Bonds and Beyond in Today's Fixed Income Markets

Disruptive Forces in Investing

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Anu Rajakumar: Following a historically negative year in 2022 for fixed-income markets, combined with the highest yields in over a decade and support from strong credit fundamentals, many had high hopes for a strong fixed-income rebound in 2023. But as we shift into the latter part of the year, have those expectations been met? And as investors reassess their strategic asset allocation in this new investment regime, how should they position their fixed income portfolio, and what challenges lie ahead?

My name is Anu Rajakumar, and to answer those questions and more, I'm delighted to be joined by Jaina Varsani, Portfolio Specialist for Fixed Income based in London, and Toby Bracey, Client Portfolio Manager for Fixed Income based in Singapore. Jaina, Toby, it's a pleasure to have you both here on the show.

Jaina Varsani: Thanks for having us, Anu.

Toby Bracey: Thanks, Anu.

Anu: So let's start off with a very basic, and admittedly, a rather open-ended question. Jaina, why fixed income?

Jaina: Well, I'm happy to be starting with an easy question. [laughter]

So I guess the alternative question is why not fixed income? For many investors, fixed income has been one of the core allocations, particularly where they have had liabilities to meet, or where they don't want to take the risk of other investible and more riskier parts of the markets. In today's market environment, we're in a new norm where you have seen central banks move away from historically low-interest rates and the large quantitative easing packages we saw during periods such as COVID and the global financial crisis. Because of this, and due to other reasons, we've now seen fixed income yields reset much higher, and fixed income now looks very attractive.

From an investment perspective, what clients had to do within the fixed income markets was either go longer duration or reduce the quality of their portfolios to get yields. Given the changes we've had in the market environment, that's no longer the case. In particular, from a yield curve perspective, we're now starting to see flatter curves, so they don't need to extend duration and can actually still stay within the shorter duration parts of the market and still get 5 to 6% yields in investment-grade bonds.

Toby: Yeah, that's absolutely right. And I think maybe just to kind of add to that, I mean we've seen yields obviously reset higher, across the board, you know, from investment grade to high yield to EM, kind of wherever you look. I guess from an entry point perspective, fixed income's looking very attractive. I think one thing that I would maybe just kind of highlight here is that one interesting topic of conversation, I guess it's almost more of a pushback that we're getting, to this point, is that, why shouldn't I just be in cash, right?

So cash yields or cash rates are very high. They're at levels, you know, not seen pretty much since the early 2000s or so, or pre-GFC. And why should we kind of roll out into fixed income, or even any other kind of asset class? And I think our take on this is that one way of sort of looking at this from a forward-looking basis is to, you know, think about basically what happens next. And one way of trying to figure that out is to look when the yield curve was this inverted. Right? So we're obviously currently in an environment of a very inverted yield curve that I think, since the 1980s, has been the case, I think four times.

And when we looked at the average length of time that yield curves have stayed inverted is about six months. And what I think what's interesting is that obviously every cycle's different. And the current cycle's different from previous ones, of course. But either way, we're kind of in overtime already since the curve started inverting last year and around November time.

And I think the key point here for investors is that there's kind of a window of opportunity here now. Yes, cash rates are high, but for fixed income, there's really a really nice entry point for yields because historically what happens next is that obviously, when we go into the next cycle when the curves start normalizing, right? So typically that's a kind of steepening episode,

where your kind of front-end yields fall. That means fixed income offers just a much better opportunity for essentially yield maintenance. Because your cash return goes down very quickly, at or after this kind of peak rate environment that we're currently in.

Anu: Thanks for that. You know, so it looks like it's a, as you said, it's a good time for fixed income, a good entry point. And Toby, to your key points, just sitting in cash may work for now, but investors, it sounds like they should be ready to pivot if we do see rate cuts. So, on that note, and to your question, Toby, you know, what happens next? Let's go a bit deeper onto that topic, what is the fate of rates?

Toby: Yeah, thanks. That's obviously, [chuckles] that's obviously the sort of a key question. that underpins, you know, not just fixed income, but every kind of major asset class really. I think when we look at central banks, as we all know, since last year, we've come from pretty much zero, for the major central banks in terms of rates. The Fed, ECB, or even negative to positive. In the case of the Fed, we're at 5.5% now at the upper bound of the Fed funds rate. That's the highest level since the early 2000s, and that's in the span of one and a half years.

