Optimising flexibility in the new era

Pierre Chartres, Investment Director, Fixed Income

April 2023

With higher yields, declining inflation and the end of the interest rate hiking cycle in sight, fixed income continues to offer an attractive entry point for investors. From high-quality government bonds and corporate credit, to emerging market (EM) local currency bonds and even some high yield (HY), investors seeking value should be flexible in their allocations.

At-a-glance: where next for fixed income?

A global economic snapshot

- The market is pricing in an end to the US Federal Reserve's (Fed's) interest rate hiking cycle over the coming months.
- Efforts by governments and central banks around the world to reign-in excess liquidity have led to a sharp deceleration in money supply. This is expected to push inflation lower, albeit slowly.
- Tight labour markets should ultimately reduce the chances of a hard landing for the global economy. Yet the high demand for workers against a relatively limited supply, especially in the US, could further slow the pace of declining inflation.

Opportunities across the fixed income landscape

- In general, higher yields and inflation levels under control represent a good entry point into fixed income. However, a flexible approach when allocating to these assets is increasingly important amid continued uncertainty due to the shifting macro backdrop.
- For government bonds – the inflation spike over the past 12 months has boosted their appeal at both the longer and shorter ends of the yield curve, putting the risk/return ratio increasingly in investors' favour
- For investment grade (IG) corporate credit – with expectations that spreads may compress, value investors can find opportunities in specific parts of the market, including the banking, utilities, media and telecom sectors. Being overweight BBB European credit, for example, has led to outperformance over US credit.
- For HY debt – robust fundamentals, stemming from expectations of relatively resilient corporate profits over the next 12 months, plus current low leverage levels, suggest an appealing starting point for HY investors on a selective basis.
- For EM local currency bonds – The combination of strong and positive real yields – certainly compared with developed markets – has been supportive for this asset class. These bonds have benefited from the decision by many EM central banks to pre-empt the Fed's rate hiking action.
- An unconstrained bond fund enables investors to capitalise on the range of potential opportunities in global fixed income by adjusting exposure to instruments that offer the most compelling risk/return characteristics at different points of the economic cycle.

Global investors continue to embrace the current environment of higher yields. Coupled with greater clarity over the outlook for rates and inflation, this gradual easing of the macro dynamics that disrupted global markets and portfolios in 2022 is creating renewed pockets of opportunity across certain parts of the fixed income landscape.

For example, at both the longer and shorter ends of the yield curve, the risk/return ratio of government bonds has greatly improved for the first time in many years. In the investment grade (IG) corporate credit space, meanwhile, exposure to higher quality banking, utilities, media and telecom businesses looks appealing to us at the moment

At the other end of the risk spectrum, we think HY investors could again find value on a selective basis, given the attractive level of carry on offer in many areas and the relatively low leverage levels of many companies.

Looking geographically, we see EM local currency bonds as attractive due to strong and positive real yields compared with developed markets, spurred by pre-emptive moves by many EM central banks to start hiking before the US Federal Reserve (Fed).

Yet despite various promising entry points into fixed income, the lingering cloud of uncertainty and volatility makes it important for investors to take a flexible approach when allocating to these assets.

Coming to terms with a far-reaching economic reset

After a tumultuous 12 months or so, signs are emerging that the headwinds from rising interest rates and soaring inflation are gradually dissipating.

For a start, we believe we are nearing the end of relentless hikes to US interest rates. Based on patterns of tightening cycles since the early 1970s, we think hiking will stop once rates move durably above inflation. This echoes comments by Fed Chairman Jerome Powell's in September 2022: "You want to be at a place where real rates are positive across the entire yield curve." With interest rates now at 5% and inflation gradually declining, we believe we have reached this very important juncture for the US economy.

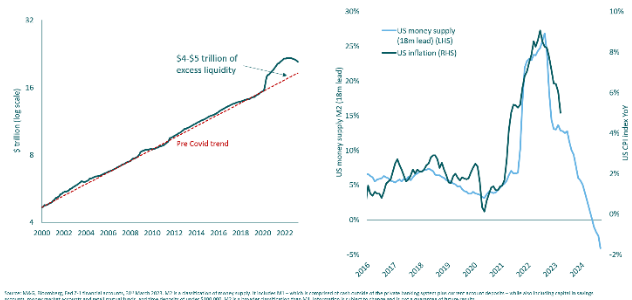
We are close to the end of the US rate hiking cycle
Hiking cycles only end with US CPI below Fed Funds Rate

*""You want to be at a place where **real rates are positive across the entire yield curve**"*
US Federal Reserve Chairman Jerome Powell, 21st September 2022

Ultimately, the market outlook will depend on the inflationary scenario. Contrary to the views of many commentators, we consider the primary driver of the inflationary spike to be the vast amounts of liquidity that governments injected in the early days of the Covid crisis, and that central banks created as they lowered rates and implemented quantitative easing.

While the deceleration in money supply is now squeezing the excesses created, given the magnitude of previous stimulus measures, we expect it to take some time to bring inflation back down to its target of 2%

The huge increase in money supply resulted in surging inflation…
…so the recent sharp deceleration in money supply could push inflation lower



The historically low levels of unemployment in the global labor markets will likely be another factor slowing the pace at which inflation falls. On the flipside, the high demand for workers against a relatively limited supply, especially in the US, lowers the chances of a hard landing for the global economy.

Finding new sources of value in global fixed income

Against this macro backdrop, investors can find attractive and diversified risk-adjusted returns within a wide range of government and corporate bonds, across IG and HY, and from developed countries to EM.

