Q1 2022

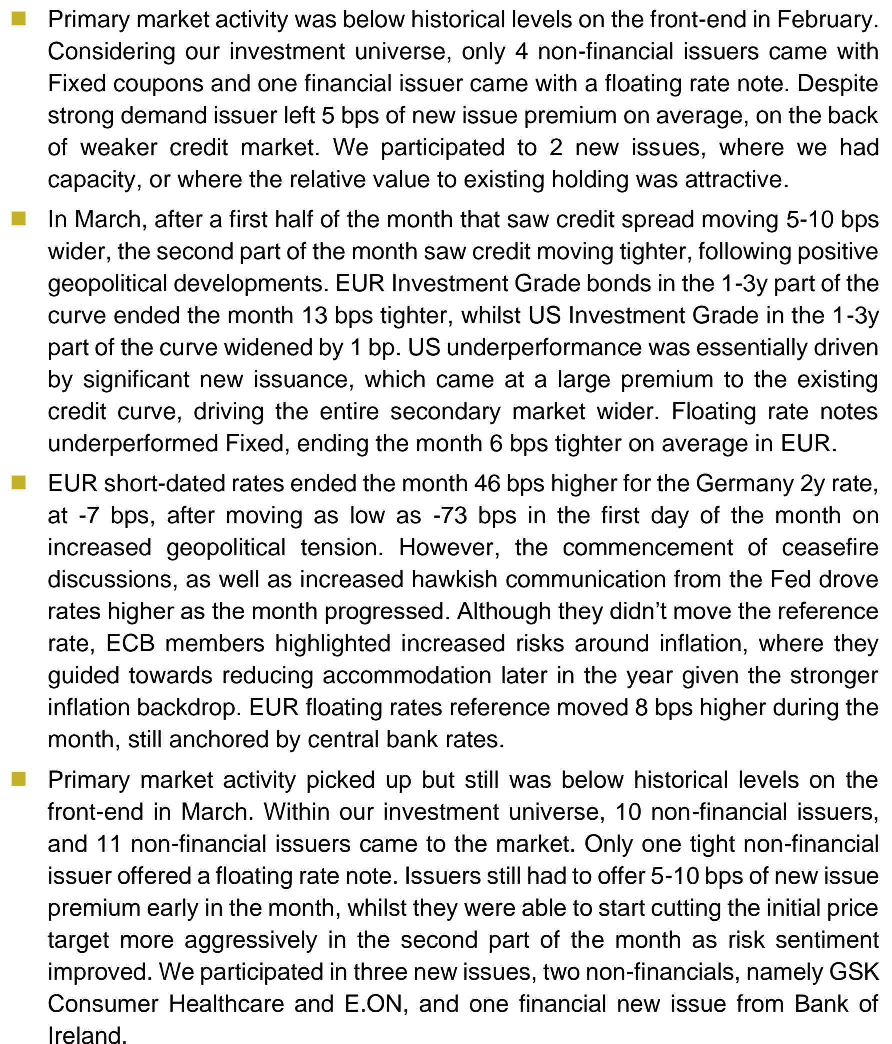
UBAM - DYNAMIC EURO BOND

Quarterly Comment

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws. The classification of the fund(s) as per the Sustainable Finance Disclosure Regulation (SFDR) is available on ubp.com or in the latest prospectus.

Market Comment

- 2022 began on a volatile note as the hawkish shift taken by several key central banks towards the end of last year extended further. One of the main messages delivered by Fed Chair Powell was that this tightening cycle will be different to the gradual hiking cycle that began in 2015, where he chose not to rule out the possibility of a 50bp hike in March or hiking at consecutive meetings in contrast to the general consensus which has been for a gradual, quarterly hiking pace.
- Markets also priced in risks of a more hawkish ECB meeting given rising inflation concerns as energy prices continued their march higher as geopolitical tensions between Russia and Ukraine escalated.
- We therefore saw government bond yields rise sharply in January as the market further re-priced their expectations for central bank tightening with more than five hikes priced for the Fed by the end of this year and two hikes priced for the ECB at the time of writing. Such developments led to US 10-year yields rising by 27 bps in January in a move that was fully driven by real rates, which rose to their highest level since March 2021.
- This real rate move weighed on risk markets, with equities coming under significant pressure on the back of a large sector rotation which saw Growth names weaken aggressively, whilst Value outperformed.
- Credit spreads followed suit with US Investment Grade spreads widening by 13 bps and European spreads were 9 bps wider on the month. Economic data released during the month generally saw a further moderation given the impact of the Omicron Covid wave in December, as observed through the ISM Manufacturing and Services prints which disappointed relative to expectations and also likely weighed on sentiment.
- In February, European credit markets underperformed the US given the current geopolitical crisis and Europe's dependency on imports of Russian oil and gas. EUR Investment Grade bonds in the 1-3y part of the curve widened 35 bps excluding Russian issuers, while US Investment Grade in the 1-3 y part of the curve widened a more modest 12 bps, excluding Russian issuers. Floating rate notes outperformed, widening 21 bps on average for the EUR bonds, compared to 9 bps widening on average for the USD bonds.
- EUR short-dated rates ended the month almost unchanged at -0.53% for the Germany 2y rate, after having shortly risen to -0.25% following the ECB meeting as President Lagarde did not rule out a hike for this year in the press conference. Rates returned however to their initial levels as the geopolitical crisis intensified as the month progressed. Floating rates however did not react during the month, being anchored by central bank rates.



