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UBAM - ABSOLUTE RETURN FIXED INCOME

Quarterly Comment | Q1 2019

Formerly: UBAM - Global Credit Opportunities

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Market Comment

- In January, risk markets reversed much of the weakness observed into year-end, as central banks globally provided support for equity and credit markets, which had also been adversely affected by poor liquidity during the December holiday period. For example US investment grade credit spreads tightened by 24 bps in January following a widening of 34 bps in the final two months of 2018, while European spreads tightened by 9 bps following a widening of 24 bps in the prior two months. AT1 yields ended the month 0.7% lower at 5.7%.The outperformance of US credit was largely driven by the dovish turn taken by the Fed in both its January statement and Chair Powell's press conference. In particular, the statement removed any reference to further gradual rate hikes, instead emphasising patience amid muted inflation pressures.
- In addition, an unexpected statement regarding balance sheet normalisation was also released, and said that the Committee is prepared to adjust any of the details for completing the balance sheet normalisation process in light of economic and financial developments. Changes herein led to US 10 year Treasury yields rallying by 9 bps in January, with a similar move observed in the front-end of the curve as the market priced out any chance of a rate hike from the Fed this year. The Fed was not alone in its dovishness, as ECB President Draghi in his opening statement at the January meeting acknowledged that risks to the economic outlook had moved from "broadly balanced" to the "downside".
- This followed poor economic releases out of the Euro Area during the month which included weak industrial production prints across the region, and led to German 10y yields also rallying by 9 bps. Chinese authorities meanwhile continued with their easing measures amid slowdown concerns, as the PBOC announced 100 bps worth of reserve requirement ratio cuts at the start of the month, and the Ministry of Finance also declared its plans for a VAT cut in March. Sentiment was further supported by positive headlines from the US-China trade discussions towards the end of January, in which both sides agreed to continue negotiations in mid-February, crucially ahead of the March 1st deadline for tariff increases.
- The positive sentiment towards risk markets remained intact in February, as the dovish shift from central banks globally continued to provide support, which was further boosted by hopes of a US-China trade deal being reached. Developments herein allowed for US investment grade credit spreads to tighten by another 10 bps during the month following 24 bps of tightening in January, whilst European investment grade spreads tightened by 14 bps following an initial 9 bps of tightening the prior month.

- The outperformance of European credit spreads could be put down to declining Brexit tail risks as Theresa May bowed into political pressure and agreed to hold votes on ruling out a "No Deal" Brexit and extending Article 50 for a short period if her Withdrawal Agreement does not pass through Parliament by 12th March, reducing cliff-edge risks. European risk markets were also helped by hopes that the ECB will react to the recent weakness in the data and announce a new TLTRO programme at an upcoming meeting in a bid to support the economy
- The market also rallied on US-China trade negotiations where after a meeting with China's Vice Premier Liu, US President Trump decided to delay the tariff hikes that had been scheduled for March 1st, lowering imminent fears of an escalation in the trade war. US 10 year yields ended the month 9 bps higher as the positive risk sentiment described allowed for some safe haven hedges to come off, whilst European interest rates outperformed as German 10 year yields declined by 2 bps in February. The move lower in European rates could be put down to the continued weakness in the data, as highlighted by the Eurozone flash manufacturing PMI for example, which moved into contractionary territory for the first time since mid-2013.
- Rates markets rallied significantly in March as investors appeared to have been caught out by the extent of the dovish messages delivered by the Fed and ECB in particular. For example US 10 year yields declined by 31 bps during the month, whilst German 10 year Bund yields fell by 25 bps and significantly yielded negative for the first time since 2016. Moves herein were initially driven by the March Fed meeting as the 2019 median dot plot moved from anticipating two hikes to zero for this year, whilst at the same time the board announced its plans to end its balance sheet normalisation process in September. The ECB also appeared to surprise investors with its timing of announcements, committing to keep rates at present levels at least through the end of 2019 and also announcing a two year targeted TLTRO, although the details of the program were saved for a later date.
- Despite the central bank decisions described above, risk markets did not react particularly positively to them given the downgrade in ECB forecasts which included a 0.6% decline in the 2019 GDP growth forecast to 1.1%. Sentiment was also impacted by the weak German manufacturing PMI which sharply missed expectations and moved further below the 50 expansion line to 44.1.
- This brought about renewed fears about the global growth backdrop which was exacerbated by the closely watched US 3 month versus 10 year yield curve inverting for the first time since 2007, flattening by a sharp 22 bps during March alone. As such, US investment grade credit spreads tightened by 6 bps and European spreads by 7 bps during the month, which was a clear loss of momentum following spread tightening of 23 bps for the US and 34 bps in Europe during the first two months of the year.

