

UBAM - ABSOLUTE RETURN LOW VOL FIXED INCOME

Quarterly Comment

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws. The classification of the fund(s) as per the Sustainable Finance Disclosure Regulation (SFDR) is available on ubp.com or in the latest prospectus.

Market Comment

- 2022 began on a volatile note as the hawkish shift taken by several key central banks towards the end of last year extended further. One of the main messages delivered by Fed Chair Powell was that this tightening cycle will be different to the gradual hiking cycle that began in 2015, where he chose not to rule out the possibility of a 50bp hike in March or hiking at consecutive meetings in contrast to the general consensus which has been for a gradual, quarterly hiking pace.
- Markets also priced in risks of a more hawkish ECB meeting given rising inflation concerns as energy prices continued their march higher as geopolitical tensions between Russia and Ukraine escalated.
- We therefore saw government bond yields rise sharply in January as the market further re-priced their expectations for central bank tightening with more than five hikes priced for the Fed by the end of this year and two hikes priced for the ECB at the time of writing. Such developments led to US 10-year yields rising by 27 bps in January in a move that was fully driven by real rates, which rose to their highest level since March 2021.
- This real rate move weighed on risk markets, with equities coming under significant pressure on the back of a large sector rotation which saw Growth names weaken aggressively, whilst Value outperformed.
- Credit spreads followed suit with US Investment Grade spreads widening by 13 bps and European spreads were 9 bps wider on the month. Economic data released during the month generally saw a further moderation given the impact of the Omicron Covid wave in December, as observed through the ISM Manufacturing and Services prints which disappointed relative to expectations and also likely weighed on sentiment.
- February was the weakest month for credit market since the Covid-19 outbreak in 2020. The weakness was driven by the Ukraine situation, where the Russian invasion and subsequent severe International, and in particular European, sanctions created uncertainty for the economic outlook.
- European credit markets underperformed, largely due to Europe's dependence on Russian oil and gas exports and the negative effect of Russian sanctions on Europe. EUR Investment Grade bonds widened 41 bps, while US Investment Grade widened a more modest 21 bps. The weakness in European investment grade bonds was exacerbated by the widening of swap spreads in Europe, caused by the high demand but low supply of high-quality liquid assets such as German bunds.



- Similarly, CDS indices (+12 bps iTraxx Main and +8 bps CDX IG) significantly outperformed bonds, reflective of the drop in liquidity conditions which is typical of severe and prolonged market weakness. Against that, USD denominated floating rate notes held up relatively well, as investors continue to look for paper that stands to outperform when the Fed will start raising interest rates.
- The weakness observed in February that was driven by the Russian invasion of Ukraine partially reversed in March as the initial sanction package news had been digested and as it became clear that Europe would not go as far as sanctioning Russian gas imports in the near term.
- As the month progressed, we also saw Russian and Ukrainian diplomats take part in discussions in a bid to find a ceasefire agreement, with talks still ongoing. European Investment grade spread tightened by 14 bps, while iTraxx Main spreads tightened 6 bps as the CDS-bond basis came off the lows following improved market sentiment, liquidity and lower volatility levels.
- In comparison, US Investment grade spreads lagged European spreads, ending the month 1 bp wider as a large amount of new supply (+233 bn) hit the market leading to the fourth largest monthly volume ever. Interest rates continued their path higher, with 5y US rates increasing by 74 bps to 2.46% and 5y Germany rates by 54 bps to 0.38%, while curves continued to flatten.

Performance Review

- UBAM - Absolute Return Low Vol Fixed Income delivered -0.2% net of fees QTD (I Share class). In relative terms, the strategy delivered +3 bps gross of fees above a EUR cash deposit reference index*.
- The excess returns for January were -46 bps, -59 bps for February and +107 bps for March.
- QTD, the main contributor to the excess returns was duration: +59 bps. The main detractor was credit bonds: -36 bps.
- Volatility remained contained with a daily 12-month rolling volatility of 1.0%.

