UBAM - MEDIUM TERM US CORPORATE 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

- 2022 began on a volatile note as the hawkish shift taken by several key central banks towards the end of last year extended further. One of the main messages delivered by Fed Chair Powell was that this tightening cycle will be different to the gradual hiking cycle that began in 2015, where he chose not to rule out the possibility of a 50bp hike in March or hiking at consecutive meetings in contrast to the general consensus which has been for a gradual, quarterly hiking pace.
- Markets also priced in risks of a more hawkish ECB meeting given rising inflation concerns as energy prices continued their march higher as geopolitical tensions between Russia and Ukraine escalated.
- We therefore saw government bond yields rise sharply in January as the market further re-priced their expectations for central bank tightening with more than five hikes priced for the Fed by the end of this year and two hikes priced for the ECB at the time of writing. Such developments led to US 10-year yields rising by 27 bps in January in a move that was fully driven by real rates, which rose to their highest level since March 2021.
- This real rate move weighed on risk markets, with equities coming under significant pressure on the back of a large sector rotation which saw Growth names weaken aggressively, whilst Value outperformed.
- Credit spreads followed suit with US Investment Grade spreads widening by 13 bps and European spreads were 9 bps wider on the month. Economic data released during the month generally saw a further moderation given the impact of the Omicron Covid wave in December, as observed through the ISM Manufacturing and Services prints which disappointed relative to expectations and also likely weighed on sentiment.
- February was the weakest month for credit market since the Covid-19 outbreak in 2020. The weakness was driven by the Ukraine situation, where the Russian invasion and subsequent severe International, and in particular European, sanctions created uncertainty for the economic outlook.
- The 4Q21 earnings season ended on a solid note in the US with 69% of S&P500 companies beating estimates on revenues and 75% beating on EPS. Revenues came on average 2% ahead of consensus while EPS came on average 13% above consensus driven by banks. Despite supply chain pressures and inflation, non-financial net margins held in fairly well as corporates were able to pass on higher costs to consumers through pricing. Net margins were down 70 bps QoQ to 13.3% but still up 140 bps vs 4Q20 and near historic highs.

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- In March, US IG credit spread performance was a tale of two halves during the month with spreads on the back foot during the first half due to geopolitical risks and hawkish monetary policy before a sharp rally in the second half of the month post the Fed's first rate hike this cycle and amid peace talks taking place between Russia and Ukraine.
- From a sector perspective, the top performers were energy and metals & mining amid surging prices due to disruptions from the war in Ukraine. The top underperformers were autos and airlines. USD IG primary market activity was buoyant as March 2022 churned out the fourth largest monthly volume ever at $233bn. YTD supply of $465 bn is running 3% ahead of this time last year.
- The key highlight was Magallanes (an issuing vehicle linked to AT&T/Discovery) printing a $30bn deal (the fourth largest on record) which was backed by a $106bn order book to fund an offsetting payment to AT&T for the spinoff of its Warner Media unit to Discovery Communications.

Performance Review

- UBAM - Medium Term US Corporate Bond delivered -4.6% QTD net of fees (I Share class). In relative terms the strategy delivered +108 bps gross of fees vs. its benchmark: the ICE BofA US 1-10 years US Corporate Index.
- The excess returns sequentially over the quarter were: -7 bps in January, +16 bps in February and +99 bps in March.
- QTD, financials contributed -12 bps, non-financials +37 bps, hedging & overlay +92 bps and other items -9 bp.

