

Is it time to revisit fixed income allocations?

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Key messages

We believe fixed income risk-returns are stabilizing and will improve going forward, so it's a good time for investors to revisit their allocation to the asset class

- While significant uncertainty remains around the macroeconomic outlook, a lot of rate hikes globally have already happened or are at least priced in, so negative market reactions should be limited.

Higher yield – a step back towards normality

- According to Bloomberg only a year ago there were a record amount of bonds (roughly USD 18 trillion) trading with negative yields, but this has largely disappeared with only around USD 2.5 trillion remaining. Most bonds now offer positive yields.
- While the sharp upward repricing across the curve led to significant negative returns and unrealized losses, current yields have become a lot more attractive, in our view.
- Higher yields mean that investors can generate more income from new bond holdings, which helps to offset potential mark-to-market losses from a further move higher in yields.

More flexibility and some additions in the core fixed income world are recommended

- To effectively navigate the road ahead and bridge the gap from now until the latter stages of the hiking cycle, we believe that investors need to keep their approach flexible as much as possible.
- Most bonds in the market are now trading at yields higher than their fixed coupons and bonds are trading at a discount to the redemption values.
- The positive convexity of bonds should be supportive even if the markets are still volatile.

I. Overview

Fixed income assets have historically delivered solid returns for investors. Using a portfolio mix of select developed market government bonds, we estimate that short duration (1-3 year) government bonds have generated a return of more than 2% on an annualized basis over the past two decades.

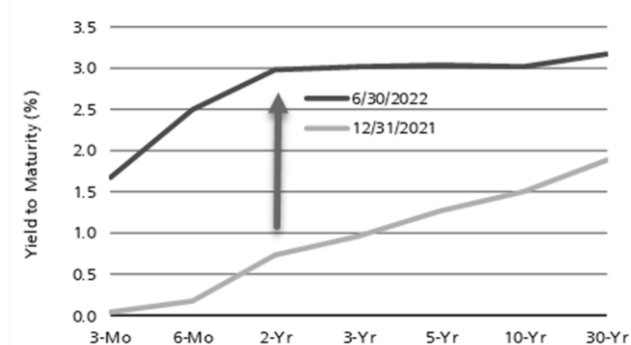
Additionally, a portfolio of longer duration bonds from these same markets has returned close to 4%. These rates of return have not only protected the purchasing power of portfolios in real terms (assuming an inflation rate of 2%), but have also played an important role as a diversifier for volatility from exposure to equity or credit markets.

But the last year has been one of the most difficult periods over the past decade for fixed income investors. Many fixed income markets came under severe pressure and sold off heavily, resulting in negative fixed income returns across the board. Of course, a negative return on longer duration

strategies could have been expected. What came as a surprise to many investors was the fact that even when invested in the short duration part of the curve, bonds were impacted negatively by increasing yields and delivered negative returns as well. The shift in the yield curve – markets have priced in an aggressive, front-loaded policy rate hiking cycle – was the main reason for the losses in the shorter end as well. With that, even the most conservative part of the yield curve came under severe pressure.

There is light at the end of the tunnel, however. As central banks have already hiked rates significantly and potentially more hikes are already priced in, we might be getting closer to the end of the hiking cycle, and therefore bond investors could benefit from much higher yield levels that may better absorb any shocks from further increases in interest rates.

Exhibit 1: US Treasury yield curve



Source: Bloomberg as of 30 June 2022.

While it was a detraction when yields increased to recent levels, it now offers the opportunity to invest at attractive yield levels and to potentially receive positive returns even if yields remain static. In short, **the income component comes back into “fixed income”** and marks a good starting point to rethink investments to make sure that the allocation is sufficient and allows participation in a broader investment universe rather than simply replicating a global benchmark.

As the European Central Bank President Christine Lagarde mentioned during a recent press conference: “The way forward now with expected rate hikes will be a way towards normalization.”¹

II. The current environment is challenging

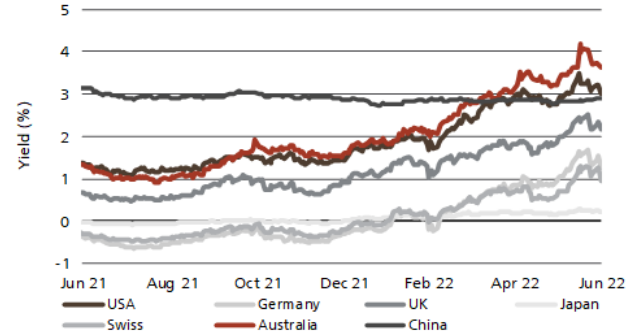
Currently, inflation fears are the most dominant theme in fixed income markets. With the significant increases in oil and energy prices, as well as skyrocketing food prices due to the Ukraine-Russia war, prices across the globe are creeping up and inflation prints have been reaching the highest levels in recent years, for example US CPI which recently printed at 8.6%. The last time we saw such a level was in the late 1970s, amid the oil crisis. In

2021, the expectation was still that inflation was more transitory and mainly driven by pent-up demand after the pandemic, supply chain disruptions, sanctions, and limited food capacity. While there’s a good chance of stabilizing price pressure somewhat, especially for core inflation, we believe that it might be premature to expect declining inflation pressure, declining yields and the end of a tighter monetary policy.

