pi roundtable

FIXED INCOME

CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

JUPITER
ASSET MANAGEMENT

Nicolas Forest | Adam Darling | Kate Hollis
Callum Logan | Umer Nazir | Gerald Wellesley

DECEMBER–JANUARY 2024 | PORTFOLIO INSTITUTIONAL

DISCUSSION: FIXED INCOME

After a difficult period, yields have climbed to levels that have made bonds more competitive with other asset classes. Yet this is also a period of low economic growth in the developed world and growing geopolitical uncertainty, especially as 2024 will see elections on both sides of the Atlantic. *Portfolio institutional* sat down with asset owners and those making investment decisions on their behalf to find out how they are navigating these markets.

How have asset owners adjusted their fixed income portfolios during such an aggressive rate-hiking cycle?

Umer Nazir: We have seen fixed income return to the fore as a result of this rate hiking cycle. The asset class is offering attractive yield and income for the first time in years. Investment grade credit yields are now roughly in the 4% to 6% range, which is what high yield was offering 18 months ago. As a result, we have seen higher flows into higher quality asset classes – our investment-grade fund has nearly tripled over the last eighteen months, which is a function of where yields are.

On the other hand, what has surprised me is the incremental addition to risk asset classes. This includes our multi-asset credit fund, which has high yield and emerging market debt exposure.

Callum Logan: The interest rate point is critical. The risk-free rate is meaningfully larger and, therefore, you are getting rewarded in the fixed income space.

We are seeing attractive opportunities for a diversified growth portfolio that we did not see previously. Prior to Covid we exited high-yield debt and other higher risk public fixed-income assets. But we now see those areas as being able to compete for capital with public equities, real estate and infrastructure, which have not seen yields rise to the same extent.

Another area we are interested in is securitised assets, which are often short dated and floating, so have been less affected from a duration perspective by the sharp rise in rates.

Nicolas Forest: We are in a new regime in terms of inflation, which is a big change for the fixed income markets. We have seen a dramatic increase in real yields over the past few months, to levels we have not seen for 10 years.

We are also at the end of the monetary cycle. Looking at history, after the last hike there is normally a bond rally of between 60bps and 100bps. This is because there is an opportunity to invest in bonds with longer maturities, especially investment grade.

For me, the big change is that we are at the end of high inflation and close to the end of the tightening cycle. That is a big change for fund managers. Comparing debt and equity for the coming year, US government debt, for example, has the same level of expected return as US equities. Because of the carry, even if we hedge the currencies, we have a reasonable expected return close to 8% from US bonds.

So bonds are back. We are in a new regime where fixed income expected returns have become much more attractive than equity on a risk-adjusted return basis.

Adam, what is your outlook for investment grade and high-yield debt?

Adam Darling: I am surprised at how sentiment towards fixed income has not improved. In 2020, yields were -2% in sterling investment grade. They have only moved one way since, thanks to interest rates going up and credit spreads selling off. The cash yield is now 6% but our fund is 7%.

And if we are coming to the end of the interest rate cycle and the inflationary paradigm, even if it falls to 2.5% or 3%, on a risk-adjusted basis, it just looks attractive.

High yield is a lot more nuanced. It has had a far better year than I would have thought because credit spreads are not pricing in a recession. If you did not have any other piece of information, the history of credit spreads would say that the high-yield market is predicting a soft landing.

My view is that is not going happen. If interest rates do not fall from where they are today, households and governments have to refinance into that and we could get a nasty landing.

We are in an environment where you can be pretty bullish on investment grade, while high yield is going to be much more about selective active management.

Kate Hollis: Our clients look at fixed income through two buckets. There is the liability matching piece and then there is return seeking.

We have seen two themes in the return seeking piece this year. The first was that people wanted more liquidity, even outside the liability matching portfolio, as central banks raised the level of collateral necessary for liability-driven investment (LDI) portfolios.

The second theme is that a lot of our defined benefit (DB) clients are moving towards buyout. While that precludes them from private equity, real assets and long-duration illiquids, they are selectively interested in private debt. Maybe they are looking to buyout in 10 or 15 years and some private debt is expected to mature in five to seven years. If you pick it carefully, there are good opportunities in private debt at some good yields.

Gerald, how are your DB and defined contribution (DC) schemes using fixed income?

Gerald Wellesley: The big focus for DC is decumulation, which has been an unloved sector because the assets have not been there. But with fixed income yielding what it does now, one can structure secure income-generating strategies that perhaps could yield 5%-plus when 3% to 4% was the mode before.

On the DB side, the big scramble now is to buy bonds. Buy and maintain is popu-

Chinese bonds are becoming less attractive, especially compared to US bonds.

