

UBAM - HYBRID BOND

Quarterly Comment

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Market Comment

- Following the significant rally in fixed income markets in December on the back of the shift in communication from Fed Chair Powell in particular, **January** saw markets in more of a holding pattern. US investment grade spreads for example were 1 bp wider on the month, whilst the European equivalent was still 6 bps tighter. Within rates markets, US 10-year yields were 3 bps higher in January, whilst German 10-year Bund yields were 15 bps higher, with curves steepening as front ends continued to outperform following less hawkish communication.
- European rates underperformed herein, as the ECB appeared less willing to commit towards an easing guidance in the near-term, although President Lagarde herself admitted at the ECB meeting that rate cuts could come as soon as the summer, whilst not closing the door to an earlier rate cut either if the data warrants.
- That said, at the end of the month Fed Chair Powell chose to push back on the market pricing a possibility of a March rate cut by saying that they may not have confidence on the inflation trend to warrant a cut by then, requiring more good data to achieve such an outcome.
- This view from Powell has largely been driven by the strength in the recent activity data with for example the global manufacturing PMI moving back into expansion, the Atlanta Fed nowcasting Q1 GDP at above 4% now, whilst last week's non-farm payrolls for January was a significant surprise to the upside at above 350k. This represents the strongest month of job creation in the US since February 2023 and reaffirms our view that the economy is not heading towards a recession in the near term. On the inflation front, we did still generally see the disinflation trend remain intact in the US as the Fed's preferred measure of inflation – core PCE MoM in 6m annualised terms – was below the 2% target for a second consecutive month.
- **February** saw the positive risk backdrop continue on the back of robust economic growth data, coupled with the Q4 earnings season ending on a strong note with on average 75% of S&P 500 companies beating EPS expectations with an average EPS surprise of 7%. 4Q23 revenues and EPS were up 4% and 8% YoY on average (+5% and +12% YoY respectively ex-energy). As a result, credit spreads continued on their recent tightening trend as observed by US investment grade spreads being 5 bps tighter in February whilst the EUR equivalent was 9 bps tighter.
- Tightening herein was observed despite the repricing higher in rates markets as upside surprises in the economic data led the market to temper its expectations for aggressive rate cuts. For example the US payrolls report was a significant beat at 353k for nonfarm payrolls vs 185k expected in the strongest print in one year, whilst wages also surprised to the upside.

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- In addition and more generally, the global all-industry PMI has now risen for a 4th consecutive month to 52.1, in a sign that economic resilience appears to be broadening out beyond just the US economy as real income growth turns more supportive in the Eurozone for example as well.
- With regards to inflation, US core CPI surprised significantly to the upside at 3.9% vs 3.7% consensus, and which also meant that the Fed's preferred measure of inflation – core PCE MoM in 6m annualised terms – picked up to 2.5% from being below 2% for two consecutive months. As a result, within rates markets we saw the front-end of curves underperform in a bear flattening move as the market priced out near-term rate cuts. For example US 2-year yields rose by 41 bps on the month with the 2 years vs. 10 years curve flattening by 8 bps, whilst the German 2-year equivalent saw yields rise by 48 bps.
- Risk assets remained largely supported in **March** with the S&P 500 reaching another all-time high and credit spreads managing to tighten further on the back of continued resilience in the economic data that was released, coupled with the major central banks guiding towards rate cuts by the middle of this year. For example USD investment grade credit spreads were 6 bps tighter in March, whilst the EUR equivalent was 8 bps tighter.
- Employment data released in the US continued to push recession fears further down the line as nonfarm payrolls were a significant upside surprise once again at 275k vs 200k consensus, with signs of reacceleration within payroll growth when viewed in three month moving average terms. We are also seeing signs of economic growth broadening beyond just the US with the PMI surveys recently released in China for example moving back into expansion territory for the first time since September last year.
- Developments herein also drove the Fed to significantly mark higher its growth expectations for this year, to 2.1% compared to 1.4% previously in their latest forecasts. With regards to inflation, we also saw the Fed mark up its expectations for core PCE this year to 2.6% from 2.4% previously on the back of stronger inflation readings year-to-date, as well as the impressive growth backdrop.
- US rates markets were largely unchanged over the month as a whole, although this masked an initial rally during the first half of the month on the back of less hawkish central bank communication, whilst rates came under pressure as the month progressed in light of the growth numbers described, as well as core PCE printing at 2.8% in the Fed's preferred six month moving average terms, from 2.5% the prior month.
- EUR rates outperformed with German 5-year yields for example 11 bps lower on the month as the disinflationary trend observed increased market conviction in a likely June rate cut.



