Optimizing A Symmetrical Payoff

Fixed Income Monthly Update - July 2021

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Positive performance amid a month where macro news dominated spread movements

The Fund performed in positive territory amidst a month where credit spreads were dominated by macro news. We see some tweaks to the big picture. The previous heightened rate vol has taken a back seat this month with both 10yr UST and German Bund retreating to the sub 1.25% and -0.45% area by the end of the month. The ECB dovishness on its forward guidance further strengthened the comfort zone for EUR credit. Meanwhile, the overall stretched asset valuation was vulnerable to the periodic volatility in the commodity space and China's crackdown on certain domestic sectors (tech, tutoring and food delivery). Thanks to the relatively elevated carry (currently at 260bps) and shortened credit duration (currently at 3.7yrs) as well as limited rates exposure (hedged to 1-2 years by mandate), the long book was able to generate positive total returns with limited volatility.

More symmetrical payoff benefitted the portfolio amid temporary market volatility

Portfolio positioning remains to a large extent similar to June. On the margin, we have trimmed some AT1 exposure and reinvested the proceeds into Corporate Hybrids and Subordinated Insurance instruments where we see a better relative value and more resistance to any macro induced volatility. In hindsight, the choppy market in the second half of the month proved that a more balanced and diversified positioning was optimal in risk-return terms in the current improving yet still wobbly environment.

As the broad asset valuation remains rich, we reiterate our preference to be rather conservative and strive for carry as capital appreciation will likely be limited and unsustainable. While July volatility from weakening macro tones gave rise to certain seemingly attractive entry points, a higher level of conviction on names and sectors was needed for us to enter a position.

Overall, we remain constructive on the asset class, but all considered, we continue to strengthen the "controlled offense" narrative. In a portfolio context this translates into an active management which is predominantly focusing on optimizing the upside/downside symmetry rather than pure upside potential assessments.

Below our thoughts on current market themes and trading regimes.

Delta variant gaining strength, but still not a 'game changer'

The Delta variant has been gaining strength and inducing market volatility but is not a 'game changer' on a big picture level. For the developed market, the increasing vaccination rate and rapidly adapting governmental measures act as a strong mitigation to any lockdown tail risk. Therefore, we see some of the pricing action in the COVID sensitive sectors (such as airlines) being overdone as sector liquidity remains solid and booking stats improve. Further, for the broader economy, given the likely delay of a full reopening and ongoing travel restrictions, policy support is more likely to linger than recede. All in all, at this stage, we are not overly concerned about a tail risk event purely driven by the Delta variant.

Inflation expectations: "forever transitional?"

The intensifying discussions around the degree of "transitory" and "permanent" inflation seems like opening Pandora's box. While we clearly support the case of a short-term overshoot followed by a medium-term normalization (or undershoot), we fear that a new level of financial repression has just started. Conventional policy tools (which the ECB made clear during its recent strategic review that there are no revolutionary changes) react upon changes of inflation input parameters which are linked to the recent past or expectations of changes in the near future. An expansion to the new average inflation framework which will be realized during the short- to medium term future is an indirect and significant expansion of the current QE philosophy. Hence, the discussion around measuring inflation, real rates and average inflation targeting has only just started - so stay tuned.

A bird's eye view on the Q2 earnings season

The Q2 earnings season has been rather solid with differentiated impact from the re-opening. For banks, broad-based earnings beats were mainly driven by lower provision from recovering asset quality, released reserves (for US banks) as well as higher fee income while trading revenue mostly missed. We also note that the generally weaker peripheral banks also showed similar trends. On the non-financial corporate side, several sectors (incl. consumer goods, capital goods, industrials, etc.) mentioned the increasing input cost due to the ongoing supply chain bottlenecks. The bird's eye view sees corporate earnings mostly beating estimates driven by ongoing build-up in consumer demand, however, this is unlikely to be sustainable as the re-opening effect wanes. We also noted though that more corporates have resumed dividends and share buybacks, both leverage and cash flow metrics screen decent. Lastly, with regards to the pandemic impacted travel & leisure sectors, guidance remains optimistic despite the Delta variant resurgence. Market financing conditions remain supportive, and credit spread impact from news flow has been mild. In short, the improving fundamentals validated certain parts of the current elevated asset valuation.

Diverging policy between the Fed and the ECB says compression in Europe while selection in the US

Diverging monetary policies between the Fed and the ECB means positioning for selection in the US and quality compression in Europe. The newly established ECB inflation framework and the strong forward guidance at its July meeting means further safeguards to the already strong 'Technicals' within the EUR credit market. The policy deviation could also lead to a lower beta of Bunds to UST movements, hence reducing adverse rates vol spillover to EUR credit spreads. The policy boost can once again trigger compression alongside the quality spectrum, which can be beneficial to our beta positioning in the Corporate Hybrids space. For US credit, however, the question remains the timing of tapering. The July Fed meeting has repeated the narrative of the encouraging gains in the labor market while 'substantial further progress' (such as the labor participation aspect) remains to be made before thez start cutting asset purchases. Additionally, the overarching fiscal bills (both infrastructure bill and social bill) remain to be finalized. Therefore, correlation is likely to fall on the back of secular growth, which means more idiosyncratic opportunities both on name and sector level, suggesting a good pre-condition for a strategy like the Cape Fixed Income Fund.

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