# UBAM - DYNAMIC EURO BOND

Quarterly Comment

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## *Market Comment*

- April provided further evidence of resilient, albeit slowing, growth coupled with signs of slowly easing inflation. In the US, underlying activity growth rebounded in the first quarter, while wages and price inflation remained too high. Yet, there were signs of fragility among some GDP components, including investment and inventories. This suggests that economic growth could slow down more meaningfully from the current quarter onwards as weakness spreads to other parts of the economy. On inflation, core PCE came in line with expectations in March while the employment cost index rose again in Q1 2023, after easing in the previous quarter, highlighting the stickiness of core price pressures. In the Euro zone, core inflation eased for the first time since June 2022 in April. Coupled with an ECB bank lending survey pointing to tighter loan and credit conditions in Q1 2023, this is likely to narrow the room for more aggressive monetary policy in the coming months. Across developed markets, core inflation should remain robust throughout the first half of the year, and ease only in the second half. In the Eurozone, tightening in credit conditions coupled with a faster drop in inflation as demand suffers further could bring more downside risks to growth and inflation and more caution amongst policymakers. Overall, as rates rise further and the impact of tighter monetary policy kicks intensifies, advanced economic activity should moderate later this year. At a global scale, growth should remain resilient, supported by Asian economies.
- April was characterized by reduced volatility compared to what seen in March as fears over a banking crisis eased. As a result, credit spreads tightened modestly over the month, both in the US and in Europe on the back of robust economic data and surveys reducing recession fears. On monetary policy, the market expected a 25 bps hike and some signals of a Fed pause at the upcoming May FOMC meeting. Such moves have been confirmed at the time of writing. The language in the May's policy statement saw significant changes as the phrase "some additional policy firming may be appropriate" was dropped. The Fed reiterated its data dependence with regards to further hikes. The Fed does not expect inflation to come down quickly, hence rate cuts this year are still seen as not being appropriate. A faster tightening of lending conditions driven by more banking stress along with the resulting recession concerns could change the Fed's view on cuts in the coming months. Meanwhile, investors' had more mixed views on the ECB path, given the resilient economic growth and still elevated inflation. Easing core inflation and tightening lending standards led to a 25 bps hike at the time of writing. The ECB, however, kept a more hawkish tone in the latest conference reiterating that the bank has "more ground to cover" as inflation remains too high. The importance of their data-dependent approach to policy decisions was also highlighted.

- Overall, after rising by over 30 basis points between the end of the first week of April and mid-month on the back of better-than-expected economic activity and evidence of sticky inflation, US government bond rates fell back on the back of renewed regional banking and recession concerns. Similar moves were registered in Europe, highlighting the benefit of holding duration to protect credit exposures in portfolios. In April we took advantage of the large underperformance of EUR duration vs USD duration and rebalanced our duration position towards EUR duration given the attractive valuations driven by the lack of rate cuts priced ahead, and in line with the increased expectations of easing euro area inflation. We also maintained our positive bias towards credit markets as credit fundamentals remain in check and we do not expect a deep recession to drive a significant rise in default rates.
- May provided further evidence of resilient, albeit slowing, growth coupled with signs of easing inflation. In the US, strong PMIs along with a 253k rise in payrolls, a fall in the unemployment rate to 3.4% and a renewed rise in job openings confirmed the resilience of the US economy. On inflation, recent reports showed easing headline inflation as base effects on food and energy continued to play out while core price pressures remain elevated largely supported by services demand and robust wage growth. We still expect US economic growth to slow down more meaningfully from the current quarter onwards as weakness intensifies and spreads across the economy. Outside the US, the economic momentum softened. In the Euro zone, the latest revised data showed that the German economy did contract in Q1, meaning that with the Q4 contraction last year, the economy was in recession this winter. What's more, investors sentiment on the Germany economy fell in May following sixth consecutive rises and business sentiment softened in Europe signalling weaker business confidence in the Eurozone economic outlook. Inflation provided encouraging news, falling by more than expected both on the headline and core front. This contrasts with what observed in the United Kingdom where food price pressures remain elevated and core goods and service price pressures intensified further in May, signalling a more domestically driven CPI with increasing fears of inflation being entrenched in the UK economy. In China there were also some weaker-than expected releases, both on industrial production, retail sales and PMIs supporting the view that Chinese economic momentum has been easing following a strong start in Q1. Overall, we continue to expect core inflation and economic growth to ease more substantially in the second half of the year across major economies. On aggregate, we continue to expect global growth to decelerate but remain robust this year.
- US credit spreads managed to hold up well in May despite concerns regarding the debt ceiling with USD investment grade spreads unchanged on the month as a whole, whilst EUR spreads were 8 bps wider. The underperformance of EUR spreads was likely due to weakness emanating out of the domestic data as mentioned above, whilst US risk assets and equities in particular were in contrast buoyed by improving sentiment towards the tech and AI sectors. Strength in both the US growth and inflation data also drove government bond yields higher with US 10yr yields rising by 22 bps in May which is in contrast to German 10yr government bond