Performance Review

- YTD, UBAM - Absolute Return Fixed Income increased +1.46% net of fees in Q1 (I Share class). In relative terms the strategy delivered +172 bps gross above its reference index: the Eonia capitalization 7 days index.
- The excess returns over the quarter were: +113 bps in January, +13 bps in February and +47 bps in March
- QTD, the key contributors were global investment grade corporates and financial hybrids.
- Volatility remained contained with a daily 12-month rolling volatility of 0.85%.

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in EUR was 1.3% and 4.4% in USD (hedged share class).
- The interest rate exposure was 2.3 years and the credit exposure exposure was 3.6 years.
- In January, we increased credit risk during the month by 1.9 years of risk adjusted spread duration to 2.4 years, slightly above the 5 year average. In the first week of the month, we added a first leg as various data released out of the US including the non-manufacturing ISM and payrolls beat expectations which reduced growth concerns, coupled with Powell's dovish shift and Chinese easing to stimulate the economy. We added a second leg of credit risk through the Senior Financials CDS index after May's Withdrawal Agreement was rejected and as the announced confidence vote was set to fail, in turn reducing the risk of a "hard Brexit" scenario. We finally arrived at 2.4 years of risk adjusted spread duration as we added a total return swap on the US Corporate Index. This addition was driven by the market continuing to be supported by positive headlines on the trade war front, and absolute and relative valuations appearing attractive. We further added to credit through the new issue market, where we saw a handful of attractive deals (elevated new issue premiums) very well received by the market. On the rates front, we added 0.3 year interest rate duration over the month as central banks turned dovish in January.
- In Feburary, we decreased credit risk during the month by 2.4 years of risk adjusted spread duration to 3.1 years. In the first week of the month, we took profit on our iTraxx senior financials and iTraxx Main CDS positions, given the remaining concerns around Euro Area growth, and partially substituted the risk by US Investment grade exposure as with the Fed remained dovish and the lack of near term risk events should support credit risk. In the second week of the month, we further decreased our credit positions as US retail sales turned weak, the new issue market appeared to lose momentum, and positive US-China trade talks appeared to be largely priced in.
- In March, we increased credit risk by 1 year of spread duration over the month as central banks turned increasingly dovish which provided support for risk markets, while our turning point indicator stabilised in the neutral zone confirming our view that we are not heading towards an imminent recession. On one hand, we added to CDS indices in Europe and on the other, we substituted part of our US investment grade cash bond exposure with CDS indices effectively taking profit on the outperformance of cash bonds vs CDS indices observed since the start of the year. In interest rates, we increased duration by 0.4 year to 2.3 years to preserve a balanced portfolio risk profile.

