



Q1 2021

UBAM – US DOLLAR BOND

Quarterly Comment

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Market Comment

- Following a strong end to last year, risk markets began 2021 on a more cautious note with US investment grade credit spreads flat on the month, and European IG spreads 1 bp wider. The shift in sentiment was highlighted by the spike in equity volatility observed through the VIX index towards the end of January that appeared to have been driven by retail investor activity in certain heavily shorted stocks, which triggered broader de-risking.
- That said, markets still managed to end January relatively unscathed given that from a macro perspective, the vaccine rollout was making strong progress in the US and UK in particular and daily Covid-19 cases continued to decline from the winter peak as lockdown measures began to pay off. Such heavy restrictions also impacted the data however, with payroll numbers in the US moving back into contraction for this first time since April, which was unsurprisingly driven by Covid-19 impacted sectors such as hospitality and leisure.
- January also saw the outcome of the Georgia Senate race in which both Republican seats were taken by the Democrats, resulting in a marginal Blue sweep outcome from the US elections. This fuelled hope of another stimulus package being passed by new President Biden, which also allowed for US Treasury yields to rise and the curve to steepen. For example, US 10-year yields rose by 16 bps during January, with the 5s30s curve steepening by a significant 13 bps as renewed fiscal hopes in the US allowed for the reflation trend to continue. Moves herein came despite Fed Chair Powell in the January press conference noting that the market focus on tapering is premature, adding that the likely rise in inflation this year due to either base effects or a post reopening pick-up in demand, is likely to be transient.
- In contrast, German 10yr Bund yields sold off by just 5 bps in January, outperforming US rates after reports suggested that ECB officials had not ruled out the possibility of a further cut in the depo rate which was rhetoric possibly fuelled by recent EUR strength.
- Interest rate markets took centre stage in February as improving economic data, an accelerating vaccine rollout and hopes for further fiscal stimulus led to a sharp repricing of expectations for Fed rate hikes. By the end of the month the market was pricing in three rate hikes from the Fed by end-2023, in comparison to the Fed's own dot plot which shows unchanged rates during the forecast period. As a result, 10-year US yields rose by 34 bps during February alone, whilst the curve, based on 5-year vs 30-year maturities, was largely unchanged.



- Whilst the reflation theme had previously been impacting the longer end of the curve, this impact moved towards the front end as the month progressed, as investors questioned the planned trajectory of the Fed. Throughout this period, Fed communication remained unchanged and consistent, with various members noting that yields are rising for good reasons such as higher growth and inflation expectations, although they also noted that the economy remains far from the Fed's own goals. European rates were not immune from this spike in yields with 10-year German Bund yields 26 bps higher in February, although the reaction from various ECB Governing council members suggested less comfort with the pace of the move in long end yields.
- Data during the month also allowed for investors to upgrade their growth projections for 2021 as Global PMIs moved further into expansion, whilst the US Labour market continued to recover, with the headline unemployment rate declining to 6.3%. In addition, the US consumer appeared in good health as US retail sales showed a significant beat to the upside at 5% MoM vs 1% consensus expectations. Investment grade credit spreads were relatively resilient despite the tightening in financial conditions through higher rates observed, instead taking comfort from the better growth prospects ahead. For example US IG spreads ended the month 5 bps tighter at 71 bps, whilst European spreads were 4 bps tighter at 88 bps.
- Interest rate markets remained in focus in March given that US 10-year yields rose back to levels last seen prior to the pandemic spreading globally in February 2020. Moves herein were a continuation of the sharp sell-off in rates observed since the beginning of the year, which has been driven by a combination of improving economic data, an accelerating vaccine rollout, as well as further support coming through fiscal stimulus.
- On the fiscal side, the US administration managed to pass through Congress a significant USD 1.9trn fiscal package which is worth over 8% of GDP and crucially includes stimulus checks which will allow for these funds to be put to use immediately. That said, the rates curve was unable to steepen on this news, given that high frequency data was also impressive in March and kept front end rates under pressure as investors continued to price in the likelihood of the Fed beginning its rate hiking cycle in 2023.
- The manufacturing sector was buoyed by hopes that the vaccine rollout will allow economies to begin lifting restrictions in the coming months, with the US ISM Manufacturing Survey increasing to the highest level since early-2018. Employment data was also impressive with the US unemployment rate declining to 6.2% amid a pick-up in employment in sectors most heavily impacted by the pandemic. Whilst US 10y yields rose by 33 bps during March, in contrast German Bund yields declined by 3 bps during the month.
- This divergence was largely put down to a less successful initial vaccine rollout in the Euro Area, which has come at a time when the region is suffering from another wave of Covid-19 cases, which resulted in various lockdown restrictions being extended. Credit spreads were unable to tighten in March, taking a pause following the significant tightening already observed, as well as digesting the move higher in rates which tightened financial conditions.
- As a result we saw US investment grade credit spreads widening by 6 bps during the month, whilst EUR spreads widened by just 2 bps, managing to outperform given a less volatile EUR rates market as well as enhanced ECB support after they announced an acceleration of PEPP purchases at the February meeting.



