For Qualified Clients only

First State Investments

Quarterly Update

Global Fixed Income

Absolute Return Strategy

Q4 2018

Highlights

- The Absolute Return strategy returned -0.55% during the quarter[1].
- Interest rate positioning added value. Our primary winning positions were short US rates in October and a flattening of the German yield curve in October and November. We were neutral global yields during their sharp descent in November and December.
- Our HY corporate selection hurt the fund as our HY bonds broadly underperformed the market, particularly in the energy sector.
- IG corporate security selection produced positive performance with our positions outperforming the market.
- The biggest detractor to performance in the credit sector was the limited effectiveness of the synthetic hedges we employed as cash credit markets significantly underperformed synthetic credit markets.
- Our securitized holdings broke even. Short agency MBS positioning added value in October and November. This was offset by spread widening on our non-agency holdings, primarily in the ABS sector.
- Short EM positioning early in the quarter was a negative. We covered shortly before a sharp reversal to spread widening that occurred in November and December.

Market Review

US interest rates moved higher early in Q4, with the 10YR peaking at 3.24%. At that point, weakening global growth, trade concerns, and a sharp decline in oil and stock prices caused global interest rates to plummet. Brent oil fell from $83 to $54 and the S&P 500 declined 14%, including the worst December since the Great Depression. The US ten year yield fell 37 bps QOQ, ending at 2.69%. The drop in yield was driven by breakeven spreads rather than real yields. Breakevens fell 44 bps during the quarter, from 2.15% to 1.71%. Real yields actually rose 6 bps to 0.97%. Yield curve flattening stalled as the US 2-10 spread fell 4 bps to 0.20%. The USD strengthened at the start of the quarter as the theme of 'US exceptionalism' (US economic data besting other countries) was widely held by investors. However, as the US data softened as Q4 progressed, the exceptionalism theme has faded and the dollar has stabilized. Regional fed gauges, leading indicators, and manufacturing data notably slowed although stock and commodity market declines provided the most compelling evidence of an uncertain and perhaps weaker economic outlook.

Global rate markets moved in sync. German bund yields declined from 0.47% to 0.24%, the first sustained break below 0.30% since July. German data continued to disappoint with the PMI composite index falling to a four-year low. The widely expected ECB announcement in December that it would stop purchasing securities did little to halt the fall in yields, particularly as they described the risks to GDP growth as "moving to the downside." UK Gilt price action continues to be driven by 'Brexit' and the shifting probabilities between whether the UK leaves the EU in agreement, no agreement or even if the UK leaves at all. With PM May struggling to get her agreement with the EU through the UK Parliament, the possibility of the UK 'crashing out' of the EU with no deal has risen and hence yields have fallen both outright and verses bunds. It was a very volatile quarter for BTPs, with BTP/bund spreads widening to 325bp as the Italian government disappointed investors by announcing a larger than expected 2.4% deficit as part of its 2019 Budget. The size of the deficit was viewed by the market as likely to cause the European Commission (EC) to reject the Budget proposal and instigate an Excessive Deficit Procedure (EDP) against Italy. However, in a surprising move, after weeks of discussions between Brussels and Rome, a compromised was reached with the Italian government avoiding an EDP by reducing its deficit to 2%. As a result BTP/Bund spreads narrowed to 250bp. Australian bonds stopped outperforming global markets but kept pace with AUS 10YR yields falling 35 bps to 2.32%. Japanese 30 YR yields declined 20 bps to 0.70%.

Spread sectors struggled mightily during the quarter. The combination of lower oil prices, lower stock prices, weakening data, and concerns that US and China issues are too deep to resolve in the near-term all hurt sentiment. The US mid-term election had something for everyone with Democrats winning the House but Republicans retaining control of the Senate. The US government shut down is not expected to be a significant economic event but bodes ominously for US government cooperation over the next two years. Investors expected the December rate hike delivered by the Fed but were deeply disappointed the accompanying rhetoric was not more dovish.

IG corporate spreads widened 47 bps to +152, their widest levels since mid-2016. AAA CMBS spreads widened 28 bps to +105. HY took a sharp turn for the worse, widening 210 bps to +522. MBS was an outlier, widening 15 bps in October and November before tightening 10 bps in December. EM spreads widened 54 bps to +339. Although EM underperformed on an absolute basis, it greatly outperformed IG and HY corporates on a beta adjusted basis.

