Q2 2021

UBAM - EURO BOND

Quarterly Comment

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Market Comment

- Risk markets were supported in April as the vaccine rollout continued to pick up pace, particularly in Europe, which raised hopes that strict lockdown measures would soon be eased. High frequency data points were also impressive during the month, as the US ISM manufacturing survey for example rose to the highest level since the 1980's, whilst payroll growth also surprised on the upside, with almost 1 million new jobs being added and the unemployment rate declining to 6%. Although US growth data outperformed, buoyed by Biden's fiscal stimulus measures, the better sentiment was also observed elsewhere with the Global Manufacturing PMI rising to the strongest level since 2011, with global trade continuing to recover.
- As a result, credit spreads ended the month tighter with US investment grade spreads 4 bps tighter in April and European spreads 6 bps tighter. Moves herein were also helped by Fed and ECB meetings, in which both banks remained consistent with their prior dovish rhetoric, despite the recent strength in the data and at a time when the Bank of Canada decided to announce tapering. In contrast, Fed Chair Powell said in the press conference that now is not the time to talk about tapering, adding that the economy's improvement so far is not close to substantial further progress, which will take some time to be achieved.
- Similarly at the ECB, President Lagarde said that discussions to phase out PEPP was premature, where the economy has a long way to go until it has crossed the pandemic bridge. This allowed US 10-year yields to decline by 11 bps on the month, which was a significant outperformance when compared to German 10-year yields which rose by 9 bps in a curve steepening move. This underperformance of EUR rates in April could largely be put down to a catch-up to the rates sell-off that took place earlier in the year in the US, as well as significant progress on vaccinations in Europe during the month, paving the way for growth expectations in the region to be revised higher.
- With developed economies gradually reopening as the vaccine rollout progresses, the focus in May was on the data to see the impact that reduced lockdown measures were having on the real economy. From a global perspective, the data remained impressive, with the global manufacturing PMI for example reaching its highest level since 2010 at 55.8, with forward looking indicators such as new orders also at cycle highs.

- In the US however, despite the rise in mobility observed, the nonfarm payrolls report saw a significant miss to the downside, largely driven by a lack of incentives to return to work for low wage workers given the current enhanced unemployment benefits.
- This allowed investors to push back their expectations for any imminent tapering announcement to be made by the Fed, where continued accommodation herein resulted in US Investment Grade spreads tightening by 4 bps in May. In contrast, European spreads were 2 bps wider on the month, as strong survey data released out of the region including consumer confidence and the ISM Services led to investors speculating whether the ECB would bring its PEPP purchases back towards a more normal level in Q3, following an accelerated pace in Q2.
- Developments herein also allowed for German 10y Bund yields to rise during the month to a high of -10 bps, although this move was faded by month-end after several ECB officials made comments that reduced the likelihood that PEPP purchases would be tapered at the upcoming meeting. US 10y yields also ended the month with a modest move of just 4 bps lower despite the disappointing payrolls print, as inflationary pressures continued to support inflation breakevens. In particular, headline US CPI surprised significantly on the upside at 4.2% compared to the consensus of 3.6%, in what was the strongest reading since 2008, whilst the prices paid component within the ISM Manufacturing survey also surged to the highest level since 2008.
- The hawkish shift taken by the Fed at its June meeting was the main focus this past month and led to significant moves in interest rate markets. The Fed surprised investors through its updated dot plot projection in particular, which now forecasts two rate hikes in 2023 compared to their prior dot plot which showed no hikes. In addition, 7 out of the 18 board members already see a hike as soon as 2022. Fed Chair Powell also confirmed that they began initial tapering discussions, although he added that they are still far from the "substantial further progress" required to actually begin to taper.
- As a result, the rates curve saw a sharp flattening move as the front-end came under pressure given the move higher in the dots, whilst the longer end was supported by the possibility of a less patient Fed with regards to rising near-term inflation pressures. This led to the US 2-year vs 10-year curve flattening by 23 bps on the month, with the 10 year yield itself ending June 12 bps lower. In contrast to the Fed, the ECB maintained its pledge to continue with its PEPP purchases at a "significantly higher" pace in Q3 compared to Q1, despite recent strength in the data as highlighted by both the manufacturing and service PMIs rising to new cycle highs in June.
- As a result of contrasting central bank communication, there was a significant divergence in USD and EUR rates during the month, with German 10-year yields ending June just 2 bps lower, whilst the German 2s10s rates curve was only 2 bps flatter. Despite the volatility in rates observed, risk markets were resilient in June with the S&P 500 reaching new highs, whilst credit spreads continued to tighten.

