THE DRIVE YOU DEMAND

UBAM - CORPORATE EURO BOND

Quarterly Comment | Q3 2019

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

Market Comment

- In July, central bank decisions were in focus this past month following the dovish shift made earlier in the year which had supported the rally in both risk and rates markets, but had also led to elevated expectations into the July meetings. The ECB July statement largely met market expectations as they altered their language with regards to interest rates, noting that they can remain at present "or lower" levels at least through the first half of 2020. The statement also highlighted the bank's determination to act, in line with its commitment to symmetry in the inflation aim, whilst also tasking its committees with examining options to reinforce forward guidance on policy rates, mitigating measures such as a tiered system, as well as options for the size and composition of potential new net asset purchases.
- Whilst markets initially took these headlines well, Draghi's press conference appeared not as convincing for investors, given the lack of details he provided on the potential stimulus measures themselves, whilst he also noted different nuances of views amongst council members on parts of the package. The Fed also tried to meet heightened expectations by cutting interest rates by 25 bps in July, although given talks of a 50 bps move, investors also appeared to be slightly disappointed with Powell's comments of this being just a "mid-cycle adjustment" to policy.
- Rates markets breathed somewhat in light of these developments, with German 10 year yields rising by 11 bps on the month, offsetting the 13 bps rally in June, whilst US 10 year yields were largely unchanged despite the Fed cutting interest rates by 25 bps at the end of the month.
- Data globally also put a cap on any rates sell-off, as Asian data in particular continued to highlight the impact of the US-China trade war, whilst Germany's Manufacturing PMI moved deeper into contraction territory with a reading of 43. With central banks remaining supportive of financial conditions, US Investment Grade credit spreads tightened by 7 bps in July whilst European spreads by 11 bps, outperforming largely due to hopes that another asset purchase program including corporate bonds will be announced by the ECB shortly.
- Trade war concerns continued to weigh on markets in August after US President Trump decided to announce new tariffs on the remaining goods imported from China at 15%, whilst also raising current tariffs from 25% to 30%. Developments herein led to China retaliating, implementing their own tariffs on USD 75bn worth of US goods, with the Chinese Renminbi weakening by almost 4% versus the dollar during the month.

- As a result, investors feared a further global growth slowdown, which supported a continuation of the interest rate rally as US 10 year yields declined by a significant 51 bps in August alone, whilst German 10 year Bund yields fell by 26 bps.
- The underperformance of Bunds could perhaps be put down to positive developments in Italy, with BTP spreads tightening by 28 bps in August after League Leader Salvini's efforts to dissolve the government backfired, as it appears to have led to the formation of a more market friendly, PD and Five Star Coalition forming, with snap elections crucially being avoided.
- Rate curves also flattened substantially in August, with the closely watched US 2s10s curve for example inverting for the first time since 2006, flattening by 15 bps in August, in a move that was likely exacerbated by summer illiquidity.
- The flattening of rate curves was a global phenomenon and allowed Germany to issue a 30 year zero-coupon bond at a negative yield for the first time, whilst the UK Gilts 2s10s curve also briefly inverted after Q2 GDP unexpectedly moved into contraction for the first time since 2012. Data elsewhere was also largely disappointing as the US ISM manufacturing release fell to its lowest level since 2016, whilst data out of Asia including PMIs and export data continued to highlight the impact of the US-China trade war.
- Risk markets struggled amid this backdrop as US Investment Grade credit spreads widened by 9 bps in August, with their European counterparts widening by 8 bps. The widening in spreads came despite Fed Chair Powell's comments at Jackson Hole, in which he emphasised the significant downside risks to the outlook, that have only increased since the last meeting. Whilst comments herein did indicate to investors that an upcoming rate cut was imminent, the market has already priced such action and so his comments were unable to provide any further substantial support for risk markets.
- The focus in September was on the eagerly anticipated central bank meetings from the Fed and ECB, in which they both made monetary easing announcements.
- The Fed cut interest rates by 25 bps in line with expectations, maintaining its commitment to act as appropriate to sustain the expansion. The Summary of Economic Projections that accompanied the decision however showed significant differences of opinion on the path of rates going forward. For example whilst seven board members saw one more rate cut this year, five members still projected a hike, whilst five saw unchanged rates.
- A lack of unanimity could also be observed following the ECB's easing package which included a 10 bps deposit rate cut coupled with a tiering announcement, as well as asset purchases to be restarted from November 1st at EUR 20bn per month. The bank also made a change to its forward guidance, looking to now keep rates at their present or lower levels until the inflation outlook robustly converges towards target, with asset purchases to end shortly before interest rates are increased.

