UBAM - CORPORATE EURO BOND

Quarterly Comment

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Market Comment

- Renewed concerns around Covid-19 in July led to heightened volatility in fixed income markets and resulted in a further rally in interest rates, as the more infectious Delta variant spread globally. The focus was on the UK, where the experiment of fully reopening an economy at the same time as a significant acceleration in Covid-19 cases was being watched with much caution. Positively however, there was limited feedthrough from case growth into hospitalisations and deaths, suggesting that the vaccine has weakened this link.
- Fed Chair Powell did not come across as overly concerned with the Delta variant either, noting in his press conference that with each wave of Covid-19, there has tended to be less in the way of economic implications which he thinks is not an unreasonable expectation for this wave. As a result, the Fed continued with its tapering discussions in July, anticipating that the labour market will continue to improve following the impressive report which showed 850k payrolls growth for June. For example in the statement, the Fed added that the economy has made progress towards its goals and that the Committee will continue to assess progress in coming meetings.
- Meanwhile at the ECB, the main development in July was the conclusion of the strategy review in which they have a new and symmetric 2% inflation target, which considers negative and positive deviations from 2% as equally undesirable. In addition, the Council provided some further dovish communication, noting that when the economy is close to the lower bound, this requires especially forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched.
- US and German 10 year yields both rallied by 25 bps in July, with real rates in the US declining to new lows and the USD rates curve flattening further, back to levels last seen in February of this year. Global growth concerns due to the Delta variant and policy uncertainty in China given ongoing regulatory changes resulted in US investment grade credit spreads widening by 5 bps on the month, whilst European spreads ended the month unchanged, outperforming given continued purchases from the ECB.
- Fed Chair Powell's eagerly anticipated Jackson Hole speech at the end of August was well received by markets as it was perceived as being less hawkish than comments from several regional Fed Presidents who spoke earlier in the month. Whilst Powell said that it could be appropriate to start reducing the pace of asset purchases this year, he added that the timing and pace of such an action does not carry a signal for the timing of rate hikes which has a substantially more stringent test. This caveat from Powell on rate hikes was taken well by risk markets, as were his comments around inflation, where he expects the current higher prices to prove temporary. This patient message

delivered by Powell came despite another impressive employment report which showed payroll growth of 943k as service sector jobs continued to recover.

- That said, weakness was observed in several consumer surveys during the month such as US consumer confidence as the Delta variant weighed on sentiment, whilst Covid and policy uncertainty in China resulted in a growth slowdown, as observed through their manufacturing and services PMI reports which increased market expectations for further policy support from both monetary and fiscal authorities.
- We did however see higher rates in August following the significant rally in interest rate markets observed in July, as the number of new Covid-19 cases appeared to be plateauing at the global level, whilst investors also took comfort from the fact that this wave was not leading to a significant spike in deaths, as the vaccine rollout appears to have weakened this link.
- US 10 year yields for example rose by 9 bps, whilst German 10 year Bund yields rose by 7 bps, as several ECB Governing Council members mentioned the possibility of bringing PEPP purchases back towards a more normal pace in Q4, following the recent acceleration. This led to a marginal underperformance of European spreads as well, which were 1 bp wider in August, compared to US Investment grade spreads which ended the month flat.
- September saw equity markets react negatively to heightened interest rate volatility, as inflation fears rose further amid the surge in gas prices that was observed. This led to a sharp move higher in inflation breakevens in Europe and the UK in particular, allowing for government bond yields to rise, despite the major Central Bank Governors continuing to emphasise that they see the current inflationary pressures as largely transitory in nature.
- UK gilts led the way with 10 year yields rising by 31 bps during the month, in a move that was also helped by increasingly hawkish commentary from the Bank of England. As a result, the market brought forward pricing for the first hike to Q1 next year despite mixed growth data and a clouded labour market outlook given that the furlough scheme has just ended.
- In the US, the 18 bp move higher in 10 year yields followed a more hawkish Fed meeting where they not only hinted towards an upcoming tapering decision, but Fed Chair Powell in the press conference added that it was the Committee's intention to conclude the tapering process around the middle of next year. In addition, the updated dot plot, which included expectations for 2024 for the first time, now shows the Fed projecting 6.5 hikes out to the end of 2024, compared to market pricing of less than 5 hikes during this period.
- The ECB also decided to reduce its balance sheet support by moderately lowering the pace of asset purchases under PEPP for Q4 compared to the previous two quarters. From a growth perspective, concerns also rose during the month largely due to developments out of China as fears around a property sector induced slowdown grew in light of the Evergrande fallout, whilst power shortages also appear to be weighing on the near term growth outlook. For risk markets, although the S&P in September had its weakest performance of the year, credit markets were more resilient, as US Investment Grade spreads were able to tighten by 3 bps during the month whilst European spreads were also 1 bp tighter.

