RBC Global Asset Management

Global Government Bonds

Diversifying risks and enhancing returns

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Small adjustments to your approach can help capture returns and lower risks in core government bond allocations.

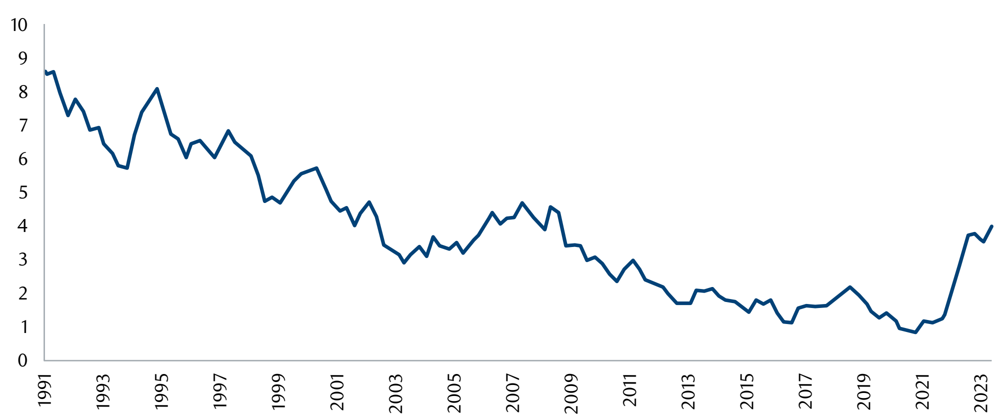
With favourable yields as a backdrop, there is an opportunity for active managers to exploit dislocation in the global sovereign bond market to generate considerable alpha. In this paper we outline:

- **Why Active** – Fixed income is alpha-rich, and portfolio managers have many tools at their disposal to deliver returns..
- **Why Global** – the UK market is relatively flat in terms of opportunity, going global can enhance yields, increase credit quality, and diversify risk.
- **Why Now** – Covid has set global economies on different paths, meaning an active approach to positioning and deep fundamental analysis can unearth frequent opportunities.

Why Active? – A forgotten tool

Fixed income is an alpha-rich asset class that has been overlooked, as yields have spent the last 30 years marching to zero. Portfolio managers with the right approach can consistently target **significant alpha over the benchmark, adding a boost to returns**.

Figure 1: YTW of the Global Aggregate Index



Source: Bloomberg, as at 22 August 2023.

Today benchmark yields across fixed income, in both corporates and sovereigns, are at levels not seen in the last 15 years (see Figure 1). Meaning you are paid to hold fixed income and rewarded for going active through meaningful upside, adding a valuable tool alongside direct or passive approaches. **As in equity, the important ingredients for active alpha, are the right opportunity set, dispersion, proprietary analysis and strong fund construction and risk management.**

Alongside active underweight or overweight positioning, fixed income investors have a number of tools at their disposal. This does not have to be via complexity, you can still clip coupons, and position relative to the benchmark, but also:

- adjust maturity and change duration, including taking risks associated with the changing shape of the yield curve;
- take, or isolate, risk in the currency or interest rate of individual bonds;
- structure trades that focus on the relative outperformance of two instruments.

In addition, understanding the liquidity and trading environment, and using derivatives selectively, can protect or create exposures that help insulate against macro volatility.

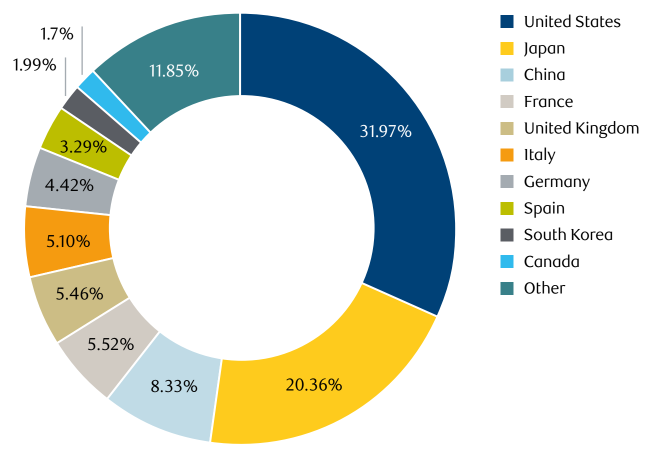
Why Global? – Increasing your opportunity

The opportunity set matters. In core fixed income, Sterling bonds can be a fairly flat asset class driven by one rate component and a single set of economic factors. By expanding your universe, you can greatly increase the frequency of alpha capture, allowing portfolio managers to choose the most compelling investments and take advantage of different economic regimes.