- Primary market activity was below historical levels on the front-end in February. Considering our investment universe, only 4 non-financial issuers came with Fixed coupons and one financial issuer came with a floating rate note. Despite strong demand issuer left 5 bps of new issue premium on average, on the back of weaker credit market. We participated to 2 new issues, where we had capacity, or where the relative value to existing holding was attractive.
- In March, after a first half of the month that saw credit spread moving 5-10 bps wider, the second part of the month saw credit moving tighter, following positive geopolitical developments. EUR Investment Grade bonds in the 1-3y part of the curve ended the month 13 bps tighter, whilst US Investment Grade in the 1-3y part of the curve widened by 1 bp. US underperformance was essentially driven by significant new issuance, which came at a large premium to the existing credit curve, driving the entire secondary market wider. Floating rate notes underperformed Fixed, ending the month 6 bps tighter on average in EUR.
- EUR short-dated rates ended the month 46 bps higher for the Germany 2y rate, at -7 bps, after moving as low as -73 bps in the first day of the month on increased geopolitical tension. However, the commencement of ceasefire discussions, as well as increased hawkish communication from the Fed drove rates higher as the month progressed. Although they didn’t move the reference rate, ECB members highlighted increased risks around inflation, where they guided towards reducing accommodation later in the year given the stronger inflation backdrop. EUR floating rates reference moved 8 bps higher during the month, still anchored by central bank rates.
- Primary market activity picked up but still was below historical levels on the front-end in March. Within our investment universe, 10 non-financial issuers, and 11 non-financial issuers came to the market. Only one tight non-financial issuer offered a floating rate note. Issuers still had to offer 5-10 bps of new issue premium early in the month, whilst they were able to start cutting the initial price target more aggressively in the second part of the month as risk sentiment improved. We participated in three new issues, two non-financials, namely GSK Consumer Healthcare and E.ON, and one financial new issue from Bank of Ireland.

Performance Review

- UBAM - Dynamic Euro Bond delivered -0.35 % net of fees QTD (I Share class). In relative terms, the strategy delivered -16 bps of excess return before fees vs. a reference to a EUR cash deposit index*.
- The excess returns sequentially over the quarter were: -8 bps in January, -46 bps in February and +38 bps in March.
- QTD, the core holdings of investment grade floating rate notes, fixed coupon bonds (with interest rate exposure hedged) and single name CDS generated -46 bps of excess return. The duration overlay contributed +34 bps.

**Index provided for comparison and information purposes only.*

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in EUR was -0.2% vs. -0.5% for EUR cash deposit
- The interest rate exposure was -0.4 years
- The average life of the core portfolio (excluding liquid CDS overlay) was 21 months
- The credit spread exposure was 2.2 years
- The average rating was A-

