UBAM – EUROPEAN CONVERTIBLE BOND

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

- During the first quarter of 2024, markets have continued their way up and reached record highs, it has been the case for the S&P 500, the Stoxx 600 and the Nikkei 225. Performances have been driven by the resilience of the US economy and the strong corporate earnings reports. The “Higher for Longer” rhetoric made a comeback in February and rate cuts expectations have been pushed to later this year. US Federal Reserve, the Bank of England and the European Central Bank kept their interest rates unchanged over Q1. Three rate cuts by the Fed and the ECB are priced for 2024 vs. six at the end of last year. In this context yields have moved higher globally, and they reached new YTD highs at 4.32%, 2,46% and 2,94% for US, German and French 10-year yields respectively over the quarter. In the US, the 2-year to 10-year part of the yield curve moved higher by 30bps to 40bps. In France and Germany, we’ve seen a similar pattern, but stronger on the 2-year to 5-year part of the curves with upward shift reaching close to 45bps. Overall, it did not alter the upward trend of equity markets, and volatility was stable during the first three month of the year. High Yield credit spreads barely moved as they were just slightly up 4bps and 5bps in the US and Europe respectively.
- Major equity markets posted strong gains over the first quarter of the year ending at +9.9% (MSCI World TR hedged in euros). In Europe, the Stoxx Europe 600 index lagged being up 7.8% q/q. In terms of investment styles, the “Growth” play outperformed the “Value” style, as revealed by the MSCI Europe Growth index up 9.9% q/q, while the Value index was higher 3.9% q/q. Equity performances were mainly driven by large caps and small caps lagged, the MSCI Europe Small cap rose only by 3.5%. That being said, small and mid-caps have started to catch up with large caps in March.
- Weak performances of small caps are reflected in the underperformance of convertible bonds’ underlying equities, 4.0%. In this context, convertible bonds ended the quarter 3.8% higher.
- Primary market activity was strong during Q1 2024 with $25.6bn issued. It was almost fully done by the US market which saw 34 new issues, for a total of $20.7bn. In Japan, there were 7 new convertible bonds for $2.9bn. It was relatively quiet in Europe where only 3 new convertible bonds and 1 exchangeable bond issued totaling $1.5bn. In Asia ex-Japan, there was only one new convertible bond for $0.4bn.

Performance Review

- In the first quarter of the year, the UBAM – European Convertible Bond increased by 2.2% after fees (IC EUR share class), lagging its index, the Refinitiv Europe Hedged Convertible Bond index (EUR), by 1.6%.
- During Q1, most of our absolute performance was led by names in the Industrials (+143bps), Consumer discretionary (+58bps) and Energy sectors (+57bpd), while our exposure to Semiconductors detracted the most (-34bps). The main driver of underperformance was actually our relative underweight to the Defense industry, specically to Safran and Rehinmettal, which peformed very well over the quarter. Relative to the index, the main contributor was our absence of Atos / Worldine (+43bps), as Atos went through a major credit stress over Q1. Among other relative detractors we find Saipem (+31bps, overweight) and Spie (+25bps, overweight), while main detractors include Delivery Hero (-30bps, closed over the quarter), Rheinmetall (-107bps, not in portfolio) and Safran (-109bps, not in portfolio).

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.

Portfolio Activity

- At the end of March, the average equity sensitivity of UBAM – European Convertible Bond stands at 36.3% (+2pts q/q), +5pts above the index's. The strategy's interest rate sensitivity is very much contained at 1.7 for a 3.0-year duration. Lastly, the portfolio exhibits an average credit spread of 121bps (-36bps q/q) vs. 197bps for the index.
- From a sector standpoint, the sub-fund is primarily exposed to equity markets through investments in Industrials (9.5%), Consumer Discretionary (7.0%) and Technology (4.1%). Despspite being in our lagest sector exposure, we actually are underweight in Industrials (-4.1pts) when compared to the index. Vs. the index we are overweight in Consumer discretionary (+3.5pts), Financials (+1.9pts) and Technology (+1.8pts).
- On the back of the primary market, we repositioned the portfolio on more balanced bonds. We replaced the exchangeable Lagfin / Campari by the new convertible Campari 2.38% 2029. We participated to the new exchangeable Citi / LVMH 1% 2029 and made a partial switch from the JP Morgan / LVMH 0% 2024. We also made a partial switch from the Schneider Electric 0% 2026 towards the more balanced Schneider Electric 1.97% 2030. We initiated a position in the Orpar / Remy Cointreau 2% 2031. Over the quarter we reinforced Wendel / Bureau Veritas, STMicroelectronics, Pirelli and Veolia. This has been financed by taking profits and/or reducing our exposure to some names such as Saipem, Prysmian, Edenred, Hellofresh, BE Semiconductor and Accor. We closed our position on America Movil / KPN as the bond reached maturity in March.

Outlook

- While inflation pressures are easing, it is not yet sufficient to trigger the first rate cut. The strength of the US economy supports the current Federal Reserve *wait & see* and *data dependent* approach. In Europe, central bankers are giving a bit more visibility with a potential first rate cut as soon as June. This should be put into perspective with the strong US economy and signs of stabilization in European economic activity. We recently saw a rebound in Eurozone composite PMI and some improvement among investor sentiments as the global trade cycle has started to turn. It underpins a new scenario characterized by modest growth and falling inflation. When combined, these factors could frame an environment supporting further broadening of equity performances beyond large caps. In addition, European equities are attractively valued when compared to US ones (Stoxx 600 was trading at a 34% discount to the S&P 500 at the end of March 2024). The catch up from small and mid-caps could intensify in Europe, as they should benefit from their attractive valuation and from the eventual rate cuts. This would be a positive scenario for our asset class given the convertible bond bias towards smaller companies.
- Convertible bonds would also benefit from their fixed income features supported by an accommodative interest rate environment and tighter credit spreads.
- In addition, primary market is expected to be busy, thanks to refinancing activity. In the European convertible bond space alone $18bn worth of debt is due to mature in the next two years. Backed by the potential of financial debt costs savings, we believe the pool of corporates considering the convertible bond market should expand beyond its traditional issuers to High Yield and even Investment Grade issuers. The primary market speeding up and appealing new deal terms offering higher convexity potential, should foster the good momentum of the asset class.
- From a macroeconomic viewpoint, we should not ignore the desynchronization in economic cycles between Europe and US, and geopolitical tensions which could exacerbate divergence. We do not under-estimate the risk of seeing volatility navigating to a higher level. When combined, this tends to refrain risk-on positioning among investors. This type of foggy market environment is precisely when convertibles should be considered to build or maintain an equity exposure.

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