Kevin Zhao on global active fixed income strategies

Q&A with Kevin Zhao, Lead Portfolio Manager of UBS Global Dynamic Bond strategy and Head of Global Sovereign and Currency, Fixed Income

Q: Does the current market environment for fixed income investing remind you of a similar situation in the past?
A: The current market environment has some similarities with 1995, 2014 and early 2016, when the Fed had either tightened monetary policy or turned hawkish. The common feature of these previous episodes was a positive environment for risky assets such as equities and selective carry-based investment strategies.

Q: Is active management in the fixed income area becoming more important as volatility is on a higher level than during the past years?
A: Active managers should do well in those market conditions where volatility is reasonably high or correlation is relatively low. Historical evidence has shown that active managers in fixed income have generally outperformed passive index trackers with no particular changing patterns over time. There are a couple of reasons behind better active performance in fixed income including far more securities in aggregate bond indices than in major stock indices, higher transaction costs for passive fund rebalancing and new issue discounts for active managers participating in auctions and syndications. Furthermore, insightful managers could anticipate monetary policy changes ahead of time with well-defined central bank reaction functions to anchor inflation expectations and to maintain macro stability.

Q: It looks as though there won’t be a further interest rate hike, either by the Fed nor by the European Central Bank in the coming months. How should fixed income investors position themselves in this situation?
A: We agree with this characterisation of the Fed and the ECB. We had anticipated before the last rate hike in December 2018 that the Fed would stop tightening. A lack of inflationary pressure globally allows most central banks to pause or not to start tightening even though unemployment rates have fallen near or below the prior cycle low. The Phillips Curve is neither linear nor stable over time. And with realised inflation well below central bank targets since 2008, we believe there is no need for monetary policies to be pre-emptive at this point of the economic cycle, especially under the structural headwind of global disinflation.

Therefore, we think that in the months ahead, with none of the central banks tightening, high quality credit and emerging market bonds with reasonably good fundamentals should perform well. However, we will continue to seek well diversified strategies to generate attractive risk adjusted returns for investors, rather than purely relying on earning carry.

Q: How can an active fixed income manager benefit from the divergence in central bank policies?
A: We have anticipated and proactively exploited opportunities in central bank policy divergence over the past 3-4 years. For instance, we went very short US bonds in September 2017 in anticipation of the Fed restarting a tightening cycle. We then went significantly long duration later in 2018 on emerging signs that the Fed dots of further rate hikes in 2019 and 2020 were unjustified as inflation had not overshot its 2% target in spite of the very low unemployment rate and weakening growth in the rest of the world. Similarly, in August 2017 we went short the U.K. versus long duration in New Zealand in anticipation of the BoE raising rates in contrast to a dovish tilt by the RBNZ.

1 The Phillips curve states that inflation and unemployment have an inverse relationship. Higher inflation is associated with lower unemployment and vice versa. The economic concept behind it was developed by Alban W. Phillips.
Q: What is your view on the latest discussions about independence of central banks? Will we see more pressure from politicians on central banks going forward, or is the US just an exception?
A: We believe that central banks’ operational independence will be largely maintained even though central banks, as a branch of government, cannot be totally independent. In other words, there will always be some evolutionary changes in the governance of central banks in response to political pressure as well as changing economic circumstances. The recent political interference in the Fed was more related to President Trump’s personal style of governing, and we believe that the Fed will survive largely unscathed by the end of the Trump presidency. In contrast, we don’t see much merit in the so called Modern Monetary Theory (MMT), and if adopted fully by any major country, would be a disaster for current bond holders.

Q: The UBS Global Dynamic Bond strategy has a very flexible investment approach. Can you give us an example of a recent market situation when this flexibility added value?
A: The flexibility allows us to deviate significantly from market duration and country weights and when opportunities are compelling to invest in emerging market and high yield bonds that are not included in the widely followed Bloomberg/BarCap Global Aggregate Bond Index.

At the overall portfolio level, we have maintained quite low duration since the strategy’s inception in June 2013. There are two exceptions however: the first was in late 2013 when duration was more than five years after bond yields rose sharply following the taper tantrum, and the second time was just before the 2016 US election with a duration over six years when we used long duration to hedge the portfolio’s exposure to credit.

