Tough Love

- Mixed global data and the unsettled Delta variant coupled with expensive markets sets the backdrop of the current "tough love" situation for risky assets
- We switch to neutral risk positioning by reducing downside convexity given where valuations are
- Credit vol elevated due to higher hedging demand, divergence in IG and HY credit correlation suggests quality decompression in the near term

Michael Lienhard
michael.lienhard@capecapital.com

Sarah Zhu
sarah.zhu@capecapital.com

Table 1: Weekly performance overview

		Change			
	20-Aug-21	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	85	1	2	1	-7
BBB	97	1	1	1	-12
IG-ex BBB	35	1	0	1	5
EUR HY Corp spread (bp)	302	5	7	-4	-56
BB	224	4	8	-4	-32
Capital Structure spread (bp)					
Bank AT1	316	7	13	-1	-86
Bank Tier 2	114	0	-1	-4	-19
Corporate Hybrids	191	3	10	-4	-31
Sub Insurance	152	1	0	-3	-23
ETF Total return					
EUR IG ETF (IEAC LN)		0.0%	-0.1%	0.4%	0.5%
EUR HY ETF (IHYG LN)		-0.1%	0.0%	0.4%	2.6%
USD IG ETF (IEAC LN)		0.9%	-1.0%	0.1%	-1.0%
USD HY ETF (IHYG LN)		0.4%	-0.2%	-0.1%	2.5%
***Cape Fixed Income Fund (EUR B Inst.)**		0.0%	0.0%	0.4%	1.8%
***Cape Fixed Income Fund (USD B Inst.)**		0.0%	0.0%	0.5%	2.3%

* as of Aug 19st 2021

		Change			
	20-Aug-21	1 Week	2 Weeks	1 Month	YTD
iTraxx Europe OTR (5 year, bp)*					
Main	47	1	1	0	-9
Xover	237	5	5	0	-37
Snr Fin	54	1	1	-1	-12
Sub Fin	102	1	2	-2	-22
CDX OTR (5 year, bp)*					
CDX IG	50	1	1	1	-6
CDX HY	293	9	7	9	0
					*since index roll
Govt. bond yield (bp)					
10 year US yield	126	-2	-4	-3	34
10 year Bund yield	-50	-3	-4	-10	8
10 year Gilt yield	52	-5	-9	-8	33
10 year BTP yield	55	0	-2	-14	0
BTP - Bund spread	104	3	2	-4	-7

Source: Bloomberg, Bloomberg Barclays, Markit as of 20th August 2021

As the summer break approaches its end, we welcome you back to our weekly update on the fixed income market.

Recent credit markets have not been as hot as the summer heat wave here in Europe. Over the summer, data from the US was mostly solid, albeit with some cooling reopening effects. In Europe, the survey data (PMI, German ZEW & IFO index) have been on a less steep recovery curve due to the recent Delta variant disruption. Elsewhere, China started to see a slowdown from peak recovery as well as tightening regulatory scrutiny, which caused some volatility end of July / beginning of August.

A quick update on US data: As pent-up demand is progressively filled and supply bottlenecks are gradually easing, consumer spending and retail numbers are likely to normalize into Q3. The recent consumer survey showed a sharp decline in sentiment (University of Michigan Consumer Sentiment survey), which may be linked to the past peak consumption and the end of the additional unemployment benefits. US July CPI was largely off the highs seen since April as the constituents that are mostly affected by the pandemic have rapidly faded away (such as lumber, used cars, **Chart 1**). While a single data point doesn't suffice to prove the fading price pressure, it shows the degree of the transitory nature of certain factors within the CPI basket. On the labor front, job creation continues on headline level though underlying data shows an ongoing uneven sectorial divergence, suggesting that slack within the virus sensitive sectors is yet to reduce.

Last week, the release of the July FOMC meeting minutes unveiled more details regarding the discussion of the committee on the timing and format of asset tapering. Though we think that the implied higher likelihood of an earlier than next year tapering should not read as a new piece of information to most of the market participants, however, coupled with the chilling effect of climbing numbers of new infected cases, risky asset valuations have continued to come down their recent peak.

