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UNCONSTRAINED GLOBAL BOND STRATEGY: A OR THE NEW DAWN?

Bond Investing Without Central Bank Support
By Peter De Coensel, CIO Fixed Income

SECULAR BASE CASE SCENARIO

Fed minutes show us that less central bank interventionism lies ahead. We expect a gradual contraction of the Fed Balance Sheet by the end of 2017, and in Europe the ECB will gradually taper its APP (Asset Purchase Programme) from the current €60 billion/month over 2018. In line with Fed policy, it will maintain balance sheet size by reinvesting proceeds over 2019, possibly beyond, while gently starting to increase policy rates that year.

Term premia across core government bond markets will rise. For the US yield curve we agree with the valuation of 3-year forwards, i.e. 10-year Treasuries at 3.00% in 3 years' time, and 30-year Treasuries at 3.50%. However, for German Bunds we believe that 3-year forwards on 10-year bunds are mispriced. As we model 0% ECB balance sheet growth by 2019 we see 10-year German rates in the neighbourhood of 1.25% to 1.50% above the 0.84% currently priced in by markets.

The risk scenario is that central banks hold onto aggressive interventionist balance sheet policies and fall into a Japanese-style low growth, low inflation debt trap alongside detrimental financial repression, and that this then keeps the world economy mired down in a negative feedback loop. The Fed central bank leadership, backed by US reflationary and responsible economic policy, needs to inspire the EU to take another historic leap forward.

The eurozone needs to finish the EMU project by initiating proposals to establish a Eurobond market. After elections have passed in France, Germany and Italy, the EC and European Council are urged to push forward to strengthen the eurozone construct and propose the partial mutualisation of eurozone government debt. A true European Debt Agency (EDA) could issue AAA Eurobonds up to 60% of GDP for each member of the eurozone that accepts the rules and conditions guiding the EMU legislation. A genuine and credible banking union would then ensue. Increased budgetary surveillance and fiscal discipline, enhanced financial stability and the creation of a deep and liquid European bond market could come about. The common first tier would thus be syndicated through the EDA, with the remaining borrowing requirements being funded and organised through traditional national debt agency channels. Alternatively, not dealing with these structural deficiencies might become lethal for EMU and the survival of the euro.

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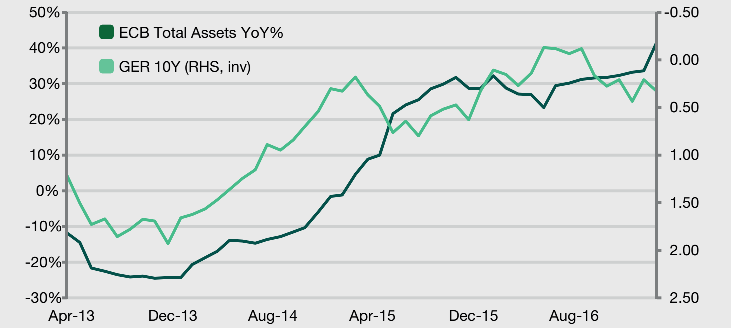
ECB ASSETS AND GERMAN 10-YEAR RATES

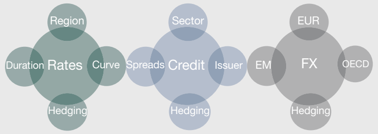


Source: DPAM, Bloomberg

FIXED-INCOME STYLES AND RISK FACTOR EXPOSURE

The DPAM Bonds Universalis Unconstrained fund uses a risk-factor-based process to translate our medium and longer-term economic and financial market convictions into a robust portfolio.

The strategy is not driven by market betas offered across fixed-income sectors. Instead, from a top-down perspective we decide on which fixed-income styles fit our secular view. From a bottom-up perspective we then grow capital by managing our risk factor exposure across FX, rates, credit spreads and idiosyncratic risks.



Rate markets will not roll-over tomorrow, followed by a bear market. However, we do not see value in holding onto momentum strategies in rates and opt for high protection regarding this factor. Here, carry and value become the main styles that push total returns over the medium term. We have been accumulating Spanish, Italian and Portuguese government bond exposure, mainly hedged through 30-year Bund futures. In credit we have adopted a neutral stance favouring US IG credit. Specific value investments are found in UK retail credits and through hybrid corporate credit in the utility and energy sectors. Long-term value is also captured through a high-conviction allocation in US TIPS at the long end of the real curve.

Next to rate hedges we remain tactically protected through a long protection Itraxx Crossover overlay. The idea here is that, given rampant asset inflation and high political uncertainty, one needs to be prepared for the unexpected.

	Risk Factors		
Styles	**Rates**	**Credit**	**FX**
Momentum	Stalling	Neutral	USD
Carry	EMU periphery	USD IG credit	BRL and ZAR
Value	US Long end TIPS	€ HY	SEK
Protection	Short 30y Bund Short 10y Bund Short 30y US Long Bond Short 10y Gilts	Long Itraxx Crossover protection	GBP hedged

CONTROLLED VOLATILITY

Investors buying into the unconstrained strategy can expect to achieve capital growth under a realised 3-year rolling volatility range of 5% to 7%. Through our POINT risk engine we track Value at Risk and Expected Shortfall across risk factors. We abide by a maximum 3.00% VaR measure over a 1-month horizon at the 90% confidence threshold. At this juncture our VaR is at a cyclical low of 1.95% and is distributed across FX at 0.95%, Rates at a low 0.25% (including linkers), IG credit at 0.25%, Sovereign credit at 0.40% and Idiosyncratic risk at 0.10%.

CONCLUSION

European bond investors sticking to traditional bond diversification solutions have been well treated until today. However, having reached the 0% lower boundary in core EU long-term rates and negative rates for short and intermediate maturities, investor should be prepared to diversify into global bonds. Using this approach, measured allocation to an unconstrained strategy will improve your risk-reward profile.

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