Q1 2024

UBAM - ABSOLUTE RETURN FIXED INCOME

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

- Following the significant rally in fixed income markets in December on the back of the shift in communication from Fed Chair Powell in particular, **January** saw markets in more of a holding pattern. US investment grade spreads for example were 1 bp wider on the month, whilst the European equivalent was still 6 bps tighter. Within rates markets, US 10-year yields were 3 bps higher in January, whilst German 10-year Bund yields were 15 bps higher, with curves steepening as front ends continued to outperform following less hawkish communication.
- European rates underperformed herein, as the ECB appeared less willing to commit towards an easing guidance in the near-term, although President Lagarde herself admitted at the ECB meeting that rate cuts could come as soon as the summer, whilst not closing the door to an earlier rate cut either if the data warrants.
- That said, at the end of the month Fed Chair Powell chose to push back on the market pricing a possibility of a March rate cut by saying that they may not have confidence on the inflation trend to warrant a cut by then, requiring more good data to achieve such an outcome.
- This view from Powell has largely been driven by the strength in the recent activity data with for example the global manufacturing PMI moving back into expansion, the Atlanta Fed nowcasting Q1 GDP at above 4% now, whilst last week’s non-farm payrolls for January was a significant surprise to the upside at above 350k. This represents the strongest month of job creation in the US since February 2023 and reaffirms our view that the economy is not heading towards a recession in the near term. On the inflation front, we did still generally see the disinflation trend remain intact in the US as the Fed’s preferred measure of inflation – core PCE MoM in 6m annualised terms – was below the 2% target for a second consecutive month.
- **February** saw the positive risk backdrop continue on the back of robust economic growth data, coupled with the Q4 earnings season ending on a strong note with on average 75% of S&P 500 companies beating EPS expectations with an average EPS surprise of 7%. 4Q23 revenues and EPS were up 4% and 8% YoY on average (+5% and +12% YoY respectively ex-energy). As a result, credit spreads continued on their recent tightening trend as observed by US investment grade spreads being 5 bps tighter in February whilst the EUR equivalent was 9 bps tighter.
- Tightening herein was observed despite the repricing higher in rates markets as upside surprises in the economic data led the market to temper its expectations for aggressive rate cuts. For example the US payrolls report was a significant beat at 353k for nonfarm payrolls vs 185k expected in the strongest print in one year, whilst wages also surprised to the upside.

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- In addition and more generally, the global all-industry PMI has now risen for a 4th consecutive month to 52.1, in a sign that economic resilience appears to be broadening out beyond just the US economy as real income growth turns more supportive in the Eurozone for example as well.
- With regards to inflation, US core CPI surprised significantly to the upside at 3.9% vs 3.7% consensus, and which also meant that the Fed's preferred measure of inflation – core PCE MoM in 6m annualised terms – picked up to 2.5% from being below 2% for two consecutive months. As a result, within rates markets we saw the front-end of curves underperform in a bear flattening move as the market priced out near-term rate cuts. For example US 2-year yields rose by 41 bps on the month with the 2 years vs. 10 years curve flattening by 8 bps, whilst the German 2-year equivalent saw yields rise by 48 bps.
- Risk assets remained largely supported in **March** with the S&P 500 reaching another all-time high and credit spreads managing to tighten further on the back of continued resilience in the economic data that was released, coupled with the major central banks guiding towards rate cuts by the middle of this year. For example USD investment grade credit spreads were 6 bps tighter in March, whilst the EUR equivalent was 8 bps tighter.
- Employment data released in the US continued to push recession fears further down the line as nonfarm payrolls were a significant upside surprise once again at 275k vs 200k consensus, with signs of reacceleration within payroll growth when viewed in three month moving average terms. We are also seeing signs of economic growth broadening beyond just the US with the PMI surveys recently released in China for example moving back into expansion territory for the first time since September last year.
- Developments herein also drove the Fed to significantly mark higher its growth expectations for this year, to 2.1% compared to 1.4% previously in their latest forecasts. With regards to inflation, we also saw the Fed mark up its expectations for core PCE this year to 2.6% from 2.4% previously on the back of stronger inflation readings year-to-date, as well as the impressive growth backdrop.
- US rates markets were largely unchanged over the month as a whole, although this masked an initial rally during the first half of the month on the back of less hawkish central bank communication, whilst rates came under pressure as the month progressed in light of the growth numbers described, as well as core PCE printing at 2.8% in the Fed's preferred six month moving average terms, from 2.5% the prior month.
- EUR rates outperformed with German 5-year yields for example 11 bps lower on the month as the disinflationary trend observed increased market conviction in a likely June rate cut.