Nicolas Forest
Chief investment officer
Candriam

lar and I have a mature scheme where it will pay the payroll on a gradually maturing basis. On top of that is multi-asset credit, which is now yielding 8% or more. What is not like to like about that if the required return on the assets is 5%, which seemed unachievable years ago.

What role does fixed income play in your portfolios, Callum?

Logan: Our schemes are growth focused, but we have a small allocation to lower risk assets, such as gilts and cash, to call on if we need to avoid being a forced seller of our growth assets.
They clearly offer a lower expected return although higher than previously. In the growth portfolio, fixed income has become more interesting. There was no place for some of these fixed income mandates in recent years because they could not compete with equities and real estate, whereas now they can.
We are seeing much more interest in private debt, but we are careful in how we approach that because some of these companies have too much debt and are vulnerable from rises in interest rates.
The public side is where we have been making the biggest changes. Emerging market debt is an area of interest, as you are going to get a bit more yield.
Emerging markets are further on in the rate cycle and are beginning to cut rates. They have historically been the ones suffering from high inflation, but in recent years we are seeing that in developed markets. Brazil is a good example where they hiked early and are now in a stronger position.

Is the rising cost of debt stifling green bond issuance?

Forest: Issuance of green bonds is significantly below expectations, but this is the case for many credit segments.
When you say the high-yield market has been resilient, the main reasons have been the technicals. We expected a huge level of issuance for high yield and investment-grade green bonds, but it didn't happen.

Will green bond issuance improve in 2024?

Forest: It will depend on the evolution of the European Green Bond Standard and the appetite for issuers to come with green bonds. The point is there is less incentive for issuers to come with green bonds today. We are expecting more clarification about the framework and are monitoring it closely.

When will inflation hit the Bank of England's 2% target?

Darling: Are we going to be at 2% next year? I don't know, but it will be a lot lower than it is today.
From a psychology perspective, it doesn't have to get back to 2% for people to lose their panic about inflation. If the UK is at 3.5% or 4% by the end of the year, we are coming from double digit at the start of 2023 so people will not feel that they are in an inflationary paradigm so much. You will see cooling pressures and things like wage negotiations, you will see companies pricing inflation risk differently from what they planned for their budgets, capex and their employment schemes.
We are going to be in a more normal world next year. It might not be 2%, it might be 2.5%, it might be 3.5%, but the psychology could change quickly. A lot of that will be due to what's happened with money supply, monetary discipline and the end of the fiscal splurging that we had after Covid.
Hollis: Back in the late 90s, equity allocations in some UK pension funds were

more than 90%. But as schemes progress to run-off, they need more fixed income.

Our clients on the whole hedge their inflation. From that point of view, not much re-allocation has been needed. Their inflation metric is normally 5% limited price indexation, so when inflation hit double digits, they were way over hedged. I don't see the attitude to inflation-hedging changing much because our clients have moved so much away from equities.

It is still, however, relevant for real assets. We are seeing some interest in long inflation-linked cashflows in infrastructure, but it is not something people try and build into their fixed income portfolios. They do it through LDI mandates if they are going to do it.

How big a risk is inflation for investors longer term, say over three to five years?

Forest: When you look at the curve positioning, three to five years are the best maturities today in terms of carry and roll-down, especially in the US.

In this new regime it makes sense to be balanced, to have more fixed income, to look at liquid investments, especially if we are expecting more volatility next year. And I agree that spreads do not price in a recession.

In emerging markets, local currency in the long-term perspective is something we like. You are talking about Brazil, but we can also mention Mexico as offering attractive medium-term opportunities for bond investors.

Nazir: Inflation is always a concern for most of our clients, but less profound than initially thought at the start of this inflation cycle, given it also impacts their liabilities. Five-year breakeven has come down to around 2.1% and two-year breakeven in the US is around 2.5%, which explains that while it was a concern for markets at the start of the year it is less of a concern now.

Additionally, our clients also allocate to equities as a hedge against inflation. There were significantly higher allocations to equities ahead of the rate hikes, but we have seen some de-risking since, and they are not as concerned about inflation as they were maybe 18 months ago.

Overall, from an inflation perspective, we have seen incremental additions to gilts and inflation-protected treasuries, but less so year-to-date than what we saw last year.

Logan: Some emerging markets are now less dependent on foreign funding. They are building out their local markets.

Forest: When we talk about emerging markets, we need to talk about China. We are in a situation where Chinese bonds are becoming less attractive, especially compared to US bonds. We have to be selective for emerging markets because valuations are not the same for all countries.

Next year there will be elections here, in the US and in the EU. How could they impact the bond markets?

