UBS ETF *Market Matters*

CHF bonds and passive opportunities

- The Swiss Confederation just announced it plans to reduce the issuance of government bonds in 2H 2015 due to "higher-than-average" liquidity. The new target is said to be CHF 3-4bn for 2015, down from CHF 7bn in 2014. With CHF 3.3bn already issued in 1H 2015, limited volume is to be expected in 2H 2015.
- For investors seeking CHF-denominated fixed income investments, this move implies they should consider bond issues from other providers (domestic or foreign issuers), or to purchase existing papers from the secondary market.
- In light of this scenario, two options based on indexed-investments are discussed: Mortgage Bond Institutions (performance captured by the SBI® Domestic Swiss Pfandbrief Index) and Investment Grade Foreign Issuers (SBI® Foreign AAA-BBB Index). Both have outperformed the domestic government benchmark (SBI® Domestic Government) in recent years.

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The Swiss Confederation has substantially reduced the issuance of new debt in recent months, turning to net negative, the first time since 2012 (**Figure 1**). It will be also conservative when issuing in the second half of 2015 (Source: Swiss Confederation, 4 August 2015). For investors seeking CHF-denominated fixed income investments, this move implies they should consider bond issues from other issuers (domestic or foreign), or papers listed in the secondary market.

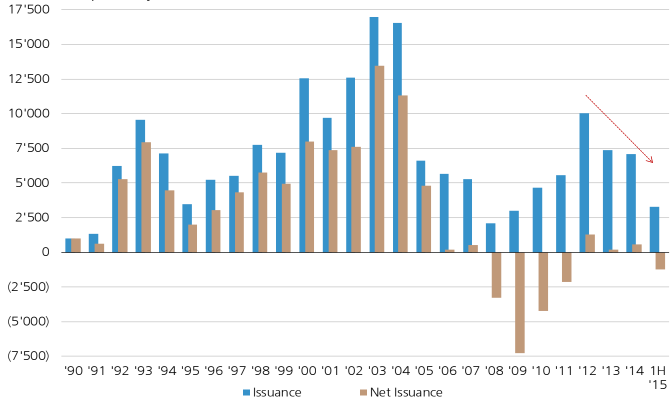
Domestic volume providers: Pfandbriefe at peak

In the last four years, the CHF-bond issuance by Swiss domestic issuers amounted to a net average (issuance less repayment) of approx. CHF 19bn p.a. This is a substantial increase compared to the long net average (between 1990-2010) of approx. CHF 7bn p.a. Looking at the breakdown by issuer type (**Figure 2**) it becomes apparent that the Swiss mortgage bond institutions (Pfandbriefe[1]) currently dominate the primary market by providing approx. 40% of net volume in recent years. In contrast, the role of the Swiss Confederation appears minor, e.g. an average 3% of net volume in 2012-2014. While the Treasury currently enjoys "higher-than-average liquidity", and thus limits issuance, domestic financial and industry corporate issuers as well as Pfandbriefe issuers have taken advantage of more favourable interest rates to issue more aggressively (**Figure 3**). The continuous increase in volume since 2009 is striking in both segments. For example, Pfandbriefe volume reached more than CHF 16bn (CHF 9.5bn in net terms) in 2014, incl. private placements. Nearly CHF 9bn of Pfandbrief volume has already been issued in 1H 2015 (CHF 5.5bn net), making a new peak likely this year. Increased issuance has led Pfandbriefe be the largest segment, with 29% of total domestic debt outstanding comparing to 25% share of Eidgenossen (Source: Federal Treasury, Activity Report, March 2015).

