MIRABAUD
Asset Management

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FINDING RISK-ADJUSTED OPPORTUNITIES IN GLOBAL FIXED INCOME DURING EXTREME MARKET VOLATILITY

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End of a cycle

Despite the fact that this has been a very difficult time for all investment classes, except for cash, the Mirabaud – Global Strategic Bond Fund (the "Fund") has been top quartile in terms of volatility and drawdown over the course of the crisis in March. We refrained from chasing yield in Emerging Markets and High Yield assets.

We have continued to focus on risk-adjusted returns and trying to moderate cash losses as far as we can. We were worried about overvaluations anyway and felt they had been ignored for too long. The good news is that we are now re-pricing at much more sensible levels. The end of a cycle always presents huge opportunities as well as pressures and volatility. This will be the same as all other end of cycle opportunities as we go into recovery and start to pick assets at much better valuation levels.

Liquidity remains problematic at this point. Indeed, we have been talking about this for some time. This lack of liquidity has been accentuated by the sell-offs in the ETF market. ETFs are price agnostic, so when they have to sell they sell at any price and buy at any price. This adds to the volatility, particularly as investment banks have a lot less balance sheet strength to play with than they have done in the past. So liquidity is key and having flexibility from that liquidity is important.

Strong cash positions and a hedge for high yield

In terms of the first quarter, at the end of February we had 10% of the Fund in 10-Year US Treasuries and 3% in 30-Year US Treasuries, in addition to another 15% in short duration US Treasuries. This was because we were struggling to find value in the market. We felt it was better to wait for the sell-off after the rally we saw in January. We also thought that the market had gone too far and we expected to see a pull-back as we moved into March and April. Phase one of the US/China trade deal was signed and we were looking at a V-shaped recovery and a good first quarter for risk assets. We also took our allocation to Emerging Markets down a little.

We then went into March with a fairly conservative position, with around 30% in US Treasuries and we had cash as well. We'd also bought into short-term maturity bonds in December 2018, which were offering very good yields at that point in time. This was when the US Federal Reserve was still likely to raise rates in 2019, so the yield curve was very flat. These bonds are now rolling off or maturing as we enter the first half of 2020.

Furthermore, our cash positions were pretty high at that point and our exposure to US Treasuries worked very well until the 19 March and at that time the Fund was still in positive territory. However, the US Treasury market became very illiquid and we saw the bid offer spreads between Treasuries really begin to widen. It was at this point that the US Federal Reserve stepped in. It provided a trillion dollars in funding for the short-term market over a number of days. It also started buying Treasuries and corporate debt a week later. At that time there was a real risk of this becoming a financial crisis in the vein of 2008. But the Fed and other central banks had learned the lessons of 2008 and stepped in very quickly this time to allay the fall in confidence. We saw that in Treasuries. We saw a 100bps, plus and minus, over the course of one week for the entire curve. At this point the Fund began to face some performance challenges because of its exposure to 10-Year and 30-Year US Treasuries, which in the past had always been a hedge against risk off. Every asset class collapsed and even gold sold off. Ironically, the Fund was holding assets that in the past had always been regarded as much lower risk assets.

We then took the decision to reduce our 10 and 30-Year US Treasury exposure and moved into cash, given the increasing unknown risks we were seeing with the virus and shutdowns in Europe and later the US. By the end of March we had 30% of the Fund in cash or short-term Treasuries and we reduced our exposure to 10-Year Treasuries to 4% and we were out of 30-Year Treasuries.

Since then we have been opportunistically back and forth into 10-Year Treasuries. We owned 4 or 5% of US Treasuries last week and then took that off after a 10 or 15 basis points gain last Friday. We will continue to do this but these are much smaller positions than they were previously. As we've become more confident that the financial system is normalising, we've seen the VIX (CBOE Volatility Index) move from a peak of around 80 to 46 today. As we learn more about what central banks are doing in terms of providing fiscal support, we're starting to invest some of our cash in investment grade in Europe and the US. Historically, we were reluctant to invest in Europe because the valuations weren't there, but we think they are now.

We also started putting on a CDX Index short position to hedge the Fund against more volatility. We started this two-and-a-half weeks ago and it currently stands at 15%. We also have about 34% of the Fund in cash or cash-like bonds ready to invest. We have had flexibility in liquidity throughout this period, so we are in a good position to invest in the market.

We have little in the way of cyclicals and energy

We have very little in cyclicals such as mining and basic materials. We have about 1.5% in the Fund and half of that is in gold. We have added to telecommunication companies because they are less cyclical and we have added to Verizon. We have very little exposure to energy. Most of it is investment grade and it is just under 5%. In short-term treasuries, we have about 5% maturing every month for April, May and July, which make up about 15% of the Fund. More generally, the flexibility of the Fund remains very high and we believe it is able to react to the market.

Where do we go from here? Focusing on better quality credit.

It's very difficult to predict where we go from here. The bottom of the market was probably about two weeks ago and since then we have seen equity markets rally by over 20%. The irony is some of companies that still face shutdown, such as hotels, cruise liners, restaurants and airlines, have all rallied significantly as well. We think it's a little too early to get too bullish. We think that there are still a lot of downgrades coming. From a High Yield perspective, for example, we are seeing the impact of the economic shut down and a raft of downgrades as results come in and some of the weaker companies will not survive.

At over a thousand basis points, High Yield looks interesting in line with a default rate of 8 to 9%. If you have a 12 to 24 month view High Yield looks interesting if you can stomach some of the short-term volatility and there is a case for slowly getting back into High Yield.

Active management should be in the ascendancy, particularly given how ETFs have performed over the last few months. We think there are some good opportunities for some good credit selection. But in the Mirabaud – Global Strategic Bond Fund, we are wary of getting involved in High Yield right now. Although a lot of bad news has already been priced in, we still think there's a lot uncertainty about the economy and lots of rating downgrades coming.

We have done relatively well on the way down and we don't want to miss the inevitable rally that will come, but we need to sit back and wait to see how things unfold over the next few weeks. Clearly, the virus seems to be stabilising in some countries and the data is beginning to look a little better. But a decision will need to made when to lift the shutdown and we need to think about the material effects on companies. We therefore think it will take a little bit longer to get the economy back to normal. So we'll have a poor Q2 and then the resumption of activity in Q3 and Q4.

The market will begin to look through this. However, given the philosophy behind our Fund we can wait a little bit longer to see how things develop before we take too much risk. We will continue to gradually invest in better quality credit to begin with, because there are some great bargains there, and then we'll look at High Yield again over the next few weeks.

It is also important to point out that the oil market is under a lot of pressure. The market is expecting a huge deal from OPEC, but we are a little more sceptical. If it does go through that will be another risk off moment. On the whole we are positive. We didn't change a great deal during the crisis. Unfortunately, our Treasury positions hurt us the most as the market was at risk of breaking in mid-March.

To recap, since then we have begun to reinvest cash into investment grade with nothing in High Yield as yet, and we have a CDX short position as a tail-risk hedge, which will run a little bit longer. Overall, our outlook over the next 12 months is positive. We need to see the end of the crisis, but we will be reinvesting some of the cash over the next few weeks with a view that on a 12 month basis credit will do well. Fixed Income is in a good place at the moment, particularly versus Equities in our opinion. Credit should come out this first, being higher up the capital structure, and the Fund has performed as expected given the crisis that we have just been through.

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