Market Insights

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The Big Mac on Fixed Income Opportunities

What's on the Menu?

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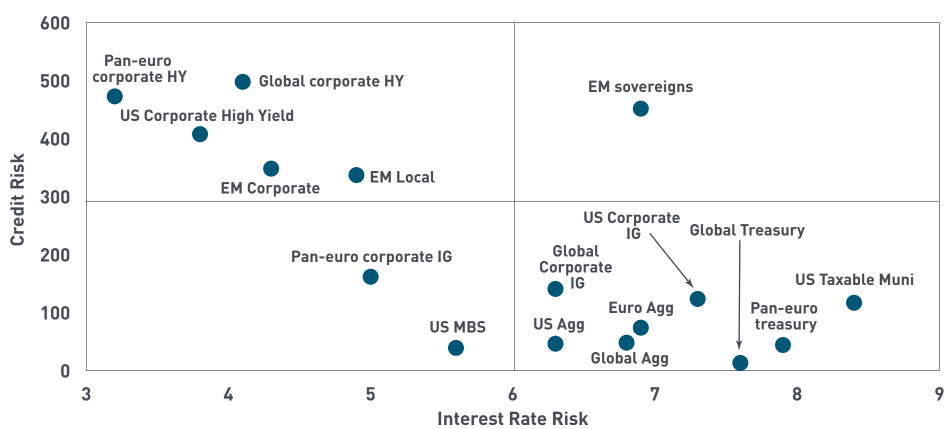
The case for fixed income is well established. The question now is which segments of fixed income should we invest in? This answer really depends on each investor's specific needs. Some investors may want to de-risk their portfolios, while others may wish to boost their income returns. Some investors may want to increase their duration exposure, while others may be thinking about deploying more credit risk. The good news is that there is something for everyone in global fixed income — from munis to emerging market debt.

Welcome to the opportunity buffet in fixed income. The case for fixed income has become much stronger. In our view, now is the time to get back into it. This is because the global macro environment is turning much more supportive, fixed income is now much better positioned in a multi-asset context and valuations have improved considerably.

The next big question then becomes: Where in fixed income do I want to be positioned? The answer mainly depends on the investor's specific risk appetite, duration target and return objectives. But the good news is that there is something for everyone in global fixed income.

Investing in fixed income is about taking duration risk and credit risk. Global fixed income offers great variety in terms of the combination of these two types of exposures (Exhibit 1). For instance, high yield operates in the high spread/short duration quadrant. In contrast, global treasuries and munis are in the low spreads/longer duration quadrant.

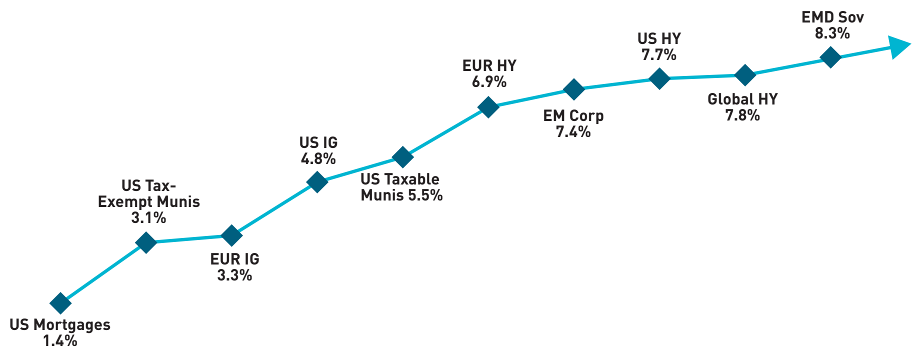
Exhibit 1: Fixed Income Spreads vs Duration



Source: Bloomberg. Data as of 13 January 2023. Spreads are expressed against US Treasuries. EM Local spreads measured against a theoretical global treasury comprised 33% of a 5-year Bund and 67% 5-year UST.

Now looking at the riskiness of fixed income sectors, there is significant variation between the excess return volatility (defined as the 10-year annualized volatility of monthly excess returns) of US mortgages — the least volatile — and the volatility of EM sovereign debt, which stands at the opposite end of the spectrum, exceeding 8% (Exhibit 2).

