



UBAM - ABSOLUTE RETURN LOW VOL FIXED INCOME

Quarterly Comment | Q2 2019

Formerly: UBAM - Unconstrained Bond

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

Market Comment

- ◆ In April, risk markets continued to benefit from the dovish shift taken by major central banks earlier in the year, as spreads tightened for yet another month, with both US and European investment grade credit spreads now 46 bps tighter year to date. European credit markets outperformed the US, with European IG spreads tightening by 14 bps in contrast to the 5 bps of tightening observed in the US. The regional outperformance herein could be put down to reduced fears of a Eurozone slowdown after Q1 GDP for the region surprised on the upside at 0.4% QoQ.
- ◆ In addition, investors became increasingly optimistic that growth in China has troughed, given the stronger credit growth numbers observed, with hopes that this will feed through to better Eurozone data with a lag. Also, sentiment towards the periphery improved during April after Italy's rating was left unchanged at BBB at S&P, whilst Spanish elections provided no negative surprises for investors. This positive backdrop described allowed for interest rate markets to breathe following the rally observed YTD, as US 10 year rates rose by 9 bps and German 10 year Bund yields rose by 8 bps on the month.
- ◆ Whilst US data including the ISM Manufacturing survey and the labour market data was robust in April, investors appeared more concerned with regards to inflation, as core PCE missed to the downside at 1.6% vs 1.7% consensus. As such, the market priced in a full rate cut by the Fed for the end of this year amid a lack of inflationary pressures, which also led the curve to steepen in April, with the US 2s10s breaking above 20 bps for the first time this year, rising by 9 bps during the month.
- ◆ In May, the resurfacing of trade war concerns led to risk markets coming under pressure following the strong start to the year, with US investment grade spreads widening by 17 bps and European spreads by 20 bps. Moves herein were largely triggered by Trump's decision at the start of the month to increase tariffs on Chinese imports worth USD200bn from 10% to 25% given slow progress in the trade negotiations. In addition, Trump began the formal process of implementing tariffs of 25% on the remaining USD300bn of Chinese imports, although no announcement on this was anticipated at least until the two Presidents met at the G20 at the end of June.
- ◆ Towards the end of May the US broadened the trade war further, as the administration announced the imposition of 5% tariffs on all goods imported from Mexico, which will rise by 5% each month until it reaches 25% unless Mexico managed to dramatically reduce or eliminate the illegal flow of immigrants into the US.



- ◆ European political concerns also returned in May after the European Commission sent a letter notifying the Italian government that they had not made sufficient progress towards compliance with the debt criterion of the EU's fiscal laws. This would be the first step in a disciplinary process that would put Italy at risk of financial penalties, and led to negative price action with BTPs widening by 33 bps in May. Risks within the region were also highlighted by the results of the European elections in which Salvini's League Party came top in Italy with 34% of the votes, which has left open the possibility of early elections being called to take advantage of his rise in popularity. Meanwhile the newly formed Brexit Party came top in the UK with 32% of votes amid growing frustration on the lack of Brexit progress.
- ◆ The less positive risk backdrop described led to interest rate markets performing well given the bid for safe haven assets. US 10 year yields for example rallied by a dramatic 38 bps in May, as the market priced in the chance of two rate cuts from the Fed for this year alone. European rates also rallied, with German 10 year Bund yields 21 bps lower by the end of the month as well.
- ◆ Risk markets managed to recover in June following the weakness observed in May. Whilst trade uncertainties lingered heading into the G20 at the end of June, investors were instead able to take comfort from the dovish communication provided by the major central banks, which appeared to open up the window towards monetary policy easing. This could be highlighted in ECB President Draghi's speech at the Sintra forum in which he said that additional stimulus would be required in the absence of an improvement in the outlook.
- ◆ This was followed by the Federal Reserve who in the June statement said that they will act as appropriate to sustain the expansion. The latest dot plot projection released showed 8 out of 17 members now looking for a cut this year, with Chair Powell saying that even those who did not call for a cut, said that the case for a cut has increased, confirming the dovish bias. As such, US 10 year yields rallied by 11 bps in June, following a 38 bps decline in yields in May, which resulted in the market now pricing in multiple rate cuts for this year alone and allowed for the curve to steepen. German 10 year bunds also benefitted, with yields declining by 13 bps as hopes of stimulus through rate cuts or asset purchases were renewed.
- ◆ This backdrop of central bank support in June is one that allowed for credit spreads to tighten, with US investment grade credit spreads tightening by 12 bps, whilst European spreads tightened by 15 bps, perhaps outperforming as the market priced in an increasing probability that the ECB re-launches its Corporate Sector Purchase Programme (CSPP).



