Cape Fixed Income Monthly

Cape Capital

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Central banks addressing Credi(t)bility

- Spot inflation has reached new highs in Europe but medium-term inflation expectations have come down - credibility has to be deserved.
- Cape's universe remains in good shape from a fundamental perspective and the deteriorating growth picture is only slowly feeding into the credit metrics.
- The Cape Fixed Income Fund maintains an up-in-quality bias and takes advantage of the recent market weakness.

Traded inflation expectations have arrived, but so did growth perspectives…

2y U.S. Breakeven inflation rates came down from roughly 4.5% to 3.8% while the 5y Breakeven rate has dropped below 3% vs. 3.4% during May. The Fed is fighting for credibility and needs to anchor medium term inflation expectations at any price, successfully thus far. A similar picture is visible in Europe, despite higher-than-expected inflation prints in essentially all major member states. The focus has shifted from inflation to growth deceleration and like the "transitory" vs. "permanent" camp type of discussion in 2021, there are two camps forming: "recession" vs. "non-recession".

While we can sense the importance of this question, we clearly do not have a strong bias for either side. However, where we have a strong conviction is that the deteriorating growth picture does only slowly feed into credit fundamentals within the IG universe.

…which meets strong company fundamentals – "micros" look OK

Companies are starting the current growth slowdown with strong balance sheets and overly comfortable liquidity positions. In addition, earnings reports showed a relatively broad-based resilience albeit weakening dynamics. Hence, we think that a prolonged period of rising credit dispersion is ahead of us but default rates will only rise slowly in Europe. Credit dispersion is ultimately linked to the significantly deviating industry trends given the severe geopolitical and macroeconomic challenges, leading to diverging leverage ratios, and default rates linked to the liquidity situation which have experienced positive pandemic-related special effects.

Hence, a logical path within the credit market is to expect less homogeneity and quantitative tightening has the potential to accelerate this trend. In an environment of rising dispersion and lower Central Bank support the Cape Fixed Income Fund maintains an "up-in-quality" bias and have seen a number of bonds benefiting from positive credit rating actions, especially on the financials side.

Global positioning is supportive but investors need a "look through"

Global investors are clearly underweight/under-risked in credit as an asset class with large cash balances on the side. With Fundamentals and "Technicals" at an acceptable level, it is all about Central Banks and macro as the markets needs more visibility in terms of the terminal rate for a "look through" scenario in the current rate hike cycle.

Hence, the coming two ECB meetings are of utmost importance and the market will not only react on the magnitude of the rate hike but even more on the credibility to anchor medium term inflation expectations. Within an environment of global growth slowdown this "look through" will likely lead to a lower equity-bond correlation, which increases the diversification benefits of Fixed Income-related assets. This can trigger inflows into the asset class given valuations seem attractive with Fundamentals and "Technicals" looking fine.

Companies are using the somewhat dampened rates volatility to issue new bonds

The lower credit and rates volatility towards the end of the month has also opened the window for new issues. Given the high cash balances held by investors and decent new issue premiums, the recent financials deals have performed relatively well (and not just on the break). It is interesting to highlight that the new insurance subordinated deals attracted strong investor demand despite the structures (30NC10 and 20NC10) with longer duration. In light of the active capital management, we saw some liability management/tender offer announcements as well (from Athora and Axa) linked to the new issues, offering (up to 10pt) upside for bondholders. Regarding banks, while SEB reopened the USD AT1 market with over 10x order book cover, Deutsche Pfandbriefbank decided not to go ahead with its new T2 deal (and to not redeem its existing T2 at the first call date) which highlights the extension risk on the bank T2s. With many banks and insurers yet to come to the market, we expect further supply in June across the capital structure.

The Cape Fixed Income Fund is slowly moving towards "controlled offense"

The Cape Fixed Income Fund invests in subordinated bonds of IG issuers, which per definition is a default-remote universe and fits well with our conviction of a world with a higher credit dispersion. In light of the challenging macro environment, we continue to stay disciplined with a defensive positioning comprised of higher cash balances and an even stronger shift to "household" names. In an environment of higher dispersion and tighter financial conditions "Know your Issuer" becomes equally important as to "Know your Issue".

Additions to strong names in Utilities/Energy, Telecommunication and Market Infrastructure (Euroclear, Deutsche Bahn, Deutsche Börse) were executed during the latest weakness at attractive levels, at least from a medium-term perspective. Furthermore, we took advantage of generous new issue premium especially within the Insurance sector. The overall credit duration has been moderately increased to currently 3.9 years while keeping interest duration anchored at 1.9 years. Overall, we see a (very) slow trend of movement towards "controlled offense" with a clear focus on low default risk.

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