OCTOBER 2022

FIXED INCOME IN A WORLD WITH INFLATION
AN ASSET CLASS WITH PLENTY TO OFFER

RISING INFLATION AND RISING BOND YIELDS MAY HAVE DELIVERED UNWELCOME DRAWDOWNS IN 2022, BUT FIXED INCOME STILL HAS AT LEAST FIVE IMPORTANT STRATEGIC ROLES TO PLAY. WE BELIEVE INVESTORS SHOULD FOCUS ON THE OPPORTUNITIES OFFERED BY HOLDING BONDS, INCLUDING INCOME, RETURNS, RELIABLE SOURCE OF CASHFLOW AND DIVERSIFICATION.

THE SILVER LINING IN BONDS

- **Yields:** The recent market moves leaves many fixed income instruments with their highest forward-looking yield in recent years, as well as greater proportions of each market providing yields above particular thresholds.
- **Income:** The amount of income generated by fixed income instruments (running yield) has risen dramatically this year.
- **Market returns:** Credit spreads are close to their widest levels for five years. We believe this could provide an attractive entry point, potentially allowing clients to achieve their target income level with a higher credit quality than would have been possible for some considerable time.
- **Alpha:** Extended dispersion in credit spreads across similarly rated issuers since the start of the year could increase opportunities for managers to add value.
- **Liability management:** Higher yield levels provide a more attractive entry point for CDI mandates, which helps to increase outcome certainty, as they should be largely indifferent to future yield and credit spread fluctuations.
- **Risk management:** Historically, bonds have low correlation to equities and have lower volatility.

BROAD MARKET WEAKNESS CREATING CONUNDRUMS FOR INVESTORS

The weakness and volatility investors have experienced in most mainstream liquid asset classes in 2022 may have left them feeling downbeat, but also confused and concerned about what to do next. The drawdowns in credit markets particularly have been substantial this year, even in the high-quality investment grade (IG) space, exemplified by the Bloomberg Euro Aggregate Corporate Index which has declined by 14.6% to the end of September in 2022. High yield (HY) sectors have suffered even greater volatility and setbacks. The negative returns generated by widening credit spreads have been exacerbated by the rise in government bond yields, as central banks attempt to fight inflation. This uncertainty is reflected in market volatility with global equities and bonds experiencing the highest level of volatility, based on monthly returns, since 2015.

THE END OF A BOND-SUPPORTIVE BACKDROP

Yield levels have trended lower over the last 40 years reflecting the decline in inflation. Ultra-loose monetary policies and bond buying programmes provided more downward pressure on interest rates. In many countries both short-term and long-term rates fell below zero.

The ‘hunt for yield’ forced many investors requiring income streams to move into longer-term bonds and/or weaker credits.

Figure 1: Global government bond index, yield to maturity

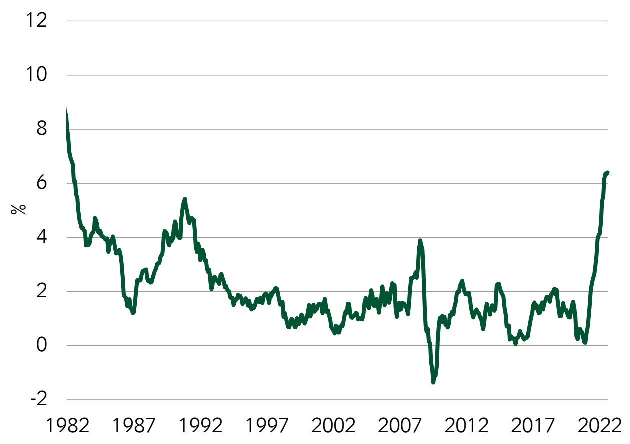
Source: Bloomberg, JPMorgan. As at 30 September 2022.

IS A NEW PARADIGM EMERGING?

The recent surge in inflation is greater than anything experienced globally since the early 1990s and many market participants are experiencing near double-digit percentage inflation rates for the first time in their working lives. Few expect a rapid reversal to the previous range below 2% anytime soon.

Many countries face the risk of wage inflation especially those with tight labour markets. If this risk materialises, it could fuel longer-term inflationary impetus and force central banks to raise interest rates even more aggressively.

