


# UBAM - EURO BOND


## Quarterly Comment

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### *Market Comment*


- In October the loss of economic momentum continued. Elevated inflation has weighed on domestic and foreign demand for most developed economies, leading to a further drop in manufacturing and service sectors' activity as shown by major surveys. A recession now appears almost a done deal for Europe and it is becoming an increasing risk for North America. Labour markets remain robust by historical standards but signs that labour demand might have peaked are arising. Meanwhile, inflation has continued to surprise on the upside prompting major central banks to increase interest rates at an accelerated pace to try to cool down price pressures by limiting demand. The impact of tighter monetary policy on the real economy has yet to be seen and will take some more months to fully materialise, but is starting to kick in. Demand has not deteriorated as sharply as needed to bring down price pressures, which remain high and broad based across economies. Central banks are therefore expected to deliver more rate hikes throughout the rest of the year and possibly early next year. As the impact on economic activity intensifies, more cautiousness across policy makers will emerge. In the United States, where economic conditions have proven resilient until now, the latest surveys are pointing towards a further slowdown in the coming quarters. Tighter financial conditions should lead to declines in homebuilding, non-residential construction, business equipment investment, and consumer spending on goods next year. A rise in auto production as semiconductor availability improves could yet provide some support to growth. Meanwhile both the Eurozone and UK are likely to face a deeper recession. High inflation continues to weigh on real incomes and consumer spending, while rising rates, uncertainty and energy issues are leading to weaker business investment and activity. The Eurozone CPI inflation climbed to a new high of 10.7% in October boosted by energy and food, but core also continued to accelerate. Base effects on the energy front should enable a gradual decrease of headline inflation in the coming months but domestic pressures are likely to keep core inflation elevated for some time. We will probably need to wait for the second half of 2023 to see more meaningful drops in core inflation. Rising debt burdens also threaten the medium to long growth prospects of many European countries. Meanwhile, the Chinese economic recovery eased this month. Retail sales along with October's PMIs provided signs that weaker demand is weighing on Chinese growth. Virus disruptions worsened and demand related indices (new orders and new export orders) deteriorated further, hinting a weakening in domestic and global demand. The current Covid policy, the property sector issues and the expected deterioration in exports growth will weigh further on the Chinese economic recovery throughout the rest of the year and start of 2023. Soft economic growth in China is increasing concerns for other developed countries including Australia, prompting a more cautious stance from their central banks.

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- At the global level, easing commodity prices and supply issues along with weaker demand will help to ease global price pressures in the coming six to twelve months. Tight labour markets, sticky core price pressures will however, keep core inflation elevated and above 2% in most economies, increasing the risks of policy rates remaining higher for longer. This will weigh on global growth, but a global recession is still not our baseline scenario.
  - Developments in the UK continued to drive markets in October amid the fallout from the new cabinet's mini budget. The sell-off in the gilt market that followed drove not only liquidations in Gilts, but also in equity and credit markets from UK pension funds who were forced to raise cash to meet margin calls. This dynamic was seen as one of the reasons for why US Investment Grade Credit spreads widened by 5 bps in October on the back of forced sellers, whilst European credit outperformed, with spreads 6 bps tighter on the month. European credit would have found support from the substantial decline in natural gas prices observed, which should take pressure off households, businesses and inflation. European duration also outperformed US duration in October in a move that also followed the ECB meeting towards the end of the month in which they appeared to be preparing the ground for a slower pace of rate hikes ahead following the 75 bp hike delivered, by noting in the statement that substantial progress in withdrawing monetary policy accommodation had been made. Gilts also reversed much of the sell-off observed at the start of the month after the BoE decided to step in to stabilize the market via a temporary purchase program, whilst the decision by the Conservative Party to oust Lizz Truss as Prime Minister and replace her with the fiscally prudent Rishi Sunak helped drive an almost 100 bp turnaround in Gilts. In contrast for US rates markets, investors continued to react to strong economic data that was released in October and continued to signal tight labour markets and stickier than expected price pressures which reaffirmed expectations for another 75 bp rate hike to be delivered at the November meeting. As a result US 10 year Treasury yields rose by 22 bps in October whilst the equivalent German yield rose by only 4 bps. At the time of writing, the market is now pricing in the Fed to hike rates to a 5.2% mid-point which appears sufficiently restrictive in the near term given the cumulative tightening provided and due to the lags of policy pass through which of significance, are comments recently added to the latest Fed statement as well.
  - November provided more evidence of the global economic slowdown. Higher interest rates combined with elevated inflation and economic uncertainty continued to weigh on domestic and foreign demand for most developed economies, leading to a further drop in manufacturing and service sectors' activity as shown by major surveys. Eurozone business activity fell for a fifth consecutive month while US activity registered its second-fastest drop since May 2020. Labour markets remain robust by historical standards but signs that labour demand might have peaked are slowly emerging. Meanwhile, inflation has eased on the back of a drop in energy prices, providing encouraging news that we might have seen the worse in inflation even if we could see some more months of elevated price increases, in particular in the Eurozone. We continue to believe that the impact of tighter monetary policy on the real economy has yet to be seen and will take some more months to fully materialise but is gradually starting to kick in.