Portfolio Activity

- At the end of the quarter, the yield of the portfolio was 3.0% vs 3.4% for the benchmark.
- The interest rate exposure was 3.0 years vs. 4.3 years for the index
- Main positions:
  - Overall credit exposure: overweight vs benchmark: overweight financials and corporates
  - Financials exposure: overweight banks senior, small underweight banks Tier II, underweight insurance
  - Corporates exposure: overweight tmt, autos and hybrids, neutral consumer and underweight industrials and utilities
  - Country exposure: underweight Latam, overweight US, UK, EU Core & periphery countries and China

    Synthetic exposure: long CDX IG index

- In January, we increased our overweight credit risk stance during the month with the relative risk-adjusted spread duration ending the month at +1.1 year vs +1.0 year at end December. This addition of credit risk was done through CDX IG on the back of our expectation of a continued strong fundamental backdrop for credit (robust GDP growth, resilient corporate profitability).
- On the rates side, we increased our short duration position from -0.4 year to -0.6 year following a hawkish set of December Fed minutes which hinted at a quicker start to rate hikes and balance sheet normalisation than prior guidance. In addition, we implemented a US 2s10s flattener position during the Fed's January press conference as a hedge for portfolios in case we continued to flatten following the hawkish guidance given by Chair Powell.

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- In February, amid a robust global growth outlook and recovery from the Omicron variant we retained our overweight credit risk stance during the month with the relative risk-adjusted spread duration ending the month at +1.1 year largely in line with end January levels.
- On the rates side, we increased our short duration position on US rates early in the month from -0.6 year to -0.9 year on the back of strong payrolls and wage growth in January. We added long exposure (0.55 year) to 5y EUR rates as a hedge against escalating geopolitical tensions amid the threat of a Russian invasion of Ukraine.
- In March, amid a still robust global growth outlook and peace talks taking place between Russia and Ukraine, we added credit risk in the fund, taking the relative risk-adjusted spread duration to +1.6 year (up from +1.1 year at the end of February).
- This risk addition was mainly achieved through participation in the primary market, adding to energy hybrids as well as rolling our iTraxx index position into the new on the run series on a notional neutral basis (equivalent to a 6 month maturity extension of the position).
- On the rates side, we increased our short duration position from -0.9 year to -1.4 year by going short 10y Japanese government bonds given an attractive risk-reward profile as Japanese rates have significantly lagged the higher rates move observed elsewhere amid BoJ Yield Curve Control. We also maintained our US 2s10s curve flattening position given the increasingly hawkish rhetoric from the Fed.

Outlook

- Although COVID-19 concerns have eased since the start of the year, which has allowed for the global reopening of economies to continue, the Russia-Ukraine crisis has begun to reshape the geopolitical and economic outlook. Geopolitical tensions, persistent supply constraints and less accommodative monetary and fiscal policies will likely lead to a decline in global economic growth from 5.8% in 2021 to around 3% in 2022 and 2023. Activity in regions such as Europe and Latin America will be softer as countries struggle with either a greater impact from the Russia-Ukraine crisis or higher deficits and inflation rates, whilst the US economy should outperform. At a global level, rising energy prices and persistent supply chain disruptions should continue to keep inflation elevated throughout most of the year, with further pressure in some countries to come through tight labour markets driving wage growth. As a result, global inflation is expected to rise from 3.9% in 2021 to around 6.5% in 2022, before slowing back to 3.5% in 2023, where this year's strength in inflation is likely to force most central banks to tighten their monetary policies further.
- Across major countries, the United States will stand out. Despite the impact of higher food and energy prices, less supportive monetary and fiscal policies and weaker growth in export markets, the United States economy should remain relatively solid. Strong labour market conditions coupled with robust household and business balance sheets should provide resilience and help maintain private demand and investment. Meanwhile, the Eurozone and United Kingdom economies will likely contract in the second quarter of the year as fiscal policy is unlikely to be enough to prevent a slowdown in activity driven by a greater impact from the Russia-Ukraine crisis, which is squeezing real households' incomes. Provided geopolitical tensions moderate however, economic growth in Europe should resume later in the year driven by a post-Covid-19 rebound in services consumption, declining inflation, and easing supply chain issues. In China, should the government stick to its zero-Covid policy, new outbreaks of COVID-19 will continue to keep industrial production and household consumption subdued, preventing a swift rebound in economic activity. While threats to activity from virus infections, high corporate debt and the weak real estate market remain, the government will continue to support economic growth via easing monetary policy measures, accelerated infrastructure investment and tax rebates for firms in an attempt to achieve its 5.5% growth target for 2022, for which risks currently appear to the downside.
- During the first quarter of the year, the Fed accelerated its hawkish shift given that they have been consistently surprised to the upside by the extent and duration of the current inflationary pressures, coupled with their increased confidence in the strength of the labour market, which Fed Chair Powell described as extremely tight. For example at the March meeting, the Fed's updated dot plot projections showed the Fed Fund's rate above the neutral rate at 2.8% in 2023, up from 1.6% previously with Powell saying that there is an obvious need to move expeditiously to return the stance of monetary policy to a more neutral level.