[1] First State Investments Absolute Return Composite. Past Performance is not indicative of future performance. Composite returns do not reflect the deduction of investment advisory fees. A client's return will be reduced by the investment fees. If a client placed $100,000 under management and a hypothetical gross return of 5% were achieved, the investment assets before fees would have grown to $162,889 in 10 years. However, if an advisory fee of 0.4% were charged, investment assets would have grown to $156,490, or an annual compounded rate of 4.6%.

Portfolio Performance

The Absolute Return strategy returned -0.55% during the quarter. The one year return is -0.06%[2].

Interest Rates and FX

Our macro positions outperformed, driven primarily by short positions in US rates in October and our flattening bias for the German yield curve throughout the quarter. We had short positions in both the US 2YR and 10YR rates. Our short positioning was predicated on strong US labor data and the belief that inflation pressures were building. The Fed expected to hike rates more than market pricing indicated and the market was moving in the Fed's direction in October. We went neutral in late October as equity weakness threatened to spill over into other markets. We were neutral global yields during their sharp descent in November and December. Our flattening view of German rates was predicated on lower German 10YR yields. Catalysts for German rates rotated between Italian stress, global equity weakness, and lousy European PMI trends. We also had a profitable tactical short position on Italy vs Germany in October. We have a skeptical view on Italy but substantial widening of BTP/Bund spreads in mid-2018 and severe sentiment based volatility make this a challenging relationship to trade.

We had some positions that underperformed. We positioned for wider 10YR swap spreads in the US. Before the crisis, 10YR swap spreads had been floored around +40 but they collapsed when after Fed crisis policy caused excess reserves to soar, ultimately taking swap spreads negative. We expected policy normalization should eventually move swap spreads significantly into positive territory. Unfortunately this is a long-term process. In the shorter-term, the tidal wave of US treasury issuance is overpowering long-term forces and holding swap spreads near zero. We also positioned for French yields to outperform German yields. Unfortunately OAT/Bund spread convergence trades faltered as protests in France coincided with weaker economic growth and forced President Macron to offer concessions that could push 2019 budget deficits over 3%. FX positions had minimal net impact.

Securitized Sectors

Our securitized holdings broke even. Short agency MBS positioning added value in October and November. This was offset by spread widening on our non-agency holdings, primarily in the ABS sector. Our negative view on agency MBS stemmed from low rate volatility that had more room to rise rather than fall. The supply/demand balance is stressed by Fed balance sheet runoff combined with high organic supply. Additionally, we viewed relative value as poor as spreads were at levels that historically have been difficult to sustain without quantitative tightening. We moved neutral in late November after spread widening improved relative value in the sector. Agency MBS benefitted from a flight to quality as prepayment concerns remain low, liquidity is superior to other spread sectors, and rate volatility increased less than spread sector risk premiums. Our ABS, CMBS, and non-agency MBS holdings widened in sympathy with all risk assets in the 4th quarter. Losses on our holdings were modest because we were conservatively positioned in anticipation that a risk meltdown was possible. We also took profits on some sectors including timeshares and structured settlements before spreads widened. In general, the securitized markets outperformed corporate markets as consumer balance sheets are strong, the economy remains near full employment, and construction has been restrained since the financial crisis.

Corporate Markets

We entered the 4th quarter neutral IG credit as we viewed valuations as rich given the potential headwinds. We maintained our neutral stance as spreads softened through the final half of the quarter as sentiment turned more negative and the technical backdrop eroded with IG credit failing to find support. During December we actively reduced IG beta in the portfolio as credit spreads leaked to multiyear wides. Late in the quarter we entered an IG spread curve steepener as credit curves had become unsustainably flat heading into the end of the year with the backend having limited sponsorship and the more liquid intermediate part of the curve bearing a disproportionate share of the selloff. IG security selection added value throughout the quarter, both from our overweight positions as well as our active underweights in names that underperformed. Our short HY position early in the quarter produced positive performance as the HY market sold off after HY spreads had collapsed to their post crisis tights. We maintained a neutral position in HY throughout the remainder of the quarter as HY spreads continued to widen. HY security selection detracted from performance as the names we owned underperformed the market. We used EM CDX to short EM spreads during the quarter which detracted modestly from performance as spreads tightened before we moved the position to neutral. The biggest detractor from performance in credit during the quarter was the significant decompression of the basis between our IG and HY cash bonds and the synthetic hedges we employed, especially late in the quarter.

