IS IT TIME TO ALLOCATE TO FIXED INCOME?

September 2024

Investment views from our partners at Insight Investment

With yields near levels not seen since before the global financial crisis, we believe a dynamic shift lies ahead for fixed income investors. Investors may no longer need to risk equity-type drawdowns or sacrifice liquidity to achieve their investment objectives. In our view, it is an opportune time to consider increasing fixed income allocations.

YIELD IS BACK, AND WE BELIEVE IT'S HERE TO STAY.

The 2008 global financial crisis ushered in an era of low rates.

At its heart, the 2008 global financial crisis (GFC) was a credit crisis — a reassessment of vulnerabilities within the banking sector that caused an increase in both regulation and bank capital requirements. Global central banks reacted by easing policy aggressively, but their main transmission mechanism into the real economy, the banking sector, was broken. Years of painful deleveraging were required for banks to recapitalize themselves and reduce their systemic risk, with many businesses unable to invest, or even survive, as sources of finance were cut off.

The era of low rates may be over.

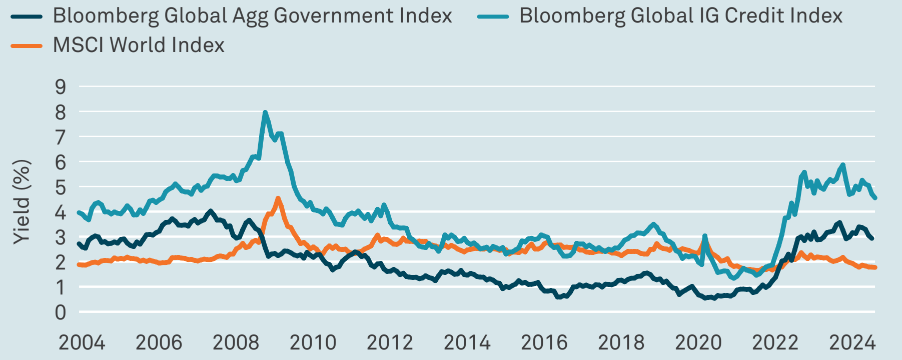
In the years that followed the crisis, the damage to both the economy and banking sector healed. Banks became so well capitalized that many started sizeable share buyback programs as a way to distribute excess capital. This was largely ignored by central bankers who, blindsided by the pandemic, attempted to re-enact the same GFC policies into a world facing a very different kind of shock. We believe this episode was a wake-up call for central bankers. In our view, this recent era of ultra-low yields has ended.

Rates hover near the pre-GFC era, and we believe they will remain there.

It's likely to take some time for market participants to get used to the idea that ultra-low interest rates are not coming back. After all, some investors today have never known a period that wasn't dominated by easy central bank policy and quantitative easing.

But optimism around rate cuts is likely to be tempered by persistent inflationary pressures. Globalization, which exerted considerable downward pressure on goods prices, is giving way to increasingly protectionist rhetoric and we believe this is one of several factors that will make it difficult for central banks to bring inflation back to target on a sustained basis. At the longer-end of the yield curve, elevated issuance of government debt and the declining proportion of debt held on central bank balance sheets should keep yields elevated. In our view, this should slowly become embedded into market psychology in the years ahead, keeping bond yields at similar levels to those seen before the GFC.

A NEW NORMAL FOR BOND YIELDS[1]



[1] Sources: Insight and Bloomberg. Data as of August 31, 2024.

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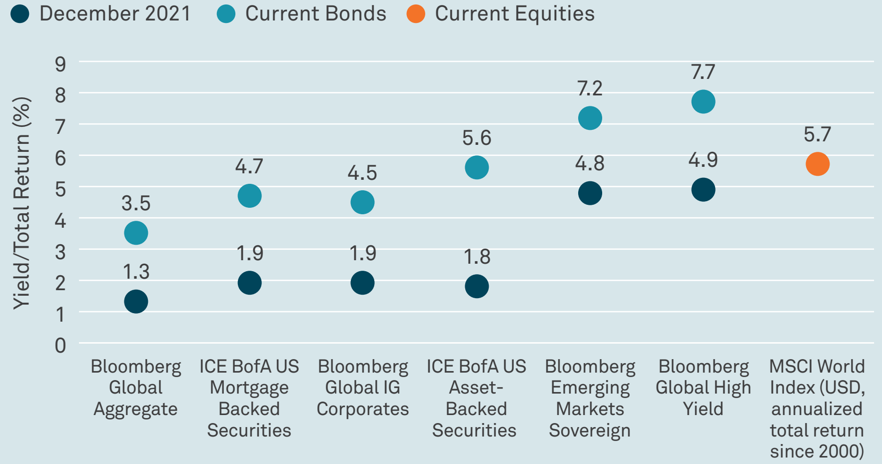
Not FDIC-Insured. Not Bank-Guaranteed. May Lose Value.