- However, speeches from Governing Council members from core Eurozone countries both in the lead up to and following the package highlighted significant pushback to the decision to restart QE in particular.
- In light of these developments, US 10 year yields rose by 16 bps in September, as the market lowered its expectations on the extent of further rate cuts, whilst German 10 year yields rose by 13 bps. Whilst US investment grade spreads tightened by 5 bps on the month, European investment grade spreads ended 2 bps wider despite the ECB announcing upcoming corporate bond purchases.

  Differences within the Governing Council likely led to the underperformance of European spreads, as well as the fact that data within the Eurozone continued to disappoint, as highlighted by the ongoing weakness in the manufacturing sector survey data. In contrast, US spreads appeared to take some comfort from the fact that US and China trade negotiators agreed to another round of talks on October 10th, crucially ahead of the October 15th deadline for new tariffs to be implemented.

Performance Review

- UBAM - Corporate Euro Bond increased +1.0% net of fees in Q3 (I Share class). In relative terms the strategy delivered -19bps gross vs. its reference index: the ICE BofAML Euro Large Cap Corporate Index.
- The excess returns sequentially over the quarter were: -11bp in July, -3bps in August and -5ps in September.
- QTD, financials contributed -7bps, non-financials -15bps, hedging & overlay +6 bps and other items -3bps.
- Looking at financials in Q3: banks senior contributed -3bps. Looking at non-financials in Q3: key contributor was industrials (-6bps, underweight).

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in EUR was 0.3% vs. 0.4% for the reference index.
- The interest rate exposure was 5.2 years vs. 5.2 years for the index.
- The average credit spread was 101bps for an average rating of BBB vs. respectively 109bps and A- for the index.
- The main positions for the portfolio were:
  - Overall credit exposure: underweight vs benchmark
  - Underweight financials and underweight corporates.
  - Financials exposure: underweight banks senior, underweight banks Tier II, underweight insurance.
  - Non-financials exposure: overweight utilities and TMT, underweight cyclical industrials and autos and neutral Consumer.
  - Country exposure: underweight Germany, US, UK, Italy.

- In July, we reduced the fund's underweight position on credit risk during the month from a risk adjusted spread duration of -1.05 to -0.51 on the back of more support from global central banks. More specifically we participated in select new issues and added a long Italy position via BTP futures given Italy would be one of the main beneficiaries of a new ECB QE programme. We also replaced our iTraxx Main position with French banks Tier II bonds early in the month as we expect cash to outperform CDS given the prospect of potential asset purchases from the ECB. The duration of the fund increased from 5.2 to 5.4 years as we added to our duration overweight during the month on the expectation of new easing measures from central banks
- In August, we maintained an underweight position on credit risk in the fund due to ongoing uncertainties including the US-China trade war, Brexit and Italian politics as well as fears of a global growth slowdown. As a result, the risk adjusted spread duration of the fund remained stable at -0.54. The duration of the fund decreased from 5.4 to 5.1 years as we took profit on our long duration overlay trades during the month following a sharp rally in rates which left US rate markets pricing another 2.5 rate cuts for this year alone.
- In September, we maintained an underweight position on credit risk in the fund due to ongoing uncertainties including the US-China trade war, Brexit negotiations as well as intensifying concerns about a global growth slowdown (September saw continued weakness in manufacturing data in the US and Europe). As a result, the relative risk adjusted spread duration of the fund remained stable around -0.55. The absolute duration of the fund also remained stable around 5.2 years during the month.