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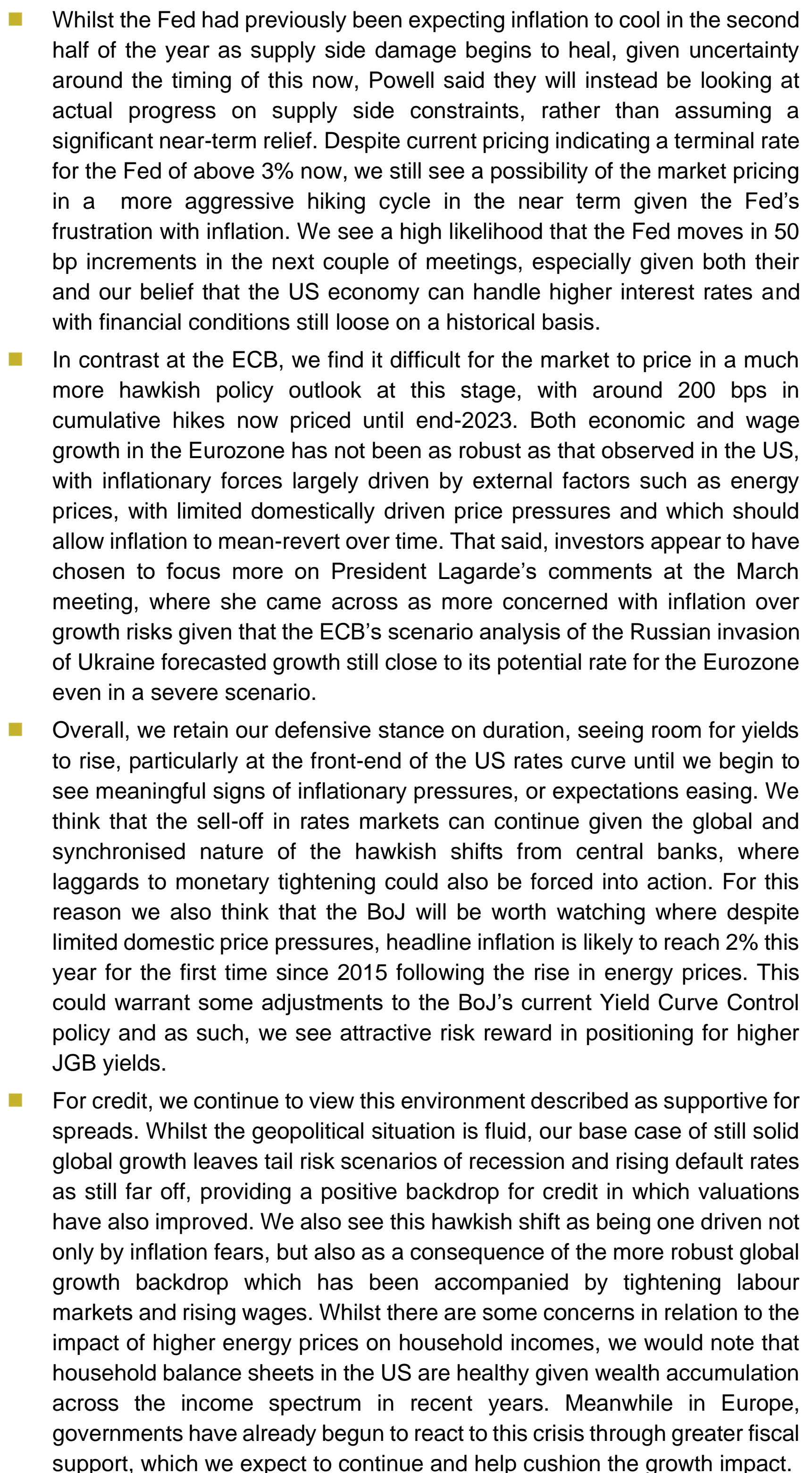

