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Navigating challenging fixed income markets: The case for broadening investment guidelines and increasing flexibility

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Overview

2021 has been a difficult year for fixed income investors, particularly those exposed primarily to high quality government bonds. Even short duration investment grade fixed income, widely regarded as the poster child for conservative fixed income investing, is on track to deliver a negative return for the first time in nearly thirty years.

Why is this happening? Low yields from developed market bonds have failed to offset the negative price return from bonds in a rising interest rate environment. The road ahead is a challenging one from a total return standpoint; likely to be characterized by low absolute [albeit rising] yields and negative price returns as central banks move to normalize policy rates in a post-pandemic recovery.

There is light at the end of the tunnel, however. As central banks near the end of the hiking cycle, bond investors will benefit from much higher yield levels that better absorb any shocks from further increases in interest rates.

To bridge the gap between the current environment of meager yields and low returns and a future state where yields are high enough to better cushion against losses, we believe investors need to move away from a siloed approach to fixed income markets and embrace flexibility. This can be accomplished either by broadening their investable universe to include more countries, sectors and instruments or by allocating to flexible fixed income strategies that are actively managed across these different dimensions. The combination of an expanded opportunity set, and diversification of return sources can play an important role in helping protect fixed income portfolios.

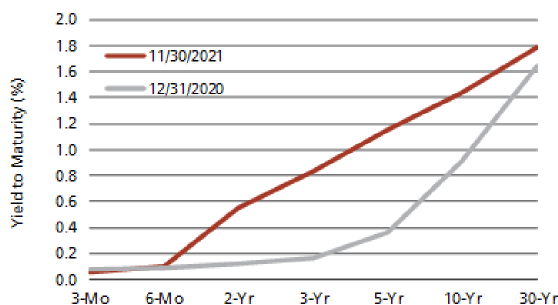
I. The current environment is challenging

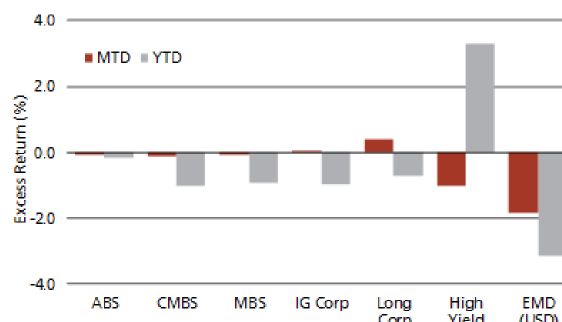
2021 started with the political drama of the disputed US election results, Capitol Hill riots in the US and renewed lockdowns in Europe due to surging COVID-19 cases. Shortly thereafter, market sentiment improved quickly due to positive expectations for global GDP growth, driven by USD 1.9tn in fiscal stimulus announced by the newly elected Biden administration and the rollout of effective vaccines against COVID-19. The dramatic improvement in the economic outlook coupled with persistent supply side bottlenecks in labor, energy and product markets led to a higher-than-expected rise in inflation.

While the US central bank now acknowledges the current increase in prices might be more persistent than previously thought, the US Fed is sticking to its "transitory" view and has not yet signaled any imminent increase in policy rates. This has not prevented the market from pushing up yields as it believes persistent inflation will eventually force the Fed to hike rates earlier than anticipated.

Year-to-date, the largest increase in yields has been in the 3–5-year part of the curve. 3-year US yields have risen 60bps YTD and 5-year yields by more than 80bps. Also,10-year US yields have moved up 65bps, back to pre-COVID-19 levels. The rise in US yields YTD has translated into widespread losses for US government bonds, rate-sensitive credit and other spread products.

