A Rather Calm Week

- Curve flattening marginally reversed
- Strong European datasets with both German IFO and Euro area PMI reaching record highs
- AT1s significantly outperformed, led by lower quality peripheral issuers; stretched valuation and thin summer liquidity prompt us to move into lower beta and diversification

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Table 1: Weekly performance overview

		Change			
	25-Jun-21	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	83	0	0	-3	-9
BBB	95	-1	-1	-4	-13
IG-ex BBB	33	-1	1	1	3
EUR HY Corp spread (bp)	306	13	19	4	-52
BB	212	-1	0	-15	-44
Capital Structure spread (bp)					
Bank AT1	302	-12	-13	-32	-100
Bank Tier 2	116	-1	-1	-7	-17
Corporate Hybrids	192	-6	-3	-18	-29
Sub Insurance	151	-3	-2	-9	-25
ETF Total return					
EUR IG ETF (IEAC LN)		-0.2%	-0.3%	0.2%	-0.8%
EUR HY ETF (IHYG LN)		0.0%	-0.3%	0.7%	2.1%
USD IG ETF (IEAC LN)		-0.6%	-0.1%	1.3%	-2.4%
USD HY ETF (IHYG LN)		0.6%	0.4%	1.1%	2.6%
***Cape Fixed Income Fund (EUR B Inst.)**		0.1%	0.2%	0.6%	1.3%
***Cape Fixed Income Fund (USD B Inst.)**		0.1%	0.2%	0.7%	1.7%

* as of June 24th 2021

		Change			
	25-Jun-21	1 Week	2 Weeks	1 Month	YTD
iTraxx Europe OTR (5 year, bp)*					
Main	46	-3	-1	-5	-10
Xover	225	-14	-6	-26	-49
Snr Fin	53	-3	-2	-6	-13
Sub Fin	100	-7	-3	-11	-25
CDX OTR (5 year, bp)*					
CDX IG	47	-4	-1	-4	-9
CDX HY	270	-17	-6	-21	-23
					*since index roll
Govt. bond yield (bp)					
10 year US yield	152	9	7	-5	61
10 year Bund yield	-16	5	12	5	42
10 year Gilt yield	78	3	7	3	58
10 year BTP yield	92	5	18	0	38
BTP - Bund spread	108	1	6	-5	-4

Source: Bloomberg, Bloomberg Barclays, Markit as of June 25th, 2021

It was a relatively calm week following the recent monetary policy meetings from the ECB and the Fed. The USD curve (as well as other DM curves) marginally reversed its recent sharp flattening over the week with the 10yr rising relatively more than the front-end (2-3yr rates). Current market discussions continue to focus on 1) the early liftoff of the US front-end and incoming job and pricing data may bring volatility to this part of the curve; 2) how transitory the near-term inflation prints will be, which will have a larger impact on the 10yr part of the curve. In the meantime, market-based measures continue to show both medium- and long-term inflation expectations remains well below the Q2 peaks (**Chart 1**). While the monetary policy divergence between the US and Europe points to a more technically supportive credit market in Europe, the ECB support is likely to have peaked and therefore this factor will gradually fade out, but this remains a medium-term rather than an imminent risk.

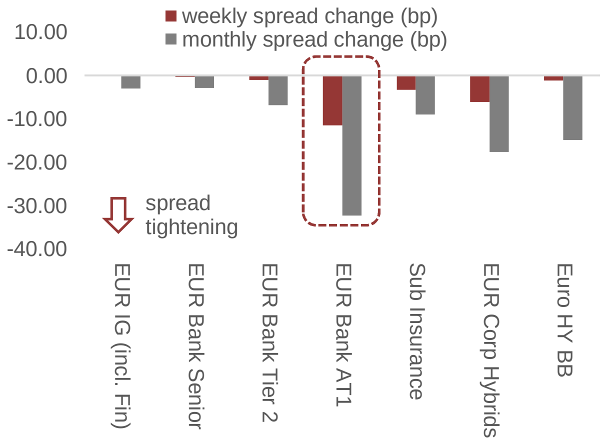
Data releases this week saw some very strong survey results in Europe. The German IFO reached another record high with the most momentum seen among the subcategories such as expectation, service and trade. June Euro area PMI continues to accelerate led by the Service sector whereas Manufacturing maintains its firm stance. Although the underlying economic recovery reinforces the improving corporate fundamentals, the overall stretched credit spread is capping the upside from valuation expansion.

More on the late credit spread movements: With lingering uncertainty on the rates front and the tight valuation coupled with thin summer liquidity, cash bonds underperformed both synthetics and equities last week. **The one corner that followed the equity rally was the bank AT1 segment, visibly outperforming all other sub asset classes** (**Chart 2**). Zooming in, EUR AT1s led the compression vs. USD and GBP. We'd highlight that different from the more global large-cap profile of USD AT1s issuers (mainly France, Germany, Nordics, Swiss, Asia, North America), EUR AT1 issuers consist mainly (and logically) of peripheral and non-core European regional banks (incl. Italy, Spain, Portugal, Austria, etc.). This quality compression could be derived partially from the catch-up of its underperformance earlier in the month and partially from the sharp expansion in service PMI given most of the non-core European economies are more reliant on the service sector. On the aggregated index level, the AT1 segment now stands at 30bps wider vs. its pre-COVID tight, similar to the Corporate Hybrid segment which tends to have a lower beta to market vol. We tend to shift our preference to the latter as from a vol-adjusted return perspective, we prefer to avoid investments that have a 'bond like' return with an 'equity like' vol. **Therefore, our current AT1 book is running low on beta with an overweight in high quality USD AT1 issuers coupled with selective convictions in EUR issuers. We further boosted diversity by investing into US based best-in-class banks without compromising too much on yield and we tend to switch out of names with 'mediocre' risk-return profiles into similar yielding alternatives in other lower beta asset classes.**

Chart 1: Market-based inflation expectation still well below the Q2 peak
US 5-yr and 10-yr breakeven

Source: Bloomberg as of June 25th, 2021

Chart 2: AT1 visibly outperforming all other sub asset classes
spread change, in bps, Bloomberg Barclays



Source: Bloomberg as of June 25th, 2021

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