

UBAM – DYNAMIC US DOLLAR BOND

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.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

- 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.



Q1 2024

Performance Review

- UBAM - Dynamic US Dollar Bond delivered +2.14% net of fees QTD (I share class).
- In relative terms, the strategy delivered +89 bps of excess return before fees vs. a reference to a USD cash deposit index QTD*.
- The excess returns sequentially over the quarter were: +28 bps in January, +46 bps in February and +15 bps in March.
- QTD, credit generated +73 bps of excess return and the duration overlay +16 bps.

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



Q1 2024

Portfolio Activity

- **Portfolio** at the end of the quarter:
 - ◆ Yield: 6.4% (cash rate: 5.3%)
 - ◆ Duration: 0.0 year
 - ◆ Average life core portfolio: 22 months
 - ◆ Spread duration: 1.7 years
 - ◆ Average rating: A

- In **January**, US Investment Grade credit spreads in the 1-3 years part of the curve ended the month 6 bps tighter, underperforming EUR Investment Grade bonds in the 1-3 years part of the curve which ended the month 9 bps tighter. USD credit spreads in the front-end outperformed longer-end credit spreads which ended 1 bp wider on average. Despite Fed pushing back on early rate cut probabilities, strong employment and manufacturing data helped the credit to perform as numbers are suggesting the economy is not heading towards a recession in the near term. Floating rate note spreads outperformed the Fixed spreads following well absorbed supply.
- USD short-dated rates ended the month 4 bps lower at 4.21% on the US 2 years rate, while US 10 years were 3 bps higher, following Fed's push back during their meeting on a march rate cut probability. Fed Chair Powell confirmed they require more good data and strong confidence on the inflation to start cutting rate, suggesting March was too early to achieve such an outcome. On the floating rate note side, the Secured Overnight Financing Rate (SOFR) was almost unchanged at 5.32% in line and anchored to the Federal reserve effective action.
- Primary market activity was extremely busy during the entire month of January. Within our investment universe, 15 financial issuers and 16 non-financial issuers came to the market. We participated to 6 of them, all in FRN format, namely Banque Federative du Credit Mutuel, JP Morgan, Lloyds Banking Group, Societe Generale, Morgan Stanley, and NextEra Energy on the non-financial front.
- We performed some credit extension in January, positioning the fund at 1.7 years of spread duration. Tighter credit spreads combined with spread carry allowed the fund to outperform its USD cash reference by +28 bps in January.
- In **February**, US Investment Grade credit spreads in the 1-3 years part of the curve ended the month 6 bps tighter, underperforming EUR Investment Grade bonds in the 1-3 years part of the curve which ended the month 16 bps tighter. Credit spreads were tighter on the back of robust economic growth data and good results on the earnings front. US credit spreads underperformed given some rates cuts were removed from the market pricing in the US.
- New issue indigestion as well weighted on US credit spreads given significant primary market activity. Floating rate note spreads outperformed the Fixed spreads following smaller supply and attractiveness given expectations of lower rate cuts.
- USD short-dated rates ended the month 42 bps higher at 4.62% on the US 2 year rate, while US 10 year were 34 bps higher. Interest rates cut removed



from market pricing following stronger economic growth data pushed interest rate higher, on the front end of the curve in particular. On the floating rate note side, the Secured Overnight Financing Rate (SOFR) was unchanged at 5.32% in line and anchored to the Federal reserve effective action.

- Primary market activity continued to be extremely busy in February following an intense January. Within our investment universe, 7 financial issuers and 12 non-financial issuers came to the market. We participated to 6 of them, all in FRN format, namely SEB, American Express, Natwest group on the financial side, and Bristol-Myers Squibb, Caterpillar and General Motors on the non-financial front.
- No changes were made to core positioning. We tactically reduced duration via US futures following stronger macroeconomic data.
- Tighter credit spreads combined with spread carry allowed the fund to outperform its EUR cash reference rate by + 30 bps in February, while +16 bps are coming from our short US interest rate tactical position.
- In **March**, US Investment Grade credit spreads in the 1-3 year part of the curve ended the month 6 bps tighter, performing in line with the EUR Investment Grade in the 1-3 years part of the curve which ended the month 6 bps tighter as well. Credit spreads were tighter in March on the back of continued resilience of US economic data both on the employment and growth front, coupled by central banks guiding towards rates cuts to start by the middle of the year. FRN credit spreads performed in line with Fixed spreads.
- USD short, dated rates ended the month unchanged at 4.62% on the US 2y rate, while US 10y were 5 bps lower. Federal Reserve meeting confirmed 3 cuts expected this year, which is now in line with the market pricing. On the floating rate note side, the Secured Overnight Financing Rate (SOFR) was unchanged at +5.34% in line and anchored to the Federal reserve effective action.
- Primary market activity continued to be extremely busy in March. Within our investment universe, 11 financial issuers and 13 non-financial issuers came to the market. We participated to seven of them, all in FRN format, namely Crédit Agricole, Goldman Sachs, Nordea, Barclays and Santander on the financial side, and Keurig Dr Pepper and BMW on the non-financial front. No changes were made to core positioning.
- Tighter credit spreads combined with spread carry allowed the fund to outperform its USD cash reference rate by + 15 bps in March.

