


# UBAM - DYNAMIC US DOLLAR BOND

## Quarterly Comment

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### Market Comment

- The first month of 2023 brought additional positive news on inflation and, to some extent, better than expected news on the growth front. This led to an upward revision in the economic outlook for some countries which, coupled with the reopening of China, improved the general sentiment on the global economic outlook and upward revisions in forecasts by institutions such as the International Monetary Fund. On activity, PMIs highlighted more resilient economic growth in the Eurozone while the economic momentum eased further in the United States and the United Kingdom. China's activity also improved across sectors on the back of the combined effect coming from the country's reopening and the Lunar new year holiday. On inflation, January provided further evidence of easing price pressures, driven by lower energy prices and contracting demand. Meanwhile, core inflation remains elevated, well above central bank's target, and while some signs of easing wages and core price pressures (excluding rents) have emerged in the United States, the Eurozone and the United Kingdom seem to be facing stickier core inflation. Across developed markets, headline inflation is expected to continue to trend downward, while core inflation should remain robust across developed markets throughout this year, largely supported by service prices and wages. We continue to believe that a large chunk of the impact from higher rates still needs to be felt across most economies. What's more the labour market is still lagging behind, remaining extremely tight and providing support to households meaning more slack is needed. Even in the US where the economy has been weakening, the latest payrolls report provided further evidence of the strength in the labour market. The outlook for the US economy seems to be pointing to a slowing economy and slowing inflation and a path towards a soft landing, but volatility in key indicators including non-farm payrolls and ISM services numbers keep uncertainty elevated. The outlook looks even more uncertain in the Eurozone where core price pressures remain elevated, and the economy has so far proven to be more robust than what anticipated. As rates rise further and the impact of tighter monetary policy kicks in, advanced markets should experience a slowdown in activity later this year. At a global scale, growth should remain resilient though, largely supported by Asian economies.
- 2023 has begun on a strong footing for fixed income with both interest rate and credit markets rallying in January. Positive risk sentiment was driven by a re-rating of global growth expectations as China's economic reopening appeared to be taking place faster than anticipated, whilst the Eurozone economy was deemed as being less at risk of suffering from blackouts following the sharp decline in natural gas prices. In addition, positives were also seen on the inflation front as US headline and core inflation continued its decline, whilst wage growth pressures abated further, as highlighted by the fall in the Employment Cost Index. As a result, credit spreads were supported in January



despite the heavy supply which came to the market, highlighting the strength in demand and the cash that was ready to be put to work. For example US Investment Grade spreads tightened by 14 bps during the month whilst EUR spreads tightened by 20 bps in moves that were a continuation of the trend observed in Q4. We entered 2023 maintaining our positive bias towards credit markets, viewing growth as slowing rather than collapsing and with the market overly pessimistic with regards to expectations for recession. As the range of possibilities for the Fed's terminal rate narrowed, we expect this to keep rates volatility capped, where reduced uncertainty herein could support inflows back into credit markets and support spreads. We view corporate fundamentals as starting the year in a healthy position, bank balance sheets strong with earnings benefiting from the higher rates backdrop and with valuations attractive. Interest rate markets also rallied in January as inflation pressures appeared to decline which all but confirmed that the Fed would be stepping down its hiking pace once again at the February meeting, down to 25 bps. As a result, US 10 year yields declined by 37 bps during January whilst the comparative German yield declined by 29 bps, with the latter underperforming given that the market was still digesting the increasingly hawkish communication from President Lagarde at the December ECB meeting.


- February provided further evidence of growth resilience while it brought renewed concern on the inflation front. Inflation surprised on the upside in several countries including the Eurozone and the United States while it fell by more than expected in few (United Kingdom and Canada). Japan also provided evidence of broadening price pressures. While energy inflation eased further, food and service prices (largely driven by wages) continue to put pressure on developed economies inflation prints. Producer prices remain below their 2022 highs and their annual growth remains on a downtrend but are still elevated. Recently, the ISM manufacturing prices paid index went back into expansion territory signalling rising cost pressures on producers. Such volatility in monthly data highlights the risks of having a less linear downtrend in inflation and stickier core price pressures in the first half of the year. In some economies, this is translating in core inflation being above headline inflation. As base effects on energy and food become more favourable from March onwards and weather gets warmer, we expect headline inflation to continue to trend downward. Meanwhile, core inflation should remain robust across developed markets throughout H1, largely supported by service prices and wages, and ease only in the second half of the year. On activity, PMIs highlighted sustained resilient economic growth across major economies. Strong services activity offset weakness in the manufacturing sector and enabled a rebound of private economic activity growth in recently underperforming economies such as the United States and the United Kingdom. Across developed markets, we continue to believe that a large chunk of the impact from higher rates still needs to be felt. The labour market is still lagging behind, remaining extremely tight and providing support to households meaning more slack is needed. We continue to expect the US economy to slow as excess returns are depleted and consumers' and businesses exposure to rates intensifies. The labour market and ongoing recovery of the services sector remain key upside risks. In the Eurozone, we expect stickier core inflation pressures to mean rates higher for longer and greater pressure on consumers at a later stage. As rates rise further and the impact of tighter monetary policy kicks in, advanced markets should



