak of 2.5% and the Fed's LT dots). This somehow makes rates look rather vulnerable at this stage as the tolerance for lower rates seems naturally limited while the current market expectations in term of the average rates over the cycle screens still rather low in a historical context.

Hence, we start the new year with high conviction that the Fund's payoff fits the current market regime well since credit-risk should profit from both low default rates and solid credit fundamentals while the interest rate risk is the x-factor in the equation. A Fund like the Cape Fixed Income Fund takes advantage of the opportunity to interpret the credit duration (medium term nature, just below 4y as per year end) differently to the interest rate duration (short term nature, 1.4y as per year end) - a simple but effective way to navigate through an uncertain inflation outlook.

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