Q3 2023

UBAM - ABSOLUTE RETURN 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

- July provided further evidence of slowing growth and disinflation among major developed economies. In the US, activity remained robust although some softness was observed by the most recent PMIs with emerging signs of easing service sector momentum. Meanwhile, headline and core inflation along with core PCE all surprised to the downside with forward looking indicators including the moderating employment cost index and producer price growth pointing to further downside pressures on inflation in the coming months. The labour market has softened further as shown by dropping job vacancies, quits and hires, but the labour market remains tight overall. Robust labour market demand coupled with moderating inflation led to an improvement in consumer sentiment in July which, coupled with the ongoing stabilisation of the housing market, suggests postponed risks of a more pronounced economic downturn. In the Euro-zone, the economy lost further momentum this past month. German data disappointed again with PMIs showing an intensified downturn in the manufacturing industry and easing services momentum. As a result, pessimism over the German economic outlook increased among businesses and investors. Eurozone inflation provided encouraging news on the headline front, decelerating by more than expected, while core remained elevated supported by services inflation. We expect inflation to be supported during the summer and ease more meaningfully later this year as weaker loan demand from households and businesses, as shown by the recent ECB bank lending survey for Q3 2023, translates into softer consumption and investment. In China economic data continued to disappoint prompting the announcement of several new targeted measures to boost consumption, support the property market and promote investment. Overall, we expect global inflation and economic growth to soften in the second half of the year but global growth to remain robust in 2023 as a whole.
- With data released from the US suggesting that the soft-landing narrative remains intact, risk markets continued to be supported as a result. US investment grade spreads for example tightened by 9 bps on the month and the European equivalent by 14 bps. The earnings season also kicked off positively where with over two-thirds of the S&P 500 companies having reported, 60% have beaten on revenues and 82% on EPS which is a strong beat to miss ratio. In addition, the average EPS beat is 6% which compares to the historical average of closer to 3%. Support for European credit also came from ECB guidance which is sounding more balanced over time. For example at the July ECB meeting, President Lagarde did not commit to a hike at the September meeting with an emphasis on data dependence, whilst the most hawkish members of the board in the Bundesbank & Dutch Presidents also refrained from providing clear guidance.

- This allowed for European rates to outperform, particularly at the front-end of curves with German 2-year rates for example declining by 16 bps and the US equivalent declining by just 2 bps in July. Whilst Fed Chair Powell at the July Fed meeting also chose not to pre-commit to another rate hike despite it being in their dot plot projections, the market instead chose to focus on the more resilient economic backdrop relative to the Eurozone. Overall we view these recent central bank meetings as confirming that peak hawkishness is behind us, which supports our positive duration bias, particularly at the front-end of curves given the potential for the curve to steepen further, as is typical at the end of hiking cycles. Recent data divergence also suggests that European rates have room to outperform US. 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 as has once again been observed with this past month's data releases.
- US economic growth continued to outperform in August, supported by tight labour markets and driving expectations for Q3 growth higher as the month progressed, with the Atlanta Fed's own nowcast for the quarter at an elevated 5.6%. Whilst we did observe some moderation in activity, with the flash PMIs for example surprising to the downside in the US, they still remain in expansion territory for both the manufacturing and service sectors. This is in contrast to what was observed for the Eurozone, with its flash PMIs in contraction for the manufacturing sector for the 14th consecutive month, whilst the service sector moved into contraction for the first time this year. The outlook for Chinese growth is also weighing on the Eurozone, where high frequency indicators continue to highlight an economy that is increasingly at risk of missing its 5% annual growth target. This is also forcing the Chinese authorities to announce further measures to support the economy, and particularly in the property sector in August with cuts to both mortgage rates and downpayments for homes announced. We anticipate for the trends described herein to continue, with the US economy finding support from a tight labour market and elevated wage growth, allowing for a soft landing to occur. The disinflation trend also appears to remain intact as US headline inflation surprised the downside in August, whilst core inflation trends in both the US and Eurozone remain encouraging. For example we see a clear possibility that core PCE could reach the Fed's year-end estimate by the end of Q3.
- Rates curves steepened in August as investors pushed out their expectations for rate cuts in the US amid the resilient growth backdrop, instead following the "higher for longer" interest rate environment being communicated by central banks. US 10-year yields rose by 15 bps in August amid this backdrop, although the 2-year yield declined by 2 bps as the curve twist steepened with expectations for the Fed's terminal rate were largely unchanged. Fed Chair Powell also chose to not deliver an increasingly hawkish message at the Jackson Hole conference, instead maintaining his communication from the prior press conference which highlights to us that the Fed is close to, if not at the end of its tightening cycle now. European rates outperformed in August with 10-year yields declining by 3 bps given growth underperformance relative to the US and with even the most hawkish members of the board unsure whether a September rate hike is still warranted. We view such developments as supporting our positive duration bias, particularly at the front-end of curves given the potential for the curve to steepen further, as is typical at the end of hiking cycles.

