EDMOND DE ROTHSCHILD

BOND MARKETS: WHERE IS THE REBOUND?

- The current environment is still prone to low interest rates, political uncertainty and lack of visibility on risky assets. Investors are seeking ways to manage efficiently their bond assets, having issues to identify suitable solutions. Which segments or sectors should be given priority in the pursuit for yield? Which risks should be hedged?

- Guillaume Rigeade and Eliezer Ben Zimra, fund managers of EdR Fund Bond Allocation[1], give their own views on current bond markets trends, and explain their approach to market positioning.

GUILLAUME RIGEADE

ELIEZER BEN ZIMRA

FUND MANAGER OF EDMOND DE ROTHSCHILD FUND BOND ALLOCATION

INTERVIEW

HOW WOULD YOU OUTLINE YOUR VISION OF BOND MARKETS IN RECENT MONTHS?

Corporate debt market suffered negative returns across almost all segments in 2018. Credit spreads widened regardless of sector, rating or geographical zone. This was partly due to a number of political and geopolitical risks like US-China trade tensions, the approach of the Brexit deadline and Italy's populist party ruling coalition but it was primarily the result of fears of reduced central bank liquidity. And yet, at the same time, government bond yields eased in core countries and the only positive returns for 2018 came from markets where we were not expecting good news.

WE HAVE WITNESSED AN INCREASE IN US SHORT-TERM RATES, LEADING TO THE STEEPENING OF THE US YIELD CURVE: SHOULD WE FEAR THIS SITUATION?

The Fed has now been tightening for 3 years and yields have risen significantly. To limit volatility and achieve orderly monetary normalization, rates have been hiked gradually and accompanied by efficient communication. The Fed has at any rate avoiding making the same mistakes as in 2013, when its statements surprised markets and triggered a brutal correction on all bond markets. The US yield curve is now practically flat, its normal shape when investors expect a growth cycle to end in the near future. Therefore, I wouldn't use the term «fear», but rather «opportunity».

First, the yield curve is no longer discounting any hike after the December 2018 move. We believe the market has overreacted to the notion of the Fed possibly marking a pause in its rate-hiking cycle. In fact, the bank wants some time to assess if past hikes have produced results. For our part, we see no worrying inflection to US growth momentum so it would be interesting to take a negative sensibility stance over short term rates in case the Fed increases rates again in 2019, even cautiously. Moreover, Donald Trump's fiscal stimulus has resulted in higher budget spending and thus an increase in government issuance. And as the Fed has shrunk its balance sheet, the longest-dated maturities are probably those which are most at risk in the US.

WHAT ABOUT RECENT ECB STATEMENTS AND EUROPEAN RATES?

The situation in Europe is different. As a result of an extremely accommodative monetary policy, rates remained firmly rooted in negative territory. But improving fundamentals will now allow the ECB to reduce its stimulus and so we expect European bond valuations to normalize. The ECB is not going to raise its benchmark rates for several quarters and the end to its quantitative easing program does not mean it will stop buying bonds altogether. It will, in fact, continue its purchases through reinvestment of coupons and repayments of bonds already on its balance sheet.

> THE END TO ITS QUANTITATIVE EASING PROGRAM DOES NOT MEAN THE ECB WILL STOP BUYING BONDS ALTOGETHER.

KEY POINTS

- Active and flexible allocation across all bond market segments
- A broad range of bond classes and strategies for access to varied investment opportunities
- A fund which capitalizes on Edmond de Rothschild Asset Management's broad expertise in bond management
- Active management of modified duration within a [-2;+8] spread
- The Fund is exposed to credit risk

WHAT IS THE RELEVANCE OF EDR FUND BOND ALLOCATION IN SUCH A CONTEXT?

Building bond portfolios that provide attractive returns and are properly balanced in terms of risk has become a challenging area. EdR Fund Bond Allocation takes an active and flexible approach to an investment universe which covers all bond market segments (sovereign, corporate, developed, emerging, Investment Grade, High Yield...). It seeks to best adapt to prevailing market conditions with a triple flexibility. First, through the screened instruments: by taking an overall view on bond markets, we pick the bond types we consider to be the most suitable for the current situation. Second, we also have significant leeway over managing interest rate exposure; possibly negative when the opportunity arises. As a result, we can find several opportunities from expected rate shifts. Third, our issuer selection, the last milestone of our investment process. To provide optimal coverage of all the universe opportunities, all our analysts take part in the selection process. The objective is to outperform a composite index of European government and corporate bonds and to achieve positive returns over an investment horizon of 3 years, whatever the prevailing market conditions. EdR Fund Bond Allocation is a core element in Edmond de Rothschild Asset Management's fixed income expertise, with a team gathering nearly 20 experts on the asset class, it offers investors a solution to volatile bond markets.

GIVEN THESE ELEMENTS, HOW IS THE CURRENT EXPOSURE OF THE FUND SHAPING UP?

