For Professional Investors Only

Global Asset Management

Why it's time to re-examine your fixed income allocation

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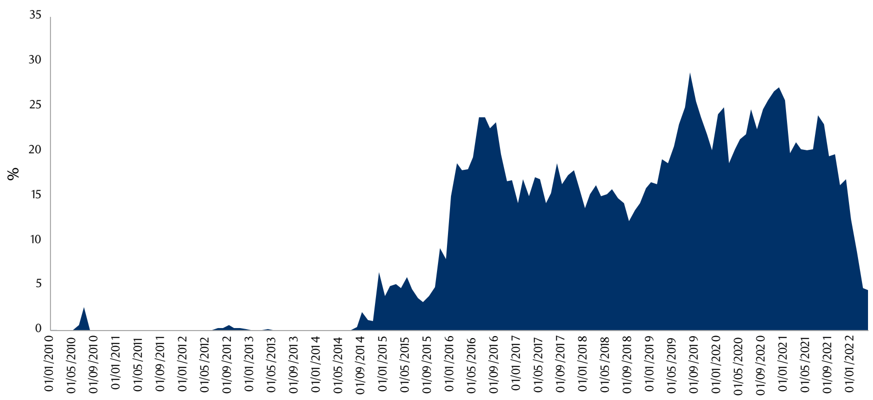
> "For the first time in years, high yield bonds are offering high yields and investment grade fixed income has income to fix."

Over the last few years, fixed income allocations pulled below strategic weight for many allocators as equity markets kept rising and accommodative monetary policy pushed yields lower and duration longer. Attractive fixed income yields were becoming scarcer and fear around what would happen if rates normalised meant risks in the space were elevated.

Cut to 2022 when central banks began guidance to raise rates and followed through with action, bond markets sold off aggressively. Clients responded by reducing duration, moved in favour of floating rate from fixed-rate securities, and in some cases, moved entirely to cash and cash-plus strategies.

Chart 1: Negative yielding debt has fallen from c.USD24trn to USD4trn in 9 months (to end April 22)



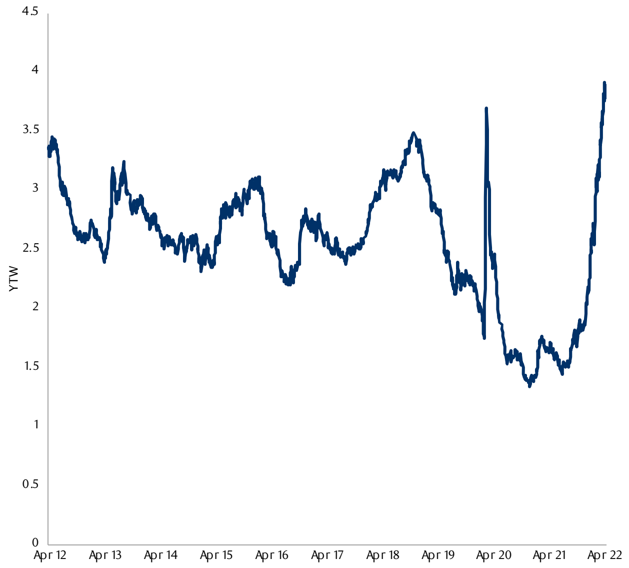
Source: Macrobond, as at April 2022

Fast forward to today, and for the first time in years, high yield (HY) bonds are offering high yields (some 7.7%[1]), and investment grade (IG) fixed income has income to fix (3.9%[2]). This said, investors are still understandably on the fence as to whether to re-engage with the asset class.

While macro risks remain elevated, a new challenge has entered the fray – not owning enough duration against your strategic allocation.

[1] Yield to maturity (%) on ICE BofA Global High Yield Constrained Index, as at 18 May 2022
[2] Yield to maturity (%) on Bloomberg Barclays Global Aggregate Corporate Index USD Unhedged, as at 18 May 2022

Chart 2: Bloomberg Barclays Aggregate yield to worst over last 10-years

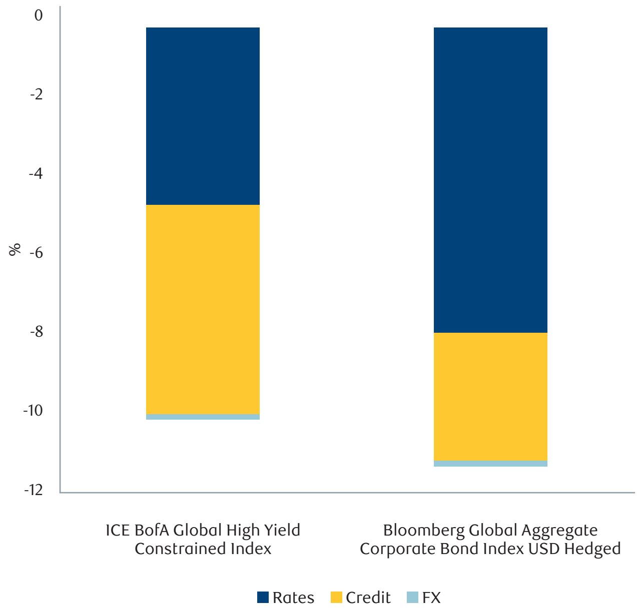


Source: Bloomberg, as at 27 April 2022

Chart 3: ICE BofA ML Global High Yield Constrained Index yield to worst over last 10-years

Source: Bloomberg, as at 18 May 2022

Chart 4: What has driven the sell-off in IG & HY?



Source: BlueBay Asset Management, as at 16 May 2022

Valuation's context

Both IG and HY bonds have underperformed year-to-date. For IG, this is largely across rates, while weakness in HY has been due to both the rates and spread components. In terms of historical standards, this puts yields in both asset classes above their 10-year average and into the 99th and 93rd percentiles, respectively.

