



UBAM - ABSOLUTE RETURN LOW VOL FIXED INCOME

Quarterly Comment | Q4 2018

Formerly: UBAM - Unconstrained Bond

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

Market Comment

- ◆ Risk markets came under significant pressure in October, with weakness led by US equities as the S&P was down 7% on the month. While Q3 earnings growth in the US remained largely impressive, investors reacted negatively to company outlooks for the year-ahead, given concerns related to margins, tariffs and Chinese growth. Economic data globally was also less supportive during the month as manufacturing PMIs missed to the downside in the Eurozone and China in particular, which only added to concerns. While Chinese authorities attempted to calm fears through various stimulus measures, the move higher in USD/CNY towards the closely watched 7 level kept investors cautious. As a result, both US and European investment grade credit spreads widened by 15 bps in October.
- ◆ Sentiment was not helped by Italy either, as BTP spreads widened by 37 bps on the month, crossing 300 bps as the European Commission responded to the government's 2019 budget target of 2.4% by requesting for it to be resubmitted, as it represented a significant deviation from the recommended adjustment path. This led to safe haven demand for German bunds, with 10 year yields rallying by 9 bps in October, in a move that was also helped by Draghi's ECB press conference, in which he acknowledged somewhat weaker momentum in the economy, as well as highlighted risks related to protectionism, EM and financial market volatility. In contrast, US 10 year yields rose by 8 bps in October despite the risk-off backdrop, as the equity sell-off and the tightening of financial conditions were not seen as large enough to put the Fed off its gradual hiking cycle given continued strength in the growth data as highlighted by the upside surprise in the Q3 GDP release
- ◆ In November, risk markets remained under pressure, resulting in both US and European investment grade credit spreads widening by 21 bps during the month. Negative sentiment was exacerbated by news related to Brexit, following domestic criticism to the withdrawal deal that Theresa May agreed with the European Commission. Developments herein put into question both the Prime Minister's position, as well as whether the deal would be able to pass through Parliament in the December vote, increasing tail risk scenarios. In addition, risk markets watched with caution as the European Commission published its opinion on Italy's revised budget plan, which resulted in the recommendation of an Excessive Deficit Procedure, with investors now awaiting the response of the Italian government to see if such action can be avoided.



- ◆ The move lower in oil prices also weighed on markets, as prices fell by over 20% as long positions were liquidated amid concerns related to demand given weak manufacturing PMIs in China and Europe, and whether OPEC and non-OPEC members can agree on a production cut at the December meeting. In light of the risk-off moves described here, US 10 year rates rallied by 15 bps in November given the bid for safe haven assets. The US rates rally was also driven by Fed pricing, as various board members, including Chair Powell himself, were seen to make comments leaning in the dovish direction. Powell for example said in a speech that rates remain “just below the broad range of estimates of the level that would be neutral for the economy” in contrast to October when he said that “we’re a long way from neutral at this point, probably”. As such, the market reacted by removing close to one hike from Fed pricing, now anticipating a hike in December and one more hike in 2019 in contrast to the Fed’s own dot plot which currently forecasts three hikes next year.
- ◆ Risk markets ended the year on a weak note in December, as US investment grade credit spreads widened by 13 bps on the month and European spreads widened by a more muted 3 bps. Moves were driven by continued concern related to trade, as the market did not react positively to US President Trump’s meeting with President Xi at the G20, in which the meeting only delivered a delay of 90 days to further tariffs on Chinese imports to provide time for more negotiations, rather than announcing any concrete solutions to end the trade war. Chinese growth data continued to suffer as a result, with the manufacturing PMI for December released at the end of the month moving into contractionary territory for the first time since mid-2017.
- ◆ Demand fears also resulted in crude oil prices falling below USD 50 for the first time since October 2017, despite the OPEC+ production cut agreement, and was one of the reasons cited for US risk markets underperforming herein. The Federal Reserve meeting was also unable to support risk sentiment, as market participants appeared to anticipate a more dovish outcome compared to what was delivered. In particular, although the median dot plot projection for 2019 moved lower to forecast two hikes from three hikes previously, the market did not take well to the phrase “some further gradual hikes” being included in the statement, and Chair Powell’s comment that there are no plans to change the balance sheet normalisation process. As a result of the risk-off moves described, US 10 year yields rallied by 27 bps on the month, with the market pricing out any rate hikes from the Fed in 2019. In line with the move in risk markets, the reaction of German bunds was also less significant, with 10 year Bunds rallying by 7 bps in December. The outperformance of European risk could largely be put down to reduced tail risks in Italy, as 10 year BTP spreads tightened by 40 bps in December following the Italian government’s decision to go back to the European Commission with a budget deficit of 2.04% of GDP, from 2.4% previously, in a compromise which is set to prevent the Commission from taking any negative action on the Italian sovereign.