Outlook

- Q3 culminated with both the Fed and ECB delivering with their eagerly anticipated monetary easing announcements. As we look ahead to the fourth quarter, the key focus for investors will be whether there is further easing in the pipeline given that the September meetings from both central banks have highlighted clear divisions within their respective boards. A lack of consensus on future monetary stimulus may also put pressure on fiscal authorities to finally react to the slowing growth backdrop. On growth itself, markets will be looking to see whether weakness being observed in manufacturing sectors globally will spill over to the more robust and stable services part of the economy amid on-going trade uncertainty, which would add further to the already heightened recession fears. This also increases the importance of both US-China trade talks and Brexit negotiations into year-end, to see whether a breakthrough can be made in either.
- The Fed at its latest meeting cut interest rates by 25 bps in line with expectations, maintaining its commitment to act as appropriate to sustain the expansion. The Summary of Economic Projections that accompanied the decision however showed significant differences of opinion on the path of rates going forward. For example whilst seven board members saw one more rate cut this year, five members still projected a hike, whilst five saw unchanged rates. Despite these differences, data since the meeting has increased our conviction that the Fed will continue cutting interest rates, with another 25 bp cut likely at the October meeting.

- In particular, we highlight recent weakness not only in the ISM Manufacturing survey, which fell to a 10 year low as the US-China trade conflict continues to bite, but perhaps of more concern is that softness herein may have started to spill over to the more stable service sector, as the ISM non-manufacturing survey also missed significantly to the downside this past month, although remains firmly in expansion territory. Whilst some comfort can be taken from the labour market with continued steady payrolls growth, the lack of wage pressures, as well as downside risks emanating from the manufacturing sector, should be enough reasons for the Fed to cut interest rates further.
- A lack of unanimity could also be observed with regards to the ECB's easing package which included a 10 bps deposit rate cut coupled with a tiering announcement, as well as asset purchases to be restarted from November 1st at EUR 20bn per month. The bank also made a change to its forward guidance, looking to now keep rates at their present or lower levels until the inflation outlook robustly converges towards target, with asset purchases to end shortly before interest rates are increased. We view this change in guidance as significant, in that it is now open-ended and state contingent, heavily reliant on inflation returning. Our own view is that we see a lack of inflationary pressures building not only within the region, but globally given demographic trends and low productivity. We therefore see any hawkish shift from the ECB as unlikely in the near-term and would expect asset purchases to continue for the foreseeable future, which should provide a backstop for core government yields as well as peripheral spreads. However, speeches from Governing Council members from core Eurozone countries both in the lead up to and following the September meeting indicate significant pushback to the decision to restart QE in particular. Therefore we do not anticipate for significant additional easing measures to be announced in Q4 given these divisions.
- Incoming ECB President Christine Lagarde's focus will therefore likely be to try and convince government's within the region to facilitate fiscal easing. Draghi himself at the last press conference said that "there was unanimity that fiscal policy should become the main instrument to support growth". Therefore if growth does continue to disappoint, then the likelihood of some form of fiscal support will increase. This theme has already begun to pick up traction, with the Netherlands and France making some fiscal supportive announcements for their 2020 budget in recent months. We see Germany as a core Eurozone country where fiscal stimulus could be used to support a slowing economy which is being hurt by global trade and manufacturing weakness. Crucially, Germany is also a country with low debt levels which provides room for them to loosen the fiscal belt somewhat at a time when support for government spending via "green" initiatives appears to be on the rise. We do not see this as an imminent announcement, instead seeing it likely that the German authorities are forced into action if the economy moves deep into recession.
- In light of the above, our bias remains to add to duration on yield spikes as we still expect the Fed to cut rates further this year to sustain the expansion. If a more negative growth scenario were to play out, then Fed Chair Powell may have to alter his "mid cycle adjustment" view of rate cuts to a more substantial cutting cycle. We do not think we are at this stage yet given that the labour market still remains strong, and as such we wait for better levels to add back to duration, with the front-end of the US curve looking increasingly attractive. In contrast in the Eurozone, our bias would be to add to duration further out the curve given that we see low inflationary pressures and as such, the likelihood that asset purchases will continue and support yields further out the curve.

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- Overall, we see the potential for further gains in duration larger in the US than the Eurozone given that the latter appears to already be hitting limits within the Council with regards to monetary easing possibilities. We also think that UK gilts could lead the rally if Brexit negotiations continue to stall, as BoE members appear increasingly concerned with the ensuing slowdown as companies halt their investment decisions. For credit markets, we see much of the monetary stimulus described as largely priced into current valuations, whilst uncertainty surrounding trade, Brexit and global growth still weighs on the outlook and leaves us cautious in our exposure at this current juncture.

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