

pi *FIXED INCOME* *roundtable*



DISCUSSION: FIXED INCOME

Fixed income is an important element of institutional portfolios, providing a regular stream of cash. But given the economic uncertainty, how are asset owners preparing these portfolios. *portfolio institutional* brought a group of experts together to find out.

We are living in interesting political and economic times.

Interest rates are high, growth in the West is low but inflation appears to be under control. We have a new government, but so could many other countries as more than 50 national elections are scheduled for this year.

So, what impact will all of this have on the debt markets?

“The first half of the year has been more challenging for fixed income markets than perhaps people thought,” said Rickey Thevakarrunai, director of fixed income at bfinance.

The view coming into the year was of deep rate cuts and improved economic activity, however inflation has been stickier than hoped. “So fixed income has lagged behind the equity markets,” he added.

But there is interest in these markets as “yields have drifted up”, Thevakarrunai said.

Following the financial crisis, interest rates were at an historic low and yields were rock bottom. “You weren’t getting a great deal from fixed income,” he added.

But in the past two years interest rates have returned to pre-financial crisis levels. “Bond investors suffered the pain of 2022 and 2023, but it now looks more interesting given where yields are,” Thevakarrunai said.

The return of yield is one of the big stories for fixed income this year, said Gurpreet Garewal, a macro strategist in fixed

income and liquidity solutions at Goldman Sachs Asset Management. “It means bonds, once again, can deliver income,” she added. “They can buffer portfolios from downside growth risks, and a higher yield buffer creates a higher bar for rate volatility to offset any income gains.”

She points to positive fixed-income spreads in the first half of the year from corporate bonds, securitised credit and emerging market debt. “Even the frontier part of emerging markets has done well,” she added.

New themes

Goldman Sachs has three key themes for this year. The first is navigating easing cycles. Then there is living with higher rates because if there is easing, we are not returning to the low-rate world of the last cycle. And the third is steering through new realities. On the easing theme, six G10 central banks have started cutting rates, including the European Central Bank and the Bank of England. “The pace, timeline and where those policy rates end up is divergent,” Garewal said. “So that creates lots of interesting opportunities in interest rates.”

Goldman Sachs likes Canadian rates due to disinflation, the labour market is loosening and, unlike the US, has no upside risk to inflation from tariffs later this year. “So there are lots of interesting opportunities under the hood,” Garewal said.



The second theme of living with higher rates underscores the importance of bottom-up security selection.

“What is remarkable is that we have had a sharp rise in central bank policy rates and a series of shocks over the past few years,” Garewal said, pointing to the gilts sell-off, geopolitical tensions and concerns about US commercial property. “Yet even with all of those headwinds, company balance sheets are remarkably resilient,” she added.

“While credit spreads remain low at a headline level, under the hood there is a lot of dispersion.”

Kunaal Vora, Railpen

So the capital markets have been wide open this year and a lot of companies have locked in low rates. “So on the whole, the private sector is in good shape,” Garewal said. “Expansion in debt in this current cycle has been concentrated in the public sector and your active bond selection may need to find companies which can navigate this higher-rate regime.” And in the final theme of new realities, the markets are being re-shaped by what Garewal calls the five Ds: digitisation, demographic ageing, destabilisation in geopolitics, deglobalisation in goods and labour, and decarbonisation. “We look for which compa-

nies and countries are on the right side of these trends,” she added.

Decarbonisation is a theme that stands out for Jo Richardson, head of research at the Anthropocene Fixed Income Institute. She is looking into sustainability’s impact on credit worthiness. And one of the conclusions of her research is: “More investors are looking to use their debt allocation decisions to promote their sustainability objectives,” she said.

There are two drivers of such a strategy. One is that the more sustainable a company’s operations are, the less it should pay for its debt funding. The other is that companies are starting to apply their engagement efforts beyond equities to include their fixed income portfolios in a bid to make all of their exposures sustainable.