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- The move higher in real rates weighed on risk markets during the month with credit spreads also impacted as US investment grade spreads widened by 6 bps in August and the European equivalent by 8 bps. Despite this widening we remain positive on spreads given our soft-landing growth outlook and as we anticipate that peak hawkishness has now passed. From a micro perspective the latest earnings round also indicates that company fundamentals remain in decent shape with all major sectors reporting positive earnings surprises in the US and as forward guidance from companies is finally beginning to improve.
- Central bank meetings were in focus over the past month as both the Fed and ECB committed to a higher for longer communication with regards to the path of monetary policy. This could most clearly be observed at the Fed where although they chose to maintain unchanged policy rates, attention turned to their updated dot plot projections which now signalled just two rate cuts for 2024 relative to the four rate cuts in the prior forecast, whilst one final hike was maintained in the projections for this year. The economic growth revisions were also significant, with GDP growth revised higher to 2.1% from 1% previously for this year, whilst the unemployment rate is now forecast to see no further loosening for the remainder of 2023, unchanged at the current level of 3.8%. Developments herein highlight the recent strength in the US economic data, as confirmed once again by this month’s data releases which included a beat on retail sales as well as upward revisions to the savings rate which suggest that the consumer is still in good shape. Meanwhile at the ECB, the Governing Council decided to unexpectedly hike the deposit rate to 4% given continued inflationary pressures as observed through their updated forecasts in which headline inflation is only expected back to the 2% target in Q3 2025. As a result of these developments, we saw rates move higher in September and particularly at the longer end of curves which led to bear steepening pressures. For example, the US 2-year vs 10 year curve steepened by 29 bps in September alone whilst the German equivalent was 15 bps steeper. The move higher in rates was largely driven by real rates with the tightening in financial conditions herein weighing on risk markets as the month progressed and particularly in the US. For example, US investment grade spreads ended September 6 bps wider, whilst the European equivalent was in contrast 5 bps tighter, being supported by hopes of a pick-up in growth as hinted at in the stabilization of the latest flash PMIs and on expectations that Chinese stimulus efforts could provide support the outlook.
- With regards to interest rate duration, we continue to believe that we have passed peak hawkishness from the central banks. Even though the ECB hiked the deposit rate to 4%, a new sentence in the statement hinted to us that this could represent the final hike of the cycle as they noted that rates have now reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target. For the US, we do see signs of labour market loosening which we expect to weigh on Fed decisions ahead, as clearly seen with the decline in payroll growth over the past year to 150k in three month moving average terms, which compares to over 300k at the beginning of this year and over 500k at the beginning of 2022. We also believe that the disinflation trend remains intact, which could result in core PCE ending the year below the Fed’s current 3.7% year-end projection.

- That said, we continue to have a steepening bias within our duration view, having a preference for holding interest rate exposure towards the front end of curves which should be anchored, seeing room for curves to dis-invert over time as hiking cycles come to an end. For credit, we continue to view it as an environment which will see an orderly slowdown in growth over time, rather than a reacceleration or severe recession. This backdrop is one in which default rates should remain well contained and suggests holding credit exposure within portfolios. Specifically, we believe that one should be building balanced portfolios, holding both interest rate duration and credit risk, as government bonds should protect portfolios in a growth slowdown environment, where one can also benefit from elevated all-in yields as a result.

Performance Review

- UBAM - Absolute Return Fixed Income delivered -0.34% net of fees YTD and -1.22% QTD (I share class).
- In relative terms, the strategy outperformed a Global Aggregate EUR hedged index by +55 bps YTD and +109 bps QTD.
- Against a EUR cash deposit index*, the strategy delivered -208 bps gross of fees YTD and -194 bps QTD
- The excess returns by months against the cash deposit index were sequentially: +43 bps in July, -55 bps in August and -182 bps in September.
- QTD, the main contributor to the excess returns was credit: +44 bps. The main detractor was duration: -228 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 3.8% and 5.6% in USD (hedged share class).
- The interest rate exposure was 6.7 years and the credit exposure was 0.9 years and the risk adjusted credit spread duration was 2.0 years.