So, as a consequence, you know, rates now are the highest really since the last sort of 20 years. But at some point, that's also going to change, right? So the debate, of course, in markets now, is that we've kind of come out of almost the debate of, you know, how many more hikes are we going to get? I think markets broadly agree, I would say, that we are at, or at least near, the peak of the hiking cycle in the US at least. But also at some point, that has to change. And, you know, in our assessment, that's probably less likely this year. It's more a topic for next year sometime. For other markets, like for example, in the UK, inflation is higher, it's stickier. They may have a couple of more hikes left there. But in general, we'll see lower rates eventually. But in our view and assessment, that's unlikely going to be before sometime next year.

Now, that's good for fixed income investors. And that's pretty much the opposite, I guess, of what's been the case for much of the post-global financial crisis period. So that makes fixed income attractive from a kind of absolute perspective. And we think we'll come back to that probably a little bit later, in terms of outlook. But that's what's keeping yields at these kind of nice levels, at least in the short to medium term.

Jaina: So Toby, I think you just mentioned fixed income looks attractive from an absolute perspective, but I guess it's also worth considering fixed income from a relative basis as well. So, really, relative to other asset classes, given the yields that are available. As an example, many areas of fixed income market are offering more income at levels higher than other income paying asset classes, but with less risk. So this continues to make fixed income, once again, increasingly attractive, particularly for those investors which are income seeking.

Anu: Excellent. You both have answered that question about the fate of rates, that's a very helpful response. I mentioned the opening that credit fundamentals have also been quite solid. Could you share your thoughts on the fate of credit as well?

Jaina: Thanks, Anu. So credit really is one of the key things that we're looking at this year, and particularly idiosyncratic risks at an issuer level. So, from our perspective, we think the outlook for credit isn't as bad as investors may be thinking. From our bottom-up expectations for defaults, they're actually reasonably muted. So, for the US, we expect 3.25% to 3.75% in terms of defaults. And that's for this year and also for 2024. For Europe, we expect 2% to 3% for this year, and only slightly higher at 2.5% to 3.5% for 2024. Now, this is under our base case scenario of what we're seeing at the moment of this sort of sluggish type growth but not a recessionary environment.

What's important to note is these assessments, so our assessments on defaults, are really based on bottom-up analysis at an issuer level. So we're looking at the balance sheets of these individual companies and looking at essentially, their performance within stress scenarios. However, when you compare this with some of the market, we're seeing some of the market coming out with default projections which are significantly higher for the high-yield markets. However, much of these projections are actually based on the top-down. And when we say the top-down, they're really imputed from macroeconomic assumptions, and hence they're very sensitive to the data inputs that are being used. However, we think these much higher double-digit types of defaults are very unlikely to materialize.

Anu: Jaina, just one quick follow-up question to that. You know, you mentioned the numbers, you know, Neuberger Berman's expectations for defaults are fairly muted. How does that compare with historical default rates? Is that at the lower range of what we've historically seen, or average? What would you say about that?

Jaina: No, great question. So these default rates are more in line with averages, probably slightly elevated for 2024, but definitely closer to the averages and not near the peaks. I think some of the estimates we've seen in the markets are close to the peaks we saw in the global financial crisis. That is definitely not our base case scenario.

Toby: And, yeah, if I can just jump in, just one quick comment on that as well is, I think from a ratings trend perspective, when we look at high yields, you know, we do think there's going to be more upgrades than downgrades here. And I think one of the reasons for that is really since COVID, sort of 2020, we saw a lot of fallen angels then. So going forward as a consequence, the market's cleaned up, and we just see more potential for upgrades rather than downgrades and defaults over the short to medium term.

And, you know, one of the reasons for that, that kind of goes into the default rate analysis as well that we do is that, you know, the maturity wall in terms of the refinancing burden for high yield, is fairly low, is basically manageable in the short term. Just to elaborate on that for the wider, high-yield market, including EM. So when we look at EM on the corporate side, I think there's obviously been very idiosyncratic pockets of volatility that we've seen. Now, the obvious ones, as we know, it's Russia, Ukraine, it's China high-yield, mainly in the property sector.