WE BELIEVE LONG-TERM RETURN OBJECTIVES MAY BE ACHIEVABLE WITH FIXED INCOME.

The recent rise in bond yields means that many segments of fixed income markets are currently offering yields competitive with the long-term returns of the MSCI World Index. We believe this presents opportunities for fixed income investors. An unconstrained fixed income mandate can allow a manager to allocate across the whole spectrum of fixed income assets, building a portfolio that is tilted towards where they perceive the greatest value at any given time. Alternatively, an investor can allocate to a specific segment of the fixed income universe to complement or replace equity investments, locking in contractual income-based returns for the long term.

BOND YIELDS NOW OFFER COMPELLING YIELDS VS. LONG TERM EQUITY RETURNS[2]



[2] Sources: Insight and Bloomberg. Data as of August 31, 2024.

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Don't let liquidity concerns restrict potential opportunity.

Some subsets of the fixed income universe offer higher returns, historically similar to those exhibited by equity markets over longer periods of time. But accessing these subsets can come with a liquidity cost if investing is approached in a traditional way. Rather than letting this act as a deterrent to investment, we believe that there are different approaches that can allow investors to harvest the potentially higher returns available without compromising on liquidity.

In high yield markets, a focus on short-maturity issues can be one approach that ensures regular maturities create natural liquidity. Combined with careful company analysis this can also minimize default risk, focusing on companies that have a clear plan for how to repay their maturing debt. For those seeking duration exposure, a systematic approach can provide a way to overcome liquidity challenges.

Natural liquidity can also be key in asset-backed markets. A carefully designed portfolio can be structured to have regular coupon and maturity payments, or to mature entirely within a given timeframe. The capital structures of these instruments means that higher-rated issues have very low default risk — the last default in a US investment grade rated asset-backed security was in 2010.[3]

Sources: Insight and Bloomberg.

[3] S&P Global Ratings, "2022 Annual Global Structured Finance Default Study and Rating Transitions," March 2023.

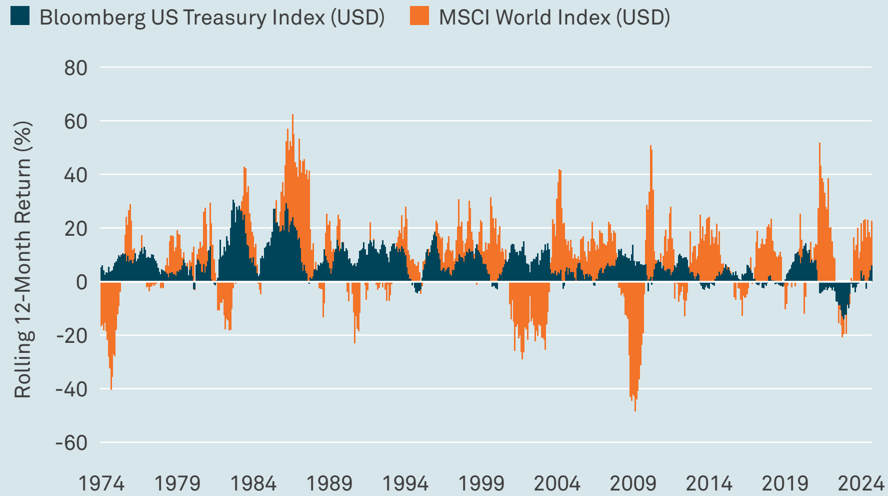
POTENTIAL FOR STEADY RELIABLE RETURNS, LOWER DRAWDOWN RISK AND DIVERSIFICATION BENEFITS.

Income-based returns can be more predictable.