Darling: One of the biggest reasons people are attributing the spike in real yields over the summer to is investors getting their head around how much money the US government wants to borrow.

I'm not a great believer in supply kills the bond market; when people are scared enough, they will come back to bonds. The point is, among most Western governments there is not much fiscal restraint. They will spend as much money as they are allowed to. There is no appetite for running balanced budgets, for getting their house in order.

In the US, you can't ignore the politics, but it does not matter who wins in terms of the economy. The Democrats are not a tight money party, and the Republicans are no longer a tight money party. Whoever wins, will spend what they can spend.

What is interesting about the UK is we had a horror moment last year with Truss and the credibility of the Bank of England. The weird thing now is that the UK is running quite a tight ship. That has not been appreciated. Politicians have been scared by that event. If you look at their spending plans, if you look at the tax burden in the UK, it feels like we are just grinding back towards potentially quite a slow growth disciplined ship.

We liked UK assets at the start of 2023, where you got a lot spread premium for buying the UK, because we were almost trading like a distressed emerging market.

And I wonder if as things settle down, the election is going to be between a relatively bureaucratic incumbent and a challenger who is trying to be very middle of the road. We will have a political campaign without anything too extreme on the economic side. And maybe that could be a bit of a tailwind for UK assets.

Over the medium term, bonds look more attractive than equities.

Umer Nazir
Portfolio manager, fixed income
London CIV

A different perspective from finance

In the bond world, one of the greatest risks is the possibility of default. By performing our analysis from multiple perspectives, Candriam offers you more ways to manage it. Our exclusive analysis models and the integration of **ESG*** criteria into our investment process are designed to enable us to select the best opportunities and to rule out profiles deemed too risky. With **€32.9 billion**** under management in sustainable bonds, we enjoy the confidence of many investors. Join them.

Please note that any investment involves risks, in particular the risk of capital loss.

INVESTING FOR TOMORROW

* Environmental Social Governance. ** Source: Candriam, data at 31.12.2022

This document is an advertising communication. It is provided for information purposes only and does not constitute an offer to buy or sell financial instruments, an investment recommendation or the confirmation of any type of transaction, unless expressly agreed otherwise. Although Candriam has carefully selected the data and sources contained in this document, errors or omissions cannot be excluded a priori. Candriam cannot be held responsible for any direct or indirect loss resulting from the use of this document. Candriam's intellectual property rights must be respected at all times. The content of this document may not be reproduced without prior written authorisation. The investor bears a risk of capital loss. Information on the sustainability aspects contained in this communication is available on the Candriam website https://www.candriam.com/en/professional/sfdr/.

There are lots of ways of getting impact into your portfolio rather than using green bonds.

Kate Hollis
Global head of credit, manager research
Willis Towers Watson

Forest: European elections will be important. I see three big questions for them.

The first is debt sustainability. There is no agreement between France and Germany about the debt sustainability rules, which is a big challenge. Europe does not have the same level of budget deficit as the US, but we have higher interest rates and the question of debt sustainability will come back. So the European election will be important to define the new set of rules regarding debt sustainability.

The second point is growth. You are expecting a US recession, but we are observing that the potential growth of the United States is higher than expected, thanks to immigration. In Europe, I'm afraid growth is close to zero.

And what is the impact of the Green Deal on growth? What are the next steps regarding the measures to stimulate growth in Europe?

Last but not least, are the measures set by the von der Leyen commission for the green transition: ESG, SFDR, etc. The commission has been one of the biggest defenders of the ESG transition. We are observing a push back in ESG sentiment in Europe and the next commission should define, validate or not, the different measures for ESG. So European elections are important.

Logan: What you have touched on with the UK and then some countries in Europe comes back to your earlier quote about the discipline that can be enforced on countries through the bond market. Effectively, that is what we saw last year in the UK and in a lot of peripheral European countries during the euro crisis.

But we have not seen it in the US. Clearly, it has a unique advantage as the global reserve currency. That is, to come back to our earlier discussion about Covid stimulus and inflation, a mechanism in which inflation could be persistently higher in the US relative to the UK or Europe because they will be able to continue to spend. How that manifests itself and the implications for that, on the bond market and other areas, is something that we have to watch and consider.

Is it worth paying for active management in these markets?

Nazir: Fixed income is hard to replicate in indices. It is a different asset class to equities in that you have maturities to deal with. So passive makes less sense.

We do not have a passive fixed income strategy. We do, however, have a buy and maintain fund, which is where we have seen a lot of demand. It is not a maturing portfolio, but one with constant duration.

In terms of fees, we don't have the beta tailwind we had over the last five or six years where with lower rates it was easy for any duration fund to deliver good returns. But going forward, where you position yourself along the curve, which credit sectors you pick will be key, so it makes sense to pay active fees in fixed income.

