For Professional Investors Only

Global Asset Management

Rates & inflation

Allocation in a brave new world

David Horsburgh
Head of Client Solutions,
BlueBay Fixed Income Team

Marketing Communication

Published April 2022

With inflation and central bank hiking, the role of fixed income in investor portfolios is being examined. This theme is often thought of as one issue, but it is actually four specific questions that allocators are trying to address:

1. **How can you add yield without adding risk?**
2. **How can you insulate from rising rates?**
3. **What is the diversification benefit of fixed income?**
4. **Which approach can protect in a stagflationary environment?**

Investors need to think about all these issues both together and separately in the context of their portfolios and introduce assets that can help mitigate and address these risks. Working with a specialist asset manager provides an effective way to isolate these risks and examine how different approaches can lead to portfolio outcomes.

Why do investors care about inflation?

Today, inflation is high and the expectation is for it to be above central-bank targets for some time. Rates expectations have already repriced a lot of fixed income, yet still don't go all the way in terms of capturing the extent and speed of increases required to bring things back under control. All of this is set against a backdrop characterised by high uncertainty and volatility. While fixed income valuations already look more attractive than they have in some time, the rates picture is likely to be a cause of volatility and risk until inflation becomes more settled.

Regardless of your view on where these risks will be going short and long term, this environment provides an opportunity to re-examine fixed income and integrate into portfolios some of the beneficial characteristics of non-traditional segments of the market.

These 4 allocator questions in detail

1. Real yields

With inflation at 7.4% in the US, and similar lofty levels elsewhere, there is a dearth of assets that return greater than this in the client's base currency (see chart 1). Across the whole of the fixed income universe today, if you want an inflation-beating yield, emerging market (EM) local currency is the only sub-asset class that would consistently deliver. Though EM local, with its inherent volatility and currency risk, isn't suitable for most clients.

This real return objective has driven yields lower over the last few years. Spreads have compressed as a result. Outside of the riskiest assets, safely achieving high levels of income is a challenge.

Taking a step back, inflation levels in key economies around the world are far away from their central bank targets. The current high-level regime could be considered a transitional extreme – we would expect rates to increase and inflation to normalise. Even with inflation back under control, it's unclear where yields will settle and whether they will be higher than any continued inflation.

2. Duration

While yield can help compensate for interest rate rises, over the last 40 years we've seen yields steadily decrease as maturities and index duration increase.

Yields today are very low and duration is very high across a number of fixed income assets. Any rate rise is likely to drive higher yields, and there is little in the way of existing yields to compensate investors. There is a very real need to insulate portfolios from this duration effect.

3. Correlations

Over the last year, we've noticed a lot of large companies in equity indices showing signs of rate sensitivity and selling-off on the prospect of rate rises. At the centre of this is the fact that at high multiples a company's value is dependent on results that are further in the future, and this is sensitive to rates and growth.

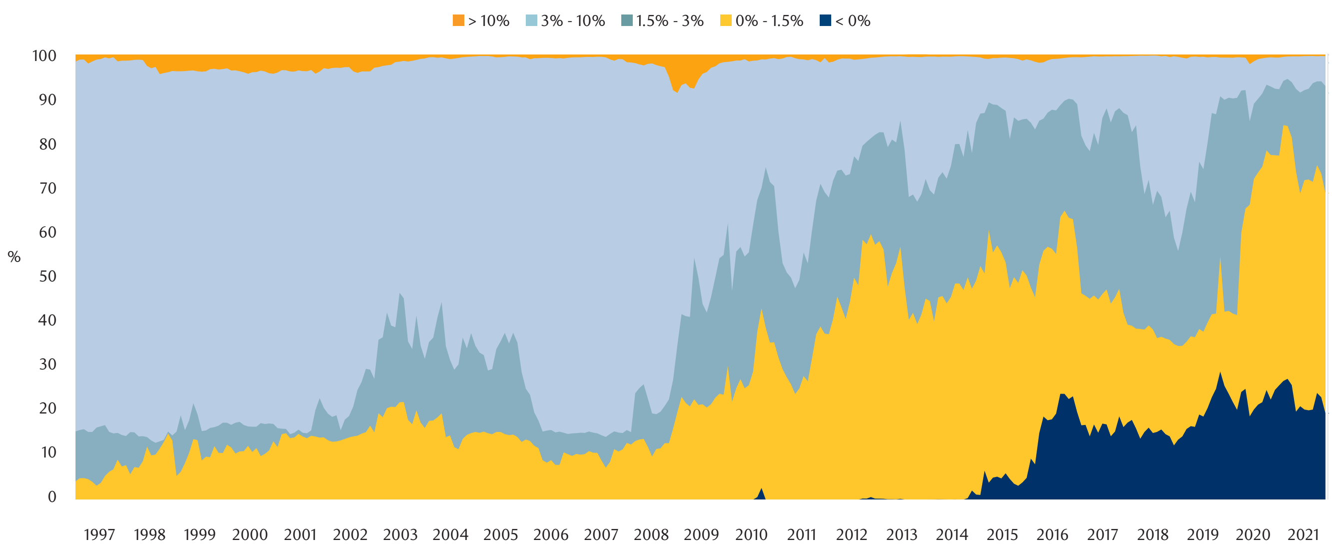
As a result, we've seen equities and bonds both sell-off on inflation and rate increases (see chart 2). The commonly applied endowment model of 60/40 equity bond portfolio was built on the pretence that bonds and equities have low correlation. If that correlation is suddenly positive, then the diversification benefit is called into question.

