Q1 2020

UBAM - HYBRID BOND

Quarterly Comment

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

Market Comment

- Following a strong end to 2019 for risk markets, 2020 has begun on a weaker footing in light of the unexpected coronavirus outbreak emanating from China. This new development has raised concerns given that the number of cases continued to grow throughout the month, with market participants anticipating a near term impact on growth in China in particular, as countries globally look to implement measures to restrict travel to the impacted areas. US Investment Grade credit spreads widened by 6 bps in January, whilst European IG spreads were more resilient, and only widened by 1 bp herein. The outperformance of the latter could in part be put down to positive news flow in Italy, which saw BTP spreads tighten by 23 bps in January alone following the strong performance of the Democratic Party in regional elections, which reduced market expectations of near-term snap elections being called. US markets had to also deal with several growing risks including geopolitics, following President Trump's decision at the start of the year to target the head of Iran's Quds force, whose death increased fears of retaliation within the region. In addition, the rising popularity of Bernie Sanders in the polls ahead of the Democratic primaries also brought US elections at the end of 2020 into focus early, as he looks to close the gap with Joe Biden in representing the Democrats.
- Given the risk off tone described, safe haven assets performed well with US 10 year yields for example rallying by 37 bps in January, outperforming German Bunds, whose 10 year yields in contrast declined by 25 bps. The January FOMC meeting also supported US rates following a dovish change to the statement, where the current stance of policy was judged as supporting inflation "returning to" rather than "near" the 2% objective. Chair Powell in the press conference noted that this change was to emphasise the symmetry of the inflation target and to avoid any possible misinterpretation that the Fed was comfortable with inflation running below 2%.
- The threat from the coronavirus outbreak escalated in February as the number of positive cases spread beyond China, as cases were reported to have accelerated in South Korea, Japan, Iran and Italy. With Covid-19 reaching as far as Europe, investors began fearing that the impact on growth may be broader and deeper than had initially been feared. As a result, the last week of February saw a sharp correction in risk assets as the market priced in these fears, with the S&P 500 for example declining over 10% in the last week of the month. Credit markets were unable to escape this move, with US investment Grade credit spreads widening by 21 bps in February and European IG spreads by 20 bps, in what was a sudden shift in sentiment compared to the buoyant mood of 2019.
- This intense tightening in financial conditions resulted in market participants pricing in likely support from central banks, which also allowed for interest rate markets to rally sharply. For example in the US, 10 year yields declined by 36 bps, whilst the 2 vs 10 year part of the curve was still able to steepen, as pricing for rate cuts from the Fed at the front end of the curve surged. Fed Chair Powell at the end of February did not appear to push back on this price action either, as he released an unexpected statement, saying that Covid-19 poses evolving risks to economic activity, where they will use their tools and act as appropriate to support the economy.

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Italian BTP sovereign spreads also suffered into month-end given the rise in coronavirus cases in Northern Italy, with 10 year spreads widening by 34 bps in February alone. Increasing concerns in the region also fuelled a safe haven bid for German Bunds, which saw yields decline by 17 bps during the month.

- March was a month in which the coronavirus outbreak spread globally, as cases reported outside of China exceeded those within China, with the World Health Organisation describing the situation as a pandemic. In an effort to slow the spread of Covid-19, western governments announced social distancing and lockdown measures, forcing individuals to stay at home, with non-essential services put on hold. This resulted in a violent re-pricing of risk markets, as such strict measures led analysts to forecast a global recession this year. Central banks reacted aggressively to this news flow, with the Fed cutting rates by 150 bps in March alone, bringing interest rates down to the zero lower bound. The Fed also re-activated various liquidity tools used in 2008, whilst also adding new ones, including the primary and secondary market corporate credit facilities, to specifically target short maturity debt of US investment grade issuers. The ECB also provided enhanced liquidity measures such as additional LTROs, as well as a sizeable increase of its QE programme. In particular, the current asset purchase programme envelope was increased by EUR 120bn, whilst the bank also announced a EUR 750bn pandemic emergency purchase programme, which has more flexibility than the APP to target stressed parts of the market. Not to be outdone, governments globally have also been proactive in trying to contain the impact of the virus on the economy with fiscal stimulus packages including SME lending, public guarantees and various types of moratoriums, as well as pursing more traditional stimulus measures such as tax cuts and credits. The sizes of these packages announced have been significant, as highlighted in the US, with phase 3 of the package here totalling USD2trn, 10% of GDP.
- In light of these developments, US IG credit spreads widened by 199 bps in March, whilst European IG spreads widened by 126 bps, in moves which were likely exacerbated by poor liquidity. Interest rate markets benefitted from monetary easing and safe haven inflows, with US 10 year yields rallying by 48 bps, whilst German bund yields declined by 14 bps, underperforming US rates as the ECB deposit rate was left unchanged at -50 bps.

Performance Review

- QTD, the net return of the fund was -11.33% net of fees (I share class).
- The gross return contribution was:
    - Additional Tier 1: -11.78%
    - Insurance subordinated: -0.80%
    - Corporate hybrid: -1.11%
    - Other items: +2.87%

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in USD was 7.9%
- The interest rate exposure was 3.8 years
- Main positions:
    - 61% AT1, primarily core Europe (ex Germany), in particular Netherlands, France and Switzerland
    - 2% Banks Tier II
    - 6% Insurance Sub

    11% Corporate Hybrids

- In January, we slightly increased the fund's credit positioning across segments and geographies.
- In February, we added interest rate and credit hedges to the portfolio as the Covid-19 outbreak spread beyond China. In interest rates, we added up to 2.2 years of duration through both US and European interest rate futures, as we anticipated both a bid for safe haven assets and the market pricing in likely support from central banks. In credit, we tactically put on a short Italian sovereign spread position through 10 year interest rate futures vs Germany as Italy became a focal point for the virus outside of China. Furthermore we purchased out-of-the money payer options on iTraxx Main to protect the overall portfolio in case of further credit spread widening.
- In March, in the second week of March we reduced our duration and credit exposure to lower the overall fund risk levels. We simultaneously reduced our interest rate duration overweight position, and credit positioning. In particular, we reduced AT1 exposure from 68% to 63% and Insurance Sub exposure from 9% to 6% and took profit on our iTraxx Main option hedging position.

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Outlook

- Whilst risk markets started the year on a firm footing in light of improving fundamentals, the focus quickly shifted to the coronavirus outbreak which initially started in China, however spread globally, with the World Health Organisation describing the situation as a pandemic. In an effort to slow the spread of Covid-19, western governments announced social distancing and lockdown measures, forcing individuals to stay at home, with non-essential services put on hold. This resulted in a sharp re-pricing of risk markets, as such strict measures fuelled expectations for a global recession to play out this year, as economies were put into a self-induced coma. Central banks reacted aggressively to these developments through substantial rate cuts, asset purchases and liquidity facilities. Not to be outdone, governments globally have been proactive, with fiscal stimulus packages including SME lending, public guarantees and various types of moratoriums, as well as pursing more traditional stimulus measures such as tax cuts and credits. As we look ahead to Q2, the key question will be whether these lockdown measures are able to contain the spread of Covid-19 in the near future, which will allow for restrictions to be lifted and economic growth to resume.
- The Federal Reserve has had a very busy first quarter, bringing rates down to the ZLB after 150 bps worth of cuts following two emergency meetings, as well as re-activating various liquidity tools used in 2008, such as the opening up of swap lines with other central banks to help deal with dollar funding stresses. Significantly, the Fed went beyond the measures adopted during the GFC and provided for the first time a real backstop to the front-end of the corporate investment grade market. The Primary and Secondary Market Corporate Credit Facilities were designed to specifically target short maturity debt of US IG issuers. The Fed also lifted the previously defined limits on US Treasury and MBS purchases have in another signal of intent. We take positives from the Fed's reaction function here, which was quick and targeted in attempting to contain the spillover effects of Covid-19 on financial markets, with liquidity in the Treasury market having somewhat normalised as a result.
- We anticipate that the Fed will remain on the front foot in providing accommodation to the economy and as such, we expect for these easing measures put in place to remain for the foreseeable future. This is especially the case given the shocking initial data that has been released for the period since the US implemented greater restrictions. For example weekly initial jobless claims numbers for those receiving unemployment benefits sky rocketed during the second half of March, to almost 10x the level observed during the financial crisis. With much uncertainty surrounding how long this pandemic will last, we expect for the Fed to try and offset any significant spikes in yields with larger asset purchases, in a bid to keep financial conditions loose. We see this more activist approach from the Fed bringing it one step closer to a yield curve control type policy in a bid to cap yields and enhance forward guidance.
- The ECB in Q1 not only enhanced its liquidity measures through additional LTROs, but also announced a sizeable increase of their QE programme. In particular, the current asset purchase programme envelope was increased by EUR 120bn, whilst the bank also announced a EUR 750bn pandemic emergency purchase programme, which has more flexibility than the APP to target stressed parts of the market. This allowed for Italian BTP spreads to recover from the sharp move wider, which was a move triggered by ECB President Lagarde's comment in the March press conference, where she said that it was not the bank's job to "close the spread" in sovereign debt markets. The fact that the ECB reacted to BTP weakness with such a large purchase package is another sign to us that they are serious about managing financial conditions, in line with the Fed.

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- Central banks elsewhere, from the BoJ through increased ETF purchases to the BoE via another corporate and government bond purchase programme also remain committed to cushioning the blow from the public health crisis. Our bias in Q1 was to hold interest rate duration from both a monetary policy easing and portfolio construction perspective. We continue to believe that adding to duration on yield spikes makes sense at a time when central banks are providing so much support, inflation remains low and whilst the outlook is still clouded by Covid-19 uncertainty, which warrants holding more balanced portfolios of both interest rate and credit risk.
- Our central scenario remains for the virus to be contained in a reasonable amount of time and thus the slowdown in growth, albeit meaningful in the short-term as highlighted by the large drop in recent PMIs and labour market indicators, to be temporary. This central scenario is supported by the observation that prior to the virus outbreak, the global economy had bottomed, was beginning to recover and inventories were lean. In addition, the stimulus provided by both central banks and governments is ultimately likely to help buffer the shock and should outlast the virus itself. Fiscal packages announced globally are already larger than what had been announced during the GFC, with room for this to grow if the pandemic is drawn out. Therefore whilst the global economy has caught the virus, it was healthy before and is therefore expected to recover, further helped by the support of stimulus.
- While the exact timing of risk market stabilisation is inherently difficult to pinpoint, any sign that the virus is contained is likely to provide an attractive entry point in risky assets, specifically in light of the pace of the market correction, where we are already seeing such signs within Europe. We can also take positives from valuations when it comes to spreads of the main segments of credit markets, which are currently trading in line or above recent market crises: i. 2015-2016 Oil bust (concerns about the growth outlook) and ii. 2018 Sell-off (Fed hiking, China growth slowing down). Thus, in a scenario where Covid-19 has a transitory impact on growth and monetary or fiscal stimulus support the economy, those spreads levels should start to offer entry points for investors looking to deploy cash.

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