Direction of travel

For Railpen, this is a year to reposition its fixed income portfolios, said Kunaal Vora, the scheme’s head of external manager oversight. “It is fair to say that what investors were expecting at the start of the year has not materialised where six cuts were priced in, but now we are down to one, maybe two,” Vora said. “So what this year has given us is the opportunity to build up our positioning in fixed income while rates remain quite high,” he added.

THE PANEL



Huw Evans
Director
BESTrustees



Gurpreet Garewal
Macro strategist, fixed income and
liquidity solutions
Goldman Sachs Asset Management



Jo Richardson
Head of research
Anthropocene Fixed Income Institute



Rickey Thevakarrunai
Director, fixed income
bfinance



Kunaal Vora
Head of external manager oversight
Railpen

Although Railpen is wary of duration and is on the shorter side of its intended allocation, the direction of travel is to increase its credit and duration exposures.

“That serves to diversify our book, but also gives us those starting yields and those prospective returns that we should be seeing long term from equity markets of close to 10% a year.

“So we have taken this opportunity to start building up our credit exposures,” Vora said.

But for Huw Evans, a director at BESTrustees, scheme maturation is still a dominant theme among defined benefit schemes. “They are keen on contractual income, which points to fixed income assets,” he said.

De-risking is another area of focus as many schemes are on the path to buying insurance policies, and so are interested in matching risk relative to annuity pricing.

For defined contribution schemes it is a little different, with a focus on their default funds and an interest in assets such as infrastructure debt.

Also conversations about decumulation are starting to happen in this space. “I am expecting to see some pretty creative solutions that allow investors to stay invested for longer rather than having to annuitise,” Evans said.

A changing market

It appears that following the reset in yields, institutional investors are looking to allocate to safe fixed-income assets again.

“Before you had to reach further down the risk curve for that, but now we are seeing more clients allocate to European government bonds,” Thevakarrunai said.

Before Covid, European sovereign debt yielded about 0.5%. Now they are over 3%. “So we are certainly seeing more demand for essentially safe yields, with clients not needing necessarily to take as much risk as in the past to generate a certain level of yield,” he said.

The question is, do gilts offer a safe yield once again following 2022’s mini budget, which resulted in a sell-off of Britain’s sovereign debt?

Thevakarrunai described that event as a mixture of “reckless fiscal policy from the then government and a febrile view of inflation in the markets”.

He added that the economic outlook has stabilised and the new government has been clear about not looking to spend too much, while yields look attractive again. “So it is certainly a safer haven,” Thevakarrunai said. “If you look at Europe and how the bond markets reacted to the elections there, it looks a more stable place to invest than perhaps some other places.”

But Garewal is not sure that gilts are a safe-haven asset, as investors have not flocked to the market with volatility appearing on the horizon. But she agrees that the asset class has a place in institutional portfolios given its higher yields. And that, in the near-term, gilts stand to benefit from further policy easing by the Bank of England.

Instead, the safe haven assets that are in demand are US treasuries along with perceived safe-haven currencies such as the US dollar, Japanese yen, Swiss franc and to an extent the German bund. “The widening we saw in France was not just

caused by French government bond yields rising; it was also driven by German bund yields falling,” she said.

But Evans believes that defined benefit pension schemes are potentially overexposed to gilts, a sign perhaps that many are on the path to buying an insurance policy, and so are minimising their risk.

A lesson the liability-driven investment (LDI) crisis taught him was that when you are desperate to sell your long gilts, not many people want to buy them. “So gilts are not necessarily a safe asset,” Evans said. “At some point, I anticipate needing to hand gilts over to an insurance company, which in general do not hold such assets and so will sell them more or less straight away. The Bank of England is also trying to sell them and so, with all that sales pressure, it is not necessarily going to be a particularly good asset to hold.

“The only reason I’m holding gilts is that it is the cheapest way to hedge out interest and inflation risk. I wouldn’t hold gilts beyond that,” he added.