Q3 2021

Performance Review

- UBAM - Corporate Euro Bond delivered -0.06% QTD net of fees (I Share class). In relative terms the strategy delivered +2 bps before fees vs. its benchmark: the ICE BofA Euro Large Cap Corporate Index.
- The excess returns sequentially over the quarter were: -9 bps in July, +2 bps in August and +9 bps in September.
- QTD, financials contributed +3 bps, non-financials +5 bps, hedging & overlay -7 bps and other items +1 bp.

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in EUR was 0.5% vs 0.3% for the benchmark.
- The interest rate exposure was 4.9 years vs. 5.4 years for the index
- Main positions:
  - Overall credit exposure: overweight vs benchmark and overweight financials and underweight corporates
  - Financials exposure: overweight banks senior, insurance subs, banks Tier II and underweight insurance senior
  - Corporates exposure: overweight TMT and hybrids, neutral autos, and underweight industrials, utilities and consumer
  - Country exposure: overweight US, EU periphery, UK, Switzerland, underweight France and Germany
  - Synthetics exposure: Overweight CDS indices iTraxx Main

- We reduced our overweight credit risk during July with the relative risk-adjusted spread duration of the fund dropping from +1.2 year to 0.2 year. More specifically, we removed CDS index risk in the fund amid worries over the Delta variant, passing the peak in growth and Chinese growth concerns. On the rates side, we remained short duration against the benchmark by 0.6 year (fund absolute duration of 4.9 years) but with the short exposure more to the front end of the curve. The reason for this shift on the curve is that we no longer expected a large steepening move, where any move higher in rates will likely be front-end driven as the market prices in a more hawkish Fed. By the same logic we closed our EUR curve steepening position.
- In August, we increased our overweight credit risk with the relative risk-adjusted spread duration of the fund rising from +0.2 year to +0.7 year. More specifically, we added risk through the iTraxx Main index as well as cash bonds as concerns around China’s regulatory crackdown remained sector specific and didn’t lead to a broader sell-off while Covid-19 hospitalisations remained under control. On the rates side, we remained short duration against the benchmark by 0.5 year (fund absolute duration of 4.9 years) with the short exposure focused on the front end of the curve. We added a 5s30s curve flattener as the payroll report for July was strong and as we expected the front end to underperform as the hawkish focus will move onto fed hikes given that the tapering decision has been well telegraphed.

- In September, we maintained our overweight credit risk stance with the relative risk-adjusted spread duration of the fund stable at +0.7 year. On the rates side, we remained short duration against the benchmark by 0.5 year with the short exposure focused on the front end of the curve. We closed our 5s30s curve flattener around the middle of the month, taking advantage of a sharp move flatter, which appeared to have been technically driven. Furthermore, the curve had been trading quite directionally and so holding the flattener was providing a long duration beta which did not align with our higher rates view.