Bond markets have historically had far lower volatility than equity markets, without the large drawdowns that equity markets periodically experience.

Returns in fixed income are less volatile as they are largely generated by income — the average 12-month rolling return for the Bloomberg US Treasury Index since 1973 has been 6.6%, with 6.2% of that income and just 0.4% driven by prices.[5] A very different dynamic can be seen in equity markets, where the vast majority of returns have been generated by capital appreciation. This changed for a period during the era of low yields, as income became a much smaller component of returns but, with yields seemingly returning to pre-financial crisis levels, we believe income has the potential to once again be a leading source fixed income returns in the years ahead.

12-MONTH ROLLING RETURNS[4]



[4] Sources: Insight and Bloomberg. 12-month rolling returns for MSCI World Index and Bloomberg US Treasury Index. Data between January 31, 1973 and August 31, 2024.

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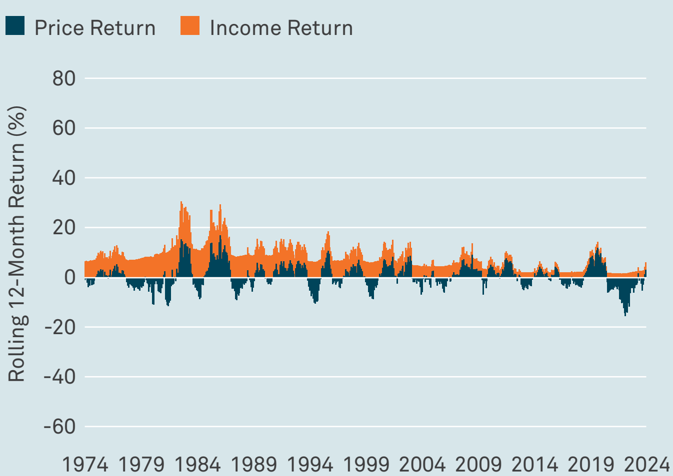
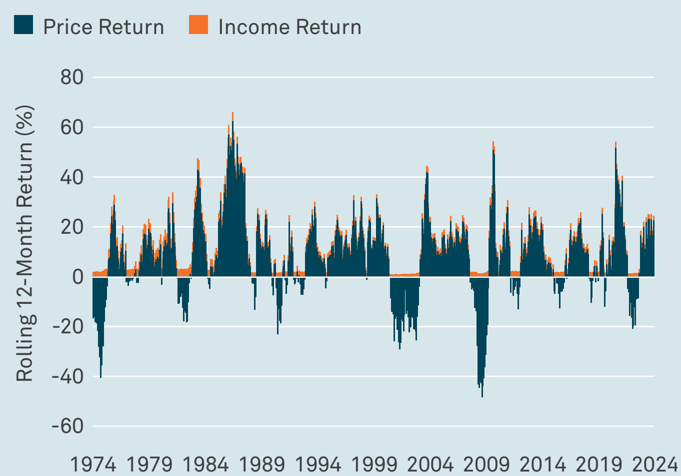
Bond market returns are driven by income.

12-MONTH ROLLING US TREASURY RETURNS[6]



12-MONTH ROLLING MSCI WORLD INDEX RETURNS[7]



[5,6] Sources: Insight and Bloomberg. 12-month rolling returns for Bloomberg US Treasury Index. Data between January 31, 1973 and August 31, 2024.

[7] Sources: Insight and Bloomberg. 12-month rolling returns for MSCI World Index. Data between January 31, 1973 and April 30, 2024.

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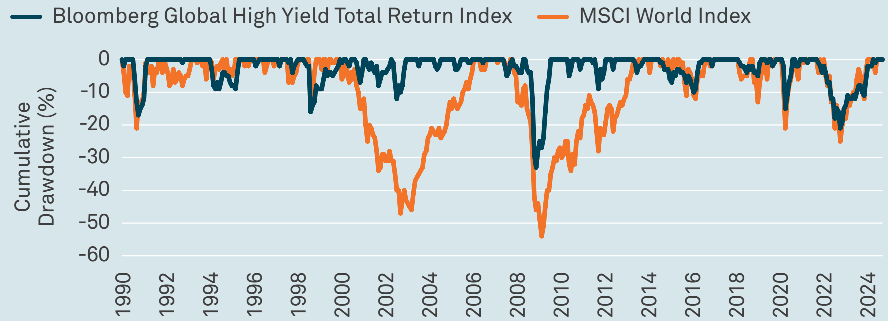
Drawdown risk has been much lower in fixed income markets.

