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Knowledge Transfer Program
Module 2 - Back to Fixed Income

Three benefits of higher income in fixed income

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The last six months in fixed income markets

- Over the previous decade, fixed income has been seen as the boring asset class, with yields restrained by central bank policy aimed at stimulating growth and inflation. We are now in unchartered territory, with inflation rates across major developed economies reaching 40-year highs.
- This has created a lot of pain for existing fixed income investors. At the beginning of the period, bonds were at the end of a multi-decade bull run, and yields had dropped to extreme lows. But with central banks adopting hawkish policy stances, aimed at fighting inflation pressures, bonds have repriced significantly and there's been very little room to hide from deeply negative returns across developed markets.
- In the US, the yield curve has flattened substantially since the beginning of the year, with yields moving sharply up, driven by the front end. This is a result of aggressive Federal Reserve tightening, frontloading rate hikes in order to combat overshooting inflation. One-year yields have risen from close to 0% to 2.9%, and most of the curve now is within a 2.5% - 3% band.
- Looking at 7-10 year maturities globally, in Australia, yields were a significant underperformer, selling off by 2% to get to the current yield level of 3%, while returning -16%.
- For those investors who either track a benchmark or had a low flexibility tolerance and had to own negatively yielding bonds in markets such as Germany, they also felt a lot of pain. German government bond yields rose 1.25% from -0.60% to +0.66%, resulting in a negative return of just under 10%.
- U.S. Treasuries had a slightly better starting point of just over 1%, rising by 1.5%, but delivering an equally disappointing return of -10%.
- For those investors willing to be selective and opportunistic, there are three potential benefits of investing in fixed income at the current time: higher yields, a wider opportunity set and a better risk-return asymmetry.

Developed markets’ policy rates

- The Fed’s aggressive tightening path is reflected across most major economies. What's important to note is that policy rates among many of these central banks are now close to neutral rates and further tightening is already priced in, so only if these markets have to tighten more than expected, yields would go up. This is where flexibility and active management come at a great advantage.
- Investors who can be flexible can avoid either the lower yields or those where the pricing hasn't caught up to economic reality. Investors can gain greater exposure to those markets where central banks are approaching the end of their rate-hike cycle, so the potential for yield widening is more limited. In our more flexible portfolios, we can also take relative value positions across these different markets.

Opportunities in credit

- Year-to-date, credit sector spreads widened in both investment grade and high yield, driven by risk aversion. While they aren’t at the distressed levels seen in the initial stages of the COVID-19 pandemic, the recent widening has created some opportunities, if you can be selective. Compared to the all-time tights, credit spreads are now in the second quartile of all-time wides and spreads in sectors such as Europe, for example, are in the first quartile.
- Investors need to remain selective and nimble, even within these sectors: credit and sector selection and curve positioning will be key to navigating choppy and volatile markets over coming quarters.

The universe of negative yield debt shrinks dramatically

- For the past three years, since 2019, we've been advising our clients of the challenges for fixed income investors in avoiding negative yield in debt, so as not to lock in negative total returns.
- Due to the rapid yield rises, the amount of negative yielding debt has shrunk from as high as $18 trillion to only $2 trillion now, as measured by the Bloomberg Global-Aggregate Index, which is an investment-grade fixed income proxy.
- Keeping in mind that the total market value of this index is around $60 trillion, the slice of negative-yielding debt went from 30% to 3%. This gives us a much wider opportunity set when constructing client portfolios.
- So, deconstructing the whole of fixed income universe, as measured by Bloomberg Multiverse Index, which is the global-aggregate index plus the global high yield index, only 25% of the market had yields of more than 2% at the end of last year. Today, this universe has tripled to 75%. Previously, clients had to reach down the credit scale and found themselves cornered in higher-risk sectors or longer-duration assets if they wanted attractive yields. This is not the case now.
- This development allows for a better starting point in achieving both capital preservation and the ability to hit the yield targets our clients typically seek out. This is especially pertinent for insurance clients who have risk capital charges that increase as you go down the quality spectrum.
- Diversification among issuers and sectors means clients have added benefits, while flexibility for sector rotation without going down the credit spectrum means performance can be easily achieved with sensible guidelines.

Attractive risk return profile due to positive return asymmetry

- The higher yields have also brought excitement to bond math. For example, for 10-year US treasuries, given a current yield of 2.9% and a duration of roughly eight years, if yields rise by 50 bps over the next 12 months, then the return will be -1.1%. However, if yields fall by 50 bps over the same time period, then the expected return is 7%.
- Compare this to the beginning of the year, when yields were around 1.5% and duration was slightly greater at around nine years. The same math would lead to a 6% return if yields fall, and -3% should they rise. That's a ratio of 2:1 rather than 7:1.
- So, the key point is that investors have a better yield cushion, as of now. Should yields rise from here, then losses will be smaller compared to the beginning of the year. Total returns are seven times the expected loss now, versus only double at the beginning of the year. Carry has also close to doubled should yields do nothing.

Higher break-evens act as 'shock absorbers'

- Break-evens reflect the magnitude of the yield rise needed to generate a negative total return (i.e. wipe out the positive contribution from yield income). Today, the overall yield moves required have almost doubled since the beginning of the year, while in short-duration sectors they have trebled.
- Looking at the Bloomberg Global Aggregate Index, break-evens were at 17 bps at the beginning of the year; they are now at 37bps. The global corporate index has risen from needing 25 bps of yields rising to 59 bps before negative total returns set in.
- The short duration sectors are really shining: this is because curves have flattened, and by definition, short duration assets have much less interest rate sensitivity. Here, for example, the global aggregate 1-3 year index will now need 119 basis points of yield increases before a negative total return sets in.

How this translates to our strategies

- Investors now have greater flexibility to achieve their yield targets. The balancing act is still quite tricky, with sticky inflation and slowing growth. The flexibility to capture opportunities from market dislocations will be important in generating attractive returns. So, we recommend flexible fixed income and short duration strategies to ride through the volatility.
- Our flexible fixed income offering does not only benefit from higher yields but also targets total return. Here, we have full flexibility to navigate the current macroeconomic environments without the constraints of benchmarks, and we can utilize strategies such as relative value trades. We encourage our clients to choose flexible strategies where possible.

- For those that still need a benchmark for, for example, risk management purposes, then flexible, benchmark-aware strategies will work well too.
- Given attractive risk-free rates, flat curves and wide spreads, investment grade corporates can also offer attractive opportunities. Here, we prefer short duration securities to keep interest rate sensitivity low and break-evens high. For those whose investment guidelines permit outright exposure to sectors such as high yield, keeping duration short, or close to zero, can also be an attractive proposition.

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