



# UBAM - ABSOLUTE RETURN LOW VOL FIXED INCOME

Quarterly Comment | Q4 2019

*Formerly: UBAM - Unconstrained Bond*

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

---

## *Market Comment*

- ◆ Risk markets performed well in October with the S&P hitting all-time highs as investors took comfort from the progress made with regards to both US-China trade discussions and Brexit negotiations. On trade, talks in Washington headed in a positive direction, with both sides indicating hopes of a “Phase One” partial trade deal to be signed in Mid-November, tempering any fears of a further escalation in the trade war in the coming months. In the UK, the EU provided another Article 50 extension until January 31st, reducing no deal Brexit risks.
- ◆ The third rate cut from the Fed this year that came through at the end of the month was also taken well by risk markets, despite the dovish phrase in the statement of “acting as appropriate to sustain the expansion” being replaced with more neutral guidance, with Chair Powell in the press conference saying that monetary policy is currently in a “good place”. The market instead seemed to focus on Powell shrugging off any chances of a hike in the near term as he said that it would require a “really significant move up in inflation that is persistent before we even consider raising rates to address inflation concerns”.
- ◆ This environment allowed for credit spreads to tighten on the month, with US Investment Grade spreads tightening by 4 bps in October, whilst European spreads outperformed and tightened by 10 bps, buoyed by Brexit progress as well as likely positioning in advance of fresh QE purchases which commenced at the start of November. Interest rate markets also saw some unwinds of safe haven inflows as tail risks around trade and Brexit were seemingly reduced, and resulted in US 10 year yields rising by 3 bps on the month whilst German yields sold off by 16 bps, with Mario Draghi announcing no new stimulus measures in his final meeting as ECB President.
- ◆ November was another decent month for risk markets with the S&P 500 index breaking new highs, as hopes continued to rise that the US and China will manage to agree on a Phase One trade deal, whilst central banks also helped sentiment as the ECB’s previously announced new asset purchase programme began to be implemented.
- ◆ Amid this environment, US investment grade credit spreads tightened by 6 bps in November, whilst European spreads were largely flat on the month as heavy issuance weighed on spreads. The outperformance of US credit risk could also be put down to optimism around the trade deal, with reports suggesting that the US may be willing to roll back some of the previously implemented tariffs to agree on a deal, although no deal has been signed at the time of writing.



- ◆ Interest rate yields also rose in November given positives from the trade deal, as well as the fact that data globally appeared to be turning off the lows. For example the payrolls report in the US continued to highlight a robust labour market, whilst the global manufacturing PMI improved marginally for the third consecutive month. In addition, investors reacted positively to the initial polls that were released ahead of the UK's general election in which the Conservative Party were estimated to enter parliament with a majority government, which would allow for the passage of Boris Johnson's Withdrawal agreement and for the UK to exit the EU ahead of the new Article 50 deadline of January 31st 2020.
- ◆ This constructive backdrop led to some safe haven flows being unwound, with US 10 year yields rising by 9 bps during the month, whilst German 10 year yields were 4 bps higher. The move higher in rates was not overly aggressive given that the major central banks still appear committed to accommodative policy after Fed Chair Powell in the October press conference lowered the likelihood of any rate hike in the near term, whilst the ECB President Lagarde in her first official speech chose not to rock the boat and provided a consistent message to previous President Draghi with regards to monetary policy.
- ◆ Risk markets ended 2019 on a strong footing with the S&P 500 index breaking new highs once again, whilst credit spreads also benefitted from the positive sentiment into year-end.
- ◆ US Investment Grade spreads tightened by 8 bps in December and European IG spreads by 9 bps, resulting in both segments of the market tightening by over 60 bps in 2019 alone. This constructive backdrop in December was likely fuelled by optimism on the US-China trade front as negotiations resulted in a Phase One agreement being found and which is set to be signed early this year. In addition, the UK elections resulted in a large Conservative majority, which has cleared the path for the UK to leave the EU on January 31st, removing some near-term uncertainty herein.
- ◆ Data globally also hinted at stabilisation following weakness earlier in the year as the US labour market tightened further amid strong payroll gains, whilst the Global Manufacturing PMI improved for a fourth consecutive month and moved back into expansionary territory for the first time since April as trade tensions receded.
- ◆ Central bank meetings in December also provided comfort for investors, as it was clear that any hawkish shift in policy that would upset risk markets was not imminent. The Fed's latest dot plot projection has a median dot that guides towards unchanged rates this year, with Chair Powell in the press conference noting that there is more slack out there. Powell also appeared to link any rate increases to actual inflation pressures, by saying that he would want to see a significant move up in inflation that is also persistent, before raising rates to address inflation concerns. Meanwhile in Christine Lagarde's first press conference as ECB President, instead of looking to make any immediate policy changes in her new role, she instead focussed on the bank's decision to go ahead with a strategic review, which is expected to run from January through to late 2020 and will include a comprehensive assessment of the ECB's toolkit, including its side effects, as well as covering other topical issues such as climate change and the impact of technological change on monetary policy.
- ◆ US 10 year yields rose by 10 bps over the month to 1.88% as the positive risk backdrop reduced the demand for such safe haven assets, whilst German 10 year yields sold off by 17 bps to end the year at -19 bps.