Exhibit 2: Excess Return Volatility in Fixed Income

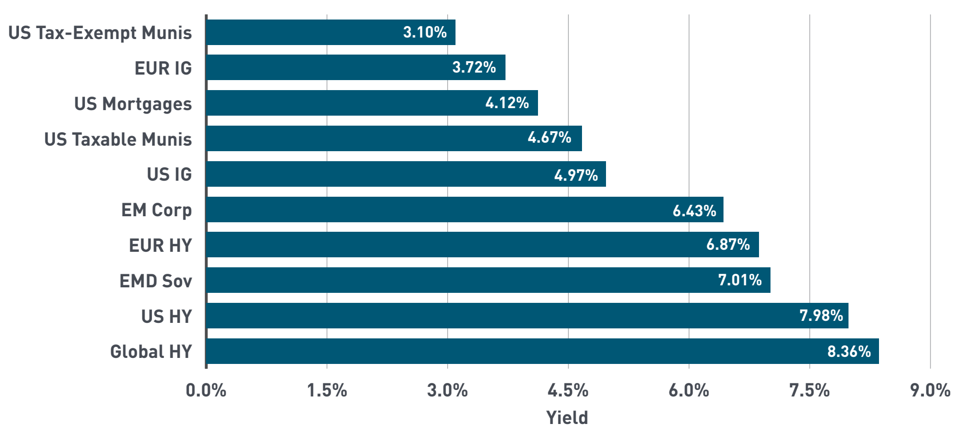


Sources: Bloomberg. ICE BofA. Volatility is defined as 10-yr volatility of monthly excess returns (annualized). Data from December 2012 to December 2022. Excess returns are defined as total return minus the return from the same maturity US Treasury. We opted to not use total return volatility as a measure of risk as we wanted to isolate the effect of duration.

Likewise, there is a yield level suitable for everyone in global fixed income. Looking at our sample of fixed income sectors, yields currently range from about 3% for tax-exempt munis to about 8.4% in global high yield (Exhibit 3). It is also worth looking at the broad range of yield per unit of duration that fixed income offers, with the high yield sectors offering by far the highest yield per unit of duration (Exhibit 4).

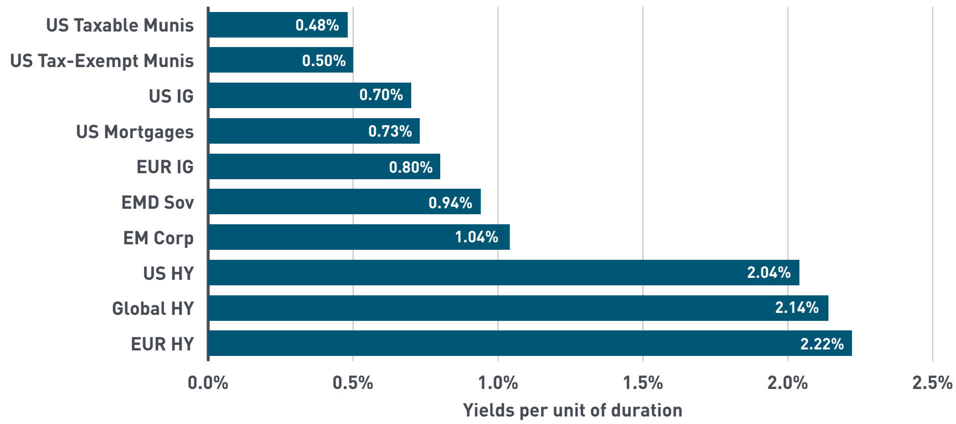
Risk-adjusted returns also display major variation over the long term. Overall, the high yield sectors tend to present more attractive risk-adjusted return profiles than their investment-grade peers. This tends to confirm the significance of income in driving total returns over the long period. Separately, it is interesting to underscore the powerful risk-adjusted return profile of tax-exempt munis in IG, mainly reflecting the low volatility.

Exhibit 3: Current Yields in Fixed Income



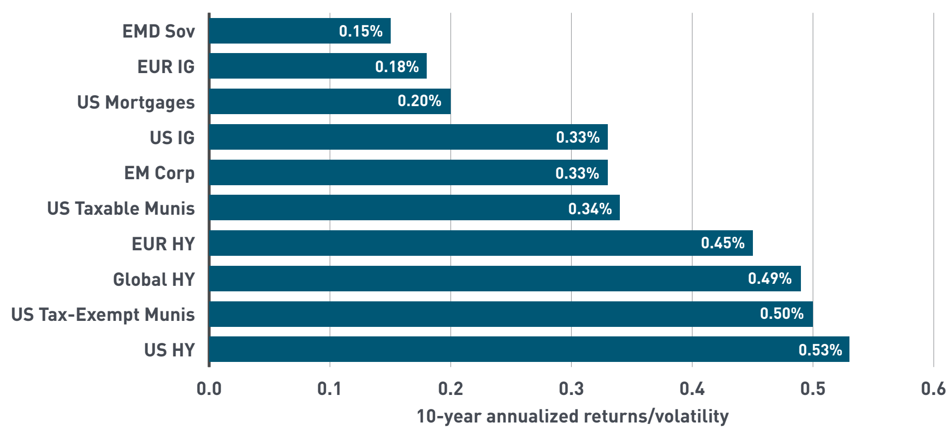
Sources: Bloomberg. ICE BofA. As of 18 January 2023.