experience a slowdown in activity later this year. At a global scale, growth should remain resilient though, largely supported by Asian economies. China's activity recently surprised on the upside, improving across sectors and providing evidence of a robust economic recovery, which is likely to persist in the near term.

- Whilst January was a strong month for fixed income markets, February saw a reversal in fortunes for the asset class which was largely a result of the repricing of terminal rate expectations for both the Fed and ECB. Pricing for the Fed's peak terminal rate jumped by over 50 bps in February, with a similar trend witnessed for the ECB as expectations for the deposit rate rose 46 bps on the month, and this was largely as a result of the strong data mentioned above. In the US the focus was on the blowout payrolls report which led investors to believe that further hawkish policy is required to loosen the labour market. In the Eurozone attention turned to inflation trends in which prices are appearing stickier than had been hoped by ECB members, whilst resilient growth is also allowing the board to push for tighter financial conditions given reduced near-term recession risks. This repricing led curves to flatten aggressively globally, with the US 2 year vs 10 year yield for example flattening by 20 bps in February, with the 10 year yield rising by 41 bps during the month and the 10 year German Bund yield rising by a similar 37 bps. This latest repricing suggests to us that the rates sell-off is in a mature phase and hence we maintain our positive bias towards interest rate duration, favouring US duration in the belly of the curve. With the market now pricing a higher terminal rate for the Fed than the updated March dotplot is likely to show, we see valuations as attractive. This is especially as we expect for the disinflation trend to remain intact, and as it appears as though some of the strength in the January data released may have been due to seasonal effects and warmer weather, which are at risk of reversing in the months ahead. Credit spreads were resilient despite the volatility in rates markets observed, managing to hold onto the majority of gains since the rally commenced in October. For example US investment grade spreads were only 3 bps wider on the month whilst the EUR equivalent was 4 bps tighter. Support herein came from the continued re-rating of global growth expectations given upside surprises in high frequency growth, and as China's re-opening takes full effect. This has reduced fears around a deep recession that would drive a rise in default rates and which now appears less likely. In addition, the earnings season just passed was not as bad as some investors had been fearing. For example the US earnings season was overall decent with around 70% of companies beating EPS expectations. However we would note that the average size of the earnings surprise was below 1% (vs a 3% beat on average historically) despite weakened expectations going into this season. Revenues were up 6% YoY in nominal terms while EPS were down 3% YoY on average underscoring some margin erosion but from a high base. The financial sector meanwhile continued to exhibit robust earnings and is a sector we believe can benefit from this higher rates and inflation backdrop. As a result, we maintain our positive bias towards credit markets, viewing all-in yields as attractive and elevated enough to provide a buffer even if there are bouts of spread widening

