

UBS ETF *Market Matters*

ECB's QE ... any yield left?

- The ECB presented on January 22, the details of the expanded asset purchase programme, incl. purchases of Eurozone sovereign bonds amounting to EUR60 billion a month.
- It appears that the only "yielding papers" of Eurozone sovereign issuers are long-term ones (10+ or so).
- The incremental yield can be 'sourced from' EUR corporate bonds, and this *market matters* discusses two corporate bond investible indices with sizable allocation in the lower end of the investment grade segment.

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The Governing Council of the European Central Bank's (ECB) has presented on January 22, the details of the expanded asset purchase programme (Quantitative Easing, QE). The key points are as follows (Source: ECB, 22 January 2015):

- ECB expands purchases to include bonds issued by euro area central governments, agencies and European institutions
- Combined monthly asset purchases to amount to EUR60 billion
- Purchases intended to be carried out until at least Sep. 2016
- Programme designed to fulfil price stability mandate

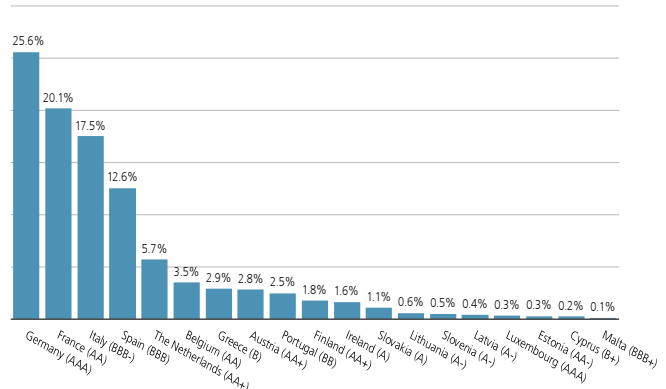
The EUR1.1tn monetary stimulus aims to support investment and consumption in the Eurozone, which ultimately should move inflation rates towards the target of 2%. The ECB will buy bonds (on the yield curve, up to 30 years) in the secondary market. The purchases of securities will be based on the National Central Banks' shares in the ECB's capital key (**Figure 1**), however, not more than 25% of each issue, and not more than 33% of each issuer's debt.

The ECB QE had been largely "priced into" sovereign debt. **Figure 2** shows the yields of the iBoxx EUR Germany of different maturity buckets. Last year was characterized by a *straight-line* decay of German yields, including all maturity buckets, and into to negative territory for the mid-term (up to five years). The portfolio yield for the iBoxx EUR Sovereigns - a market-value weighted basket of Eurozone sovereign issuers listed in Figure 1 - has also experienced a sharp decline from its peaks in 2011-2012, in particular driven by the intensified anticipation of the QE. Consequently, the spreads of the iBoxx EUR Sovereigns over German Bunds are nearly back to 2009 levels, when the Greek debt crisis escalated (**Figure 3**), approx. 30bps for the 1-5 bucket and 60bps for the 10+ bucket. The spread of the Italian bonds is approx. 160bps for iBoxx EUR Italy 10+ long-end bucket (c. 70bps premium as compared to June '09 level), and approx. 60bps on the short-end 1-5 years (c. 15bps premium to June '09). It appears that the only "yielding papers" of Eurozone sovereign issuers are long-term ones. The prospective implication of the QE is that investors will likely get "crowded out" from sovereign market, leading to a continued appetite for corporate credit.

Corporate Yield Pick-Up

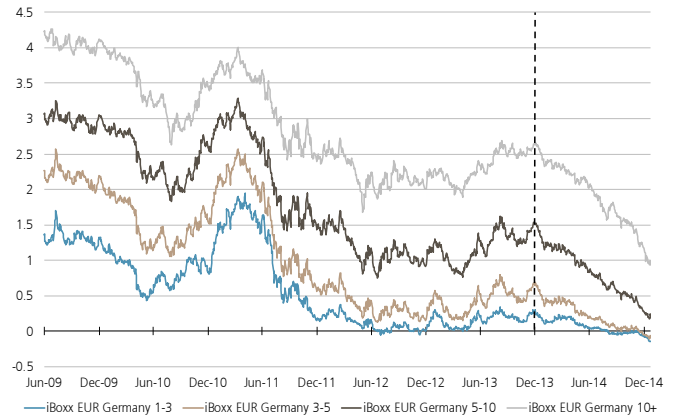
The current landscape of EUR-denominated bond indices is summarized in **Table 1**. The Barclays Euro-Aggregate Corporates benchmark delivers a yield of 98bps as compared to the 68bps of the Barclays Euro-Aggregate Treasury. Higher yield is associated with higher credit risk (prime grade vs. default risk), with longer duration (interest rate risk) or a liquidity premium (investment grade vs. high yield issues).

