

Fixed Income Under the Spotlight

Navigating the Fixed Income Valuation Conundrum

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In brief

- Credit risks have increased but remain contained, while private credit transparency is a concern with investors now on alert
- Attractive bottom-up opportunities exist across spread markets, though a defensive, top-down and sector approach is preferred given tight valuations
- Robust liquidity is a key focus in order to take advantage of dislocations resulting from volatility

The intricate web of financial relationships, macroeconomic risks, global uncertainties, fiscal dominance and valuation challenges in fixed income highlights the complexity of today's investment landscape. In such an environment, we believe that thorough research, a strategic approach to portfolio construction, and a focus on liquidity can allow investors to navigate markets successfully.

Managing Risks and Finding Opportunities in Fixed Income Markets

Credit risks have increased but remain contained, despite the appearance of cockroaches.

Understanding credit fundamentals is increasingly critical as spread compensation for credit risk is historically low, and we see increasing fractures in segments like leveraged loans, private credit, office commercial real estate and certain consumer lending areas. This weakness is highlighted by recent defaults and bankruptcies in these sectors. Corporate refinancing at higher costs of debt will put the spotlight on those with weak balance sheets and may lead to increased defaults, reinforcing the cyclical nature of credit stress. Areas of excessive leverage are typically where problems begin, and a credit crunch usually leads to recession; we remain vigilant for signs of increased pressure from both the top-down and bottom-up perspective.

Interconnectedness and lack of transparency are challenges for private credit. In our view, the defining characteristics of private markets are their lack of transparency and lack of mark-to-market pricing. These traits leave investors with insufficient data to fully ascertain where risks lie, particularly as the rapid growth in credit lending can lead to lax underwriting standards. The private credit asset class has yet to experience a full credit cycle, so the performance of these balance sheets in a normalized rate environment remains uncertain. Looking at the transmission mechanism into the real economy, we are also concerned about the interconnectedness of investment funds with the banking system and AI companies, as it increases the potential for individual credit events to turn into a systemic issue.



Consumers are still spending, supported by government spending and monetary easing. The US economy, driven largely by consumption, has shown resilience despite fluctuations. This consumption is heavily reliant on the top income decile, which in turn depends on the continuation of the equity market performance driving the wealth effect. At the same time, fiscal dominance is emerging as a key concern, not only in the US but also globally, with the size of balance sheets in many countries and a complacent approach to fiscal discipline raising questions about inflation expectations and financial stability. In addition, China is still weighed down by the collapse of its property market, posing increased geopolitical risks, including trade wars, that add to the uncertainty.

Valuations present challenges, but there are still attractive, idiosyncratic opportunities. With tight valuations across fixed income asset classes, we are leveraging our strong research platform to find compelling, bottom-up ideas across sectors, regions, credit quality and capital structure. In this spread environment, returns are less likely to come from further top-down spread compression, so we are focused on constructing portfolios that combine carry as well as price appreciation potential. We are currently finding value in pockets of structure credit, defensive corporate exposures, idiosyncratic high yield and emerging market sovereigns.

Global Fixed Income Positioning

Our base case scenario remains consistent with a low-growth and contained-inflation macro environment that should support relatively attractive global bond returns. Given the low volatility and low dispersion in most spread markets, we believe it is important to stay nimble in our active investment approach. Importantly, our focus on portfolio liquidity remains as we look to take advantage of future market dislocations.

Corporate Credit

The tight spread environment in **investment-grade credit** reflects both resilient fundamentals and strong technicals as inflows continue in this asset class. We expect this to continue in line with our macro base case, and thus we remain slightly overweight but with a defensive bias, having also added hedges to offset the risk of sudden spread widening. In **high-yield credit**, we tactically reduced our exposure to higher-beta names in anticipation of some volatility in lower-rated credits going into year end. The bigger picture for the public high-yield market is still supportive given the improvement in quality of the index, and it could generate returns over the next 12 months if monetary and fiscal easing continues. Overall, given tight credit valuations in high yield, we expect returns may be generated via carry rather than spread compression.

Rates

While a global recession seems unlikely in the short term given policy easing, duration could perform well should economic growth slow further. As a result, we are slightly overweight duration but with lower conviction on curve steepeners than we had previously. Rate expectations for developed market sovereigns appear fairly priced in. We see more room for some emerging market sovereigns to ease, provided the US dollar does not strengthen materially. Interesting idiosyncratic rates opportunities exist in markets such as Iceland, South Korea, New Zealand and Australia.

The US represents one of our higher-conviction markets for being overweight duration given our expectation of real neutral rates closer to 1%, though we prefer exposures in bond maturities of 10 years and under. On the other hand, we don't believe the Bank of Japan's hawkish stance is sufficiently priced in by markets, leading us to remain underweight duration in that country (expressed in the front-end of the curve).



We have reduced exposure in Europe, particularly in the periphery, given historically tight spreads to Germany, though Italy remains a favored market. Our exposure in France has moved from a large underweight to a neutral duration position, given spread widening that largely reflects their political and fiscal challenges ahead. We remain overweight duration in the United Kingdom given our view that the Bank of England is behind the curve in easing.

With regards to local emerging rates markets, in Latin America we favor countries like Uruguay, Peru, and Brazil that offer high real yields and benefit from favorable electoral cycles. We also prefer other exposures such as South Africa given our expectations of improving central bank credibility and reduced fiscal risk. We expect the Bank of China to remain dovish, but with a flat curve and low yields, we maintain our underweight duration position in China.

Conclusion

Navigating the valuation conundrum in fixed income requires vigilant monitoring of credit risks, leveraging strong research capabilities, and being prepared to take advantage of market dislocations. Current tight valuations and the uncertain global outlook call for a strategic and selective approach to portfolio construction, utilizing the expertise of credit analysts and sovereign strategists to identify bottom-up opportunities. Even in this environment, we believe a well-constructed portfolio has the potential to continue to deliver attractive returns from the global fixed income universe. ▲



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