Performance Review

- ◆ UBAM - Absolute Return Low Vol Fixed Income increased 0.18% net of fees (I Share class). In relative terms the strategy delivered +40bps gross above its reference index: the Eonia capitalization 7 days index.
- ◆ The excess returns for April were +17bps, -5bps for May and +29bps for June.
- ◆ The QTD, main contributor to the excess returns was duration (+23bps) and CDS indices (+13bps).
- ◆ Volatility remained contained with a daily 12-month rolling volatility of 0.4%.

Portfolio Activity

- ◆ At the end of the quarter, the yield of the portfolio in EUR was 0.2% and 3.1% in USD (hedged share class).
- ◆ The interest rate exposure was 1.0 years and the credit exposure was 1.2 years at the end of March.
- ◆ In April, we left the fund's credit positioning largely unchanged, but added 0.1 year EUR duration at the start of the month as the increase in rates following stronger than expected data out of China provided us with an attractive entry point, and as we saw the Fed and ECB unlikely to shift back towards a hawkish stance anytime soon given the lack of inflationary pressures.
- ◆ In May, we further decreased the fund's credit positioning by 0.5 year to 1.1 years of spread duration. We reduced credit beta as uncertainty around the US-China trade deal increased further. We specifically reduced credit risk through the European iTraxx Main as tensions within the Italian government resurfaced and as the European Commission hinted on the possibility of fining Italy for its excessive budget deficit. In interest rate, we added to 2 year US duration given lingering uncertainties around the trade war which could have a detrimental impact on the growth outlook if it persists. As such we decided to add duration to the front-end of the US rates curve, in case such developments also started to weigh on the Fed's thinking, especially at a time when the board is looking to sustain the expansion.
- ◆ In June, we left the fund's credit positioning unchanged. In duration we initiated a US curve steepening position following the Fed meeting, given the dovish tone of Chair Powell's conference and the fact that further weakness in the data could lead the market to price in a full rate cutting cycle and not just insurance cuts. On the other hand, we extended the EUR duration exposure from the 5y point to the 10y point on the back of more attractive carry rolldown and in the anticipation of QE being re-launched, which would lead to flatter rates curves.



