Cape Fixed Income Weekly

Cape Capital

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"Not so affected"-rally

- Bear market rally based on (too) bearish positioning, oversold territory and low supply helped credit markets to stabilize towards the end of the week.
- Singapore Dollar is the new rockstar for European Financial Issuers, BNP, SocGen printing SGD deals.

Table 1: Performance overview

		Change			
	08-Jul-22	1 Week	2 Weeks	1 Month	YTD
EUR IG Corp spread (bp)	205	-11	4	43	110
BBB	242	-9	9	54	134
IG-ex BBB	68	3	6	11	30
EUR HY Corp spread (bp)	646	-14	58	175	328
BB	500	-17	44	145	259
Capital Structure spread (bp)					
Bank AT1	550	-23	12	105	228
Bank Tier 2	292	-7	12	57	162
Corporate Hybrids	479	-69	53	173	280
Sub Insurance	357	-16	14	88	191
ETF Total return					
EUR IG ETF (IEAC)		0.9%	1.5%	-0.9%	-10.7%
EUR HY ETF (IHYG)		1.0%	-0.6%	-4.6%	-12.9%
USD IG ETF (LQD)		-0.7%	0.5%	-1.5%	-15.7%
USD HY ETF (HYG)		1.2%	0.2%	-3.0%	-11.9%
EUR Corp. Hyb. ETF (EHYB)		1.9%	-1.5%	-6.6%	-16.8%
*Cape Fixed Income Fund (EUR B Inst.)		0.3%	-0.7%	-3.4%	-8.9%
*Cape Fixed Income Fund (USD B Inst.)		0.4%	-0.5%	-3.2%	-8.3%

* as of July 7th 2022

		Change			
	08-Jul-22	1 Week	2 Weeks	1 Month	YTD
iTraxx Europe OTR (5 year, bp)*					
Main	117	-4	7	26	61
Xover	576	-14	42	121	327
Snr Fin	128	-4	9	29	66
Sub Fin	243	-8	16	52	128
CDX OTR (5 year, bp)*					
CDX IG	90	-10	-4	7	34
CDX HY	517	-60	-12	35	216
					*since index roll
Govt. bond yield (bp)					
10 year US yield	308	20	-5	6	157
10 year Bund yield	134	11	-10	-1	152
10 year Gilt yield	223	15	-7	-1	126
10 year BTP yield	328	20	-16	-9	211
BTP - Bund spread	194	9	-6	-8	59

Source: iTraxx, CDX, iShares, Bloomberg as of July 8th 2022

Last week saw some decent rebound in the credit market as medium- to longer term inflation pressures were priced out to a large extent. With Central Banks restoring credibility on the expense of growth expectations the market is gaining some "look through" in spite of additional short term inflation pressures. This benefited the fixed income asset class which typically reacts more sensitive to persistent inflation rather than growth deterioration in case the latter is moderate (..which is what the market is currently pricing in). From a pure positioning point of view this rebound screens comprehensible but the face of it represents more one group than the other in this bear market rally, namely the names and/or segments which can be summarized by "not-so-affected by XYZ" rebounded to a larger extent in credit than the ones which would rally if problems would get solved and conviction built. Hence, the tightening came on the back of a clean(er) technical picture, bearish positioning and lower than expected supply within a generally "oversold"-sentiment. The bear market rally has legs to go at this stage, but its magnitude is clearly dependent on the gas situation if it wants to continue into the summer holiday season. Last Friday some news of the gas turbine release from Canada to Germany eased some concerns, but significant worries remain with the scheduled Nordstream 1 maintenance shut down this week. While we think that a complete escalation is not yet priced in the market there is already a decent European risk premium visible, with the EU IG credit index (iTraxx Main) trading more than 25bps wide of US IG (CDX IG), where -1bps has been the mean for the last 5 years (source: Bloomberg). The majority of the EU-US spread has been built during the last 2-3 weeks. The current EU-US spread is therefore at the highest level since the European Sov Debt crisis period in 2011-2013.

As Central Banks are committed to act data-dependent the new week offers room for some elevated volatility, with US and EU CPI numbers on Wednesday, US PPI on Thursday and US Retail Sales and University of Michigan confidence on Friday. We are especially interested in the Univ. of Michigan confidence number as last month's number triggered doubts with regards to the state of consumers. The name of the game screens rather clear to us: Any surprise on the inflation front influences the speed on how fast Central Banks have to match the policy rate with the neutral rate and any surprise on the growth/consumer front influences how much they will overshoot vs. the neutral rate (as credibility is in play they will be forced to hike at least until they have reached "neutral"). Since Central Banks are "OK" to sacrifice growth, which makes them credible at this stage, there was a relatively pronounced unwind of the inflation trade which has started to accelerate at the beginning of 2022. Meanwhile in Europe, the ECB is expected to announce more details on the fragmentation tool soon while the reinvestments of the PEPP seem to have no rules yet. This de facto means that basically all reinvestments will flow to the peripheral Government Bonds (an average of 17bn of bonds from the PEPP expire each month).

Within our universe there was a relatively pronounced rebound in Corporate Hybrids. The segment profits from low supply and its tilt towards defensive sectors (Telecom, Utilities). We expect some new issues in case the market stabilises further. There was much more action within Financials where European issuers increasingly brace for Asian investors. The Singapore Dollar primary market remained active the third week in a row for European Financials, with BNP printing a Tier 2 and SocGen tapping the market with a new AT1. Regarding ratings, we note that AXA received another upgrade (from Moody's this time), which moved the composite rating on certain perpetual bonds also to the A- bucket. Axa remains one of our preferred names within the Cape Fixed Income Fund. Sterling financials have been facing political risks with PM Boris Johnson's resignation and the headlines regarding the Scottish referendum vote in October. On the regulatory front, ECB released its climate stress test results on Friday, indicating that 60% of the Euro area banks do not have a climate risk stress testing framework. The exercise was not spread moving as banks are not facing Pillar 2 capital add-ons this year on the back of the stress test results. Elsewhere, EBA published an update regarding the bank legacy capital. While this did not really include material new information, in our view it puts more pressure on banks to clean out their legacy bonds.