4. Stagflation

Perhaps the most challenging aspect of our current situation and the inflation outlook in a low-rate environment is that we may end up with rising prices and lower growth.

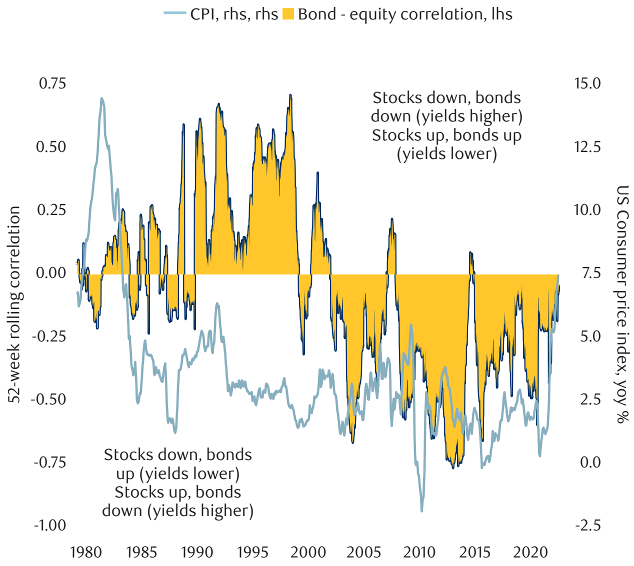
A dwindling central bank toolkit has hit as geopolitical factors start to affect demand and confidence all of this at a time when the same central banks are being asked to protect savers and companies by tightening fiscal policy to control inflation. This presents a challenge for risk assets as their growth outlook – which we rely on to counter rising rates – is eroded by inflation. In this environment, both equities and bonds come under pressure, creating a unique challenge for investors.

Chart 1: Global bond market by yield bucket



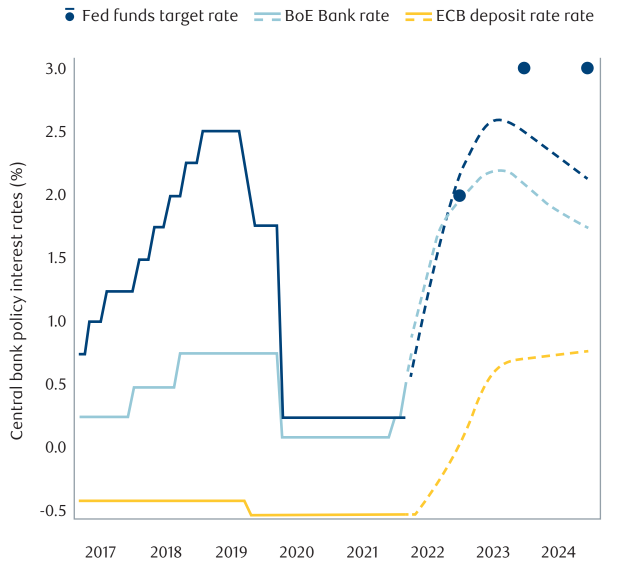
Source: ICE BofAML Global Fixed Income Markets Index (GFIM); latest monthly data for September 2021

Chart 2: Equity-bond correlation & inflation



Note; rolling 52-week rolling correlation between weekly returns between the BoA US Treasury index and S&P500; US consumer price index year-on-year change. Source: Macrobond; BoA; BlueBay calculations; latest data at January 2022

Chart 3: Market-implied path of policy interest rates[1]



[1] Dotted lines are implied path of policy rates derived from overnight index swap (OIS) forward rates. Source: Bloomberg; latest data at 22 March 2022. Blue dots is the median interest rate forecast from FOMC (16 March 2022)

The final piece of the puzzle is the notion that after a long bull run in fixed income (falling yields), we've come to an inflection point. From here, there is a higher probability of rate rises (see chart 3) than cuts and when rates settle, the spread component is likely to matter more for the performance of bonds than the interest rate component.