ESG is another added element of why you would pay an active fee. That is another place where I have seen a lot of progress. We went to the market looking for a sterling active fund, looking at what managers are capable of doing in terms of ESG. We then went to the market five months ago for another mandate, and I saw a tremendous improvement with managers doing a lot more in terms of ESG.

Wellesley: Putting ESG into the fixed income arena was difficult to do a year or two ago but is now a lot easier. It may not be done for all the right reasons other than winning some business, but it has become a lot more prevalent, and, therefore, on the active side it is important.

Obviously, buy and maintain active management is important. Aside from anything else, security selection is important. Then it is trying to understand what it is you are trying to achieve with fixed income. Normally, it is something that wouldn't be reliably provided by something across a board index.

I tend to be more favourable on the active side. I'm not a big fan of fees but you get your money's worth in fixed income to a large degree.

Forest: If we are expecting more defaults and credit spreads to widen, it will become important to be active.

If we want to avoid defaults, it is important to have a good credit analysis. We are also integrating ESG factors, which is important. If you are passive, it is not the best solution for the coming years.

Logan: You are expecting a buy and maintain fund of short-dated, high-quality investment-grade credit to deliver for your members at a relatively low cost.

Whereas, if you are looking at an unconstrained emerging market debt mandate where the amount of credit research and

WHAT ARE YOU **TUNING INTO?**

The past year has seen a spate of interest rate increases to quell rampant inflation. A corollary of that is growing concerns about growth, and uncertainty over the outlook for the global economy. In these fraught times, it's important to cut out the noise, and fine tune your investment choices. Our wide range of fixed income funds may be able to provide the bandwidth to match your wavelength. We call it the value of active minds. To find out more about our fixed income capabilities, visit **jupiteram.com/inflation**

For investment professionals only. Not intended for retail investors. This advert is for informational purposes only and does not constitute an investment advice. Issued by Jupiter Asset Management Limited, registered address: The Zig Zag Building, 70 Victoria Street, London, SW1E 6SQ, authorised and regulated by the Financial Conduct Authority. JAM000146-002-1023

work that needs to go into that is clearly a lot greater, then you have to pay for that. And if you are not, you might be concerned that the investment work is not being done.

It is about value for money. Clearly, as an asset owner, it is on us to scrutinise the managers.

Wellesley: The same thing applies in high yield as emerging market debt. These days, particularly with all the comments that we made earlier about how companies are going to go under, security selection is vital. You would want a high-yield manager who knows what they were doing and understands the underlying trends that can affect issuers.

For longer-dated bonds, the sustainability of the company is absolutely crucial.

Callum Logan
Head of investment strategy
Coal Pension Trustees

Kate, how is fixed income meeting the sustainability challenge?

Hollis: We are working with managers to make sure they are integrating ESG into their processes. I had a slightly disastrous call not so long ago with a portfolio manager and a credit analyst where it became abundantly clear that ESG was something that was done by the ESG team who are kept in a cupboard and consulted only when necessary. It clearly wasn't anything to do with the standard credit analysis and the standard portfolio construction.

Is ESG properly integrated? Is it being properly reported on, by which I mean mandate level TCFD reporting, mandate level climate transition risk reporting and mandate level engagement reporting? And are the managers engaging with all the credits in the portfolio, not just the ones who have listed equity?

If the answer to all that is yes, and it isn't yet at many managers, but we are getting a hell of a lot better than we were, then we can move on to the next stage, which is: our clients have the information about what you are doing for them in the portfolios. Then we can start digging down into the exact details.

We don't mind if you have somebody who is a high emitter if they contribute to the solution. Electricity generation transmission companies, for example, generate heat that counts as emissions, they are always going to be high emitters, but we are never going to decarbonise unless we have a lot more electricity transmission and someone has to finance that.

Our clients are also looking at impact in private debt where you could be a lot more targeted in what you invest in. You can also build in covenants, coupon ratchets and all sorts of things to make sure that issuers do what they say on the tin.

How are asset owners making the money they lend sustainable?

Nazir: There was a perception that equity holders will have a say, as they get a seat at the table, and bondholders don't. But there are still many other things you can do as a debt holder.

One key area is the labelled bonds where we can see direct outcomes. That is a segment of the fixed income market which was in its infancy a few years ago, but now represents a sizeable opportunity. Hopefully, now there with more scrutiny, we are improving the clarity on use-of-proceeds for these bonds, which then gives you a more measurable ESG outcome.

Hollis: There are lots of ways of getting impact into your portfolio rather than using green bonds. We have nothing against green bonds if they are truly green and are at the right price. Five or six years ago, an awful lot of companies were issuing lots of green bonds because they thought: "There is all this money there and we can issue a bond which has a meaningless label and can save ourselves four basis points."