Another asset owner using gilts to hedge its exposures is Railpen. “Given the repricing of gilts over the last few years, the hedges are effectively slightly cheaper,” Vora said. “This has allowed us to hedge appropriately for certain schemes, apply some hedging to longer-term liabilities but given we are an open pension scheme, we remain committed to growth too.

“It is rare that our economists would be more constructive on AI than our bottom-up corporate analysts, but right now that is the case.

Gurpreet Garewal, Goldman Sachs Asset Management

“So in terms of an active allocation on the investment side, gilts are probably not what we are going to be using to express our duration views,” he added. “But in terms of a long-term hedging exercise, gilts are a valuable tool.”

So the expectation is that the gilt market will change. It has to. Evans believes that the debt management office understands that defined benefit schemes will no longer be a big buyer of these assets.

“There will be fewer super-long gilts and more of them will be designed to attract investors from a broader market,” Evans said. “It will be quite interesting to watch.”

Long-term green

Perhaps more of these bonds will be sustainable. Richardson is finalising her research into the relationship between climate commitments and performance on sovereign bond yields.

And it looks like there is a positive link between stronger climate commitments and tighter bond yields, controlling for credit factors.



“We are certainly hoping that with the new government, there will perhaps be a little bit more on the environmental side,” she said.

“Hopefully, if there is a strong electoral performance, including in Scotland, the new government will feel more confident not to issue new oil and gas licenses. Transitioning to renewables can provide longer-term stability, which might be a driver of longer-term credit performance.”

The previous government raised billions of pounds from issuing green bonds to fund projects designed to reduce carbon emissions in the country.

“We haven’t seen any debt tied to longer term, more holistic KPIs, and that is often a good signal that people are prepared to make commitments longer than the electoral cycle.”

Election year

The discussion then turned to this year’s congested election calendar and how institutional investors are approaching the various outcomes.

“It is always an opportunity or a threat. Navigating that is going to be the challenge,” Evans said.

“It is difficult to call,” he added. “In the pension universe, I don’t think we are going to see asset owners making big bets here. It will be more about ensuring that their portfolios are resilient to the geopolitical risks.”

For Vora, markets tend to price-in elections quite well when they are far out in the future. France is an example of how calling a snap election can take markets by surprise.

“There could be some developments once these elections come to fruition in terms of where bond markets go and where risk markets go, but largely we see lower volatility from these election risks,” he added.

Time for a cut?

And how are investors preparing themselves for potential cuts in interest rates?

“We could have answered this question last year and I could have said the same thing, and I would have been wrong, but for the next 12 months I might just be right,” Vora said.

He added that the bias is there for a cutting cycle to begin as soon as September. The Bank of England, European Central Bank and Canada have already embarked on it, but the US is the big one. “It is not always that the US follows Europe, but the macro-economic variables this time around are slightly different, where a lot of the reasons for the cut bias are now due to disinflation,” he said. “A lot of the inflation in Europe was due to an energy shock, whereas in the US it was animal spirits and strong consumers.

“What we are positioning for is that resiliency in portfolios that Huw mentioned. We see that the next 12 months are not going to be a one directional downward road to a path of least resistance to lower yields.

“There could be some bumps in the road along the way, and there is this talk of resurgent inflation leading to more hikes, but the political will and the will from central banks is for lower rates, and that is how we are trying to position in our portfolio.”

So increasing Railpen’s fixed-income exposures in the next year is on the agenda, and diversifying the sources of its contractual return away from equities is key. “We are moving away from growth markets to build portfolios that can withstand potential inflation hikes, geopolitical woes or election surprises,” Vora said.

It’s all about the Fed

Garewal agrees that the direction of travel for policy rates is lower. “It is remarkable that the UK has been the exception with headline inflation still above target in other major advanced economies but has been at target for a couple of months in the UK, while unemployment is below the natural rate.”

So central banks are easing because what matters between now and the end of the year is what makes the Fed start its cutting cycle. Could that be the labour market starting to loosen or evidence that the US economy is weakening?