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- March provided further evidence of resilient growth coupled with signs of easing inflation as base effects on the energy front started to kick in. Headline inflation continued a downward trend across major economies, while core inflation remained high, particularly in Europe. In the US, Core PCE came lower than expected in February and personal income and spending growth decelerated from the strength seen in January, hinting at reduced demand and prices ahead. Meanwhile, risks of stickier core price pressure persisted in the Eurozone, where core inflation accelerated to a new high of 5.6%, keeping pressure on the European Central Bank. As base effects on energy and food play out, we expect headline inflation to continue to trend downwards. Meanwhile, core inflation should remain robust across developed markets throughout H1, largely supported by service prices and wages, and ease only in the second half of the year. On activity, flash March PMIs highlighted sustained resilient economic growth across major economies. Strong service activity continued to be the sole driver of growth, while easing supply issues enabled a stabilization of the manufacturing activity downturn. That said, the latest ISM manufacturing survey in the US showed activity contracting by much more than expected with all sub-indices, including prices, new orders and employment in contraction territory. Behind the services resilience, continues to lie the strength of labour market conditions. Overall, recession fears seemed to ease in the first half of the month. What brought them back in focus later in the month, were the financial news on the failure of Silicon Valley Bank and the takeover of Credit Suisse by UBS, which led to heightened market volatility and uncertainty. Although these were isolated cases and rather unique situations, they led to increased concerns among market participants around bank portfolio losses, deposit flight, and contagion risks. Several statements and liquidity support measures from central banks helped reduce market fears herein and stabilized sentiment before month end. Looking ahead, despite the banking crisis being contained, recent developments could result in a faster and more pronounced tightening of financial conditions, in particular in Europe and the United States where banking sector issues were reported. This could translate into more adverse economic consequences in most developed markets, where a large share of the impact from higher rates still needs to be felt. The labour market continues to lag, remaining extremely tight and providing support to households, but should cool down as economies weaken. We continue to expect the US economy to slow as excess returns are depleted and consumer and businesses exposure to rates and tighter credit conditions intensifies. In the Eurozone, we expect stickier core inflation pressures to result in further ECB tightening and greater pressure on consumers, although a faster than expected tightening in credit conditions 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 in, advanced markets should experience a slowdown in activity later this year. At a global scale, growth should remain resilient though, largely supported by Asian economies. China's activity continued to recover in March, largely supported by the Chinese domestic market, whilst foreign demand weighed on exports and manufacturing production
  - March exhibited significant volatility across risk and interest rate markets as investors digested the banking stress described above. Given uncertainty with regards to contagion risks from these events, credit spreads widened with the



financial sector underperforming. For example US investment grade credit spreads widened by 20 bps during the month and the European equivalent by 21 bps as expectations for domestic growth outlooks were also put into question on the back of the likely tightening in credit conditions that is set to follow. That said, we did see spreads recover in the 2nd half of the month after the Fed announced emergency liquidity facilities to shore up the banking system, whilst the Fed meeting also received a dovish reaction. Whilst the Fed still hiked rates by 25 bps, the updated dot plot projections showed an unchanged 2023 median dot of 5.1% which suggests that Fed participants are only pencilling in one more rate hike in the cycle. Furthermore, the language in the statement saw significant changes and hinted that the tightening cycle may have already ended as the committee is now anticipating “that some additional policy firming may be appropriate”, which is in contrast to the prior statement which said that “ongoing increases” would be appropriate. Importantly, the Fed also acknowledged recent banking sector stress by viewing it as likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring and inflation. Although the ECB provided a larger 50bp hike, President Lagarde also provided a more cautious tone in her press conference relative to previous meetings, whilst the ECB statement also recognised current market tensions and emphasised the importance of their data-dependent approach to policy decisions. In light of the banking stress, we saw demand for safe haven assets soar, including US and European government bonds, which drove a sharp rally in rates markets. US 10 year yields for example declined by 45 bps in March alone in a move that was also supported by a dovish Fed meeting, whilst the equivalent German yield declined by 36 bps during the month. Developments herein also resulted in a re-assessment of terminal rate expectations which fell by 53 bps in the US and 43 bps in Europe and which also allowed for curves to steepen. Market moves this past month have highlighted the benefit of holding interest rate duration in portfolios, which has provided protection against the credit spread widening observed, and we maintain our positive bias here in the US in particular. This is especially the case at a time when the Fed appears to be approaching the end of its tightening cycle and as we now await for the hikes delivered to feed through to the economy which should allow for the disinflation trend to remain intact. Despite the widening in spreads observed, we maintain our positive bias towards credit markets as well, with policymakers appearing to have dealt with the near-term stresses in the banking sector. Whilst further volatility cannot be ruled out, we believe that one is being compensated for this through elevated all in yields and with credit fundamentals in check for this stage of the cycle. In addition whilst we do expect to see growth slowing down, we do not expect a deep recession to drive a significant rise in default rates.



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### *Performance Review*

- The fund delivered +1.50 % net of fees QTD (I Share class). In relative terms, the strategy delivered +45 bps of excess return before fees vs. a reference to a USD cash deposit index\*.
- The excess returns sequentially over the quarter were: +65 bps in January, +35 bps in February and -55 bps in March.
- QTD, the core holdings of investment grade floating rate notes, fixed coupon bonds (with interest rate exposure hedged) and single name CDS generated +45 bps of excess return. The duration overlay contributed +0 bps.