Exhibit 1: US Treasury and Fixed Income sector returns





Treasury	YTM	MTD Change	3-Month Change	YTD Change
3-Month[1]	0.05%	-0 bps	+1 bps	-3 bps
6-Month[1]	0.10%	+4 bps	+5 bps	+1 bps
2-Year[1]	0.55%	+6 bps	+34 bps	+43 bps
3-Year[1]	0.83%	+8 bps	+43 bps	+67 bps
5-Year[1]	1.15%	-4 bps	+38 bps	+80 bps
10-Year[1]	1.44%	-12 bps	+13 bps	+53 bps
30-Year[1]	1.79%	-15 bps	-13 bps	+15 bps

	YTW	MTD Tot.Ret.	3-Month Tot. Ret.	YTD Tot. Ret.
ABS[2]	0.98%	-0.07%	-0.56%	-0.18%
CMBS[2]	1.80%	-0.09%	-1.25%	-1.01%
MBS[2]	1.94%	-0.09%	-0.64%	-0.95%
IG Corp[2]	2.29%	0.06%	-0.75%	-0.96%
Long Corp[2]	3.06%	0.40%	-0.03%	-0.71%
High Yield[3]	4.79%	-1.04%	-1.19%	3.29%
EMD (USD)[4]	5.41%	-1.84%	-3.85%	-3.15%

Source: Barclays, ICE BofAML, JPMorgan Market As of November 30, 2021
1. Bloomberg Bellwether index
2. Bloomberg Index
3. BofAML Cash Pay US High Yield Constrained Index
4. JPMorgan EMBI Global Diversified Index

Outside the US, a similar dynamic has taken place in Europe, the UK and other developed economies. The only exception has been in Japan, where the Bank of Japan (BOJ) controls the yield curve directly as a policy.

Exhibit 2: DM Government bond yields and returns

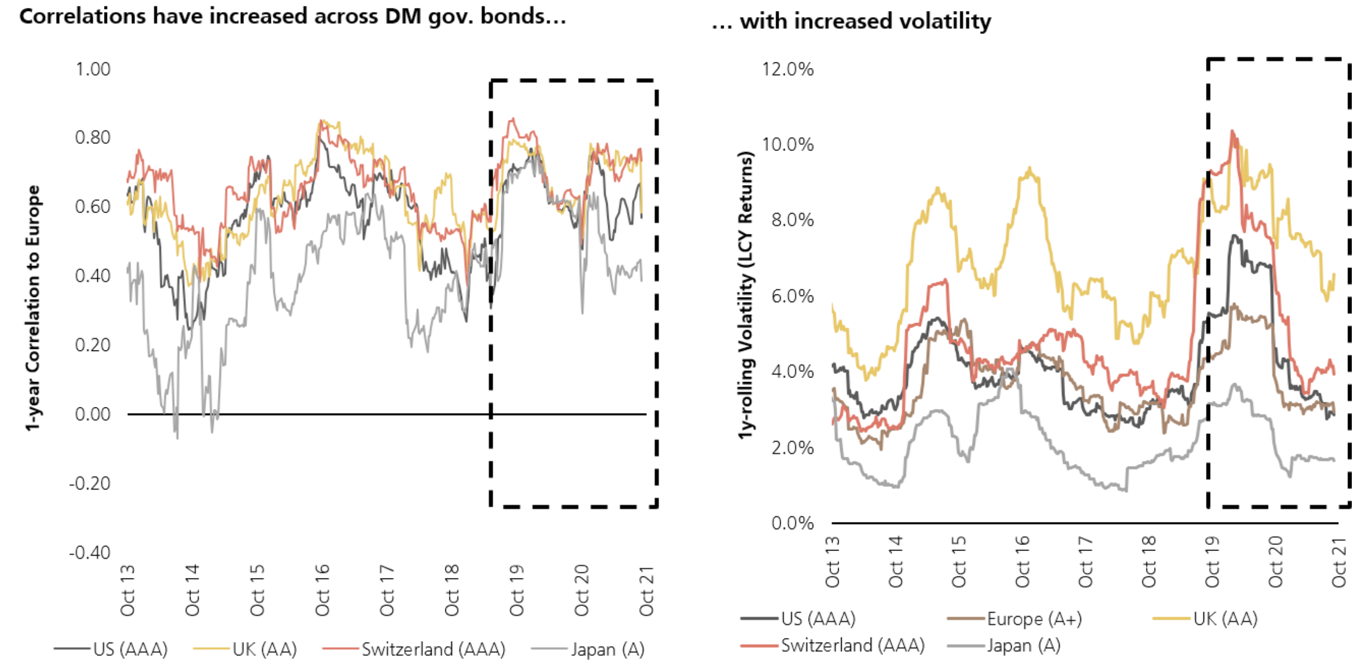
	Yield	MTD Change	3-Month Change	YTD Change
AUS 7-10Yr	2.09%	+60 bps	+91 bps	+112 bps
Ger 7-10Yr	-0.11%	+9 bps	+36 bps	+46 bps
Japan 7-10Yr	0.10%	+3 bps	+8 bps	+8 bps
Swiss 7-10Yr	-0.03%	+13 bps	+34 bps	+52 bps
UK 7-10Yr	1.03%	+1 bps	+47 bps	+84 bps
US 7-10Yr	1.55%	+6 bps	+33 bps	+64 bps