*Outlook: Global Fixed
Income Markets*

- With significant progress on inflation finally made, the end of 2023 saw Fed Chair Powell communicate an important shift in his guidance, which suggested that the Fed's focus is moving away from discussing further hikes and instead towards the timing of potential rate cuts. Such a shift in messaging came perhaps earlier than many investors had been anticipating, driving a rally across fixed income and risk assets into year-end. As a result, the focus in the first part of 2024 will likely be on whether the inflation and labour market data released is able to support this message from the Fed, as well as whether other major central banks decide to communicate a similar shift. We believe that this pivot from the Fed cannot be ignored, especially given the recent progress made on inflation, where central banks such as the ECB and BoE are likely to follow suit in the coming months. This reduces the tail risk of central banks overtightening policy into a recession, keeping a soft landing scenario as the base case. We therefore continue to view this backdrop as one that warrants holding balanced portfolios of both credit risk and interest rate exposure in portfolios.
- As the fourth quarter progressed, communication from central banks evolved as well. This was most clearly observed with the Fed at its December FOMC meeting as Fed Chair Powell surprisingly admitted that the committee is already discussing dialing back the amount of policy restraint in place given the substantial progress on inflation that has been made. This shift could also be observed in the release of the Fed's quarterly economic projections, where core PCE forecasts were downgraded to just 3.2% for 2023 from 3.7% previously, which also appeared to be the main driver for the revision lower in the dots for 2024 to 4.6% for the Fed Funds rate from their prior 5.1% forecast. Data released during the month would have also convinced the Fed to deliver such a message with inflation in particular surprising to the downside and with core PCE declining to below the 2% target in 6 month annualised terms. Labour market rebalancing is also taking place with payroll growth having declined to around 160k in 3 month moving average terms, from above 300k at the beginning of 2023. Importantly, this rebalancing is taking place from not only the demand side, but also the supply side as the participation rate finally picks up which will take pressure off wage growth over time.
- Whilst the ECB and BoE chose not to make similarly dovish shifts in their communication at their December meetings, this is still expected to occur in Q1 given the outlook for both growth and inflation. At the ECB for example their latest inflation forecasts released signaled another large downgrade with headline inflation now expected to average 2.7% in 2024 compared to 3.2% in the September forecast. That said, these forecasts still appear too pessimistic on the inflation front and we would expect to see the ECB provide further downgrades in Q1, which would also open the path to a change in rhetoric. Meanwhile at the BoE, the latest CPI release was a significant downside surprise at 5.1% for core inflation, which compares to the BoE's own forecast of 5.7% and highlights the speed of the disinflation process. Furthermore given that the outlook for UK and Eurozone growth appears to be weaker than that of the US, with the consumer in a less robust position amid the rolling over of shorter dated mortgages, we would be



surprised if these central banks were to commence their easing cycle at a much later stage than the Fed. In addition, weak Chinese growth remains a concern without large-scale stimulus and will also continue to weigh on the outlook for the Eurozone economy given its open nature.

- Overall, we continue to hold a positive bias towards interest rate duration, where both the data in terms of the disinflation trend, as well as the communication from central banks and in particular the Fed, is supporting this bias. We would anticipate for other major central banks to follow suit in the coming months, which could provide further support herein. From a valuation perspective, despite the move lower in rates observed in Q4, we do not view valuations as stretched, with the market pricing the Fed rates trough at 3.2% currently, which is above their own guidance of 2.9% for end-2026 and the neutral rate of 2.5%, which still suggests room for the market to price policy towards normalisation. Furthermore Fed Chair Powell recently noted that his expectation is for real rates to decline as we move forward, which means that the 140bps worth of rate cuts priced for 2024 do not appear unreasonable in a world where inflation returns towards the 2% target. From a portfolio construction perspective, we also believe that it makes sense to hold more balanced portfolios with both credit risk and increased levels of interest rate duration. In particular and in contrast to what was observed in 2022, we think that exposure to duration could protect portfolios against any growth shocks, especially as the prior hikes delivered by central banks continue to feed through to the real economy.
- We also enter the year with a positive bias towards credit given that the path towards a soft landing remains intact. Whilst rates volatility and uncertainty around the Fed's terminal rate weighed on credit spreads at times in 2023, this should be less of a headwind in 2024 given recent developments. In addition, Powell's communication suggests that the Fed is willing to cut rates due to progress on inflation alone, rather than waiting for a further and significant growth slowdown, which also reduces the tail risk of the Fed overtightening into a recession. We view high income strategies as continuing to screen attractive from an all in yield perspective. For example the high yield segment of the market through CDS indices is compensating investors more than adequately for the risk being taken where 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. Furthermore we anticipate that the benign default rate backdrop will continue in 2024 given resilient growth and less refinancing risks as rates move lower and the new issue market reopens.
- 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 market as an attractive opportunity and an asset class that has recovered from the volatility observed in March last year. Crucially, this recovery has not only been helped by the regulators in their communication, but also the banks in their decision to call the bonds outstanding. This comes despite the market still pricing around 60% of the



AT1 universe to-call, providing attractive upside over the medium term given that we expect most AT1 bonds to be called by their issuers and refinanced in the market

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