Fixed income markets do experience periodic drawdowns, but they tend to be shallow and short for two key reasons:

- A bond is a contractual asset — it pays a regular rate of interest and, unless the issuer defaults, it repays its full principal at a future date. As bonds generally mature at 100, there is a gravitation towards that price over time, so bond prices naturally recover. This is commonly known as the "pull to par."
- The income generated in bond markets counterbalances price declines, and this creates natural downside mitigation as long as yields are high and there is a sufficiently long time horizon.

These effects can be seen in action in high yield markets. Although global high yield has had similar long-term returns to global equity markets, the asset class has generally experienced shallower drawdowns and recovered more quickly than equities.

HIGH YIELD CREDIT HAD SIMILAR LONG-TERM RETURNS, BUT GENERALLY SHALLOWER DRAWDOWNS AND FASTER RECOVERIES[8]



[8] Sources: Insight and Bloomberg. Bloomberg Global High Yield Index and MSCI World Index (total return), data between January 31, 1990 and August 31, 2024.

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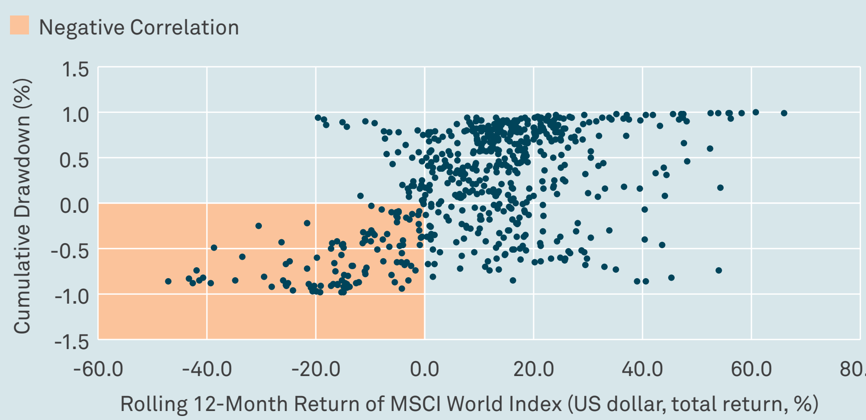
A potential risk diversifier in severe downturns.

Another attribute of government bonds and some highly rated credit markets is their potential to perform well during economic downturns. As central banks ease policy to boost growth it generally pulls longer maturity yields downwards — and lower yields can mean capital appreciation in bond markets. The negative bond/equity correlation during the worst equity drawdowns can be clearly seen below. This means that high quality fixed income investments can be a complementary addition and portfolio diversifier to holdings.

THE CORRELATION BETWEEN BOND AND EQUITY RETURNS HAS BEEN NEGATIVE WHEN EQUITIES FALL SHARPLY[9]



[9] Sources: Insight and Bloomberg. Correlation between MSCI World Index (total return, USD) and Bloomberg US Treasury Index. Data between January 31, 1973 and August 31, 2024.

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CORPORATES ARE WELL POSITIONED FOR THIS STAGE OF THE CYCLE.

We believe many corporate balance sheets are in good shape. The level of debt relative to enterprise value is at healthy levels for high yield issuers, and a similar story can be seen across a range of credit metrics.

The debt profiles of many corporate issuers are also in a strong position. During the pandemic, issuers used the low level of interest rates to lock in advantageous funding levels for an extended period, pushing out corporate maturity profiles. Additionally, the maturity profiles of lower-rated US issuers are spread widely over time, peaking at just over $250bn in 2029. This should allow corporates ample time to adjust their business models and plan for higher future funding costs.

DEBT TO ENTERPRISE VALUE APPEARS AT HEALTHY LEVELS FOR HIGH YIELD ISSUERS[10]

[10] Source: Bank of America Global Research. Data as of August 30, 2024.