Exhibit 4: Yields per Unit of Duration



Sources: Bloomberg. ICE BofA. As of 18 January 2023. Duration = effective duration.

Exhibit 5: 10-Year Risk-Adjusted Returns



Sources: Bloomberg. ICE BofA. Volatility is defined as 10-yr volatility of monthly total returns (annualized). Data from December 2012 to December 2022.

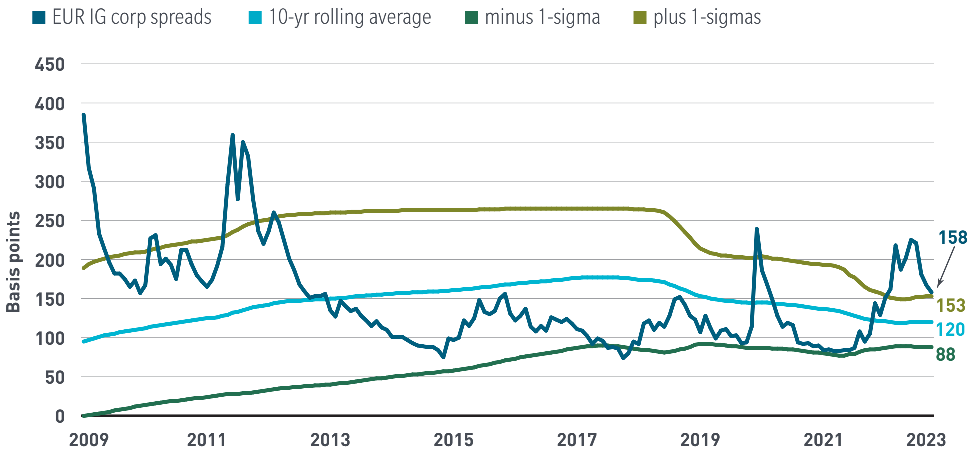
Fixed income à la carte. Let's now discuss our selection of attractive opportunities that global fixed income offers, which may address various investor needs and objectives.

Take advantage of cheapest spread valuations in global fixed income

European IG Credit currently screens as the most attractive asset class in global fixed income based on our fixed income valuation screener, with a valuation z-score of 1.16. EUR IG correction has been substantial over the past year, mainly reflecting the impact of European Central Bank policy, mounting concerns over a recession in the eurozone and the impact of the war in Ukraine. The z-score is a measure of deviation from the average in units of standard deviation. Z-scores are estimated using a 10-year average rolling window. A positive z-score indicates a valuation that is more attractive than the long-term average. Conversely, a negative z-score indicates a valuation that is less attractive than the long-term average. Looking ahead, we believe that EUR credit represents an interesting opportunity for the investor with a longer-term horizon. The current yield stands at 3.8%, a level that is considered attractive from a historical perspective.

Looking ahead, we believe that the future ECB tightening is more than fully priced in, which should limit any risk of market shock coming from ECB action. In addition, while the eurozone is facing severe growth challenges, we believe that it has been partly reflected in asset prices, including in credit spreads. It is also interesting to note that the data have started improving more recently in the eurozone, which may suggest that further macro downside may now be more limited. There have been significant dislocations between sectors, as well as single names in the EUR IG universe, so we advocate exposure to the asset class through an active asset manager who will be able to rely on a robust security selection process.

Exhibit 6: EUR IG Spread Valuation

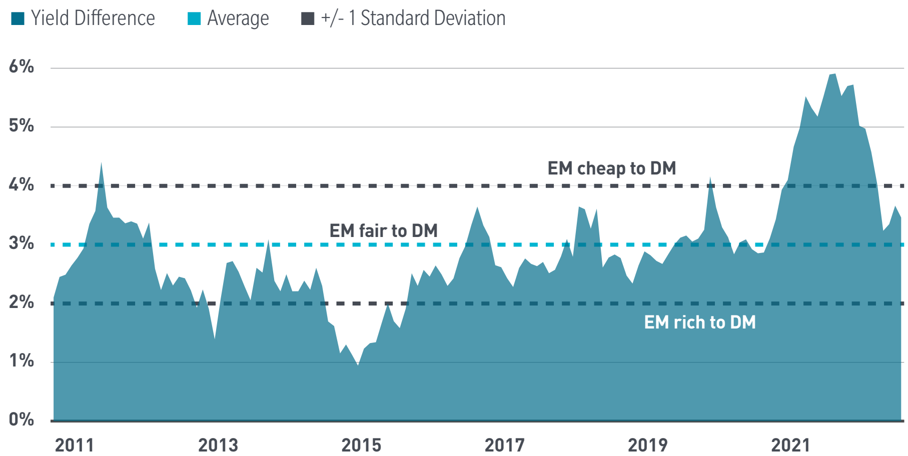


Source: Bloomberg. Monthly data from April 2009. Based on data as of 19 January for the preliminary January 2023 datapoint. EUR IG Corp Spreads = Bloomberg EuroAgg Corporate Average OAS, LECPOAS Index. Historical average is estimated using a 10-year average rolling window. The 1-sigma deviation from the historical average typically designates a level that would be considered attractive on a historical valuation basis (z-score of 1). Conversely, the minus 1-sigma tends to designate a level that would be considered expensive.

