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UBAM -
ABSOLUTE RETURN FIXED INCOME

Quarterly Comment | Q3 2018

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Market Comment

- Positive sentiment towards risk markets was observed in July on the back of the highly anticipated Trump and Juncker trade meeting in which they agreed for European imports of US gas and soybeans to expand, to lower industrial tariffs between the two and resolve the steel and aluminium tariffs imposed earlier this year. This offset some of the concerns related to rising global trade war risks, following the imposition by the US of a 25% tariff on USD34bn of Chinese imports, which was announced in June and came into effect on July 6th. Fears over a tariff induced Chinese economic slowdown also subsided somewhat after the authorities announced various monetary and fiscal easing measures to support the economy. Developments herein allowed for credit spreads to tighten on relatively low volumes given summer markets, with European investment grade credit spreads tightening by 11 bps, while US IG spreads tightened by 13 bps.
- With regards to interest rates, with little new information out of both Fed Chair Powell's testimony to Congress and Draghi's July ECB press conference, moves were instead largely driven by expectations into the Bank of Japan meeting. In particular, during the month there were reports from various news outlets suggesting that a change in the yield curve control monetary policy framework was imminent. Such risks led to interest rates to rise globally, with the US 10 year yield for example rising by 9 bps to 2.96% in July, while German 10 year yields rose to 44 bps from 30 bps. In the end the BoJ tweaked its yield curve control framework and crucially maintained the 10 year JGB yield target at 0%, rather than make any significant policy shifts. This, coupled with the forward guidance provided of maintaining the current low level of rates for an extended period of time, provided relief for a market which had feared a tapering-like announcement.
- Unresolved issues including the Italian budget, Turkish Lira weakness and US-China trade weighed on risk markets in August. European investment grade credit spreads widened by 10 bps for example to 121 bps on the month, while US spreads widened by 3 bps to 98 bps. European underperformance was driven by ongoing developments in Italy, as investors feared an upcoming wider budget deficit announcement given initial comments on the subject from various coalition members. Concern that such a move would lead to confrontation with the European Commission resulted in BTP spreads widening by a significant 63 bps in what was likely to have been a less liquid summer market.

- In addition, the Turkish authorities were unable to halt lira depreciation, with the currency weakening by over 30% against the dollar in August as questions around central bank independence remained unanswered. Moves herein also weighed on European risk markets given Turkey's ties to the region, with some contagion effects, notably on European banks with Turkish exposure. Rhetoric from the US administration meanwhile suggested risks that further tariffs worth USD200bn of Chinese imports could be added to the initial USD50bn tariff list that had already been implemented. This backdrop was supportive for safe haven US Treasuries in August, with 10 year yields for example rallying by 10 bps, while German 10 year bund yields rallied by 11 bps. Fed Chair Powell's Jackson Hole speech was unable to derail the rates rally, given that his comments were cautious and largely provided a defense of the committee's outlook for the gradual normalisation of monetary policy, while noting that there does not seem to be an elevated risk of overheating.
- Italian politics remained in focus in September as BTP spreads initially recovered from their wides on growing optimism into the budget announcement. However the announcement of a deficit of 2.4% of GDP for the next three years disappointed what seemed to be elevated hopes for a deficit of under or at 2%, resulting in spreads sharply widening by 35 bps in the final two days of September, although still 23 bps tighter on the month. Despite concerns around Italy, both European and US investment grade credit spreads still managed to tighten by 7 and 8 bps respectively in September. Moves herein were supported by the market choosing to fade near-term fears related to trade tariffs from the US on China, while relief was also taken from Turkey as the central bank decided to hike interest rates aggressively to stem Lira weakness.
- The positive sentiment also allowed for rates markets to sell-off as hedges were removed. Data in the US supported a further repricing of the front-end of the curve as key indicators such as ISM manufacturing and wage growth surprised on the upside. This led the market to add another hike to its Fed expectations for 2019, in total seeing 1 more hike this year and close to 2 more hikes in 2019, which is just one hike shy of the Fed's own dot plot. Pressure on rates markets also came from the ECB where despite a non-eventful press conference, President Draghi followed this up later in the month with a speech in which he highlighted a relatively vigorous pick-up in underlying inflation, adding that domestic prices pressures were strengthening and broadening. While Fed Chair Powell at the September press conference still saw no signs of inflationary pressure, the move higher in oil prices to four year highs also added to the higher rates momentum, helping 10y USTs rise by 20 bps and 10y Bund yields by 14 bps in September amid this backdrop.