January was marked by cautious comments by the central banks: the ECB pointing downward risks on the economy with indicators of activity that were published falling; the Fed confirms being in a pause phase of its rate hikes despite a better performance of its indicators. Rates generally tightened with a flattening of European curves and a steepening of the US curve. However, we believe that markets are overreacting. We don't believe in the scenario priced in the US yield curve: the market is pricing a statu quo in 2019 and a cut in 2020. US economy will slow in 2019 compared to 2018, but will not fall into recession this year. In this environment, emerging, High Yield, financial and peripheral debts outperformed, supported also by the easing of worries related to US-China negotiations.

The fund remains positioned on the two core management team convictions, namely sovereign debt and financial subordinated debt. However, we significantly decreased the global exposure of the portfolio over the last month, now standing close to 80%. We reduced our corporate bonds exposure of 10%. In contrast, our emerging bonds exposure increased thanks to market movements. As a matter of fact, special situations are recovering, but overall the last monetary policy decisions in the US are strong supports for the whole asset class. We have sharply reduced the modified duration of the fund, currently achieving negative territory. Lastly, while increasing our flattening positioning, we reduced further our exposure to European rates. Indeed, valuations are not in line with fundamentals but only pricing an excessive accommodative monetary policy.

FOR OUR PART, WE SEE NO WORRYING INFLECTION TO US GROWTH MOMENTUM.

[1] Edmond de Rothschild Fund Bond Allocation is a sub fund of the Luxembourg-regulated SICAV which is approved by the CSSF and approved for marketing in France, Luxembourg, Switzerland, Austria, Germany, Spain and Italy.

GLOSSARY

- High Yield: corporate bonds with a higher default risk than investment grade bonds but which pay out higher coupons.
- Investment Grade (IG) is a term used to define bond issues with a low level of risk whose financial ratings range from AAA to BBB- according to the Standard & Poor's scale. The risk of default of such issues is low, and their level of remuneration is much lower than that of high-yield issues.
- The modified duration of a bond measures the change in its value, expressed as a percentage, resulting from a given variation in interest rates.
- The yield spread or credit spread is the difference between the bond's yield-to-maturity and that of a zero risk loan of identical duration. The better the issuer's solvency seems, the lower the spread.

FUND INFORMATION

Inception date: 30/12/2004

ISIN Codes: 'A' Share: LU1161527038
'B' Share: LU1161526907
'I' Share: LU1161526816

Maximum management charges
'A' and 'B' Shares: 0.80% net
'I' Share: 0.40% net

Variable management fees
15% of annual performance in excess of the benchmark

Minimum initial subscription
'A' and 'B' Shares: 1 share
'I' Share: €500,000

Front load charge
'A' Share : 1% maximum
'B' Share : 3% maximum
'I' Share : None

Redemption charges: None

Income attribution
'A' and 'I' Shares: Capitalisation
'B' Share: Distribution

Benchmark: 50% of the Barclays Capital Euro Aggregate Corporate Total Return index and 50% of the Barclays Capital Euro Aggregate Treasury Total Return index

Recommended investment horizon: > 3 years

* Shares described herein are the main euro-denominated shares. The fund also has shares in USD, GBP, CHF. Please ask you sales contact for any further information.

PRINCIPAL INVESTMENT RISKS

The subfund is classified in category 3 (A, B and I shares) in line with the nature of securities and geographical zones in the "objectives and investment policy" section of the key investor information document (KIID).

Capital loss risk: as the subfund does not have any guarantee or protection, the capital initially invested might not be restituted in full even if subscribers hold their shares over the recommended investment horizon.

Credit risk: the main risk is issuer payment default on interest payments and/or on reimbursement of the capital. Credit risk also concerns issuer downgrades. Subscribers are warned that the subfund's net asset value ould fall should a total loss be incurred on a transaction due to counterparty default. Any private company debt held directly by the portfolio or through mutual subfunds exposes the subfund to changes in the issuing company's credit rating.

Credit risk from investing in speculative securities: the subfund may invest in government and corporate rated as non-investment grade by a rating agency (i.e. rated below BBB- by Standards and Poor's or an equivalent rating from another independent agency) or considered as equivalent by our investment company. These issues are so-called speculative debt securities with a higher risk of issuer default. The subfund must be viewed as partly speculative and concerns in particular investors who are aware of the risks inherent in these securities. Consequently, investing in high yield securities (speculative securities which have a higher default risk) may entail a bigger fall in the subfund's net asset value. Interest rate risk: exposure to bond instruments, whether debt securities or money market instruments, means the subfund is sensitive to interest rate fluctuations.

Interest rate risk might entail a capital loss from yield curve movements and therefore a fall in the subfund's net asset value.

Risks from emerging market investments: the subfund may be exposed to emerging markets. In addition to stock-specific risks, there is a risk from external factors, especially on these markets. Investors should also note that operating conditions and supervisory standards on these markets may differ from those on major international stock markets. As a result, holding these securities may increase the portfolio's risk. As market falls in emerging markets may be more pronounced and faster than in developed countries, the subfund's NAV may also suffer larger and faster declines.

Risk from participation in financial contracts and counterparty risk: the use of financial contracts may mean a sharper and faster fall in the subfund's net asset value than that of the markets in which the subfund is invested. Counterparty risk stems from the subfund's use of OTC financial contracts and/or temporary acquisitions and disposals of securities. These transactions may expose the subfund to counterparty default risk and therefore a fall in the subfund's net asset value.

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