We have used the flexible mandate to add alpha in cross country monetary policy divergence trades (please see the examples in question 4) and also in relative value between inflation linked bonds and nominal bonds. We were long inflation linked bonds on attractive real yields such as in US TIPS at the end of 2018 and inflation linked bonds in New Zealand in 2017 and most of 2018. Recently we have shifted the portfolio to benefit from cheap breakeven inflation in New Zealand by paying fixed rate swaps to hedge the duration risk of inflation-linked bonds.

Q: What were the main positive and negative performance drivers over the past 12 months?
A: Our strategy delivered very strong positive returns due to its timely switch to long duration in the US in early Q4 and long duration in New Zealand and Australia, while our exposure to risky credit was relatively moderate. What distinguishes us is that our portfolio has benefited from a variety of diversified positions, such as our long duration in the US, long credit and emerging market, as well as active currency management. The main negative contributors came from short duration in Japan and exposure to emerging markets during the first half of 2018.

Q: What is your market outlook for the coming months? How have you positioned the portfolio?
A: Currently, duration is relative low, which implies that we think in most bond markets investors are not adequately compensated by the very low yields for taking very long duration risk, particularly in Japan, Germany, Switzerland and Sweden.

As in recent years, we focus on relative value opportunities by going long the countries, such as the US and New Zealand, where we believe there is significant room for central banks to cut rates if growth suddenly falls below potential or if inflation stays significantly below the central banks’ target. In addition, we have moderate exposure to both IG and HY corporate bonds to earn positive carry, as well as diversified exposure in a few emerging markets for both carry and relative value opportunities.
Q: What do you see as the biggest risk for global markets?
A: Since the election of President Trump, we believed that the biggest risk to global markets is neither Fed tightening nor China slowdown, but a US initiated trade war, followed by retaliation from major trading partners. The Great Depression was preceded by the passing of protectionist legislation in the form of the Smoot-Hawley Act in June 1930. We continue to believe the biggest risk is a global trade war.

Recently there has been a turn in trade negotiations between the US and China, indicating some setback following a period with significant progress being reported. The tariff measures announced by the Trump administration have increased, but so far they are still sector specific and are aimed at boosting his chances of re-election. There is a fine line to walk and talks could break down at any time even though there are strong incentives for both Presidents to do a deal. At this stage we think the overall impact on the global economy is still reasonably contained and see a widespread global trade war as the major tail risk.

Our response is to have below average portfolio risk, long duration in the US and China, below average exposure to credit such as investment grade and high yield, and to minimize exposure to currencies such as CAD, AUD, NZD, TWD, KRW, etc. which are highly dependent on foreign trade.

Q: The Global Dynamic Bond strategy is not allowed to have net overall short exposure to interest rates or credit markets. What are the main reasons for these restrictions?
A: The main purpose is to make it similar to other core bond strategies by maintaining an overall positive exposure to the bond market and earning a positive income/coupon. This contrasts with absolute return strategies which normally aim to outperform cash by having the freedom to go overall short in duration.

Our strategy also distinguishes itself from leveraged investment products by prohibiting borrowing of any individual security which will limit contingent liabilities that might arise from going short by borrowing securities in the market as commonly used by hedge funds.

In summary, having duration between zero and 10 years as well as positive exposure to higher yielding credit markets enables the portfolio to earn attractive income and benefit from falling bond yields during periods of risk-off or declining inflation, while at the same time giving the portfolio manager reasonable flexibility in seeking attractive investment opportunities through active rates, currency and credit management.

Q: What is the UBS Global Dynamic strategy’s investment approach?
A: The strategy’s investment approach is based on a 4 step dynamic investment process by combining both long-term fundamentals and short-term technical and market dynamics.
– dynamic allocation by keeping just ahead of the curve into a country or asset class before it becomes popular.
– truly diversified by country, asset class, strategies, investment styles, long-term trends vs. short-term trades, fundamentals vs. tactical.
– balancing exposures to high yield and emerging markets bonds with allocations to AAA/AA government bonds.
– risk control and the aim to deliver positive risk-adjusted returns in all market and economic environments.
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