

Delivering value in challenging fixed income markets through an unconstrained global bond fund

Petercam L Bonds Universalis

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In order to construct a robust global portfolio we need to be aware of and understand the mechanics that drive global fixed income markets. As per the end of April 2015 we run, manage and control risk factors within the Petercam L Bonds Universalis along the following lines of thought:

1. Interpretation of the ECB's QE programme

The question investors should ask is not IF but WHEN EGB core curve will normalize and leave negative rates behind them. It's a decision strategy based on 2 agents: one the one hand real money investors that have the fiduciary duty to protect capital and realize value in the face of inflated valuations on EGB's, on the other hand you have the ECB as 'must buy' agent. Portfolio rebalancing will occur between today and the end of the QE programme in September 2016. This game theory challenge will unfold so one should be prepared today and not tomorrow. Modeled against future size of ECB balance sheet and 10y Treasuries as priced by current forwards by September 2016 at 2.40% we arrive at a fair value for 10y German rates in between 1.00% and 1.20%.

2. The use of unconventional monetary policy instruments has become mainstream

This means that astute fixed income investors will, within the degrees of freedom provided by the UCITS framework, seek relative value in fixed income markets globally. Value is assessed in between the US Treasury curve at the top end and the Swiss, German and Japanese government bond curves at the bottom end. Buy attractive risk premia on USD bond curves (TIPS, US IG credit & USD EM credit) and sell rich, negative risk premia in € German and Japanese government bond markets. No need to go into the € periphery in search of value. The only condition that would allow for exposure towards for example Italy and Spain would lie in your assessment that political EU leadership will decide to mutualize part of the € EGB market. That would create an EMU debt office, issuing Eurobonds up to 60% of GDP, leaving the responsibility to fund above that level to each national DMO. Interest rate spreads to German Bunds would collapse and converge instantly to a degree that was witnessed in 2005-2006.

3. From long duration to short EUR/USD as the main driver of performance.

At the start of 2014 we constructed a global portfolio that was long in duration across regions/currencies. A solid 2014 calendar year performance was booked. By the end of 2014 we altered our main theme and shifted our construction towards a portfolio that would receive a tailwind under conditions that saw a depreciating EUR/USD pair. On the break of the flagged level around 1.21 the momentum accelerated and made a first bottom at 1.05 around mid-March, days after the ECB started on their QE purchase programme. We hold onto a positive tilt towards our USD allocation at around 47% of the fund against 38% towards the Euro currency. Our medium to long term assessment is that a revisit of December 2000 valuations on EUR/USD around 0.90 is to be expected. Key drivers of this revaluation are:

- Ascent of the Euro as a funding currency for global companies and making less use of the USD market
- Smaller supply in petrodollars given the change in power over oil supply towards the USA to the detriment of the Middle East
- Improving fiscal deficit as well as less drag from oil imports on the current account deficit for the US, again lower the USD funding needs.

Interest rate duration risks are present in USD component of the fund and are hedged to a large extent in our EUR component. Our allocation to other currencies remains subdued with 5.5% each to GBP credit and BRL government bonds. Allocations of 2% towards ZAR and 0.5% to NZD close our currency distribution. We refrain from investing in the Nordics and Eastern European currencies as we detect better value in specific USD and Euro fixed income sectors (please see below).

The Petercam Bonds Universalis main convictions are summarized as follows based on inventory end of April 2015:

- a. 10% allocation to US TIPS within the Inflation linked bond sector. Preference to longer end of the real curve given attractiveness of BE's (break-even rates of inflation) at 2.00%. We expect 30y BE's to adjust towards 2.5% over the medium term given Fed normalization and consolidating energy complex. Comparing real rates in US versus comparable levels in Europe, UK or Japan provides us attractive relative risk premia in USD TIPS.
- b. 37% allocation to quality USD Investment Grade credit (30% to US Corp and 7% to EM USD Corp). This allocation delivers an interest rate modified duration contribution at fund level of 5.25% versus 0.60% on the Euro component. The sectors that stand out are Technology (Apple & Oracle), Basic Resources (BHP, Vale and Anglo American) and Telecom (Verizon, AT&T).
- c. We apply interest rate hedges through short 30y & 10y Bund futures subtracting 1.40% and 0.32% respectively from portfolio duration. As explained in our comment on the ECB QE programme above we expect further normalization of DBR Bund yield curve over the coming year.
- d. The rate hedge through short 10y JGB's subtracts 2.81% from portfolio duration. The latter however has a very low beta to rates in US and Germany inducing us to apply a more aggressive hedge. We assess that Abe will eventually succeed in raising inflation and inflation expectations. We also witness a willingness to portfolio rebalancing by the state pension fund. On a macro level we pertain that the JGB market should internationalize given the shift away from being a structural CA surplus country.
- e. In order to dampen volatility arising from our credit exposure we apply a static tail risk hedge through a long protection iTraxx Crossover holding. We are prepared to pay a insurance premium (25bp per annum) in order to protect us from systemic worsening of credit spreads.
- f. The last conviction that we want to address is our positioning in € hybrid bonds. We carry an allocation of 9% to that increasing niche in European credit markets. Based on internal models we hold investments in the following names: Deutsche Annington (German real estate), Bayer, Volkswagen, EdF, Engie (GdF Suez) and Hutchison Whampoa.
- g. The Petercam L Bonds Universalis offers a yield of 2.62% for a portfolio mod duration (in %) of 4.02.

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