Outlook

- ◆ The dovish turn taken by major central banks globally was one of the most significant developments in the second quarter and was one that allowed risk markets to hold onto gains, despite weakness in global growth data and continued uncertainty around US-China trade. Therefore as we look ahead to the second half of the year, the focus will be on whether the Federal Reserve and ECB will deliver the easing that is now priced into markets. In addition, whilst the G20 meeting appeared to result in a trade truce between the US and China in the near-term, progress in talks that are set to restart will determine whether trade uncertainty will still weigh on the outlook. Brexit developments will also increase in importance as the year goes on, especially as we approach the new October 31st deadline for the UK to leave the EU.
- ◆ Whilst the Fed removed its hawkish bias in Q1, the board went one step further in Q2 as the June statement said that they will act as appropriate to sustain the expansion, whilst the dot plot showed 8 out of 17 members forecasting a cut for this year. The tone of Fed Chair Powell's press conference followed suit, as he said that even those who did not call for a cut, have said that the case for one has increased. Uncertainties and crosscurrents related to trade given the US-China trade war, as well as the weakening global growth outlook appeared to drive this shift from the Fed, especially at a time when inflation pressures have been so muted. As a result, the market has priced in the likelihood that the Fed goes through with insurance rate cuts, with over two cuts priced for the remainder of this year.
- ◆ Our own view is that the US economy is still fairly robust, with a strong labour market intact as highlighted by the latest payrolls print and as such, we do not see the economy heading towards a recession in the near-term. That said, if domestic growth data continues to weaken amid trade uncertainties which may not be resolved in the near-term, then investors may start to price in a sharper slowdown. We therefore expect the Fed to go through with an insurance cut at the upcoming July meeting in line with market expectations in a bid to sustain and lengthen the expansion. This should allow the front-end of the curve to continue to outperform as the risks are that the market may start to price in a full rate cutting cycle once the first cut has passed, unless the data or trade picture improves significantly.
- ◆ The Fed meeting described above, followed a surprisingly dovish speech by ECB President Draghi at the Sintra forum in which he also opened up the door towards further easing by saying that additional stimulus would be required in the absence of an improvement in the outlook. Such a shift has come at a time when market based measures of inflation expectations such as the 5yr5yr inflation swap rate have hit all-time lows, and was unable to materially recover following Draghi's speech, highlighting the difficulty for the ECB in changing perceptions around low inflation. With data such as manufacturing PMIs in the region remaining in contraction territory, investors see it as unlikely that the outlook will substantially improve in the near-term and so expectations for both rate cuts and another round of quantitative easing have increased. For this reason we have seen Italian 10 year BTP spreads tighten by almost 50 bps since Draghi's Sintra speech on renewed hopes of further easing, where the nomination of IMF Chairman Christine Lagarde for the ECB Presidency has also supported the periphery as fears that a hawk such as Germany's Jens Weidmann replacing Draghi in October have faded.



- ◆ The current backdrop of weak global growth has appeared to drive a “race to the bottom” from central banks in bringing interest rates lower, which may also drive the Bank of England to remove its hawkish bias at its upcoming meeting. This was already hinted at by Governor Carney in a recent speech in which he said that global trade tensions have increased downside risks with Q2 economic growth being considerably weaker, and that the bank will reassess both Brexit and trade risks at the August meeting. We anticipate for both of these uncertainties to have not cleared up by August, and as such may result in less hawkish communication from the BoE. With Boris Johnson set to become the next UK Prime Minister, the tail risk of a no-deal Brexit outcome on October 31st taking place has also increased and will also weigh on the BoE’s outlook. As such, we would anticipate that GBP remains under pressure until some clarity is reached on Brexit, whilst Gilts could continue to perform well as the market prices out rate hikes in the near term.
- ◆ Overall, we think that the bar for the Fed and ECB to deliver easing is now low, and so our bias to add to interest rate duration on yield spikes remains intact. This is especially the case given our view that prices globally will continue to be weighed down by longer term factors such as demographics and low productivity, where renewed easing from central banks is unlikely to fuel significant inflationary pressures in our opinion. We also continue to believe that the market will trade more sensitively to the data and news flow given the late stage in the growth cycle we are believed to be in. Such a backdrop also warrants holding more duration in a bid to construct increasingly balanced portfolios in which duration exposure is able to complement the credit risk held, limiting drawdowns during risk-off moves.
- ◆ We remain cautious with regards to credit markets, given that the global growth trend remains poor, with the outlook still clouded by the trade war. Although the G20 meeting appeared to result in a trade truce between the US and China, it does not seem as though any material breakthrough in negotiations was made, which leaves open the risk that additional tariffs could still be announced if tensions escalate again. Whilst the Chinese authorities continue to try and stimulate the economy, the more targeted approach to this slowdown is yet to be enough to offset lingering trade issues. Though spreads remain close to five year averages across segments, monetary easing from the Fed and ECB appear to be in these valuations and so central banks will have to deliver on easing priced for markets to hold onto gains. We wait to see whether the data globally can improve before looking to add back to our credit exposure, which currently sits below, but close to historical average levels. We also continue to think that a strong focus on liquid credit instruments as core holdings such as CDS indices is crucial given a seemingly less liquid and shallow market, as these have better behaviour during stressed phases and allow for more flexibility when volatility does increase.

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