Outlook

- Although COVID-19 concerns have eased since the start of the year, which has allowed for the global reopening of economies to continue, the Russia-Ukraine crisis has begun to reshape the geopolitical and economic outlook. Geopolitical tensions, persistent supply constraints and less accommodative monetary and fiscal policies will likely lead to a decline in global economic growth from 5.8% in 2021 to around 3% in 2022 and 2023. Activity in regions such as Europe and Latin America will be softer as countries struggle with either a greater impact from the Russia-Ukraine crisis or higher deficits and inflation rates, whilst the US economy should outperform. At a global level, rising energy prices and persistent supply chain disruptions should continue to keep inflation elevated throughout most of the year, with further pressure in some countries to come through tight labour markets driving wage growth. As a result, global inflation is expected to rise from 3.9% in 2021 to around 6.5% in 2022, before slowing back to 3.5% in 2023, where this year's strength in inflation is likely to force most central banks to tighten their monetary policies further.
- Across major countries, the United States will stand out. Despite the impact of higher food and energy prices, less supportive monetary and fiscal policies and weaker growth in export markets, the United States economy should remain relatively solid. Strong labour market conditions coupled with robust household and business balance sheets should provide resilience and help maintain private demand and investment. Meanwhile, the Eurozone and United Kingdom economies will likely contract in the second quarter of the year as fiscal policy is unlikely to be enough to prevent a slowdown in activity driven by a greater impact from the Russia-Ukraine crisis, which is squeezing real households' incomes. Provided geopolitical tensions moderate however, economic growth in Europe should resume later in the year driven by a post-Covid-19 rebound in services consumption, declining inflation, and easing supply chain issues. In China, should the government stick to its zero-Covid policy, new outbreaks of COVID-19 will continue to keep industrial production and household consumption subdued, preventing a swift rebound in economic activity. While threats to activity from virus infections, high corporate debt and the weak real estate market remain, the government will continue to support economic growth via easing monetary policy measures, accelerated infrastructure investment and tax rebates for firms in an attempt to achieve its 5.5% growth target for 2022, for which risks currently appear to the downside.
- During the first quarter of the year, the Fed accelerated its hawkish shift given that they have been consistently surprised to the upside by the extent and duration of the current inflationary pressures, coupled with their increased confidence in the strength of the labour market, which Fed Chair Powell described as extremely tight. For example at the March meeting, the Fed's updated dot plot projections showed the Fed Fund's rate above the neutral rate at 2.8% in 2023, up from 1.6% previously with Powell saying that there is an obvious need to move expeditiously to return the stance of monetary policy to a more neutral level. Whilst the Fed had previously been expecting inflation to cool in the second half of the year as supply side damage begins to heal, given uncertainty around the timing of this now, Powell said they will instead be looking at actual progress on supply side constraints, rather than assuming a significant near-term relief. Despite current pricing indicating a terminal rate for the Fed of above 3% now, we still see a possibility of the market pricing in a

more aggressive hiking cycle in the near term given the Fed's frustration with inflation. We see a high likelihood that the Fed moves in 50 bp increments in the next couple of meetings, especially given both their and our belief that the US economy can handle higher interest rates and with financial conditions still loose on a historical basis.

- In contrast at the ECB, we find it difficult for the market to price in a much more hawkish policy outlook at this stage, with around 200 bps in cumulative hikes now priced until end-2023. Both economic and wage growth in the Eurozone has not been as robust as that observed in the US, with inflationary forces largely driven by external factors such as energy prices, with limited domestically driven price pressures and which should allow inflation to mean-revert over time. That said, investors appear to have chosen to focus more on President Lagarde's comments at the March meeting, where she came across as more concerned with inflation over growth risks given that the ECB's scenario analysis of the Russian invasion of Ukraine forecasted growth still close to its potential rate for the Eurozone even in a severe scenario.
- Overall, we retain our defensive stance on duration, seeing room for yields to rise, particularly at the front-end of the US rates curve until we begin to see meaningful signs of inflationary pressures, or expectations easing. We think that the sell-off in rates markets can continue given the global and synchronised nature of the hawkish shifts from central banks, where laggards to monetary tightening could also be forced into action. For this reason we also think that the BoJ will be worth watching where despite limited domestic price pressures, headline inflation is likely to reach 2% this year for the first time since 2015 following the rise in energy prices. This could warrant some adjustments to the BoJ's current Yield Curve Control policy and as such, we see attractive risk reward in positioning for higher JGB yields.
- For credit, we continue to view this environment described as supportive for spreads. Whilst the geopolitical situation is fluid, our base case of still solid global growth leaves tail risk scenarios of recession and rising default rates as still far off, providing a positive backdrop for credit in which valuations have also improved. We also see this hawkish shift as being one driven not only by inflation fears, but also as a consequence of the more robust global growth backdrop which has been accompanied by tightening labour markets and rising wages. Whilst there are some concerns in relation to the impact of higher energy prices on household incomes, we would note that household balance sheets in the US are healthy given wealth accumulation across the income spectrum in recent years. Meanwhile in Europe, governments have already begun to react to this crisis through greater fiscal support, which we expect to continue and help cushion the growth impact.

- We also see this backdrop as positive for credit from the micro perspective, given strong credit fundamentals underpinned by good pricing power - which allows companies to sustain high profit margins despite an inflationary environment - as well as continued prudent balance sheet management. Net leverage for US Investment Grade names has fully reversed the increase observed during the pandemic, whilst a US HY default rate of under 1% for 2021 highlights how this segment of the market benefitted from the reopening of economies on the back of the vaccine rollout. As such, we prefer high beta credit with low duration, favouring high yield and subordinated financial debt, in particular AT1s which should benefit from the rising rates environment, as well as floating rate notes which can be an attractive allocation at a time of rising rates.

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