Performance Review

- UBAM - Absolute Return Fixed Income delivered +1.89% net of fees QTD (IP H USD share class). In relative terms, the Global Aggregate USD hedged index* returned -0.16% QTD.
- UBAM - Absolute Return Fixed Income delivered +1.51% net of fees QTD (IP EUR share class). In relative terms, the Global Aggregate EUR hedged index* returned -0.53% QTD.

- Against a EUR cash deposit index*, the strategy delivered +65 bps bps gross of fees QTD.
- The excess returns by months against the cash deposit index were sequentially: -133 bps in January, +85 bps in February and +114 bps in March.
- QTD, the main contributor to the excess returns was credit: +146 bps. The main detractor was duration: -109 bps.

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

Portfolio Activity

- **Characteristics** at the end of the quarter:
  - Yield: 6.3% in EUR, 7.8% in USD
  - Interest rate duration: 3.9 years
  - Credit spread duration: 3.2 years
  - Risk adjusted credit spread duration: 7 years
  - Average rating: A-

- In **January**, we left the fund's credit exposure unchanged at 6.1 years of RASD, as we continue to hold a positive view on credit given that spreads stand to benefit from the strength of the US economy and reduced fears around a recession, allowing for default rates to remain low.
- On the duration side, we reduced from 7.5 years to 6.7 years as we saw a risk of Fed Chair Powell pushing back against dovish market pricing considering the strength of the domestic data, and with 150 bps of rate cuts priced for 2024.
- We also continued to hold MXN (5%) and BRL (5%) overweights vs. USD through currencies and local bonds to capitalise on the attractive carry and falling inflation trend in Emerging Markets relative to Developed Markets.
- In **February**, we maintained a positive bias towards credit within the portfolio, with a risk adjusted spread duration of 6.6 years, which is 0.5 RASD higher than the prior month as we increased the portfolio's exposure to 10 year Italian BTP spreads.
- We continue to hold a positive view on credit given that spreads stand to benefit from the strength of the US economy and reduced fears around a recession, allowing for default rates to remain low.
- On the duration side, we reduced the interest rate duration significantly to 2.9 years from 6.7 years the prior month, as we took profits on a significant portion of our positive duration exposure given the rally observed following the Fed pivot in December, and as market pricing of 150 bps of cuts for this year appeared too extreme relative to the strong data being released.
- We continued to hold MXN (5%) and BRL (5%) overweights vs USD through currencies and local bonds to capitalise on the attractive carry and falling inflation trend in Emerging Markets relative to Developed Markets.
- In **March**, we maintained a positive bias towards credit within the portfolio, with a risk adjusted spread duration of 7.0 years, which is 0.4 rasd higher than the prior month as we increased the portfolio's credit risk by rolling the CDS Indices on to the new on-the-run series.
- We continue to hold a positive view on credit given that spreads stand to benefit from the strength of the US economy and reduced fears around a recession, allowing for default rates to remain low.
- On the duration side, we re-increased our duration exposure from 2.9 to 3.9 years through long end UK rates as we see more downside growth risk in the UK and as it scans attractive in relative value terms as less rate cuts remain priced in relative to other geographies.

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- We continue to hold MXN (5%) and BRL (5%) overweights vs USD through FX and local bonds to capitalise on the attractive carry and falling inflation trend in Emerging Markets relative to Developed Markets.