Figure 2: Global inflation



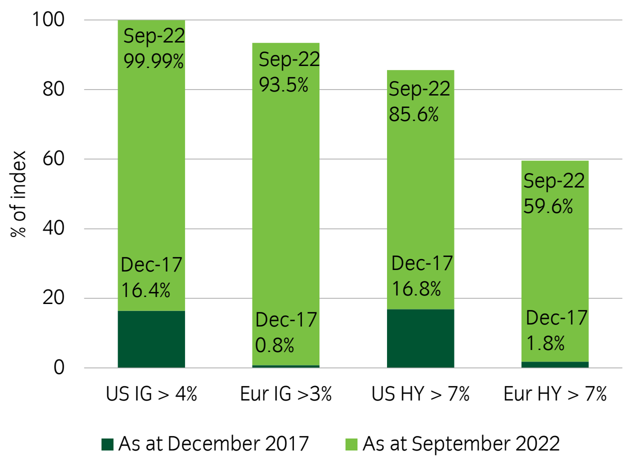
Source: Bloomberg, Insight. As at 30 September 2022. Global inflation calculated as 1/3rd US CPI, 1/3rd Japanese CPI, 1/3rd European CPI (1/3rd UK, 1/3rd Germany, 1/3rd France from Jan-1992. ½ UK, ½ France prior to Jan-1992). For illustrative purposes only.

MARKETS HAVE UNDERGONE A 'RESET'

More bonds are providing yields above threshold levels

Though inflation may take a while to be reconquered, we maintain that the expression "every cloud has a silver lining" should not be dismissed by investors. Achieving a yield of 4% in the US, or even 3% in the case of the euro market where yield levels have been even lower, could be an important threshold for some investors and the vast majority of the IG fixed income market now meets that objective compared to the end of 2017, as Figure 3 shows. The same is also true for the high yield market where bonds with yields greater than 7% now account for most of the indices.

Figure 3: Greater proportions of each market can now provide a particular income or yield



Source: Bloomberg. As at 30 September 2022 ICE BofA US Corporate Index (C0A0), ICE BofA Euro Corporate Index (ER00) ICE BofA US High Yield (H0A0), ICE BofA Euro High Yield Index (HE00) Yield to worst (YTW)

Equity returns may be harder to achieve and be more volatile

Additionally, without the extensive support central banks provided to the economy and corporate sector through quantitative easing and ultra-loose monetary policy, strong returns from equities may be harder to achieve and become more volatile. Fixed income may have an advantage going forward in the prevailing environment, as their returns tend to be more predictable and reliable than equities as they are primarily dependent on coupon, rather than price appreciation. This change in dynamic could provide an added attraction for fixed income.

FIVE IMPORTANT STRATEGIC ROLES FIXED INCOME CAN PROVIDE FOR INVESTORS

Recent fixed income market weakness does not diminish the important strategic roles the asset class can play in broad and diversified investment plans. We identify five of those strategic roles here and highlight how fixed income markets can provide the outcomes in the current market climate.

- **Income**: For investors seeking or relying on fixed income assets providing an income stream, higher absolute levels of yields may be welcomed as it becomes possible to gain higher levels of income for every pound, euro or dollar invested. This means that investors who have an income stream as an objective are likely to be able to enjoy generating a higher income from their investment, achieving a given income with less investment committed, or some combination of both. Yields for most, if not all types of bonds, have risen in the course of 2022, in some cases significantly. For example, the IG ICE BofA Euro Corporate Index ended September 2022 with a yield to worst (YTW) of 4.11%, having been at just 0.51% at the end of December 2021, while US IG yields have increased by 3.37% from 2.34% to 5.71% in that period.

  The widening of credit spreads at all credit rating levels makes it more possible to achieve a given income stream with less average credit risk. For example, at the end of December 2021, the yield (as measured by the yield to worst, YTW) on the ICE BofA Euro High Yield Index was so low at 2.89% that it was more than 1% below the level carried by the higher-quality, IG index nine months later. By the end of September 2022, the HY yield had risen substantially, reaching 8.21%, an increase of more than six percentage points.