Looking at credit spreads during the past months, although issuance and liquidity follow the usual seasonality pattern, credit spreads have been put under a somewhat moderate stress test as the elevated valuations weigh on investors' nerves. Despite rather upbeat Q2 earnings, the volatility from receding risk appetite has put pressure on high beta segments such as Bank AT1s and Corporate Hybrids (**Chart 2**). Within the universe of the developed market IG (incl. the capital structure) spreads are currently stuck in a less attractive risk-reward environment between improving fundamental and supportive 'technicals' on the one hand and compressed risk premium and the unsettled Delta variant on the other. Given relatively low opportunity costs at this stage as well as less favorable seasonality going into September, we switch to a neutral risk positioning, aiming for less downside convexity (hence

reducing stretched callable bond structures in the cash bond space). Despite strong technical support, elevated cash levels in global portfolios and "manageable" supply, we think that current valuations warrant to moderately reduce the avg. portfolio credit risk at this stage, still preserving decent upside potential in some of the pockets.

In order to gain information from reliable indicators it is often worth to look at the credit derivatives market: On the credit volatility front, option implied volatility has stayed elevated in its local range over the summer period and has started to rise further due to increasing hedging demands (**Chart 3**). This, in combination with the elevated cash levels in global portfolios leads to the assumption that "forced selling" would be unlikely in a sudden adverse scenario, strengthening the case of a still relatively healthy credit market. As expected, credit correlation has come down in Investment Grade credits for both EUR and USD and now sits only marginally above its pre-COVID level as the ballpark of the systemic risk is perceived to have dissipated (**Chart 4**). We also noted that the same metric has been developing in the opposite direction for the High Yield space as the new Delta variant, peak stimulus and recovery phase has prompted some more cautiousness on the lower spectrum. Therefore, we see quality decompression in the near term, i.e. IG credit will outperform HY credit on a beta-adjusted basis in the near- to medium term.

Chart 1: July CPI components: constituents that are mostly affected by the pandemic have rapidly faded away
in %

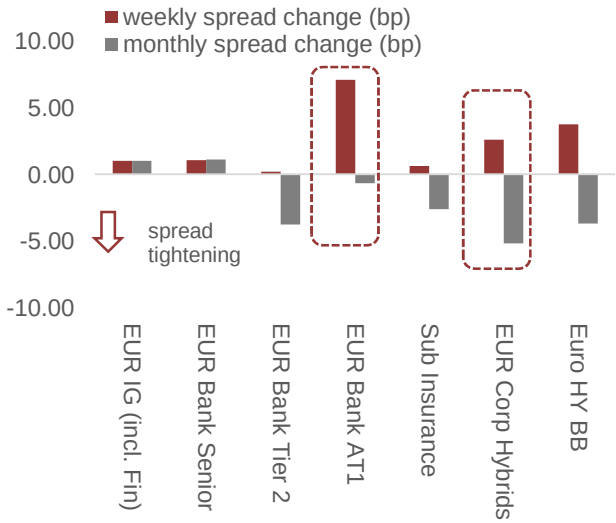
Table A. Percent changes in CPI for All Urban Consumers (CPI-U): U.S. city average

	Seasonally adjusted changes from preceding month							Un-adjusted 12-mos. ended Jul. 2021
	Jan. 2021	Feb. 2021	Mar. 2021	Apr. 2021	May 2021	Jun. 2021	Jul. 2021	
All items	0.3	0.4	0.6	0.8	0.6	0.9	0.5	5.4
Food	0.1	0.2	0.1	0.4	0.4	0.8	0.7	3.4
Food at home	-0.1	0.3	0.1	0.4	0.4	0.8	0.7	2.6
Food away from home[1]	0.3	0.1	0.1	0.3	0.6	0.7	0.8	4.6
Energy	3.5	3.9	5.0	-0.1	0.0	1.5	1.6	23.8
Energy commodities	7.3	6.6	8.9	-1.4	-0.6	2.6	2.3	41.2
Gasoline (all types)	7.4	6.4	9.1	-1.4	-0.7	2.5	2.4	41.8
Fuel oil[1]	5.4	9.9	3.2	-3.2	2.1	2.9	0.6	39.1
Energy services	-0.3	0.9	0.6	1.5	0.7	0.2	0.8	7.2
Electricity	-0.2	0.7	0.0	1.2	0.3	-0.3	0.4	4.0
Utility (piped) gas service	-0.4	1.6	2.5	2.4	1.7	1.7	2.2	19.0
All items less food and energy	0.0	0.1	0.3	0.9	0.7	0.9	0.3	4.3
Commodities less food and energy commodities	0.1	-0.2	0.1	2.0	1.8	2.2	0.5	8.5
New vehicles	-0.5	0.0	0.0	0.5	1.6	2.0	1.7	6.4
Used cars and trucks	-0.9	-0.9	0.5	10.0	7.3	10.5	0.2	41.7
Apparel	2.2	-0.7	-0.3	0.3	1.2	0.7	0.0	4.2
Medical care commodities[1]	-0.1	-0.7	0.1	0.6	0.0	-0.4	0.2	-2.1
Services less energy services	0.0	0.2	0.4	0.5	0.4	0.4	0.3	2.9
Shelter	0.1	0.2	0.3	0.4	0.3	0.5	0.4	2.8
Transportation services	-0.3	-0.1	1.8	2.9	1.5	1.5	-1.1	6.4
Medical care services	0.5	0.5	0.1	0.0	-0.1	0.0	0.3	0.8