Outlook

- The third quarter of the year saw central banks take the first step towards monetary policy normalisation following the extreme levels of accommodation that have supported the economy since the onset of the pandemic. For example both the Fed and ECB guided towards upcoming tapering plans of the balance sheet, whilst the BoE increased expectations for a near term rate hike. This hawkish guidance came despite disappointing growth data during the quarter as the Delta variant led to another spike in global Covid cases, which hurt consumer sentiment. In addition, supply side constraints continued to weigh on production and added to inflation fears, which rose further during the quarter. Looking ahead to the final quarter of 2021, the focus will be on the growth data to determine whether much of the recent weakness was indeed due to the Delta variant, or whether the market has to reassess its growth forecasts lower. For risk markets, the question will be whether the start of balance sheet normalisation from the Fed and ECB leads to an unwarranted tightening of financial conditions, or whether the process will run smoothly given enhanced forward guidance.
- The Fed at its September meeting continued with its hawkish shift on both balance sheet and interest rate guidance. As expected, the Fed hinted towards an upcoming tapering decision by adding an additional comment in the statement that “if progress continues broadly as expected, the Committee judges that a moderation in the pace of asset purchases may soon be warranted”. What was perhaps more surprising was Chair Powell in the press conference when he noted the Committee’s intention to conclude the tapering process around the middle of next year. This relatively fast tapering timeline would provide an opportunity for the Fed to hike rates before the end of next year if conditions were to warrant it and we therefore saw rates markets price in this possibility. In addition, the updated dot plot, which included expectations for 2024 for the first time, now shows the Fed projecting 6.5 hikes out to the end of 2024, compared to market pricing of less than 5 hikes during this period.

- Developments herein came despite recent softness in the data including the latest payroll number, although Powell chose to focus on the three-month average of payrolls, which still stands at a solid 750k. Given recent data, the Fed actually revised down its growth forecasts for this year by over 1% to 5.9%, although its belief that much of the current weakness is due to temporary supply side effects and the Delta variant, which has now peaked, resulted in upward growth revisions for 2022 by 0.5% to 3.8%. On the inflation front, it is clear that recent pressures have been more forceful than the Fed had initially anticipated, and as a result they revised higher their core PCE projections throughout the forecast horizon. For now, the Fed is maintaining their view that these pressures are transitory in nature, however its potential persistence is one of the key uncertainties for the year ahead.
- The ECB also decided to reduce its balance sheet support by moderately lowering the pace of asset purchases under PEPP compared to the previous two quarters. President Lagarde followed this up by going out of her way to emphasise that “This lady is not for tapering”, confirming that ECB balance sheet support will continue through the APP even when PEPP has ended. The other details from the meeting were also rather dovish including the core inflation forecast, which is at just 1.5% in 2023, well below what is now a symmetric 2% inflation goal and confirms to us that the ECB will remain relatively more dovish than other central banks such as the Fed and Bank of England. Given the bank’s clear sensitivity to higher inflation, the market is now pricing in a hike by Q1 of next year, with the main near-term question being how the labour market reacts to the recent end of the furlough program.
- What is clear from the above is that we have now passed the peak in central bank stimulus, which should provide room for rates to rise. This is particularly the case at the front-end in the US, given that there is still a significant gap between market pricing for the Fed and its own expectation for rate hikes based on the latest dot plot. On inflation itself, much of the increase in price pressures has been driven by supply side constraints, which are largely due to the shifting behaviour of consumers since the pandemic and which has resulted in an imbalance in demand versus supply in certain sectors and between regions. We do anticipate for these constraints to normalise over time, which should allow for inflation to return closer to typical levels during 2022. That said, bottlenecks herein have already lasted longer than what the Fed had anticipated, and there is a risk that this trend continues in the near term, which is why we think it still makes sense to be positioned with a short duration bias, to protect portfolios against this possibility.

- We continue to see this environment as positive for credit, as we do not anticipate an aggressive tightening in financial conditions from the hawkish central bank actions described above, where our base case is for an orderly rise in rates. Although inflation risks have increased, crucially we note that the central bank reaction function to inflation has also changed, as the Fed has moved to an average inflation targeting framework, whilst the ECB now has a symmetric 2% inflation target. This makes it less likely that central banks will tighten policy aggressively to growing inflation fears, which is in stark contrast to what we have seen during previous inflationary episodes and should be a source of comfort for markets.
- This should allow investors to instead focus back on the fundamentals, which remain supportive from both the macro and micro levels. From the macro perspective, we anticipate that the recovery will continue, with the service sector providing the next leg of support as economies normalise further following the latest spike in Covid cases, which has now passed. At a micro level we see credit fundamentals as improving, where strong earnings and prudent balance sheet management has allowed leverage to decline. For example gross leverage for US Investment Grade names now stands at 3x from a peak of 3.3x in Q3 of last year, almost fully reversing the increase observed during the pandemic. We see this backdrop as one that is beneficial for high beta credit with low duration.

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