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Performance Review

- QTD, the return of the fund was +5.26% net of fees (I share class).
- The gross returns sequentially over the quarter were: +98 bps in January, +171 bps in February and +263 bps in March.
- QTD, the sector contribution was:
 - ▶ Additional Tier 1: +330 bps
 - ▶ Insurance subordinated: +17 bps
 - ▶ Corporate hybrid: +45 bps
 - ▶ Overlay and other items: +146 bps

Portfolio Activity

■ Portfolio at the end of quarter:

- ◆ Yield-to-call: 9.4%
- ◆ Yield-to-Worst: 8.8%
- ◆ Credit spread duration: 2.3 years
- ◆ Interest rate duration: 2.4 years
- ◆ Average rating: BBB-

■ Main Positions:

- ◆ 87% AT1, primarily core Europe (excluding Germany), in particular Netherlands, France, UK and Switzerland
- ◆ 3% Insurance Sub
- ◆ 6% Corporate Hybrids

- In **January**, the earnings season for Q4 started in the USA: Altogether large US banks have reported solid set of results, as their profits continued benefitting from higher rates, and trading activity continued to pick up. The asset quality remained solid and capital ratios were robust. Large banks aside, end of January saw some resurrection of the worries about certain US regional players after NY Community Bancorp reported a loss on January 31 after raising their expected loan losses on commercial real estate. The CRE topic remains constrained to regional lenders, as large US banks have only limited exposures and those have performed well.
- January also saw a re-opening of the AT1 issuance, as Credit Agricole and Caixabank printed new deals. Also, in the insurance subordinated market, there has been a new issuance of Restricted Tier1 – the insurance industry's equivalent of AT1s. Axa sold 1.5 billion EUR of RT1 notes, for which it received orders of almost 8 billion EUR. Axa's debut RT1 deal marks the biggest sale of a single tranche of such securities. The offering portends the end of a fallow period for RT1s. The market grew consistently after the creation of the securities in 2017, but the issuance in other currencies has been sparse for the past couple of years. We participated to the Axa RT1.
- With regard to redemptions, in January KBC and Svenska Handelsbanken have announced calls of their AT1s securities at the first call date. This extends this year's perfect record of AT1 calls in Europe, as all AT1 bonds with first calls in January and February have been called.
- In terms of market moves, AT1 spreads tightened by about 4 bps during the month, insurance subordinated spreads tightened by about 15 bps and corporate hybrids tightened by about 19 bps.
- From a positioning perspective, our exposure to AT1s was at 88% as of month-end, while corporate hybrids stayed at 6% and insurance subs were at 3%. On interest rates we added curve flattening bets and our duration exposure was modified by short positions in the front end of the US curve.
- In **February**, US regional banks continued to struggle, as investor concerns persisted about their exposures to commercial real estate. However, large US banks have been unaffected, as they are seen as largely immune to the



current woes due to their low and diversified CRE exposures. In European banking space, in February earnings season has continued. Altogether banks had a decent 2023, with revenues benefitting from higher rates, while asset quality remaining robust and capital levels being solid.