Everybody has tightened up on that. But there are many, many ways other than green bonds to get ESG and impact into your portfolio. If you are going to only invest in green bonds, tick the box, job done – that was a five years ago story.

Darling: The level of work and disclosure have improved but importantly, for the managers at a company level, you could argue that the whole focus on ESG is achieving what it is supposed to do. If you are an issuer, investors have ESG, either through explicit mandates or exclusions, and you need to come up with better answers.

In the high-yield market, for example, one of the biggest issues has been information. If you are dealing with a smaller or less sophisticated company, two or three years ago a lot of them didn't understand what the fuss was unless they were in a contentious sector. Now they realise that investors want to know what is being done to support the transition.

I agree that it is a terrible idea to have an exclusionary policy that stops you investing with companies that are trying to

improve. But there is no doubt that it is being made easier for managers, because now you get more information as companies understand what they need to provide and why it is important.

That is improving the average quality of the opportunities. It is no longer ESG and not ESG – you have a market where the general level of awareness and knowledge and policies are improving.

Hollis: That's true even of issuers that are owned by private equity. Three years ago, I was told consistently by managers that they can't get these guys to engage; all they were interested in was the financials.

Then it dawned on the private equity managers that if they want to IPO some of their holdings, they were going to have to produce the ESG numbers. They suddenly realised that it is important for them, too.

Wellesley: But if I look at the private debt mandates that exist in the schemes I'm involved with, there is very little so far. I'm glad to hear that there is another motivation with the IPO market to get them moving in that direction.

But there is lip service: "Oh, yes, it is integrated into everything we do." But the evidence is not presented.

There just haven't been the drivers, it has been purely financial. I haven't seen much ESG engagement yet but I'm encouraged that I'm going to see more of that.

Hollis: We are pushing hard on reporting in private debt, in particular. In the public debt markets, we are engaging with managers and so will all our peers. There are some big pools of money looking at impact private debt and a lot of private debt managers are waking up and realising that this applies to them, too.

Forest: More than 70% of Candriam's assets are ESG related. We are following SFDR regulation and have article 9 funds for all asset classes.

We have been developing our ESG model for more than 20 years. It is not easy. It is always a question of data, of reporting and of the materiality of the ESG indicators we are using. It is a long road. But there are plenty of opportunities, especially in fixed income.

The climate is becoming a big risk for bond investors. So we have to incorporate it but it is a question of how do we incorporate that in terms of data and how we monitor and explain that to a client and in the reporting.

And today for us, the big demand from our clients, especially French and German clients, is not about climate, the big question is biodiversity.

That is another step, but that is the big question: tell me how you have an impact on biodiversity. So it is becoming more and more sophisticated.

Nazir: Biodiversity and natural capital are the two key issues that we are currently discussing with our clients. In the last three or four months, it seems to have shot to the top of their priorities.

Overall, I agree that the ESG credentials and data disclosure has improved immensely across the field. However, there are some asset classes which are still laggards, and faced with complexities, for instance, data coverage for securitized assets. Lastly, in terms of ESG optimisation, there are many ways that investors are currently looking at it: index customisation, positive screening, ESG integration, the best-in-class issuers that the managers will have on the ESG ratings.

Logan: It is also about being transparent about what you are trying to achieve. We have a fiduciary duty to our clients in terms of delivering returns. That can be complemented with impact, but you have to be clear about what impact it is you are trying to achieve.

And as we are seeing more information and more disclosure, it is all the more important for asset owners to hold managers to account on considering ESG risks within bonds. In particular, for longer-dated bonds, the sustainability of the company is absolutely crucial. Because you are not going to get your money back for a number of years, you need to consider all of those factors in that decision-making process and it is on us to hold the managers to account.

I'm not a big fan of fees but you get your money's worth in fixed income to a large degree.

Gerald Wellesley
Client director
Vidett

What can we expect from fixed income markets going forward?

Wellesley: The average age of an American is 33, so they will not have experienced anything but rock bottom interest rates during their adult life. The effect of the new interest rate environment is an eye opener, in lots of ways.

There is quite a lot of adjustment to thinking about bonds in a different way. To secure a yield of 5%, 6% or 7% requires a lot of rethinking. It is going to be quite an interesting year or two for bonds from that perspective.

As an active manager, you should welcome volatility and complacency.

Adam Darling
Investment manager, fixed income
Jupiter Asset Management

Nazir: Over the medium term, bonds look more attractive than equities. The yield on US corporates is 5.4%, global aggregate is 5.6%, so over the medium-term fixed income seems like a better proposition.

