Cape Fixed Income Weekly

Cape Capital

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Transitory vs. Permanent camp 2.0

- The Fed is advocating aggressive rate hikes to gain flexibility towards the end of the year. This has caused rates vol to come down and revived the "transitory camp"
- The lower credit- and rates volatility has opened the window for new issues. Crisis vintages have the reputation to be good bonds – watch primary market activity

Table 1: Performance overview

		Change			
	27-May-22	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	167	-1	-1	16	72
BBB	193	-1	-1	18	85
IG-ex BBB	56	-1	0	3	18
EUR HY Corp spread (bp)	499	-6	-5	49	181
BB	383	-9	-13	26	141
Capital Structure spread (bp)					
Bank AT1	461	-31	-33	8	140
Bank Tier 2	238	-2	-10	13	108
Corporate Hybrids	336	-7	-28	19	136
Sub Insurance	288	-8	-21	15	122
ETF Total return					
EUR IG ETF (IEAC)		0.5%	0.0%	-0.8%	-8.2%
EUR HY ETF (IHYG)		1.7%	0.5%	-0.2%	-7.6%
USD IG ETF (LQD)		2.6%	3.3%	1.8%	-12.4%
USD HY ETF (HYG)		4.9%	4.4%	1.8%	-6.4%
*Cape Fixed Income Fund (EUR B Inst.)		0.3%	0.1%	-1.1%	-5.6%
*Cape Fixed Income Fund (USD B Inst.)		0.3%	0.1%	-0.9%	-5.2%

* as of May 26th 2022

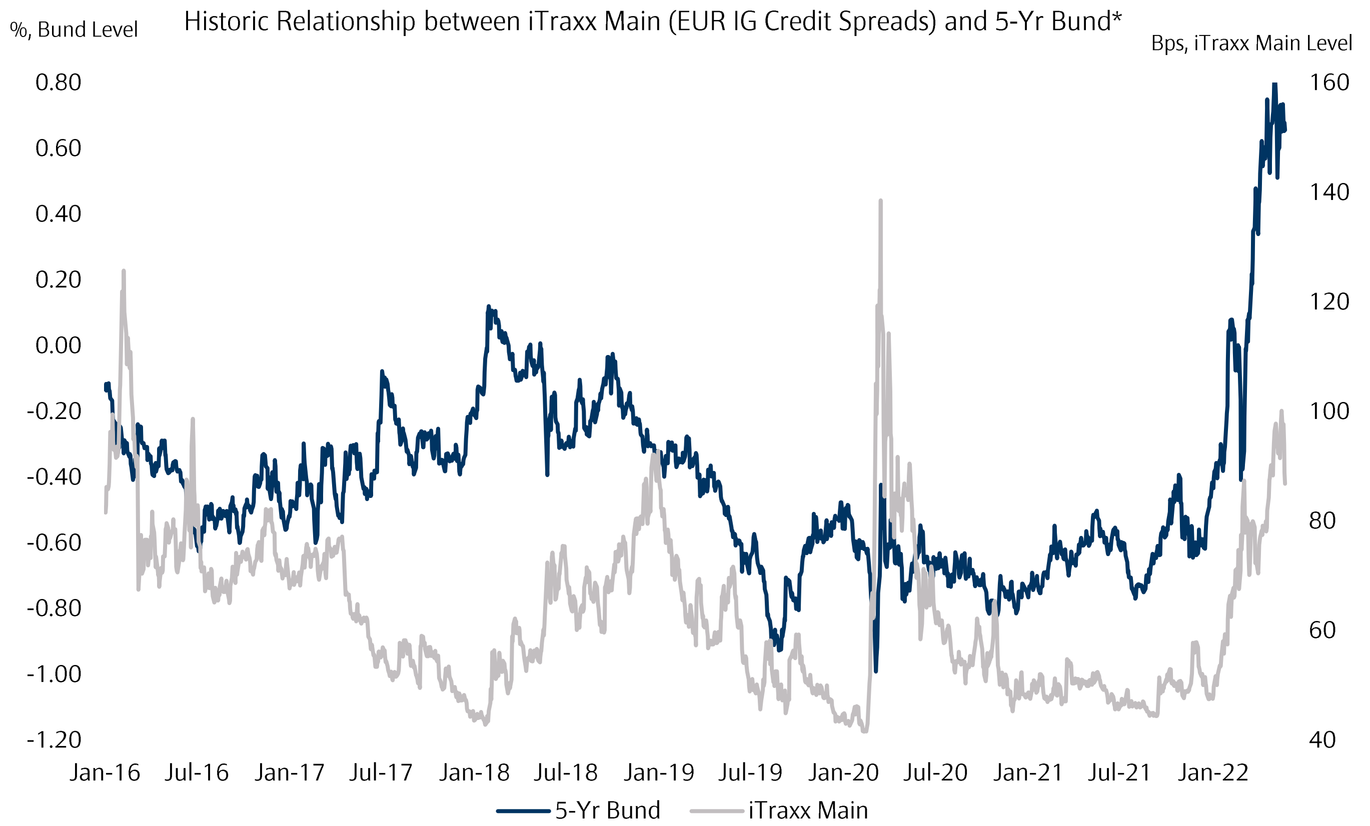
		Change			
	27-May-22	1 Week	2 Weeks	1 Month	YTD
iTraxx Europe OTR (5 year, bp)*					
Main	87	-13	-6	-1	32
Xover	431	-57	-15	17	182
Snr Fin	96	-14	-6	-1	34
Sub Fin	183	-29	-13	-5	68
CDX OTR (5 year, bp)*					
CDX IG	79	-12	-6	-3	22
CDX HY	457	-66	-27	7	156
					*since index roll
Govt. bond yield (bp)					
10 year US yield	274	-4	-18	-9	123
10 year Bund yield	96	2	2	16	114
10 year Gilt yield	192	2	17	11	95
10 year BTP yield	290	-10	5	32	173
BTP - Bund spread	194	-12	3	16	58

