Confidence must be earned

Amundi ASSET MANAGEMENT

Amundi Funds Global Aggregate Fund

Special Corona Virus Update: A week for the history books

17 March 2020

Corona Virus Impact on markets

The last week saw volatility spike to levels not seen since the 2008 financial crisis, with equity markets selling off as the full extent of the COVID-19 outbreak dawned on investors, especially as wide sweeping travel bans were announced by the US and European countries to reduce contagion. What is clear is that at least some countries will enter recession in 2020, in stark contrast to predictions made initially. Markets do not like uncertainty and a sell-off ensured that spread to equities, government bonds, corporate bonds and currencies, many traditional hedges like high quality government bonds stopped working as correlation rose between assets. And this was made worse by a large number liquidity providers globally working from home or completely shut-off and therefore unable to smooth market volatility spikes.

Corona Virus Impact on fund: performance month to date to the 16th of March 2020:

I-USD share-class: -6.95%
Benchmark: -1.73%
Excess return: -5.57%

What has affected returns in global fixed income markets (benchmark)?

Absolute performance has continued to suffer, as risk assets sold-off in the month to date period. In the last week, the sell-off made the jump from corporate bonds and emerging markets bonds to developed markets government bonds. Incredibly, the only developed markets bonds that have had positive performance in the month to date period were Canadian government bonds and US treasuries. Similarly, within currencies, the traditional safe haven currencies; CHF, JPY and USD saw very strong performance as risk aversion and market volatility touched levels not seen since the 2008 / 2009 financial crisis.

What worked in the fund?

Bonds: High quality duration positions have performed very well over the period, and the long exposure to US and Canadian duration added to returns in absolute and relative terms. A preference for US treasuries over German has been a strong contributor as the yield spreads between them has tightened by 70 bps in the year to date period. Flattening positions on both curves have also helped significantly.

Credit: A preference for European corporate bonds (+75 bps yield spread) vs. US corporate bonds avoided the deeper sell-off in US corporate bonds (+124 bps yield spread). The higher leverage of US corporates might be spooking investors.
Currencies: the hedging power of the traditional safe haven triplets; USD, CHF and JPY came back in force and our long positions in these currencies helped to mitigate losses from other parts. Short allocations to commodity currencies and Asian currencies also worked well as a hedge after they sold off significantly (AUD, CAD, ZAR, KRW, TWD, SGD).

What didn't work?

Bonds: Overweight allocations to Spanish and Italian peripheral sovereign bonds detracted as yield spreads rose at an unusually rapid pace led by Italy as the nation was the first European country to go into lockdown to stem the COVID-19 contagion, however our exposure at the long end of the curve did protect the portfolio as the 5 year to 30 year yield spread tightened by 100 bps (*overall performance estimated at -2.0% vs. benchmark*).
Credit: overweight allocations to corporate bonds and emerging markets bonds: indiscriminate yield spread rises saw panic selling in the markets as volatility spiked and many money managers cut risk by selling assets that are in our opinion still backed by good fundamentals (*overall performance estimated at -0.8% vs. benchmark*).
Emerging markets bonds: emerging markets hard currency bonds saw their yield spreads widen again as institutional investors tried to reduce portfolio risk or were led into forced bond sales, this exacerbated the sell-off in oil related bonds like Pemex. Over the last few weeks we have significantly reduced our holdings of Middle Eastern sovereigns that are closely linked to the price of oil (*overall performance estimated at -1.6% vs. benchmark*).

Currencies: overweight allocations to emerging markets currencies like the RUB, MXN and INR continued to sell off as investors dumped EM bonds and currencies (*estimated at -0.7% vs. benchmark*).

How are we positioned and what have we changed recently?

Portfolio is now overall **overweight duration** at 7.5 years vs. benchmark 7.2 years, with a yield of 4.30% vs. the benchmark yield of 1.22%. We are using around 2.6% of the total 4.5% **tracking error** limit. **Liquidity** has somewhat deteriorated in the market and as such, we are keeping a much larger cash buffer in the portfolio (11%). From speaking to our traders, this is the result of many traders on the sell- and buy-side **working from home** and having trading restrictions placed on them as well having access to less communication channels, rather than any statement on the underlying assets. We see a similar pattern during the European summer period and the Christmas season, albeit to a lesser extent. These are not ideal conditions for trading large volumes.

