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Transcript of Andrzej's podcast regarding: The Era of Quantitative Tightening

June 17, 2022

Head of U.S. Fixed Income, Andrzej Skiba, breaks down the recent Federal Open Market Committee meeting and its effect on fixed income markets and the global economy.

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With inflation levels running at more than 40-year highs, the Federal Reserve raised interest rates by 75 basis points on Wednesday. This marks the steepest interest rate increase since 1994. Why is the Fed hike necessary?

The likelihood of recession in the U.S. has definitely gone up over the recent weeks. Stubbornly high inflation necessitates aggressive action by the Fed and the more aggressive the tightening of financial conditions we see across our markets and the economy, the higher the likelihood of a recession. We were hoping to see inflation coming down, but it remains stubbornly high and market participants have been surprised by the extent to which it refuses to budge lower in the face of weaker economic conditions. That means that growth will be under pressure and we need to consider a serious likelihood of recession hitting in 2023. What used to be a lower probability in our opinion is now a 50/50 chance as we look towards 2023, and we need to monitor how inflation evolves between now and the end of the year to assess the likelihood of that scenario happening.

When it comes to other markets in Europe, we've already seen a higher recession risk because of the unprecedented shocks faced by those economies to do with spiking energy prices, but also impacts of the conflict in Ukraine. So when it comes to Europe, we already believed that flattish growth is at best the outcome that you can see in Europe and a recession is a distinct possibility.

So when it comes to our perspectives on growth, it's a higher likelihood of recession in the U.S. that is a recent change in our view, whereas the European expectations remain unchanged.

So how can investors navigate a landscape of rising growth in geopolitical risk?

In simple terms, with caution. We would advise all investors to reassess their portfolios in light of a more challenging growth outlook and continued geopolitical risks like the conflict in Ukraine. In fixed income, it has a number of implications. It means that within your portfolios, you should prefer shorter duration assets to longer duration assets, where the carry of the shorter duration assets can offset the negative impact of higher yields as we move through the rest of this year. It also means that you want to focus on credit exposures in sectors that are non-cyclical and are less sensitive to the growth of the economy. So in markets like investment grade, that would mean focus

on sectors like TMT or healthcare or utilities that are less impacted by the weaker growth trajectory while reducing exposure to cyclical issuers in the industrial space and similar areas of the market.

In high yield, it means being very careful about your CCC-rated exposures. While the U.S. economy is doing well right now, with the weaker growth expectations ahead and recessionary risk increasing, that segment of the market will be most vulnerable to default risk as we steer through the next year. The same comment about non-cyclical preference in terms of sector exposure also applies of course, in high yields. And when we're looking at securitized markets, we would advise investors to focus on securities with a strong paydown profile, with shorter duration and those with greater liquidity.

This is not the time to look for esoteric assets within the ABS or MBS markets at a time when market stress could be increasing, volatility remains high and the liquidity profile of our markets will be diminishing. So in summary, we would advise investors to focus on shorter duration assets, both in non-cyclical industries and also more liquid strong paydown characteristic securities within the securitized space.

Thanks. Those are all very helpful insights. Now, Andrzej, who do you believe are the key winners and losers in the fixed income universe from this rate hike?

I'm not sure we can say there are many winners when it comes to such aggressive policy tightening as we've seen over the recent days. However, we do think that issuers with strong balance sheets, those that can withstand economic pressures and have an ability to address their capital structures without needing to access the market over the months to come will be favored by investors.

That applies across the spectrum of fixed income investments. And the good news is that a lot of companies have done their homework. They have refinanced their obligations. They do not have meaningful maturities ahead. When we look at high yield markets, the forward looking maturity world, i.e., bonds that need to be refinanced or debt securities that need to be refinanced in the markets, are the lowest they've been in many years.

So from that perspective, a lot of issuers are entering the slowdown from a position of strength and in much better shape than was the case in previous downturns. At the same time, we would highlight among losers those issuers that have running elevated levels of debt where their deleveraging is predicated on strong economic outturn, and those issuers that operate in deep cyclical and more esoteric parts of our investment universe.

We strongly feel that what used to be a diamond in the rough as an investment opportunity in bull markets, can quickly become an albatross hanging down your neck when liquidity evaporates and investors focus on larger, more liquid capital structures, larger, more liquid issuers within our investment universe. So name selection is key. This is not the time for passive investing; this is absolutely the time to make very careful selections within your investment portfolios that align with a challenging growth outlook and less illiquidity within fixed income markets.

All right. And as we head into the second half of 2022, investors are looking for ways to predict returns. Alpha and beta are both measures used to compare and predict returns. Why should investors be paying closer attention to alpha over beta?

The simple answer is that because alpha can make a difference between losing money on a forward looking basis and not. When markets are in much better shape and we can describe broader conditions as a bull market, then whether you are running an active or passive strategy often doesn't matter that much as everyone is enjoying positive returns. At a time when market dispersion will be on the way up, volatility is high and central banks are not your friend anymore, what choices you make within your portfolio construction, how you can contribute to alpha generation, can make a world of difference - can make the difference between losing money to your clients over the next 12 months, and making money. So from our perspective, this is exactly the time when asset managers need to focus on capital preservation and alpha generation as ways to offset market pressures.

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