[1] Not seasonally adjusted.

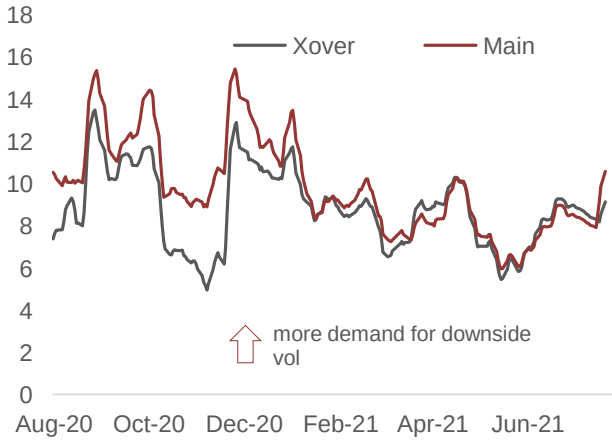
Source: U.S. Bureau of Labor Statistics, as of August 2021

Chart 2: volatility from the receding risk appetite has put pressure on high beta segments
spread change, in bps, Bloomberg Barclays index



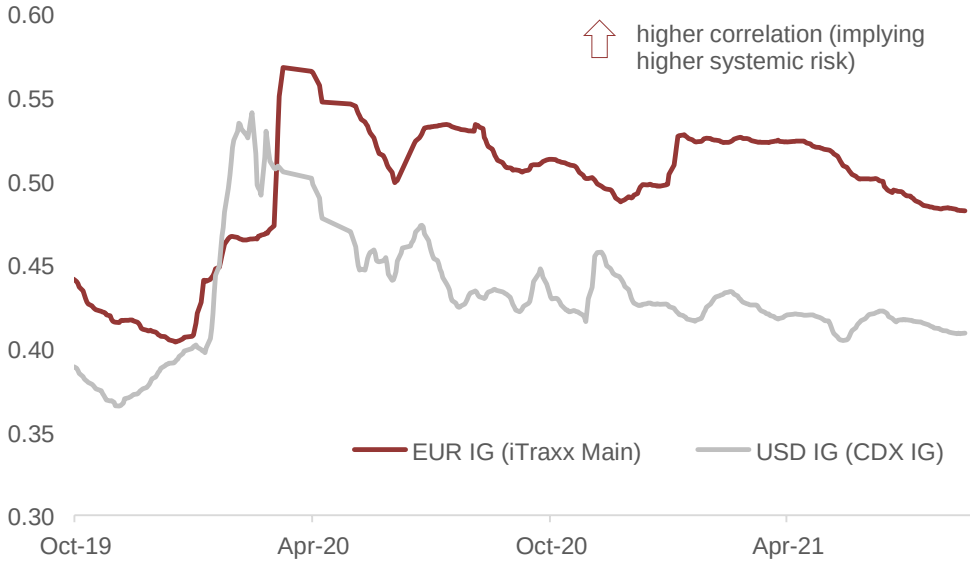
Source: Bloomberg as of 20th August 2021

Chart 3: option implied volatility has stayed elevated in its local range
Payer skew (25delta option vol – 50delta option vol), 1-month, 5d moving average



Source: Citi velocity as of 20th August 2021

Chart 4: credit correlation has come down in Investment Grade credits for both EUR and USD
implied correlations, 5d moving average, IG CDS index (iTraxx Main 5yr & CDX IG 5yr), equity tranche



Source: Citi velocity as of 20th August 2021

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