Those two outcomes will have different implications for fixed income. “In the former, you could see US treasuries do well, but you may also see fixed income spread sectors start to price in that cutting cycle,” Garewal said.

“But if the Fed is cutting because of a more pronounced weakness in the economy, then of course you could see rates do better and perform their role as a hedge against downside growth risks. High yield and other cyclical parts of the market may prove less resilient.”

When it comes to election uncertainty, there are still three months until the US goes to the polls. “A lot can happen between now and then,” Garewal said.

“What is interesting about the UK election is that there has been little market response. Everybody is watchful of what happens with fiscal policy, what happens with supply-side reform, what happens with taxation. “We are in a wait and see mode, but I agree that fiscal prudence looks likely,” she added.

Hitting the wall

Maturities and refinancings are important events in a fixed-income portfolio, but Railpen does not keep notes on them.

The portfolio is managed as a “multi-asset credit construct” which has regular maturities. “That way we are always aligning to the prevailing market rates and benefiting from the near-term yields that are on offer,” Vora said.

“More investors are looking to use their debt allocation decisions to promote their sustainability objectives.”

Jo Richardson, Anthropocene Fixed Income Institute

In terms of duration, Railpen’s profile is around three years, which is in-line with the high-yield benchmark. “We are an open pension scheme, so our credit portfolios are return seeking in nature and diversify us away from equity risk,” he said. “So we look for managers to create alpha and to get into those areas of the market where we believe outperformance can occur.”

Vora then turned to the “maturity walls” discussed in the financial press, which he admitted Railpen is mindful of. “Over the last few years, these maturity walls have dissipated quite quickly, with issuers tending to push the maturities out further,” Vora said.

“That cliff edge has not been a factor for most investors. The important thing is the role of other sources of funding for a lot of these companies that have maturing debt, like private credit are coming into the market, which are alleviating some of the stress for the cohorts of credit which are struggling, or at the bottom end of credit quality.

“That is masking some of the default rates that we are seeing and masking some of the stress that we would tend to expect to see in credit spreads,” he said.

Evans pointed out that refinancing does not only concern the assets a scheme owns, but also the covenants trustees rely on. “So, if our sponsor is debt financed, we track when they are next due to roll over, and what is happening in the market around that time,” he said.

“So far, so good. The debt walls have been well managed. They saw it coming and jumped in early.

“But at the same time, private credit managers are telling me this is a golden time for private credit. This makes me think that my private equity-owned sponsors are going to have to roll over their debt in a market where the lenders believe they are holding all the aces.

“So there are two sides to the refinancing coin,” Evans said.

High risk, long duration

Sustainability could influence how much a corporate pays to be funded by debt when the loans in its fixed income portfolio start maturing.

“[Refinancing] is one of the key reasons why fixed income investors tend to have potentially more impact than equity investors,” Richardson said.

“Companies are constantly coming back to market and asking for your money and basis points matter,” she added. “You can negotiate covenants, make various commitments and engage on their strategic objectives and how they fit in with their transition plans.

“That is part of the core reason why we support a price-based fixed income engagement, where that discussion happens every year.”

The other interesting point is that, in general, issuance is down because people are holding on for lower rates. This may have led to shorter maturities in those bonds that have been issued, however in some core transition-rich sectors, such as oil and gas, maturities have extended.

A lot of long-dated bonds have come out of the oil and gas sector. “It is easy for a benchmarked investor to buy everything

and think it is okay, but within that you often surreptitiously extend duration to some of the sectors that might be of highest transition risk,” Richardson said.

Good or bad?

Garewal pointed out that the volume of upcoming maturities is falling. She used US high yield as an example of where in the past three years maturities have shrunk to \$325bn (£253bn) from more than \$840bn. “That speaks to the capital markets having been open and companies being able to refinance.

“They have broken down maturity walls, and remarkably, distressed issuers in the emerging market space have come back to capital markets for the first time in years,” she added.