If you strip those out, and, look at the remainder of the EM high-yield corporate universe, we're sort of looking at a 3.5% also default estimate for this year, which is pretty much in line with its sort of prior average over the last 10 years or so. If you count China high yield property back into that, it takes it up to just above 6%, I think 6.3% for this year.

Anu: Yep, so like you said a 3.5% expected default rate for EM corporates, which you said, I believe, is 10-year average or so, but when you include China high yield property, that number almost doubles to 6.3%. So let's talk a little bit more about China. What are some of your broader expectations for the country, particularly given some of the weaker economic data that's been coming through recently?

Toby: Yeah, thanks, Anu. Yeah, on that topic there's obviously a lot to unpack, right, on China, and sort of China macro. I'd say the big picture that we've had since the start of the year is we've had a more muted expectation of GDP growth for 2023 relative to what we've seen in the market, right? So at the start of the year, a lot of people in the market were essentially talking about very lofty expectations for China GDP growth this year based on reopening and optimism, and so forth.

In our view, we've been closer or pretty much the same as the official target, which is about 5%. Now, since then, as I'm sure you know, we've all read in the news recently, the pace of economic activity has really been weak, and it's been weaker than expected. And one of the key reasons at least has been the property sector, in terms of drag. That's going to have other ramifications too. So, for example, it could probably lead to lower commodity demand mainly in things like steel, iron ore, and so forth.

And when we look beyond the borders, you know, domestically, in China, just from a global perspective, another key sort of takeaway is that we're seeing exports, lower exports, to China. And that's impacting places in Asia, of course and is also impacting Europe to a fairly significant extent, especially the more export-oriented kind of economies there. For example, Germany is one. So putting all of that together, we've now seen many people in the market revising down some of these very lofty GDP expectations that we've seen at the start of the year, because of muted economic performance since then.

We've also actually taken down our forecast for the year below 5% now, and below 4% for next year. And that's really based on the fact that data that's come through has just turned out to be softer than even now below consensus expectations initially. So yeah, we see potential I guess for further downside there.

Jaina: And I guess I would just add a little bit more in terms of China property, because I think that's really been in the headlines for most investors. So China property has clearly been the weakest spot within the Chinese market. What we did see over the most recent weekend was that the government actually came out with various accommodating measures, such as easing rates on new mortgages. So these easing measures were more than actually what we had expected and were definitely a step in the right direction.

In addition, you've probably all heard about Country Garden, which missed their coupon payments. So they had a 30-day grace period in which they had to then make that coupon payment. They actually came out today and made that payment, which actually surprised the market. And that's temporarily stabilized the China property market. The sentiment, in general, still remains quite weak.

Anu: Great. Thank you very much for those thoughts, Jaina. Maybe shifting in a little bit of a different direction, tell us some of the innovations that you're seeing in fixed income that you think are rather compelling, either from competitors or just the broader market or what investors are seeking.

Toby: Sure, yeah, maybe I can kick that one off. I-I think broadly speaking, we see opportunities in places where yields used to be just much lower or spreads much tighter. So, you know, we're seeing obviously investors looking for a-attractive yields now. As we've discussed before, a lot of it is focused on, I guess, the more shorter duration part of the curve. People kind of heavily invested in cash, in many parts and across regions. But from a kind of opportunity set perspective, in terms of global fixed income, one area that sort of stands out to us is actually on the securitized side.

So, for example, in the US, you know, we have agency mortgages. That sector that's turned out to be a very attractive destination for capital in our assessment. So yields are very attractive. And there's- there's a lot of kind of things going on in that space that make this sector very attractive, that's largely due to rates going up last year. And then obviously prices have to adjust lower.

So there's an interesting kind of convexity dynamic at play there. And you know, now some of the more current production coupon issuance that's coming out is coming at really nice coupon and yield levels, right in the sort of mid-single digit space, which, you know, for an asset class that's essentially rated in line with the US sovereign, we think is very, very attractive.

On the non-agency side, there's obviously quite a lot going on and there's been a topic in the news as well over the last few months, particularly in things like CMBS. So, from an entry point perspective, for example in the conduit mezzanine space, there's a lot of value there. Spreads are pretty wide because of some of the uncertainties lingering there. Broad uncertainties in terms of, you know, potential macro slowdown as well as more specific uncertainties around office real estate but spreads are pretty wide. So it offers pretty nice opportunities from a security picking perspective in that space that especially when valuations are well wide of what they used to be. If you compare that to IG and high-yield credit, for example.