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US Investment Grade spreads for example were 4 bps tighter on the month, whilst European spreads were 1 bp tighter, as investors took confidence from the continued rebound in the growth data and reopening of economies ahead of the summer.

Performance Review

- QTD the strategy returned -0.77% net of fees (I Share class).
- The excess return over the benchmark (ICE BofA Euro Government index*) was +2 bps before fees.
- The gross excess returns sequentially over the quarter were: +13 bps in April, -3 bps in May and -8 bps in June.
- QTD, interest rate exposure and yield curve contributed -14 bps, swap and agencies were +0bp and credit added +14bps (other items 2bps).

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

Portfolio Activity

- At the end of the quarter, the yield of the portfolio was 0.1% vs 0.1% for the reference index.
- The interest rate exposure was 8.0 years vs. 8.6 years for the index
- The main position for the portfolio was:
  - Overweight German Futures vs underweight German and core bonds
  - Underweight duration
  - Duration curve steepening position: underweight 5-year duration vs overweight 10-year duration
  - Overweight credit through cash bond market and CDS indices
- During April the fund's short duration bias was maintained given the impressive high frequency data that continued to be released. In addition, our confidence in the growth recovery in Europe in particular increased during the month given vaccine distribution progress that raised hopes that lockdown restrictions would soon be lifted. As such, we initiated a German 5-year vs 10 year curve steepening position towards the end of the month.
- Few changes were made to the fund's positioning in May, in which underweight duration and curve steepening positions were maintained given the impressive high frequency data that continued to be released globally. In addition, the fund maintained its exposure to credit through an overweight position through both investment grade CDS indices, as well as its exposure to the investment grade cash market.
- The fund's duration positioning was left unchanged in June, remaining underweight given the hawkish shift from the Fed, as well as our belief that the growth recovery will continue as economies reopen further and labour markets recover. We also maintained our EUR curve steepening position given improving high frequency indicators as observed by the latest PMI surveys, as well as the impressive vaccine rollout in the region, which should allow for growth expectations to be revised higher. We took profits on the fund's long credit risk exposure through investment grade CDS indices, taking advantage of the sharp squeeze in spreads observed. The fund remains overweight credit through its exposure to the investment grade cash market.

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Outlook

- Risk markets continued their strong run in Q2, with the S&P 500 for example closing the quarter at new highs as the vaccine rollout accelerated globally, which allowed domestic lockdown restrictions to ease further and for growth expectations to be revised higher. In contrast in rates markets, Q2 saw reflation trades lose momentum with US 10-year yields declining off the first quarter highs in a move that was driven by real rates, despite the hawkish shift taken by the Fed at the June meeting. Looking ahead, having passed the initial smooth "V" shaped part of the recovery from the pandemic, the attention for investors during the second half of the year will be on whether growth can continue to normalise and improve, despite potential Covid-19 variants posing a risk to the outlook. This will keep the data in focus, particularly the labour market in the US to see if the upcoming expiry of enhanced unemployment benefits results in a further pick-up in job gains, which will allow the Fed to adjust its forward guidance in the coming months to prepare for the eventual tapering announcement.
- The hawkish shift taken by the Fed at its June meeting was one of the main events for investors to digest during the second quarter. The Fed surprised markets through its updated dot plot projection in particular, which now forecasts two rate hikes in 2023 compared to their prior dot plot which showed no hikes. In addition, 7 out of the 18 board members already see a hike as soon as 2022. Fed Chair Powell also confirmed that they began initial tapering discussions, although he added that they are still far from the "substantial further progress" required to actually begin to taper. As a result, the rates curve saw a sharp flattening move as the front-end came under pressure given the move higher in the dots, whilst the longer end was supported by the possibility of a less patient Fed with regards to rising near-term inflation pressures.
- We believe this hawkish outcome was driven by the Fed's increasing confidence in the economic growth outlook, as well as uncertainty with its inflation forecasts given the unprecedented nature of the economic reopening. The Fed is reacting to a strengthening consumer, in which low wage workers have continued to benefit from enhanced unemployment benefits which have supported incomes. Although labour market gains have been slower in recent months than had been anticipated, the Fed is confident that jobs growth will continue, specifically as these enhanced unemployment benefits which have already expired in many states this past month, will be fully expired by September and will force individuals to come back into the labour force and look for work. Whilst the Fed's inflation forecasts for 2022 and 2023 were largely unchanged, the significant overshoot that is now expected for this year at 3% for core PCE seems to have also been behind the decision to shift the dots higher. Whilst the Fed expects current inflationary pressures to be transitory in nature, a more hawkish dot plot provides them with some room to manoeuvre if these pressures were to become more persistent.