Figure 1: NCBs' contributions to the ECB's capital and long-term sovereign S&P ratings



Source: ECB, S&P, as of 2 January 2015

Figure 2: Annualized yield (in %)



Source: Markit, as of 22 January 2015

Figure 3: Annualized benchmark spread (in bps)



Source: Markit, as of 22 January 2015;

*Annualized benchmark spread for iBoxx EUR Italy 1-5 is computed as the average benchmark spread of the iBoxx EUR Italy 1-3 and iBoxx EUR Italy 3-5.

For all charts/tables: Past performance is not a reliable indicator for the future.

Table 1: EUR Fixed Income Aggregates: Landscape

Benchmark	Yield to Maturity	Modified Duration	Maturity (in Years)
Barclays Euro-Aggregate: Corporates	0.98	4.91	5.53
Barclays Euro-Aggregate: Corporates 1-3	0.50	1.91	2.00
Barclays Euro-Aggregate: Corporates 10+	1.82	10.52	13.15
Barclays Euro-Aggregate: Corporate Aaa	0.87	8.28	9.57
Barclays Euro-Aggregate: Corporate Baa	1.26	4.74	5.40
Barclays Euro-Aggregate: Treasury	0.68	7.14	9.02
Barclays Pan-European High Yield (Euro)	4.07	3.88	4.77

Source: Barclays POINT, Markit, UBS Global AM, as of 22 January 2015

Figure 4 shows the historical compositions of the credit quality for investment grade (IG) and high yield (HY) segments. The lower-rated IG segments (A-Baa) have expanded, at the cost of the prime credit segment (Aaa). Notably, the market value of the European HY segment (right panel) is highly volatile: it enjoyed a substantial increase in 2010-2012 (increase in net new issuances and uplifting valuations), after it had significantly contracted in 2008 due to credit stress.

In the Euro-Aggregate Corporates, the market value of Euro Area issuers is approx. 60%. In particular, the yield pick-up is decomposed in **Figure 5** at the issuer country level, ordered clock-wise by decreasing yield. The yield contributions come from emerging market issuers (China, Turkey, Brazil or India), whose market value is however marginal, and from US and UK issuers, who *yield* more than the average Eurozone issuer, and who have a combined market share of 25%.

Investible Corporate Bond Indices

The investible indices typically under-represent the aggregate universe by selecting a certain maturity range, credit quality, seniority, liquid issues, risk of domicile, etc.. UBS WM CIO sees the best risk-return relationship in or just below the lower end of the investment grade segment Baa (UBS Chief Investment Office WM, 20 January 2015). Two examples of indices with substantial exposure to the lower end of the investment grade segment are the Barclays Euro Area Liquid Corporates 1-5 index and the iBoxx EUR Liquid Corporates index (details in **Table 2**).

The Barclays Euro Area Liquid Corporates 1-5 year index captures liquid short-end bonds issued by Euro Area corporates. This index has approx. 14% excess allocation to the lowest IG credit as compared to the Barclays Euro-Aggregate Corporates presented in Figure 4 (i.e. 56% vs. 42%).