Performance Review

- QTD the strategy returned -4.24% net of fees (I Share class).
- The gross excess return over the Benchmark (ICE BofA US Government index*) was +39bps.
- The gross excess returns sequentially over the quarter were: +17bp in January, +44bps in February and -21bps in March.
- QTD, interest rate exposure and yield curve contributed +26bps, swap and agencies were +0bp and credit added +6bps (other items -8bps).

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

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in USD was 1% vs 1% for the reference index.
- The interest rate exposure was 6.3 years vs. 6.9 years for the index
- The main position for the portfolio was:
 - Underweight duration
 - Overweight credit through cash bond market and CDS indices
- In January, we tactically took profit on several reflation trades following news related to new virus strains and a slower vaccine rollout in Europe, which increased uncertainty around economic reopening plans. As such, we took profits on the fund's underweight duration and USD 5s10s curve steepening positions, as well as closing the short USD vs AUD FX position and long credit risk held through the iTraxx Senior Financials CDS index.
- In February, we re-engaged in several reflation trades as hopes increased that the US administration would pass a large fiscal package, whilst we also saw the decline in Covid cases in conjunction with progress on the vaccine rollout. We saw these developments as likely to lead to economies reopening in the coming months, which could result in further growth upgrades. To position for this theme we implemented an underweight duration position through both EUR and USD rates, held a US 5 vs 10 year curve steepener, as well as being overweight credit through the investment grade bond market.
- In March, the fund's short duration bias was maintained given the impressive high frequency data that was released out of the US in particular, including the ISM Manufacturing survey as well as payrolls. This increased our confidence in the growth recovery, which we anticipate will accelerate further once economies begin to re-open in Q2 and should allow for interest rate markets to continue to normalise. We also decided to close the fund's US rates curve steepening position in March. Although we still see room for long-end rates to rise and underperform, in the near term we think that the strength of domestic US data could lead to investors pricing in a more hawkish Fed which would weigh on the front-end.