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

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in EUR was -0.1% and 1.4% in USD (hedged share class).
- The interest rate exposure was -1.0 year and the credit exposure was 3.3 years.
- In January, we have maintained a positive view on credit in our positioning on the back of solid credit fundamentals and a still supportive macro backdrop given resilient global growth, with the fund's credit exposure at 3.1 years of spread duration and 3.2 years of risk adjusted spread duration.
- Whilst central banks are in the process of making a hawkish shift, we expect this to be gradual and unlikely to result in an aggressive tightening of financial conditions which remain at historical loose levels. On the rates side, we have decreased the fund's duration through USD following the Fed minutes that indicated a more hawkish stance, as the discussion suggested that they were open to bringing forward balance sheet normalization which would provide room for earlier rate hikes as well.
- Additionally we added a US 2y10y curve flattening position following the Fed's January press conference as Chair Powell did not rule out a 50bp hike or hiking at consecutive meetings, providing room for the front-end of the curve to underperform the long end, as has also been the case with prior Fed hiking cycles.
- In February, we have maintained our credit positioning, at 3.1 years of spread duration and 3.0 years of risk adjusted spread duration, as credit fundamentals remain solid, the global economy was rebounding ahead of this conflict as Omicron concerns were fading, and as we expect global GDP to remain robust once geopolitical tensions ease.
- On the margin, we continued adding to USD denominated Floating Rate notes through the new issue market, that stand to outperform in an environment of upcoming Fed rate hikes which we still expect.

- On the rates side, we continue to hold a USD short rates position as the Fed stands to hike interest rates despite the observed geopolitical induced market tensions, as the job market continues to tighten and inflation surprises to the upside in absolute terms and persistence. We are also sticking to our US 2y10y curve flattening position, initially initiated when the Fed began discussing the possibility of faster and larger rate hikes, as well as the fact that the position benefits from rising geopolitical tensions as concerns rise around future growth prospects, acting as a hedge for the portfolio.
- Ahead of Russia's invasion of Ukraine, we bought duration through 5y Germany bund futures to hedge the portfolio against a further escalation of the conflict given a lack of clarity on how it would play out. The fund does not have exposure to Russian issuers or heavily Russia exposed issuers.
- In March, we have increased our credit positioning from 3.1 to 3.3 years of spread duration and 3.6 years of risk adjusted spread duration, as credit fundamentals remain solid, the global economy was rebounding ahead of the Ukrainian conflict as Omicron concerns were fading, and as we expect global GDP to remain robust once geopolitical tensions ease.
- The increase was done through participating in the new issue market when and where attractive as well as by extending CDS index exposures.
- On the rates side, we continue to hold a USD short rates position as the Fed continues to guide hawkishly with its rate guidance given the tightening labour market and inflation which continues to surprise to the upside in absolute terms and persistence.
- We are also sticking to our US 2y10y curve flattening position, initially initiated when the Fed began discussing the possibility of faster and larger rate hikes. During the month, and to hedge the portfolio against further deterioration in the Ukrainian conflict, we purchased call options on 5y Germany rates.
- Finally, we entered into a short position on Japanese 10y rates seeing attractive risk reward given that the BoJ has so far significantly lagged the hawkish shift taken by central bank's elsewhere, where it's Yield Curve Control policy may need to be adjusted given that inflation is likely to hit 2% this year.

Outlook

- Although COVID-19 concerns have eased since the start of the year, which has allowed for the global reopening of economies to continue, the Russia-Ukraine crisis has begun to reshape the geopolitical and economic outlook. Geopolitical tensions, persistent supply constraints and less accommodative monetary and fiscal policies will likely lead to a decline in global economic growth from 5.8% in 2021 to around 3% in 2022 and 2023. Activity in regions such as Europe and Latin America will be softer as countries struggle with either a greater impact from the Russia-Ukraine crisis or higher deficits and inflation rates, whilst the US economy should outperform. At a global level, rising energy prices and persistent supply chain disruptions should continue to keep inflation elevated throughout most of the year, with further pressure in some countries to come through tight labour markets driving wage growth.



As a result, global inflation is expected to rise from 3.9% in 2021 to around 6.5% in 2022, before slowing back to 3.5% in 2023, where this year's strength in inflation is likely to force most central banks to tighten their monetary policies further.