Performance Review

- ◆ UBAM - Absolute Return Low Vol Fixed Income decreased 0.23% in Q4 before fees, -0.36% after fees (I Share class). In relative terms the strategy delivered 13bps gross below its reference index: the Eonia capitalization 7 days index.
- ◆ The excess returns for October were -11bps, -5bps for November and +3bps for December.
- ◆ The QTD, main contributor to the excess returns was duration at +17bps whereas the main detractor was exposure to CDS indices at -19bps.
- ◆ Volatility remained contained with a daily 12-month rolling volatility of 0.38%.

Portfolio Activity

- ◆ At the end of the quarter, the yield of the portfolio in EUR was 0.4% and 3.5% in USD (hedged share class).
- ◆ The interest rate exposure was 0.8 years and the credit exposure was 0.8 years at the end of December.
- ◆ In October, we remained relatively defensively positioned on credit explaining the resilience of the performance amidst risk aversion. The bulk of credit exposure continues to come from CDS indices. At the end of the month we added 0.2 year of risk adjusted spread duration on CDX HY as the equity led weakness provided an attractive entry point in an otherwise unchanged macro-economic backdrop of solid growth, low inflation and strong earnings. In parallel, we reduced USD interest rate exposure by 0.25 year to close to zero, as markets stabilised following the equity sell-off, and with US growth data continuing to print strong..
- ◆ In November, we reduced credit spread duration from 1.6 years down to 1.1 years over the month. After having increased CDX HY exposure towards the end of October (equity led weakness provided an attractive entry point in an otherwise unchanged macro-economic backdrop of solid growth, low inflation and strong earnings) we took profits during the second week of the month after the CDX HY index had rallied from 390 to 340 in spread terms, and in case the market started reacting to concerns over Chinese growth and the 20% move lower in oil prices. We further shifted the remaining European credit CDS index exposure (iTraxx Crossover) into US index exposure as uncertainties around the UK withdrawal process from the EU should weigh more heavily on European credit. On the rates side, we added 0.2 year of US duration exposure during the month to balance the portfolio's risk profile and as risk markets started trading poorly on Brexit developments and the drop in oil prices.
- ◆ In December, we further reduced the fund's credit spread duration from 1.1 years down to 0.8 years by reducing our exposure to CDX IG to protect the portfolio as risk sentiment remained weak with and market volatility and illiquidity increased. For the same reasons we modestly increased the portfolio's interest duration by 0.1 to 0.8 year.