yields which declined by 3 bps in a move supported by the improving inflation trend finally being observed within the Eurozone.

- Rate curves also flattened as the market priced in the likelihood of one more hike from the Fed rather than a pause, with the 2 year vs 10 year curve flattening by 18 bps. Overall we maintain our positive bias towards interest rate duration viewing current levels as attractive from a valuation perspective and with recent central bank communication from both Fed and ECB members suggesting that we have passed peak hawkishness as inflation trends begin to improve. Holding government bonds also makes sense from a portfolio construction perspective in case growth concerns rise, helping to offset any widening in credit spreads that could be observed. For credit we remain positive, particularly on the higher income segments of the market given elevated all in yields, our view of growth decelerating but not collapsing and with fundamentals still in good shape for this stage of the cycle.
- June provided further evidence of resilient, albeit slowing growth coupled with signs of easing inflation. In the US, activity softened, with consumer spending growth moderating and ISM surveys highlighting an intensified downturn in the manufacturing sector and easing service activity momentum. Yet the US economy still proved more resilient than expected. Improved consumer sentiment coupled with the stabilisation of the housing market have postponed risks of a more pronounced economic downturn. The tight labour market continues to support activity, despite some emerging signs of softening including a greater than anticipated rise in the unemployment rate to 3.7%, easing earnings growth and several consecutive weekly rises in initial claims across various US states. Looking ahead, the US economic slowdown should intensify later this year as the remaining impact from tighter monetary policy starts to be felt and services activity moderates as loan debt repayments resume in October. As demand moderates, services inflation is also expected to ease. In the Euro-zone, the economy lost further momentum. The latest revised data showed that the euro bloc was in a technical recession over the past two quarters whilst investor sentiment towards the German economy fell further, signalling weaker business confidence. Inflation provided encouraging news on the headline front but remained elevated on the core front supported by services inflation which shows no signs of falling yet. The UK remains an outlier to this general disinflation trend as CPI stayed at 8.7% in May while core rose further to a new 31-year high of 7.1%. In China economic data continued to disappoint prompting the PBOC to ease monetary policy and announce several credit-boosting policies. Overall, we continue to expect global inflation and economic growth to continue their downtrend trend in the second half of the year. Despite economies slowing down, we continue to expect global growth to remain resilient and above 2% this year.
- Risk markets reacted positively in June to the impressive economic data released out of the US in particular, which increased investor expectations that a soft landing was still possible despite the tightening in policy observed. US investment grade credit spreads tightened by 13 bps as a result, outperforming its European equivalent which saw 8 bps of tightening given the weakness in survey data described above. Government bond yields moved higher in June despite the Fed skipping a hike, as they instead