	MTD Tot. Ret.	3-Month Tot. Ret.	YTD Tot. Ret.
AUS 7-10Yr	-0.79%	-4.49%	-9.16%
Ger 7-10Yr	-1.16%	-5.47%	-8.72%
Japan 7-10Yr	-2.26%	-4.33%	-9.63%
Swiss 7-10Yr	0.83%	-3.83%	-6.82%
UK 7-10Yr	1.35%	-4.37%	-5.30%
US 7-10Yr	-0.45%	-2.42%	-3.89%

Source: Bloomberg Finance LP, Barclays.
As of November 30, 2021

Further, movements in the yields of major developed markets have been highly correlated in recent times, thereby reducing the diversification benefits of owning a portfolio of bonds from these markets. In addition, volatility has increased meaningfully with negative consequences for fixed income investors.

Exhibit 3: Correlation and volatility among major developed market bonds

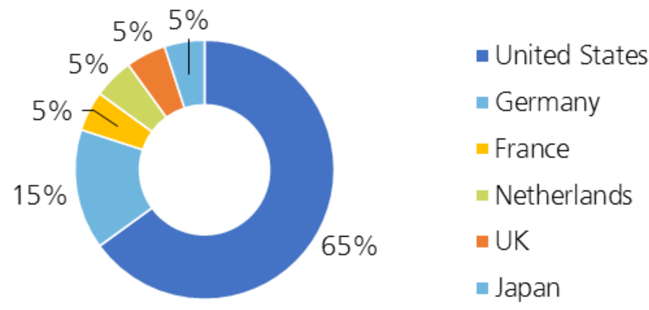


Source: Bloomberg.
US (AAA): J.P. Morgan GBI US, UK (AA): J.P. Morgan GBI UK, Switzerland (AAA): Swiss Bond Index (SBI), Japan (A): J.P. Morgan GBI Japan, Europe (A+): J.P. Morgan GBI EMU. As of end October 2021

II. The good old days may be behind us

Fixed income assets have historically delivered strong returns. Using a portfolio mix of select developed market government bonds as shown in the adjacent chart, we estimate that short duration (1-3yr) government bonds have generated a return of more than 2% on an annualized basis over the last two decades. Additionally, a portfolio of longer duration bonds from these same markets have returned more than 4%.

Exhibit 4: Composition of short- and long-term government bond sample portfolios (GGB1-3 and GGB)



Source: UBS 2021.

Beyond government bonds, returns in spread products have ranged between 4% for asset-backed securities on the lower end to 8% for hard currency denominated emerging market debt on the upper end. These attractive 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 markets.

III. Doing nothing is simply not good enough

The ability of conventional fixed income assets to serve the dual role of providing returns above inflation and diversification from equity risk will likely be tested going forward. Going back to our earlier portfolio of developed market government bonds, our base case is that future returns could decline dramatically from a historical average of 2.4% for the short duration portfolio and 4.1% for the longer duration portfolio to as low as 0.70% and 0.60% for the respective portfolios. This assumes the current high bout of inflation is transitory and that interest rates will normalize over the next 2-3 years.

In an environment of stagflation characterized by low growth, high inflation and high interest rates, our hypothetical portfolios fare even worse as expected returns turn negative across short and long duration bonds. Similar undesirable outcomes can be observed in an inflationary growth scenario such as what we are currently experiencing. It is therefore not surprising that even shorter duration high quality portfolios are in the red so far this year.