Performance Review

- Volatility remained contained with a daily 12-month rolling volatility of 0.83%.
- Looking at the broader credit market, the ICE BofAML Global Corporate index, hedged to EUR an indicator for the returns of global credit markets, was up 0.11% in Q3 vs. 0.28% before fees for the fund.
- UBAM - Absolute Return Fixed Income increased 0.28% in Q3 before fees, 0.11% after fees (I Share class). In relative terms the strategy delivered 37bps gross below its reference index: the Eonia capitalization 7 days index.
- The excess returns over the quarter were: +32ps in July, +7bps in August and -3bps in September.
- QTD, the key detractor to the excess returns was sovereigns (-16bps).

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in EUR was 1.1% and 4.3% in USD (hedged share class).
- The interest rate exposure was 1.4 years and the credit exposure exposure was 2.1 years.
- In July, we have left our credit exposure unchanged over the month, and remain defensively positioned at 1.7 year spread duration. On the rates side, we increased the interest rate duration exposure by 0.1 year to 1.3 year as catalysts for a near term sell-off were lacking (ECB meeting and Powell testimony passed without incident). We partially substituted US duration with EUR duration for portfolio construction and diversification reasons as well as due to the ECB remaining firmly committed to keeping rates unchanged at least through the summer of 2019.
- In August, we left our overall credit exposure largely unchanged in August, and remain defensively positioned at 1.7 year spread duration. During the month we did decide to reduce the fund's exposure to UK banks and replaced this exposure with core European banks, in case the market reacted adversely to the inevitable increasing Brexit noise as the March 2019 deal deadline approached. On the rates side, we increased the interest rate duration exposure during the month through US and European five year futures given various unresolved issues including the Italian budget and the US-China trade war which could weigh on risk markets and provide a bid for safe haven government bonds. We took profits on this position towards the end of the month following a decline in yields towards the bottom of the recent range, which left duration levels largely unchanged from July at 1.2 years. We also initiated a short France vs Germany spread position through futures as a hedge to a further escalation of tensions in Italy, and in case it led to any contagion to the rest of the region.
- In September, we left our overall credit exposure largely unchanged until the end of September. We added 0.6 yr of risk adjusted spread duration through CDS indices towards the end of the month on the back of continued benign fundamentals (solid global growth and limited inflation) as well as easing risks on Italian budget slippage. In addition, trade tariffs from the US on China passed with little incident and the fundamentals of robust global growth and benign inflation remain intact. On the rates side, we added 0.2 yr of duration exposure through 2 yr US futures as the dot plot projection out to 2021 was left unchanged, with Powell seeing little signs of inflationary pressures. Furthermore, market pricing at the front-end appears to be more closely aligned with the Fed's dotplot as close to 3 hikes are priced in over one year, and the carry/rolldown profile remains attractive.