Table 1: Yields and credit spreads in Euro and US markets

Index		31-Dec-2021	30-Sep-2022	Change
US IG	Yield	2.34%	5.71%	+3.37%
	Credit spread	94bp	165bp	+71bp
US HY	Yield	4.28%	9.49%	+5.21%
	Credit spread	327bp	538bp	+211bp
Euro IG	Yield	0.51%	4.11%	+3.60%
	Credit spread	97bp	220bp	+123bp
Euro HY	Yield	2.89%	8.21%	+5.32%
	Credit spread	342bp	618bp	+376bp

Source: Bloomberg. As at 30 September 2022. ICE BofA US Corporate Index (C0A0), ICE BofA US High Yield (H0A0), ICE BofA Euro Corporate Index (ER00), ICE BofA Euro High Yield Index (HE00) Yield to worst (YTW) and Option adjusted spread vs govts.

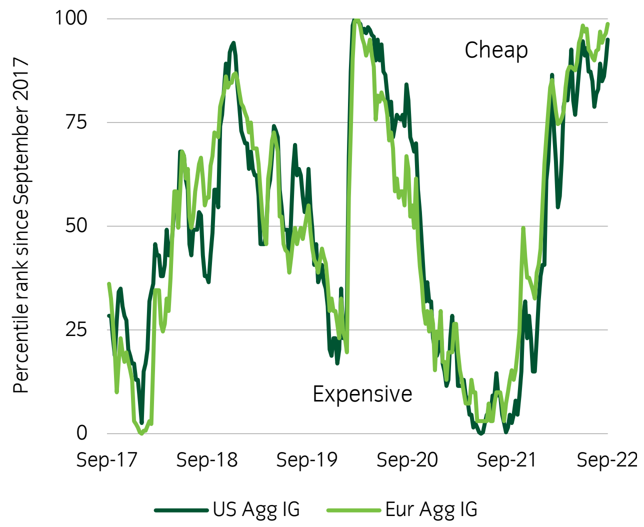
- **Market returns (beta):** As opportunities for higher income have arisen, so has the potential for achieving overall returns from the market – beta. Capital gains may be achieved if bond markets recover, and yield levels begin to decline. From a higher base, there is now probably greater potential and scope for yield levels to fall back, generating capital gains as values increase, than there was at the start of the year, or for some time before that.

  As absolute yields have risen and spread levels widened, we believe that markets generally have become more attractive from a value perspective.

  Credit spreads have neared their widest points in percentile terms compared to the last five years (since 30 September 2017). Although they were wider at the start of the pandemic in 2020, in our view, credit has cheapened and appears to be reflecting good value. From here they may offer the potential to generate attractive positive returns over the medium term.

  We are mindful for the cyclical position and the potential for movements in both yields and credit spreads to overshoot, particularly if inflation continues to move markedly higher or recession strikes hard.

Figure 4: IG credit spreads appearing cheap



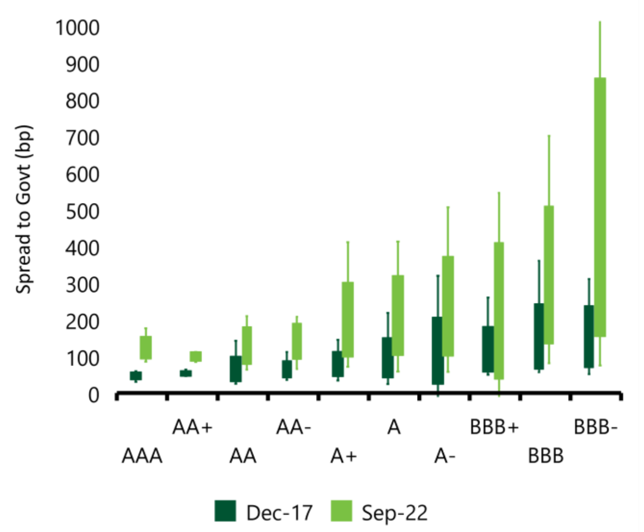
Source: Bloomberg, Insight. As at 30 September 2022. Bloomberg US Agg IG Index, Bloomberg Eur Agg IG Index

- **Excess returns (alpha):** Alpha represents the additional returns investment managers generate above any benchmark index.

  The increase in the volatility of fixed income markets in recent months has, if anything, increased the opportunities to generate potential alpha. In our opinion, the volatility of recent months and rise in inflation may have even enhanced them: not only have yields increased and credit spreads widened but the dispersion of spreads within similar categories, such as credit rating bands, or industry sectors, has also increased.