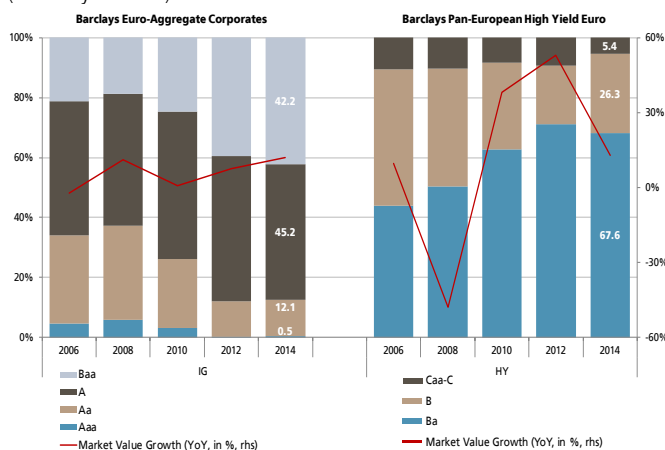
The iBoxx EUR Liquid Corporates index captures EUR-denominated bonds (incl. issuers from the US, UK or Australia), and it partially 'imports' the yield from outside the Eurozone, in a similar way as in Figure 5. For example, 28% of this index is exposed towards non-Eurozone corporates, and it captures EUR-denominated bonds from some major US and UK financial institutions (e.g. Citigroup, Bank of America, Toyota Motor Credit Corp., or Barclays Bank Plc, Lloyds Bank Plc, respectively), with the spreads (of some issues) higher than 100bps against German bunds. The implementation of the QE starting in March is likely to further tighten the spreads in EUR corporate bonds.

Table 3: Euro Fixed Income UBS ETFs

Fund name	TER	AuM	Base Ccy.	Replication	Domicile	Distribution	Incept. date	ISIN	WKN
UBS ETF (LU) Barclays Euro Area Liquid Corporates 1-5 UCITS ETF (EUR) A-dis	0.18%	106	EUR	Physical	Luxemburg	semi-annual	30.05.2014	LU1048314196	A110QF
UBS ETF (LU) Markit iBoxx € Liquid Corporates UCITS ETF (EUR) A-dis	0.20%	60	EUR	Physical	Luxemburg	semi-annual	24.01.2012	LU0721553864	A1JRDJ
UBS ETF (LU) Markit iBoxx € Germany 1-3 UCITS ETF (EUR) A-dis	0.17%	139	EUR	Physical	Luxemburg	semi-annual	24.01.2012	LU0721553351	A1JRDF
UBS ETF (LU) Markit iBoxx € Germany 3-5 UCITS ETF (EUR) A-dis	0.17%	4	EUR	Physical	Luxemburg	semi-annual	24.01.2012	LU0721553435	A1JRDG
UBS ETF (LU) Markit iBoxx € Germany 5-10 UCITS ETF (EUR) A-dis	0.17%	28	EUR	Physical	Luxemburg	semi-annual	24.01.2012	LU0721553518	A1JRDH
UBS ETF (LU) Markit iBoxx € Germany 7-10 UCITS ETF (EUR) A-dis	0.17%	8	EUR	Physical	Luxemburg	semi-annual	24.01.2012	LU0721553609	A1JRDI
UBS ETF – Markit iBoxx € Sovereigns 1-5 UCITS ETF (EUR) A-dis	0.17%	3	EUR	Physical	Luxemburg	semi-annual	29.11.2013	LU0969639128	A1W40U

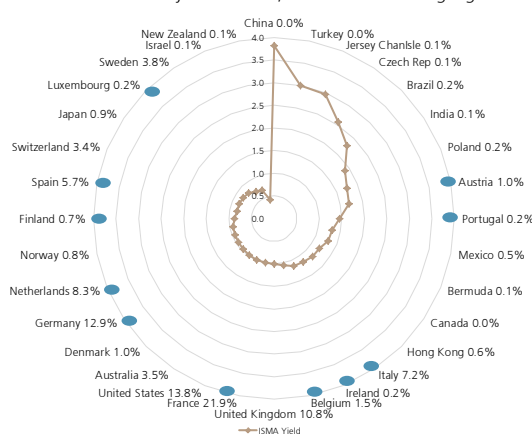
AuM in EUR, million

Figure 4: European Bond Market: Credit Quality and Market Value (end-of-year data)



Source: Barclays POINT, UBS Global AM, as of 31 December 2014

Figure 5: Barclays Euro-Aggregate Corporates: Yield (Market value behind country name in %, Euro Area issuer highlighted in blue)



Source: Barclays POINT, Markit, UBS Global AM, as of 22 January 2014

Table 2: EUR Fixed Income Investible Indices

Benchmark	Yield to Maturity	Modified Duration	Maturity (in Years)	Baa	Euro Area
Barclays Euro Area Liquid Corporates 1-5	0.62	2.91	3.07	56%	100%
iBoxx EUR Liquid Corporates	0.74	4.56	4.83	24%	72%

Source: Barclays POINT, Markit, UBS Global AM, as of 22 January 2014

For all charts/tables: Past performance is not a reliable indicator for the future.

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