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- Hard data continue to be more resilient than what surveys suggest, and demand has not deteriorated enough to bring prices down meaningfully yet. As the impact on economic activity intensifies and the cumulative tightening made so far increases more cautiousness across policy makers will emerge. The slowdown in economic growth intensified in November across major economies and this, along with lower energy prices, is weighing on prices. US Inflation has moderated and seems to be on a downward trend. Goods inflation has eased on the back of weaker demand and services inflation also provided encouraging signals. While on the goods front prices should continue to decelerate as demand deteriorates further and supply chain issues continue to ease, developments on the services front are still uncertain. There is a good chance that a rising unemployment rate coupled with slowing rent inflation will provide some relief to prices towards the late first half of next year but wages growth remains an upside risk to inflation in the second half of the year and beyond that. Deeper recessions are expected in the Eurozone and the United Kingdom. Activity data have been resilient so far while inflation has eased in many Eurozone economies in November. However, prices remain high and continues to weigh on real incomes and consumers spending. Eurozone core inflation was unchanged at 5% in November and the labour market is still very tight, with the unemployment rate remaining at historical lows, putting pressure on wages. What's more, the combination of higher rates, uncertainty and energy issues continue to weigh on business investment and activity according to surveys. Looking ahead, base effects on the energy front should enable a gradual decrease of headline inflation in the coming months but domestic pressures are likely to keep core inflation elevated for some time. We will probably need to wait for the second half of 2023 to see more meaningful drops in core inflation within the euro bloc.
  - Meanwhile, the Chinese economic recovery continues to remain poor in November. The latest PMIs signalled that the manufacturing sector can no longer rely on export demand as the global economy enters a downturn. Domestic demand is also restricted by persistent measures amid surging Covid cases, the struggling property sector and low household confidence. These factors are weighing on both manufacturing and services activity which both contracted in November. Recently, frustration and weariness of the public have increased with multiple protests in cities and factories. As a result measures are slowly being relaxed. Headlines confirm that China's path toward a broader reopening continues. We expect more policy support along with further relaxation of Covid-related measures in the coming months to support the Chinese economy. That said, the road towards stronger growth remains bumpy. At the global level, easing commodity prices and supply issues along with weaker demand are expected to keep inflation on a downward trend. Due to some lags in prices transmission, the strength of the labour market and other sticky core pressures, it might take until late 2023 to see a meaningful drop in inflation, and in particular core inflation. That said, rising economic growth concerns along with acknowledgement of the cumulative tightening done could still prompt most developed economies to pause their hiking cycle as soon as early next year. Overall, despite the economic downturn in some major developed economies, we continue to expect positive global growth next year.