  Enlarged dispersion effectively creates more scope for identifying attractive (relative) value opportunities within credit markets that experienced managers can seek to capture. Figure 5 shows how the dispersion of credit spreads within each IG credit rating bracket for the ICE BoA Euro Corporate Index has significantly increased between December 2017, which was close to the tightest that spreads achieved in recent years, and the end of September 2022.

Figure 5: Alpha opportunities expand as dispersion of spreads across the Eur IG corporate index has increased



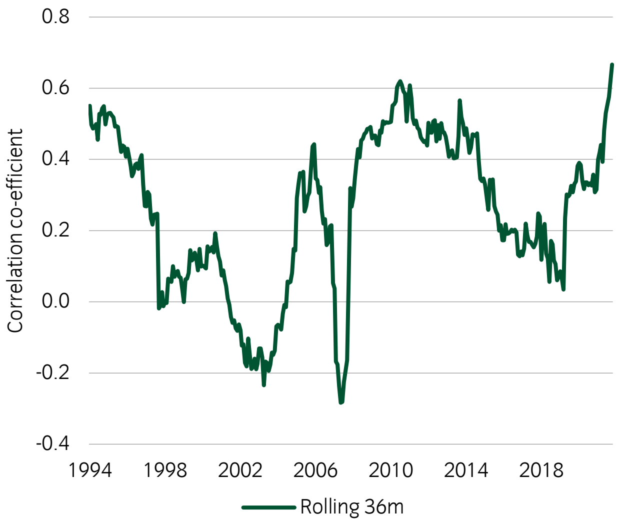
Source: Bloomberg, ICE BoA, Insight. As at 30 September 2022. ICE BoA Euro Corporate Index (ER00). Showing maximum OAS to govt spread, minimum, and interquartile range. For illustrative purposes.

- **Liability management:** With greater numbers of pension schemes now moving into the decumulation phase of their lifecycle, a cashflow driven investment (CDI) strategy is now likely to become a key component of their investment strategy. CDI involves building a platform of assets which are aligned to the cashflow profile of the liabilities. Certainty of meeting the cashflow requirements is increased by investing in assets believed to be sound and of such quality that investors can be confident of holding them to maturity – typically 'contractual' assets such as bonds which provide more certainty on the timing of cashflows. Such CDI portfolios enables investors to be largely indifferent to the subsequent fluctuations in yield and credit spread levels, allowing them to focus on ensuring the credit fundamentals of the issuer are sound in order to monitor that the assets remain 'money good' throughout. The higher levels of yield now available in markets across the spectrum of risk – be it credit risk or liquidity risk – are likely to permit schemes newly considering a CDI approach in the evolution of their strategy, to achieve greater coverage of their liability profile for a given amount invested. This feature of higher yields in fixed income is distinct from that of delivering greater amounts of income.

- **Risk management (reducing volatility of returns):** Fixed income assets can be a useful diversifier and are often considered helpful in managing risk in a broad investment plan that includes other asset classes, such as equities, if its inclusion can reduce the overall volatility of returns.

While the correlation of bond and equity returns has been positive for much of the last 30 years and has become elevated in the recent sell-off, that correlation has rarely been above 0.5, and has frequently been below 0.2, which effectively represents only a loose relationship at most. It has even negative at times, though again only loosely related – as in not below -0.2 – as Figure 6 shows. Combining lowly-correlated assets in a broader investment portfolio can help to reduce overall scheme volatility.

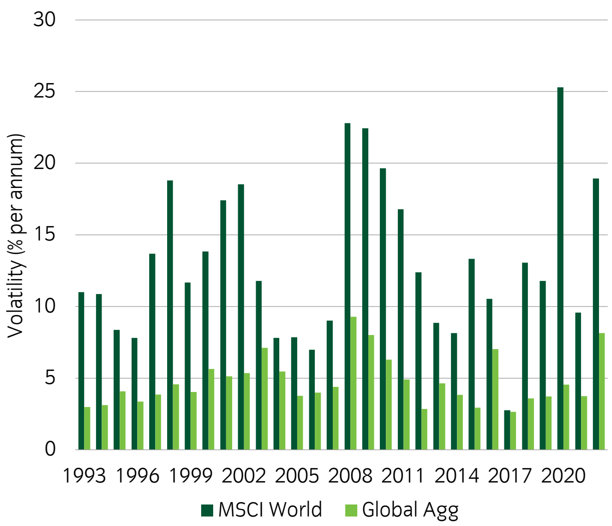
Figure 6: Correlation of monthly returns for global equities and global bonds