---

### Performance Review

- ◆ UBAM - Absolute Return Low Vol Fixed Income decreased 0.1% net of fees (I Share class). In relative terms the strategy delivered +10bps gross above its reference index: the Eonia capitalization 7 days index.
- ◆ The excess returns for October were +1bp, +1bp for November and +8bps for December.
- ◆ The QTD, the main contributor to the excess returns was CDS indices exposure (+15bps).
- ◆ 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 0.0% and 2.3% in USD (hedged share class).
- ◆ The interest rate exposure was 0.8 years and the credit exposure was 1.1 years at the end of September.
- ◆ In October, we re-added to credit exposure throughout the month. Initially, at the start of October we added 0.3 year spread duration through the CDX HY and CDX IG CDS indices as US payroll numbers came in strong, reducing the market's fears of manufacturing weakness spilling over to the services sector and hard data in general. Moreover, subdued wage growth provided the Fed with additional comfort in cutting interest rates at the upcoming October meeting. We further increased the credit exposure when the partial trade deal between the US and China, and more constructive Brexit negotiations reduced tail risks in the near term. We chose the iTraxx Crossover as the index stood to profit most from a rally in the UK Brexit premium. At the end of the month we partially took profit on before mentioned positions as the market had priced in a fair amount of the positive developments. On the rates side, we increased duration along with our credit risk, to conserve a balanced portfolio and as the entry point appeared attractive following the spike in yields.
- ◆ In November, we added 0.2 year spread duration mainly through CDX HY as manufacturing data was bottoming out, and as positive momentum in US and China talks increased the hopes of a phase one trade deal. For similar reasons we lowered our duration exposure back to 0.7 year.
- ◆ In December, we left the fund's credit exposure unchanged in December. We increased the interest rate duration by 0.2 year to 0.8 years by adding to 5 year German rates. In our view, the selloff in rates provided a good entry level to add back to duration given that central banks are set to remain accommodative in 2020 and as the global growth recovery story is not necessarily a robust one yet. In addition, we initiated 2s10s steepeners split across the US and EUR on expectations of fiscal easing, and a stabilisation of the macro-economic backdrop resulting in a steeper curve.