- The market for AT1s has been busy in February, as several banks took advantage of friendly conditions to issue new securities. UBS sold USD denominated AT1s. This deal pulled in more than 11.7 bn USD of investor orders. It follows UBS's return to the market in November, when it pulled in 36 billion USD of orders across two tranches. Also, in February new banks entered international AT1 markets with SMFG bringing first ever USD AT1 issue. It is the only other Japanese bank USD AT1. Finally, Standard Chartered, BNP Paribas, Swedbank and ABN AMRO issued news AT1s.
- With regard to calls, February has been a busy month with BNP Paribas, BBVA, Danske. ING all announcing calls of their respective AT1s at the first call date. This extends this year's perfect record of AT1 calls in Europe, as all AT1 securities with first call dates until April have been called.
- In terms of market moves, AT1 spreads tightened by about 18 bps during the month, insurance sub spreads tightened by about 29 bps and corporate hybrids tightened by about 17 bps.
- From a positioning perspective, our exposure to AT1s was at 88% as of month-end, while corporate hybrids at 6.5% and insurance sub at 3%. On interest rates, on the back of stronger incoming macroeconomic data we reduced our duration exposure by altogether 2.4 years and maintained the flattening bias on the curve.
- The market for AT1s has been busy in **March**, as banks continued taking advantage of friendly conditions and investors demand to issue new securities, e.g. Societe Generale brought new USD-denominated AT1 securities. Also, in March, the insurance RT1 market continued developing, with Dutch insurer NN Group bringing its first ever RT1 security to the market. Similar to their banking equivalents, RT1s are perpetual in nature with possibility of suspending coupons and principal loss absorption under certain conditions. Altogether investors showed a healthy appetite for such type of insurance debt, with recent RT1 deals being oversubscribed multiple times, as investors draw confidence from solid insurance companies fundamentals.
- Regarding calls, in March UBS has announced a call of its AT1 at the first call date. This action extends this year's perfect record of AT1 calls in Europe, as all AT1 securities with first call dates until May have now been called.
- In terms of market moves, AT1 spreads tightened by about 20 bps during the month, insurance sub spreads tightened by about 10 bps and corporate hybrids tightened by about 10 bps.
- From a positioning perspective, our exposure to AT1s was at 87% as of month-end, while corporate hybrids at 6% and insurance sub at 3%. On interest rates, on the back of stronger incoming macroeconomic data we kept our flattening curve bets unchanged and reduced our duration underweight position by about 1 year. On the credit side, we held to our long US high yield credit index position.

Outlook: Global Fixed Income Markets

- At the beginning of 2024, major central banks were guiding towards rate cuts by the end of Q2, and therefore the focus during this quarter will be on whether the data allows them to deliver on this prior guidance. Whilst we see the path for near term rate cuts from the ECB & BoE as more likely than not given the disinflation trend being observed, there remains more uncertainty on the timing of the Fed's first rate cut amid a stronger growth backdrop and recent stickiness in inflation. Overall, we expect for the rate cutting cycle to likely be very gradual in nature when it does commence, which favours a strategic allocation to fixed income to benefit from higher yields over the medium term and taking advantage of the carry opportunity that continues to present itself today.
- One of the key developments over the last quarter was the updated economic projections released by the Fed at the March meeting. Of significance were the large upward revisions to growth, with real GDP estimated at 2.1% for this year compared to 1.4% previously. US growth is being supported by a resilient consumer on the back of tight labour markets and an improving supply-side story amid rising immigration and improving productivity. The growth upgrade was also met with a revision higher to the inflation forecasts, with core PCE for example seen at 2.6% for this year, up from 2.4% previously. Despite these hawkish revisions, the Fed left its near term guidance within the dot-plot projections unchanged, to show three rate cuts for this year, whilst it did remove one rate cut further out, resulting in the end-2026 dot to be at 3.1% compared to 2.9% previously. Fed Chair Powell also maintained his message from prior meetings by guiding towards rate cuts later this year, although requiring a couple months of more data to confirm that the disinflation trend is intact given recent disappointing readings.
- Meanwhile at the ECB and in contrast to the Fed, both inflation and growth projections were revised lower, with growth estimated at just 0.6% for this year now, whilst core inflation is to average 2.6% in 2024 and be back to target in 2026. Following these more dovish forecast revisions, President Lagarde sounded increasingly convinced that rate cuts would probably become appropriate by the summer, by which time they would have had more time to digest the data. Such a decision would most likely come at the June meeting given Lagarde's comment that they will know "a little more in April, but a lot more in June". At the BoE, the March meeting also represented a dovish shift as the vote split no longer showed any member of the board voting for a rate hike for the first time since September 2021, which came as a surprise to market participants and signalled the first step towards easing policy.
- With regards to our interest rate duration views, at the end of January we decided to hold a more defensive bias, especially in the US given the strength of the domestic data and recent upside surprises to inflation. If anything, when observing the US data there appears to be no rush for the Fed to deliver its first rate cut despite Powell's guidance, with signs of reacceleration appearing. For example payroll growth in 3 month moving average terms has accelerated from a trough of 198k in November last year to 276k currently, whilst the ISM Manufacturing index just surprised to the upside and moved back into expansion for the first time since September