Outlook

- Politics remain in focus as we enter the last quarter of 2018, with various issues that weighed on investor sentiment in Q3 remaining unresolved. For example while Donald Trump implemented another round of tariffs on China, risks of a further escalation in the trade war remain given the lack of constructive negotiations between the two sides thus far. Furthermore the populist Italian coalition continues to cause volatility in the BTP market, as investors await the European Commission and the rating agencies response to the government's budget deficit plans. Brexit negotiations also come to a head in Q4 as the UK and Europe look to come to an agreement on a withdrawal deal before year-end. Finally, the upcoming US mid-term election results will be an important signpost in defining the remainder of Trump's first term, and whether he will be able to push through Congress any further policies which have thus far provided a boost to the US economy.
- Despite concerns related to trade tariffs, the US economy defied expectations and strengthened even further in Q3. The ISM manufacturing index for example averaged an impressive 60 during the quarter, which is the highest this cycle, while the labour market tightened further, as the unemployment rate reached 3.7%, which is the lowest level since 1969. Signs of a pick-up in wage growth were also apparent, with monthly average hourly earnings of 2.8% YoY printed during Q3, which again is the fastest reading this cycle. In light of the strong data, the Federal Reserve was able to hike interest rates once again at the September meeting for the third time this year, while leaving the dot plot projections unchanged, seeing one more rate hike in 2018, followed by three hikes in 2019 and a further hike in 2020. Fed Chair Powell in his press conference remained positive on the growth outlook and welcomed accelerating wage growth given that the board is currently seeing no signs of inflationary pressures at present.
- The market has since priced Fed hikes fairly close to its own dot plot, seeing another hike this year. In 2019, while the Fed has pencilled in a median of three hikes, the market is not too far behind and is now expecting a little more than two hikes. Importantly in our view, the latest rates sell-off and repricing of the Fed herein was driven by the strong growth numbers, rather than fears over inflation, as inflation expectations and breakevens have remained largely stable during this period, despite the move higher in oil prices. Our inflation view is similar to that of the Fed in that we do not see any significant inflationary pressures building up, despite a tightening labour market. This view is supported by anchored inflation expectations and the long term drivers of low productivity, technological change and demographics which are capping inflation rates. As such, and with the market now well priced out to 2019, our bias would be to fade further yield spikes in the US, where we will look to add back to duration once the rates market stabilises following the latest sell-off.

- In the Eurozone, the ECB stuck to its commitment of leaving rates unchanged through the summer of 2019, as well as reducing its asset purchases down to EUR15bn per month in Q4 from EUR30bn previously, in a process that is set to end fresh purchases by year-end. President Draghi did however surprise the market with a speech to Parliament, in which he commented on a relatively vigorous pick-up in underlying inflation and that domestic price pressures were strengthening and broadening. While wage growth is beginning to slowly pick-up, for now we see inflation as very much subdued. Furthermore the growth data including manufacturing PMIs have normalised from the highs where they began 2018 above 60 and now sit at the 53 level. As such, and despite Draghi's comments, we do not think that now is the time for the ECB to make any abrupt changes to their policy in Q4.
- In addition to the above, Italy remains an unresolved issue for the Eurozone, which the ECB will be watching with great caution. At the time of writing the Italian government has prepared a budget for 2019 that forecasts a deficit of 2.4% for 2019, 2.1% for 2020 and 1.8% for 2021, with growth estimates of 1.5%, 1.6% and 1.4% respectively. Comments from the European Commission thus far suggest that the growth forecasts are too optimistic, and that the policies are unlikely to be enough to bring down elevated debt levels, which has led to significant volatility in the BTP bond market. That said, ultimately we think that neither the Italians, nor the rest of the Eurozone would like to have to deal with another crisis, and as such a compromise should eventually be found.
- In contrast, the European authorities appear to be sounding increasingly conciliatory when it comes to the UK and a Brexit deal, with both sides aiming to have a withdrawal agreement in place by November. While the details are still sparse, investors appear to be positioning for an agreement, predicting that any deal for the UK would be better than the alternative of a no-deal scenario. Developments herein remain fluid, with the market likely to price in earlier rate hikes from the Bank of England if we were to get a reasonable agreement. The Bank of Japan meanwhile is set to have a relatively uneventful end to the year following its decision in July to tweak its Yield Curve Control policy, outlining a more sustainable policy by widening the trading range around the current 0% target for 10 year yields. At the same time, the BoJ once again revised down its inflation forecasts, which suggests that the current policy will remain intact for the foreseeable future.
- In light of the above, our bias would be to add back to both interest rate duration and credit exposure once rates markets settle and risk markets have navigated through some of the near-term uncertainties including the Italian budget, and the upcoming US mid-term elections. The fundamental macro backdrop remains supportive for risk markets in our opinion, given the robustness of global growth, which is being driven by the US, while inflation remains subdued. Furthermore despite fears related to trade wars, we are yet to see a significant slowdown in the data as of yet. In addition, the Chinese authorities appear to be reacting to any negative impact from the tariffs through rate cuts and stimulus policies which should stabilise growth somewhat. China has also been measured in its response to US tariffs, which suggests that they will not look to exacerbate market fears further by aggressively responding to Trump. In the near term however, a lack of clarity on how some of the risks described will unfold, coupled with a seemingly less liquid and deep market as central banks gradually remove accommodation, does warrant caution and a focus on optimising a portfolio's liquidity profile.

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