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- In contrast to the Fed, the ECB recently maintained its pledge to continue with its PEPP purchases at a "significantly higher" pace in Q3 compared to Q1, despite recent strength in the data as highlighted by both the manufacturing and service PMIs rising to new cycle highs in June. The Eurozone has also impressed with its vaccine rollout in Q2, having previously been a laggard in its distribution. This should provide resilience to the growth recovery, as it reduces the likelihood that we return to strict lockdown measures and it should allow for the crucial summer tourism season to be at least somewhat saved. We think that the ECB will take comfort from the Fed's shift, which will also provide them with the opportunity to turn less dovish in the coming months. With the Fed moving first, the ECB will be able to bring PEPP purchases back towards a more normal pace in Q4 without fearing a significant tightening of financial conditions on such an announcement, which has been a clear focus for President Lagarde. With underlying growth and inflationary pressures in the Euro area less advanced than that in the US, any hawkish shift would be through tapering purchases only, rather than bringing forward guidance for rate hikes.
- From a positioning perspective, we remain comfortable with our short duration bias following the outcome of the Fed. We expect it to also limit the downside in US government bond yields, where we see room for rates to move back towards the top end of recent ranges, as the market prices in risks of a more hawkish Fed given the impressive growth data. This is likely to be driven by the front-end and belly of the curve, rather than the longer end, as the Fed acts to control inflationary pressures. In contrast in Europe, we continue to see room for the EUR curve to steepen given impressive growth trends and still elevated pessimism towards the region, where any hawkish shift from the ECB set to be focused on asset purchases, rather than rate hikes.
- For credit markets, we remain positive and see a Fed that is now no longer significantly behind the curve as reducing one of the major tail risks that investors have been concerned about. In particular, that of a persistent surge higher in inflation over the medium term, as the Fed's guidance on rates indicates that they will not let inflation get out of hand, which also increases the likelihood that any inflationary pressures end up being transitory in nature. The other major tail risk being tracked is that of a more infectious and deadly Covid-19 variant resulting in a pause or reversal in the reopening process. Whilst the Delta variant has clearly been in focus given accelerating cases in the UK, hospitalisation and mortality data is more encouraging and indicates that the vaccine is preventing severe illness from this variant, which should allow for economies to continue to reopen.
- We expect for risk markets to focus back on the global economic growth path, which is now expected to exceed the pre-Covid trend. Our confidence in the recovery remains intact, not only due to the increasingly confident consumer, but also due to capex growth, which we expect to be helped from both the private and public sides as companies and governments get up to speed on the digital and green transformation taking place. This environment is one in which the higher beta segments of the market can outperform and where credit compression can take place.

High Yield spreads should benefit as the most severely impacted sectors from the pandemic begin to recover, whilst we also think that Subordinated Financial debt provides an attractive opportunity given strong fundamentals for the banking sector and resilient earnings throughout the pandemic.

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