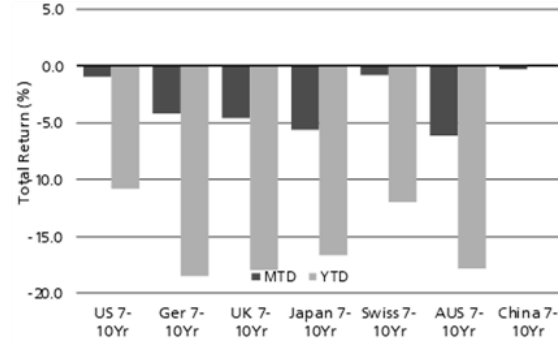
1. “Lagarde Tells Ministers ECB Plans for Limit on Bond Spreads.” Bloomberg, June 16, 2022. <https://www.bloomberg.com/news/articles/2022-06-16/lagarde-tells-ministers-ecb-expects-to-put-limit-on-bond-spreads>

Exhibit 2: Yield changes resulted in negative returns across all FI asset classes

Government Yields



Total Returns

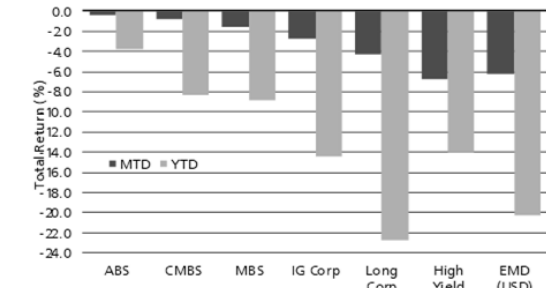


(7-10YR)	Yield	MTD change	3-month change	YTD Change	1-year change
USA	3.62%	+31 bps	+83 bps	+200 bps	+229 bps
Germany	1.25%	+24 bps	+79 bps	+154 bps	+162 bps
UK	0.24%	+5 bps	+7 bps	+23 bps	+24 bps
Japan	0.94%	+24 bps	+47 bps	+113 bps	+124 bps
Swiss	2.15%	+18 bps	+62 bps	+125 bps	+149 bps
Australia	3.01%	+15 bps	+65 bps	+156 bps	+164 bps
China	2.89%	+7 bps	+3 bps	+4 bps	-24 bps

(7-10YR)	MTD total return	3-month total return	YTD total return
USA	-6.17%	-13.36%	-17.84%
Germany	-4.15%	-11.65%	-18.55%
UK	-5.63%	-11.03%	-16.64%
Japan	-0.88%	-6.42%	-12.04%
Swiss	-4.62%	-11.51%	-17.94%
Australia	-0.98%	-4.46%	-10.78%
China	-0.35%	0.16%	0.08%

Source: Bloomberg Finance LP, Barclays. As of 30 June 2022.

Total Returns



	YTW	MTD total return	3-month total return	YTD total return	1-year total return
ABS ²	3.78%	-0.46%	-0.91%	-3.77%	-4.27%
CMBS ²	4.07%	-0.76%	-2.85%	-8.28%	-8.89%
MBS ²	3.77%	-1.60%	-4.01%	-8.78%	-9.03%
IG Corp ²	4.70%	-2.80%	-7.26%	-14.39%	-14.9%
Long Corp ²	5.11%	-4.32%	-12.80%	-22.75%	-21.71%
High Yield ³	8.78%	-6.80%	-9.93%	-13.99%	-12.58%
EMD (USD) ⁴	8.56%	-6.21%	-11.43%	-20.31%	-21.22%

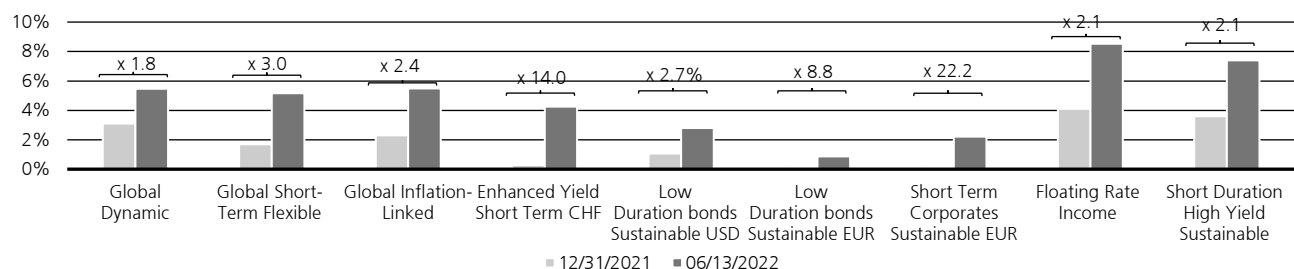
Source: Barclays. As of 30 June 2022.