- Sentiment towards fixed income saw a general improvement in November and in particular following the lower than expected CPI print in the US. Investors were relieved by the release as it increased the likelihood of the Fed stepping down its hiking pace to 50 bps for the December meeting. As a result we saw a decline in government bond yields with US 10 year yields for example falling by 44 bps during the month in a curve flattening move. German 10 year yields meanwhile declined by 21 bps, underperforming US rates as a result of continued hawkish commentary from ECB members who continue to flag upside risks to inflation through second round effects of stronger wage growth and rising long term inflation expectations. Sentiment towards the Eurozone also saw initial signs of improvement which weighed on Bunds as observed with the German ZEW for example following the decline in nat gas prices observed and no further escalation in the Russia-Ukraine war. Credit markets also reacted positively following the US CPI print and given the decline in real rates observed, with 10 year US real rates for example falling by 50 bps from the early November peak. In light of the developments described, US investment grade credit spreads tightened by 25 bps during the month whilst European spreads were 37 bps tighter, with the latter outperforming given the extent of pessimism that had been priced for the Eurozone region amid the Russia-Ukraine War. Improving sentiment towards China as the month progressed also supported European risk assets as the region would set to benefit from a Chinese reopening given close trade ties. Although a full reopening is not likely until March next year, initial signs of loosening measures provide hope that the Chinese growth story for 2023 may not be as poor as 2022. These developments in China, as well as the lower US CPI print both provided impetus for the dollar to fall of historical highs in November, with the Dollar Index declining back to levels last seen in August.
- The fourth quarter of 2022 was characterized by a further slowdown in global growth and emerging signs of peaking inflation across developed economies. Weaker demand along with reduced energy prices and further improvements of supply chains have enabled some easing in global price pressures. According to the latest PMIs, both input and output price pressures started to ease recently, albeit remaining elevated by historical standards. Despite the positive news on the prices front, inflation remains well above central bank targets. While some commodity prices have eased, food and core price pressures are keeping inflation high. Core inflation is expected to continue to remain robust throughout next year, largely supported by service prices (resulting from wages and rents). Meanwhile, evidence of economic weakness has increased, leading to greater monetary policy caution amongst the most rates sensitive economies such as Canada and Australia. We still believe that the impact of tighter monetary policy on the real economy has yet to be seen across developed countries. Global leading indicators are pointing to a deteriorating economic outlook, while global purchase manager indices have been in contractionary territory for several months now. Hard data has so far been resilient, but the weakness seen in surveys is expected to emerge in real economy indicators. Although several developed economies are on track to experience economic contractions in subsequent quarters, global growth is still expected to be positive in 2023. Asian countries in particular will provide the largest support to the global economy with China set to reopen in the months ahead.

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- Downside risks to the global economic outlook remain, including monetary and fiscal policy mistakes and renewed commodity or COVID related supply disruptions. Inflation meanwhile should continue its downward trend on the back of slowing economic activity, loosening labour markets restraining wage growth, improving supply chains and easing commodity price pressures.
  - Central bank meetings were in focus in December to see whether there would be any further hawkish shifts following the repricing observed throughout 2022. The Fed meeting saw a muted market reaction given that it followed a second downside surprise in a row for US CPI which all but confirmed the Fed's decision a day later to step down its hiking cycle pace to 50 bps from 75 bps previously. Recent inflation trends in the US would have given the Fed increased confidence in its expectations for inflation to decline as 2023 progresses and has also narrowed the range of possibilities for the Fed's terminal rate, for which the market is pricing a 5.0% mid-point which is not far from the Fed's own dotplot showing 5.1%. Away from the Fed however, the market was caught off guard by significant hawkish shifts from key central banks. At the ECB for example, whilst they hiked by 50 bps as expected, it was the forward guidance that was taken as a surprise by the market. In particular they indicated that rates will have to rise significantly at a steady pace to reach sufficiently restrictive levels, with President Lagarde clearly stating that this steady pace would mean raising rates in 50 bp increments for a period of time. Finally the BoJ shocked markets by taking its end-December meeting at a time of poor liquidity as the moment to adjust its yield curve control policy, widening the band around the 0% target on 10yr JGBs from +/- 25bps to +/- 50bps which took 10yr JGBs immediately towards the upper end of the new target band. Although investors had been anticipating such a shift in 2023, recent guidance from the BoJ suggested that this would happen at a later stage, and most likely following the end of Governor Kuroda's term after Q1 23.
  - As a result of these developments we saw EUR rates sell off aggressively and across the curve given the ECB's communication, with 2yr and 10yr yields rising by 63 & 64 bps respectively. USD rates outperformed with the curve steepening given the US CPI downside surprise, although yields still rose on the month given contagion from ECB & BoJ action with 10yr US yields rising by 27 bps whilst 2yr yields only rose by 12 bps. Despite rates volatility herein, US Investment Grade credit spreads still managed to tighten on the month by 5 bps as the market reacted positively to the CPI release. European IG spreads were 14 bps tighter on the month, likely outperforming due to the extent of pessimism that had been priced for the Eurozone region amid the Russia-Ukraine War. Improving sentiment towards a potential China reopening also supported European risk assets as the region would set to benefit given close trade ties.