Outlook

- Risk markets in Q1 continued on the strong tone that they ended 2020 on, as investors took confidence from the vaccine rollout, which provided hope that some lockdown restrictions would soon be lifted. Growth expectations were also revised higher after US President Biden's fiscal package was passed through Congress, whilst high frequency data released during the quarter was also impressive. For example the March jobs report in the US saw an almost 1mn increase in payrolls, whilst global PMIs rose to a cycle high and led investors to price in more hawkish policy from the Fed in particular over the coming years. Despite this, central banks continued with their dovish tone, emphasising their commitment to maintain accommodation until economies have fully recovered from the pandemic. As we look ahead to Q2, the focus will be on whether vaccine distribution will allow economies to begin reopening, or if any vaccine rollout delays or virus mutations will slow reopening plans. Central banks will also be closely tracked to see if they begin to react to the consistent strength in the data and start guiding towards a less accommodative policy stance down the line.
- US growth outperformed in the first quarter, helped by an accelerating vaccine distribution trend, coupled with support from another fiscal package passed. This latest package was significant, at over 8% of GDP and crucially included stimulus checks which are funds that will be quickly be spent in the real economy, lifting already elevated retail sales growth. Despite this progress, the Fed remained consistent with its messaging and left its dot plot to show unchanged rates throughout the forecast period compared to the market, which is now pricing in around three rate hikes by the end of 2023. One of the main reasons for why the Fed has not followed the market's tightening expectations is due to a change in its reaction function. For example the Fed's maximum employment aim is now a broad based and inclusive goal which we see as an inherently dovish message where they will look to ensure that all minority groups are able to benefit from this recovery, which will likely require an overshoot of aggregate employment targets. Fed Chair Powell himself has repeatedly spoken of the true unemployment rate being closer to 10% right now compared to the official 6% level, as he also takes into account the decline in labour force participation since the commencement of the pandemic. The Fed's new average inflation targeting framework also suggests a more patient approach to tightening as they will now be comfortable seeing inflation above 2% for an extended period of time, given that it has been below 2% for so long. This is a major divergence to what was observed under the previous leadership, where former Chair Yellen looked to tighten policy on the first signs of inflationary pressures building.
- The ECB went a step further than the Fed in Q1 and actually enhanced its dovish support for markets where given lower inflation, less fiscal support and a slower vaccine rollout compared to the US, the Governing Council acted more aggressively against tightening financial conditions. As a result, they announced an increase in the pace of QE purchases through their PEPP programme for Q2 in a bid to manage long end yields.
- From a fiscal perspective, we see the recent appointment of Mario Draghi as the Italian Prime Minister as a major step in ensuring that EU Recovery Funds are put to good use, which should support peripheral growth in the coming years. Meanwhile there has been some disappointment in relation to near-term growth prospects in the region given a slow initial vaccine rollout and as several countries suffer from a third wave of Covid-19 cases which has led to an extension of lockdowns. However, recent data suggests to us that vaccine distribution is picking up pace and getting back on track, which provides hope for an improving growth trajectory for the region in the coming months.

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- From a positioning standpoint, we have been bearish on duration since Q4 and continue to position for higher yields. Although the Fed has been consistent with its dovish messaging, its forward guidance is outcome rather than calendar based, which provides room for investors to keep pricing in the possibility of rate hikes given the strength in the data, which we anticipate will continue as the economy reopens. Ongoing fiscal stimulus measures, coupled with revisions higher in growth and inflation expectations should also allow for the curve to continue to steepen. Although the ECB has been more active in managing the long end of the curve through accelerated PEPP purchases, we think the Governing Council will eventually allow for an orderly move higher in rates, especially if accompanied by stronger growth. We see growth within the Euro Area region as being close to an inflection point here with much of the pessimism around the slow vaccine rollout and latest Covid-19 wave in the price, where investors may soon be surprised to the upside by the pace of the vaccine distribution which should also allow for Bund yields to rise.
 - We see this rise in yields as being driven by good reasons of stronger growth expectations, which should allow for risk markets and credit spreads in particular to continue to digest this move well. We anticipate that global growth this year will not only meet its pre-pandemic GDP trend growth level, but actually rise above it as while economies are set to normalise, the stimulus provided by both governments and central banks is here to stay, keeping policymakers as tailwinds to this recovery. Importantly, we think that once central banks are ready to finally tighten policy, this will have been largely priced in and therefore should come as no surprise for investors, in contrast to what was observed during the 2013 Taper Tantrum episode when markets were caught off guard. For credit markets, we think this strong growth environment is one in which the higher beta segments of the market can outperform and where credit compression can take place. High Yield spreads should benefit as the most severely impacted sectors from the pandemic begin to slowly recover, whilst we also think that Subordinated Financial debt provides an attractive opportunity given strong fundamentals for the banking sector and resilient earnings throughout the pandemic, which should also be supported by our expectations of steeper rate curves.

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