- Across major countries, the United States will stand out. Despite the impact of higher food and energy prices, less supportive monetary and fiscal policies and weaker growth in export markets, the United States economy should remain relatively solid. Strong labour market conditions coupled with robust household and business balance sheets should provide resilience and help maintain private demand and investment. Meanwhile, the Eurozone and United Kingdom economies will likely contract in the second quarter of the year as fiscal policy is unlikely to be enough to prevent a slowdown in activity driven by a greater impact from the Russia-Ukraine crisis, which is squeezing real households' incomes. Provided geopolitical tensions moderate however, economic growth in Europe should resume later in the year driven by a post-Covid-19 rebound in services consumption, declining inflation, and easing supply chain issues. In China, should the government stick to its zero-Covid policy, new outbreaks of COVID-19 will continue to keep industrial production and household consumption subdued, preventing a swift rebound in economic activity. While threats to activity from virus infections, high corporate debt and the weak real estate market remain, the government will continue to support economic growth via easing monetary policy measures, accelerated infrastructure investment and tax rebates for firms in an attempt to achieve its 5.5% growth target for 2022, for which risks currently appear to the downside.
- During the first quarter of the year, the Fed accelerated its hawkish shift given that they have been consistently surprised to the upside by the extent and duration of the current inflationary pressures, coupled with their increased confidence in the strength of the labour market, which Fed Chair Powell described as extremely tight. For example at the March meeting, the Fed's updated dot plot projections showed the Fed Fund's rate above the neutral rate at 2.8% in 2023, up from 1.6% previously with Powell saying that there is an obvious need to move expeditiously to return the stance of monetary policy to a more neutral level. Whilst the Fed had previously been expecting inflation to cool in the second half of the year as supply side damage begins to heal, given uncertainty around the timing of this now, Powell said they will instead be looking at actual progress on supply side constraints, rather than assuming a significant near-term relief. Despite current pricing indicating a terminal rate for the Fed of above 3% now, we still see a possibility of the market pricing in a more aggressive hiking cycle in the near term given the Fed's frustration with inflation. We see a high likelihood that the Fed moves in 50 bp increments in the next couple of meetings, especially given both their and our belief that the US economy can handle higher interest rates and with financial conditions still loose on a historical basis.

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- In contrast at the ECB, we find it difficult for the market to price in a much more hawkish policy outlook at this stage, with around 200 bps in cumulative hikes now priced until end-2023. Both economic and wage growth in the Eurozone has not been as robust as that observed in the US, with inflationary forces largely driven by external factors such as energy prices, with limited domestically driven price pressures and which should allow inflation to mean-revert over time. That said, investors appear to have chosen to focus more on President Lagarde's comments at the March meeting, where she came across as more concerned with inflation over growth risks given that the ECB's scenario analysis of the Russian invasion of Ukraine forecasted growth still close to its potential rate for the Eurozone even in a severe scenario.
 - Overall, we retain our defensive stance on duration, seeing room for yields to rise, particularly at the front-end of the US rates curve until we begin to see meaningful signs of inflationary pressures, or expectations easing. We think that the sell-off in rates markets can continue given the global and synchronised nature of the hawkish shifts from central banks, where laggards to monetary tightening could also be forced into action. For this reason we also think that the BoJ will be worth watching where despite limited domestic price pressures, headline inflation is likely to reach 2% this year for the first time since 2015 following the rise in energy prices. This could warrant some adjustments to the BoJ's current Yield Curve Control policy and as such, we see attractive risk reward in positioning for higher JGB yields.
 - For credit, we continue to view this environment described as supportive for spreads. Whilst the geopolitical situation is fluid, our base case of still solid global growth leaves tail risk scenarios of recession and rising default rates as still far off, providing a positive backdrop for credit in which valuations have also improved. We also see this hawkish shift as being one driven not only by inflation fears, but also as a consequence of the more robust global growth backdrop which has been accompanied by tightening labour markets and rising wages. Whilst there are some concerns in relation to the impact of higher energy prices on household incomes, we would note that household balance sheets in the US are healthy given wealth accumulation across the income spectrum in recent years. Meanwhile in Europe, governments have already begun to react to this crisis through greater fiscal support, which we expect to continue and help cushion the growth impact.

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