- In July, we decreased the fund's credit exposure by from 5.9 years to 2.5 years of risk adjusted spread duration by taking profit on CDS index exposures and credit bonds with maturities above 3 years, following the rally in spreads observed since the wides last seen in March, and as central banks, notably the Fed, remained relatively hawkish in its communication despite the disinflationary trend observed. In parallel we increased our duration position to 6.1 years, through EUR and Canadian rates as we expect toning down of hawkish central bank communication in the months ahead. During the month we shortened the tenor of the EUR rates exposure from the 10-year point on the curve into 2 and 5 year tenors as we expect interest rate curves to steepen as is typical at the end of hiking cycles, and as a term premium needs to be repriced into curves in our base scenario of a soft landing. We hold a MXN (4%) overweight vs USD through FX and local bonds to capitalise on the attractive carry and falling inflation in Emerging Markets relative to Developed Markets.
- In August, we further decreased the fund's credit exposure by 0.5 year to 2.0 years of risk adjusted spread duration following the rally in spreads observed since the wides last seen in March, and as central banks, notably the Fed, remained relatively hawkish in its communication despite the disinflationary trend observed. We further increased our duration position to 6.7 years, through JPY rates on the long end of the curve as we expect the exit from YCC to the flatten the curve in Japan, a geography where the interest rate curve remains significantly steeper relative to other global rates curves. We continue holding EUR, USD and CAD duration on the 2- and 5-year part of the curve as we expect interest rate curves to steepen as is typical at the end of hiking cycles, and as term premium needs to be repriced into curves in our base case scenario of a soft landing. We continue to hold our MXN (4%) overweight vs USD through FX and local bonds to capitalise on the attractive carry and falling inflation trend in Emerging Markets relative to Developed Markets. We entered a USD overweight FX position vs a basket of EUR, GBP and JPY to position for relative outperformance of the US economy on the back of weaker growth prospects in Europe, muted policy moves in Japan and a potential market repricing of BoE expectations which remains the most hawkish within DM despite UK economic activity set to slow further.
- In September, we held on to fund's credit exposure of 2.0 years of risk adjusted spread duration, largely held through AT1's, CDX HY and BB's. We tactically reduced our exposure between May and July following the rally in spreads observed since the wides last seen in March, and as central banks, notably the Fed, remained relatively hawkish in its communication despite the disinflationary trend observed. We also held on to our duration position of 6.7 years, largely held at the short end of the curve 2 and 5y and split 2.8 years in EUR, 2.4 years in USD with the remainder held through 5y CAD and GBP rates duration, as we expect interest rate curves to steepen as is typical at the end of hiking cycles, and as term premium needs to be repriced into curves in our base case scenario of a soft landing.

- We continue to hold our MXN (4%) overweight vs USD through FX and local bonds to capitalise on the attractive carry and falling inflation trend in Emerging Markets relative to Developed Markets. Furthermore, we have held on to our USD overweight FX position vs a basket of EUR, GBP and CHF to position for relative outperformance of the US economy on the back of weaker growth prospects in Europe, a potential market repricing of BoE expectations which remains the most hawkish within DM despite UK economic activity set to slow further.

