Cape Fixed Income Monthly

Cape Capital

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Some sort of credibility – Some sort of capitulation

- "Credibility comes from results. Everything else is just marketing" (Richie Norton).
- Central Banks are committed to act data-dependent, i.e., rate hikes based on hard facts. This has brought medium- to longer term inflation expectations down to levels close to the inflation target. The price of this is growth.
- Credit risk has widened substantially during June, the weakest month since March-20.
- A mild recession is in the price – more to come? We prefer non-cyclicals and quality.

Markets pricing in a (mild) recession...

The month of June proved to be weakest one for credit risk in 2022 with iTraxx Main (EU IG) widening by >30bps and iTraxx XO (EU HY proxy) by >140bps respectively. Cape's universe of subordinated bonds of IG companies corrected in unison. June was the month where the narrative shifted from inflation to growth as Central Banks restored credibility, even though the ECB is severely lagging in our view. This is visible in traded medium to long term inflation, i.e., the highly regarded 5y5y inflation swap (a relatively reliable Central Bank "credibility" measure) which has dropped below its 1y average (!) and approached <2.5% levels in the US and the 2%-mark in EU.

In other words, the market believes in the Central Bank's ability to bring down inflation. However, this comes at a significant cost in form of growth deterioration which the market has started to price in. The severity of the recession which is already priced in can be derived from the rate cuts which are priced in forward rates (currently approx. three rate cuts priced in for 2H-2023), meaning the market -so far- expects a mild recession.

The major challenge for risky assets at this stage is the fact that growth is a result and not a target for CBs, i.e., the hit to growth is "accepted". As a direct consequence of their policy to remain solely data-dependent, the market cannot count on less hikes due to growth deterioration, at least not at this stage.

In addition, the looming macro risks (Gas, Covid) are in tendency pro-inflationary which either forces government intervention or additional hawkish policy response. If these macro uncertainties translate into reality, the market must price out the only remaining benign inflation-growth mix in form of "peak inflation & not so hard landing". This may require a further increase of risk premium in risky assets.

...and credit risk stays vulnerable but ultimately overcompensates default risks

Still, even with growth-inflation dilemma in mind, current IG credit valuations deserve a close look. More defaults than the highest historical realized default rates are currently priced in. Accounting for the overly solid credit, solvency, liquidity measures and the already bearish investor positioning, the asset class has reached a level where many segments screen outright "cheap".

IG benchmarks lost 12-16% in the 1H-2022 which is one of the most severe drawdowns in a century in price terms. While in the absence of defaults, IG credit returns are more or less mean reverting, the correction based on interest rates starting from negative territory may be of permanent nature. In some of our past Cape Fixed Income weekly comments, we were looking at bond-equity correlation which we think is crucial at this point.

A low-carry asset class (EUR, USD) must diversify equity risk in a balanced mandate context and if it does not diversify, it has to be a high-carry asset class, i.e., valuation MUST be attractive. General ETF/Benchmark-driven flows were negative YTD, and we think that this can revert to a certain degree once the bond-equity correlation comes down from high and positive levels. Hence, as this has not been the case yet, credit must stay attractive or become even more attractive.

As Central Banks have transformed from supportive to non-accommodative within a short timeframe the upper end of the spread range is determined by fundamentals. Within an environment of growth deterioration, we expect quality to fair better than non-quality in BOTH, positive and negative scenario.

A rally would be driven by policy relief and benefit high-rated liquid assets. A sell-off would be driven by weak growth and low-rated cyclical credit would be most vulnerable. Hence, Cape's portfolio has a clear tilt towards non-cyclicals and quality.

Fund performance & positioning

In the month of June, the Fund returned around (-3.4%), broadly outperforming available liquid IG and/or HY ETFs which were down between (-3.6%) and (-7.0%).

The representative universe in form of subordinated bonds of IG companies has performed in the area of (-9.4%) in the Corporate Hybrid space and (-6.5%) in Financials taking Bank Tier 2s and Bank Tier 1s into account.

The Cape Fixed Income Fund strategically and generically reduces its interest exposure to the corridor of 1-2y at any time while maintaining a medium-term credit duration (3.8y right now and probably slightly increasing throughout the year 2022).

Despite the devastating performance within the entire asset class, the Fund managed to outperform the relevant proxies as a result of lower interest rate exposure and its cash buffer.

The Fund is holding an elevated cash buffer and we expect it to shrink very slowly throughout the year. As the focus has shifted from inflation towards growth, we stay disciplined in our up-in-quality conviction. In turn, we are comfortable to take credit duration risk within these names/segments.

In terms of positioning, we note that sub insurance has outperformed bank AT1s and its performance screens better compared to EUR HY corporates as well YTD. We continue to like the sub insurance space and expect bank T2s to be more resilient vs. AT1s if the soft market tone continues.

Overall, we remain constructive on the European financial sector and see value in selected bonds with positive catalysts (such as upgrade, LME and M&A upside). We expect to see further interesting opportunities on the primary market over the next months across the capital structure.

These are unprecedented times for global fixed income investors, and we thank you for your trust in our strategy and portfolio management capabilities based on credit risk of investment grade companies.

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