Exhibit 5: Historical returns compared to expected returns under four potential scenarios

	Historical returns	Base case	Recession	Stagflation	Inflationary Growth
		Return	Return	Return	Return
Cash	**1.6%**	0.68%	0.00%	0.56%	0.77%
Global Government Bond 1-3	**2.4%**	0.70%	0.17%	-0.04%	-0.05%
Global Government Bond	**4.1%**	0.60%	0.80%	-2.69%	-3.22%
Corporates	**5.5%**	0.61%	1.73%	-0.92%	-1.27%
TIPS	**5.3%**	-0.55%	-0.50%	0.60%	-1.81%
Securitized	**4.1%**	1.17%	1.35%	-0.34%	-0.66%
Supranational	**4.3%**	1.20%	1.23%	-1.12%	-1.49%
EMD Hard Currency	**7.9%**	2.98%	4.28%	2.50%	1.13%
EMD Local Currency	**5.2%**	1.26%	4.48%	3.44%	4.86%

Source: UBS as of November 2021. For more information please refer to the appendix.

At the individual asset class level, returns are also expected to be meaningfully lower on a forward-looking basis even in spread sectors such as corporates and securitized assets. We observe that both hard and local currency emerging market debt have positive return expectations across all scenarios in our analysis. While we are constructive about the long-term outlook for emerging market debt, we note that the current macroeconomic backdrop resulting from the COVID-19 pandemic, as well as higher refinancing costs for EM economies with rising US Treasury yields, could be headwinds in the short-term.

IV. Why flexibility matters

As we have established in the preceding sections, there is a high probability that expected returns for fixed income will be 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 the table on the next page 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 all four scenarios and the increase in volatility is relatively small when compared to more conservative portfolios.

Exhibit 6: Example conservative Fixed Income portfolios

	FI1	FI2	FI3	F4	
Cash		**10%**	**10%**	**10%**	*Citigroup US 3m*
GGB 1-3	**100%**	**50%**	**20%**	**20%**	*Citigroup weighted index *)*
GGB			**10%**		*Citigroup weighted Index *)*
Corporate Bond		**10%**	**10%**	**10%**	*Bloomberg Barclays Corp. Investment Global-US Hedged*
TIPS		**10%**	**10%**	**10%**	*Bloomberg Barclays US Gov. Inflation-Linked All Mat.*
Securitisied		**10%**	**10%**	**10%**	*Bloomberg Barclays Global Aggregate Securitised*
Supranationals		**10%**	**10%**	**10%**	*Bloomberg Barclays Global Aggregate Gov. Related*
EMD Hard Currency			**20%**	**20%**	*JP Morgan EMBI Global*
EMD Local Currency				**10%**	*JP Morgan GBI-EM Diversified (TR)*

5y outlook

Base case	**0.70%**	**0.71%**	**1.22%**	**1.28%**
Recession/Stagnation	**0.17%**	**0.56%**	**1.55%**	**1.98%**
Stagflation	**-0.04%**	**-0.07%**	**0.25%**	**0.92%**
Upside	**-0.05%**	**-0.43%**	**-0.49%**	**0.37%**
Standard Dev	2.00%	2.63%	3.23%	3.60%

Source: UBS as of November 2021. *) Please refer to the appendix for a breakdown by issuing sovereign of our short-term (GGB1-3) and long-term (GGB) government bond sample portfolios

V. How we manage flexible bond portfolios

At UBS-AM Fixed Income, our approach to flexible bond investing is built on a few important tenets. Firstly, we favor an outcome-oriented measurement of performance instead of traditional benchmarks. We are cognizant of the fact that benchmark-driven investing and asset allocation have been a prominent feature in most institutional mandates. However, partly because of the current low yield environment, there are certain dangers lurking in traditional fixed income benchmarks, including the lengthening of their sensitivity to interest rates, low yields on offer and the decline in their overall credit quality.