Source: Bloomberg, Insight. As at 30 September 2022. Rolling 36-month correlation of total returns for Bloomberg Global Aggregate Index (LEGATRUU) and MSCI World (USD) (NDDUWI).

The volatility of fixed income returns has also historically been well below that of equities as Figure 7 shows, which may then help to reduce the variability of total investment plan returns.

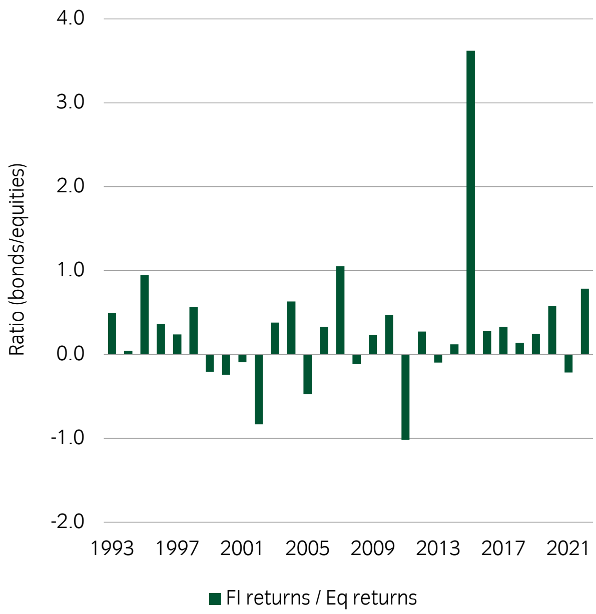
Figure 7: Fixed income returns volatility compared to equities



Source: Bloomberg, Insight. As at 30 September 2022. Annual volatility of monthly total returns for Bloomberg Global Aggregate Index (LEGATRUU) and MSCI World (USD) (NDDUWI).

Lower volatility and the potential for some capital protection benefit arising from helpful diversification can also be seen in Figure 8. Fixed income returns, both positive and negative, have generally been less extreme than those of equities – the ratio of fixed income returns to equity returns being less than 1 in most years. In some years the moves in one asset class have been in the opposite direction to the other, where the ratio of returns is negative. This can sometimes arise when investors seek the perceived 'safety' of bonds, particularly government bonds, during periods of volatility for riskier assets.

Figure 8: Fixed income beta is usually less than equity beta



Source: Bloomberg, Insight. As at 30 September 2022. Monthly total returns for Bloomberg Global Aggregate Index (LEGATRUU) and MSCI World (USD) (NDDUWI).

NEXT STEPS – REFOCUS ON BONDS

Fixed income is expected to continue providing for the benefits of diversification, risk management and liability hedging strategies in addition to returns and income. Now that yields have risen and credit spreads widened, they may be offering appealing entry points for investors who until recently may have felt constrained in certain areas of the market due to low yields and compressed spreads.

In our view, the value and return opportunities bonds may bring should be appealing. However, it will still be important to ensure that, when identifying the mix of investment strategies for a wider platform, the blend of risk and reward suits the investor, and the prospective time horizon is also likely to have an important part to play in the decision.

Overall, though inflation and monetary tightening has helped drive bond yields higher and spreads wider, we believe the medium-term future is now more promising. Investors may soon be rewarded by a market that could begin emerging like a proverbial phoenix from the flames.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and certain charges, such as currency conversion charges may depend on the individual situation of each investor and are subject to change in future.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialize or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

- Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.
- A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.
- The issuer of a debt security may not pay income or repay capital to the bondholder when due.
- Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.
- Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.
- Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.
- Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.
- The investment manager may invest in instruments which can be difficult to sell when markets are stressed.
- Exposure to international markets means exposure to changes in currency rates which could affect the value of the portfolio.
- Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

FIND OUT MORE

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