chose to guide towards two more rate hikes this year based on the latest dot plot projection. The significant upside surprise to UK CPI also drove another volatile sell-off in front-end Gilts and led the BoE to hike by 50bps at the MPC meeting. As a result we saw front-end yields underperform as markets priced in the possibility of further rates hikes and fewer rate cuts over the next year. US 2yr yields for example rose by a notable 50 bps in June alone with the 2yr vs 10yr curve inverting by a further 30 bps and with similar moves observed at the front-end of the German curve. Overall we maintain our positive bias towards interest rate duration in the belly of the curve which screens attractive from a valuation perspective given what is now priced in and as the disinflation trend appears to be broadening. Holding government bonds also makes sense from a portfolio construction perspective in case growth concerns rise, helping to offset any widening in credit spreads as was clearly the case during the US regional banking crisis. For credit we remain positive, particularly on the higher income segments of the market given elevated all in yields and the resilient growth backdrop which continues to push out any recession fears.

## *Performance Review*

- UBAM - Dynamic Euro Bond delivered +1.89% net of fees YTD (I Share class). In relative terms, the strategy delivered +64 bps of excess return before fees vs. a reference to a EUR cash deposit index*.
- QTD, the net performance was +1.09% and the gross excess +37 bps.
- The excess returns sequentially over the quarter were: +17 bps in April, -1 bp in May and +21 bp in June
- QTD, the core holdings of investment grade floating rate notes, fixed coupon bonds (with interest rate exposure hedged) and single name CDS generated +34 bps of excess return. The duration overlay contributed -1 bps.

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

## *Portfolio Activity*

- At the end of the quarter, the yield of the portfolio in EUR was 4.6% vs. 3.4% for EUR cash deposit
- The interest rate exposure was 0.3 years
- The average life of the core portfolio (excluding liquid CDS overlay) was 19 months
- The credit spread exposure including CDS index exposure was 1.9 years
- The average rating was A-

*Outlook*

- In the second quarter of this year, growth and inflation continued to ease across most developed markets. Services activity remained the main driver of economic growth, although the post pandemic services boost appeared to lose some momentum. Tight labour market conditions continue to support household income and services demand. In contrast, the manufacturing sector downturn intensified despite a further normalisation in supply conditions, as demand continued to shift from goods to services.
- Inflation continued to decelerate as base effects on the energy and subsequently on the food front intensified. Core inflation remains well above target amongst most economies, supported by services and tight labour market conditions, but has recently started to show signs of easing, particularly on the good prices front. Looking ahead, global inflation is expected to ease further, benefitting from softening demand and weaker cost pressures. Wage pressures are expected to ease as unemployment rates begin to rise on the back of weaker growth, enabling a more pronounced deceleration in service prices later this year. Having said that, we still believe that some volatility could persist in global inflation as a large share of the lagged impact of tighter monetary policy will take some more time to be fully felt and base effects are likely to prove less supportive from the summer period onwards. Overall, the strength of labour markets within DM economies combined with resilient growth from EM countries should support global growth this year and prevent a global recession from occurring.
- In the United States, the economy softened but remained resilient in the second quarter of the year. Improving consumers sentiment coupled with the stabilisation of the housing market have postponed risks of a more pronounced economic downturn. The tight labour market continues to support activity, despite some emerging signs of softening including several consecutive weekly rises in initial claims across various US states. The US economic slowdown should intensify later this year as the impact from tighter monetary policy starts to be felt and services activity moderates on the back of reduced savings and resuming student loan debt repayments in October. That said, excess savings have not been fully drawn down still and continue to provide a buffer for the higher inflation backdrop, especially given the nominal wage growth observed. Developments herein should also allow for core prices to find further relief, especially given the trend of slowing rental inflation.
- In the Euro-zone, the economy lost further momentum. The latest revised data showed that the euro bloc was in a technical recession over the past two quarters, whilst the latest data indicates that investors and market participants sentiment towards the German and Eurozone economy has weakened further. Inflation provided encouraging news on the headline front as energy inflation turned negative in May and base effects started to kick in on the food front. Core inflation has also shown encouraging news on the goods front whilst services inflation is still high and has remained sticky. As noted by the ECB, the effect on inflation from higher wages has been amplified by lower productivity growth leading to higher unit labour costs in recent months. Looking ahead, rising interest rates, tightening credit and reduced savings are expected to limit near-term growth despite

some likely resilience in the service sector over the summer period. We expect inflation to continue its downtrend this year and decelerate at a faster pace towards the fourth quarter of 2023.