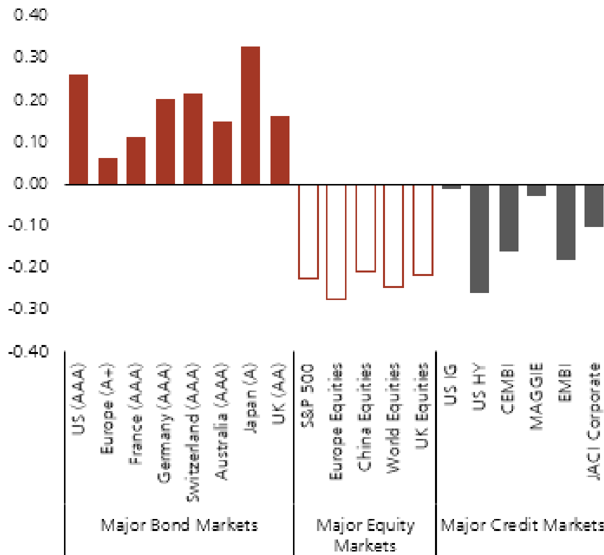
In the place of benchmarks, we advocate a focus on a return that meets the specific needs of the investor subject to a risk tolerance constraint. For investors that are unable to do away with traditional fixed income benchmarks in their entirety, relaxing investment guidelines particularly around duration, asset class and country can help overcome the challenge of low expected future returns.

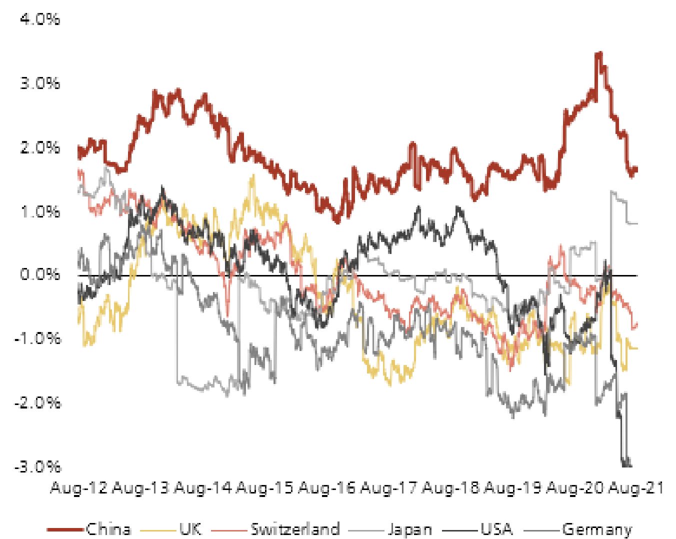
Secondly, there are ample opportunities to generate returns beyond bonds issued by G7 member countries. In fact, in many ways, G20 is the new G7. Countries such as China, Russia, Mexico, India and Indonesia offer an attractive yield pick-up relative to their developed market peers and also have stable-to-improving fundamentals. As an example, China's onshore bond market is now the second largest fixed income market globally.

As the below chart illustrates, China Fixed Income offers a positive real yield and diversification benefits due to its low correlation to developed market government bonds and negative correlation to developed market risk assets. In our flexible bond strategies, we are currently long duration in Chinese Government Bonds for

these exact reasons, in addition to our view that policy makers are likely to pursue accommodative monetary policy going forward, leading to a decline in yields and appreciation in the price of the bonds.

Exhibit 6: China Fixed Income brings benefits to a flexible bond portfolio





Source: Bloomberg
Note: (1) Correlations are made to the China bond market, represented by Bloomberg Index I08271CN. (2) Major equity markets are represented by the following indexes: (S&P 500) Bloomberg code: SPX:IND; Europe Equities represented by EURO STOXX 50 Index, Bloomberg code: SX5E:Ind; China Equities: represented by Shanghai Stock Exchange Composite Index. Bloomberg code: SHCOMP; World Equities represented by MSCI World Index, Bloomberg code: MXWO; UK Equities represented by FTSE 100 Index, Bloomberg code: UKX.
(3) Left hand side chart: China (A+): Bloomberg Barclays China Agg Index, US (AAA): J.P. Morgan GBI US, Europe (A+): J.P. Morgan GBI EMU, France (AAA): J.P. Morgan GBI France, Germany (AAA): J.P. Morgan GBI Germany, Switzerland (AAA): Swiss Bond Index (SBI), Australia (AAA): J.P. Morgan GBI Australia, Japan (A): J.P. Morgan GBI Japan, UK (AA): J.P. Morgan GBI UK. (4) Indices used are in local currency.
Data as of end August 2021

Also, **low yield is not synonymous with low return**. In our flexible fixed income portfolios, 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. Similarly, taking active currency views either outright against the US dollar or pairs (e.g., long Norwegian krone vs. short Australian dollar). Certain safe-haven currencies such as the Japanese yen and Swiss franc provide added benefits in the form of diversification in risk-off markets. 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.