Forest: The cost of debt has become higher for sovereigns and corporates, so the question of debt sustainability will come back in 2024. We are talking about deficits and higher interest rates, so how can we add a sustainable debt dynamic? That will become an issue and is something that we need to monitor.

Nazir: It is good to see someone concerned with the debt issuance in high yield because whenever I speak to managers, there are two reasons that are always highlighted and perceived to negate those concerns. The first is that the quality of high yield as a universe is much better now. The other is the maturity extension argument, i.e., corporates are not hitting the debt maturity wall yet, so it was good to hear a contradictory view.

Darling: Forecasting the future is difficult and if you work in markets that is inherently what you are trying to do. The good thing about working in fixed income at the moment is, for the first time in probably a decade, your yield is high, giving you more scope to make mistakes.

It also gives you as an underlying investor more comfort that if you are buying today, you can look forward to six months of volatility, 12 months of volatility or 18 months of volatility. If you take a two, three or four year time horizon with starting yields where they are, you have a much higher prospect of making positive returns.

Hollis: Part of the reason why the quality is higher is because so much got downgraded. There were so many fallen angels in 2020, which haven't been upgraded. There are a lot of rising stars which have been updated by one agency but not the other two.

You have to be careful because indices are funny things. The next issue you could have if all the recent fallen angels are upgraded is that the quality of the high-yield index has gone down.

Darling: A lot of the analysis that goes into a credit rating is backward looking. When we talk about the credit quality of the market, it does not tell us what the market will look like in 12 months' time, if we are in recession, in inflation or deflation.

As an active manager, you should welcome volatility and complacency. That is the best environment where you have scope to do things differently and maybe find some alpha.

Logan: The forward looking aspect is the real challenge we are all faced with, whatever side you are coming at it from. The central banks have abjectly failed in terms of inflation. You can blame the Covid stimulus, but ultimately the central banks have been given a mandate, and inflation continually overshot and they were far behind the curve. People are looking at: will the Fed hike? Will the Bank of England hike? But they have reached a point where a lot of their models are broken, they have even said it. Increasingly they are data dependent. Don't look at what the Fed is doing, look at what the data is telling you. Because from here, there is a lot of uncertainty about those long and variable lags in monetary policy, where inflation goes from here has such a huge impact in terms of that decision-making process and how that influences fixed income.

Look at the hard data and the numbers that are coming through, because that is what the central banks will be looking at.

Nicolas Forest is chief investment officer of Candriam.

CHALLENGING TIMES

After a decade of low to negative yields, fixed income is now faced with a higher rate environment. Whilst keeping rates higher for longer is a default measure to deal with inflation, the broader environment is complicated further with the ending of 12 years of monetary accommodation and a lower liquidity environment.

The decarbonisation trajectory and its regulatory implications also feature heavily in how companies and countries are adjusting their respective economies. De-globalisation is generating disruption in the form of tariffs and trade wars, resulting in heightened protectionism across the globe. And this is before we get to the heightened geopolitical risks as evidenced through the Russia/Ukraine and Middle East conflicts. These interconnected risks are reshaping the global economy as we witness lower growth, higher inflation and heightened volatility across markets.

But a time to be active…

We believe this backdrop lends itself to active management to navigate efficiently the resulting challenges and opportunities. The ability to swiftly adapt asset allocation strategies, the use of specialised investment strategies, such as sustainable debt, the ability to apply strong issuer selection through deep fundamental analysis are valuable tools to capture distinct opportunities often neglected by broad-based ETF markets.

To capture the many opportunities that lie ahead

With bond yields at 12-year highs, bonds can provide potential price appreciation as well as a hedge against economic deterioration. In a period of slowing growth, bonds provide a more stable source of income than other volatile asset classes. Investors appear to be recognising the power of yields now offering a higher coupon than equity dividend yield.

Major central banks are close to the end of their hiking cycle, though the sudden tightening of financial conditions will likely lead to greater economic pain. In this context, combined with inverted yield curves, short-term government debt appears attractive. An allocation to short-duration bonds provides an opportunity across the G10, except on the Japanese curve as the Bank of Japan is the only central bank with its key interest rate still in negative territory.

With a yield of 4.6%, investment grade is an interesting proposition, particularly on the three to five year segment. It provides a diverse opportunity set with more than 800 companies that present robust business profiles and sound financial profiles.

Companies have deleveraged since the great financial crisis, using central bank support to de-risk their balance sheets and extend their debt maturity profiles. Non-financials companies need to refinance 23% during the next two years at a higher cost which is manageable.