Jaina: I would just add from a EMEA specific perspective, I've had to dust off my old books on Danish mortgages. So Danish mortgages function very similarly to US agency bonds. And that's been an area that clients have been inquiring about in EMEA. So that's been something that's been sort of new, and I guess not innovative, but that's now looking yield-y and attractive that investors want to know about.

Another area is corporate hybrids. So, corporate hybrids, I would probably say are more well-known, within EMEA and Asia. So they're essentially subordinated bonds of investment grade issuers, but with stable and strong cashflow profiles. They're also very short-dated, as they're likely to be called at the first call date. And this is really driven by the favorable equity content they receive by the rating agencies. And that's S&P in particular. So, these assets in particular, both Danish mortgages and corporate hybrids, require very specific expertise in analyzing the issuers and the actual bond structures themselves. So this is why not all managers offer these capabilities. And because of that uniqueness, we're often getting a lot of inquiries on these bases.

I guess the other innovation angle that I wanted to mention was ESG. Particularly in EMEA, this is something which is really front and center. And you can't really get past any conversation without having some element of ESG embedded in that conversation. So what we're seeing is we're seeing increasing amount of clients wanting to integrate ESG and actually climate factors into their portfolios. And we have implemented this in actually quite various forms. As an example, on our high-yield platform, we have a number of pooled vehicles which focus on areas such as SDG-aligned engagements in which we've actually created a proprietary engagement potential indicator. Now what this does is this indicator assesses, it monitors, and it allows us to track the engagements we're having with issuers, alongside the SDG targets. We also have high yield capabilities with net zero goals in addition to ESG integration and exclusions.

But I would add to that, in the multi-sector credit space—now, this has been a trend we've seen particularly within the UK market—we've seen a number of multi-sector credit net zero portfolios, and these really utilize our proprietary net zero alignment indicator. Now, this indicator is an indicator we've created to help capture a company's progress towards net zero goals. And I'm going to make a really shameless plug here to say that our indicator was actually written about in a paper by a professor at Harvard Business School who really liked our idea and concept and step away from just simply looking at carbon intensity measures as a way of thinking about net zero in our fixed income portfolios.

Anu: Terrific. And I'm always okay with a shameless plug on our podcast. So glad to hear that the work that's been done has really been a high impact that others have really appreciated as well. And I agree, I think I'll have to look up some Danish mortgages

'cause I'm not-not as familiar with them myself. So lots of good innovations going on in fixed income. Let's maybe balance those exciting opportunities with some of the key risks that investors should be aware of. Toby, what are some thoughts there?

Toby: Yeah, thanks, Anu. I think risk is obviously key for us, right? And um, I guess the sort of top-level statement I would make is that yields are back to what used to be normal levels. But so is risk, right? So yields are back and so is risk, and that's why I guess when I hear the word risk is, the key thing that comes to mind is really idiosyncratic risk, right? So, we've seen obviously rates go up and they're likely going to stay high for some time.

I know we've spoken about our default forecast, that it's benign, but, you know, we are seeing more dispersion basically across the market, and that's across different sectors, different names. So, in that sense, you know, it's really key to focus on idiosyncratic risk here. When I think about this year, it wasn't long ago, just in March, where we've seen worries around the financial sector in the US and in Europe, which is a kind of direct consequence of where rates are now compared to where they used to be, at least in the US.

And it's just a reminder that you know there are risks out there, and investors just need to be very focused on the issuer level balance sheets, just to make sure that, you know, nobody's getting caught off guard here with some of these situations. But I appreciate that of course a lot of this can be unknown, and it can just sort of suddenly pop up, which is also why we think there's going to be this kind of pockets of volatility popping up, even though broadly, volatility we think is going to trend lower, at least compared to last year. But we think that the key emphasis is going to be on security selection going forward, so that's on, I guess, an idiosyncratic level.

I guess from a big picture perspective, on a macro level, I would just say that of course the two kind of key things on a very high level to watch are the US and China from a growth trajectory perspective. Now, the US has probably been much more resilient than many expected this year so far. We're seeing some signs of cooling and some signs of a labor market slowdown there. And China, we've discussed before where we've seen weaker trend growth.