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## Performance Review

- QTD the strategy returned +1.0% net of fees (I Share class).
- The excess return over the benchmark (ICE BofA Euro Government index\*) was +121 bps before fees.
- The gross excess returns sequentially over the quarter were: +35 bps in October, +69 bps in November and +17 bps in December.
- QTD, interest rate exposure and yield curve contributed +7 bps, swap and agencies were +16 bps and credit added +89 bps (other items +9 bps).

\* Index provided for comparison and information purposes only.

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## Portfolio Activity

- At the end of the quarter, the yield of the portfolio was 3.4% vs 3.2% for the reference index.
- The interest rate exposure was 7.4 years vs. 7.1 years for the index
- The main position for the portfolio was:
  - Overweight German Futures vs underweight German and core bonds
  - Overweight duration through USD
  - Overweight credit through corporate bond market
- In October, we maintained the fund's overweight credit exposure, seeing much of the bad news as being priced into spreads and viewing the growth slowdown as necessary to help lower inflationary pressures. We view all-in yields as attractive where they can also help buffer against current market volatility and growth fears. On the rates side we have maintained the fund's overweight duration bias in the belly of rates curves, where we think that holding US 5 year rates makes sense from a valuation perspective given what is now priced in terms of restrictive policy for the Fed and ECB. We decided to take profits on the fund's overweight Italian BTP spread position which was held through 10yr futures towards the end of the month following the sharp tightening in spreads observed, and in case the market shifted its focus back on to the ECB's QT plans into year-end.
- In November, we maintained the fund's overweight credit exposure, seeing much of the bad news as being priced into spreads and viewing the growth slowdown as necessary to help lower inflationary pressures. We view all-in yields as attractive where they can also help buffer against current market volatility and growth fears. On the rates side we maintained the fund's overweight duration bias and added further to it as the month progressed, particular at the long-end as we believed that the flattening bias could remain intact. As a result, the fund ended the month holding a diversified overweight interest rate duration position through USD, AUD and JPY rates. With regards to forex, the portfolio held a short USD bias vs EUR, AUD and JPY during the month to take advantage of the move lower in US rates. Towards the end of the month we decided to take profits on the majority of these shorts given the extent of the move, whilst maintaining short a short USD/JPY position which can benefit from a slowing growth backdrop.




- In December, we maintained the fund's overweight credit exposure, seeing much of the bad news as being priced into spreads and viewing the growth slowdown as necessary to help lower inflationary pressures. That said, we did take advantage of the significant tightening in spreads observed since late September, particularly the move observed in CDS indices to which the portfolio had exposure to, whilst keeping the cash bond allocation largely unchanged. Whilst the portfolio continues to exhibit a constructive stance towards credit markets, we decided to take profits on some of the exposure given event risks through key central bank meetings and poor liquidity into year-end. On the rates side we maintained the fund's overweight duration bias as the Fed appears to be closer to the end of its hiking cycle, whilst holding duration also makes sense from a portfolio construction perspective if investors become more fearful of the growth outlook. That said, we did reduce overall duration levels, closing overweights held in other major DM's away from the US, given that the path for the Fed appeared to be clearer, especially given two consecutive downside misses to US CPI. We also took profits and closed the fund's short USD/JPY exposure as we looked to reduce risk into year-end.