- 1 Bloomberg Bellwether Index
- 2 Bloomberg index,
- 3. BofAML Cash Pay US High Yield Constrained Index
- 4 JP Morgan EMBI Global Diversified Index

An opportunity for income generation arises from the recent increases in yields. Current yields allow for some buffer in case yields move up further. If yields are more range-trading over the next couple of months, some of the losses that occurred during the past 12 months might be cancelled out - the closer the bonds come to maturity – and this might be the case for investments in the 2-4-year horizon.

To manage the recent, even high market uncertainty, we are currently still of the view that **investing in the shorter to middle part of the curve is the most attractive** investment. Long duration positions might still be too early to invest in.

Exhibit 3: Yields increased significantly since 31 December 2021



Source: Bloomberg as of 13 June 2022.

III. Why flexibility matters

As we have already established, we believe there is a high probability that expected returns for fixed income will remain lower than what investors have grown accustomed to over the past three decades. More importantly, this prognosis is regardless of whether inflation will be transitory or persistent.

However, it is our view that investors can improve the risk-adjusted return prospects of their fixed income portfolios by embracing flexibility in their allocation to different fixed income asset classes.

Table 1: Historic returns by asset class since 2002

	Annual Return	Annual Standard Deviation	Worst rolling 12m	Return/Risk	Sharpe Ratio
Cash	1.6%	0.45%	0.1%	3.51	0.00
Corp	4.5%	5.99%	-14.2%	0.75	0.49
Global Govt Bonds S-T	2.2%	1.25%	-2.6%	1.78	0.51
Global Govt Bonds L-T	3.5%	4.02%	-7.2%	0.86	0.47
TIPS	4.6%	5.87%	-9.3%	0.79	0.52
Securitized	3.5%	2.55%	-8.8%	1.37	0.75
Supra	3.7%	2.88%	-7.7%	1.30	0.75
EMD	6.5%	8.84%	-21.2%	0.73	0.55
EMD Local	3.9%	11.77%	-26.2%	0.33	0.19
Global Equity	6.5%	15.35%	-47.1%	0.42	0.32

Source: Bloomberg, UBS as of June 2022. Global Govt Bonds S-T (short-term 1-3 years) and L-T (long-term 7+ years) refers to a basket of global government bonds hedged to US dollar.

In the table below we show 4 different fixed income portfolios. They all share one feature: they have a higher exposure to cash and short-duration bonds, which we believe is the best way to protect fixed income portfolios from

inflation risk. Portfolios 3 and 4 outperform less diversified portfolios in almost all scenarios and the increase in volatility is relatively small when compared to more conservative portfolios.

Table 2: Example conservative Fixed Income portfolios

	F1	F2	F3	F4	
Cash		10%	10%	10%	<i>Citigroup US 3m</i>
GGB 1-3	100%	50%	20%	20%	<i>Citigroup weighted index *)</i>
GGB			10%		<i>Citigroup weighted Index *)</i>
Corporate Bond		10%	10%	10%	<i>Bloomberg Barclays Corp. Investment Global-US Hedged</i>
TIPS		10%	10%	10%	<i>Bloomberg Barclays US Gov. Inflation-Linked All Mat.</i>
Securitized		10%	10%	10%	<i>Bloomberg Barclays Global Aggregate Securitized</i>
Supranationals		10%	10%	10%	<i>Bloomberg Barclays Global Aggregate Gov. Related</i>
EMD Hard Currency			20%	20%	<i>JP Morgan EMBI Global</i>
EMD Local Currency				10%	<i>JP Morgan GBI-EM Diversified (TR)</i>

Expected 5-year returns by economic scenario

Soft Landing	2.6%	2.8%	3.6%	4.1%
Recession/Stagnation	1.4%	2.1%	3.0%	3.2%
Stagflation	1.6%	1.9%	1.9%	2.2%
Inflationary Growth	2.1%	2.0%	2.3%	3.1%
Standard Dev	3.8%	3.7%	4.6%	5.1%

Source: UBS as of 2Q 2022. UBS Investment Solutions provides estimates of capital market returns across a wide array of asset classes, horizons and from multiple currency perspectives. Here we present our 5-year baseline expected geometric returns. The return estimates are based on our expectations for inflation and central bank action, our expectations of long-term risk premia, as well as our proprietary valuation model's estimates of over- or under-valuation of asset classes and currencies.

Also, **low yield is not synonymous with low return**. In our flexible fixed income strategies, we utilize relative value strategies across interest rates and currencies that allow us to generate returns beyond the starting yields on offer. By taking long positions in countries where we believe yields are likely to fall and short positions in countries where we expect yields to rise, we can benefit from price appreciation on both legs of our position if our thesis plays out. Given the inherent volatility of currencies, we take exposures consistent with our risk budgeting framework.

Finally, we believe in **"giving credit where credit is due"**. For high quality portfolios, this means opportunistic allocations to credit. During market dislocations, we can find value in credits with strong fundamentals and attractive risk-adjusted return prospects. While we do not advocate clients change their risk profile without a change in circumstances, in our view it might be prudent to add exposure to non-sovereign holdings, subject to the overall ratings allocations for the mandate.

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