Outlook

- At the beginning of 2024, major central banks were guiding towards rate cuts by the end of Q2, and therefore the focus during this quarter will be on whether the data allows them to deliver on this prior guidance. Whilst we see the path for near term rate cuts from the ECB & BoE as more likely than not given the disinflation trend being observed, there remains more uncertainty on the timing of the Fed's first rate cut amid a stronger growth backdrop and recent stickiness in inflation. Overall, we expect for the rate cutting cycle to likely be very gradual in nature when it does commence, which favours a strategic allocation to fixed income to benefit from higher yields over the medium term and taking advantage of the carry opportunity that continues to present itself today.
- One of the key developments over the last quarter was the updated economic projections released by the Fed at the March meeting. Of significance were the large upward revisions to growth, with real GDP estimated at 2.1% for this year compared to 1.4% previously. US growth is being supported by a resilient consumer on the back of tight labour markets and an improving supply-side story amid rising immigration and improving productivity. The growth upgrade was also met with a revision higher to the inflation forecasts, with core PCE for example seen at 2.6% for this year, up from 2.4% previously. Despite these hawkish revisions, the Fed left its near term guidance within the dot-plot projections unchanged, to show three rate cuts for this year, whilst it did remove one rate cut further out, resulting in the end-2026 dot to be at 3.1% compared to 2.9% previously. Fed Chair Powell also maintained his message from prior meetings by guiding towards rate cuts later this year, although requiring a couple months of more data to confirm that the disinflation trend is intact given recent disappointing readings.
- Meanwhile at the ECB and in contrast to the Fed, both inflation and growth projections were revised lower, with growth estimated at just 0.6% for this year now, whilst core inflation is to average 2.6% in 2024 and be back to target in 2026. Following these more dovish forecast revisions, President Lagarde sounded increasingly convinced that rate cuts would probably become appropriate by the summer, by which time they would have had more time to digest the data. Such a decision would most likely come at the June meeting given Lagarde's comment that they will know "a little more in April, but a lot more in June". At the BoE, the March meeting also represented a dovish shift as the vote split no longer showed any member of the board voting for a rate hike for the first time since September 2021, which came as a surprise to market participants and signalled the first step towards easing policy.
- With regards to our interest rate duration views, at the end of January we decided to hold a more defensive bias, especially in the US given the strength of the domestic data and recent upside surprises to inflation. If anything, when observing the US data there appears to be no rush for the Fed to deliver its first rate cut despite Powell's guidance, with signs of reacceleration appearing. For example payroll growth in 3 month moving average terms has accelerated from a trough of 198k in November last year to 276k currently, whilst the ISM Manufacturing index just surprised to the upside and moved back into expansion for the first time since September

2022. On inflation, influential Fed Governor Waller himself highlighted how the 3 month and 6 month moving averages for core CPI have risen now to 4.2% and 3.9% respectively, which shows how the disinflation process appears to have stalled and which means that he now requires more time to verify progress on inflation before looking to cut interest rates. Waller concluded that it may now be prudent to hold rates at these current restrictive levels for longer than previously thought. And so whilst the dot-plot still guides towards three rate cuts this year, we believe that the discussion is evolving, where data released later this quarter will be crucial in determining whether the Fed can deliver on its first cut this summer. We took profits on our positive interest rate bias in January when the market was pricing in closer to six rate cuts for the Fed, which appeared stretched to us. Today the market is pricing in three cuts, which is in line with the dots, however these dots may also soon be stale, dependent on the data and given recent communication from Fed board members. From a relative value perspective, we would be more positive on interest rate duration outside of the US where there is greater clarity with regards to the timing of the first rate cut and where growth has not been as robust, such as in the UK and Eurozone. In the UK in particular, investors have consistently been pricing a less dovish rate cutting cycle relative to elsewhere, despite the fact that the market is currently pricing for headline inflation to be below the 2% target in the UK by the summer. As a result, we continue to view UK Gilts as a source of continued outperformance from a relative value perspective.

- For credit, we maintain a positive bias and have a preference for higher income segments given the growth backdrop and attractive all-in yields. Central banks are planning to begin easing policy at a time when there are some initial signs of economic reacceleration emerging, which is positive for credit as it pushes further down the line any recession fears. We would therefore anticipate that the benign default rate backdrop remains intact, which remained below 3% in both the US and Eurozone last year highlighting the positive fundamental backdrop. This could also be observed within the 4Q23 earnings season, which ended on a strong note with on average 76% of S&P500 companies beating EPS expectations with an average EPS surprise of 7%. 4Q23 revenues and EPS were up 4% and 8% YoY on average (+5% and +12% YoY respectively ex-energy).
- Whilst spreads have tightened on the back of positive macro developments since the beginning of the year, the high yield segment of the market through CDS indices continues to trade cheap to the cash bond market. With yields close to double-digits in dollars, we believe this segment continues to compensate investors more than adequately for the risk being taken. Furthermore at such elevated yields, the power of accrual becomes extremely important, providing a buffer against any bouts of spread widening and as was clearly observed in 2023. We also view an allocation to BB rated bonds as attractive given their superior risk-reward profile to BBBs, single Bs and CCCs and as corporate fundamentals for BBs seem in good shape for this stage of the cycle. Finally, we continue to hold a positive bias towards the financial sector given it remains a segment of the market that is benefitting from the higher inflation backdrop, as observed in recent bank earnings. In particular, we would continue to highlight the AT1

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market as an attractive opportunity and an asset class that has recovered from the volatility observed in March last year.

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