Anu: Perfect. And maybe we can wrap up, Jaina, any other follow-up comments on your broader outlook ahead?

Jaina: Yeah, absolutely. I'd say, from an inflation perspective, we've seen inflation above target across all the key central banks, and we expect that to be the norm, at least, until next year. From a policy rates perspective, we expect rates to remain high, given the growth outlook, as well as the likely path of inflation, at which, from a core perspective, core inflation is still remaining quite sticky.

This world of zero rates we saw for the last decade, that's very unlikely to return. And as we return to this new, old normal, with rates being reset higher, we think that volatility is likely to come down, but it's not going to disappear. And that's exactly why Toby made a great point on focusing on that idiosyncratic risk. So the impact of rates being reset higher, the impact that will have on balance sheets, and the impact of issuers to essentially make the new coupon payments at these higher rates. And finally, just focusing back on issuer credit selection, security selection has never been more important for successful investment outcomes within fixed income. So that's really key for us on the outlook for the next 12 to 24 months.

Anu: Great. Perfect. Thank you very much for those comments. Now I can't let you both go without a quick bonus question to wrap up today's episode. So Jaina, Toby, you each live in some of the most exciting cities in the world. Jaina, you're joining us from London and Toby from Singapore. Tell us about a hidden gem in each of your cities that some people may not be aware of, but something that you may personally quite love and tell your friends and family about when they come to visit.

Jaina: I'm happy to kick off on that one 'cause I had a very recent experience. So there's an experience you can do in London called *Moriarty's Game*. And for those that are Sherlock Holmes lovers, it's essentially a completely interactive game where you use your phone, and you get text messages of clues. You have to solve puzzles, and you literally do a walk, through London, picking up on different puzzles, different games, going to different pubs. And you end up at a final location. And if you crack Moriarty's puzzle, you essentially get a prize at the final pub. And that was actually really fantastic. It kills four hours in London. You walk all the way from Bond Street all the way down to London Bridge. So it's actually a really fun little activity for anyone who's exploring in London.

Anu: That is great. That is very good to know. I have made a note about that. Thank you very much.

[chuckling]

Anu: Toby, what about you? [laughs]

Toby: I've also made a note of that 'cause it does sound quite fun, I have to say. And I was just thinking if you did that in Singapore, you would be breaking out in sweat after about two minutes given the temperature and humidity here that, you know, it might exist. I don't know, I'll have to Google it. I think, for Singapore, I mean, there's obviously a lot going on. I think Singapore's famous for food, right? And I think people come here to eat. It's a kind of foodie destination. But I would say that if you do come here, one thing that I would just recommend is maybe rather than checking out the fancy restaurants and so forth, go to the hawker centers, you know, the local food is excellent. There are even ones that have Michelin stars, which might sound odd, but you can Google it, and they're excellent. And I think the queues have died down since they got the star a couple of years ago too. So, I'd highly recommend a bit of an eating tour through the kind of local food scene of which there's been obviously plenty.

Anu: Perfect. That sounds very delicious. And actually, right across from the Neuberger offices in New York, we have a new food hall called Urban Hawker, which is supposed to be designed after the Hawker Centers from Singapore, so, that sounds very nice. Thank you very much for those comments and more importantly for your thoughts on fixed-income markets, of course. Just to summarize some of the comments that you said, you know, cash may be king for now, but may not be king for forever, and so investors should really be observant to be ready to pivot particularly when it seems like rates are going to be cut. You talked about volatility trending lower, but not disappearing just yet. And in this environment, focusing on idiosyncratic risks and security selection is really paramount, so we really appreciate your time. Thank you for joining us both today for these insights. And we look forward to having you back on the show soon.

Jaina: Thanks, Anu.

Toby: Thanks very much, Anu.

Anu: And if you'd like to hear more about our views in fixed income markets, please check out our latest campaign on nb.com called *Bonds are Back*. And furthermore, if you've enjoyed what you've heard on today's episode, we encourage you to subscribe to the show via Apple podcast, Google podcast, or Spotify. Or you can go to our website, www.nb.com/disruptiveforces, for previous episodes, as well as more information about our firm and offerings.

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