They have also used capex to adapt their business models to the new market context and hence are better equipped to face the future context. But global conflicts and economic uncertainty hits operating and at the same time key stakeholders escalate the risks of environmental, social and governance issues. Selecting these issuers based on assessment of financial and ESG risks will add value to portfolios.

Lower rated companies will face a tougher time as defaults are likely to continue to climb over the next six months to 4% in Europe and 4.5% in the US.

Rising debt costs and falling cashflow will impact lower rated companies as B- and lower-rated finance in majority through floating rates loans. CCC issuers, that have lower duration and hence greater urgency to re-finance, need to come to the market after a quasi-closed market in 2022.

This could also lead to greater stress and delinquencies, especially since greater delays in return to market imply a downgrade in ratings for these issuers in particular. Current risk premiums do not reflect downside risks in light of refinancing at much higher levels and possible topline pressure on firms. Globally, the theme of dispersion between issuers is emerging with increasing clarity and bond-picking will be essential in delivering returns.

A credit strategy with long and short based on high conviction and selective approach will deliver performance in these market conditions. Such absolute return strategies have the advantage of providing lower volatility and uncorrelated returns, thereby delivering exposure to high-yielding asset classes through a non-directional approach.

The IMF warned that the debt distress is growing in emerging markets. At the same time, these countries are taking steps to restructure their debt and find bilateral agreements. Food security, climate change and the global backdrop has turned even more challenging for emerging markets due to rich valuations and tightening global financial conditions. The carry of emerging market debt – in terms of yields to maturity or versus US rates – is attractive from historical perspective. The value is still concentrated in higher yielding issuers that may pursue debt restructurings.

Avoiding drawdowns and investing in credits with upside or successful asset selection remains key to extracting the asset class value. Active managers deploying disciplined investment frameworks stand to benefit. Local rates seem to offer the best perspectives, as growth is slowing, inflation is declining and central banks are starting their easing cycle. But the continued increase in US treasuries and strong dollar complicate the outlook for local rates. Only countries with high real yields and embarking on a cutting cycle offer value, in particular Mexico, Brazil, Indonesia and India. Indian rates should further benefit from expected index inclusions, leading to demand from index funds.

Fixed income markets also offer huge opportunities even for investors looking to address sustainability challenges, such as carbon emissions reduction and social inequality. The expansion of the sustainable bond market, like green, social and sustainability bonds, provide opportunities to finance sustainable projects through fixed income securities.

CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

Adam Darling is a fixed income investment manager at Jupiter Asset Management

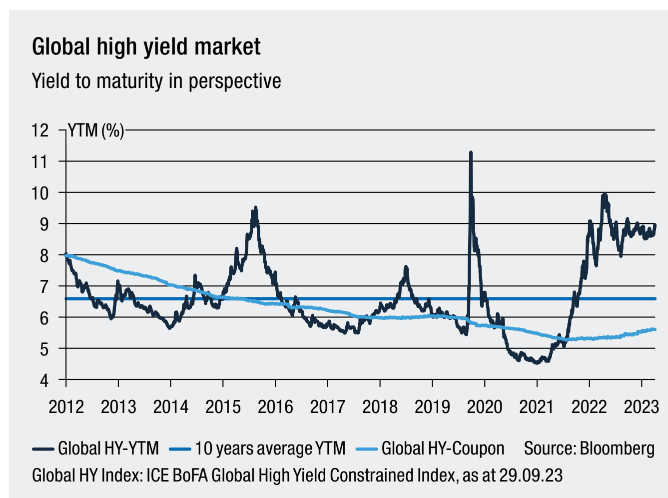
HIGH YIELD BONDS: VOLATILITY IS OPPORTUNITY

Adam Darling discusses why credit selection is crucial in the current environment as a potential recession could disrupt the asset class.

Credit spreads, the additional yield that investors demand to buy or hold high-yield bonds compared to government bonds, are still relatively tight even after aggressive rate increases by major central banks since early last year. Investors are complacent about the impact of high rates on the economy, which typically takes effect with a lag.

Many investors seem to believe that policymakers can steer the economy towards a "soft landing", where inflation is brought within desired levels without losing steam on the growth front. I believe that could prove to be a fallacy. There are many signs that growth is already faltering around the world. Recession concerns dominate Europe and the UK, while China has found it difficult to find its feet after its extended Covid lockdowns. Commodity prices have softened, with the exception of oil. Companies are also turning increasingly cautious on their outlooks and consumer confidence is deteriorating amidst toughening financial conditions and a cooling labour market.

