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Event date: 1 September 2022

Knowledge Transfer Program
Module 2 - Back to Fixed Income

Q&A

Q: Is it more beneficial to reallocate out of long duration to short duration? In addition, do you still consider high quality corporate bonds to be cheap?

- On the credit side, I would say no, we don't consider them to necessarily be cheap. Within the credit allocations of our global portfolios, we have a more defensive positioning, with credit holdings that are at the low end of the permissible ranges. Where we do own credit, we generally prefer high quality, non-cyclical sectors. We're mindful of the point we made earlier about central bank policy: in prior years central banks took policy rates to low levels, driving flows into other assets, one of them being credit. As that policy reverses, yields are moving higher, and that flow will also likely unwind.
- Regarding yield curves, arguably, yield curves are one of the more interesting parts of the fixed income universe right now. Earlier we said we were somewhat cautious on bonds overall, as short duration yields could go higher. That's our base case, but there are plenty of opportunities within fixed income that we think are attractive right now. From a yield curve perspective, there's a difference in the outlook between the US and the Eurozone. The ECB is rather hawkish right now. But if they are forced to rein that in because the situation in Europe deteriorates, perhaps heading into a deep recession with high unemployment and factories being shut down due to energy rationing, the ECB will probably have to delay their planned rate hikes, while accepting inflation at higher levels than they would want. This could produce a yield curve steepening environment. And therefore short-end bonds might look better valued.
- The yield curve in the US could evolve quite differently, and I can see a scenario where actually the US doesn't face the same sort of challenge on the energy front as they do in Europe. If the Fed delivers on the hawkish message they've talked about so far, even as the economy moves into recession - and we've already had two negative quarters of GDP growth - then I can see the US yield curve flattening a lot. Front-end rates could really sell off as the Fed is forced to do more.
- Overall, it comes back to the theme of needing flexibility and adapting to a slightly different approach in different markets.

Q: How do you use forward rates when you think about positioning in your portfolio?

- They are important tools as they are a sort of aggregation of everybody's view in the market. There's the futures markets in policy rates, like Fed funds futures. And forward curves for bond yield curves as a whole. They tell you a lot about future expectations, so we use both. But they have their limits. 50 percent of people can have a very hawkish view, the other 50 percent can have a very dovish view, and you end up with something not that representative either. Which is why we form our own outlook, with our own expectations for policy rates. The key variables we hone in on for each country are the outlook for growth and the outlook for inflation and therefore, the outlook for policy rates. And then we take our view and we compare that with what's priced into the market. Where we are aligned with the market there's probably not a whole lot to do, but where our view and the market is misaligned, then that implies there's a trade on.

Q: Is there a ceiling as to how much 10-year US Treasury yields can rise before interest payments for the US government becomes painful or too costly?

- We're a long way from the point at which people would start to stress about the US's ability and willingness to repay Treasury debt. Treasury yields would have to move a lot higher before that would become an issue. 10-year yields could easily reach 3.5% again given the way things are unfolding. But I think we're a long way from there being a threat to the ability to pay Treasuries.

Q: What are your views on taking a passive approach versus an active approach?

- Yields have risen substantially, and there's substantial market volatility. We've talked about the importance of flexibility in an investment approach, taking relative value views across various markets. Active is going to be a lot more important. And I would emphasize the benefits of an active, flexible fixed income approach to maximize what can be done within a portfolio in order to help generate that total return.
- The other perspective is where I talked about kind of keeping duration short. If you consider short duration portfolios, in order to minimize interest rate risk, what you are going to end up with in passive is high transaction costs. As bonds mature and move down the curve, indices have to sell those securities that have a maturity of less than one year. Then new bonds enter, and so you're going to generate a lot of turnover. Whereas, core active fixed income strategies can avoid that. They don't have to automatically sell bonds, and they can buy longer maturity bonds that might be in the portfolio for some time, thereby saving on transaction costs.

Q: What's your view on the European high yield sector?

- If you look at our high yield strategy, they are still defensively positioned. They are concerned about some of the cyclical sectors and they've been running short duration positions because they're concerned about higher yields. That caution has paid off, because they've delivered some fantastic results in European high yield. There's still some serious headwinds coming towards Europe and credit markets are going to get challenged, whether it's investment grade or high yield. However, if spreads move materially higher from here, then we could start to say that an awful lot of downside has been priced in, and that might drive a higher allocation, but we're not really there yet.

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