Fixed Income 2022:
Opportunity Amid Uncertainty

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With inflation at a 40-year high at the start of the year, persistent low yields in core bonds and the uncertainty from the war on Ukraine that's resulted in ongoing market volatility, fixed-income investors face a complex set of variables as they try to stay on course to meet their portfolio objectives. How should investors cut through the noise and discern the key market indicators? What are the fixed-income sectors and markets that present opportunity for diversification and yield?

To get the latest insights, *Pensions & Investments* spoke with Janet Rilling, senior portfolio manager and head of plus fixed income at Allspring Global Investments; Christopher Chapman, senior portfolio manager and co-head of global multi-sector fixed income at Manulife Investment Management; and Steven Oh, global head of credit and fixed income at PineBridge Investments.

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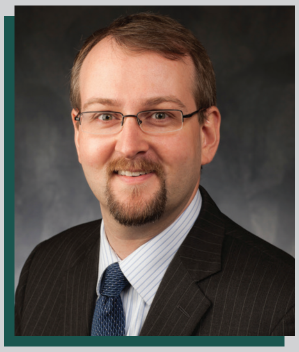

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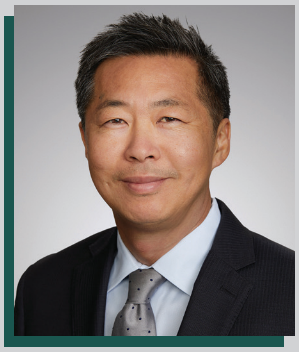

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Pensions & Investments: As we enter a new interest rate cycle, what are your predictions on rate hikes by the Federal Reserve? What key macroeconomic indicators are you watching?

JANET RILLING: After the 25-basis point increase in March, in a perfect world, we would probably see [the Fed raise rates by] 25 basis points at each of the following meetings throughout the year and take the opportunity to pause if the data makes a case to do so. But they also have the opportunity [in their back pocket] to go faster, and Fed Chair [Jerome] Powell has more recently confirmed that a 50-basis point hike is an option. With recent economic developments, we think this likelihood has gone up significantly and will be driven by persistent inflation.

In terms of economic indicators, we're looking at various measures of inflation, where it's coming into the system and how widespread it is. That's the key metric. The second important economic indicator is growth. [Gross domestic product] growth was strong in the fourth quarter, but the expectation is [we'll see that] it slowed in the first quarter due to Omicron. The worst-case scenario would be if growth comes under pressure while inflation is a concern. That would leave the Fed in a more difficult position.

CHRISTOPHER CHAPMAN: Obviously, as events unfold in Russia and Ukraine, that's tempering [the outlook] a bit. That said, the elevated levels of inflation that we've seen early this year are likely to decelerate, regardless of Fed activity. While we'll see some normalization from the Fed, it's likely to be in the first half of the year, and then it will be more of a wait-and-see approach, as opposed to [current market] expectations.

[In terms of key indicators], we're looking at supply-chain pressures and shipping costs. They look like they peaked last summer and are starting to roll over. There's also been good inventory rebuild, so that's easing some of the stress [in supply chains].

STEVEN OH: From our point of view, while the timing of the rate hikes and combating short-term inflation has materially changed the direction and the pace of tightening, an ultimately neutral outcome has not changed materially. Unlike in the past, where the Fed has effectively maintained a policy approach to interest rate hikes, this time the Fed will continue to maintain negative real policy rates for the longer term.

Assuming inflation starts to trend [flatter] in 2023 and beyond, we believe closer to the Fed's long-term average inflation goal in the 2% to low-2% range overall, the Fed will ultimately attain and settle on a neutral rate that is more accommodative in nature, which is going to be below 2%. While the Fed will be withdrawing excess stimulus as it tightens, it will still maintain an accommodative bias longer-term.

In the near term, aside from inflation data, we're watching evidence of wage pressures that can create a potential inflationary spiral. Of course, we're watching how the Ukraine situation changes [the outlook]. Barring a catastrophic scenario, it likely will not change it very much. The Fed may end up hiking less in the second half of this year and push into 2023. Of course, that hinges on a complex situation ending in a non-worst-case scenario.

P&I: How should institutional investors manage their interest rate-risk exposure going forward?