Outlook

- Divergent economic growth trends were in focus in Q3 with US exceptionalism clear, whilst growth outcomes were in contrast less impressive in other regions including the Eurozone and China. That said, the disinflation trend observed during the quarter was global in nature, where encouraging news on the prices front allowed central banks to tone down their hawkish rhetoric. As we look ahead to the final quarter of the year, we will be monitoring the impact that tighter financial conditions are having on the real economy, where it should allow for the orderly slowdown in both global growth and core inflation to continue. We believe that such a scenario will keep central banks largely in a wait-and-see mode, and warrants holding balanced portfolios of both credit risk and interest rate exposure in portfolios.
- As the third quarter progressed, communication from central banks evolved as well. This was clearly observed with the Fed, who chose to only hike rates in one of its three meetings during the quarter, highlighting how any policy tightening has been marginal in nature. At the latest meeting, Chair Powell used the phrase “proceeding carefully” on numerous occasions, which confirms this shift in stance, having already brought policy well into restrictive territory. Whilst the updated dot plot projections are still guiding towards one more hike, it is unclear that there will be enough consensus on the board to deliver this, especially given the recent tightening in financial conditions observed, which has not gone unnoticed by Fed officials. For example we have recently heard from several members of the board who have compared the move higher in longer-end rates as equivalent to the Fed delivering rate hikes and which in the end should reduce pressure on them to act. The latest economic projections also highlight how optimistic the Fed currently is with regards to the growth outlook, which could disappoint somewhat into year-end given that we expect Q4 growth to be significantly weaker than Q3. These forecasts also suggest to us that the bar for further policy tightening is high, as the data may not match the Fed’s own heightened expectations. For example the Fed anticipates an unchanged unemployment rate of 3.8% for the remainder of the year which leaves little margin for disappointment in case we do see some labour market loosening, whilst recent data also suggests that core PCE could end the year below the Fed’s current 3.7% forecast.
- However it was perhaps at the ECB where the largest shift in communication came through in Q3 where the most hawkish members of the board in particular, brought their messaging closer towards the centrists once it was clear we had passed the peak in headline inflation, and as the growth data continued to disappoint. Again, this shift could also be observed at the latest ECB meeting where although they hiked the deposit rate to 4%, the statement added a new line that hinted that the hiking cycle may have now ended.

The statement noted that “based on its current assessment, the Governing Council considers that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target”. Whilst President Lagarde left open the possibility of a further hike, she admitted that this would only happen in December at the earliest following the next update of economic projections. Meanwhile her tone was clearly downbeat on growth, and this could be viewed within the updated macroeconomic projections which saw GDP revised down by 0.2% for this year and 0.5% for next year, to 0.7% and 1.0% respectively.

- Overall, we believe that the disinflation trend that took shape in Q3 will continue to encourage central banks to approach any further policy tightening with caution. Instead, central banks are likely to view recent inflation trends as encouraging, with the Fed’s closely watched super core inflation measure for example, which looks at core services inflation ex housing, having declined from 6.2% at the beginning of the year to 4.1% currently. Several Fed members have also commented on the importance of looking at the sequential inflation data, which is also promising and suggests that we are much closer to the inflation target when looking at it in 3-month average or 6-month average annualized terms.
- As a result, we continue to hold a positive bias towards interest rate duration, particularly at the front end of rate curves given the risk of curve steepening as we approach the end of the tightening cycle, which is beginning to play out. We also view policy as sufficiently restrictive from the central bank’s perspective when viewed from the angle of real rates, which recently broke 2% this past quarter on the US 10 year real rate and are now at levels last seen in 2008. We also continue to have a duration preference for EUR over USD given US exceptionalism from a growth perspective highlighted above, with the economy continuing to benefit from a tight labour market supporting household incomes. This comes in contrast to the growth backdrop for the Eurozone, as confirmed with the latest PMIs in which the composite index has now been in contraction for four consecutive months. Such dynamics could also continue to provide support for the broad dollar, especially if China’s economic growth outlook continues to underwhelm.
- From a portfolio construction perspective, we also 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.

- 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. Whilst rates volatility has weighed on risk markets and credit spreads in recent weeks, we believe that the move higher in real rates will likely calm over time, providing relief for investors, which should also allow credit spreads to recover from the recent widening. 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. From a relative value perspective it is also worth noting that CDS indices are trading at historically cheap levels relative to the cash market in High Yield.
- We also view 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 for this stage of the cycle. Finally, we continue to hold a positive bias towards the financial sector given it remains a segment of the market that stands to benefit from a higher inflation and interest rates backdrop, as observed in recent bank earnings. We view the AT1 market in particular as an attractive opportunity given recent developments, which we believe has reaffirmed the investment case for this segment of the market. For example several large banks have called their AT1 bonds since the Credit-Suisse takeover with several banks having also issued new AT1's, and received strong primary demand for them. Valuations are also attractive in this segment of the market with only around 45% of the AT1 universe priced-to-call, providing attractive upside over the medium term given that we expect most AT1 bonds to be called by their issuers and refinanced in the market. Finally we would note that the regulation has turned more supportive with both European and UK regulators have distanced themselves from the Swiss authorities decision to fully write-down the debt of Credit Suisse.

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