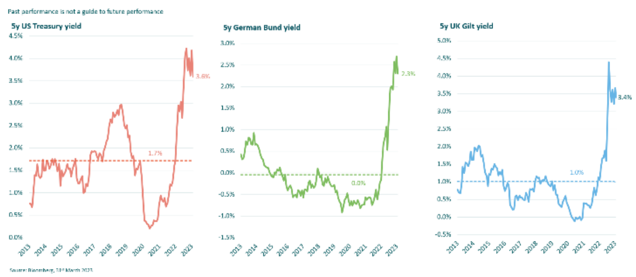
Government bonds

- The inflation spike has meant that US Treasury yields have broken out of their rangebound territory. A 30-year inflation-linked US treasury bond with a yield of 1.4% could generate 1.4% real return (i.e on top of realized inflation) over the long term. Source: Bloomberg, as of 31 March 2023. . This type of instrument can serve as akin to an insurance policy for portfolios, given there will likely be bouts of volatility and inflation could remain stubbornly elevated in the near term.

- A similar boost to government bond yields can also be seen at the shorter end of the curve globally – including with five-year German Bunds and UK Gilts.

- With these opportunities in mind, we are finding that our unconstrained approach enables us to add duration within portfolios across regions, in turn helping investors capitalize on the benefits of changing bond yields and diversification. Further, based on our view that yields can only rise so far if inflation stabilizes , now seems a good entry point.

5 year government bond yields
US, UK and Germany



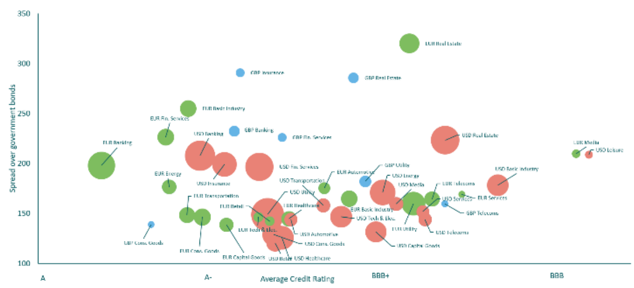
Corporate bonds

- Within the credit space, we think there is room for spreads to compress, so we generally see value in global IG corporate bonds. And with a total face value of over US$10 trillion in this asset class from around 2,000 issuers in diverse sectors (Source: ICE BoFA Global Corporate Index, as of 26 April 2023), it represents a formidable terrain for active managers such as ourselves to add value for our clients.

- In particular, for global investors hunting value, an allocation to European and UK corporate bonds has driven outperformance versus US corporate bonds in recent times. This is based on the appeal of European credits, with regional valuations in favour of European IG names compared with their US IG counterparts following the disruptions of 2022.

- From a sector perspective banking stands out in the more highly rated segment – especially with the larger institutions, which are well-capitalised and more resilient than in the past . In the BBB rated space, the utilities, media and telecom sectors are attractive at the moment.

Credit valuations remain diverse across sectors
Investment Grade 5Y to 10Y corporate bonds



We currently find many investment opportunities in Banking, Utilities, Media, and Telecoms sectors

High yield debt

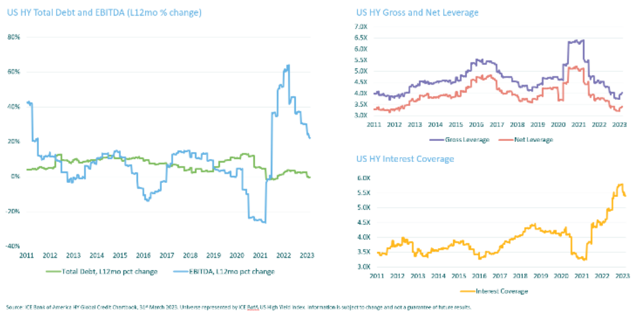
- At the other end of the risk spectrum, HY fundamentals have held up relatively well to date.

- While corporate profitability (as measured by EBITDA growth) is normalizing post the COVID-19 rebound, measures of indebtedness such as total debt, net leverage and interest coverage remain at very strong levels.

- As a result, while default rates may increase at the margin given the prevailing high interest rate regime, we believe these will be manageable for skilled managers.

- In line with this, we see potential for HY exposure on a selective basis.

HY fundamentals have held up quite well so far
Starting point for HY companies is extremely strong



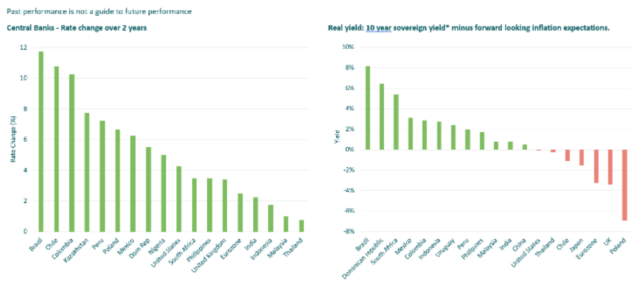
EM debt

- We see value today in EM local currency bonds, with the relative strength of real yields creating support for the asset class.

- This is a result of many EM central banks undertaking rate hikes earlier than the Fed, ensuring most EM real yields remain elevated compared with those in developed markets.

- This is a direct consequence of EMs learning from previous crises – notably the need to pre-empt Fed-led rate hiking cycles in developed markets that typically lead to capital outflows in EM due to monetary tightening.

Most EM Central Banks are hiking, most EM real yields remain elevated vs DM



We currently see value in emerging market local currency bonds

Where next for fixed income?

In our view, the market sell-off of 2022 has opened up a unique opportunity for investors to seek exposure to fixed income assets and take advantage of attractive returns over the long term.

Saying that, and despite the inflation-fighting stance of central banks around the world, inflation remains the biggest risk for fixed income investors. To counter this, we believe an unconstrained bond fund enables investor to capitalise on the range of potential opportunities in global fixed income – by adjusting exposure to instruments that offer the most compelling risk/return characteristics at different points of the economic cycle.