Foreign volume providers: On hold

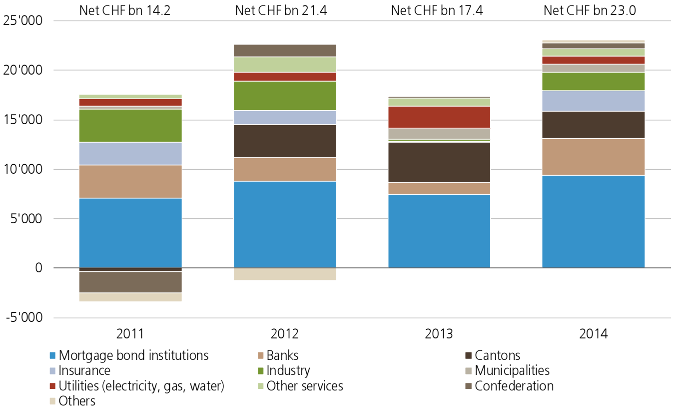
The Swiss capital market has been attractive for highly rated foreign issuers, due to regulation, market size and supportive interest rate differentials. For example, the average interest rate differential between 6m CHF Libor and 6m EUR Libor between 2000-2010 was -150bps, and -160bps vs. 6m USD Libor, respectively. For issuers from emerging countries, rate differentials were even more favourable. Accordingly, foreign issuers (mostly Eurozone, Scandinavia, North America or Asia-Pacific) have been funding their debt needs in the Swiss capital market at lower costs, and swapping the exposure back to their *home* currency (e.g. using cross currency basis swaps). **Figure 4**

Figure 1: CHF Bond Issuance by Confederation (in CHF mn)
(based on quarterly data from 1Q 1990 to 2Q 2015)



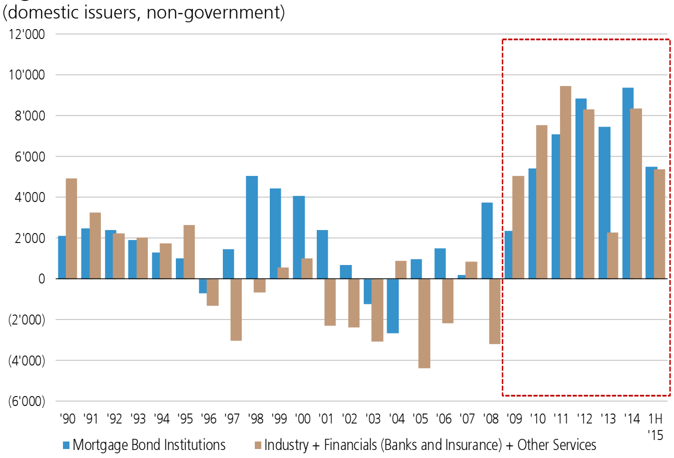
Source: SNB, Monthly Statistical Bulletin. UBS Global AM, as of 31 July 2015

Figure 2: Net issuance of CHF Bonds – by domestic issuer (in CHF mn)



Source: SNB, Monthly Statistical Bulletin. UBS Global AM, as of 31 July 2015

Figure 3: Net issuance of CHF Bonds (in CHF mn)
(domestic issuers, non-government)



Source: SNB, Monthly Statistical Bulletin. UBS Global AM, as of 31 July 2015

[1] Only two institutions are legally authorized to issue Pfandbriefe in Switzerland: The Pfandbriefbank schweizerischer Hypothekarinstitute (PBB) and The Pfandbriefzentrale der schweizerischen Kantonalbanken (PBZ).

presents aggregate (government and non-government) net issuance of CHF-bonds by domestic and foreign issuers, stressing a remarkable alteration from 2010 onwards. While domestic issuers have added net positive volume, foreign bond issuers have repaid more than they have issued, reducing their total outstanding CHF-denominated debt. This is largely due to cuts in global rates and a negative basis spread, which have led to an increase in funding costs of swap-covered CHF-issuances.