Outlook

Markets closed 2018 on a sour note and our positioning is light going into 2019. We are concerned about slowing global growth, tightening monetary policy, and the late cycle nature of the environment. Interest rates have been falling but we are concerned about how sustainable that trend is. As a result we have no outright interest rate positions on although we still have a flattening position in Germany. We are looking for an entry point to favor UK rates vs Germany on Brexit stress and to short France vs Germany on weak growth and growing budget strains in France. US breakeven rates look cheap and we intend to go long them if oil prices stabilize and the Fed becomes more dovish.

We are cautious on risk markets overall, particularly in corporates. The liquidity risk index has climbed to late 2015 levels. Some of this probably reflects year end stress that may diminish and provide opportunities to go long in January. This will be particularly true if the Fed becomes patient in its approach to interest rate hikes. Another potential positive catalyst would be a breakthrough on US/China trade talks. Long side opportunities appear more relevant for securitized sectors that are in better fundamental and technical shape than corporate sectors.

We are more likely to view a first quarter improvement in risk markets as an opportunity to sell risky securities than to buy them although the dynamics vary by sector. A halt in rate hikes will be helpful but risks remain. Debt levels are high, policy support is fading, and QE policies that supported the market for so long are being slowly reversed. Spread market volatility has increased which should create opportunities for both long and short position opportunities in 2019.

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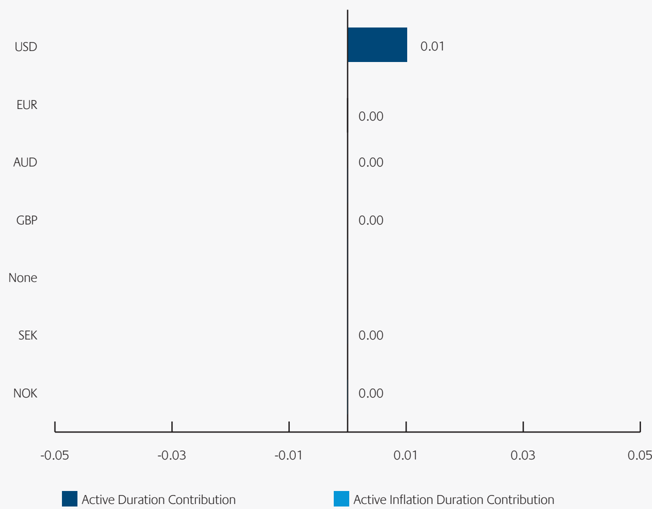
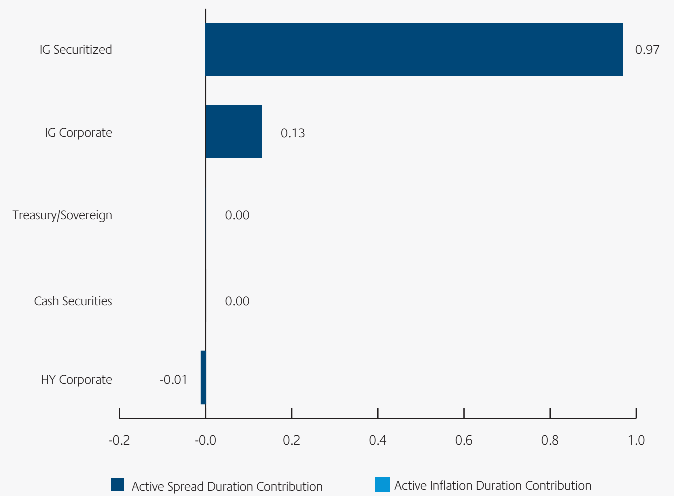
Active Duration Contribution by Currency



Source: First State Investments

Active Spread Duration Contribution



Source: First State Investments

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