UBAM - HYBRID BOND

Quarterly Comment

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Market Comment

- Risk remained under pressure in **October** as the market reacted to tighter financial conditions, with the US index for example rising to its tightest levels since November 2022. This tightening was largely driven by the bear steepening curve move observed in interest rate markets, with the 2 year vs 10 year curve steepening in the US by 32 bps during October to -16 bps. The longer end of the curve came under particular pressure, with several reasons being cited including a more resilient than expected US economy, the higher-for-longer rates environment being communicated by central banks, as well as supply & budget deficit concerns rising. We would also note that a curve steepening move is quite typical towards the end of tightening cycles and as such, whilst we have a positive bias towards interest rate duration, this is focused at the front-end of rate curves given the steepening bias that we also hold.
- Significantly as the month progressed, we appeared to see central bankers take note of this tightening in financial conditions as a reason for them to tighten policy less, as it could be viewed as a replacement for rate hikes. This idea was initially brought up by Dallas Fed President Logan, however was then echoed by Fed Chair Powell, especially if the tightening in financial conditions is “persistent”. This clear communication shift from the Fed has been helped by the disinflation trend which remains intact, and supports our view that we have passed peak hawkishness, where we continue to see plenty of value in building duration in portfolios which screen attractive from a valuation perspective. For example the market is currently pricing a trough in the Fed funds rate at around 4% over the next few years, which is well above their neutral rate estimate of 2.5%. At the ECB, the communication shift has been even clearer given recent weakness in the growth data, with one of the most hawkish members of the board, Klaas Knot, recently saying that current policy is at a “good cruising altitude”.
- **November** turned out to be a strong month for fixed income markets as both the data released, as well as communication received from the central banks, suggested that we have passed peak hawkishness. Regarding the data, we saw a continuation of the disinflation trend take place as both US and Eurozone CPI surprised to the downside for headline and core prints. In addition, we continued to see signs of labour market loosening with payroll growth in the US for example printing at just 150k, with the unemployment rate rising to 3.9% from a trough of 3.4% at the beginning of the year. Central banks appeared to take this data onboard given the further shift in communication observed from key policy makers. At the Fed for example, we heard from Governor Waller who toned down his previously hawkish rhetoric by noting that he is increasingly confident that policy is well positioned as he is encouraged by the recent data.

Waller went further and also mentioned the possibility of interest rate cuts in the coming months if we continue to see inflation coming in lower. Whilst Fed Chair Powell sounded more balanced in his latest comments, he also described policy as being well in restrictive territory which suggested that no further rate hikes are on the table, unlike the Fed's prior guidance in their dot plot. As a result, we saw a sharp global rates rally with US 10 year yields declining by 60 bps on the month, whilst the German equivalent declined by 35 bps.

- US rates managed to outperform given that the larger communication shift relative to market pricing came from the Fed, whilst at the ECB the growth data has been weak for some time and which had already led to less hawkish communication from the board. Developments herein have supported our positive bias towards interest rate duration at present, which is a view we maintain given the disinflation trend and growth slowdown being observed. Furthermore despite the rates rally of November, the market continues to price the Fed more hawkishly than their own guidance, with a trough in the Fed funds rate in 2026 priced at 3.4% vs the Fed's own dot plot which has 2.9% by this stage. Similarly for the ECB, whilst the market is pricing the possibility of a rate cut for as soon as the end of Q1 now, the trough in pricing for both the ECB and Fed remains above estimates for their neutral rates which suggests that a growth slowdown is priced to a much lesser extent. Credit spreads benefitted from this backdrop as well, with US investment grade spreads tightening by a significant 22bps in November, to the tightest levels observed since February and prior to the US regional banking crisis, whilst European spreads also tightened to a lesser extent, by 13 bps. US outperformance herein matched the rates outperformance for the US, as well as continued expectations for US exceptionalism from a growth perspective.
- Central bank meetings were in focus in **December** with communication from the Fed in particular driving a rally across fixed income and risk markets into year-end. The meeting signalled a significant dovish shift in rhetoric as Fed Chair Powell not only appeared to close the door to further hikes, but he surprisingly admitted that the committee is already discussing the timing of future rate cuts given the substantial progress on inflation that has been made. This shift could also be observed in the release of the Fed's quarterly economic projections, where core PCE forecasts were downgraded to just 3.2% for 2023 from 3.7% previously, which also appeared to be the main driver for the revision lower in the dots for 2024 to 4.6% for the Fed Funds rate from their prior 5.1% forecast. Data released during the month would have also convinced the Fed to deliver such a message with inflation in particular surprising to the downside and with core PCE declining to below the 2% target in 6 month annualised terms now.
- Whilst the ECB and BoE chose not to make similarly dovish shifts in their communication at their December meetings, this is still expected to occur in Q1 given the outlook for both growth and inflation. At the ECB for example their latest inflation forecasts released signalled another large downgrade with headline inflation now expected to average 2.7% in 2024 compared to 3.2% in the September forecast. That said, these forecasts still appear too pessimistic on the inflation front and we would expect to see the ECB provide further downgrades in Q1, which would also open the path to a more dovish shift in communication.