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## Outlook

- The fourth quarter of 2022 was characterized by a further slowdown in global growth and emerging signs of peak inflation across developed economies. Weaker demand along with reduced energy prices and further improvements of supply chains have enabled an easing in global price pressures. Despite positive news herein, inflation remains well above central bank targets. Whilst some commodity prices have eased, food and core price pressures have kept inflation high. Core inflation is expected to continue to remain robust throughout the first half of the year at least, largely supported by service prices (resulting from wages and rents), but should still ease gradually. Headline inflation should continue its downward trend on the back of slowing economic activity, improving supply chains and easing commodity price pressures. Meanwhile, evidence of economic weakness has increased, leading to greater monetary policy caution amongst the most rates sensitive economies such as Canada and Australia. We still believe that the impact of tighter monetary policy on the real economy has yet to be seen across developed countries, where global leading indicators are pointing to a deteriorating economic outlook. Hard data has so far been resilient, but the weakness seen in surveys is also expected to emerge in the real economic indicators. Although several developed economies are on track to experience further economic weakness this year, recent evidence suggests that the overall impact could be smaller than previously anticipated. Overall, we do not anticipate a collapse in global growth given the strength of labour markets within DM economies, whilst Asian countries should provide support to the growth backdrop amid Chinese reopening.
- In the United States, the impact of tighter monetary policy on rate sensitive sectors increased in the last quarter of 2022. The housing market downturn intensified while goods demand weakened further. Households have used savings accumulated during the pandemic and this has kept sales robust throughout most of the quarter, although these savings have now diminished. Labour market conditions however remain extremely tight by historical standards, preventing a sharp contraction in services demand. That said, signs that employment conditions are easing are arising via employment leading indicators including average hours worked, which continue to weaken. Looking ahead, the combination of weaker economic activity weighing on labour demand and wage growth suggests greater weakness in goods and services demand in the coming quarters. Higher rates will also limit construction and investment keeping any economic growth subdued for some quarters. On the prices front, goods inflation has started to come down on the back of weaker demand and improved supply. Services inflation remains strong supported by rents but overall core price pressures are easing and heading in the right direction. There is a good chance that a rising unemployment rate coupled with slowing rent inflation will provide some more meaningful relief to prices towards the second quarter of the year.
- In the Eurozone and the United Kingdom, the economic outlooks look gloomier. Price pressures are starting to show some signs of easing, mainly on the energy price front, but remain extremely high and continue to weigh on real incomes and consumer spending. However, it is not just about energy. In contrast to what observed in the United States, signs of easing core price pressures are missing in Europe. What's more the labour market remains tight keeping wage growth robust.