---

## Outlook

- ◆ 2019 was a year in which the major central banks of the Fed and ECB delivered significant monetary easing in light of growing global growth risks. Therefore as we look ahead to this year, one of the key questions will be whether the easing delivered will be enough to stabilise growth, or if lingering uncertainty around trade will continue to weigh on the manufacturing sector in particular. If growth is unable to improve, investors will begin to anticipate more support through fiscal policy given that central banks such as the ECB appear to be putting more pressure on governments to provide the next round of stimulus, if and when it is required. Much of the geopolitical stories that caught the attention in 2019 will also gain focus this year, as an arguably tougher Phase Two US-China trade negotiation will commence, whilst the UK and EU aim to agree on a new trade deal ahead of the end-2020 transition period deadline. In addition, the US Presidential elections will be taking place in November, where the initial Democratic primaries in Q1 will be watched closely as they should provide a clearer picture of Trump's likely opponent.
- ◆ The latest communication from the Fed indicates that they would be in favour of unchanged policy in 2020 were developments to play out as they anticipate. For example if we look at their latest dot plot projections released in December, the median dot for this year suggests no rate changes, followed by one hike in each of 2021 and 2022. In addition, the accompanying statement described the current policy stance as appropriate, which is language that Chair Powell reiterated in his press conference. Whilst the dots show that the board is not expecting any rate cuts, it also appears as though rate hikes are not yet on the table, after Powell said that "there's actually more slack out there", which was emphasised through the economic projections which showed another downward revision to the unemployment rate over the forecast period. Crucially, Powell linked any future rate increase to actual inflation pressures, by saying that he would want to see a significant move up in inflation that is also persistent, before raising rates to address inflation concerns.
- ◆ The reaction function of the Fed around the possibility of raising rates appears to be very different to the previous hikes of 2017/2018. During this period, rate hikes took place on the expectation that strong growth and a tightening labour market would impact inflation, where the Fed chose to act ahead of such a development. Given that these inflation fears were never realised, it now looks as though the Fed wants to wait and see for real and persistent inflationary pressures before acting. With Fed board members emphasising that the inflation target is a symmetric one, it suggests that they are also comfortable with inflation moving above the 2% target for a period of time, given that it is has been persistently below target for so long. As such, we think that any Fed policy actions in 2020 are still skewed towards rate cuts rather than hikes, especially if geopolitical risks related to trade resurface following the upcoming Phase One trade deal signing. With the Fed funds rate still closer to the neutral rate rather than the zero lower bound, there is clearly still room for the Fed to ease through cuts, unlike central banks elsewhere who are now more constrained.



- ◆ The ECB is one such bank that appears more constrained with regards to providing additional stimulus in 2020. For example former President Draghi's final stimulus package did not receive unanimous support on the board, with pushback observed on the need to restart QE in particular. Meanwhile President Lagarde has begun her tenure with a decision to perform a strategic review, which is expected to run from January through to late 2020 and will include a comprehensive assessment of the ECB's toolkit, including its side effects, as well as covering other topical issues such as climate change and the impact of technological change on monetary policy. Given this focus, the next major policy move from the ECB will likely come once the strategic review has been finalised, where during this interim period, we will only see changes to policy if there is a significant growth shock. Even if growth were to disappoint, initial comments from Lagarde suggest that she would put more pressure on governments within the Eurozone that have fiscal space (such as Germany), to take advantage of the low interest rate environment and provide stimulus to support the region, rather than acting aggressively through monetary policy. With the side effects of negative rates becoming increasingly discussed, and the last QE decision not being unanimous, it will be hard for Lagarde to push through large scale easing on these fronts. That said, we anticipate that the bank will maintain its asset purchase programme for the foreseeable future, given that the forward guidance in place is state contingent, continuing with the current easing package until the inflation outlook robustly converges towards the target.
- ◆ Major central banks elsewhere such as the BoJ, PBOC and BoE are also unlikely to shift in the hawkish direction this year. Although imminent Brexit uncertainty is set to fade with the UK likely to leave the EU on January 31st given the now large Conservative majority sitting in parliament, we do not think this means that the BoE will be forced into hiking rates. Firstly, the BoE in 2019 was on the side-lines and in wait-and-see mode during Brexit negotiations and hence did not partake in the monetary easing observed elsewhere. In addition, Boris Johnson's recent amendment to the Withdrawal Agreement now outlaws an extension of the transition period beyond the end of this year, which has introduced some cliff-edge risks once again in case the UK and EU cannot agree on a trade deal by then. Meanwhile in China, the PBOC's announcement on January 1st to cut the reserve requirement ratio by 50 bps clearly highlights their dovish intention, where further cuts later in the year cannot be ruled out amid the headwinds to growth from the current trade war with the US.
- ◆ In light of the above, our bias remains to add to duration on yield spikes in 2020, as we see hawkish moves from central banks as unlikely in the near term given on-going subdued inflationary pressures and a growth backdrop that is stabilising, rather than sharply accelerating. Our bias would be to increase duration exposure in the front-end of rates curves given that no rate cuts are now priced by markets for the Fed this year providing good risk-reward, whilst the long-end of EUR curves could be hurt in a scenario in which fiscal policy becomes a more prominent theme. For credit markets, we see stable growth and accommodative central banks as supportive for spreads, however our preference would be to build increasingly balanced portfolios holding both interest rate and credit exposure. This makes sense to us at a time when hawkish risks from central banks are low and when volatile episodes could still return and impact markets from various angles such as the trade negotiations, US elections and the recent uptick in Middle-Eastern tensions.