Key Bond Positions:

Position	Recent Portfolio Changes	Comment
US duration	We went longer US treasuries to an overweight of 409 bps vs 269 bps for the benchmark.	We added this before the surprise 100 bps cut over the weekend. This has helped as a hedge, although not to the extent we had hoped due to the treasury market becoming distorted.
Peripheral Europe: Italy / Spain /	We remain overweight but reduced our exposure to both Italy and Spain. Holdings are mostly at the very long end of their yield curves.	Yields on these bonds have risen, especially after a confusing message from the ECB last week. However we expect to see yields recover after the initial panic phase has passed, we also expect that as central banks start to support small businesses sentiment will improve.
German bunds	We remain net short German bunds after a taste of what ECB actions under Christine Lagarde would be.	The yields on German bunds rose rather than fell as volatility increased. ECB has disappointed markets here and will likely continue to do so.
Yield curve positioning	We have continued to add to our flattening positions on the US treasury and German curves	This serves a dual purpose of picking up some of the more attractive yields available at the long end of curves but also provides a hedge against further poor sentiment in the markets.

Credit:

Position	Recent Portfolio Changes	Comment
Investment grade bonds	We maintain holdings for now. Important to note that we hold mostly high quality bonds from **investment grade issuers**	We have a preference for European names supported by better fundamentals and less leverage. We do not believe this is the best part of the portfolio to trim risk from as liquidity is currently challenging.
Emerging Markets bonds (Mexico / Russia / Brazil / South Africa)	We took profits on South Africa but remain holding others	As with corporate bonds, this is not the best time to reduce holdings of what are bonds backed by relatively stable fundamentals.

Key FX Positions:

Position	Recent Portfolio Changes	Comment
Safe havens: Overweight USD, JPY and CHF Against commodity bloc: AUD, CAD, ZAR	We increased exposure to the safe haven currencies: +6.1% USD, +6.5% JPY and +0.3% CHF. Vs:	The USD and JPY are still the world's "safe-haven" currencies and in the last few weeks the CHF reclaimed this role.

	-5.5% CAD, -1.9% ZAR and -0.6% AUD	
Overweight higher yielding EM currencies with an underweight allocation to Asian currencies with strong ties to China.	Volatility this week spread to all currencies so we continued to reduce exposure to EM currencies. Still hold: INR, MXN, RUB and PLN vs. TWD, SGD and KRW.	The crisis has spread and investors are acting irrationally, as a precaution, we have reduced overweight EM FX allocations despite seeing solid fundamentals.

Current Outlook: markets are trading on panic rather than rational sentiment

Our assessment is that markets and global growth are going to take a “U” shape in terms of recovery but that we are still to reach the bottom of the first down leg. After the lock down in Italy, Spain and other European countries it’s clear that this is a very serious situation – however for now markets are reacting to uncertainty rather than concrete data. Most are predicting a recession for 2020 across Europe and possibly the US and parts of Emerging markets a very rapid deterioration led by small and medium sized businesses that have simply had their business stopped. This is a major change compared to just a few weeks ago, a co-ordinated developed markets central bank response to pump liquidity into the real economy is widely expected bank. The bad sentiment is being made worse by the fact that a large portion of market participants from Asia, Europe and the US are now practicing social distancing and working from home with reduced markets access for both sellers and buyers – meaning that liquidity on many risk assets is vastly affected. This is creating much larger than normal bid-ask prices on for example corporate bonds and do not reflect the underlying quality of these assets. We expect that this could last for a while various countries enforce necessary social distancing measures. Our view would be to let the dust settle before making large revisions to assets or risk allocation decisions. Along the same lines we also believe that it’s too soon to make a call on underlying fundamentals and whether we expect to see an uptick in default rates yet, especially given that we expect measures like government provided interest free loans to support struggling sectors to be unveiled soon.

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