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2022. On inflation, influential Fed Governor Waller himself highlighted how the 3 month and 6 month moving averages for core CPI have risen now to 4.2% and 3.9% respectively, which shows how the disinflation process appears to have stalled and which means that he now requires more time to verify progress on inflation before looking to cut interest rates. Waller concluded that it may now be prudent to hold rates at these current restrictive levels for longer than previously thought. And so whilst the dot-plot still guides towards three rate cuts this year, we believe that the discussion is evolving, where data released later this quarter will be crucial in determining whether the Fed can deliver on its first cut this summer. We took profits on our positive interest rate bias in January when the market was pricing in closer to six rate cuts for the Fed, which appeared stretched to us. Today the market is pricing in three cuts, which is in line with the dots, however these dots may also soon be stale, dependent on the data and given recent communication from Fed board members. From a relative value perspective, we would be more positive on interest rate duration outside of the US where there is greater clarity with regards to the timing of the first rate cut and where growth has not been as robust, such as in the UK and Eurozone. In the UK in particular, investors have consistently been pricing a less dovish rate cutting cycle relative to elsewhere, despite the fact that the market is currently pricing for headline inflation to be below the 2% target in the UK by the summer. As a result, we continue to view UK Gilts as a source of continued outperformance from a relative value perspective.

- For credit, we maintain a positive bias and have a preference for higher income segments given the growth backdrop and attractive all-in yields. Central banks are planning to begin easing policy at a time when there are some initial signs of economic reacceleration emerging, which is positive for credit as it pushes further down the line any recession fears. We would therefore anticipate that the benign default rate backdrop remains intact, which remained below 3% in both the US and Eurozone last year highlighting the positive fundamental backdrop. This could also be observed within the 4Q23 earnings season, which ended on a strong note with on average 76% of S&P500 companies beating EPS expectations with an average EPS surprise of 7%. 4Q23 revenues and EPS were up 4% and 8% YoY on average (+5% and +12% YoY respectively ex-energy).
- Whilst spreads have tightened on the back of positive macro developments since the beginning of the year, the high yield segment of the market through CDS indices continues to trade cheap to the cash bond market. With yields close to double-digits in dollars, we believe this segment continues to compensate investors more than adequately for the risk being taken. Furthermore at such elevated yields, the power of accrual becomes extremely important, providing a buffer against any bouts of spread widening and as was clearly observed in 2023. We also view an allocation to BB rated bonds as 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 is benefitting from the higher inflation backdrop, as observed in recent bank earnings. In particular, we would continue to highlight the AT1



market as an attractive opportunity and an asset class that has recovered from the volatility observed in March last year.

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