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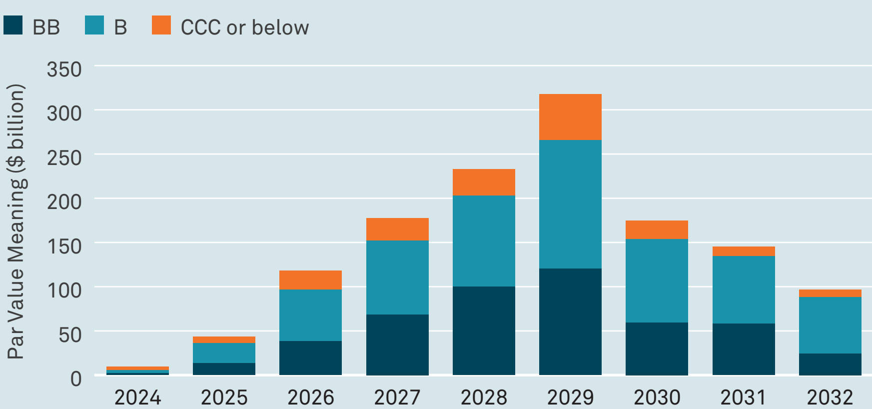
LOWER RATED CORPORATE MATURITIES ARE WELL SPREAD OUT OVER TIME, AND PROACTIVELY MANAGED[11]



[11] Sources: Insight and Bloomberg. Data as of March 31, 2024.

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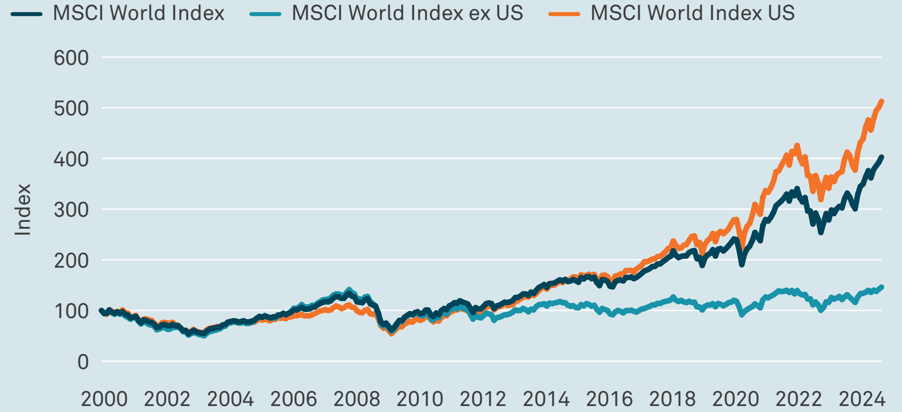
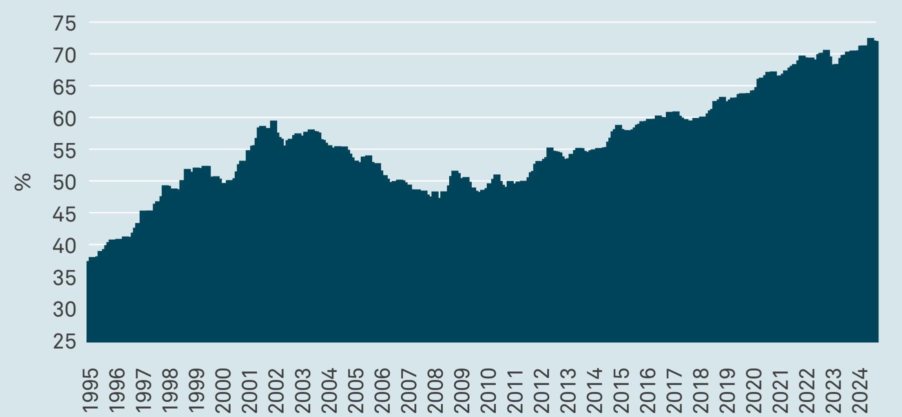
A LOPSIDED EQUITY WORLD MAKES A FIXED INCOME ALLOCATION EVEN MORE COMPELLING.

At the same time that fixed income markets have been offering returns comparable with equities, equity markets are becoming increasingly lopsided, and dominated by a small number of US companies. The outperformance of megacap tech stocks, led by the Magnificent 7 (Alphabet, Apple, Amazon, Meta, Microsoft, Nvidia and Tesla) has resulted in a huge divergence between the MSCI World US Index and the MSCI World ex US Index, and US equities have grown to over 70% of the MSCI World Index. Although the ascent of the Magnificent 7 has reflected a period of exceptional earnings growth, their dominance means many equity investors could now be more concentrated than they may realize. We believe this makes the case for bonds as a portfolio diversifier even more important.