Outlook

- ◆ Trade negotiations between the US and China remain at the forefront of investor concerns heading into 2019 given the March deadline for a deal to be agreed before tariffs on USD200bn worth of Chinese imports increases to 25% from 10%. This is especially the case given that the knock on effect from the trade war which was initially felt on Chinese growth, appears to now be spreading wider, as recently highlighted by the latest ISM manufacturing print in the US. Developments herein, coupled with the tightening in financial conditions observed towards the end of 2018 following the equity sell-off, has also led the Fed to temper its previous communication, with Chair Powell at the start of the year calming markets with his dovish tone. Brexit negotiations are also in focus in Q1 as the Article 50 deadline approaches at the end of March, although there still appears to be little clarity on how the process will play out from here.
- ◆ Following a stellar 2018, data for the US economy released in January has begun the year on a softer note following the dramatic decline in the closely followed manufacturing ISM, which dropped sharply to 54.1 from 59.3 the previous month, to the lowest level since 2016. While still well above the 50 expansion line, the steep decline in the forward-looking new orders sub index has led to some concern amongst investors that the US is not immune to the growth slowdown being observed in China and the Eurozone, especially as fiscal stimulus support will fade this year. On the other hand and more positively, the labour market has continued to strengthen, with the payrolls report released in January strong across the board. While the manufacturing survey is clearly off the highs, we believe that these were elevated levels in the survey, which could not be sustained for much longer. As such, we view the decline as likely being the first signs of a moderation in US growth, rather than a sharper slowdown towards a recession, which we still see little signs of at present.
- ◆ The Federal Reserve meanwhile has had to adjust its communication in the dovish direction since its December meeting, in light of recent market turbulence. The meeting itself was unable to provide support for risk markets despite the median dot for 2019 being lowered to two hikes from three hikes previously. Instead, the market was disappointed with the phrase “some further gradual” hikes being included in the statement, as well as Powell’s comment in the press conference that there are no plans to change the balance sheet normalisation process. Given the heightened volatility that ensued, Powell was forced to change his message in early January, where he highlighted the current risk management focus of the board. He said that he is listening carefully to the message of markets, taking downside risks into account. Furthermore he altered his comments regarding the balance sheet, saying that the normalisation process can be adjusted if the outlook were to change. This intervention from Powell was enough to support markets in the near term, and has left Fed pricing for this year largely non-existent at 0 bps, with modest cuts anticipated by investors in 2020.



- ◆ Communication from the ECB has been steadier, as the bank left intact its commitment to keep rates unchanged through the summer of 2019, while it smoothly managed to announce the end of fresh asset purchases at the December meeting. That said, in his opening statement President Draghi did acknowledge that incoming data has been weaker than expected, although this was put down to softer external demand. He also flagged how uncertainties related to geopolitical factors, protectionism, vulnerabilities in emerging markets and financial market volatility remain prominent. Given slowing growth in the Eurozone as highlighted by the fall in manufacturing PMIs, as well as still subdued inflation, we see it as unlikely that the ECB will be able to make any significant hawkish shifts to its policy or communication this year. Developments in Italy perhaps helped the ECB end its QE program with little market impact, as Italian BTP spreads bucked the risk-off trend and managed to tighten by a significant 40 bps in December. This followed the Italian government's decision to go back to the European Commission with a budget deficit of 2.04% of GDP, from 2.4% previously, in a compromise which is set to prevent the Commission from taking any negative action on the Italian sovereign.
- ◆ In light of the above, we feel that volatility is set to remain elevated in 2019 as the liquidity backdrop continues to turn less supportive as the ECB has ended fresh asset purchases and the Fed unwinds its balance sheet expansion. In addition, trade tariffs from the US have resulted in the synchronised global growth story of one year ago being halted, which is weighing on investor sentiment. That said, strong fundamentals in the US remain intact due to a robust labour market, recession risks still appearing far away and a subdued inflation backdrop. Furthermore the weakness in risk assets at the end of 2018 has led to valuations across equities and credit markets becoming more attractive, while positioning has also cleansed significantly. These factors should provide some support for markets at the start of 2019, especially if any positive developments can be made on the trade war front. In addition, we anticipate ongoing easing measures from the Chinese authorities to increasingly help the economy throughout the year, while positively, recent commentary from Fed officials also suggest that they are in favour of lengthening the expansion.
- ◆ With regards to inflation, we continue to see little inflationary pressures globally, where prices continue to be weighed down by long term factors such as demographics and low productivity. Furthermore fiscal stimulus in the US appears to have only provided a short term boost to the economy, rather than altering its potential growth rate. Given this view, our bias remains to add back to interest rate duration, especially in light of the uncertain risk backdrop described above. That said, in the near-term we see scope for rates to rise somewhat given 0 bps of hikes priced for the Fed in 2019, and so we prefer to wait for better levels to add back to duration. Overall, we remain focussed on optimising a portfolio's liquidity profile amid this environment given a seemingly less liquid and deep market, and the need to be more nimble and flexible as volatility rises.

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