Global Matters Weekly

31 July 2023

Taking the fixed income tack in multi-asset portfolios

by Gregoire Sharma

The last two years have seen their fair share of volatile events, including, amongst others, an ongoing and tragic geopolitical travesty in Russia's invasion of Ukraine, the fastest central bank policy rate increase in recent memory, China's protracted zero-COVID-19 policy, a banking crisis which led to the subsequent tightening of lending standards, and to top it all off a tense debt-ceiling drama. For many investors, who were left scarred by last year's worst annual total return in the bond market's history, it still feels too early to add back to fixed income assets.

Yet as these bouts of volatility ebbed away, the discussion has turned once again to the debate of a hard landing versus a soft landing, with the latter seemingly getting the upper hand as demonstrated by the latest inflation numbers. Indeed, focusing on the US, Goldman Sachs now predicts only a 20% chance of a recession over the coming year. Consumer sentiment has reached a near two-year high, unemployment has barely ticked up, and economic activity has remained resilient despite the 500 basis points of Federal Reserve Funds target rate rises over the past 18 months.

Whilst inflation has been slow to come down from this cycle's historic highs, we may very well be seeing a turning point in recent data releases. However, this is still from a very high base and inflation is expected to fall back to levels higher than the pre-COVID-19 pandemic era. This has consequences as central banks look to tackle high inflation with higher policy rates and are keen to do so having been proven wrong during COVID-19 when they stubbornly pushed the "transitory" rhetoric. In theory this should lead to diminished economic activity and slower growth, in turn crimping the credit cycle. So, why hasn't this been the case yet and should we be adding to risk assets rather than positioning portfolios more defensively?

Firstly, throughout the COVID-19 pandemic, a lot of weaker issuers had been weeded out and those that remained in the weaker cohort, were able (for the most part) to term out their debt, meaning the dreaded 'maturity wall' has not been a concern. In addition, corporate fundamentals have improved drastically since the global financial crisis with leverage ratios close to historical lows and interest coverage ratios close to historical highs. Whilst it's true that we are seeing defaults pick up, they remain some way below the more conservative levels forecast by economic analysts and even the harbingers of doom have been revising their default forecasts down.

Secondly, as the lagged effects of such a rapid and significant policy tightening begin to take hold, inflation will naturally start to fall, and central bankers will need to react by pausing rate hikes. Whilst it's true there are still a few more rate hikes ahead of us, we are certainly closer to peak rates now than we were eighteen months ago. In addition, it is not yet clear how fast and to what degree central banks' rate rises will pass through to the real economy, but as activity declines, so too will inflation and ultimately interest rates. Furthermore, as earnings releases start disappointing, we can expect investors to flock to safe-haven government bonds. In essence, bond investors can look forward to a significant capital gains boost from the lower interest rates that could follow the anticipated fall in inflation. Whilst we wait for this scenario to play out, it's hard to argue against locking-in the attractive yield levels we are seeing currently, certainly via short-dated government bonds and to a certain degree corporate credit, but increasingly to longer-dated bonds to benefit from the capital gains element.

This brings me to my final point. Whilst we do expect the credit cycle to turn negative, corporate credit year-to-date has delivered positive total returns, mainly thanks to the high level of income generated. Higher quality investment grade credit has suffered due to its inherent higher interest rate sensitivity compared to lower quality credit, but whilst yields are elevated, spreads don't seem to be compensating for the risks of an economic slowdown. It is worth noting, however, that corporate credit yields are now above their equity counterparts' dividend yields. Hence, the case can be made for a risk-managed high yield credit allocation from equities, given the former's historically lower drawdowns and higher recovery speeds coming out of a recession.

In conclusion, whilst we patiently decipher the latest data releases, there is a strong case for allocating to fixed income in multi-asset portfolios, locking in high levels of income whilst positioning for the potentially significant capital gains element. It would certainly be a shame to miss that boat!

Global Matters Weekly

31 July 2023

For more information, please contact your adviser or alternatively contact:

Belvest Investment Services Limited
研富投資服務有限公司
9th Floor, Centre Mark II
305-313 Queen's Road Central
Sheung Wan, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
belvest@bis.hk
www.bis.hk

Important notes

This communication is issued by Belvest Investment Services Limited and/or Belvest related companies (collectively, and individually Belvest) solely to its clients, qualified prospective clients or institutional and professional investors. Unless stated otherwise, any opinions or views expressed in this communication do not represent those of Belvest. Opinions or views of any Belvest company expressed in this communication may differ from those of other departments or companies within Belvest, including any opinions or views expressed in any research issued by Belvest. Belvest may deal as Distributor or Agent, or have interests, in any financial product referred to in this email. Belvest has policies designed to negate conflicts of interest. Unless otherwise stated, this e-mail is solely for information purposes.

This message may contain confidential information. Any use, dissemination, distribution or reproduction of this information outside the original recipients of this message is strictly prohibited. If you receive this message by mistake, please notify the sender by reply email immediately.

Unless specifically stated, neither the information nor any opinion contained herein constitutes as an advertisement, an invitation, a solicitation, a recommendation or advise to buy or sell any products, services, securities, futures, options, other financial instruments or provide any investment advice or service by Belvest.

No representation or warranty is given as to the accuracy, likelihood of achievement or reasonableness of any figures, forecasts, prospects or return (if any) contained in the message. Such figures, forecasts, prospects or returns are by their nature subject to significant uncertainties and contingencies. The assumptions and parameters used by Belvest are not the only ones that might reasonably have been selected and therefor Belvest does not guarantee the sequence, accuracy, completeness or timeliness of the information provided herein. None of Belvest, its group members or any of their employees or directors shall be held liable, in any way, for any claims, mistakes, errors or otherwise arising out of or in connection with the content of this e-mail.

This e-mail and any accompanying attachments are not encrypted and cannot be guaranteed to be secure, complete or error-free as electronic communications may be intercepted, corrupted, lost, destroyed, delayed or incomplete, and/or may contain viruses. Belvest therefore does not accept any liability for any interception, corruption, loss, destruction, incompleteness, viruses, errors, omissions or delays in relation to this electronic communication. If verification is required please request a hard-copy version. Electronic communication carried within the Belvest system may be monitored.

Belvest 研富