Low rates and negative basis spread

While interest rate differentials were favourable to foreign issuers for fund raising in the Swiss capital market for a long time, the post-financial-crisis monetary easing policies led to significant cuts in rates globally. For example, the average rate differential between 6m CHF Libor and 6m EUR Libor between 2011-1H 2015 has compressed to -60bps, and -50bps vs. 6m USD Libor, respectively. The *arbitrage* incentive for CHF-issuance has thus partly faded away, simply by comparing rate differentials. More importantly however, the USDCHF basis spread has become significantly negative, also for EURCHF, see **Figure 5**. A positive (negative) basis swap spread x indicates that a counterparty entering a swap with US dollars - market standard is to quote against USD Libor - for a foreign currency must pay *x* basis points above (below) the benchmark rate on foreign currency funds in return for USD Libor reference rate. As shown in Figure 5, CHF currency basis swap spreads were near-zero till the beginning of 2008, and then turned negative. The more negative the basis spread is, the more expensive is the swap-covered issuance in Swiss francs by foreign issuers (in particular USD), and the more attractive the purchase of CHF bonds. Low rates and negative basis spreads can explain a combined increase in domestic volume with a substantial decrease in foreign volume.

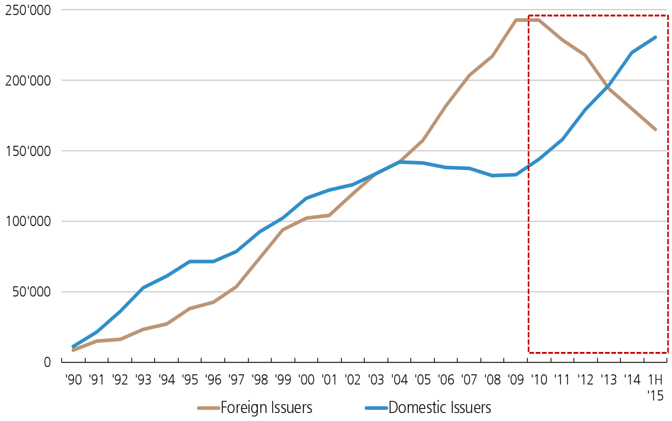
Passive Opportunities

Investors seeking CHF-bonds should consider fixed income benchmarks accessible via Exchange Traded Funds. While a standard *buy-and-hold* investment through the primary market limits the impact of interest rate changes on a total performance (as it is held until maturity), the ETF *rolls-over* the underlying eligible-for-index bonds before their mature; in other words the ETF sells issues near their expiry date (typically one year) and buys the recently-issued ones, or those fitting basket constraints (e.g. only five-to-ten years). The price return component of the fixed income ETF can thus be material; positive with decreasing interest rates, and negative in the opposing scenario. **Figure 6** shows performance of the CHF-based fixed income benchmarks, comparable on the basket maturity basis:

- Long-maturity exposure has outperformed its short-maturity counterparts in absolute terms (at a higher interest rate risk, and at a higher volatility).
- Foreign issuers exposure has outperformed domestic exposure (at a higher credit risk), whilst domestic Pfandbriefe have outperformed the Eidgenossen (at a higher credit risk).
- Even though foreign issuers are *yielding* higher (to compensate for higher credit risk), the biggest contribution comes from price component, as yields have decreased substantially overall over that period, as has volume.

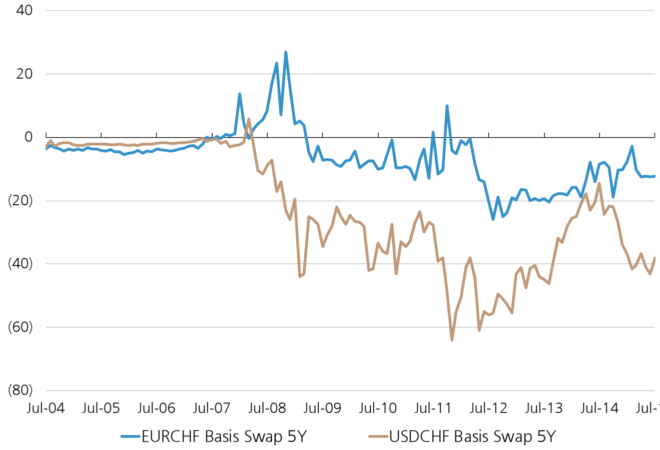
It seems likely that domestic treasuries (despite negative yields) and high quality foreign issuers will feature in near future excess demand due to downward trends in volume.