CHAPMAN: It's about flexibility. You want to have flexibility from an opportunity-set perspective, from a geographic perspective, from a credit-quality perspective and a duration-management perspective. That provides a lot of tools to be defensive against rising interest rate risk.

> We're using a tactical mindset when thinking about the rate picture and duration management this year. [And] if you can add [some] diversified exposure to other income-producing securities in the portfolio, that can be a good technique to help blunt the impact of rising rates.
>
> — JANET RILLING, ALLSPRING GLOBAL INVESTMENTS

From a geographic perspective, it's a little less clear this time around as, globally, central banks are mostly coming from a similar starting point as we come out of the pandemic. So you might see some opportunities as certain jurisdictions move faster than others, or perhaps as they're not able to be as aggressive in terms of normalization.

Historically, some asset classes have performed better than others in a rising-rate environment, depending on the reasons for the rise. That includes the high-yield sector, [which] continues to perform well, so you want to have the flexibility to look at an array of opportunities.

While we don't use a lot of derivatives in our products, you might want some ability to use bond futures as an overlay to protect against interest rate risk. Overall, it's about having that flexibility to broaden into the areas of the fixed-income world where you can pursue opportunities.

OH: We're in an environment where we believe that interest rates have more volatility risk. We're looking at a few key pillars that have become very meaningful on a continuation basis. We believe that traditional fixed income, over the next five-plus years, will not be able to adequately meet the core objectives of serving as a safety ballast or generating real income.

We see many market participants shifting the safety component of their portfolio into more cash substitutes and [moving] shorter-maturity government bonds and into cash-plus substitute asset classes. As for the income component, we believe investors should start to consider taking on additional targeted risk exposure to generate their desired yield. They may want to look at the parts of the risk universe where they can potentially get excess returns, such as illiquidity premiums, complexity premiums and/or geographic premiums. They are going to have to navigate those in a more targeted fashion, as well as be able to shift their portfolio in market conditions that are more dynamic than they were pre-financial crisis.

RILLING: At this point, everyone recognizes that inflation is elevated and that it's persistent, not transitory.

Photo credit: iStock

It's on everyone's mind. So a large amount [of inflation risk] has already been priced in, and the opportunity to take a different view on the market is no longer as compelling as it was last year.

Rather than taking a strategic position, we're thinking more tactically about the current environment. We went to short duration last year, but we took the opportunity earlier this year to move it back to neutral, and then we took on another short-duration position. Then, as the 10-year [Treasury] note moved closer to 2%, we've been able to neutralize it again. We're using a tactical mindset when thinking about the rate picture and duration management this year.

We are also looking at ways to get more incremental yield [to] help offset some of the price declines that occurred due to the rate move. So if you can add that diversified exposure to other income-producing securities in the portfolio, that can be a good technique to help blunt the impact of rising rates.

P&I: Given the shift in the rate cycle, is it a more compelling time for active management in fixed income?

OH: Yes. We were recently in an environment where we basically had a beta market rally following COVID, and there was minimal dispersion generally. We've been in a market where beta has been more prevalent, as central banks have been a bigger part of influencing financial markets overall. Under that scenario, active management is more challenging.

While central banks will continue to have a material influence on markets, as they withdraw some of that influence and accommodation overall, we expect markets to return to exhibiting a higher degree of dispersion and beta returns are going to be anemic.

So, with that combination, we believe active management becomes more critical as a wider dispersion across asset classes, industries, and credits starts to emerge with the withdrawal of excess stimulus from the market — it becomes more impactful to leverage active management.

RILLING: This [market] volatility really shows you how an active investor can add to total returns. Passive investors are just buying the market, which has been growing in duration terms while yields have been falling. So you're basically getting paid less for more duration risk. But if you're active, you can make decisions based on valuations.

Another important attribute of active management is security selection. If you have good research, [it] can help you pick the individual credits that are outperforming. That's an advantage in any market environment.

CHAPMAN: One of the dynamics in fixed income that's been at play for a long time is the asymmetry between the interest rate risk in global bond benchmarks relative to the yield. It doesn't take much of a rise in interest rates to be destructive in value from a strictly benchmark perspective. So, yes, the environment is absolutely a moment for active management in fixed income. A rising interest rate environment is going to be challenging, and a passive approach doesn't leave you much opportunity to avoid the harmful impacts of those interest rate rises. When you take an active approach, you have the ability to pull more levers.