---

## Disclaimer

**This is a marketing document and is intended for informational and/or marketing purposes only. This document is confidential and is intended only for the use of the person(s) to whom it was delivered.** This document may not be reproduced (in whole or in part) or delivered, given, sent or in any other way made accessible, to any other person without the prior written approval of Union Bancaire Privée, UBP SA or any entity of the UBP Group ("UBP"). This document reflects the opinion of UBP as of the date of issue.

This document is for distribution only to persons who are Qualified Investors in Switzerland or Professional Clients, Eligible Counterparties or equivalent category of investors as defined by the relevant laws (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. It is not intended for distribution, publication, or use, in whole or in part, in any jurisdiction where such distribution, publication, or use would be unlawful, nor is it directed to any person or entity to which it would be unlawful to direct such a document. In particular, this document may not be distributed in the United States of America and/or to US Persons (including US citizens residing outside the United States of America).

This document has not been produced by UBP's financial analysts and is not to be considered as financial research. It is not subject to any guidelines on financial research and independence of financial analysis.

Reasonable efforts have been made to ensure that the content of this document is based on information and data obtained from reliable sources. However, UBP has not verified the information from third sources in this document and does not guarantee its accuracy or completeness. UBP accepts no liability whatsoever and makes no representation, warranty or undertaking, express or implied, for any information, projections or any of the opinions contained herein or for any errors, omissions or misstatements. The information contained herein is subject to change without prior notice. UBP gives no undertaking to update this document or to correct any inaccuracies in it which may become apparent.

This document may refer to the past performance of investment interests. **Past performance is not a guide to current or future results.** The value of investment interests can fall as well as rise. Any capital invested may be at risk and you may not get back some or all of your original capital. In addition, any performance data included in this document does not take into account fees and expenses charged on issuance and redemption of securities nor any taxes that may be levied. Changes in exchange rates may cause increases or decreases in your return.

All statements other than statements of historical fact in this document are "forward-looking statements". Forward-looking statements are not guarantees of future performance. The financial projections included in this document do not represent forecasts or budgets, but are purely illustrative examples based on a series of current expectations and assumptions which may not eventuate. The actual performance, results, financial condition and prospects of an investment interest may differ materially from those expressed or implied by the forward-looking statements in this document as the projected or targeted returns are inherently subject to significant economic, market and other uncertainties that may adversely affect performance. UBP disclaims any obligation to update any forward-looking statement, as a result of new information, future events or otherwise.

It should not be construed as advice or any form of recommendation to purchase or sell any security or funds. It does not replace a prospectus or any other legal documents that can be obtained free of charge from the registered office of a fund or from UBP. The opinions herein do not take into account individual investors' circumstances, objectives, or needs. Each investor must make his/her own independent decision regarding any securities or financial instruments mentioned herein and should independently determine the merits or suitability of any investment. In addition, the tax treatment of any investment in the fund(s) mentioned herein depends on each individual investor's circumstances. Investors are invited to read carefully the risk warnings and the regulations set out in the prospectus or other legal documents and are advised to seek professional advice from their financial, legal and tax advisors. The tax treatment of any investment in the Fund depends on your individual circumstances and may be subject to change in the future.

The document neither constitutes an offer nor a solicitation to buy, subscribe for or sell any currency, funds, product or financial instrument, make any investment, or participate in any particular trading strategy in any jurisdiction where such an offer or solicitation would not be authorised, or to any person to whom it would be unlawful to make such an offer or invitation.

Telephone calls to the telephone number stated in this presentation may be recorded. When calling this number, UBP will assume that you consent to this recording.

UBP is authorised and regulated in Switzerland by the Swiss Financial Market Supervisory Authority and is authorised in the United Kingdom by the Prudential Regulation Authority. UBP is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority.