

UBAM - CORPORATE EURO BOND

Quarterly Comment

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

Market Comment

- Q2 began on a positive footing for risk markets following the Covid-19 induced sell-off in Q1, as infection rates of the virus dropped significantly across Europe and the US. This allowed governments to start planning and announcing their exit strategies from the lockdown, which would enable economies to begin the process of restarting again. This hope was taken well by markets, with US investment grade credit spreads managing to tighten by 104 bps following a widening of 199 bps in March alone, whilst European equivalent spreads tightened by 58 bps after a widening of 126 bps the prior month. Central banks played a role in the market recovery, with the Fed for example taking the unprecedented step in April of announcing that its corporate credit facilities will also include purchases of fallen angels who have been downgraded from investment grade since March 22nd.
- The recovery in risk markets also came despite historically weak economic data releases, as initial jobless claims in the US suggested that the unemployment rate is set to surge well into double digits in the coming months. Services PMIs reached new lows given the impact of the restrictions on businesses which have been forced to temporarily close, whilst manufacturing activity dropped to the weakest level since 2009 amid the global growth slowdown. This demand shock led to an increase in oil inventories in the US as well, specifically in Cushing, Oklahoma which is where crude is traded and stored. Market fears rose during the month that there would be no more storage capacity available within weeks, which led to the front-month WTI contract trading negatively for the first time in history.
- The uncertain backdrop due to Covid-19, the weakening economic data, as well as the oil price shock which is set to keep inflation subdued, kept interest rate markets supported despite the Q1 rally, with US 10 year yields ending April 3 bps lower at 64 bps, whilst German 10 year Bund yields moved 12 bps lower to -59 bps.
- Risk markets continued to normalise in May following the significant risk off moves observed in the first quarter. The positive sentiment was driven by a continued fall in the pace of infection growth rates across Europe and the US, despite several lockdown restrictions being lifted. Without any signs of a 2nd wave of infection cases, the market was instead able to shift its focus on the likely improvement in economic data as mobility increases.
- This could already be observed in the high frequency labour market data released during the month as initial jobless claims were not as weak as the prior month, whilst continuing claims hinted at some workers already being redeployed back into the labour market. Global PMIs also provided hope that April represented the trough in manufacturing and service activity, which although still weak, appeared to be on the rise in May. Policy support also cushioned any lingering concerns, as the Fed commenced its corporate credit facilities, buying US IG ETFs for the first time, whilst in Europe, progress was made towards the EU Recovery Fund following the joint proposal brought forward by Germany's Merkel and France's Macron.



- US Investment Grade credit spreads managed to tighten by another 41 bps in May, adding to the 104 bps of tightening the prior month, whilst the European equivalent was 16 bps tighter after tightening by 58 bps in April. While US 10 year yields were steady throughout the month, the curve managed to steepen as the market became more confident in the likely economic recovery, and heavy US Treasury supply due to the increase in fiscal spending also weighed on the long-end of the curve. In Europe, the German 10 year Bund yield rose by 14 bps as safe haven hedges were taken off as hopes of an EU Recovery Fund being created this year rose. The idea of this fund being based mainly on grants rather than loans, along with debt mutualisation across the region helped peripheral spreads in particular, with 10 year Italian BTP spreads for example tightening by 43 bps during May alone.
- The second quarter ended on a more subdued note following the sharp recovery observed in risk markets the prior two months, as investors waited to see whether reopening economies would result in a second wave of Covid-19 infections.
- Spreads still managed to tighten in June however, buoyed by the strong bounce in economic data after lockdown measures were lifted. For example in the US, the closely watched payrolls report saw a massive beat versus analyst expectations, as substantial rehiring already appears to have taken place. In addition, global PMIs improved substantially for a second straight month, whilst retail sales growth was also impressive, in a clear sign of pent up demand. Spreads were also supported by the fact that the Fed began to buy individual corporate bonds for the first time in June as part of its previously announced secondary market corporate credit facility, providing a technical tailwind.
- This helped US investment grade credit spreads outperform its European counterpart, tightening by 28 bps in June, whilst European spreads were 19 bps tighter. Despite this positive risk backdrop described, interest rate markets were largely unchanged during the month as uncertainty regarding the Covid-19 endgame persisted and kept yields capped. In particular, concerns were raised in the US, where some of the largest populated states including Texas, Florida and California began seeing accelerating Covid-19 infection growth rates, which led to some fears that this may at some point lead to the reintroduction of growth restrictive, lockdown measures. As a result, investors seemed unwilling to take off safe haven interest rate duration positions, with US 10 year yields for example ending June just 1 bp higher, whilst the equivalent German Bund yield was 1 bp lower by the end of the month.

Performance Review

- Over the quarter, UBAM - Corporate Euro Bond increased 5.14% net of fees (I Share class). In relative terms the strategy delivered -10bp net of fees vs. its Benchmark: the ICE BofAML Euro Large Cap Corporate Index.
- The excess returns sequentially over the quarter were: +29bp in April, -20bp in May and -5bp in June.
- QTD, financials contributed +15bp, non-financials -14bp, hedging & overlay +12bp and other items -9bp.

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in EUR was 0.7% vs 0.9% for the Benchmark.
- The interest rate exposure was 5.2 years vs. 5.3 years for the index
- Main positions :
 - Overall credit exposure: overweight vs benchmark: overweight financials and underweight corporates
 - Financials exposure: overweight banks senior and underweight banks Tier II
 - Corporates exposure: overweight utilities, tmt, consumer, neutral hybrids, underweight cyclical industrials and autos
- In April, early in the month we added credit risk through iTraxx Main CDS index as the European trend of new Covid cases had declined even further to new lows, indicating that containment measures are working. We also reduced our EM exposure in the fund given more vulnerability to the global growth slowdown. The relative risk adjusted spread duration of the fund ended the month at -0.3. The duration of the fund ended the month at 5.5 years as we added duration in the belly and long end of the curve given ongoing uncertainty and supportive central banks as well as to hedge in case the WTI induced sell-off in risk markets continued.
- In May, at the beginning of the month we took profit on some of our holdings in the banks sector (mainly Tier II paper) and rotated into corporates. Towards the end of the month we added credit risk through the purchase of bonds in the 7-10 year maturity bucket issued by companies we perceive as winners from Covid-19. This risk addition was driven by positive developments including the EU recovery fund proposal by Merkel and Macron and the risk of a 2nd wave of Covid cases diminishing, increasing our confidence that the trough in the economic data has passed. Note that we also replaced our long iTraxx Main with bonds.
- In June, credit risk in the fund was reduced with the relative risk-adjusted spread duration of the fund ending the month at 0.25. The risk reduction was predicated on a still volatile and uncertain backdrop, despite an improving trend in the economic data, with growing risks of a potential 2nd wave in certain US states. We initially reduced credit risk in the fund by buying protection on CDS indices and later through selling bonds. In addition, to further hedge the portfolio against headlines around a 2nd wave of Covid infections we implemented a long AUD/USD put option. The duration of the fund ended the month at 5.3 years. That being said, we entered a US 5s10s steepener as well as a short 30y position early in the month as we saw US rates lagging the move higher in risk markets and decided to sell the long end of the curve which we believed was likely to underperform on any recovery/reflation type theme, whilst we expected the front end to remain more anchored given central bank accommodation. We closed these trades around mid-month amid growing risks of a potential 2nd wave in certain US states.



Outlook

- The second quarter of 2020 saw a sharp recovery in both risk markets and economic data as infection rates of the corona virus dropped significantly across Europe and the US, which allowed for governments to lift strict lockdown measures and for non-essential services to resume. The recovery was boosted by central banks which did not let up with their easing measures through Q2, whilst on the fiscal side we also saw governments go above and beyond what was announced during the global financial crisis. Looking ahead to Q3, the focus will be on whether the reopening of economies leads to a second wave of Covid-19 infections which results in another lockdown, given that we are already seeing worrying signs of infection rates increasing in certain US states. In Europe, hopes are building for an EU Recovery Fund to be passed that includes debt mutualisation, which would crucially provide the region with another easing lever away from just the ECB. Given social unrest in the US, attention is already turning towards the November Presidential election as well, which could create a more volatile backdrop as we head into the second half of the year.
- Following a very busy first quarter for the Fed in which they brought interest rates down to the zero lower bound, the second quarter saw their various facilities be put to good use. For example Investment Grade credit spreads continued to normalise with the credit curve steepening as the Fed began purchasing both ETFs and individual corporate bonds during the quarter and took another unprecedented step of including the purchases of recent fallen angels within the program. In addition, USD funding stresses observed at the end of Q1 were dealt with through central bank swap lines, which allowed for the Libor-OIS spread to also revert and the dollar to weaken. Whilst no changes were made to the Fed Funds rate, US yields remained in a tight range throughout the quarter given that Fed Chair Powell appeared credible with his forward guidance of rates remaining at the zero lower bound for the foreseeable future. Despite the recent bounce in economic data for example, Powell chose to concentrate his communication on the potential longer term damage of the recession, which further emphasises the bank's accommodative stance.



- With regards to the data released itself, impressively the ISM manufacturing index returned back into expansion territory at 52.6 in June. This represented a greater than 10 point rise during the quarter, whilst payroll data also suggested that workers have already been redeployed back into the labour market, which is not necessarily surprising given that the majority of layoffs were described by the survey as being temporary in nature. However at 11%, the unemployment rate still remains above the GFC peak, where risks of a spike in Covid-19 cases in the US suggest that the sharp improvement in the labour market may begin to slow from here. In addition, whilst retail sales also saw a big beat in May, growing at 18% MoM, the fear is that some of this strength may dissipate once the direct payments program and enhanced unemployment benefits from the US Treasury to individuals expires. As a result of these lingering uncertainties, we expect the Fed to continue on its dovish course in the coming quarter, in which they will likely link their forward guidance to actual inflation outcomes. Given the lack of inflationary pressures that the US economy has managed to generate over the past 10 years, such a policy change would be a dovish development and should keep any yield spikes capped in the near term.
- After an eventful first quarter for the ECB, the bank continued with its easing policies during the second quarter, as it increased the size of its pandemic emergency purchase programme by EUR 600bn following aggressive use of the funds initially to deal with the widening of peripheral spreads. Spreads were also supported by easing LTRO terms which made carry trades at the front of the curve attractive for banks. However the more important development for the Eurozone during the second quarter was the progress made on the EU Recovery Fund following the proposal brought forward by France's Macron and Germany's Merkel. If passed, the fund will provide a credible backstop for the region, and should price out any lingering fears regarding Eurozone break up risks as well given that it should see support from the Italians as the proposal is based on grants rather than just loans and includes debt mutualisation.
- Having passed through several stages of this crisis, we are now in the early recovery phase as lockdown restrictions have been lifted, and the worst in the data appears to be behind us. Whilst the virus may not have been eliminated yet, crucially we are learning to live with it. For example although we are seeing localised spikes in cases, positively the fatality rate is not growing in line with this. As such, our view remains that as long as there is not another severe lockdown, it should allow for the impact of growth from the coronavirus shock to be short lived compared to other recessions. Although there will be some sectors of the economy that take longer to recover, this should be somewhat offset by the accommodation from monetary and fiscal authorities which we expect to remain intact for years after this crisis has ended.

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