P&I: Are you seeing a shift in approach for fixed income in a multi-asset portfolio as investors move further out on the risk spectrum?

CHAPMAN: We see [investors] move into areas like private credit, where you're essentially driving extra yield in exchange for taking on some liquidity risk. But there's also still a place for more traditional fixed income. You want to have stability within the portfolio, as we're seeing periods of [market] volatility. Moving into illiquid sub-sectors might provide the yield you're looking for, but you're not necessarily going to get the other attributes.

OH: Generally speaking, we anticipate that market participants are going to have to take more risk within their portfolio, whether that risk is in the form of reducing their overall fixed-income allocation or modifying what they're buying within their fixed-income allocation. Outside of traditional fixed income, we're seeing increasing demand for alternative strategies, [the more] illiquid strategies that historically have higher-return potential, with elements of higher risk as well.

Central bank policy has pushed many to take more risks, and then the concern longer term becomes whether those risks create the seeds for a potential future crisis. How do you balance that need to take more risk in

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order to meet the [investment] objective with the concern that valuations may be elevated? That means many need to consider a more dynamic and more targeted approach within their multi-asset portfolios.

P&I: For 2022 and beyond, could you share a couple of compelling credit opportunities by sector or industry?

RILLING: In the communications space, we favor the cable sector. Cable companies offer a very good value proposition on broadband services and will remain the market leader in that area for the foreseeable future. We also like telecom within communications, as we've seen the competitive space become more disciplined and the valuations look good to us. Within telecom, we also like the cell tower sector, as it's a stable cash flow business.

Within energy, we have seen very elevated oil prices, so we favor the oil field service part of the market. We expect improved volumes from the industry that lead to better cash flows from [capital expenditure] budgets that move up. The independent oil and gas companies have become much more disciplined about overspending. Nonetheless, given this high oil price environment, we do expect capex to trend upward.

Finally, in the financial space, we favor sectors like broker-dealers and asset managers. We find the valuations look attractive compared to the nonfinancial space. Life insurance is also a favored sector.

CHAPMAN: We're looking at the reopening trade [from the ongoing COVID recovery], and we believe we're in the later stages of that. There's still some opportunity in companies, such as airlines and hotels, that will be the beneficiaries of a return to normalcy in a post-pandemic world. Of course, we have to watch airlines, given the oil price volatility, but we are currently still comfortable with our exposure there. In addition, we have a held a constructive view on energy more broadly, both through individual corporates and exporting nations.

We're also looking at telecom and media. Our focus is on areas like cell tower [infrastructure], where there's some stability. We're not focused on the high-growth tech companies, per se. There are also some utilities in the convertible preferred space that have been interesting.

OH: In terms of sectors, there is still some opportunity within elements [that benefit from] the COVID recovery. Aspects of travel and leisure and consumer cyclicals are still trading at a discount that we think will ultimately dissipate over time.

P&I: As investors search for yield across the very diverse fixed-income landscape, where do you see opportunity?

OH: There are some broad-based opportunities, though the opportunities are constantly changing. At least for the near-term, assuming the Ukraine situation does not become a worst-case scenario, corporate fundamentals have generally been in fairly robust shape overall. While the level of improvement is declining, having a Fed that's willing to step in in periods of crisis creates conditions that are supportive of corporate credit-risk exposure.

We've also seen enormous growth in private credit and direct-lending strategies to try to capture the illiquidity premium. While there is value in that area, it's not where the bulk of capital has gone. Private capital has been targeted toward the low end of the broadly syndicated marketplace. But we see the opportunity set within private credit squarely [at] the lower end of the middle-market area, the traditional smaller companies, where you can still capture the inefficiencies of the small-company premium in relation to the illiquidity premium overall, because capital has migrated further away from it.

CHAPMAN: We've been shifting some traditional high-yield bonds into the loan space to get the floating-rate component. That's a stable way to get some protection

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against rising yield risks. You're still taking on credit risk, as a majority of these companies are below investment grade, but you're a little bit better in the capital structure. As long as you're careful about the security-selection component — so it's not just the asset allocation decision, but [also] the selection of individual loans. That's an area where we see opportunity that's shifted over the past few months.

RILLING: Investors looking to buffer their cash might look at a short-duration bond fund, specifically ultra-short-term funds. The value there is that they can make broader allocations across a range of fixed-income sectors, such as short corporates or structured products.