The headline default for US high yield and leveraged-credit market is just over 3%, which she says is in-line with the long-term average.

“But if you take out distressed exchanges, it falls to around 1.5%,” Garewal added.

Distressed exchanges occur when a financially troubled company offers new debt, equity, or a mix of both, to creditors, typically at a reduced value to existing debt to prevent default. The question is, are distressed exchanges good or bad for investors? “It depends,” Garewal said.

While they result in losses for lenders, they are typically less costly and quicker than formal bankruptcy proceedings, and lead to more stable recovery rates. In some cases, the resulting capital structure proves to be sustainable; in others, it merely forestalls larger losses. As such, the impact on eventual losses from distressed exchanges remains uncertain.



“So, the big picture is that the credit fundamentals seem resilient, but there are a lot of things happening under the hood, which ultimately could support the importance of active management,” Garewal said.

Vora is seeing similarities from 10 to 15 years ago when rates were low and zombie companies were muddling through. “You have little in public market scrutiny. The private nature of the agreed terms is giving companies who would once be classed as zombies, a bit more breathing room, a bit more maneuverability and the opportunity maybe for a private equity investor to come in and sweep them up.”

He added that as we move towards lower rates, expect some of the pressures that these companies are feeling to alleviate. “You could be moving into a more normalised situation, rather than one of stress,” Vora said.

Acid test

The extended maturities mean that defaults have been contained in recent years. Robust economic growth has been another factor.

“Earnings have been fine for the most part, so companies have been able to repay their debt,” Thevakarrunai said.

Companies tapping more private sources of capital have also kept the default rate low. “Two years ago, if you said interest rates would go to 5%, many people would have expected a high default rate, particularly in high-yield markets, but that has not materialised as much as people expected,” Thevakarrunai said. He then pondered what has to happen in the economy to change that. “If it significantly weakens, there can be a potential for the default rate to pick up. But we haven’t seen many managers put a significant spike of default rates in their outlook.”

If the level of defaults rises, it could be a case of opportunity knocking for some investors.

“Throughout my career, default risk has been overpriced,” Evans said. “So when I hear chat about default risk, my ears prick up and I start wondering whether there are opportunities.

“Right now the spreads are still quite mean, which maybe reflects demand. But if the market were worrying a bit more about default risk, I would be looking for opportunities rather than thinking this is going to be a problem. Of course, the acid test of your fixed income manager is how many defaults they experience relative to the market as a whole,” he added.

When talk of defaults pick up, there tends to be more dispersion within markets. “And more dispersion should be a valuable source of returns for your active manager,” Vora said, who added that Railpen works with managers to take advantage of such opportunities. “We expect our managers to pick credits in this environment and do well with their own proprietary research, rather than what ratings would suggest.



“While credit spreads remain low at a headline level, under the hood there is a lot of dispersion. You are also seeing a bit of a bifurcated market in terms of quality when it comes to the lower rated issuers versus the BB and above cohort,” Vora said.

Emerging assets

The conversation then turned back towards ESG and sustainability. Railpen’s strategy here leans towards engagement. “Divestment, whilst offering a market signal, doesn’t achieve much in terms of change,” Vora said.

“We prefer to engage and use our clout as large investors in equities and debt to try and influence companies,” he added. For example, Railpen is allocating assets to an energy-transition portfolio, which, it is hoped, will give it a say in how the bigger energy companies operate. “We believe we get the best from companies – and can influence them most effectively – when we actively engage with them on ESG issues.”

This reflects what Thevakarrunai is seeing. He said that more than 80% of institutional investors across the world demand that their managers demonstrate ESG integration in their debt

portfolios. “They want to see a clear ESG process,” he added. The good news is that more debt specifically labelled green, social or sustainable is being issued to fund certain projects, which are typically focused on the energy transition.

Garewal predicts that we could potentially see \$1trn (£778bn) worth of issuance of such debt this year, after almost \$500bn hit the market in the first half – 11% of the investment-grade market equivalent.

