RBC Global Asset Management

The value is back in public market fixed income

And private markets look a little less shiny.

BlueBay Chief Investment Officer, Mark Dowding, recently sat down with Institutional Investor to share his insights into the macroeconomic developments of 2022 and how they are impacting fixed income markets.

It was getting to the point where you almost wondered if "fixed income" needed a new name.

"Last year, all people wanted to talk about was private markets," says Mark Dowding, CIO, BlueBay Asset Management. "There was no income left in fixed income. High yield was no longer high yield."

The fixation on private markets hasn't waned, but Dowding, who is never at a loss for an unvarnished truth bomb, believes many investors are showing their "lemming" tendencies – and missing an opportunity in the process.

"The intense focus on private markets begs the question if many investors are simply chasing what's happened in the recent past," says Dowding.

"A lot of value has come back to public market fixed income," he continues. "We came into the year with U.S. high yield at about 4.5% and today it's almost double that – it's back to being high yield again."

View of value

For investors who can take a medium-term view – which should include vast numbers of institutional investors – Dowding sees the opportunity in fixed income shaping up in juxtaposition to the public equities market.

"I think there is value in U.S. high yields north of 7.5%," he says. "Default rates will rise a bit, but right now they are incredibly low. Even if the default rate reaches 3%, there's value to be had in areas like high yield and emerging markets if you're taking more of a medium-term asset allocation view."

In the near term, investors are more likely to be considering when to add more risk to their overall portfolios. The S&P and the NASDAQ are down considerably year-to-date, but both are still substantially higher than they were at end of 2019. If the recent correction in equities continues a bit longer, investors might anticipate the remaining performance gap to close near the top of the market pre-COVID.

"To some degree, I look at equities as risk assets that take the lead in this environment," says Dowding. "And the outlook for them could be a bit challenging short term – you really don't want to load up on risk assets just yet. The market is getting a bit oversold. You're probably going to be paid to add some risk when the time is right. From our perspective, we feel that timing is influenced by when the trajectory of inflation heads back toward the Fed's inflation target."

A cautious eye on private markets

In contrast to his optimism around public fixed income, Dowding says he is "becoming more concerned about private markets in general."

"In private equity, there are a lot of deals chasing very high IRR [internal rate of return] combined with high exposure to tech companies," he says. "About 10% of the NASDAQ is down 90% so far this year. Smaller entities, which are trading on multiples to cash flow and revenues rather than making any profit, are taking the worst price performance hits."

As a result, investors are likely to see companies that are burning cash and need to refinance. When that occurs, the accompanying material markdowns will impair some private equity vehicles.

"Some of the big [alternatives] firms out there are running private debt alongside private equity, and I can see challenges coming in the private credit space, too," says Dowding. "Investors really should give some serious thought to these considerations instead of just impulsively chasing the crowd and the shiny objects."

Influences on the opportunity in public fixed income markets

Dowding is bemused by the bum rap that the Fed gets domestically in the U.S., and instead is impressed with the work done by America's central bank.

"The Fed is filled with bright minds and thoughtful people," says Dowding. "I meet with many central banks, and some are pretty darn hopeless. The ECB is currently staffed with politicians who know little about monetary policy, and the Bank of England is making a dog's dinner of controlling

inflation. The U.S. could be doing a lot worse than what it has in the Fed."

To Dowding, who meets with Fed representatives in Washington, D.C. fairly regularly, the bank is currently on point to keep the U.S. economy on the rails even if the ride is a little bumpy. He is quite optimistic that the U.S. will avoid a full-blown recession, thanks in large part to the efforts of the Fed.

"I'm putting only a 30% probability on a recession in the U.S. in the next 18 months. In the eurozone, I think it would be 50% plus. And in the U.K., I think we're already in a recession," says Dowding. "China looks more and more like an economy in recession. The property market there is still massively overvalued. Some of the dynamics in the Chinese property market look a little bit like we saw in the U.S. in 2008."

Comparatively speaking, the Fed is assertively tackling the current environment, according to Dowding.

"They might have been a bit surprised by the fact that six months ago no one expected the level of inflation that we've seen, but in response they've been racing to tighten financial conditions and get ahead of the curve," says Dowding.

"The clear narrative when I speak with the Fed is they're going to keep on hiking rates until PCE [Personal Consumption Expenditures Price Index] goes below 3%," he continues. "I think it'll be back to that level by this time next year. If the path is the Fed keeps hiking rates and it's frontloaded, you end up with rates getting to 3.25% or so and it's largely priced-in to markets already."

"If that scenario pans out, the U.S. economy and markets will likely experience a soft-ish landing," says Dowding. Some other things need to happen – a slow-down in growth, for example – but in the round Dowding believes it's doable.

If inflation stays more elevated and the job market remains hot the PCE core could end up stuck at around 4%. Even in that scenario, Dowding has faith in the Fed.

"The Fed knows that the longer inflation is away from the target, the more it gets embedded into inflation expectations," Dowding says. "It will use all the tools at its disposal to keep things moving in the right direction. They don't want a recession – no one does – but if we need one, it's better to have a small one sooner than a big one later."

This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell any security, product or service in any jurisdiction; nor is it intended to provide investment, financial, legal, accounting, tax, or other advice and such information should not be relied or acted upon for providing such advice. This document is not available for distribution to investors in jurisdictions where such distribution would be prohibited.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, RBC Global Asset Management (Asia) Limited, and BlueBay Asset Management LLP, which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe this document is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

Additional information about RBC GAM may be found at www.rbcgam.com.

This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate and permissible, be distributed by the above-listed entities in their respective jurisdictions.

Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

Opinions contained herein reflect the judgment and thought leadership of RBC GAM and are subject to change at any time. Such opinions are for informational purposes only and are not intended to be investment or financial advice and should not be relied or acted upon for providing such advice. RBC GAM does not undertake any obligation or responsibility to update such opinions.

RBC GAM reserves the right at any time and without notice to change, amend or cease publication of this information.

Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index.

Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

® / ™ Trademark(s) of Royal Bank of Canada. Used under license.
© RBC Global Asset Management Inc. 2022
Publication date: (June 6, 2022)

.