Source: iTraxx, CDX, iShares, Bloomberg as of May 30th 2022

Fixed Income markets have finally experienced some relief and turned rather positive towards the end of the week with public holidays helping to squeeze credit spreads. While the strong performance in synthetics at the end of the week confirms demand for "quick beta/participation" in an under-invested market, we think that the cash bond market moves slower considering the new supply. The current consolidation has opened the window for these new issues and some prominent names have joined the market. Three subordinated insurance debt deals have printed (Allianz, Axa and Athora) in spite of the long weekend in Europe. Athora came with a 10NC5 T2 structure in EUR to refinance the upcoming call on its USD perpetual bond. On the more systemically important side, Allianz printed a EUR 30NC10 T2, while AXA tapped the market with a 20NC10 T2 deal. Axa (which recently got upgraded on the back of its reinsurance license) also announced on Wednesday evening that it would use the new issue proceeds to take out two of its XL reinsurance bonds (using make-whole price) which have been issued out of XL Insurance company prior to the merger, sending both the new bond and the legacies tighter. We continue to like the EUR subordinated insurance space at these levels - on a relative basis - with attractive investment opportunities on both the primary and secondary market. With school and bank holidays coming up in the UK, we expect a slower week ahead but the new issue bonanza has definitely started and will influence the short-term trading pattern.

Outside the demand-supply mechanics we currently see two important camps building, similar to the transitory vs. permanent camps during 2021. One camp expects a lower terminal rate with a policy error forming given the rapidly declining disposable income "ex. Energy & Mortgage costs" and the other camp is doubtful that the policy transition mechanism does not work as intended such that Central Banks have to hike more aggressively than what is currently priced in. What makes forecasting even more difficult is the fact that supply-side constraints (lockdowns, war, de-globalization) are accumulating on top of the already unprecedented post-Covid stimulus. The path of least resistance from a portfolio management point of view is to expect a few (very) harsh Central Bank meetings with a frontloading bias, while still believing in their medium to longer term credibility - essentially what they are fighting for right now. As the current tightening cannot ease price pressures especially on Food and Energy, it is - and will probably remain - all about anchoring medium term inflation expectations. Since the focus has clearly shifted from "where will inflation peak?" to "preserving credibility", the frontloading of policy actions is inevitable and with it some further IG-HY decompression. Hence, IG credit spreads look vulnerable vs. the macro picture like essentially all risky assets but seems like a good investment on a relative basis and for medium

term investors. We have argued in other “Cape weekly” publications that the bond-equity correlation is important to keep an eye on and were highlighting that we have seen the peak. With the current moderate rebound in rates, there is also hope for some IG credit spread tightening. Whether this is a consequence of a generally better risk appetite or just a safety-reflex from investors fearing a growth slowdown or even recession is yet to be seen. In any case, the magnitude of the credit correction in relation to the rates correction has started to weaken lately (see below chart).



**ITRX EUR CDSI GEN 5Y Corp vs 5-Year German bund Generic*

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