- As a result, we saw further support for interest rate markets with US 10 year yields declining by 45 bps and breaking through 4%, whilst German 10 year yields managed to decline by a similar 43 bps. Loosening financial conditions herein also provided support for risk markets which could clearly be seen in the tightening of credit spreads, with both USD and EUR Investment Grade spreads for example tightening by 10 bps respectively.

Performance Review

- QTD, the return of the fund was +10.63% net of fees (I share class) and +7.57% YTD.
- The gross returns sequentially over the quarter were: +15 bps in October, +552 bps in November and +483 bps in December
- QTD, the sector contribution was:
  - Additional Tier 1: +890 bps
  - Insurance subordinated: +16 bps
  - Corporate hybrid: +44 bps
  - Overlay and oter items: +102 bps
- YTD, the sector contribution was:
  - Additional Tier 1: +648 bps
  - Insurance subordinated: +8 bps
  - Corporate hybrid: +100 bps
  - Overlay and oter items: +69 bps

Portfolio Activity

- Portfolio at the end of quarter:
  - Yield-to-call: 8.6%
  - Yield-to-Worst: 7.6%
  - Credit spread duration: 3.6 years
  - Interest rate duration: 4.5 years
  - Average rating: BB+

- Main Positions:
  - 89% AT1, primarily core Europe (ex-Germany), in particular Netherlands, France, UK and Switzerland
  - 1% Banks Tier II
  - 2% Insurance Sub
  - 6% Corporate Hybrids

- In October, for the banking sector, the results in both the US and Europe have generally been strong, with earnings on balance higher than the prior year and driven by higher revenues. Revenues mostly surprised on the upside due to solid net interest income (particularly at banks with more exposure to floating rate loans, e.g. periphery) and a rebound in trading and fee income. Asset quality held up strong by historical standards, with stable NPL ratios and provisions being usually lower than expected. Deposits were generally stable, whilst capital ratios remained robust, as internal capital generation mostly compensated for ongoing capital return programs. In terms of market moves, AT1 spreads widened by about 4 bps during the month, whilst the average yield to worst increased by about 10 bps, expressed in local terms. Insurance sub spreads widened by about 4 bps and corporate hybrids tightened by about 4 bps. October net AT1 issuance has on balance been negative with about -0.2 bn USD, as supply remained muted. In fact, in October there was only one AT1 deal from international institutions, coming from Japanese bank MUFG. Given that up to now Japanese banks were issuing AT1s only in local currencies, with this inaugural issuance in USD; MUFG has broaden ranks of banks issuing AT1s in international markets. The deal was well placed with investors, as it provided diversification and, as a result, it performed well in the secondary market despite volatile market conditions.
- From a positioning perspective, our exposure to AT1s was at 87% as of month-end, whilst corporate hybrids were at 7% and insurance subs 2%. On interest rates, we kept our duration exposure unchanged mom, concentrated at the front end of the curve: 2 and 5 year segment in EUR rates and a 2-10 curve steepener in the US rates.
- In November, for the banking sector, the earnings season continued to come on the strong side, as revenues were boosted by higher net interest income and trading revenues improved from the previous quarter. Higher profitability supported solid capital rations, while asset quality remained solid. November has been the best month for AT1 securities since before Credit Suisse turmoil, as the market found new energy supported by good banking earnings, investor demand for new issuances and expectations that policy rates plateaued. In this context high coupons in the 9-10% range these securities offer, are particularly