In summary, fixed income investors are waking up to the realization that after almost three decades of a bull market in bonds, the road ahead will be more challenging. A combination of record-low starting yields and rising interest rates as central banks begin policy normalization in the aftermath of the shocks to the global economy from COVID-19, make the current starting point particularly difficult. These challenges are not insurmountable, however.

To effectively navigate the road ahead and bridge the gap from now till the latter stages of the hiking cycle, investors need to keep their approach flexible as much as possible. This includes expanding their horizons beyond low-yielding developed markets, introducing other asset classes into their portfolio mix and moving

beyond benchmarks. At UBS-AM Fixed Income, these solutions form the core of our flexible investment approach and allow us to generate attractive risk-adjusted returns over a market cycle.

Appendix

Exhibit 7: Historic returns by asset class since 2002

	Annual Return	Annual Standard Deviation	Worst rolling 12m	Return/Risk	Sharpe Ratio
Cash	1.6%	0.46%	0.1%	3.55	0.00
Corp	5.5%	5.76%	-13.9%	0.95	0.67
GGB 1 3	2.4%	1.20%	-0.3%	2.01	0.66
GGB	4.1%	3.90%	-3.9%	1.05	0.63
TIPS	5.3%	5.80%	-9.3%	0.91	0.63
Securitised	4.1%	2.29%	-0.8%	1.78	1.07
Supra	4.3%	2.73%	-0.9%	1.56	0.97
EMD	7.9%	8.54%	-20.2%	0.93	0.74
EMD Local	5.2%	11.57%	-20.9%	0.45	0.31
Global Equity	7.8%	15.19%	-47.1%	0.52	0.41

Source: Bloomberg, UBS as of November 2021.

Exhibit 8: Expected 5-year returns by economics scenario.

	Base case			**Recession**			**Stagflation**			**Inflationary Growth**		
	Return	**Std Dev**	**Risk/ Return**	**Return**	**Std Dev**	**Risk/ Return**	**Return**	**Std Dev**	**Risk/ Return**	**Return**	**Std Dev**	**Risk/ Return**
Cash	0.68%	1.35%	0.51	0.00%	1.34%	0.00	0.56%	1.36%	0.41	0.77%	1.35%	0.57
Global Gov. Bond 1-3	0.70%	1.96%	0.36	0.17%	1.96%	0.09	-0.04%	2.08%	-0.02	-0.05%	1.96%	-0.02
Global Gov. Bond	0.60%	5.58%	0.11	0.80%	4.49%	0.18	-2.69%	5.85%	-0.46	-3.22%	5.58%	-0.58
Corporates	0.61%	6.44%	0.09	1.73%	5.57%	0.31	-0.92%	8.88%	-0.10	-1.27%	6.44%	-0.20
TIPS	-0.55%	5.32%	-0.10	-0.50%	5.21%	-0.09	0.60%	5.38%	0.11	-1.81%	5.32%	-0.34
Securitized	1.17%	6.45%	0.18	1.35%	5.02%	0.27	-0.34%	8.13%	-0.04	-0.66%	6.45%	-0.10
Supranational	1.20%	5.77%	0.21	1.23%	4.62%	0.27	-1.12%	6.25%	-0.18	-1.49%	5.77%	-0.26
EMD Hard Currency	2.98%	7.38%	0.40	4.28%	8.65%	0.49	2.50%	10.47%	0.24	1.13%	7.38%	0.15
EMD Local Currency	1.26%	13.20%	0.10	4.48%	14.09%	0.32	3.44%	14.57%	0.24	4.86%	13.20%	0.37

Source: UBS as of November 2021.

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