Figure 4: Cumulated Net Issuance of CHF Bonds of Domestic vs. Foreign Issuers (in CHF mn)



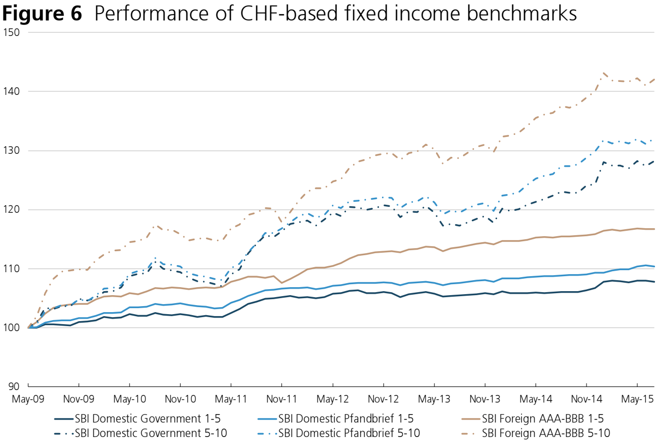
Source: SNB, Monthly Statistical Bulletin. UBS Global AM, as of 31 July 2015

Figure 5: Cross Currency Basis Spread (in bps)



Source: Bloomberg, UBS Global AM, as of 30 June 2015

Figure 6 Performance of CHF-based fixed income benchmarks



Source: UBS Global AM, as of 30 June 2015

Past performance is not a reliable indicator for the future.

Table 1: Passive opportunities for CHF-bonds.

Fund name	TER (ex ante)	AUM (in CHF, mn)	Base currency	Yield	Duration	Replication	Distribution	Domicile	Launch	ISIN	Valor
UBS ETF (CH) SBI® Domestic Government 1-3	0.15%	115	CHF	-0.84	1.89	Full replication	Distributing	Switzerland	29.11.2010	CH0118923876	11 892 387
UBS ETF (CH) SBI® Domestic Government 3-7	0.15%	105	CHF	-0.63	4.82	Full replication	Distributing	Switzerland	29.11.2010	CH0118923892	11 892 389
UBS ETF (CH) SBI® Domestic Government 7-15	0.15%	9	CHF	-0.12	9.28	Full replication	Distributing	Switzerland	29.11.2010	CH0118923918	11 892 391
UBS ETF (CH) SBI® Domestic Pfandbrief 1-5	0.20%	17	CHF	-0.35	2.82	Full replication	Distributing	Switzerland	16.08.2012	CH0184305016	18 430 501
UBS ETF (CH) SBI® Domestic Pfandbrief 5-10	0.20%	7	CHF	0.02	6.98	Full replication	Distributing	Switzerland	16.08.2012	CH0184308952	18 430 895
UBS ETF (LU) SBI® Foreign AAA-BBB 1-5 UCITS ETF	0.20%	144	CHF	-0.12	2.79	Full replication	Distributing	Luxemburg	30.07.2013	LU0879397742	20 557 004
UBS ETF (LU) SBI® Foreign AAA-BBB 5-10 UCITS ETF	0.20%	79	CHF	0.23	6.67	Full replication	Distributing	Luxemburg	30.07.2013	LU0879399441	20 557 019

Source: UBS Global Asset Management. As of 19 August 2015.

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Index-tracking investment solutions have been a core competence of UBS Global Asset Management for over 30 years. As a leading fund house in Europe, UBS launched its first ETF in Europe in 2001 and is currently both one of Europe´s foremost providers as well as a dominant force in currency hedged ETFs in the region. The range comprises more than 160 ETFs and offers investors a transparent and flexible opportunity to diversify their investments across key markets and all asset classes, including equities, bonds, real estate, commodities and alternative investments. UBS ETFs are listed on the following stock exchanges around the world – the SIX Swiss Exchange, Borsa Italiana, London Stock Exchange, XETRA Germany, the Australia Exchange ASX, the KRX Korea Exchange and the Tokyo Stock Exchange.

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