The global sovereign bonds asset class benefits from great breadth and dispersion. It is made up of 45 countries and 27 currencies, although the US, eurozone, Japan, China and the UK make up 90% of the issuance. On average the asset class is AA, or one notch higher in quality than the UK's current AA- rating. It also yields 4.8% in GBP hedged terms, 30bps higher than the yield on the UK 10-year (as at 30 June 23). **In investing it is a rare thing that diversifying exposure, can have the twin benefit of both raising your yield and also improving credit quality.**

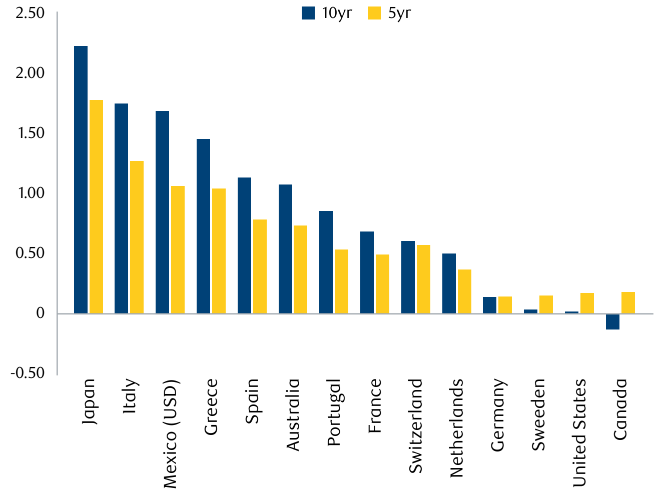
The most straightforward benefit of going global is access to higher yields. While interest rates can be higher or lower in different countries, the devil in the detail is the cost of hedging. There is a real cost or benefit, which translates into a change in yield when converting. By hedging the currency risk, you are effectively borrowing the currency, and the cost of doing so is the difference in interest rates or carry of the currency.

Figure 2: Bloomberg Global Agg Treasury by Issuer



Source: Breakdown Of Bloomberg Agg Treasury USD index, as at 31 July 2023.

Figure 3: 10 year yields in GBP terms



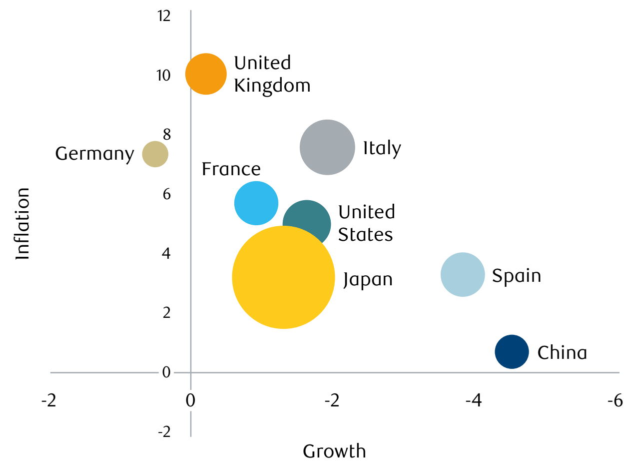
Source: Yield Pick Up hedging 10yr yields to GBP 31 July 2023.

For some currency pairs, this means a lower yield, but given UK rates are higher than most other countries, converting the yields results in an increase versus a large swathe of sovereign issuers. Even when yields are lower, such as in the US, **you benefit from a deeper and more liquid market, with a significantly improved economic outlook versus the UK.**

Why now? – Taking advantage of the dislocation

Covid had a dramatic effect on global trade and inflation. By making countries compete for goods and prices, you have seen markedly different outcomes play out regionally, translating into vast divergences in the outlook for individual economies. As winners and losers emerge, countries have responded with their own playbook, and central banks have found themselves at different points of the monetary cycle.

Figure 4: Growth and inflation versus Debt to GDP (Bubble)



Source: IMF Growth and Inflations YOY Q1 2023, Bubbles are debt to GDP end 23 (estimated).

Today, there is a marked difference in rates between emerging markets, which have been at peak for a while, the UK and the US at or nearing their cycle peaks, and Japan, still in the midst of yield curve control. An asset class that spent the last decade having little to no yield is now higher yielding and rich in distortion, with inverted yield curves implying different future expectations, creating outright long, short and relative-value opportunities.

Short-term yields are driven by interest rates, but longer term, the yield is driven by expectations of economic performance and future expectations for monetary and fiscal policy. This, in turn, leads to ratings and sets yields at different levels, as credit quality affects the demand. This is why in Europe, at the end of July 23, Germany could borrow for 10 years at 2.5%, while Italy had to pay 1.6% more at 4.1%, despite sharing a monetary union and single currency.

Higher inflation limits growth prospects as monetary policy needs to be more restrictive. In turn, this limited growth puts pressure on debt as a percentage of GDP, as GDP growth cannot act to offset total debt outstanding. Despite similar ratings, the underlying state of economies can be very different, and the outlook and future expectations even more so. This allows active positioning as countries look to manage their debt, and support growth.

Conclusion

The economic pathway remains unclear, however, for active investors looking to drive returns in this space, this continues to be a tailwind for developing trade ideas. We also believe this dislocation driving the opportunity set will remain structurally elevated for some time. This, combined with the dual benefits of diversification and a strong return profile, offers a compelling reason for active global sovereign bonds to play an important role in asset allocation.

Portfolio Manager Perspectives

Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

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