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

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### *Portfolio Activity*

- At the end of the quarter, the yield of the portfolio in USD was 6.5% vs. 4.8% for EUR cash deposit
- The interest rate exposure was 0.1 years
- The average life of the core portfolio (excluding liquid CDS overlay) was 20 months
- The credit spread exposure including CDS index exposure was 1.6 years
- The average rating was A-

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## Outlook

- In the first quarter of 2023 a recession was averted by the global economy with major developed markets proving more resilient than expected. Demand remained robust and mainly driven by services, whilst supply conditions continued to improve, enabling a stabilization of the manufacturing activity downturn. As a result, recession risks eased in the first part of the quarter, with PMI indicators providing evidence of economic strength and improved outlooks across major economies throughout the quarter. In March, financial news of the failure of Silicon Valley Bank and the takeover of Credit Suisse by UBS drove bouts of financial market volatility amid heightened uncertainty. Although these were isolated cases and rather unique situations, they led to increased concerns among market participants regarding bank portfolio losses, deposit flight, and contagion risks. Several statements and liquidity support measures from central banks helped to reduce market fears herein however, with sentiment improving towards the end of the quarter. Despite the banking crisis being contained, recent developments could result in a faster and more pronounced tightening of financial conditions through tighter lending standards which will need to be monitored.
- According to central bank surveys, lending and credit conditions were already tightening before the recent market stress. This suggests that any acceleration or intensification in tightening standards could translate into more adverse macroeconomic consequences, posing risks to the recently improved economic and inflation outlook for developed economies. Inflation could now ease faster than anticipated as the reduced availability of credit and tighter borrowing conditions weigh on households and business demand, employment and prices. Inflation continued to decelerate in the first quarter of the year and even more so towards the end of it as base effects on the energy front kicked in. Core inflation remains well above target amongst most economies, supported by services and tight labour market conditions. Looking ahead, financial news aside, global inflation is expected to ease further, benefitting from base effects on commodity prices, cooling demand, and improving supply chain conditions. Wage pressures are also expected to ease as unemployment rates begin to rise on the back of weaker growth, helping a deceleration in service prices. That said, we expect for some volatility to persist meaning that the path towards lower inflation may not be a linear one. Overall, the strength of labour markets within DM economies combined with resilient growth from Asian countries should support global growth this year, which we expect to remain solid and above 2%.
- In the United States, the economy decelerated in the first quarter of the year but remained resilient as a solid gain in consumer spending was offset by declines in residential construction, business equipment investment, and inventory accumulation. Indicators including retail sales, housing starts and industrial production provided evidence of this resilience, although economic activity is still solely driven by services. The latest ISM manufacturing survey for example was weaker than expected, with all sub-indices, including prices, new orders and employment in contraction. Behind service sector resilience continues to lie the strength of labour market conditions. While job openings dropped by more than expected and initial



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claims seem to be on a gradual upward trend, the latest non-farm payrolls continue to point to resilient labour demand, mainly coming from leisure and hospitality services. Overall, the impact of tighter monetary policy still needs to be felt across the economy and which should translate into weaker consumer spending and investments. The combination of weaker economic activity weighing on labour demand and wage growth suggests greater weakness in goods and services demand in the coming quarters. In addition to this, other factors could weigh on spending including the potential restart of student loan repayments (on hold during pandemic – around 400\$ per month per household) and falling house prices. Developments in the labour market will be key in determining the ultimate outlook for consumption and prices. As things stand now, goods inflation should continue to ease gradually. Core PCE came lower than expected in February and personal income and spending growth decelerated from the strength seen in January, hinting at reduced demand ahead. Services inflation remains strong supported by rents but overall core price pressures are easing and heading in the right direction. We continue to expect some labour market weakness and slowing rent inflation to provide further relief to prices later in the year.