With eight emerging countries believed to be responsible for almost half of all climate-harming gas emissions, there is a major need for transition funding in these economies.

Much of the green, social and sustainable bond market will be green. Goldman Sachs has looked into green bonds issued by emerging market sovereigns and companies.

There is a strong case for allocating capital towards emerging markets for sustainable development, Garewal said. Such economies are home to more than 80% of the world’s population and are responsible for approximately three quarters of global carbon emissions. “To put it simply, you cannot have a global energy transition without the active participation of emerging markets,” she added.

“We haven’t seen many managers put a significant spike of default rates in their outlook.”

Rickey Thevakarrunai, bfinance

Yet only a fraction of the \$2.5trn (£1.9trn) globally sitting in sustainable or ESG funds finds its way to the emerging world. “That needs to increase,” Garewal said, adding that the benefits for investors are higher yields thanks to inefficiencies in the market and high economic growth.

She added that more emerging market sovereigns and corporates are starting to issue debt and tapping into global appetite for sustainable bonds can diversify their funding. If companies and sovereigns can show their commitment to making their operations more sustainable it could open the door to funding global private investors, or public funding from the EU and the IMF. However, she warned that despite improvements, there are still questions over the standards of transparency and reporting, especially on how the proceeds of the bond are invested.

Regime shift

Evans then highlighted a big issue for trustees in their approach to building sustainable portfolios.

He said that 95% of the time trustees allocate to responsible investment and ESG is spent generating compliance documents, such as implementation statements and TCFD reporting.

“We have next to no bandwidth for the discussion that has just taken place,” he said.

“From a trustee perspective, we all want to make the world a better place, and we will be all over it if the risk-reward is appropriate, but we are not going much deeper into it.”

Richardson added that with sustainability increasingly being seen as a driver of returns will change that. “The more that some of the externalities come into pricing, the more there are valuation shocks, the more your asset managers may come and talk to you, then maybe it can get up the agenda.”

The good news is that green bonds can offer a spread over conventional bonds of the same credit risk in some instances, according to Garewal. “So, even investing with sustainability in mind is primarily about the risk-adjusted return potential, but with the added benefit of contributing to sustainability objectives,” she added.

Another issue is that a lot of the sustainable impacts are going to be realised over the next 10 to 15 years. “So it is hard to price in a lot of the positive externalities today. But governance concerns have always been a key consideration, especially when investing in emerging markets where weak governance can contribute to default outcomes. This holds true, to some extent, among developed market sovereigns and corporates as well.

Richardson and her colleagues spend a lot of time identifying unpriced externalities. “We all agree that over 20 years they are going to be in,” she said. “It doesn’t need many of them to come through to suddenly refocus minds.

“I believe we are on the brink of a valuation regime shift in that more of these things will be priced into markets, and there will be a re-adjustment of thinking,” she added.

One area where Richardson has completed a lot of research is oil and gas where she found that bond spread curves over 10 and 30 years are invariant to production changes.

Some companies predict a reduction in production, while others, some of whom are A-rated, are forecasting increasing their operations. “A 30-year investment in a company which is predicting a \$68 price and planning unconventional production, is a bad credit investment. At some point, we will realise that.”

An artificial approach

A new innovation that is expected to change many areas of our world is artificial intelligence (AI). But what impact is it having on fixed income investing?

Goldman Sachs is looking at generative AI from the perspective of how the technology can enable business growth and enhance client experience, improve developer productivity and increase operating efficiency across all parts of the firm. Garewal explained that human-like outputs and the ability of generative AI tools to produce novel outputs for generalised uses are what distinguishes generative AI from previous AI tools. “You don’t need to have a PhD in computer science to interact with them,” Garewal said. “They have a usable interface.

“The first two of these traits increase the use cases, and the last one will increase adoption,” she added.