- Mainland China's economic growth started to disappoint this past quarter after a stronger start of the year. Recent PMIs suggest that Chinese economic activity is losing momentum, with inflation set to go negative in the months ahead and forcing the PBOC to ease monetary policy and announce several credit-boosting policies. We expect subdued demand and weak confidence to limit economic activity in the country, likely leading to more stimulus measures to revive demand. That said, given the limited room for further fiscal support, upside risks to Chinese medium-term growth remain limited at this stage.
- From a monetary policy perspective, despite encouraging signs with regards to the slowdown in growth and inflation being observed, central banks have chosen to stick to their hawkish communication with inflation remaining well above targets. This was clear to see at the ECB's recent Sintra forum where President Lagarde used the platform to focus her speech on the potential for more persistent inflation due to resilient labour markets and poor productivity, whilst Fed Chair Powell chose not to rule out the possibility of still hiking at consecutive meetings. This follows the latest Fed meeting in which they decided to finally take a pause in the hiking cycle as they assess the impact of the aggressive tightening already delivered on the economy. To prevent investors from assuming that the tightening cycle has ended though, the Fed's revised dot plot was raised for 2023, with two hikes now penciled in by the committee for the remainder of the year.
- Despite this communication, from a portfolio construction perspective, we believe that it makes sense to hold more balanced portfolios of 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 hikes delivered by central banks begin to feed through to the real economy. This was clearly observed during the US regional banking crisis at the end of Q1, where banking system stress drove significant demand for government bonds given uncertainty with regards to the impact that it would have on the outlook for monetary policy.
- The recent move higher in rates has also meant that valuations are attractive to hold interest rate duration. Whilst central banks continue to sound hawkish, their actions indicate that we have passed peak hawkishness and that we are approaching the end of hiking cycles as the pace of rate hikes clearly slows, as has been observed with the Fed. At the ECB we would highlight a notable shift in communication of late as the hawks on the board appear to be providing a more balanced message of one more hike in July, whilst the September decision will be data dependent. At the time of writing, the market is fully pricing hikes in both July and September, and so even this perceived hawkish scenario is now well priced. From a fundamental perspective, we have clearly passed the peak in headline inflation and we are beginning to observe more concrete signs of core inflation moderating. We anticipate for this disinflation trend that is now being observed globally to continue in the months ahead as the

tightening policy impact continues to temper demand and for one to position portfolios for this expectation.

- Our positive bias towards credit that we entered 2023 with also remains intact with the growth data suggesting that a path towards a soft landing remains, with recession fears being pushed further down the line. With the higher inflation and rates backdrop in mind, 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 current market volatility and any bouts of spread widening. We also think that an allocation to BB rated bonds is attractive given their superior risk-reward profile to BBBs, single Bs and CCCs and as corporate fundamentals for BBs seem in good shape heading into a slower growth environment.
- Finally, with European and UK regulators appearing to distance themselves from the Swiss regulator's decision to write-down Credit Suisse AT1 debt, we continue to view subordinated financial debt as an attractive opportunity. This is especially the case given the latest set of results which confirm that banking fundamentals remain robust and are benefitting from the higher rates backdrop. There have also been several other recent hurdles crossed within the AT1 market which further validates the investment case including the return of supply with BBVA coming to the market with a EUR 1bn AT1 which saw strong demand of over EUR 3bn. In addition, all AT1 bonds from major European banks have been called in 2023 thus far, despite 70% of the market still not being priced to call which highlights the attractive opportunity from a valuation perspective.

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