appealing. As a result, the BAML AT1 index turned positive for the year after dropping about 8% in the first quarter. UBS, which took over Credit Suisse in mid-March, returned to the AT1 market in style in November, raising 3.5 bn USD. UBS sale, which saw over 36 bn USD in demand, has revitalized the asset class. The rush for securities shows recovery in the asset class in general and return of market confidence in Swiss banks in particular, as market moved post CS debacle. Santander and Barclays also tapped the AT1 market, raising 2.5 bn USD and 1.75 bn USD, respectively. Santander has also issued AT1, proceeds of which is has used to redeem the old outstanding AT1. All newly issued AT1s had a good performance, pushing price well above face value on the secondary market. November has also been the month, where AT1s continued to be redeemed. Societe Generale has announced a call of its AT1 at the first call date, while Santander has called its AT1 3 months after the first call date. Finally, Credit Agricole has already announced its intention to call its AT1, which is coming due in 2024. In terms of market moves, AT1 spreads tightened by about 35 bps during the month, insurance sub spreads tightened by about 58 bps and corporate hybrids tightened by about 12 bps.

- From a positioning perspective, our exposure to AT1s was at 87% as of month-end, while corporate hybrids were at 6% and insurance subs at 2%. On interest rates we increased duration exposure by 0.375 years via US futures to capitalize on weaker macroeconomic data . Our duration exposure remained concentrated at the front end of the curve: 2 and 5 year segment in EUR rates and there was a 2-10 and 5-30 curve steepener in the US rates. On the credit side, we added to credit risk via CDX HY index.
- December has been a good month, with both banking shares and AT1 securities rallying on higher profitability and increased soft landing scenario, supported by incoming macroeconomic data. Combined net interest income for European banks has climbed from 270 bn EUR in 2021 to an estimated 378 bn EUR this year after central banks began rapidly razing interest rates. Rebound in AT1 markets was also partly driven by a return of its investor base ranging from hedge funds and private banks to traditional asset managers and by continued redemptions. In details, in December there has been further AT1 redemptions, with Santander and UBS, both announcing calls of their AT1 at the first call date. In such a way, European banks have already sorted all of their major AT1 calls until March. In terms of market moves, AT1 spreads tightened by about 33 bps during the month, insurance sub spreads tightened by about 14 bps and corporate hybrids tightened by about 17 bps.
- From a positioning perspective, our exposure to AT1s increased to 89% as of month-end to capitalize on the good market performance, while corporate hybrids stayed at 6% and insurance subs were at 2%. On interest rates we closed curve steepening bets and our duration exposure was enhanced by long positions in 10 year US and UK futures. On the credit side, we kept credit risk position via CDX HY index.

Outlook

- With significant progress on inflation finally made, the end of 2023 saw Fed Chair Powell communicate an important shift in his guidance, which suggested that the Fed's focus is moving away from discussing further hikes and instead towards the timing of potential rate cuts. Such a shift in messaging came perhaps earlier than many investors had been anticipating, driving a rally across fixed income and risk assets into year-end. As a result, the focus in the first part of 2024 will likely be on whether the inflation and labour market data released is able to support this message from the Fed, as well as whether other major central banks decide to communicate a similar shift. We believe that this pivot from the Fed cannot be ignored, especially given the recent progress made on inflation, where central banks such as the ECB and BoE are likely to follow suit in the coming months. This reduces the tail risk of central banks overtightening policy into a recession, keeping a soft landing scenario as the base case. We therefore continue to view this backdrop as one that warrants holding balanced portfolios of both credit risk and interest rate exposure in portfolios.
- As the fourth quarter progressed, communication from central banks evolved as well. This was most clearly observed with the Fed at its December FOMC meeting as Fed Chair Powell surprisingly admitted that the committee is already discussing dialing back the amount of policy restraint in place given the substantial progress on inflation that has been made. This shift could also be observed in the release of the Fed's quarterly economic projections, where core PCE forecasts were downgraded to just 3.2% for 2023 from 3.7% previously, which also appeared to be the main driver for the revision lower in the dots for 2024 to 4.6% for the Fed Funds rate from their prior 5.1% forecast. Data released during the month would have also convinced the Fed to deliver such a message with inflation in particular surprising to the downside and with core PCE declining to below the 2% target in 6 month annualised terms. Labour market rebalancing is also taking place with payroll growth having declined to around 160k in 3 month moving average terms, from above 300k at the beginning of 2023. Importantly, this rebalancing is taking place from not only the demand side, but also the supply side as the participation rate finally picks up which will take pressure off wage growth over time.
- Whilst the ECB and BoE chose not to make similarly dovish shifts in their communication at their December meetings, this is still expected to occur in Q1 given the outlook for both growth and inflation. At the ECB for example their latest inflation forecasts released signaled another large downgrade with headline inflation now expected to average 2.7% in 2024 compared to 3.2% in the September forecast. That said, these forecasts still appear too pessimistic on the inflation front and we would expect to see the ECB provide further downgrades in Q1, which would also open the path to a change in rhetoric. Meanwhile at the BoE, the latest CPI release was a significant downside surprise at 5.1% for core inflation, which compares to the BoE's own forecast of 5.7% and highlights the speed of the disinflation process. Furthermore given that the outlook for UK and Eurozone growth appears to be weaker than that of the US, with the consumer in a less robust position amid the rolling over of shorter dated mortgages, we would be