Goldman Sachs’ economists believe this will influence the economic outlook within five to 10 years. “Economics is often considered to be a dismal science,” she added. “It is rare that our economists would be more constructive on AI than our bottom-up corporate analysts, but right now that is the case. The difference in view lies in the time horizon in question; economists are thinking about the potential long-term boost to productivity and growth, while corporate analysts are assessing the near-term impact on company revenues.”

“Throughout my career, default risk has been overpriced.”

Huw Evans, BESTrustees

AI tools have the capabilities to optimise investment research and analysis as well as improving the efficiency of tasks such as compiling legal documents. “It has the potential to increase the breadth of investment ideas and will hopefully improve your information ratio, but there will always be a human in the loop,” Garewal said.

It is unclear at this stage if generative AI will grow revenue or if it is just about cost efficiency. Is it truly going to lead to more productive activities? “That remains to be seen,” Garewal said.

T-bill and chill

The final theme of our roundtable discussion concerned the outlook of the asset class.

Thevakarrunai homed in on credit spreads, believing that they should remain relatively stable in the next 12 months.

“None of the managers we speak to are predicting huge credit narrowing or widening,” he added. “Low default rates, the ability to refinance and a more benign economic outlook with moderated inflation, mean that credit spreads are going to be relatively range bound, certainly in the investment grade and high-yield markets.”

Thevakarrunai then explained that one of the big themes in the next 12 months within fixed income will be when to extend duration. He pointed to the US saying: “T-bill and chill” – just invest in a money market fund and earn 5%.

“So why would you need to move out of the curve and take further risk,” Thevakarrunai said.

What typically happens when central banks start cutting and the curves normalise, is that people potentially look to lock in yields further along the curve.

“So it would be interesting if we see a movement out of shorter-dated fixed income into intermediate and longer-maturity markets. That will be key over the next 12 months,” Thevakarrunai said.

Earning and spending

Government expenditure could be another key theme that drives yield curves steeper, but perhaps is one that we will see in the longer term. “Generally, when we see yield curves getting steeper, credit spreads behave themselves a lot better,” Vora said. “That is a function of investors moving into credit and lending to corporates rather than to governments. It also indicates an economy that is moving along nicely – generally a positive for corporate health.”

Living in a higher for longer environment will be another issue. “Even as we settle to a lower interest rate than we are now, it is going to be higher than what we have seen in the last maybe 15 or 20 years since the financial crisis,” Vora said.

“As that culminates in more defaults, more distress and some companies hitting the wall, you are likely to see a big discernment in terms of credit performance. And that dispersion, that ability for a manager to actively select credits, is going to be paramount for investors.”

Garewal picked up on navigating the higher for longer theme. Certain households have savings buffers and locked in low mortgage rates, while corporate balance sheets are healthy. “But now we are at a point, in the US at least, where the labour market has returned to where it was pre-pandemic. So any further loosening could lead to weakening.

“As long as consumers are employed and earning, they are spending, but that could change over the next six to nine months. What will be key to assess is to what extent Fed easing will help to elongate that cycle.

“So, the importance of active bottom-up security selection may become increasingly more important,” she added.

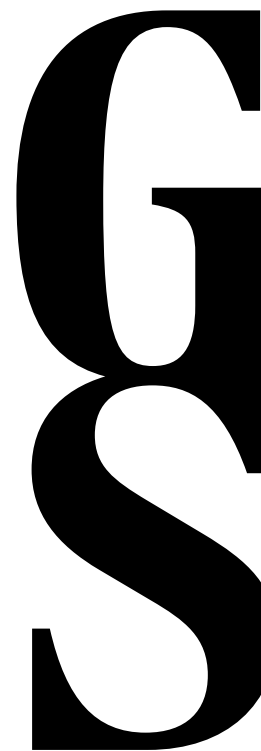
Richardson then put deforestation on people’s radar. Thinking about investor impact on our climate has broadened out to more of a focus on nature. Regulators are taking more notice of the impact of corporate behaviour on the natural world. Indeed, the EU is implementing regulation that means products sold in the bloc need to be deforestation free.