In the intermediate-duration space, you want to think about broad market exposure, so a core-plus strategy could be a good option. That includes below investment-grade securities, but the entire portfolio has an investment grade profile. A good core-plus strategy managed by a skilled active manager could also tactically move into high yield, global credit and emerging markets when valuations are attractive.

Finally, there are some interesting opportunities in the long-duration space. Pension plans that might be getting close to fully funded status already have a lot of credit in their portfolio. We recommend they consider allocating to the smaller-issuer part of the market, rather than buying more of the big names that they already own. The smaller-issuer part of the universe, which doesn't include the top 10% of the market value, has similar high-level characteristics in terms of the yield, duration and quality profile, but it's made up of different constituents. So, layering on that additional allocation can broaden out the diversification for a pension plan allocation in long credit.

P&I: What about opportunities across global or emerging markets fixed income?

CHAPMAN: In the higher-quality space, global fixed income looks more interesting than it has been in quite a while, given how much yields have already risen in some places around the world relative to the actual interest rate cycle. New Zealand, for example, offers high-quality fixed income with a fairly hawkish central bank, but with a good risk-reward profile. We see yield levels, relative to what they've been, starting to look a little more attractive.

We're also active in currency management. Over the course of this year, we would not be surprised to see further weakness in the U.S. dollar as we come out of the start of the Fed's rate-hike cycle. That's historically been the case. In addition to structural factors, the dollar tends to strengthen up until the first hike, and then you start to see some weakness. So the yields in some [global fixed-income] investments could be low, but you get an additional contribution from the currency piece versus the base currency U.S dollar, and we're taking that into the equation.

Finally, we've seen some dislocations in emerging market credit that present some opportunities. There are some good companies that get hurt more than they should because they're in an EM zip code.

OH: We believe that areas that have been historically underinvested or areas that have undergone more volatility currently have excess return potential. That includes parts of the emerging markets, specifically corporate emerging markets. One area of problems and rising defaults has been Asia credit and the Chinese property sector. Typically, when there's that level of trauma, the good businesses are thrown out with the bad. We see select opportunities within Asia corporates, in general, and China, in particular.

Overall, emerging markets have historically been under-invested, and we're reminded periodically that there are one-off blowups and real risks there. But on a targeted basis, there are also opportunities, particularly if they trade off in sync with other areas that are safer and not as impacted. Currently, we like select areas of Latin America within emerging markets overall, where we see a path toward improvement and yields adequately compensate for those risks overall.

P&I: Is environmental, social and governance integration in fixed income catching up to the widespread adoption of ESG factors in equity?

RILLING: The primary challenge is data. There are efforts underway to improve standardization and transparency. But we are still in the early stage, so it can be a more difficult exercise for a [fixed income] investor trying to evaluate ESG data and factors. It's not like you can pull metrics that are consistent across companies, because some might report them differently or not at all. While we are seeing some progress, this is still one of the bigger limitations in this part of the market. There is also still a degree of greenwashing going on, and [investors] need to take a critical eye to that.

OH: Asset owners are requiring a more robust ESG incorporation into their investment portfolio, and one of the key challenges is that there is not necessarily the same standard or agreement on how that should be done. The challenge is twofold in fixed income relative to equities. One is that equity has a built-in mechanism, via proxy voting, to have influence in the ESG arena, while it is more challenging for fixed income investors to [influence on ESG issues]. Second, there's simply a lack of data in many parts of fixed income, particularly in leveraged finance for private companies. But we have always integrated ESG evaluation and elements into our fixed income investment process; what's changed in recent years is the formalization of that evaluation.

CHAPMAN: It's accelerating fairly quickly, and it has been for the last couple years. We're signatories to the United Nations' Principles for Responsible Investment, and our management has taken an approach that all investment teams will integrate ESG considerations into their existing approach, philosophy and process. We've had an internal framework for a couple of years.

In terms of challenges, we are still in the early days for ESG in the fixed-income space. There's a wide breadth [of ESG-related] areas from the perspective of issuers. In the beginning, ESG ported over from equities to corporate debt, but now we're looking at areas like sovereign analysis. We've built our own in-house proprietary model to take ESG considerations into account for sovereigns, both developed markets and emerging markets. ■

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