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- Wage growth represents a major upside risk to European core inflation which is on track to remain high until the second half of 2023. This is particularly true in the United Kingdom where, following Brexit and Covid, a large share of the workforce is missing. Meanwhile, the Chinese economic recovery continued to struggle in the fourth quarter of 2022 as renewed Covid outbreaks have weighed on the economy. Weaker global demand has also been a drag on trade and economic growth. Chinese domestic demand has been restricted by persistent measures amid surging Covid cases, the struggling property sector and low household confidence. Frustration and weariness of the public have increased and resulted in multiple protests in cities and factories. This, coupled with the soft economic growth has prompted the Chinese government to relax several covid-related measures in order to calm public opinion and bring forward any economic recovery. China also adopted a more supportive stance towards the economy reiterating support to struggling sectors such as the property one. We expect more policy support along with further relaxation of Covid-related measures in the coming months to support the Chinese economy leading to a faster recovery. Yet, challenges for the medium to long term outlook remain.
  - From a monetary policy perspective, 2022 ended with key central banks appearing to be at contrasting stages in their respective tightening cycles. For example whilst the Fed appeared to be guiding markets towards an end in its hiking cycle in the coming months based on their latest dot plot projections, the ECB indicated that their tightening is far from over, whilst the BoJ has yet to normalize policy at all. Starting with the Fed, their December meeting shortly followed the second consecutive downside surprise to US CPI, which all but confirmed their decision to step down the hiking cycle pace to 50 bps from 75 bps previously. Recent inflation trends in the US would have given the Fed increased confidence in its expectations for inflation to decline as 2023 progresses and has likely narrowed the range of possibilities for the Fed's terminal rate, for which the market is pricing a 5.1% mid-point, in line with the Fed's own dot plot. Meanwhile at the ECB, whilst they hiked by 50 bps as expected, it was the forward guidance that was more surprising as they indicated that rates will have to rise significantly at a steady pace to reach sufficiently restrictive levels. President Lagarde clearly stated that this steady pace would mean raising rates in 50 bp increments for a period of time, rather than a step-down to 25 bp increments as the market had been anticipating. Whilst growth in the Eurozone remains a concern, the ECB appears more focused on the risks that current elevated inflation leads to second round effects of higher wage growth and a de-anchoring of long run inflation expectations. Finally the BoJ shocked markets by taking its end-December meeting at a time of poor liquidity as the moment to adjust its yield curve control policy, widening the band around the 0% target on 10yr JGBs from +/- 25bps to +/- 50bps. Although the bank put the decision down to market functioning rather than a hawkish shift in policy, their decision is being viewed as the first sign of policy normalisation and the market will be looking for further hints in this direction as 2023 progresses and especially after current Governor Kuroda's term ends after the first quarter.

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- Overall, we view the hawkish repricing observed across rates markets throughout 2022 as having created significant value within fixed income and we enter 2023 with a positive bias towards interest rate duration. As the tightening in financial conditions and hawkish actions delivered last year feeds through to the real economy this year, it should help slow economies and rebalance demand & supply. This should allow investors to focus their attention back onto growth over inflation concerns, for which holding interest rate duration within portfolios can protect them against any growth shocks and argues for building more balanced portfolios with both duration and credit risk this year. This is especially the case given recent inflation trends in the US for example which supports the view that the path for inflation is lower from here in 2023 and should allow the Fed to act less aggressively in the months ahead and especially as real rates turn positive across the curve. Our preference continues to be in favour of holding US over European duration at this current juncture and at a time when the ECB has been less clear as to where they estimate the neutral rate and sufficiently restrictive policy is.
  - We also head into 2023 maintaining our positive bias towards credit, seeing much of the bad news as priced into spreads. Whilst growth is slowing, we would note that it is not collapsing and we see this slowdown as necessary to ease inflationary pressures, which remains the main concern for both central banks and investors. Growth last year was more resilient than many had anticipated, supported by tight labour markets, and we see several factors that could ultimately lead to a soft landing and have not been appropriately priced into spreads. For example elevated job openings means that the labour market in the US could loosen without a need for a significant rise in the unemployment rate. The long awaited Chinese economic reopening is set to take place in the coming months, which will help offset much of the weakness coming through from DM growth. Whilst the energy crisis amid the Russia-Ukraine war clearly weighed on sentiment last year, we would note that warmer weather has resulted in current natural gas prices in the Eurozone being at levels last seen prior to the conflict. This has reduced fears of potential blackouts in the region which would have weighed on production, at a time when governments are helping to pick up the higher energy bills.
  - We expect that a stabilization in the rates backdrop will help attract inflows back into credit markets where we view high income strategies in particular as ripe to take advantage of this backdrop. 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 current market volatility and any further spread widening. We also think that an allocation to BB rated bonds is attractive given their superior risk-reward profile to BBBs, single Bs and CCCs and as corporate fundamentals for BBs seem in good shape heading into a slower growth environment. Interest coverage ratios are at record highs whilst net leverage ratios are below their 25-year average. Finally we view subordinated financial debt including AT1s as benefitting from this higher rates and inflation backdrop, as has been observed through recent bank earnings which have remained impressive.

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