Similar laws could soon arrive in the UK and the US, she said. “Supply chains that are in scopes 1 and 2 are incredibly opaque, disparate, not tracked and have multiple layers of indirect suppliers. This will have a significant cost if it is not priced in.

“A lot of investors increasingly are looking at deforestation as an entry level nature-based sustainability theme,” she added.

Evans ended the discussion by saying that for pension funds, all eyes will be on the new government. “The question will be, is it going to do anything that disrupts the megatrends?”

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Kay Haigh

Co-CIO and Co-head of Goldman Sachs Asset Management fixed income and liquidity solutions



Whitney Watson

Co-CIO and Co-head of Goldman Sachs Asset Management fixed income and liquidity solutions

SOUND FUNDAMENTALS, NARROW MARGINS

In recent earnings calls, leaders from consumer goods companies have noted a shift towards more value-conscious and selective spending among consumers.

As we pass the halfway point of 2024, more than a year on from the peak in the federal funds rate, the Goldman Sachs Asset Management investment approach mirrors this trend. We observe sound economic and corporate fundamentals, yet we approach the investment landscape with a value-oriented lens due to tight fixed income sector spreads and a rise in political uncertainty which creates a narrow margin for error.

The good news is that disinflation appears to be back on track after setbacks earlier this year. Stable inflation expectations and labour market rebalancing portend further inflation progress. Low unemployment and real income growth continues to support steady consumer spending, particularly on experiences. However, as noted, there is a discernible shift towards value in consumer goods purchases, likely a response to the residual impact of past inflation and the erosion of excess savings.

Favourable market conditions have allowed companies to issue new debt, reducing refinancing risks. The robust issuance of bonds and loans this year has been met with an enthusiastic response from investors drawn to historically high yields.

The private sector's financial health is evident in the contained rates of delinquencies, downgrades and defaults, laying a strong foundation for debt servicing capabilities. This is a positive sign for the return prospects on corporate bonds and securitised sectors like collateralised loan obligations (CLOs) and commercial mortgage-backed securities (CMBS).

Major central banks are either easing or soon to begin cutting rates, setting the stage for a supportive environment for fixed income assets.

However, the delayed start to the Fed's rate cutting cycle, coupled with upside inflation risks from weaker currencies, has prompted a slower pace of easing in some emerging market economies. Meanwhile, the Bank of Japan is set to steadily progress with its policy normalisation. These divergent monetary policies warrant a dynamic approach to duration management and offer distinct opportunities for cross-market interest rate exposures.

The coming months will likely reinforce the importance of diversification to mitigate risks, active bond selection to identify

strong corporate and sovereign balance sheets, and strategies to enhance portfolio resilience. Leaning into the US dollar's carry advantage and perceived safe-haven status amidst political volatility is one strategic way to enhance resilience.

In conclusion, while we recognise sound economic and corporate fundamentals, we remain vigilant due to stretched valuations and political uncertainties.

Our strategy is to be selective, focusing on generating attractive income in a higher yield environment and being ready to seize risk premiums to generate total returns in our clients' portfolios as opportunities arise.



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Investments in fixed income securities are subject to the risks associated with debt securities generally, including credit, liquidity, interest rate, prepayment and extension risk. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. The value of securities with variable and floating interest rates are generally less sensitive to interest rate changes than securities with fixed interest rates. Variable and floating rate securities may decline in value if interest rates do not move as expected. Conversely, variable and floating rate securities will not generally rise in value if market interest rates decline. Credit risk is the risk that an issuer will default on payments of interest and principal. Credit risk is higher when investing in high yield bonds, also known as junk bonds. Prepayment risk is the risk that the issuer of a security may pay off principal more quickly than originally anticipated. Extension risk is the risk that the issuer of a security may pay off principal more slowly than originally anticipated. All fixed income investments may be worth less than their original cost upon redemption or maturity.

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Smithfield Offices

5 St. Johns Lane

London

EC1M 4BH

+44 (0)20 7250 4700

london@portfolio-verlag.com