- Whilst the Fed had previously been expecting inflation to cool in the second half of the year as supply side damage begins to heal, given uncertainty around the timing of this now, Powell said they will instead be looking at actual progress on supply side constraints, rather than assuming a significant near-term relief. Despite current pricing indicating a terminal rate for the Fed of above 3% now, we still see a possibility of the market pricing in a more aggressive hiking cycle in the near term given the Fed's frustration with inflation. We see a high likelihood that the Fed moves in 50 bp increments in the next couple of meetings, especially given both their and our belief that the US economy can handle higher interest rates and with financial conditions still loose on a historical basis.
- In contrast at the ECB, we find it difficult for the market to price in a much more hawkish policy outlook at this stage, with around 200 bps in cumulative hikes now priced until end-2023. Both economic and wage growth in the Eurozone has not been as robust as that observed in the US, with inflationary forces largely driven by external factors such as energy prices, with limited domestically driven price pressures and which should allow inflation to mean-revert over time. That said, investors appear to have chosen to focus more on President Lagarde's comments at the March meeting, where she came across as more concerned with inflation over growth risks given that the ECB's scenario analysis of the Russian invasion of Ukraine forecasted growth still close to its potential rate for the Eurozone even in a severe scenario.
- Overall, we retain our defensive stance on duration, seeing room for yields to rise, particularly at the front-end of the US rates curve until we begin to see meaningful signs of inflationary pressures, or expectations easing. We think that the sell-off in rates markets can continue given the global and synchronised nature of the hawkish shifts from central banks, where laggards to monetary tightening could also be forced into action. For this reason we also think that the BoJ will be worth watching where despite limited domestic price pressures, headline inflation is likely to reach 2% this year for the first time since 2015 following the rise in energy prices. This could warrant some adjustments to the BoJ's current Yield Curve Control policy and as such, we see attractive risk reward in positioning for higher JGB yields.
- For credit, we continue to view this environment described as supportive for spreads. Whilst the geopolitical situation is fluid, our base case of still solid global growth leaves tail risk scenarios of recession and rising default rates as still far off, providing a positive backdrop for credit in which valuations have also improved. We also see this hawkish shift as being one driven not only by inflation fears, but also as a consequence of the more robust global growth backdrop which has been accompanied by tightening labour markets and rising wages. Whilst there are some concerns in relation to the impact of higher energy prices on household incomes, we would note that household balance sheets in the US are healthy given wealth accumulation across the income spectrum in recent years. Meanwhile in Europe, governments have already begun to react to this crisis through greater fiscal support, which we expect to continue and help cushion the growth impact.

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- We also see this backdrop as positive for credit from the micro perspective, given strong credit fundamentals underpinned by good pricing power - which allows companies to sustain high profit margins despite an inflationary environment - as well as continued prudent balance sheet management. Net leverage for US Investment Grade names has fully reversed the increase observed during the pandemic, whilst a US HY default rate of under 1% for 2021 highlights how this segment of the market benefitted from the reopening of economies on the back of the vaccine rollout. As such, we prefer high beta credit with low duration, favouring high yield and subordinated financial debt, in particular AT1s which should benefit from the rising rates environment, as well as floating rate notes which can be an attractive allocation at a time of rising rates.

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