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Outlook

- Risk markets managed to recover from the sharp December sell-off observed due to a combination of a dovish shift from major central banks, ongoing constructive trade talks between the US and China, as well as reduced concerns regarding imminent recession fears globally. As we look ahead to the second quarter, the focus will be on whether this positive momentum can be maintained, especially since the S&P 500 for example has now recovered all of its Q4 losses and there is little more that the Fed can do to support liquidity conditions without now cutting interest rates. As such, market participants will continue to track closely the trade talks to see if any conclusion can be reached, as well as looking for confirmation in the data that the deceleration in growth has now passed. In addition, while Brexit remains a fluid situation, investors will be hoping that the risk of a no deal Brexit continues to be phased out.
- One of the most significant developments in Q1 was the extent of the dovish turn from the Fed as highlighted at the March meeting in which the board decided to lower its median dot plot projection for 2019 from two hikes down to zero, whilst at the same time announcing plans to end its balance sheet normalisation process in September. The tone of Fed Chair Powell's press conference followed suit, as he emphasised the risk management approach being taken by the board, choosing to be patient given the lack of inflationary pressures and as the economy is showing mixed signals. In addition, Powell commented on the tightening in financial conditions that has also been a factor weighing on growth, which is a concern for the board given its aim of lengthening the expansion. Developments herein led to the market not only pricing out any hikes from the Fed in 2019, but investors went even further by pricing in one rate cut for the end of this year. In the days following the meeting the closely watched US 3 month-10 year yield curve also inverted for the first time since 2007, flattening by 22 bps during March alone.
- Our own view is still that the US is not heading towards a recession and as such, we do not anticipate any rate cuts from the Fed this year. The US labour market remains extremely robust and while the manufacturing sector has slowed, as highlighted by the ISM survey, we believe that this decline is a return to more normal levels of growth from unsustainably above-trend levels. Furthermore the loosening in financial conditions since the beginning of the year will only support the outlook further, as will the rally in interest rate markets that should cushion the housing sector. That said, we see the bar for the Fed to hikes rates as high at this stage as well given that recent communication from the Fed's leadership has emphasised that the inflation target is a symmetric target. As such, they would be comfortable with inflation being above the 2% target for some time, instead appearing to need sustained inflationary pressures above this level to feel the need to hike interest rates again.

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- Following in the Fed's footsteps, the ECB also surprised investors with its timing of announcements, committing in March to keep rates at present levels at least through the end of 2019, and also announcing a two year targeted TLTRO, although the details of the program were saved for a later date. The ECB also downgraded its 2019 GDP growth forecast by 0.6% to 1.1% as the impact of the Asian-led slowdown continues to bite and hurt the region's external sector, which was confirmed later in the quarter as Germany's manufacturing PMI fell further into contractionary territory at 44. These announcements from the ECB, coupled with continued weakness in the Eurozone manufacturing surveys in particular, led to 10 year Bunds trading negatively for the first time since 2016. We have always believed that it would be difficult for the ECB to commence its hiking cycle given the inflation backdrop, and so the new forward guidance provided has aligned the ECB closer to our own view. Furthermore, recent discussions around a possible tiered deposit rate highlight how the board now appears to be preparing for the plausible possibility that rates remain negative for the foreseeable future which only adds to the dovish tone.
- We think that it will take some time for the Fed and ECB to deviate off their respective dovish paths, needing to see a significant upturn in inflation to do so. Given our view that prices globally will continue to be weighed down by longer term factors such as demographics and low productivity, we see little chance of this turn happening soon. As such, we think that interest rates should remain well anchored, especially at the front-end, and our bias would therefore be to fade yield spikes to add further to our duration exposure. We believe that the increasingly volatile market environment that we have been in over the past several months is set to continue during the rest of this year as the market trades more sensitively to the data and news flow given the late stage in the growth cycle we are believed to be in. Such a backdrop also warrants holding more duration in a bid to construct increasingly balanced portfolios in which duration exposure is able to complement the credit risk held, limiting drawdowns during risk-off moves.
- With regards to credit markets, whilst valuations are not as compelling as they were at the start of the year, spreads still remain close to the five year average across segments, while various indicators suggest that positioning is still light across the investor base. As such, and unlike the beginning of 2018, we think that this could be a supportive technical factor for credit markets, especially if the data can continue to recover. Positively, early indications are that the stimulus measures taken by the Chinese authorities over the past couple of quarters are beginning to feed through to the real economy as highlighted by the recent bounce in the manufacturing PMI, which crucially moved back into expansionary territory following three months of contraction. We wait to see whether this positive trend can be maintained before adding to our credit exposure, which currently sits below, but close to historical average levels. We also think that a strong focus on liquid credit instruments as core holdings such as CDS indices is crucial given a seemingly less liquid and deep market, as these have better behaviour during stressed phases and allow for more flexibility when volatility does rise.

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