- The Eurozone and the United Kingdom also proved more resilient than expected as shown by their strong PMI indices, despite gloomier outlooks expected back in Q4 2022. In Europe, countries including Germany are still benefitting from falling energy prices and easing supply problems. On the prices front, headline price pressures eased further thanks to energy base effects. Meanwhile, core price pressures remain extremely high and continue to weigh on real incomes and consumer spending. Eurozone headline consumer price inflation eased marginally to 8.5% in February, while core inflation rose to a record 5.6%. The labour market remains tight keeping wage growth robust. Resilient growth along with the strength seen in wage growth and core inflation, suggests that the European Central Bank will likely need to hike further to cool the economy. Looking ahead, rising interest rates, tightening credit, and housing market corrections are expected to limit near-term growth. As in the US, in Europe net bank lending was extremely weak and consistent with the economy contracting even before the latest banking sector stress. As a result, a larger than expected tightening in credit conditions could pose downside risks to growth and inflation.
- Mainland China's economic growth continues to revive after the end of Covid containment measures. The latest PMIs suggest that the recovery continued throughout the quarter, largely driven by domestic demand. What's more, the government's policy shift to ease credit conditions for property developers has stabilized home prices and led to an upturn in housing construction completions from depressed levels. Meanwhile, inflation remains at low levels with no evident medium-term risks to prices. Looking ahead we expect the Chinese recovery to continue, mainly driven by the domestic economy. That said, once the recovery in services activity is completed and fragile external demand weighs further on manufacturing activity, upside risks to medium term growth remain limited in the absence of further policy stimulus.





- From a monetary policy perspective, central banks ended the quarter on a more cautious footing amid the ongoing banking sector stress and its potential impact on lending standards. Whilst the Fed still hiked rates by 25 bps at its March meeting, the updated dot plot projections showed an unchanged 2023 median dot of 5.1% which suggests that FOMC participants are only pencilling in one more rate hike for this tightening cycle. Furthermore, the language in the statement saw significant changes and hinted that the tightening cycle may have already ended as the committee is now anticipating “that some additional policy firming may be appropriate”, which is in contrast to the prior statement which said that “ongoing increases” would be appropriate. Importantly, the Fed also acknowledged recent banking sector stress by viewing it as likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring and inflation. This was also emphasised by Fed Chair Powell who in the press conference said that such tightening could substitute for rate hikes, as it does the intended work of the Fed. Although the ECB provided a larger 50bp hike, President Lagarde also delivered a more cautious tone in her press conference relative to previous meetings, with the ECB statement also recognising current market tensions and emphasising the importance of their data-dependent approach to policy decisions. The updated ECB forecasts were also not as hawkish as feared on the inflation front, as headline inflation was revised down for 2023 to 5.3% from 6.3% previously which was largely on the back of energy inflation declines in recent months.
- From a duration perspective, we entered the year with a positive duration bias believing that it was appropriate to hold more balanced portfolios of both duration and credit risk. In particular, we believed that holding 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 view was validated by developments observed over the past quarter, where banking system stress in particular drove significant demand for safe haven assets including US Treasuries, especially given uncertainty with regards to the impact that tighter lending conditions will have on growth and inflation down the line. Recent inflation data out of the US also confirmed that the disinflation trend is intact, and is likely to continue in the months and quarters ahead as shelter inflation is set to finally decline given its historical lag to house prices. This would have given the Fed confidence to push ahead with its recent shift in rhetoric, which hints at the tightening cycle coming to an end shortly. As a result, we are maintaining our positive stance towards duration at this current juncture. Our preference continues to be in favour of holding US over European duration given that the Fed appears to be closer to the end of its hiking cycle compared to the ECB, where core inflation will likely remain sticky in Q2 and which could allow the hawks on the board to dominate the discussion and policy trajectory.
- Our positive bias towards credit that we entered 2023 with also remains intact. Whilst growth is slowing, we would note that it is not collapsing and we see this slowdown as necessary to ease inflationary pressures which should allow the Fed to pause its hiking cycle shortly. If anything, growth in Q1 was more resilient than many had anticipated with robust demand, leading to recession fears being pushed further down the line. For example



the US labour market remains tight, as observed with the latest payrolls report, the energy crisis in the Eurozone has faded with the sharp fall in natural gas prices, whilst the Chinese recovery following the pandemic continues, as highlighted by the latest surge in PMIs. Whilst recent banking sector stress is a concern and uncertainty to the outlook, we would note that the stress appears to have been contained for now with deposit flight from the US banking system having halted, whilst the use of the Fed's borrowing facilities is also on the decline.

- We also expect that a stabilization in the rates backdrop and increased certainty around the Fed's terminal rate will help attract inflows back into credit markets where 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 further 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. Interest coverage ratios are at record highs whilst net leverage ratios are below their 25 year average. 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, especially following the most recent sell-off and with bank earnings remaining impressive. That said, volatility in the near term for this segment of the market could be higher than previously observed as the market digests recent developments and awaits the next round of bank earnings.

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