Position for the potential dollar downturn

EM local currency debt may well stage a recovery in 2023 if the US dollar faces higher correction risks. With tightening by the US Federal Reserve set to be complete soon, there is a possibility that the USD may come under some pressure, especially if the global risk appetite backdrop improves somewhat. EM local currency debt performance has been quite challenged over the past year, but history shows that periods of substantial drawdowns have been followed by a sharp recovery bounce. EM local debt is amongst the riskiest sectors in global fixed income as they entail EM currency risks. It is, therefore, geared towards fixed income investors with greater risk appetite. EM local currency debt also tends to be more exposed to global macro risks, which means that a robust, top-down framework is necessary to guide investment decisions. In addition, investing in EM always involves avoiding the vulnerable countries, which means a strong sovereign credit analysis should be part of a robust EM investment process. The current yield on EM local debt stands at about 7%, well above comparable yields in developed market government bonds, especially in real terms (Exhibit 7).

Exhibit 7: Real Yield Difference Between EM Local Debt and Developed Market

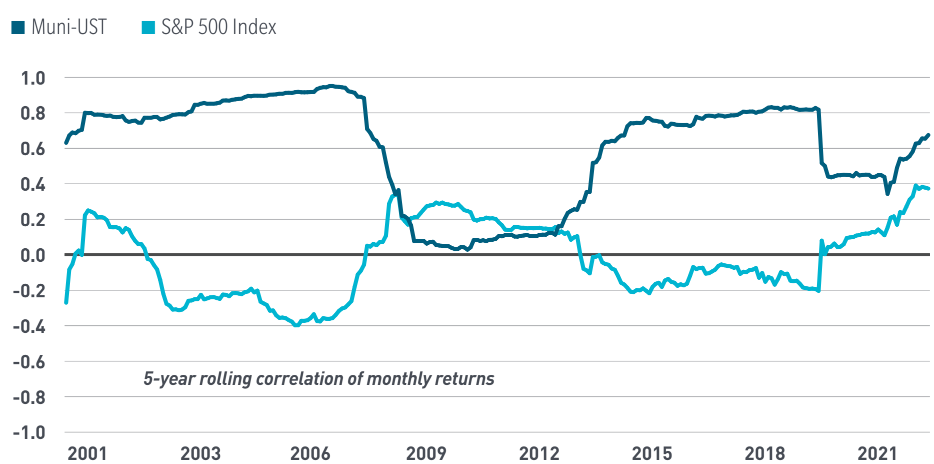


Source: Bloomberg. Monthly data from January 2011 through November 2022. DM nominal yield = 67% US 5-year Treasury, 33% German 5-year bund yield. DM real yield = 70% US 5-year Treasury minus US CPI, 30% German 5-year bund minus German CPI. EM nominal yield = GBI-EM GD yield. EM real yield = GBI-EM GD yield minus GBI-EM GD weighted CPI.

Seek protection against US recession risks

Some investors may be primarily concerned about rising recession risks in the US. If that is the case, tax-exempt munis offer an attractive alternative to outright government bonds, with an opportunity to gain exposure to slightly higher yields. Tax-exempt munis have historically been defensive in nature, exhibiting low correlation returns with equities historically and higher correlations with US Treasuries (Exhibit 8). They also have tended to be less vulnerable to the swings in the business cycle, given that they are supported by strong local state public finances. As underscored above, tax-exempt munis have displayed attractive risk-adjusted return characteristics.

Exhibit 8: Muni Correlation with US Treasuries and the S&P 500 Index



Source: Bloomberg. Correlation is defined as the 5-year rolling correlation of monthly returns. As of January 2023 (19 January used as preliminary datapoint). US Munis = Bloomberg Municipal Bond Index Total Return Index Value Unhedged USD. LMBITR Index, which covers the USD-denominated long-term tax-exempt muni bond market. UST = Bloomberg US Treasury Index, LUATRUU Index.

Staying active in fixed income. Given the elevated macro volatility, we advocate active asset management. Volatility may indeed create opportunities for the active asset manager who can engage in active asset allocation, while also taking advantage of potential dislocations that can be identified through a comprehensive research and security selection process. Overall, in our view, the key alpha generation levers include multi-sector asset allocation, yield curves and duration, and security selection. Typically, an active asset manager may also explore relative value opportunities as a way to manage the outright beta risk. Overall, we believe there are many opportunities in the global fixed income universe that may serve specific investment needs.