UBAM - US DOLLAR BOND

Quarterly Comment

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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.
- In February, US investment grade credit ended February with spreads 21 bps wider at 121 bps amid the risk off backdrop. This did not prevent US 10-year yields from rising however, up 5 bps during the month with the curve sharply flattening as investors continued to price in rate hikes for the Fed in the near term, whilst longer end yields found support from safe haven inflows.
- Despite rising geopolitical tensions, front end rates chose to instead focus on consistent communication from the Fed with regards to their tightening plans, continued strength in the labour market, whilst inflation concerns rose further given higher commodity prices which will likely force the Fed into action.
- From a positioning perspective, we have maintained our underweight duration exposure through USD as the Fed stands to hike interest rates despite the observed geopolitically induced market tensions, as the job market continues to tighten and inflation surprises to the upside.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

- In March, US investment grade credit ended with spreads 1 bp wider as a heavy month of supply prevented spreads from tightening. The first half of the month in particular saw spreads widen, although this was reversed as the market digested the more hawkish message from the Fed in its stride given Chair Powell's confidence in the strength of the economy and as geopolitical concerns from Eastern Europe became less of a focal point.
- Rates markets remained under significant pressure as US 10 year yields rose by 51 bps in March, with the US 2 year vs 10 year curve flattening sharply during the month, by 40 bps to end the month inverted by 1 bp as the market re-priced its expectations for the Fed in the hawkish direction. As a result, the market was pricing the terminal rate above 3% for the Fed after Chair Powell said that there was an obvious need to move expeditiously to return the stance of monetary policy to a more neutral stance, whilst he also hinted at the possibilitiy of moving in 50 bp increments at upcoming meetings.
- Whilst closely followed curves such as the US 2 year vs 10 year curve and the US 5 year vs 30 year curve inverted during the month, this seems unlikely to prevent the Fed from moving ahead with its tightening plans as their communication highlighted their focus on the near term forward spread and the 3m 10y curve as the best signals of policy being too tight, and these curves remain steep.

Performance Review

- QTD the strategy returned -4.8% net of fees (I Share class).
- The excess return over the benchmark (ICE BofA US Treasury index) was +74 bps before fees.
- The gross excess returns sequentially over the quarter were: -16 bps in January, +13 bps in February and +77 bps in March.
- QTD, interest rate exposure and yield curve contributed +90 bps, swap and agencies were +0 bp and credit subtracted -11 bps (other items -5 bps).

Portfolio Activity

- At the end of the quarter, the yield of the portfolio was 2.0% vs 2.4% for the reference index.
- The interest rate exposure was 5.5 years vs. 7.0 years for the index
- The main position for the portfolio was:
  - Underweight duration through USD & JPY duration
  - USD curve flattening position
  - Overweight credit through corporate bond market and Investment Grade CDS indices

- In January, we reduced the fund's duration exposure 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. We also took profits on the fund's EUR duration short position ahead of the ECB meeting. We maintained the fund's overweight credit position given that the strong growth and earnings backdrop remained intact.
- The fund's credit exposure detracted 11 bps from performance as spreads widened on expectations for tighter central bank policy. The fund's duration position added +7 bps to performance, benefitting from rising yields given underweight exposure through both EUR and USD duration, as well as a USD curve flattening position which profited from expectations for a front-loaded Fed hiking cycle.
- In February, we have maintained our underweight duration exposure through USD as the Fed stands to hike interest rates despite the observed geopolitically induced market tensions, as the job market continues to tighten and inflation surprises to the upside.
- We also continue to hold a US 2y10y curve flattening position which should benefit from the series of rate hikes we expect from the Fed. 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.
- We maintained the fund's overweight credit position given that the strong growth and earnings backdrop should remain intact once geopolitical tensions ease. We have also continued to add to selective high-quality names through USD denominated floating rate notes which should outperform in an environment of upcoming Fed rate hikes.
- The fund's credit exposure detracted 12 bps from performance as spreads widened on expectations for tighter central bank policy. The fund's duration position added +5 bps to performance, benefitting from rising yields given underweight exposure through both EUR and USD duration, as well as a USD curve flattening position which profited from expectations for a front-loaded Fed hiking cycle.
- In March, from a positioning perspective, we have maintained our underweight duration exposure through USD as the Fed continues to surprise hawkishly in its communication. For example their latest dot plot projection indicates that they are looking to get policy restrictive by end-2023, as they have the terminal rate above the neutral rate at this time. The latest speech from Fed Chair Powell also hinted at upcoming 50 bp hikes given frustration with elevated inflation, whilst he described the labour market as extremely tight which is seemingly giving them the comfort to accelerate their tightening plans.
- Such developments should also further support the fund's US 2y10y curve flattening position. At the start of the month we took profits on the fund's overweight EUR duration position that had been implemented as a hedge to the portfolio against a further deterioration in the Ukrainian conflict, and then purchased call options on 5y German rates later in the month to manage this risk.

- We also 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. We maintained the fund’s overweight credit position given that the strong growth and earnings backdrop should remain intact once geopolitical tensions ease whilst we increased risk through adding an overweight Italian 10yr BTP spread position.

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.
- 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.
- We also see this backdrop as positive for credit from the micro perspective, given strong credit fundamentals underpinned by good pricing power - which allows companies to sustain high profit margins despite an inflationary environment - as well as continued prudent balance sheet management. Net leverage for US Investment Grade names has fully reversed the increase observed during the pandemic, whilst a US HY default rate of under 1% for 2021 highlights how this segment of the market benefitted from the reopening of economies on the back of the vaccine rollout.

As such, we prefer high beta credit with low duration, favouring high yield and subordinated financial debt, in particular AT1s which should benefit from the rising rates environment, as well as floating rate notes which can be an attractive allocation at a time of rising rates.

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