Inflation is likely to be uncertain for some time, and so growth and rates trajectory remain volatile. We've seen repricing in the market, however, there is room for this to go further if the central banks need to do more quicker to get things back under control.

How do you insulate your portfolio?

First, it's important to take stock of these four allocation challenges and remember what we are trying to solve for, both collectively and as individual risks. Yields and income are a focus, but while real yields are negative today, they are unlikely to stay this way.

In my view, the most compelling way to combat the effects of higher duration assets is by investing in securities that consistently provide a higher yield to investors. Risks are important here, and portfolio quality should be maintained in the search for yield.

In terms of duration (and correlations), there are a whole host of fixed income assets that exhibit lower rate sensitivity (see chart 4). They range from floating-rate assets like loans and structured credit, to global rates and emerging markets, where we have already seen rate hikes and there is dry powder left to deploy in terms of policy action. You also have spread assets, such as high yield bonds, which generally have shorter maturities and rates are less of a driving factor versus company fundamentals.

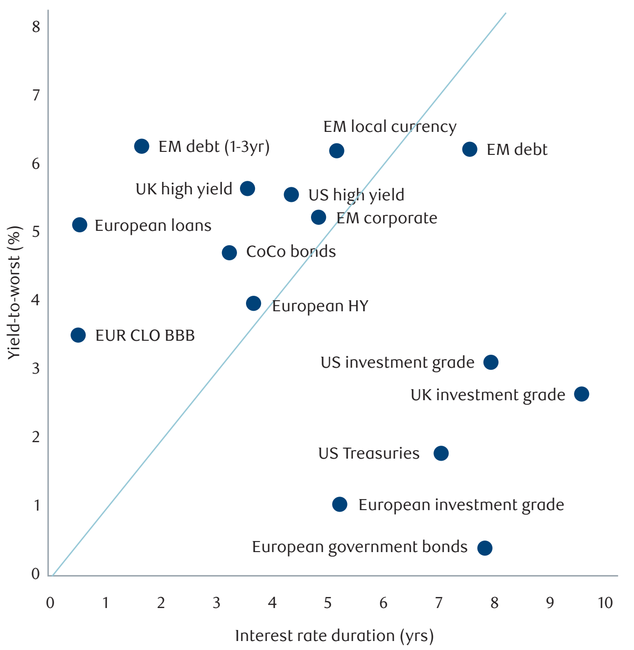
All these sub-asset classes are also places where you will see a yield pick-up over core fixed income. Blending them alongside existing holdings should lead to better overall portfolio characteristics.

Correlation is a tricky one. Diversification is challenging when assets correlate and you may ask yourself what benefit these assets provide. I think there needs to be an acceptance that inflation is a risk that affects rates and equities, however, growth shocks still exist.

> **"In my view, the most compelling way to combat the effects of higher duration assets is by investing in securities that consistently provide a higher yield to investors."**

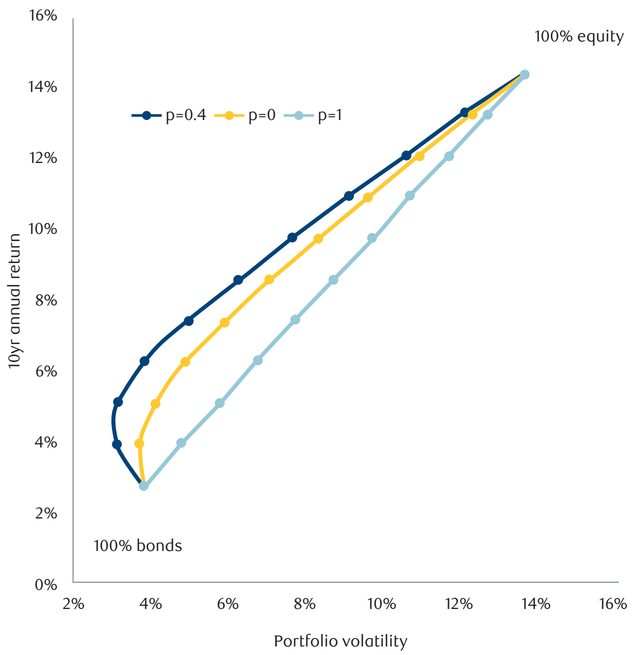
In a shock environment, we've seen evidence of negative correlations as there is a flight to quality and people expect governments and central banks to apply stimulus. In these instances, bonds hold-up their end of the bargain in terms of diversification benefits. Bonds can also help to lower overall portfolio volatility – this is an enduring trait, even when correlations increase (see chart 5).