You are now paid enough yield to weather a 179bps rise in HY and 55bps rise in IG yields, given index duration of 4.31 and 7.05 years. This facilitates income with cushion against further increases in yields, against a backdrop of notable moves in rate expectations. From here, spreads are discounting larger defaults and, while spreads may not have reached their wides, they could conceivably recover going forward.

From here, the key questions are:

Will inflation normalise?

Do central banks need to do more, either in terms of higher terminal rates or swifter action?

For now, the market seems to be roughly in line with the forward guidance, however, inflation will be the number to watch even though we're seeing suggestions of stabilisation.

As a house, we think that forward guidance is working as intended and that central banks are doing enough to prevail over inflation – or in the case of the UK and ECB, all they can do. Markets have already dramatically repriced the rates component of yields and that risk is looking well valued.

Even if further inflation pressure is felt, we may see an increase in the speed of rate moves, though are unlikely to see absolute levels rise significantly from where they are projected today. **Given HY and IG already reflect this rates view, the key area to watch out for now is what happens to spreads.**

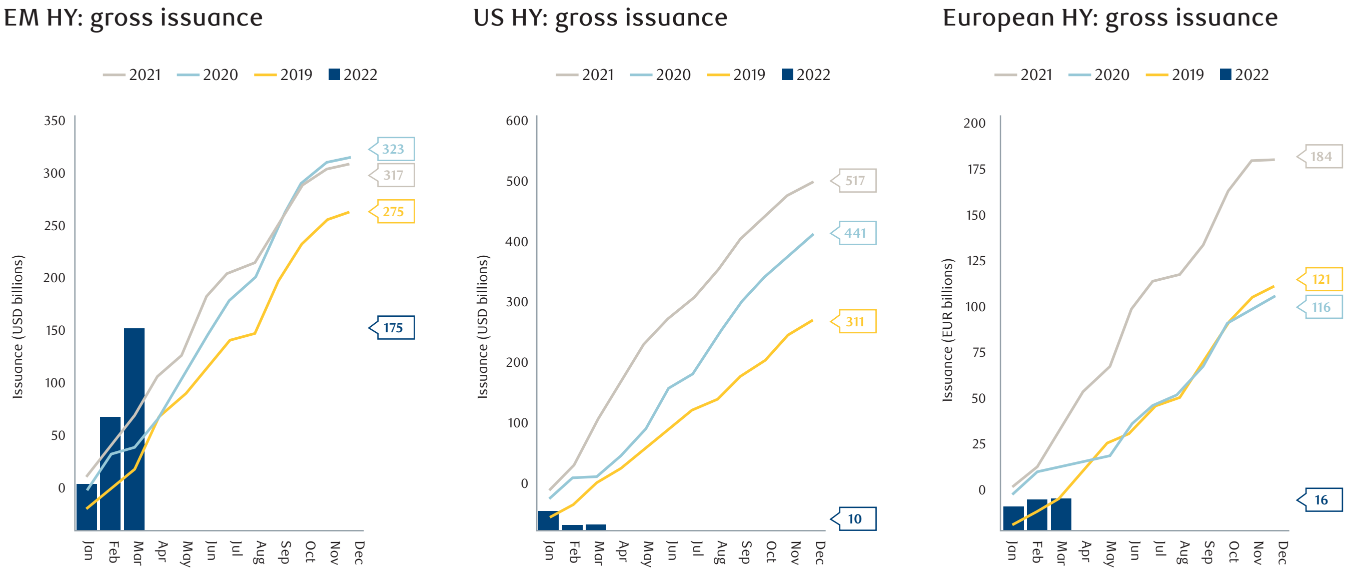
A spread of results

One of the more fascinating things about this sell-off is that while in IG the rate and spread component has driven yields equally, we've not seen HY spreads sell-off to the extent you'd expect from levered business in the context of a global inflationary shock. A few theories persist around this:

- **Pandemic clear-out:** The pandemic forced the HY asset class to have a clear out – we can see today that issuance is low compared to large levels last year; this is helping to support yields in the asset class.
- **Improved quality:** It's a much higher-quality asset class with developed market BB comprising 55.2% at the end of April, compared to 34.4% at the end of 2008.
- **Timing:** Another core belief building on the point above is that the rates move and inflationary pressures today are only likely to cause growth issues on an 18–24 month view. At which point, we may be in a position to begin to lower rates in order to support growth. 80% of the universe does not need to refinance before this time.

The reality though, is that it's all these things and the fact that the asset class is repricing individual bonds and sectors, both positively and negatively. There are idiosyncratic risks that have started to be priced in, creating a large amount of dispersion, and critically, opportunity.

Chart 5: HY gross insurance



Source: Bloomberg & BoA for EMHY; latest monthly data for March 2022

Positioning thoughts

If high-quality duration is starting to look interesting, is it also time to be looking at corporate spread as well? As ever, there's not one simple answer when it comes to investing.

From a passive point of view, the asset class beta is likely to present both opportunities and risks. That said, there are over 4750 corporate issuers across global IG and HY, all of which have repriced significantly year-to-date, with clear differentiation going forward as real economic effects and company fundamentals start to creep through into valuations.

Strategies that can take advantage of idiosyncratic performance while benefiting from tactical duration positioning should do well in this environment. While the beta of the fixed income asset classes is increasingly looking more compelling, the alpha potential hasn't been higher for some time.

All this aside, what is important to realise is that, given the repricing that's occurred so far in 2022, being underweight fixed income is a less obvious positioning than it has been. Indeed, with the potential for creeping macro risks and worries about growth coming under pressure, being underweight could become the biggest positioning risk.

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