surprised if these central banks were to commence their easing cycle at a much later stage than the Fed. In addition, weak Chinese growth remains a concern without large-scale stimulus and will also continue to weigh on the outlook for the Eurozone economy given its open nature.

- Overall, we continue to hold a positive bias towards interest rate duration, where both the data in terms of the disinflation trend, as well as the communication from central banks and in particular the Fed, is supporting this bias. We would anticipate for other major central banks to follow suit in the coming months, which could provide further support herein. From a valuation perspective, despite the move lower in rates observed in Q4, we do not view valuations as stretched, with the market pricing the Fed rates trough at 3.2% currently, which is above their own guidance of 2.9% for end-2026 and the neutral rate of 2.5%, which still suggests room for the market to price policy towards normalisation. Furthermore Fed Chair Powell recently noted that his expectation is for real rates to decline as we move forward, which means that the 140bps worth of rate cuts priced for 2024 do not appear unreasonable in a world where inflation returns towards the 2% target. From a portfolio construction perspective, we also believe that it makes sense to hold more balanced portfolios with both credit risk and increased levels of interest rate duration. In particular and in contrast to what was observed in 2022, we think that exposure to duration could protect portfolios against any growth shocks, especially as the prior hikes delivered by central banks continue to feed through to the real economy.
- We also enter the year with a positive bias towards credit given that the path towards a soft landing remains intact. Whilst rates volatility and uncertainty around the Fed's terminal rate weighed on credit spreads at times in 2023, this should be less of a headwind in 2024 given recent developments. In addition, Powell's communication suggests that the Fed is willing to cut rates due to progress on inflation alone, rather than waiting for a further and significant growth slowdown, which also reduces the tail risk of the Fed overtightening into a recession. We view high income strategies as continuing to screen attractive from an all in yield perspective. For example the high yield segment of the market through CDS indices is compensating investors more than adequately for the risk being taken where at such elevated yields, the power of accrual becomes extremely important, providing a buffer against any bouts of spread widening and as was clearly observed in 2023. Furthermore we anticipate that the benign default rate backdrop will continue in 2024 given resilient growth and less refinancing risks as rates move lower and the new issue market reopens.
- We also view an allocation to BB rated bonds as attractive given their superior risk-reward profile to BBBs, single Bs and CCCs and as corporate fundamentals for BBs seem in good shape for this stage of the cycle. Finally, we continue to hold a positive bias towards the financial sector given it remains a segment of the market that is benefitting from the higher inflation backdrop, as observed in recent bank earnings. In particular, we would continue to highlight the AT1 market as an attractive opportunity and an asset class that has recovered from the volatility observed in March last year. Crucially, this recovery has not only been helped by the regulators in their communication, but also the banks in their decision to call the bonds outstanding. This comes despite the market still pricing around 60% of the

AT1 universe to-call, providing attractive upside over the medium term given that we expect most AT1 bonds to be called by their issuers and refinanced in the market

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