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UBAM - GLOBAL CARRY ENHANCED

Quarterly Comment | Q2 2019

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Markets

- Global equity markets were up +3.23% during the second quarter of 2019 and stand at +15.90% YTD, as measured by the MSCI AC World Daily TR Net Index. After a very strong first quarter, Q2 was more volatile with two main elements influencing markets: trade war rhetoric, which initially escalated and then dampened further to the G20 meeting, and central banks, which have been intensifying their dovish stance, signalling possible rate cuts. In short, the market has been willing to ignore the weaker economic data in the hope that central bank stimulus will help avoid a recession.
- Developed Markets (DM) performed strongly in Q2, outperforming global markets on aggregate, with the notable exception of Japan. The S&P 500 TR ended the quarter up +4.30%, while the MSCI Europe gained +4.48%. In terms of styles, growth was once again the winner during Q2, while value and small cap underperformed global markets. Looking at sectors, Financials and IT were the strongest contributors. On the other hand, Energy was the laggard.
- Emerging Market (EM) equities were flattish during this second quarter of the year, with the MSCI EM TR Index being up +0.12%. As US interest rates decrease, a better environment for this asset class could emerge.
- Volatility increased slightly during Q2 but remained at a low level as of June-end (15.08) compared to the last nine months. It briefly topped the 20 mark during the month of May but came back down in June as markets rallied.
- After a very strong Q1, oil contracted somewhat between April and June (-2.78%). Q2 saw a revival in the price of Gold, as weak economic data increased fears of an economic downturn and demand for safe haven assets.
- Markets have been pricing in Fed rate cuts and the potential for further ECB quantitative easing (QE), all of which should be supportive of DM government bonds. However, and although global equities rebounded sharply in June and are off a very good start YTD, there are still a few headwinds that seem to be overlooked by markets so far, among which: (i) the on-going US-China geopolitical tension, (ii) slowing manufacturing data, (iii) early signs of a faltering American consumer, and (iv) a "whatever it takes" monetary policy easing that might not be sufficient to reverse the on-going global slowdown, all this leaving investors overly cautious at this juncture.
- In that context, we believe expanding asymmetric exposure through alternative solutions ahead of rising volatility prospects is a smart asset allocation move today. Indeed, an increased market uncertainty and volatility should provide a fertile ground for our UBAM - Global Carry Enhanced strategy, which provides a risk/return profile similar to fixed income, yet with a very different source of returns and decorrelation, and by investing in listed, highly liquid instruments.

Performance Review

- Over the second quarter, UBAM - Global Carry Enhanced returned -3.45% net to investors, underperforming its Eonia Capitalization Index 7 Day Index as well as some other short volatility and call-selling strategies.
- On a monthly basis, the performance generation was disparate (-0.03% in April, -3.06% in May and -0.38% in June), due to the succession of strong up and down moves in equity markets, especially in May and June. The amplitude of the month-on-month moves was quite similar across regions but still above expectations. Overall quarterly performance of equity markets seemed relatively quiet on the surface (+0.57% for the Nikkei 225 TR, +3.3% for FTSE100 TR, +4.3% for S&P500 TR and +5.5% for the Eurostoxx 50 TR) but the month-to-month moves were very volatile, which is detrimental to carry strategies.
- The Carry strategy – also called “delta-hedged Call selling” – contributed -434bps (gross) during Q2 2019. Return generation was led by the US component (-319bps) that was hit mainly in May and June. In fact, after the equity rally during the first four months of the year, the US equity markets went from a sharp drawdown of -6.4% in May to a sharp rally in June (+7.1%), both hitting the strategy. In both occasions, the move was greater (on the downside and then on the upside) than what was priced by the market, and the defensive positioning at the end of May dragged some performance as well. Generally, the same behaviour could be observed on European (-72 bps) and Japanese components (-44 bps). The UK component had a flat contribution given that equity swings were more controlled versus market expectations and despite a defensive positioning at the beginning of June.
- The Risk management strategy – also called “delta-hedged Tail Risk” – added +148bps (gross). In terms of regional splits, the US component added +103bps, and the European exposure added +45bps. The trend witnessed since the beginning of the year continued, as volatility futures (both in US and Europe) were oriented to the downside (VIX futures losing -24.6% and Vstoxx futures losing -23.5% over the quarter). Overall, US volatility behaved in line versus equity performance, but from a month-on-month perspective, it did not react as expected during the correction phase in May, while it remained somehow resilient during the June rally. On the other hand, European volatility futures underperformed the spot in April. While it reacted slightly better than expected in May, it was in line in June. In terms of behaviour of the strategy, both in the US and Europe, the risk management feature was overall satisfying, expect in May because of the underweight positioning in terms of volatility futures, as well as the under reaction of VIX futures in May specifically.
- Finally, -24 bps of gross contribution were generated by the EUR Treasury Bills book (as well as some residual currency exposure), where most of the cash holdings were invested for optimisation and UCITS diversification restrictions.

Portfolio Activity

- Within the Carry strategy, which represents 90% of the portfolio allocation, the quarter began with a balanced positioning overall (slightly offensive in Europe and the US, while slightly defensive in the UK and Japan). During April, given the continuing bullish trend in global equities, the portfolio was tilted towards a more offensive stance. Unfortunately, the sell-off in May led the strategy to shift to a more defensive stance with a lag (especially on the US, UK and Japan components), which was detrimental to the carry generation. Finally, in June, signals turned more offensive again with a lag. The succession of higher than expected moves in equity markets hurt the carry generation.

This kind of succession of down and up market was never observed to such extent in the past, which emphasizes the extraordinary current market environment.

- Within the Risk Management strategy, which represents the remaining 10% of the portfolio allocation, US and Europe sub-strategies evolved in the same way apart from small differences in positioning during the month of May. The exposure to volatility futures was lean and not very exciting during most of the quarter, being close to (or even at) the minimum exposure possible. This was mainly the result of the bearish momentum in volatility futures, as well as the steep term structure increasing the cost of carry of long positions in such instruments. However, in May, as volatility spiked at the beginning of the month, signals began to turn more bullish on volatility futures. In the US, VIX futures reacted quickly to the first leg of correction leading the strategy to add some volatility exposure with a lag. As volatility reversed sharply with the pause in the sell-off, the strategy stopped adding exposure and even returned to the minimum exposure by the end of the month. In Europe, as higher volatility persisted longer than in the US during May, the exposure to Vstoxx futures increased more and returned to minimum exposure by early June.

Outlook & Positioning

- At the end of June, the signals with 3 months', 6 months' and 12 months' time-horizons were indicating a bullish trend in the US, Europe, the UK and a slightly bearish trend in Japan. The turning points were rather close and the portfolio was titlted in anticipation for these likely changes as well as the several risk events looking forward. As a result, the Carry sub-strategy adopted a neutral positioning and suggested to sell a mix of 40+ delta calls across most regions except Japan were a defensive mix (60 and 40 delta calls) was implemented.

- The volatility signals on both the US (VIX futures) and Europe (Vstoxx futures) were also indicating a bullish environment. More specifically, the momentum in volatility futures was bear (hence representing a bull equity regime), the volatility regime was standard (reflecting normal market conditions on a historical basis) and the volatility futures term-structure was steeply in contago (typical of non stressed markets). As a result, the Risk Management sub-strategy had a minimal exposure to volatility futures, way below the neutral point.

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