Cape Fixed Income Weekly
January 24th 2022

Preparing for Jan FOMC

- The market prepares for the Jan FOMC meeting amid rates volatility, geopolitical risks and lower forward guidance from Q4 earnings; front end higher yielding assets as well as leveraged loans / CLOs outperformed
- 10-yr UST has temporarily reached >1.8% while the curve flattened as the market remains reluctant to price in a much higher terminal rate; real yields across the curve remain deeply negative, leaving duration products subject to further vol
- Credit valuation screens cheap on an 18-month lookback, Bank AT1s are (so far) among the best performers within the cash bond universe thanks to a higher carry buffer
- The portfolio continues to focus on a low credit duration taking advantage of attractive entry points in short-dated Bank AT1s as well as re-open themes; the portfolio also added a bit of CLO exposure given their floating rate structure

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Table 1: Weekly performance overview

		Change			
	21-Jan-22	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	100	2	6	4	5
BBB	113	2	7	4	6
IG-ex BBB	39	1	2	0	1
EUR HY Corp spread (bp)	328	17	22	2	10
BB	250	12	17	1	9
Capital Structure spread (bp)					
Bank AT1	338	11	16	2	16
Bank Tier 2	141	7	12	9	11
Corporate Hybrids	231	9	14	23	31
Sub Insurance	181	11	16	9	15
ETF Total return					
EUR IG ETF (IEAC)		0.1%	-0.4%	-1.5%	-0.8%
EUR HY ETF (IHYG)		-0.4%	-0.8%	-0.3%	-1.0%
USD IG ETF (LQD)		-0.2%	-1.1%	-2.7%	-2.9%
USD HY ETF (HYG)		-0.8%	-0.8%	-0.9%	-1.8%
***Cape Fixed Income Fund (EUR B Inst.)**		-0.2%	-0.4%	-0.2%	-0.4%
***Cape Fixed Income Fund (USD B Inst.)**		-0.2%	-0.4%	-0.1%	-0.4%

* as of Jan 20th 2022

		Change			
	21-Jan-22	1 Week	2 Weeks	1 Month	YTD
iTraxx Europe OTR (5 year, bp)*					
Main	55	3	5	5	0
Xover	270	12	18	18	-4
Snr Fin	64	4	5	6	2
Sub Fin	120	5	8	8	-1
CDX OTR (5 year, bp)*					
CDX IG	58	5	6	8	3
CDX HY	330	23	22	33	37
Govt. bond yield (bp)					
10 year US yield	176	-3	0	31	25
10 year Bund yield	-7	-2	-2	23	12
10 year Gilt yield	117	2	-1	29	20
10 year BTP yield	129	2	-3	24	12
BTP - Bund spread	135	3	0	1	0

*since index roll

Source: Bloomberg, Bloomberg Barclays, Markit as of January 21st 2022

Another week of heightened volatility and continued rates volatility ahead of the January FOMC meeting, US-Russian geopolitical tensions and lower forward guidance from US banks (e.g. GS, JPM) and large techs (e.g. Netflix). The equity market sell-off deepened over the week with Nasdaq entering correction area and VIX trading once again close to the 1yr peak (at ~29). As for credit, the general risk-off sentiment has added additional downside pressures to total returns in addition to the erosion from rising rates. Long duration products once again are the loser of the week with representative ETFs losing between -0.4% (in EUR) and -1.1% (in USD). However, on a cross asset basis, credit has outperformed equities especially in the higher yielding spectrum (mainly in high-yield and front-end capital structure risks) as well as floating rate loans / CLOs (leveraged loans spread tightened YTD and demand was high) as investors take credit risk over duration risk.

On US rates, as the market anticipates a hawkish Jan FOMC meeting, 10-yr US treasuries temporarily reached >1.8% as investors started to price in a more aggressive rate path than the base case (3 median hikes) from the Dec dot plot. This is also discussed by several FOMC participants during their recent comments should inflation refuse to ease. The rates curve flattened YTD and historically during hiking cycles, the 2s10s curve flattened as a result of aggressive Fed rate hikes as well as the reluctance of the market to price in a higher terminal rate for this cycle. However, real yields across the curve remain deeply negative and below previous cycles, leaving longer end nominal yields and duration products subject to volatility.

In Europe, though the ECB members emphasized in multiple occasions that rates normalization is beyond the horizon of 2022, the 10y Bund yield moved on the back of growth and cyclical repricing and reached above 0% at some point. This led to a sharp fall in the total amount outstanding of negative yielding IG credit in EUR, rather welcoming news to the IG asset class in the medium term.

A quick summary on the current valuation of our credit universe. Though credit spreads continue to be volatile, they improved compared to the beginning of the year given that the rate market now has more or less priced in all the hikes. Overall, valuations are screening low with an 18-month lookback window but still above the end-Nov to beginning-Dec levels when Omicron and inflation fears were at their peak. Relatively speaking, Bank AT1s outperformed thanks to thicker buffers from the spread which currently trades around 350bps on average. Corporate Hybrids spreads underperformed relative to Banks AT1s due to the sector composition of the Hybrid universe, as this sub-asset class has a higher adverse impact from supply chain constraints, chip shortages as well as rising input cost. Nevertheless, the dynamism of the Hybrid universe offers more opportunities on the idiosyncratic side and the current valuation certainly provides some interesting entry points.

Our portfolio has taken advantage of the current valuation correction and added some CLOs (to benefit from floating rate structure and low default rate environment) and short- to medium-dated callable papers (1-3years) mainly in Bank AT1s and Corporate Hybrids. Spreads significantly corrected from the Sep-21 “peak valuation” and we managed to lock in a higher-than-average carry for our investors through names we believe have 1) further re-open potential given recent Omicron restriction easing in Europe; 2) high quality cash flow generation and can pass on the rising cost pressure through superior pricing power to avoid margin erosion from inflation.

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