EQUITY RETURNS ARE DOMINATED BY US COMPANIES[12]



US IS NOW OVER 70% OF THE MSCI WORLD INDEX[13]



[12,13] Sources: Insight and Bloomberg. MSCI World Index. Data as of August 31, 2024.

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CONCLUSION

In our view, it may be time for investors to consider increasing their allocations to fixed income.

Even as the Federal Reserve begins lowering the policy rate, the multi-year rise in yields has created a potential opportunity to find more attractive income streams for the long term. Fixed income assets have historically been significantly less volatile than equities, experiencing shallower drawdowns with faster recoveries. This can help investors achieve their long-term objectives with greater certainty via potentially more reliable, income-driven returns.

With value appearing across fixed income markets, well-diversified US and global bond portfolios may provide investors access to these opportunities while also providing important portfolio diversification and mitigation of downside risk especially as the more typical stock/bond negative correlation relationship returns.

All investments involve risk, including the possible loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing.

Bonds are subject generally to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. Investment grade is a rating of fixed-income bonds, bills, and notes by credit rating agencies. **High yield bonds** are subject to increased credit risk and are considered speculative in terms of the issuer's perceived ability to continue making interest payments on a timely basis and to repay principal upon maturity.

Asset class comparisons such as comparing equities to bonds have limitations because different asset classes may have characteristics that materially differ from each other. Because of these differences, comparisons should not be relied upon solely as a measure when evaluating an investment for any particular portfolio. Comparisons are provided for illustrative purposes only. Although stocks have greater potential for growth than bonds, they also have much higher levels of risk. With stocks, the prices can rise and fall for a variety of reasons, including factors outside of the company's control. Bonds may be considered relatively safer. Because they're a debt security, they function as an IOU. The company pays interest to the bondholder, and once the bond matures, the bondholder receives the principal bank. Bonds aren't completely risk-free; there is the possibility of the issuer defaulting on its bonds, and if sold prior to maturity the market value may be higher or lower than the purchase value. But compared to stocks, historically there's been less volatility.

Correlation is a statistic that measures the degree to which two securities move in relation to each other. A **yield curve** is a line that plots the yields or interest rates of bonds that have equal credit quality but different maturity dates. The slope of the yield curve predicts the direction of interest rates and the economic expansion or contraction that could result. **Duration** measures how long it takes, in years, for an investor to be repaid a bond's price through its total cash flows. Duration can also be used to measure how sensitive the price of a bond or fixed-income portfolio is to changes in interest rates. A **drawdown** is a peak-to-trough decline during a specific period for an investment, fund, or trading account. **Drawdown risk** is the measure of how long it takes for a mutual fund or other investment to recoup its losses after it falls from a previous high.

Bond ratings reflect the rating entity's evaluation of the issuer's ability to pay interest and repay principal on the bond on a timely basis. Bonds rated BBB/Baa or higher are considered investment grade, while bonds rated BB/Ba or lower are considered speculative as to the timely payment of interest and principal. Credit ratings reflect only those assigned by Nationally Recognized Statistical Rating Organizations (NRSRO) that have rated fund holdings. Split-rated bonds, if any, are reported in the higher rating category.

The **Bloomberg Global Aggregate Index** measures market performance of global investment grade debt issued in various markets. The **Bloomberg Global IG Corporate Index** measures market performance of global investment grade corporate debt issued in various markets. The **Bloomberg Emerging Markets Sovereign Index** measures market performance of emerging market sovereign debt. The **Bloomberg Global High Yield Index** measures market performance of global high yield debt issued in various markets. The **Bloomberg US Treasury Index** measures market performance of US Treasury bonds. The **ICE BofA US Mortgage Backed Securities Index** measures market performance of US mortgage backed securities. The **ICE BofA US Asset Backed Securities Index** measures market performance of US asset backed securities. The **MSCI World Index** measures market performance for global equity markets. Indexes are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the index (collectively, "Bloomberg") and have been licensed for use for certain purposes by BNY.

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