Chart 4: Duration versus yield for a select number of fixed income asset classes



Source: Bloomberg; Macrobond; latest data at 18 February 2022

Chart 5: The effect of correlation changes on an equity/bond portfolio

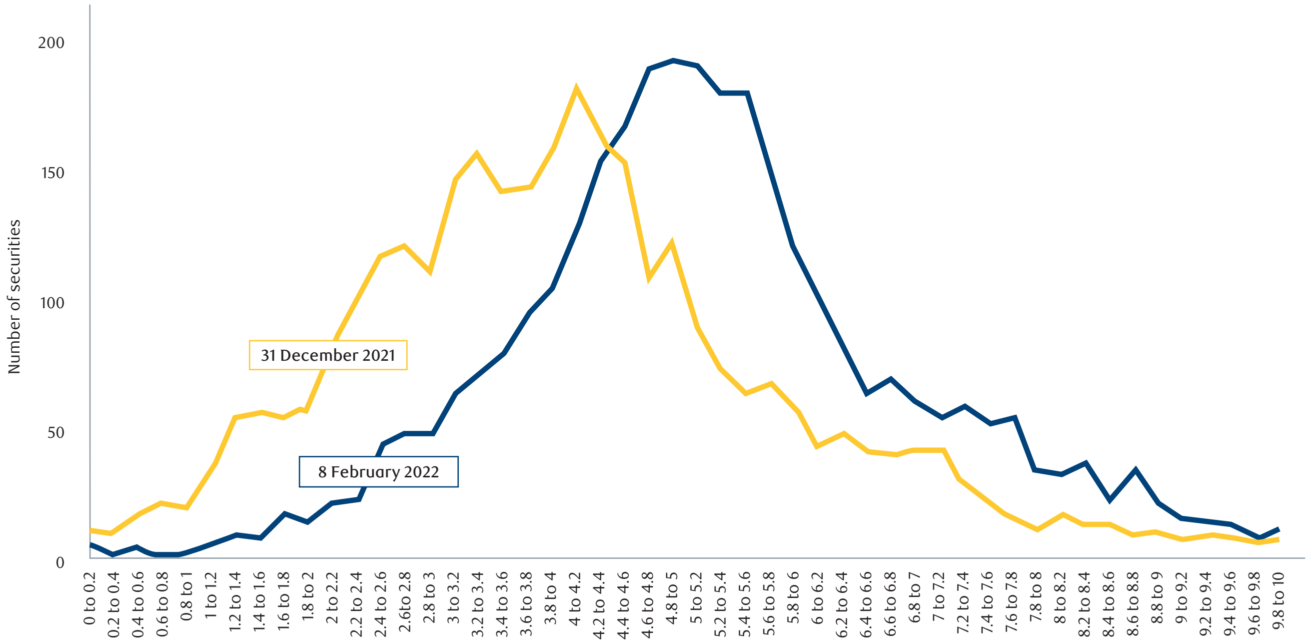


Note: based on realised volatility of monthly returns between 2010 and 2021 for BoA US Treasury index and S&P500. Source: BlueBay calculations; latest monthly data for December 2021

Finally, there's stagflation and an environment where a number of risk assets are challenged. While this pressurises risk assets, we know that not all countries or corporates are alike. Similarly, the different fixed income sub-asset classes display notable yield (see chart 6) and credit quality dispersion. The beta of asset classes are constrained, however, the opportunity for active risk and selectively owning specific issues increases. This is an environment where capturing yield while avoiding defaults and downgrades is critical.

Chart 6: Spreads moved, but wide dispersion presents an opportunity for active managers

Distribution of yields for BofA Merrill Lynch Global High Yield Constrained Index USD



Source: BofA Merrill Lynch, as at February 2022

The table below shows a selection of BlueBay's investment capabilities and how they are primed for each of these environments. From a portfolio construction perspective, there is rarely a golden bullet, though blending these strategies into your existing fixed income portfolio can potentially increase resilience against these risks.

	Real yields	Duration	Correlations	Stagflation
Alternatives & absolute return	✓	✓	✓	✓
Multi-asset credit	✓	✓	✓	✓
Loans		✓	✓	
IG structured credit		✓	✓	✓
EM debt (hard)	✓			✓
EM debt (local)	✓			✓
High tield	✓			
CoCos	✓			
Global IG			✓	

Published April 2022

Global Asset
Management