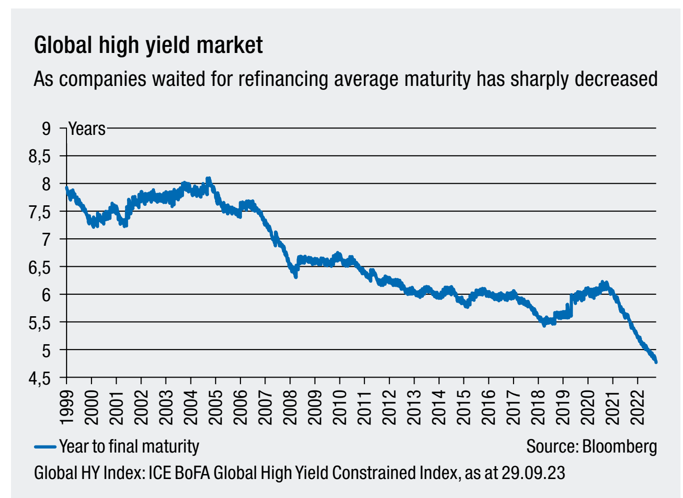
In our view, the global economy is potentially staring at a recession. The stress created by high interest rates is already evident in various sectors. The real estate market is collapsing globally (highlighted by looming Evergrande and Country Garden insolvencies in China), corporate bankruptcies are spiking and a lot of issuers in the high yield market can't survive with yields at current levels.



The chart above illustrates the conundrum facing companies right now. Unless the prevailing yield in the high yield market (*Global HY – YTM* in chart) collapses towards the average cost of what companies have actually been paying over the last decade (*Global HY – Coupon* in chart) a lot of companies could crumble as they get hit with a significant leap in funding costs. In this environment, companies with strong metrics and the ability to withstand the high cost of refinancing will survive even if that's achieved at the cost of curtailing capital expenditure or paring back dividends. However, a lot of companies that have over leveraged when interest rates were low will be in trouble. Such companies could be forced to restructure or may default with some forced to dispose of their businesses to pay down debt. This makes bottom-up credit selection all the more important.

Once a sharp economic downturn begins, credit spreads will have to widen. Currently, the spreads show that market participants have bought into the "soft landing" narrative. Technicals have also been quite supportive as high-yield bond supply has shrunk between 10% to 20% during the past 12 months. The high yield on offer too has underpinned robust demand. However, I believe the next six-to-nine months will be volatile as a looming recession could create havoc in the market.

The chart below shows how the average maturity of high-yield bonds has shrunk as companies put off refinancing on the hope that yields may decline. This exercise in "kicking the can down the road" can only last so long, and a looming maturity wall in 2025/26 will test the balance sheets of many companies.



Global high yield market

As companies waited for refinancing average maturity has sharply decreased

Source: Bloomberg

Global HY Index: ICE BoFA Global High Yield Constrained Index, as at 29.09.23

Any disruption in the market should create great opportunities for active strategies such as ours, and we are approaching the unfolding scenario in a tactical manner.

The bullish case for the asset class is that the yield on offer is very high – historically, future total returns from yield levels that we see today have been positive (often strongly so). But the ability to generate alpha and harvest these returns will depend on managing a volatile credit cycle during the next 12 to 18 months. In this environment, we are happy to remain patient to see what happens next. While getting the macro call is important, rigorous credit research is key in this environment.

Selecting the right bonds is important in this market and we believe our fundamentals-driven credit analysis process and our overall philosophy of staying "active, pragmatic and risk aware" will stand us in good stead in the coming months.

The value of active minds – independent thinking: A key feature of Jupiter's investment approach is that we eschew the adoption of a house view, instead preferring to allow our specialist fund managers to formulate their own opinions on their asset class. As a result, it should be noted that any views expressed are those of the author(s), and may differ from views held by other Jupiter investment professionals.

Important Information: This document is intended for investment professionals and is not for the use or benefit of other persons. This document is for informational purposes only and is not investment advice. Market and exchange rate movements can cause the value of an investment to fall as well as rise, and you may get back less than originally invested. The views expressed are those of the research team at the time of writing, are not necessarily those of Jupiter as a whole, and may be subject to change. This is particularly true during periods of rapidly changing market circumstances. Every effort is made to ensure the accuracy of the information, but no assurance or warranties are given. Holding examples are for illustrative purposes only and are not a recommendation to buy or sell. Issued in the UK by Jupiter Asset Management Limited (JAM), registered address: The Zig Zag Building, 70 Victoria Street, London, SW1E 6SQ is authorised and regulated by the Financial Conduct Authority. Issued in the EU by Jupiter Asset Management International S.A. (JAMI), registered address: 5, Rue Heienhaff, Senningerberg L-1736, Luxembourg which is authorised and regulated by the Commission de Surveillance du Secteur Financier. No part of this document may be reproduced in any manner without the prior permission of JAM/JAMI.